

PROBLEM ASPECTS OF APPLYING THE SUBSTANCE OVER FORM PRINCIPLE

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Abstract:

*The application of the fundamentals of accounting must be done in such a way as to lead to a true and fair view of the financial standing (**position**) and of the results obtained (**performance**). The users of the financial statements must be able to interpret them, so they must be based on financial accounting data founded on generally accepted accounting principles.*

One of the most controversial accounting principles is the priority of content over form, which is characteristic of the Anglo-Saxon accounting system and assumes that, when there are differences between the economic nature of a transaction and its legal form, the entity must record transactions in accounting in view of the economic content of the transactions. In this context, this article examines the problematic aspects of the application in practice of the principle of content priority over form.

Key words: principles of accounting, economic content, legal form, assets, debts, patrimony, property.

JEL Classification: M40, M41

1. INTRODUCTION

The accounting of any entity operates on the basis of certain principles and rules (policies), that have their origin in the "valuation convention", according to which the monetary expression is the "iron rule" of accounting. Consequently, the evaluation of the items included in the financial statements and which come from the current accounting accounts, as well as the sizing of the elements, each of them being monitored daily and summarized periodically, must be carried out in accordance with the established accounting principles, which are in fact "economic commandments", probably that is why, they are also ten (see <https://sites.google.com/site/contabilitate1913/principii-contabile>).

The basic principles of accounting are already firmly rooted in the accounting theory and practice. They are the basis for bookkeeping and determine the content of the accounting information on the financial standing of the entity and the possibility for users to perform their analysis in order to substantiate their economic decisions.

The research aims at working out the theoretical approach to the accounting issues faced by professionals in challenging current conditions.

The topicality of the research relies on the fact, that the economic content of the transactions, which take place within the entity are strongly influenced by the legal framework in which they operate, thus determining experts more and more to conclude that the economic content of the carried out transactions are interdependent on its legal form.

The research methodology consisted of consulting various bibliographic sources, consisting mainly of scientific papers published in national and international journals as well as the sources available on web sites. The authors resorted to the study of literature and presented the synthesis of its results. The basis of a clearer and representative theoretical foundation were analysis, synthesis, induction, deduction and tables.

2. LITERATURE REVIEW

The most relevant publications in the field were analyzed to identify the study carried out on the topic. Thus, the positions of the specialists in the field regarding the applicability of the content over form principle start from the acceptance of this principle as an extremely important one in accounting and end with the complete denial of the treatment of the prevalence of economic content over the legal one considering it as a completely erroneously defined one.

According to Professor Yvonne Muller-Lagarde, the Substance over Form principle is presented in various conceptual frameworks of IAS/IASB as the necessary way to provide for a faithful representation of transactions and phenomenon to be recognized. 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. Sometimes 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 recognized according to their sole legal form, that is to say, according to the national legal categories in which these transactions and phenomenon are classified (Muller-Lagarde, 2015).

Rigorous application and consistent compliance with accounting principles confer accounting information and financial reporting relevance, reliability, credibility and above all comparability over time, in space and between different fields of activity: comparison of the performance of the same entity from one period to another; comparison of entities different in size as well as from different areas, countries, domains and/or periods, and between them. Although each principle regulates a certain aspect, all the principles of accounting form a coherent and unitary system, meaning that there are interferences and reciprocal links of interdependence between all the principles, and no principle can be violated without the risk of affecting application of the others. The definition, application and acceptance of these principles and rules confer objectivity to the chosen accounting system and allows to obtain a certain image utmost fair, faithful, clear and complete on the patrimony and the results of the entity's activity (Lazari, Yavorschi, 2015).

In accordance with IFRS practice, it is assumed that, the principle of priority of the economic contents over juridical form presumes that this operation is essential for obtaining the proper economic benefits, which prevail the legal title to ownership. This position is supported by both accounting standards and by most specialists in the field, but it is also presented and perceived distorted to a certain extent in practice, as concerns the principle given. Thus, in accounting practice it is common to say that, if there is any differentiation in the legal or economic understanding of the economic fact, it will be chosen the interpretation of the economic fact to the detriment of the legal one. That is, the choice is left on account of the accounting officer's professional judgment.

In this context, the author Negara G. considers that the economic content of the economic fact is not abstract, regardless of its treatment by the legislation in force. When the economic operation is reflected in accounting, the abstract economic content takes a concrete legal form so, that it is no longer important if the accountant has been guided by the normative acts or by his/her professional reasoning. Both the one and the other are already not economic but legal categories. Consequently, there is no question of the priority/prevalence of content over form. The question of the interaction of some legal rules with others is obvious. In this context, it is considered fair to speak not about the prevalence (priority) of content over form, but about the conformity of the legal form to the economic content. The term “conformity” must be recognized as more relevant than priority/prevalence in relation to both the notions of “content” and “form” and to “the economic” and “the legal” one (Negara G, 2016).

3. REFLECTIONS ON THE PRACTICAL APPLICATION OF THE PRINCIPLE PRIORITY OF CONTENT OVER FORM

The methodological rules in the field of accounting in the Republic of Moldova have come very close to the international accounting standards. Currently, they are regulated by the National Accounting Standards, although they also contain differences compared to the provisions of the International Financial Reporting Standards, such as the rules for valuing assets and liabilities, etc. However, the accounting principles, which we could call accounting assumptions and requirements, have been set out in the accounting regulations. This happened in 2019 with the entry into force of the Law on Accounting and Financial Reporting no. 287/2017, in which the basic principles of accounting were established (table no. 1).

Table no. 1. The Main Accounting Principles underlying Accounting and their Description

Nr. ord	Accounting principles	Description
1	<i>Continuity of activity</i>	assumes that the entity will continue to operate normally for a period of at least 12 months from the reporting date, with no intention or need to liquidate or significantly reduce its business
2	<i>Accrual accounting</i>	provides for the recognition of accounting items as they arise, regardless of when cash is received/paid or otherwise cleared.
3	<i>Consistency of methods</i>	consists in applying the accounting policies consistently from one management period to the next
4	<i>Prudence</i>	provides for the non-admission of overvaluation of assets and income and/or underestimation of debts and expenses
5	<i>Intangibility</i>	assumes that the balance sheet total at the beginning of the current reporting period must correspond to the balance sheet total at the end of the previous reporting period
6	<i>Separation of assets and liabilities</i>	provides for the presentation in the financial statements only of information about the entity's assets and liabilities, which must be accounted for separately from the assets and liabilities of owners and other entities
7	<i>Non-compensation</i>	provides for the separate accounting and presentation in the financial statements of assets and liabilities, income and expenses. Mutual offsetting of assets and liabilities or income and expenses is not permitted, with the exception of those, provided in the current law and in the accounting standards
8	<i>Priority of content over form</i>	assumes that the information presented in the financial statements should reflect the essence and content of the economic facts rather than their legal form;
9	<i>Input cost measurement</i>	provides that the accounting items presented in the financial statements are measured at acquisition or production cost, except those required by the accounting standards
10	<i>Relative importance</i>	provides that there is no need to meet the requirements for the recognition and measurement of accounting items, for the presentation, publication and consolidation of information relating thereto, when the effects of the fulfillment of those requirements are insignificant.

Source: developed by the authors based on the Law of Accounting on Financial Reporting, 2018

The mentioned-above accounting principles underly the accounting methodology in the Republic of Moldova, because a series of specific rules of accounting for economic facts are formulated on their basis. Thus, they determine the content of the accounting information, that is presented in the financial statements of the entity, as well as the ability of users to analyze them. At the same time, if the principle set out in the regulations is more declarative, it will inevitably affect the content of the financial statements of the entities.

Of all the principles set out in the Law on Accounting and Financial Reporting, the principle that is most difficult to apply and respect in accounting practice is the principle of prioritizing content over form. This principle, which is in fact one of the basic principles of International Financial Reporting Standards, is the most difficult to apply in practice.

Thus, in the context of the Law on Accounting and Financial Reporting, the principle of priority of content over form must ensure that the information presented in the financial statements reflect the essence and content of the economic facts rather than their legal form. In this context, it should be noted that each operation that takes place in the activity of an entity is usually reflected in the accounting based on both the economic content and its legal form. At the same time, from the point of view of legal norms, the rights and obligations of the persons participating in the economic processes are important, while from the point of view of the economic content the impact of these economic processes/operations on the financial results of the entity is essential.

Compliance with these rules is more difficult, when the economic and legal characteristics of the transaction are contradictory. In such situations, it is necessary to establish according to the accounting methodological norms what prevails: the economic content or the legal norms? This is important in order to be aware of the need to reflect the accounting operation according to its specificity, as it can not only influence the indicators from the financial statements, but it also has a significant fiscal impact.

It should be mentioned, that the aspects of applying the principle of content over form priority at national and international levels are regulated differently in the way shown below (see figure no. 1):

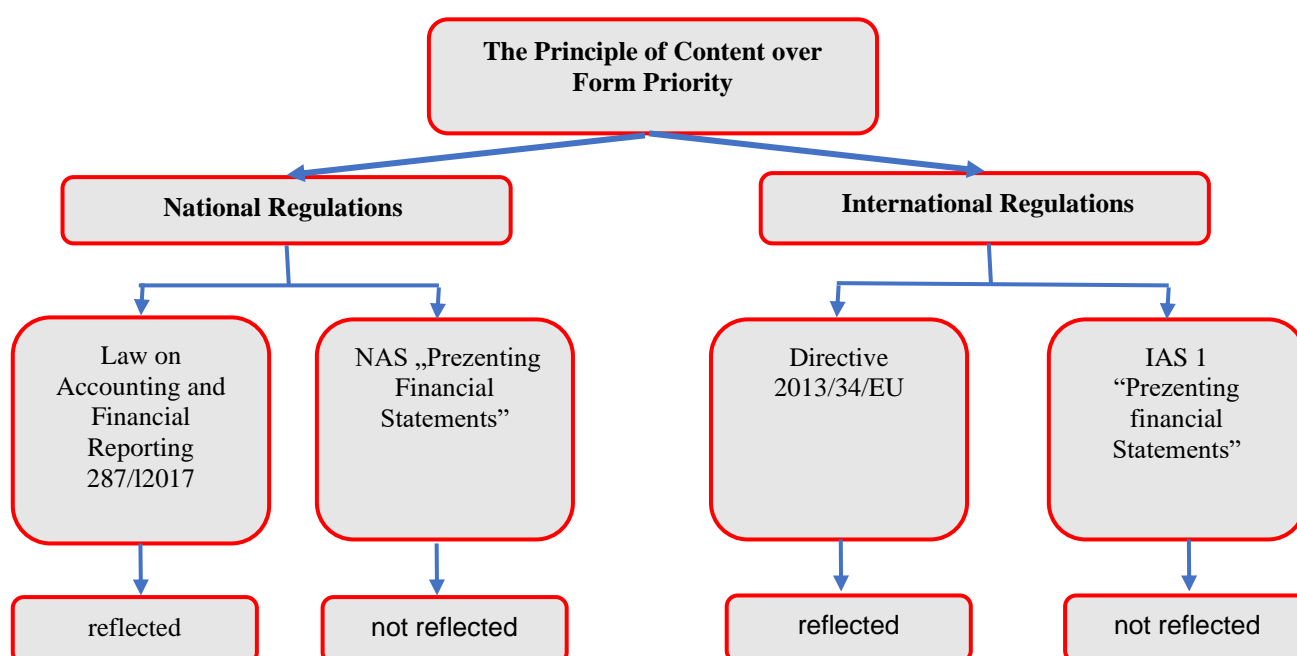


Figure no. 1. Stipulating the Principle of Content over Form Priority in national and international accounting regulations in force

Source: elaborated by the authors

From the economic point of view, **the characteristics of an asset** are represented by several requirements. Thus, the object is recognized as an asset only if the following conditions are met simultaneously:

- 1) the object is identifiable and controllable by the entity;
- 2) its properties and particularities correspond to the definition of intangible or tangible assets;
- 3) it is likely that the entity will derive future economic benefits from the use of the object; and
- 4) the entrance cost of the object can be measured reliably [National Accounting Standards, 2013].

For example, in the case of financial leasing, the object of fixed assets is recognized as an asset, because it is controllable and contributes to the economic benefits of the entity as well as its

own assets. From this aspect namely, according to the economic content, the object received in financial leasing is reflected in the balance sheet of the entity - lessee.

At the same time, according to the legal regulations, on the contrary, the decisive characteristic of an asset is the observance of the legal rights over it. In this context, only the object owned represents an asset, regardless of its ability to bring economic benefits. From this point of view, the property received under financial leasing should obviously be reflected in the balance sheet of the entity.

It is clear that the two methodological aspects mentioned (economic content and legal form) contradict each other. And regardless of the needs of users of the financial statements in disclosing both the economic content and the legal form of the economic facts, the choice in favor of the economic content or legal form is inevitable, as the property cannot be reflected simultaneously in both balance sheet and off-balance sheet.

In practice, there are situations when operations that are economically identical may have different legal characteristics. For example, the operations of purchasing goods for a customer against a certain remuneration (commission) can be legally performed differently: by sale contract or commission contract. The economic content of the transactions will not change regardless of the type of contract, while the scope of the rights and obligations of the participants in the transaction will be completely different. Thus, in the first case, the entity that purchases the goods for the customer becomes their owner and then resells them for a fee, while in the second case, from the time the goods are purchased until the sale they remain the property of the supplier and are not reflected in the balance sheet, the income of the entity being only the commission. Therefore, if the accounting methodology is based on the legal characteristics of the transactions in question, then in the case of the sale contract, the goods will be reflected in the balance sheet of the intermediary entity, while in the case of the commission contract - their records will be kept only in the off-balance sheet.

Thus, the accounting methodology depends on whether we apply the legal form or the economic content when interpreting the facts of economic activity. At the same time, the essence of the principle of priority of content over form implies that the determining factor for the accounting methodology is not the legal content but the economic one for the economic operations that take place within the entity. Reiterating the above examples, we conclude that, according to this principle the fixed asset received in financial leasing should be reflected in the balance sheet of the entity, and transactions with the goods received in this case should be accounted for in the same way, regardless of the type of contract.

As mentioned above, in the Republic of Moldova financial accounting is based on the regulations in force, namely the legislative framework in the field. Thus, according to art. 8 of the Law on Accounting and Financial Reporting no. 287/2017, the main regulatory body in the field of accounting and financial reporting is the Ministry of Finance, among the competencies of which can be mentioned:

- a) acceptance of IFRS, their publication in the Official Gazette of the Republic of Moldova and their placement on the official website of the Ministry of Finance;
- b) elaboration, approval, publication in the Official Gazette of the Republic of Moldova and placement on the official website of the Ministry of Finance of:
 - National Accounting Standards;
 - methodological indications, regulations, instructions and other normative acts in the field of accounting and financial reporting;
 - General chart of accounts;
 - primary document forms and instructions for their completion;
- c) representation of the Republic of Moldova in international organizations in the field of accounting and financial reporting;
- d) creation working groups for the elaboration and updating of the normative acts provided in let. b);
- e) provision of methodological assistance in the field of accounting and financial reporting;

f) possible delegation to elaborate draft normative acts in the field of accounting and financial reporting to a body/institution/association in the respective field " [The Law on Accounting and Financial Reporting, 2018].

We have not incidentally quoted these excerpts from the Law on Accounting and Financial Reporting no. 287/2017. It results from the mentioned norms that the normative acts, that regulate the accounting in the Republic of Moldova, are an integral part of the general legal system. Therefore, we conclude that the accounting methodology in the Republic of Moldova is determined, first of all, by the legal content of the economic facts.

At the same time, the formulation of the specific norms of the enunciated law and of other normative acts of regulation of the Ministry of Finance determines the relationship between the accounting methodology and the norms of the legislation related to accounting and, especially, the norms of civil and fiscal legislation. Thus, we conclude that it is more specific the priority of the legal form of economic facts over their economic content for accounting in the Republic of Moldova.

The object of the accounting is *the patrimony of the entity* and the totality of its obligations. In this context, it is necessary to examine the interpretation of this rule of law from the point of view of the general rules for the interpretation of the legal rules in force. Thus, the Law on Accounting and Financial Reporting no. 287/2017 uses such terms as "assets" and "liabilities". At the same time, these notions are not defined in the mentioned law or in another normative act from the domain of accounting, being only interpreted in the context of different patrimonial elements. For example, in the case of stocks, the criteria for recognizing them are applied according to the National Accounting Standard "Stocks", correspondingly the criteria for recognizing a debt are provided in the National Accounting Standard "Equity and debts" etc.

At the same time, if the normative acts in a certain legislative field use certain terms without establishing their definitions, we must be guided by the definitions of the related areas of law in which they exist. Based on this fact, when we quote art. 453 of the Civil Code, the notion of patrimony is defined as "the totality of patrimonial rights and obligations (which can be valued in money), regarded as a sum of assets and liabilities linked to each other, belonging to certain natural and legal persons". All the assets of the natural or legal person are part of their patrimony [The Civil Code, 2002].

Thus, the Civil Law norms determine to a certain extent the object of accounting. This is explained by the fact that the rules of the civil law underlie the content of economic facts by establishing the composition and size of the entity's assets and liabilities, determining as a result the accounting methodology.

The norms on property of the Civil Code of the Republic of Moldova determine the rule for the formation of a balance sheet asset based on the property right. Thus, the owner has the right to own, use and dispose of the property, namely:

the property right is perpetual;

the right of ownership may be limited by law or by the rights of a third party;

- the right of use also includes the person's freedom not to use the good.

The asset represents the patrimonial element that belongs to the entity with property right. This rule has a significant impact on the content of the accounting information and on the ability of users to make different decisions based on the data presented in the financial statements. At the same time, it fully fulfills the solvency objectives of the entity, but may lead to overestimating the indicators of the profitability and financial leverage of the entity operating with properties that do not belong to it under legal ownership.

In the context of the above, we conclude that the predominantly legal orientation of accounting, of course, has a significant impact on the content of accounting information. The users of financial statements must know not only the legal content of the economic events that have taken place, but also their economic significance for the activity of the entity.

At the same time, we note that the shortcomings mentioned are inherent in financial accounting, which is a "system for collecting, recording, processing and generalizing the

information on the existence and movement of assets, equity, debts, income and expenses for the preparation of financial statements" [The Law on Accounting and Financial Reporting, 2018]. It is aimed at complying with the regulatory framework in the field and presenting the correct and accurate data on the economic operations, that took place during the reporting period.

When we refer to *the system of management accounting* of an entity, which involves the collection, recording, processing and transmission of information for planning, controlling and analyzing the activity of the entity, *in order to prepare the internal reports for managerial decision-making*, in this case the entity is no longer limited by the requirements of the regulatory framework in the field, by double registration, etc., which allows to build the accounting methodology, emphasizing mainly the economic content of the operations inherent in the activity of the entity. Thus, for example, in management accounting the financial result can be determined based on the entity's debts relying on the time value of money, reports can be prepared on the real value of the assets, that contribute to the benefits of the entity, etc.

The essence of the principle of prioritizing content over form must also be taken into account when assessing the tax consequences of a transaction. Here their real economic meaning should be assessed. If the transaction is legally formalized in a certain way, but the economic essence of the legal act is completely different, then the results of the transaction should also be recognized for tax purposes based on the economic content. In this context, we mention that according to par. 7 of art. 44 of the Fiscal Code of the Republic of Moldova, for fiscal purposes there may be used methods of financial records based on the provisions of the National Accounting Standards and IFRS, that do not contradict its provisions.

4. CONCLUSIONS

In the context of the above-mentioned rules, it appears that economic theory presumes that the principle of content over form priority focuses on the fair representation of the company image, on offering priority to content over its legal form (although the delimitation is not always clear), also focusing on clear definitions of its accounting concepts (assets, economic operation, fair representation etc.), widely used in the economic activities of entities.

At the same time, we must note, that the freedom of professional judgment and the establishment of the accounting methodology by respecting the principle of priority of content over form currently allows to obtain a clearer view of the entity's patrimonial situation in management accounting rather than in the financial one, which is primarily focused on the compliance with the regulatory framework in force.

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