

The “substance over the form”. Evidence on the Italian Leasing Accounting after the EU Regulation 2017/1986

Roberta Provasi

Department of Business Administration Finance University of University of

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Abstract

This research aims to retrace the historical process of the evolution of the accounting principle of the prevalence of the substance over the form with specific reference to the Italian system and in comparison with the different international approaches. The topic is very current in Italy following the recent regulatory changes, especially the transposition of the EU Regulation 2017/1986 stating the obligation to account for the leasing contracts according to the provisions contained in the new IFRS 16. To implement the new accounting standard the OIC, Italian Accounting Body, has modified the Italian principle OIC 1, Financial Statement Purposes and Postulates providing for a new formulation of the principle of the prevalence of the substance over the form. This caused a new method to account for the lease and effects on the calculation of financial statement indicators and the related assessment of the financial-equity balance.

Keywords: Substance over form, accounting leasing, Italian accounting System.

I. THE PRINCIPLE OF THE PREVALENCE OF SUBSTANCE OVER FORM IN THE HISTORY OF ACCOUNTING.

Over the years the relationship between legal-formal accounting data and economic-substantial accounting data has been alternating: periods in which the juridical aspect prevailed followed other moments in which the supremacy of substance over form took place[1], [2], [3]. .

When referring to the conflict between "form" and "substance", the most emblematic accounting aspect concerns the representation of financial leasing. The modern accounting which, as is known, developed in Italy in the 13th century dealt with commerce, usually regulated by local customs and practices. The legal culture of the time was totally foreign to the accounting aspect. The juridical questions at that time were those proper to Roman law and Canon and Philosophy law

Only in the fifteenth century, with the arrival of mercantilism, the accounting practice began to take on legal significance. In fact, with the spread of

commerce, there is an increasing need to protect creditors, particularly in the event of bankruptcy. The first accounting rules accepted in the "Ordonnance de Commerce" published in 1673 in France by Louis XIV and reproduced almost entirely in 1807 on the "Code de Commerce" approved by Napoleon and in Italy, first transposed in the "Code of Commerce" of 1882 and then in the unified 1942 code.

Among the main provisions that "legalize accounting":

- keeping the journal in order of date without blank spaces and without marginal overlays;
- the books of the shopkeepers' books must be authenticated and numbered by the public authority;
- the preparation of the inventory at least every two years;
- the prescription of prudential valuation rules.

Especially in Italy in the nineteenth century the theory known as the “logismography” of Giuseppe

Cerboni [4] develops whose assumptions make the accounting office take on a more juridical role than an accountancy. For some, logismography, which through dogmatic constructions based on a postative right attributes rigorous meanings to the term "giving" and "having" to explain the functioning of the accounts, constitutes the birth of scientific accounting in Italy.

Over the years, logismography was notably criticized in particular by Besta [5] and his disciples so it was later abandoned despite the great success achieved by determining its adoption for keeping the State's accounts.

Besta affirmed his materialistic thesis of the accounts according to which all the accounts are registered to the objects relative to the company since the accounting records refer to the values of the elements that constitute the patrimony. Also some students of Besta belonging to the so-called "income school" including Zappa, De Dominicis, Amodeo, Masini have criticized the formal aspects attributed to accounting by Cerboni, reiterating the principle of the prevalence of economic substance with respect to form in particular with reference to the definition of the concept of capital. Since the 1960s, there has been a reversal of the trend that has led to the reaffirmation of the supremacy of the legal data over the economic one. The main causes of this change include the attention to the financial statement for publication by the jurisprudence, the conventional rules gradually created through the drawing up of accounting principles and the 1973 tax reform which is based on detailed and binding regulation for businesses.

The principle of the prevalence of the substance over the form according to the modern meaning arises in the United States where, as is known, the legal component constitutes a rather negligible part of the accounting system. The first references to the problem of the contrast between the formal-legal and the substantial economic aspects of a phenomenon can be seen in the Accounting Research Bulletin n. 38 of 1949 in which, although not explicitly, with reference to the financial lease, the economic and substantial nature of the transaction is privileged for the purpose of recording the asset to which the contract relates. To

follow in 1970 in Statement n. 4 of the Accounting Principles Board the principle of the prevalence of the substance over the form acquires a relevant aspect stating that "the treatment of business operations may change depending on whether the substance or form is considered prevalent ... and if it forms and substance differ, emphasis must be given to the substance of the facts for a better representation of the economic activities represented in the financial statements ". In 1973 in the Trueblood Commette Report the prevalence of the substance over the form is established as a fundamental principle for the preparation of the financial statements in particular with reference to the definition of "activity". In 1974, IAS no. 1, Disclosure of Accounting Policies provides three guiding criteria to be followed in the selection and application of accounting principles, namely: the prevalence of substance over form, prudence and relevance.

In Great Britain, on the other hand, the "Common-law" system has also influenced the accounting rules: the accounting principles and rules have no legal formalities but are prepared by accounting practice. In 1984 with the publication of the SSAP n. 21, Accounting for leases and Hire Purchase Contracts, in which, if the "financial method" is admitted, the lease is considered as an installment purchase with retention of title. Admitting this means recognizing the prevalence of the economic aspect over the financial one. Following the debate on the admission or not of the principle of the prevalence of substance over form, it became increasingly heated, sometimes involving distorted applications aimed at pursuing particular budget policies. In 1985 the Institute of Chartered Accountants in England and Wales published the Technical Release 603 entitled "Off Balance Sheet Finance and Window Dressing" in which the principle of the prevalence of substance over form is recommended in order to contain "creative accounting" phenomena. In particular, the document states that a budget to be "true and fair" must reflect the substance and not the form of business operations. Despite the strong criticism detected by the Law-Society against the substance over form, not to be applied as contrary to the law, in 1988 the ASC publishes the ED n. 42

Accounting for special Purpose Transactions in which the prevalence of substance over form is stressed, specifying that highlighting the substance of an operation means adequately representing commercial effects. In the following years the debate became more and more accessible until in 1994 a reference standard was issued, the FRS n. 5 Reporting the Substance of Transaction. The standard states that the "substance" of business operations is identified in the commercial effects of the transactions that the "true and fair view requires the substance over form".

II. THE SUBSTANCE OVER FORM IN THE ITALIAN ACCOUNTING EXPERIENCE

The principle of the prevalence of substance over form in Italy has come to the attention of the doctrine only since 1992 following the introduction of the new legislation for the credit and financial institutions balance sheet. The reference is to art. 7, fourth paragraph of the legislative decree n. 87/92 which states that " Bank of Italy provisions may provide for measures may establish, that the preparation of financial statements is based on the principle of the prevalence of substance over form. Instead the Legislative Decree n. 127/1991 which transposed the IV EEC Directive, makes no mention of the substance over the form. The absence of a specific legal provision has fueled various positions and interpretations by Italian scholars. Part of the doctrine considered that the principle is to be considered an obvious consequence of the truthful and correct representation principle since this purpose required by the financial statements can only be achieved by giving priority to the substantive aspects of company operations. This approach is consistent with what was established by the Italian accounting standard, Document No. 11. Another part of the doctrine, on the other hand, has criticized the principle itself, deeming it to be indefinite and above all no direct link between the substantial aspect of the transactions and the truthful and correct representation.

With the publication of Legislative Decree No. 6 of 17 January 2003, the legislator, in the context of the corporate law reform, introduced numerous innovations aimed to proceed with the

implementation of some indications already provided for by the national accounting principles and international. The main changes regarding valuation principles and criteria, the introduction of the principle of "economic function of the asset and liability considered" on which the valuations of the financial statement items must be based. The common interpretation of this regulatory provision is that the financial statements must be drawn up favoring, where possible, the representation of the substance over the form of company operations. The new provision has resolved the numerous doctrinal disputes that have fueled the debates of recent years. The issue in the international context was resolved as early as 1990 with the approval by the IASC of the conceptual framework of reference for the preparation of the financial statements for publication. This document clarifies that the financial statements are "aimed at providing external users with relevant useful information so that they can make economic decisions. To meet this purpose, two principles are set out, the competence (accrual basis) and the functioning of the company (going concern) and ten postulates to be followed for the preparation of the financial statements are also identified: the comprehensibility, the significance, the relevance, the reliability, faithful representation, neutrality, prudence, competence and the prevalence of substance over form ". The recognition of the prevalence of the substantial aspect of business operations in Italy has not, however, solved the problems concerning the recognition of financial lease transactions. The solution proposed by the legislator was a sort of "compromise": in the financial statements the transaction will continue to be accounted for by privileging the formal aspects, highlighting only the substantial aspects of the transaction in the Explanatory Notes. This recognition method is in line with what is already provided for in Accounting Principle No. 11: the Balance Sheet and the Income Statement reflect the form of the transaction, while the explanatory note represents its substance. This is the same approach with which English jurists initially believed that the principle of the prevalence of substance over form should be applied. The reason why the Italian accounting system has not yet considered it possible to fully implement the principle of

prevalence of the substance in the Italian accounting system is attributable to the influence of tax laws. In 2015 a further evolution of the legislation occurs with the transposition of the EU Directive 2013 /34 through the Legislative Decree 139/2015 the system of Italian accounting principles has been reformulated, also intervening on the general principles underlying the preparation of the financial statements including the principle of the prevalence of substance over form. In particular the new art. 2423-bis, paragraph 1, no. 1 of the Civil Code attests: "the assessment of the items must be made taking into account the substance of the transaction or the contract". To align with this new provision, the Italian accounting principle system in 2018 has also updated the regulation relating to the prevalence of the substance on the form envisaged by the new OIC 11 in paragraphs 25 to 28. [6] The new postulate of the prevalence of economic substance over the juridical-contractual form of the transaction is fully applied to finance lease or lease agreements. A lease qualifies as financial when the prevailing part of the risks and benefits inherent in the leased assets are transferred to the lessee. From a legal point of view, the leasing contract is, for all intents and purposes, a lease; therefore, since there is no transfer of ownership of the asset, the lessee would not be entitled to register it in fixed assets like other property assets and would continue to recognize the cost for the fees paid to the income statement. In January 2016, after 10 years of comparisons and discussions, the International Accounting Standard Board (IASB) issues the new international accounting standard for leasing accounting, IFRS 16 Leases. [7]. The new standard aims to improve the transparency of financial statements by overcoming the distinction between financial leasing and operating leasing. From 1 January 2019 the IAS adopters will abandon IAS 17[8] to account for lease contracts. According to the new provisions, all rentals, leases, rents in general, leases must therefore be capitalized, they will have to enter an intangible asset called "Right of Use" in the Balance Sheet. IFRS 16 will influence performance metrics and financial indices such as leverage, asset turnover, ROI, ROE, debt cost, interest coverage and net income; it is therefore of fundamental importance that

companies are ready for such changes. In this regard, the following scheme is to be observed.

Index	Measured Performance long-term solvency	Formula	Impact IFRS 16 increase	Explanation
Leverage		Total liabilities/Equity		increases due to the expected increase in financial debts
Asset Turnover	Asset Rotation	Revenues/Assets	reduction	It reduces with the accounting of the Right of Use between corporate assets and this is increasing the value
Debt Cost	cost of third-party capital	Financial rate interests/ third-party capital	increase	Increases due to higher financial charges for leases recognized in the financial statements.
Interest Cover	ability to pay interest on the residual debt	EBIT/ financial Rate Interests	It depends	With the introduction of the IFRS it is expected to be a increase in corporate EBIT and costs Financial. The result will depend on the characteristics of the lease portfolio of each individual company
EBITDA	profitability	MOL, Gross operating margin	increase	The increase is caused by the loss of fees for operational leases previously recognized as operating costs

Figure 1: The Effect Of IFRS 16 On The Economic And Financial Ratios

III. THE ACCOUNTING REPRESENTATION OF THE LEASE IN THE FINANCIAL STATEMENTS

In the financial statements drawn up according to the rules of the civil code, the lease must be represented with the so-called equity or lease method, which provides for the allocation to the income statement, under item B.8) Costs for the use of third-party assets, the total cost of the lease for the year.

Assuming that as at 31 December 2018 the company Alfa entered into a 24-month leasing contract for a machine, whose fair value was € 108,000.00. On the date of stipulation, Alfa pays an advance fee of 48,000.00 euros and undertakes to pay n. 7 quarterly fees of 8,000.00 euros and a redemption price of 6,000.00.

The total cost of the lease is (€ 48,000.00 + 7x8,000.00), or € 104,000.00. The management of the fees of competence is the following:

year	months	Income Statement Fee	Competence fee	initial rediscount	Finale rediscount
2018	9	72.000,00	39.000,00	0,00	33.000,00
2019	12	32.000,00	52.000,00	33.000,00	13.000,00
2020	3	0,00	13.000,00	13.000,00	0,00
totale	24	104.000,00	104.000,00		

Figure 2: The Management Of The Leasing Fee

To determine the present value of the payments due for leasing not yet paid, it is necessary to determine the implicit interest rate of the lease (quarterly), solving the following equation:

$$108.000,00 = 48.000,00 + \sum_{s=1}^7 \frac{8.000,00}{(1+i)^s} + \frac{6.000,00}{(1+i)^8}$$

The rate obtained is equal to 0.753457%. The rate can easily be obtained using Microsoft Excel® formulas, such as TIR.COST or TIR.X. On the basis of this data it is possible to draw up the financial amortization plan for the lease liability:

date	description	rate	Share capital	Interest rate	Residual debt
31/03/2018	maxfee	48.000,00	48.000,00	0,00	60.000,00
30/06/2018	fee	8.000,00	7.547,93	452,07	52.452,07
30/09/2018	fee	8.000,00	7.604,80	395,20	44.847,28
31/12/2018	fee	8.000,00	7.662,10	337,90	37.185,18
31/03/2019	fee	8.000,00	7.719,83	280,17	29.465,36
30/06/2019	fee	8.000,00	7.777,99	222,01	21.687,37
30/09/2019	fee	8.000,00	7.836,60	163,40	13.850,77
31/12/2019	fee	8.000,00	7.895,64	104,36	5.955,13
31/03/2020	Final fee	6.000,00	5.955,13	44,87	0,00

Figure 3: The Financial Amortization Plan

Assuming that the machine has a useful life of 10 years, the depreciation rate for the year 2018 will be equal to (108,000.00 / 10 * 9/12) euros, ie 8,100.00 euros. Taking the year 2018 as a reference, the representation according to the two modalities would be the following:

	Financial Method	Equity Method
ASSET		
Tangible fixed Assets	99.900,00	0,00
Bank	-72.000,00	-72.000,00
Active rediscount	0,00	33.000,00
LIABILITIES		
Passività per leasing	37.185,18	0,00
INCOME STATEMENT		
Lease payments	0,00	39.000,00
depreciation	8.100,00	0,00
Interest rate	1.185,17	0,00
Effect on economic result	-9.285,17	-39.000,00
Effect on equity result	-9.285,17	-39.000,00

Figure 4: The Financial And Equity Method

IV. CONCLUSION

With the entry into force of the new provisions, IFRS 16, companies that have failed to include general frozen accounting (GAAP) clauses in their loan agreements some conventions could be violated, the result of an increase in debt levels, with negative consequences on the creditworthiness of companies and the behavior of stakeholders.

To understand the impact of change, the best way is to examine the accounting records. This simplified example that follows in the "old" situation (IAS 17) and in the new one scenario imagining a company that has to account for a real estate lease first outside the scope of IAS 17 but now included in the provisions of IFRS 16:

BALANCE SHEET IAS 17			
ASSET		LIABILITIES	
Tangible fixed asset	3.000.000	Capital	4.500.000
Intangible fixed asset	8.490.000	Operating profit	220.000
holdings in subsidiaries	800.000	TOTAL EQUITY	4.720.000
credit	500.000	Banks debts	7.000.000
inventories	3.500.000	Debts to suppliers	2.800.000
cash	100.000	tax	1.870.000
TOTAL ASSETS	16.390.000	TOTAL LIABILITIES	16.390.000

BALANCE SHEET IFRS 16			
ASSET		LIABILITIES	
Tangible fixed asset	3.000.000	Capital	4.500.000
Right of Use	604.020	Operating profit	220.000
Intangible fixed asset	8.490.000	TOTAL EQUITY	4.720.000
holdings in subsidiaries	800.000	financial liability for leasing	604.020
credit	500.000	Banks debts	7.000.000
inventories	3.500.000	Debts to suppliers	2.800.000
cash	100.000	tax	1.870.000
TOTAL ASSETS	16.994.020	TOTAL LIABILITIES	16.994.020

Figure 5: The Balance Sheet Ias 17 And Ifrs 16

The sum of € 604,020 was determined assuming a 12-year lease (the classic 6 + 6 of the commercial world) from € 5,000 per month. However, 5,000 * 144 months = € 720,000 for the "right of use" fee. The IFRS 16 requires us to discount the future fees at the time of valuation using a rate equal to the rate implicit in the contract; if this rate is not available (as in the case of the lease tout court) the marginal lending rate of the company must be used which in this example we assume is equal to 3%. The new provisions result in an increase in liabilities. We observe a growth in liabilities due to the value of the asset entered into the balance sheet.

CONCLUSION

A conclusion section is not required. Although a conclusion may review the main points of the paper, do not replicate the abstract as the conclusion. A conclusion might elaborate on the importance of the work or suggest applications and extensions.

singular heading even if you have many acknowledgments. Avoid expressions such as "One of us (S.B.A.) would like to thank" Instead, write "F. A. Author thanks" **Sponsor and financial support acknowledgments are placed in the unnumbered footnote on the first page.**

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