The concept of substance over form in accounting

Substance over form is an accounting principle that requires companies to account for transactions based on their economic substance rather than their legal form or contractual arrangement.

It means that the financial statements should reflect the underlying economic reality of a transaction, rather than simply its legal structure or form. In other words, substance over form means that a transaction should be accounted for based on what it represents, rather than how it appears in the paper.

Therefore, Let's validate the concept by analyzing the practical examples from the IFRS perspectives as hereunder:

A sales and leaseback transaction: In a sale and leaseback transaction, a company sells an asset to another party and immediately leases it back from the buyer. The transaction is structured this way for various reasons such as raising cash or obtaining financing.

IFRS requires that transactions like sale and leaseback arrangements be evaluated based on their substance over form. In this case, the company would need to assess whether it has retained control over the asset and whether the risks and rewards of ownership have been transferred to the buyer. If the substance of the transaction indicates that the company maintains significant risks and rewards associated with the asset, it may be appropriate to account for the transaction as a financing arrangement rather than a sale.

From a legal perspective, the transaction is a sale and a lease. However, from an economic standpoint, it is a financing arrangement, where the company is effectively borrowing the money and using the asset as collateral. Therefore, the transaction should be accounted for as a financing arrangement rather than a sale and a lease.

This means the company should recognize the sales proceeds as a liability and recognize the interest expense on the lease payment. Additionally, the company would continue to depreciate the asset over its useful life, reflecting its continued economic use of the asset. If the company were to account for the transaction based solely on its legal form, it would recognize a gain on the sale of the asset & record lease payments as rental expenses, which would not reflect the economic reality of the transaction.

Operating leases: IFRS 16 requires lessees to recognize right-of-use assets and lease liabilities for all leases, including operating leases on their balance sheets & recognize depreciation expense for the ROU asset and interest expense on the lease liability in the income statement. In the past, operating leases were typically not recorded on the lease's balance sheet instead, lease payments were recognized as operating expenses on a straight-line basis over the lease term in the lease's income statement. The treatment of operating leases in the previous standard (IAS 17) allowed lessees to keep the leased assets and associated liabilities off their balance sheets. Therefore, IFRS 16 represents a shift toward greater transparency & adherence to the substance over form principle.

Recognition of Expected Credit Losses: IFRS 9 requires entities to recognize expected credit losses on financial assets based on the substance of credit risk inherent in those assets, rather than waiting for objective evidence of impairment. Under IFRS 9, entities are required to consider all reasonable and supportable information, including historical, current, and forward-looking information, to assess expected credit losses. This approach ensures that the substance of credit risk is appropriately reflected in the financial statements, even if the formal default event has not yet occurred.

Therefore, applying the principle of substance over form is important in ensuring that financial statements provide a true and fair view of a company's financial position and performance and that transactions are accounted for in a way that reflects their economic reality to enhance reliability, relevance and transparency.

Prepared by:

CPA. HAJI KASSIM
Manager – BPO Services

PKF TANZANIA

Girl Guides Building, 1st Floor Tower B
Kibasila Street, Upanga
P.O. Box 7323 - 11102,
Dar-es-Salaam, Tanzania
Tel: +255 784 520 097 /
+255 222 152 501/3/4
Email: pkftz@pkfea.co.tz

Disclaimer

PKF Advisory Limited is a member of PKF Global, the network of member firms of PKF International Limited, each of which is a separate and independent legal entity and does not accept any responsibility or liability for the actions or inactions of any individual member or correspondent firms.