Evolution of the substance over form principle in the Italian GAAP from a comparative and international perspective

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Abstract: The informative power of financial reports is unanimously based, among others, on substance over form principle. But this principle is not free of ambiguous interpretation and adoption. In fact, it has been differently issued in the US GAAP, in the IAS/IFRS framework and in the Italian GAAP. This paper aims to provide a deep review of the recent reforms of Italian accounting regulation which introduced in 2003 and reaffirmed in 2015 the substance over form as an accounting principle within the law at the same level of accrual basis, prudence and going concern. We adopt a comparative approach to show how US GAAP, IFRS, UK GAAP already include substance over form principle and that the inclusion of this principle within the Italian law did not achieve its initial purpose. This is mainly due to the traditional legal view of a financial report intended by Italian legislator as a legal claim. Further research should be addressed in order to provide also empirical evidence of this mismatch.

Keywords: substance over form; Italian GAAP; Italian accounting regulation reforms; IAS/IFRS framework; UK GAAP; US GAAP; critical accounting.

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1 Introduction

During the past decades, accounting standards and financial reporting issues have raised strong interest among academics and practitioners, at the national Italian and European levels, because of globalisation of financial markets.

European legislator, for example, devoted relevant attention to the accounting information and financial reporting related issues in order to support the decision-making process of different stakeholders (Ashbaugh and Pincus, 2001; Benston et al., 2006a; Laux and Leuz, 2009). Given that accounting standards aim to improve comparability at an international level from the formal and the substantial points of view, the European regulatory action has been addressed to find a way to enable companies' financial statements to fairly represent the economic and financial situation of a business. This effort led to a double-track strategy: *harmonisation* of accounting standards across member states through the so-called accounting directives (Dorel et al., 2015), and a *standardisation* of accounting standard through the endorsement of IFRS and its mandating adoption for all European listed companies across member states (Jones and Finley, 2011; Lehman, 2005).

Besides, at a global level, the convergence process between US GAAP and IFRS is again a topical issue, because it involves the financial reports contents of all companies listed in the greatest financial markets of the world such as NYSE and LSE (De Lange and Howieson, 2006).

With regard to financial report contents, some scholars highlighted the importance of the substance over form principle as a postulate and how its adoption allows an improvement of companies' accounting information in order to provide the 'true and fair view' of company situation to its users (Rutherford, 1985).

When accounting information goes global, it is important to safeguard its comparability across different countries and jurisdictions and this should be intended either at a formal level or a substantial level. In fact, if the same principle or rule is adopted with different interpretations this will result in different financial reports which could be comparable only from a mere formal point of view, whereas they will not be comparable from a substantial point of view.

The substance over form principle represents one of the above situations because its interpretation is quite ambiguous (Maglio, 1998; Albertinazzi, 2002). In fact, it has been issued differently in different sets of accounting standards, both national and international ones, like the US GAAPs, the UK FRSs, the Italian GAAPs and the IAS/IFRS framework (Hopwood, 1990).

Therefore, this paper aims to contribute to the international debate about the informative potential of financial reports in a globalised world by providing a critical review on how substance over form has been interpreted, adopted and included into different GAAP, European regulations and directives, and into Italian law. As far as we know, in fact, while some studies have been conducted on substance over form issues within IFRS implementation (Melis and Carta, 2010), and corporate governance issues (Cohen et al., 2010), no prior studies especially explored the practical implications of the recent Italian law reforms on Italian companies' financial reporting.

To this end, we adopt a comparative approach to show how US GAAP, IFRS, UK GAAP include substance over form principle and that the inclusion of this principle within the Italian law did not achieve its initial purpose. This is mainly due to the traditional legal view of a financial report intended by Italian legislator as a legal claim.

The Italian legal system, which is typically a *civil law* system where GAAP are subordinate to the law, introduced for the first time (Legislative Decree no. 6/2003) the substance over form principle into its accounting regulation. Moreover, the legislator confirmed this in 2015, by adopting the European Directive No. 34/2013 and modifying the civil code again: in fact, Art. 2423 *bis* of the civil code now expressly include substance over form principle among other accounting principles such as accrual basis accounting, prudence and going concern (Legislative Decree No. 139/2015).

Even if this innovation could represent the Italian legislator's attempt to be more consistent with the IASB framework, unfortunately in practice its inclusion did not achieve its initial purposes.

This article shows that this 'failure' is due to the difficulties to conciliate this principle's correct implementation with the pre-existing rules formally based on a legal view of financial reporting that has been intended as a legal claim. In addition, given that the European Parliament adopted the EC regulation 1606/2002 in order to introduce the use of international accounting standards (IFRSs) in the EU member states with a view to harmonise the financial information provided by companies, two different and hardly comparable regulatory systems presently coexist in Italy: the first regards listed companies' financial reports and the second regards all other companies.

The difficulties in first-time adoption of IFRSs in Italy also arose from the previous limited adoption of substance over form principle due to the prevalent juridical view of financial reporting and its consideration as a legal claim. Therefore, by making a survey of all Italian legislator choices throughout the recent history regarding accounting regulation, this article affirms that to improve comparability among companies' financial reports and to eliminate the negative effects of a two-speed regulatory system, if Italian GAAP's will is to be consistent with IFRSs, it is necessary to remove all of the conflicting issues still existing in the financial reporting law and in the Italian GAAP that still make the substance over form only a hollow principle.

This paper proceeds as follows. In Section 2 we propose a research question and describe the methodology we intend to adopt. Section 3 offers an evolutionary description on how the substance over form principle has been developed through traditional Italian accounting paradigms. Section 4 proposes a comparative analysis on how the substance over form principle is defined in different sets of accounting standards, i.e., US GAAPs, UK GAAPs, and IFRSs. Section 5 introduces the most critical issues related to the incorporation of the substance over form principle into the Italian law and the consequent arising conflicts. Lastly, we propose some concluding remarks and offer suggestions for a follow-up study.

2 Research question and methodology

This paper aims to address the following research question:

1) Do the 2003 and 2015 reforms of the Italian corporate law, which introduced substance over form within the Italian civil code, achieve their initial purposes of facilitating the comparability among?
   a Italian not listed companies' financial reports
   b Italian listed companies' ones
   c foreign companies' ones?

In order to address the above research question, we adopt a comparative qualitative research approach that appears to be suitable to this aim. In a context of law harmonisation, in fact, where European legislator aims to reduce differences among countries, we state that comparing the different accounting traditions involved is already implied by this aim (Carnegie and Napier, 2002; Nobes and Parker, 2008). Anyway, context differences among different countries' accounting traditions are not always easily removable (Parker, 1983) and importing rules and solutions from abroad may not get to the target.

Specifically, Italian accounting traditions lead to the Italian 'Economia Aziendale' (Vagnoni, 2002; Capalbo and Clarke, 2006). Moreover, Italian accounting studies have highlighted several different accounting paradigms [D'Amico, (1999), p.42]. A paradigm should be intended as a conceptual framework of principles and rules for the determination and measurement of every operation that companies carry out. Given that accounting studies proceed through non-cumulative processes, it is possible to say that different competing paradigms are *incommensurable* (Kuhn, 1962). It follows that all principles underpinning a paradigm shared by a scientific community are expected to change leading to a *scientific revolution* (paradigm shift) (Kuhn, 1962).

Regarding the main topic of this article, it is useful to provide a compared review of how the concepts of substance and form across different paradigms have composed the Italian accounting tradition. To this end, Kuhn's epistemological model is adopted, and a comparative analysis of how substance over form principle has been issued in international accounting standards (IFRSs), in the US GAAPs (also considering the recently issued joint framework), and in the UK FRSs is conducted in order to demonstrate that Italian accounting law is not perfectly compatible with the introduction of the substance over form principle, resulting in an obstacle in comparing Italian financial reports with IFRS and other GAAP-based ones.

3 The relationship between substance and form in Italian accounting paradigms: literature review

Concepts of substance and form are both represented in philosophy (Albertinazzi, 2002) and law sciences. In this article, we will not mention the philosophical debate about substance and form concepts[1]. Instead, with regard to the juridical concept of substance and form, it is necessary to make a distinction between *civil law* and *common law* systems. In fact, it has been observed that countries that have a civil law tradition, namely Italy, among others, usually privilege the elaboration of a conceptual framework as a starting point to understand and describe facts (scientific formalism). The law is shaped in such a way that solving a concrete issue implies the adoption of a rule that is chosen according to endogenous factors in the juridical system rather than to external and contextual factors (interpretation formalism). Through such an abstraction process, the juridical system has the advantage of making law certain and results perfectly foreseeable and objective, but sometimes it has also the limitation of simplifying the underlying reality of a fact.

This is the case of a financial statement that, in civil law countries, is intended to represent a company's facts that is only 'conventional', i.e., based on a formal set of rules that often does not represent all the aspects of a company's reality [Savioli, (2004), p.18]. Moreover, the pursuit of an excessive formalism of interpretation could lead to an over-subjective interpretation of facts, depending on who is interpreting and implementing the law. On the contrary, a more objective interpretation could be achieved by considering also external elements and objective circumstances in which the fact arises [Albertinazzi, (2002), p.20].

If we refer, for example, to Italian taxation law, specific interpretation issues arise. Taxation law shares the same formalistic approach of other law fields and often uses the same regulatory schemes of the civil code. However, taxation law has a complex objective that goes beyond the simple identification and order of a phenomenon because it also represents the starting point for identifying an economic fact whose realisation represents the levying base. Therefore, in this case, a potential conflict could occur between the economic fact in itself and its juridical representation to subdue the former to the most coherent group of rules [Albertinazzi, (20020, p.20]. The main consequence is that room for tax avoidance potentially opens to help individuals who aim for a specific economic objective by adopting the most opportune legal patterns and procedures in the taxation point of view. Hence, taxation law has evolved in order to eliminate or narrow every tax avoidance space by adding new rules specifically made to identify the economic nature of any company's ongoing operation regardless of mere juridical form.

This example has highlighted a strong similarity with what the Italian doctrine of Economia Aziendale intends when it refers to the substance over form principle.

In accounting field, the relationship between substance and form concepts has differently characterised Italian accounting paradigms throughout the ages.

Among others, an in-depth analysis of the Italian accounting tradition and its main features is given by Zan (1994) and Viganò (1998). While early studies considered accounting as a branch of mathematics and completely irrelevant to juridical construct (Zan, 1994), in the following stage the juridical construct had a strong influence on the accounting discipline by elaborating a theory of the firm (Italian *azienda*) as a *juridical transactions centre*, where management acts are always intended as rights and dues that continuously occur regarding individuals involved in enterprising activities (Cerboni, 1886; D'Amico, 1999). It is easy to understand how adopting such an approach will cause an unavoidable fragmentation of management and a lack of effectiveness of the law regarding the specific needs of enterprises.

Economic aspects were included in accounting theory later, thanks to a new concept intending for the firm to be the centre of employed factors or to employ in the production process, focusing to this end the measurement of their intrinsic values as cash flow equivalents (Besta, 1922). This represents the new scientific paradigm following the previous one and accepted by the scientific community. The value theory that follows considers the economic aspect in accounting entries. Hence, an assets' value is determined by referring to the object of a right/due rather than to the right/due *per se*.

The subsequent significant step in the doctrine's evolution path is represented by a further elaboration of the enterprise's definition as a coordination of economic operations in which individuals and worth are vital components [Zappa, (1927), p.40; Vagnoni, (2002), p.527; Capalbo and Clarke, (2006), p.68]. The *azienda* is the focus of Economia Aziendale discipline, which retains a level of economic generality to develop a fundamental unitary discipline and the postulates that could be applied to every kind of entity that meets the necessary requirements to be defined as an *azienda* (Viganò, 1998). This theoretical framework represents a break with the earlier tradition of studies and Economia Aziendale became a wider discipline within which accounting system is shaped to produce a stream of information about the object *azienda*, whose definition delimits the boundaries of the discipline [Capalbo and Clarke, (2006), p.69; Zappa, 1950].

Although this important break in academic thought represents the fall of the previous paradigm in favour of the new one and the foundation of a new scientific discipline, the focus is newly on the economic aspect of every entrepreneurial event whose accounting entry has to be carried out depending on the intrinsic effects that it could exert on the annual net income. Instead, net worth is only a residual value including all that was not included in the annual net income on accrual basis (Zappa, 1950). The shift of focus from net worth to net income avoids any conflict between substance and form by considering only economic effects of every management act in the measurement of annual net income. Net worth (capital) loses importance because it is only an abstract stock of values, and does not depend on the specific tangible and juridical characteristics but is only excluded from net income determination on accrual basis.

Because the Italian legislator has recognised a new demand for information about enterprise performances and results, the financial statement has become the new focus of many regulation efforts. By adopting the typical civil law approach, several new laws and decrees have been issued (also a consequence of European directives and regulations) in order to regulate articulation and postulates of companies' financial reports. Italian law has progressively made companies' financial statements a source of information for use by external stakeholders. The will to safeguard the interests of those who make economic transactions with a company has led to the issuing of an accounting normative based on the postulates of neutrality, comparability, and prudence of evaluations.

The juridical influence on accounting issues itself represents the source of the potential conflict within the scientific paradigm underpinning the Economia Aziendale discipline (Alexander and Servalli, 2011). The Italian juridical system requests, in fact, a kind of company information that is reliable and minimally influenced by the subjectivity of economic evaluation, to avoid the possibility that accounting capital exceeds the amount of economic capital [Capalbo and Clarke, (2006), p.72]. In this sense, the financial statement has to be intended as a legal claim on which creditors and lenders mainly could rely given that a limited company's net worth has a guarantee function just for those groups of stakeholders. Thus, this demand for safeguarding some specific interests considered so crucial for wealth production and distribution in capitalistic society leads to a conservative accounting approach with a focus on net income on accrual basis. This follows the mandatory feature of the postulate of prudence and the consequently limited ability of Italian financial statements to provide significant information for all stakeholders to foresee the economic values of an enterprise, even if they are not yet realised and to support the decision-making process.

The legislator action regarding financial statement laws provokes again the conflict between substance and form, leading to the overcoming of the juridical approach in the drawing up of financial statement and this is mainly motivated by a strong will to safeguard net worth (conservative approach).

4 The relationship between substance and form within the Italian civil law and GAAPs: a comparison with the US GAAPs, UK GAAPs, and IFRSs

The process of increasing globalisation of capital markets worldwide has made the adoption of common standards essential to achieve comparability among companies' financial reports across countries. Law and accounting scholars have progressively focused their attention both on differences and similarities among different bodies of rules and sets of accounting standards.

After the previous measure dating back to 1991[2], the first and relevant acts that Italian legislator issued about the financial reporting of companies is dated 2003[3] and modified some of the civil code's articles regarding financial report's discipline.

The 2003 reform, also known as the reform of corporate law, among others, introduced new accounting procedures for specific operations such as derivatives financial instruments, repurchase agreements (repos), and financial leases, as well as a series of rules to eliminate fiscal interferences on financial reports.[4] As already done for banks' and financial bodies' financial reporting, for which accounting discipline already includes the substance over form principle[5], the same principle has been extended to all kinds of companies that are compelled by law to draw up an annual financial report.[6]

Nonetheless, the substance over form principle has been included with a particular and quite ambiguous formulation at the same level of the prudence and going concern principles.

It clearly appears that the Italian legislator's purpose was to improve the significance of financial report values to enable a better representation of a company's underlying reality and to avoid an excessive level of subjectivity in the evaluation process at the expense of reliability.

Two other relevant directives were issued by European Commission in 2003 and recently in 2013: the 2003/51/EC and the 2013/34/EU, both with the objective of modifying the former IV and VII directives. Every European member state is expected to issue a national law to modify the order of companies' financial reports. The content of the above directives aims to change financial report postulates, its outline and evaluating criteria of assets, liabilities, revenues and expenses.[7] Among other directives, these two provide an explicit reference to the substance over form principle as a postulate of financial reporting. This implies that financial report is presented in a way that highlights the economic aspect of operations rather than the mere (juridical) form, noting the effects on the balance sheet and the income statement (Art. 1, p.2 of the 2003/51/EC and Art. 6, h of the 2013/34/UE).

The 2003/51/EC Directive has been acknowledged in Italy, and even if this directive was inspired by the best international practices, it has not achieved its original objectives in Italy because the Legislative Decree No. 32/2007 acknowledged it only in a few aspects (such as "[…] member States may permit or require […]"). In so doing, the Italian legislator left many inconsistencies with International Accounting standards (IAS/IFRS). Many companies do not have to present their financial reports under IAS/IFRS (because they are not required to by law) and so their reports are incomparable with those made under IAS/IFRS because of many substantial differences in formats, recognition and evaluation criteria, etc., and this is the first reason for the incongruence in the Italian accounting system.

More recently, the 2013/34/UE Directive was acknowledged in Italy along with the Legislative Decree No. 139/2015. This decree introduced new accounting principles and accounting rules within the civil code such as *relevance* of the accounting information, cash flow statement as a mandatory part of annual financial reports, the *amortised cost* method and the *research and promotion* cost as expenses in the income statement, etc. With regard to the topic of this article, the same decree expressly introduced within the civil code (Art. 2423 *bis*) the *substance over form* principle at the same level of other accounting principles such as *accrual basis, prudence* and *going concern*.

If the previous intervention of the Italian Legislator (2003) opted for a weaker solution with an ambiguous definition, the 2015 decree appears to be clearer and not doubtful. In contrast, the definitive introduction of substance over form in Italian legislation about financial reporting is far from being the final solution for improving the comparability of accounting information across Italy and other countries, even if it is an attempt to step forward along that path.

At an international level, there are several contributions to the substance over form concept as well as some cases of ambiguous definitions [Rutherford, (1985), p.483–492].

We could sustain that it has been a long time since in Anglo-Saxon countries a financial report that represents operations' economic substance has been preferred to a mere representation of juridical form, to be defined useful for users in their decisional process.

If we examine US GAAPs, for example, a specific definition of the principle does not appear. Only the accounting principle *Statement of Financial Accounting Concepts No. 2*, regarding the substance over form concept, explains that it has been excluded from financial report postulates because it is redundant with respect to what is already included in the *reliability* and *representational faithfulness* principles.[8]

US GAAPs are issued by the FASB, which takes a general approach to accounting standards as high detailed rules and is able to interpret every kind of concrete transaction, as opposed to a principle-based approach[9] (Benston et al., 2006b).

It is true that in most US GAAPs, it is assumed that the juridical aspect of a transaction does not matter for providing information through the financial report regarding solely the economic aspects of business operations. In other words, the concept of substance over form is implicit in the reliability and representational faithfulness principles in US accounting standards.

In this context, we have to mention the subtle difference between US GAAPs and European Commission accounting policies regarding the use of an override to obtain a fair presentation of the company's financial position and results of operations [Epstein and Jermakowicz, (2010), p.32]. In fact European fourth directive (No. 78/660/CEE) requires that financial reports offer a 'true and fair view' of a company's financial situation and if the adoption of a specific accounting rule does not fit with the true and fair view the entity could conclude that it must not apply that rule of standard and provide adequate additional information. On the contrary, US GAAPs only rarely permits a departure from an applicable standard and this represents an example of the difference between the so-called principle-based approach (European accounting policies, a major part of European countries national GAAP, and IFRSs) and the rule-based approach (US GAAPs).

Given this approach difference, with a specific reference to substance over form principle, among other scholars, Baker and Hayes (2004, p.769) argue that:

> "[…] we do not agree with the proposition that substance over form is a redundant concept in relation to reliability and representational faithfulness. The reporting of a particular transaction might be completely reliable (verifiable) and yet not provide a transparent view of the underlying economic substance of the transaction".

Then, they further explain that:

> "Many of the transactions that Enron engaged in were reviewed by Arthur Andersen as being reliably reported in accordance with US GAAP. Likewise, the concept of representational faithfulness begs the question of what it is that is being represented. The concept of representational faithfulness as defined by the FASB suggests that financial information should 'represent what it is intended to represent' […]. It could be argued that the information Enron provided to its investors and creditors was exactly what Enron's management intended to represent, and that consequently the information was representationally faithful in accordance with Enron's view of the world."

The same authors add that within an auditing system made weak by the lack of a specific principle about substance over form, even auditors remain powerless in assessing risks arising from deviant corporate policies.

On the other side, the principle-based approach is typical if we refer to other sets of accounting standards, first those of the UK and the IASB.

UK accounting standards, which are issued by the Accounting Standards Board and admitted by the Company Act, include the substance over form principle in a specific accounting standard, namely Financial Reporting Standard No. 5 *Reporting the Substance of Transactions* (ASB, 1994). This choice is quite different from that of the US standard setter, and it could be explained by the presence of a particular event that distinguished the UK accounting tradition from that of the US, even if they share the same common law juridical approach (see Nobes, 2003).

The UK, as a member state of the EU at least until the completion of the 'Brexit' process, must accept EU legislative acts such as the so-called IV and VII Directives about harmonisation of financial statement order across Europe. The UK had to issue a specific legislative act to enforce the directives' provisions. To that end, it had to introduce in its juridical order a set of general but sufficiently detailed, principles about companies' financial reporting, and this conflicted with the typical and strongly established common law approach.

A new standard has been issued, FRS No. 5, that could not be intended as a novelty but rather a necessary formalisation of already existing accounting technicalities, with the consequent re-affirmation of accounting principles, already underlying financial reporting, for the European wider harmonisation project (Hopwood, 1990; Maglio, 1998; Albertinazzi, 2002). Moreover, British accounting standards are characterised by a deep flexibility, and the acceptance of a set of general principles in the accounting system could draw a line to avoid some potential fraudulent accounting behaviours in providing a deceptive image of the company's reality and introduce a certain degree of professionals' autonomy and evaluating discretion with respect to the strictness of a law. In fact, we refer to the so-called operations of *window dressing and off-balance sheet financing*. The latter consist of the research of specific ways of financing for which emerging liabilities could not be reported in the balance sheet, as happened in the Enron Corp. case and its unexpected bankruptcy (Reinstein and McMillan, 2004). Moreover, Jeffrey (2002) highlights that under FRS No. 5 the entity cannot categorise a particular transaction as on- or off-balance sheet merely by reference to its legal structure.

It follows that unlike what occurs in the US, the FRS No. 5 highlights how the substance over form principle has to be rightly applied in the identification of an asset or liability phase, rather than in the evaluating phase (Maglio, 1998).

The International Accounting Standards (IFRSs) refers to the substance over form principle within *The Conceptual Framework for Financial Reporting* which aims to serve as a guide to the Board in developing accounting standards and in solving accounting issues that are not addressed directly in an International Accounting Standard, International Financial Reporting Standard or Interpretation. The current version of the Framework was issued in 2010 as a result of a joint effort from both the IASB and the FASB (FASB-IASB, 2010). However the reference to the substance over form principle appears within Chapter 4. The only chapter that has not been changed from the 1989 version, and the paragraph 4.6, in fact, says:

> "in assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form".

It follows that in this case, the substance over form principle is implicit in the definition of faithful representation as a qualitative characteristic of financial reporting. In their joint work, in fact:

> "[…] The Boards concluded that the qualitative characteristic of faithful representation encompasses ensuring that financial reports represent the substance of an economic phenomenon (such as a particular transaction) rather than solely its legal form. To represent legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation. Therefore, the quality of faithful representation is incompatible with representations that subordinate substance to form. Accordingly, this framework does not identify substance over form as a component of faithful representation because to do so would be redundant" (FASB, 2006, par. BC 2.18.).

Therefore, the content of the substance over form principle depends on its orientation to achieve a faithful representation as a starting point for users' decision making.

In addition, the substance over form principle is explicitly included in other specific accounting standards such as those for financial leases (IAS 17, 3 and 12), transactions and outstanding balances with related parties (IAS 24, 3), and interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses (IAS 31, 18 and 26).[10]

Therefore, the set of accounting standards issued by the IASB results in an intermediate position between US GAAPs, which consider the substance over form principle implicit in each accounting standard, and UK GAAPs, which consider the substance over form principle as a general postulate and basis for faithful representation.

Table 1 presents a synthetic comparison across the different sets of accounting standards.

5 The substance over form principle in the Italian context

The above analysis has observed how the substance over form principle is differently expressed in national and international accounting approaches.

Although on first approximation after the last Legislative Decree No. 139/2015 comparability among US, UK and Italian accounting approaches seems to arise, actually the Italian set of accounting standards is still characterised by a series of internal conflicting issues.

Table 1 The substance over form principle across different sets of accounting standards

	Italian civil code and GAAP	*UK GAAPs*	*US GAAPs*	*IFRSs*
Law system	Civil law	Common law	Common law	/
Principle/ rule-based accounting standards	Principle-based under the prominence of law.	Principle-based	Rule-based	Principle-based
Inclusion of the principle	Yes, in the civil code qualitative characteristics along with prudence, accrual basis, and going concern.	Yes, as a general postulate and basis for faithful representation.	No, because it is considered implicit in reliability and representational faithfulness.	Yes
Inclusion in the framework	Yes (OIC11)	No	Yes, but only after the adoption of the joint framework with the IASB (2010).	Yes (Joint framework, 2010, par. 4.6).
Inclusion in specific accounting standards	Yes	No	Yes	Yes
Overall application	Limited to few cases only.	Yes	Yes	Yes

This situation is likely due to the two-tier structure of the Italian order for company financial reporting. The law and civil code always dominates other law sources. It follows that even if accounting standards are generally accepted and issued by an authoritative body, they are submitted to law: they can both provide the correct interpretation of the law and add a further specification to law, but they can never be in conflict with a civil law rule. Thus, although the substance over form principle is expressly included in Italian accounting standards, it could be applied in strict boundaries fixed by civil law principles and rules.

Thus, by applying the European Regulation No. 1606/2002 and its enforcement in Italian law, the Italian firms that do not have to draw up their financial report according to IFRSs, provide a financial report in which the substance over form principle is adopted only in a way that raises no conflicts with the formal representation required by specific civil code rules (OIC 1, OIC 11).

By examining the contents of several Italian accounting standards, it is possible to find a series of contradicting issues in regard to application of the substance over form principle. An example is the recognition of revenues: these are reported when “the substantial property transfer occurs”, and it is a clear overlap of the juridical approach on the economic aspect of a transaction (OIC 11). Another case of incoherency regards stock accounting for which substantial property transfer is the starting point for related risks transfers as if a juridical concept could define an economic fact (OIC 13). The case of OIC 16 about property, plant and equipment is also relevant; in it, an asset is recognised depending on the property transfer to the company rather than simply the transfer of all the related benefits and risks. For the same reason, financial leases are not reported as assets on the balance sheet, with a consequent effect on the equity and the net income amounts (Alexander and Servalli, 2011).

According to these considerations, the substance over form principle *should* be a general postulate, and it *should* override both specific accounting standards and evaluation criteria because of its broad range of application; it *should not* be applied only in some extraordinary cases. Nonetheless, it is still submitted to Italian law and to specific rules that do not always require a representation of business transactions that is fully consistent with the principle itself. It appears to be a hollow and almost meaningless principle if its application range is limited only to particular cases.

The situation appears even worse if we consider that many big companies listed in Italian stock markets are mandated to draw up their financial reports according to IAS/IFRS, in which the substance over form principle is perfectly consistent with other postulates and standards: it follows that difficulty in comparing financial reports of these companies with those of other non-listed companies arises in the formal and in the substantial senses.

6 Concluding remarks

Before the 2003 reform of the corporate law, the absence of the substance over form principle in the Italian civil code could be interpreted as a lack of legitimacy of the principle itself, because of the prevalence of the juridical approach within the financial reporting discipline and the consideration of financial reporting only as a legal claim. The 2003 reform, which first included the principle in the law, pushed through a closer analysis of the potential evolution of the current Italian accounting paradigm.

The reform operated by Legislative Decree No. 6/2003 hides the attempt to reduce the distance from the common law approach. However, it is still bound by a rigid formalism even if new accounting standards have been issued for some transactions such as repurchase agreements (repos)[11] and financial leases[12] to achieve a substantial representation of the underlying economics of those operations. This attempt did not achieve its goals if we consider that there are still many conflicting issues in the Italian accounting standards system.

Surely it has been the right choice to include a specific definition of the substance over form principle in the Italian civil code again with the 2015 reform, but much still has to be done regarding financial reports’ capability of faithfully representing companies’ financial and economic situations and supporting users’ decision process. The Italian legislator should have taken the opportunity of the adoption of the Directive No. 34/2013 to remove any difference between listed companies' financial reports according to IAS/IFRS and other companies.

We do not agree that the substance over form is already implicit in the *true and fair* view postulate included in the civil code. This principle is quite abstract, and it fits certain accounting systems, such as the British one, based upon a large collection of application rules issued in accordance with that override (Higson and Blake, 1993).

In contrast, in Italian accounting standards there emerges a lack of application rules and at the same time, there are many general postulates consistent with the formalistic view of law and financial reporting. The true and fair view postulate has kept its general importance in Italian accounting standards without being immediately transposed in a series of detailed enforcement criteria.

In fact, until financial reporting objectives are quite undefined in Italian law, the general postulate of a true and fair view will hardly be enforced in a concrete way given that there are several accounting practices that could potentially be consistent with it (Capaldo, 1998).

The explicit inclusion of the substance over form principle in the Italian civil code must be intended as an effort to provide a principle with immediate concrete implications for the true and fair view postulate, rather than being a mere redundant explication.

This attempt, unfortunately, has not been brought forward and this is due to the limits of the formalistic view of financial reporting as a legal claim. Also, Alexander and Servalli (2011, p.308) propose similar conclusions as they state that the civil code regulation, appears to be a further element supporting the prevalence of a legal, prudent and conservative approach, that overcomes the expected flexibility of performance measurement from an economic perspective.

Unless a difference between financial reporting according to IAS/IFRS and to Italian civil code remains, Italian financial reports are unlikely to be the faithful representation of the underlying economics of a company, and the comparability principle will not be applied correctly.

Even if the substance over form principle has been expressly included in the civil code as a qualitative characteristic of financial reporting at the same level of *accrual basis, going concern* and *prudence* principles this does not imply its full application for the assets and liabilities, revenues and expenses recognition, which still depend on juridical aspects.

Only by considering the wider effect of the full application of the substance over form principle will the Italian accounting regulation be coherent with the international accounting standards system that relies on a conceptual framework based on a hierarchy of underlying assumption, qualitative characteristics, and accounting standards.

Lastly, this study could draw new paths for further research. In fact, this paper addresses the proposed research question by adopting a qualitative comparative research methodology and further research could be expected by adopting an empirical approach that could highlight the specific implication in financial reporting: for example, it could be useful to investigate the specific effects of the substance over form principle on financial reporting following the adoption of Italian GAAP and civil code accounting rules for non-listed Italian companies *vis-à-vis* the adoption of IFRSs for listed Italian companies.

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Notes

1 Albertinazzi (2002, p.5) argues that concepts of substance and form are not conflicting, given that substance is existing reality as matter and form joined together and form is part of substance after an abstracting process.

2 We refer to the Legislative Decree no. 127/1991, implementing both European Directives 1978/660/EC and 1983/349/EC (the so called ‘IV’ and ‘VII’ directives).

3 We refer to the Legislative Decree no. 6/2003, ‘Reform of corporate law’.

4 Also, taxation law has been modified with the Legislative Decree no. 344/2003 that has reformed the Italian taxation system.

5 We refer to the Legislative Decree No. 87/1992, Art. 5.

6 Even if with a different formulation. The present civil law formulation is: “[…] in financial report making it is necessary to refer […] to the economic purpose of a given asset or liability” (Art. 2423 *bis*). So, there is not a clear reference to the substance over form principle, but the interpretation provided by Italian accounting standards (OIC 1, 2004) makes the two definitions equivalent.

7 Both directives 2003/51/EC and 2013/34/EU amend Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings. These directives define which types of companies have to produce accounts, establish which format should be used for the profit and loss account and the balance sheet and lay down which valuation principles should be applied. The directives also impose disclosure requirements. “The IAS Regulation, adopted in June 2002, requires all EU companies listed on a regulated market – or those with listed debt instruments – to use IAS from 2005 onwards and allows Member States to extend this requirement to all companies. Where IAS are not applied, the 4th and 7th Company Law Directives (78/660/EEC and 83/349/EEC), also known as the Accounting Directives, will continue be the basis of EU accounting requirements and may therefore remain applicable to up to five million companies in Europe. They needed to be modernised. Directive 2003/51/EC brought EU accounting requirements into line with modern accounting theory and practice. It allows Member States which do not apply IAS to all companies to move towards similar, high-quality financial reporting. In doing so, all inconsistencies with International Accounting Standards (IAS) have been eliminated” (European Commission, 2006). Instead, directive 2013/34/EU aims to reduce the administrative burden for small companies. To a certain extent, it also aims to improve the quality and comparability of the information disclosed. The new directive merges and improves the two previous accounting directives (78/660/EEC, 83/349/EEC). This change, together with the so-called ‘think small first’ approach reflected in the directive, makes – this EU legislation aim for more consistency with the present and future needs of preparers and users of financial statements. With regard to the adoption of IFRSs for SMEs at the EU level, the recent directive rejected the option, but, IFRS for SMEs may be available as a voluntary option for small companies in jurisdictions where the standard is used.

8 Even if the substance over form concept appeared as early as 1973 in US accounting standards as included in the Trueblood Report issued by the *American Institute of Certified Accountants* (AICPA, 1973) with the aim of settling the objectives of financial statements, an explicit definition emerges only from accounting standard Statement of Financial Accounting Concept No. 2 – *Qualitative Characteristics of Accounting Information*, Appendix B (FASB, 1980, par. 160), that defines the concept as a ‘vague idea that defies precise definition’.

9 This pushes the FASB to face the hard task of issuing new standards as new facts or new kinds of complex transactions arise.

10 Although the substance over form principle is not explicitly included, the recognition of revenues (IAS 18), the definition of intangible assets (IAS 38), and the accounting of financial instruments (IAS 39) are clearly based on it.

11 The Civil Code Articles 2424 *bis*, 2425 *bis* and 2427, six *ter* have been modified and they settle that the assets involved in the repurchase agreement are still reported in the seller’s

balance sheet, which will also report the credits and debts for the operation. The income statement will report the revenues and expenses of the operation.

12 The Civil Code Articles 2424 and 2427, 22 have been modified, and they settle that financial leases are reported as if they were operating leases in the balance sheet and the income statement, but in the disclosure notes, a simulation is provided of the effects there would have been on equity and net income if the operation were reported as a purchase of an asset with a term loan.