



## Use the Substance-over-Form Convention to Regulate the Related Transaction

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### Abstract

Along with the coming of knowledge economic times, many enterprises form large groups by means of capital operations, including merger and purchase, reengineering, and stockholding. As a result, the relationships between enterprises tend to be more complex. Related parties and amounts of related transactions appear. For transactions or items that have inconsistent substances and forms, we must follow the substance-over-form convention in accounting. By this way, we can guarantee the quality of accounting information, regulate the accounting, and promote the development of market economy.

**Keywords:** Substance over form, Related party transaction, Regulation

Entering the 21<sup>st</sup> century, Chinese enterprises pursue for scale and knowledge operations. By means of different capital operations, such as merger and purchase, reengineering, and stockholding, many related enterprises form large groups. As a result, the relationship between enterprises becomes more complex and large amounts of related transactions appear. In order to adjust profits and make false balance sheet, related enterprises may mutually adjust and transfer incomes, expenses, and assets by manipulating the related transaction prices, which will lead to the unreasonable allocation of expenses and capitals. It will directly the fairness of financial reports and may cause decision mistakes. Here, we emphasize on the “substance-over-form” convention, aiming at “reflecting real accounting information” and rejecting “serious distortions” of related party transaction. That is a basic precondition for stopping false accounting. As for the related party transaction that does not realize the consistence of substance and form, we must deal with it by the “substance-over-form” convention in accounting.

### 1. The “substance-over-form” convention’s requirements for related parties and its constraints on their transactions

The “substance-over-form” concept firstly appeared in the Statement.4 --- Basic Concepts and Accounting Principles issued by the Accounting Principle Board (APB) in 1970. According to APB, financial accounting should emphasize on the transaction or item’s economic substance of transaction, no matter whether the transaction or item has a legal form that differs from its economic substance. In 1997, China issued the first specific accounting convention “Related Parties’ Relationship and Transaction Disclosure, which firstly mentions to use the “substance-over-form”, instead of merely depending on the legal form, to judge whether there is related relationship or not. China Accounting System for Business Enterprises (2001) formally took the “substance-over-form” convention as one of requirements for enterprise accounting: “Enterprise accounting is based on the transaction or item’s economic substance but not its legal form.” In recent years, in judging listed companies’ certain big cases, the “substance-over-form” convention has been applied frequently. After China’s entry into WTO, it is urgent to realize the internationalization of accounting convention in China. In February, 2006, China amended and perfected the former accounting convention and constructed an independently applied accounting convention system that is in accordance with Chinese conditions and the convention of international accounting reports and covers all economic operations in enterprises (except small and medium-sized enterprises), in which the “substance-over-form” convention regulated by China Accounting System for Business Enterprises (2001) is included. Besides, as for the scope of integrated financial reports, the new system lays more stresses on the substance. The mother enterprise should integrate all child enterprises in control into its financial reports, without regard to the proportion of stocks. This item embodies the application of the “substance-over-form” convention.

In China the enterprise accounting convention does not define the related party in special. In 2006, the new amended accounting convention extends the meanings of related party relationship, making specific requirements for the related parties’ relationship and transaction disclosure. It emphasizes more on the convention of “substance-over-form”. In

other words, whether it is related party relationship, the disclosure of financial reports focuses on the substance but not only the legal form. The disclosure of financial reports is based on whether enterprises are related parties: one party controls directly or indirectly the other party; two parties are mutually controlled or influenced to a great degree; two parties or more parties are under the control of another party. If two parties or more parties share one key manager, the two parties or more parties are not related parties, except that the key manager can control or influence these parties at the same time. It is improper to take joint operators as related parties only because they control certain joint enterprise together. The right way to establish the related party relationship of joint operators is to consider the substance of economic business between joint operators and their mutual influences on each other. As for related parties' relationship and transaction disclosure, it regulates that: no matter whether there is related transaction or not, related enterprises should disclose the mother-child relationship in their financial reports, including the mother enterprise, the final controlling party, and the lowest medium stock controlling enterprise that supplies financial reports openly. The disclosure of related parties' relationship is clearer and more objective. As for the related parties' transaction, cancel the option of disclosing the transaction amount or the proportion, and ask enterprises to disclose the transaction value. As for the unsettled items, disclose the detailed information and value. Under the condition of supplying sufficient proofs, enterprises can disclose that the related transaction adopts the same items with fair transaction.

## 2. Analyze present conditions of related transaction

Related transactions are popular among listed enterprises in China. And most exist between the listed enterprise and its mother enterprise, or its brother enterprises. In recent years, related transactions between Chinese listed enterprises develop from the equity transfer to the asset replacement, from physical asset transaction to virtual asset transaction. Various related transactions happen and the trend becomes stronger. Amounts of income are from related parties and amounts of capitals flow toward related parties.

In China's security market, asset reengineering, a kind of related transaction, has become an important way for many listed enterprises survive from losses. Thereof, related parties control profits by unfair prices in order to achieve certain goal. It apparently betrays the convention of "substance-over-form". In May, 2005, Shenzhen Stock Exchange declared a delisting of Shenzhen Over-globe Development Co. Ltd. One year later, it fails to list on the market again. In this case, Shenzhen Over-globe is profitable in form since the profit 95 million Yuan is from asset replacement in 2001, which is realized by unfair prices. In perspective of economic substance, it does not survive from losses. As a matter of fact, it gains nothing but manipulate profits. If without restricts on these activities, stockholders may make wrong decisions according to listed enterprise's financial accounting reports, damaging investors' interests. The failure of Shenzhen Over-globe is originated from it betraying the "substance-over-form" convention. Before, in order to achieve certain goal, listed enterprises may establish incomes and manipulate profits by asset replacement and other related transactions. Now it is impossible because these activities betray the "substance-over-form" convention.

(1) In other countries, accounting distortion has already become an extremely severe issue. Accounting betrays the "substance-over-form" convention to a great degree. The accounting scandals that frequently happened in American Securities Market generate a credit crisis to the world, which damages the economic development seriously. In recent years, American economy develops quickly and financial innovations are popular. However, the development of accounting system lags behind the economic development, which presents gray spaces for certain people. For example, Enron makes up false entities and financial reports by manipulating an accounting convention derived from a renting enterprise. Could not it reflect the substance of an economic item?

(2) China is also full of cases in which enterprises, mostly listed enterprises, manipulate profits and betray the "substance-over-form" convention. Recently, Chinese related enterprises manipulate profits by means of unfair related transactions in order to gain huge profits, survive from losses, and avoid taxes in operations. Data show that 1224 enterprises list on Shenzhen Stock Exchange and Shanghai Stock Exchange till 2002. Thereof, 710 listed enterprises have related transactions, accounting for 58% of all listed enterprises, concerning 2129 related transactions and 127.1 billion Yuan. In 2002, among the 510 listed enterprises in Shenzhen Stock Exchange, 412 listed enterprises disclose their related transactions, accounting for 80.78% of the total. According to information from Shenzhen Stock Exchange, in 2003, among the total 506 listed enterprises, 431 listed enterprises have related transactions, accounting for 80.01% of the total.

(3) Chinese listed enterprises manage related parties' assets by entrusted operations and realize relatively better profits. This phenomenon is common now. Till late 2001, the Ministry of Finance sets up regulations on the accounting of trust and entrusted operations, establishing the upper limit of entrusted profits. As a result, the conversely entrusted operation that entrusts bad assets to related parties appears. Although this method could not bring about direct interests for enterprises, it can delete the potential losses and increase the interests of listed enterprise indirectly. For example, mother enterprise decreases the fees paid by listed enterprises, or directly pay management fees, ad fees, and pensions for listed enterprises, or refund the fees paid by listed enterprises before.

(4) Analyzing the present conditions of related party transaction, we can conclude: no matter whether a transaction is related or unrelated in form, the transaction substance and its influence on listed enterprise is the only standard to judge whether relevant accounting is proper or not. In other words, what the important is the substance of transactions between listed enterprises, but not the legal forms.

### 3. Exercise the “substance-over-form” convention properly and regulate the related parties’ transaction

Applying the “substance-over-form” convention to restrain the related party transaction is meaningful for regulating the accounting and stopping listed enterprises manipulating accounting information by related party transaction. However, it could not solve all problems. Only when we exercise the “substance-over-form” convention reasonably and properly, can we prevent the activities that disturb economic orders.

#### (1) Enhance management and supervision and avoid a subjective use of the “substance-over-form” convention

The application of the “substance-over-form” convention needs to make best use of accountants’ professional knowledge. It leaves a larger space for accountants in the accounting policy field. To apply the convention properly will benefit the reliability of accounting information. But if emphasize the convention too much, it will affect the verification of accounting information, and even serves as an excuse for subjective accounting. Some enterprises even take its subjectivity as a tool for manipulating profits and a shield for illegal activities. Therefore, the government should keep in improving the execution of laws and the quality of supervisors. No matter what it is registered accountants’ audit or accounting supervision agencies’ check on enterprise accounting information, it is necessary to grasp the essence of the “substance-over-form” convention.

#### (2) Improve accountants’ comprehensive qualities, and ensure the effective application of the “substance-over-form” convention

To improve the accountants’ professional evaluation level is a basic precondition for understanding and applying the “substance-over-form” convention properly. First of all, accounts should study and master the accounting laws and regulations, pay more attention to the state reform policies in accounting, taxation, finance, and industry, be good at analyzing and summarizing experiences, improving the logically thinking ability, distinguishing ability, and evaluation ability; Secondly, be loyal to objective facts, build up the attitude of being objective and just, the spirit of being careful and seeking for the truth, master and apply the “substance-over-form” convention properly; Finally, enhance the professional moral education of accountants. As for the last point, we can take references from other countries’ experiences. For example, add courses concerning professional morals to accountants’ degree education. Test examinees’ professional morals by adding relevant questions to accountants’ profession and quality tests.

#### (3) Coordinate the “substance-over-form” convention with other accounting requirements

In accounting practice, the application of “substance-over-form” convention may conflict with other accounting requirements, such as the accrual basis. In this circumstance, accountants should make evaluations and choices based on which one could improve the relevance of accounting materials more.

#### (4) Perfect enterprises’ internal accounting control system, and ensure the application of the convention of “substance-over-form”

In supervising the quality of accounting information, we should not only emphasize on the construction of accounting information’s post examination, but also build up a set of quality supervision system for beforehand control and post control. In dealing with certain economic business that has inconsistent form and substance, it is necessary to consult with the registered accountant and listen to his or her suggestions before composing the financial reports. For some questionable and unsettled items, it is better to ask advices from the supervision department and then make relevant accounting reports.

Due to the diversity of related party transaction in development, it is vital for accountants to make correct and professional judgments according to the “substance-over-form” convention, if the economic substance is not in accordance with the legal form. The “substance-over-form” convention serves as an important character of accounting information quality. The quality of accounting information is the criterion for evaluating the whole accounting, which influences the orderly operation of economy and the social stability.

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