

Why are we forgetting to apply the basic accounting principle of substance over form?

As accountants, there are a few basic “rules” we live by when preparing financial statements – relevance, faithful representation, comparability, verifiability and timeliness.

Faithful representation means that the accounting in the financial statements depicts the underlying economic characteristics of transactions and events. Financial statements aim to represent the economic characteristics underlying events and transactions and not their legal substance. This is why the financial statements are prepared using accounting standards and not based on a list of prevailing laws and regulations.

So why are we not applying the principle of “substance over legal form” in preparing the financial statements?

Since the outcome of a Court case in 2021 challenging the outcome of a particular audit, there is an emerging view that the Courts should be used to solve accounting disputes. As Court orders are binding, the parties to the case are compelled to implement the outcome of the judgement or face being in contempt of Court. Implementing the outcomes of Court rulings in preparing the financial statements blurs the line between applying accounting principles aimed at reflecting economic realities and complying with Court rulings based on legal jurisprudence.

While acknowledging the rights of parties to exercise their freedoms under law, using a Court to interpret accounting standards is ill advised. Here’s why...

Lawyers have an understanding of what is called legal jurisprudence, i.e. the philosophy of law. Their jurisprudence or “legal universe” is based on an interpretation of specific laws and regulations, and common law or “case” law which is based on past Court rulings on similar matters.

Accountants have an understanding of the Conceptual Framework which outlines the philosophy underpinning the preparation of the financial statements. The Conceptual Framework, specific Standards of GRAP, and accounting policies developed based on equivalent practice for similar transactions, is the “accounting universe” used to drive the decisions of accountants and the provision of information in the financial statements.

As the Public Finance Management Act both requires entities to apply Standards of GRAP and gives the Minister of Finance the authority to issue Standards of GRAP, the Standards of GRAP are in themselves legislation and have to be applied by public entities and others.

As the Standards of GRAP are law, legal professionals should be interpreting the Standards when resolving disputes or providing opinions on accounting matters referred to the Courts. However, without a sound knowledge and understanding of the “accounting universe”, they often revert to providing opinions based on the “legal universe”. Lawyers also would not think about the users of the financial statements and their information needs as this means applying judgement rather than rigid legal rules.

Where opinions or Court rulings are based on the “legal universe” as opposed to the “accounting universe” the financial statements could fail to “faithfully represent” the economic realities of transactions and events in the financial statements as envisaged by the reporting framework. Where this is the case, applying Court rulings rather than Standards of GRAP to prepare the financial statements has the potential to erode the credibility of the Standards, financial reporting practices, and the principles of sound public financial management.

There are no winners when legal opinions are sought to interpret accounting matters.

By: Jeanine Poggiolini

CEO of the ASB

The views reflect in this article are those of the author and not the ASB or its Board.