



## Reflecting form over substance: the case of Enron Corp.

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### Abstract

The spectacular rise and fall of Enron Corp. offers a vivid illustration of how companies can use the legal form of transactions to obscure the economic substance underlying those transactions. The purpose of this paper is to examine Enron's use of misleading accounting practices in relation to: (1) off-balance-sheet financing; (2) revenue recognition; and (3) financial statement disclosures. In these three areas of accounting concern, the paper examines the relevant US GAAP requirements and the ways that Enron used US GAAP to conceal the economic substance underlying those transactions. It is the argument of this paper that had the concept of substance over form been applied at Enron, investors and creditors would have been provided with a more realistic view of the company's financial position and its results of operations, potentially avoiding what became the one of the largest corporate bankruptcies in US history.

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### 1. Introduction

In the wake of repeated revelations about misleading accounting practices at Enron Corp., WorldCom and other major American corporations, the US Congress passed the *Sarbanes-Oxley Act of (2002)*, which among other things mandated the Securities and

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Exchange Commission to study whether US Generally Accepted Accounting Principles (US GAAP) should be modified to focus on a principles-based rather than a rules-based approach to accounting standards setting (Financial Accounting Standards Committee, 2003; Largay, 2003; Nelson, 2002; Sarbanes-Oxley Act, 2002; Shipper, 2003). In the debates surrounding this issue it has been suggested that International Accounting Standards (IAS) emphasize a principles-based approach to accounting standards setting more than US GAAP, and that such an emphasis would have forestalled the accounting abuses that were perpetuated by Enron Corp. and others in recent years (SEC, 2003).

This paper does not seek to enter the debate about principles versus rules-based accounting standards, except with regard to one particular point. As will be shown in this paper, it is reasonably clear that International Accounting Standards emphasize the concept of “substance over form” more extensively than US GAAP. It is the argument of this paper that a uniform application of the concept of substance over form would have provided investors and creditors with a more realistic view of the financial position and results of operations of Enron. We demonstrate this argument by examining Enron’s use of US GAAP to conceal economic substance in the areas of: (1) off-balance-sheet financing; (2) revenue recognition; and (3) financial statement disclosures. In discussing these three areas of accounting concern, we examine first the relevant US GAAP requirements and then discuss how Enron used these requirements to conceal the underlying substance of transactions. We conclude the paper with recommendations for an increased emphasis on substance over form, particularly in light of continuing revelations about accounting abuses that have plagued the US capital markets in recent years.

### *1.1. The concept of substance over form*

The concept of *substance over form* has been addressed by American, British and International accounting standards setting bodies (AICPA, 1968; ASB, 1994; IASC, 2001a) with no significant resolution or consensus concerning the exact meaning of the concept. Rutherford (1985) observed that substance over form has been frequently defined in an ambiguous manner. He commented that there is a “shadowy nature to both the meaning and status” of the concept and a “confused and ambiguous nature in practice.” Histories of the evolution of the concept of substance over form suggest that the precise words emerged in a confused and haphazard manner, reflecting the ebbs and flows of particular legislative initiatives and policy pronouncements (Chastney, 1975; Rutherford, 1985). Some commentators have even questioned the very idea of economic substance with regard to financial reporting (Hines, 1988; Pentland, 2000; Power, 1997; Power, 2003).

In this paper we take the view that financial statements which reflect the economic substance of transactions rather than merely their legal form are generally preferred by financial statement users<sup>2</sup>, regardless whether currently existing financial statements do in fact present, or are even capable of presenting, economic substance. Emphasizing substance over form in financial reporting is therefore deemed to be an important and desirable goal. We offer evidence to support the argument that IASB standards emphasize substance over form more extensively than US GAAP. We additionally argue that this emphasis on

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<sup>2</sup> It would be absurd to argue that users of financial statements would prefer to have misleading information.

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