Case 4.3

Enron: A Focus on Revenue Recognition

Synopsis

In its 2000 Annual Report, Enron prided itself on having "metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people."[221] Enron's strategy seemed to pay off; in 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of $100 billion.[222] From 1996 to 2000, its revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry.[223] Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron's auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted of obstruction of justice in connection with shredding documents related to the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen's decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Background

Enron was created in 1985 by the merger of two gas pipeline companies: Houston Natural Gas and InterNorth. Enron's mission was to become the leading natural-gas pipeline company in North America. As it adapted to changes

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[221] Enron 2000 Annual Report, p. 7.

[222] Joseph F. Berardino, Remarks to U.S. House of Representatives Committee on Financial Services, December 12, 2001.

[223] Bala G. Dharan and William R. Bufkins, "Red Flags in Enron's Reporting of Revenues and Key Financial Measures," March 2003, pre-publication draft (www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), p.4.

in the natural gas industry, Enron changed its mission, expanding into natural gas trading and financing and into other markets, such as electricity and other commodity markets.

In the process, Enron made significant changes to several of its accounting procedures. For example, Enron began using mark-to-market (MTM) accounting for its trading business. Firms in the financial services industry typically used MTM to value their trading portfolios. That is, every day they adjusted the value of their portfolio according to its current value in the market.[224] Enron was the first company outside the financial services industry to use MTM accounting.[225]

Enron's Use of Mark-to-Market Accounting

In 1992, the SEC's chief accountant, Walter Scheutz, granted Enron permission to use MTM during the first quarter of its fiscal year ended December 31, 1992. However, he also indicated that MTM could be used *only* in Enron's natural gas trading business.[226] Enron's CFO, Jack Tompkin, wrote back to Scheutz informing him that "Enron has changed its method of accounting for its energy-related price risk management activities effective January 1, 1991 … the cumulative effect of initial adoption of mark-to-market accounting, as well as the impact upon 1991 earnings is not material."[227]

For some time, there has been debate about whether MTM should be used for assets that are actively traded. For certain assets, like stock portfolios, an active trading market exists and the determination of value is straight forward. However, the value of natural gas contracts were harder to assess as they often required complex valuation formulas with multiple assumptions for the formulas' variables, such as interest rates, customers, costs, and prices. These assumptions have a major impact on value and are related to very long time periods, in some cases, as long as 20

[224] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), p. 40.

[225] Bala G. Dharan and William R. Bufkins, "Red Flags in Enron's Reporting of Revenues and Key Financial Measures," March 2003, pre-publication draft (www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), pp. 7–11.

[226] Robert Bryce, *Pipe Dreams: Greed, Ego, and the Death of Enron* (New York: Perseus Book Group, 2002), p. 67

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years.

Early Application of MTM Accounting: Sithe Energies Agreement

One of the earliest contracts for which Enron employed MTM accounting was an agreement for Enron to supply Sithe Energies with 195 million cubic feet of gas per day for 20 years for a plant that Sithe was going to build in New York. The estimated value of the gas to be supplied was $3.5 to $4 billion. Interestingly, by using MTM, Enron was able to book profits from the contract even before the plant started operating.[228]

Prior to the use of MTM, Enron would have recognized the *actual* costs of supplying the gas and the *actual* revenues received from selling the gas in each time period. Using MTM, at the moment a long-term contract was signed, the *present value* of the stream of future inflows under the contract was recognized as revenues and the *present value* of the expected costs of fulfilling the contract were expensed.[229] Changes in value were recognized as additional income or loss (with a corresponding change to the relevant balance sheet account) in subsequent periods.[230]

Enron's Expanded Use of MTM Accounting

Although the SEC had initially given approval for Enron to use MTM in the accounting of natural gas futures contracts, Enron quietly began using MTM for electric power contracts and trades as well.[231] In one example, Enron signed a 15-year, $1.3 billion contract to supply electricity to Eli Lilly. Enron calculated the present value of the contract as more than half a billion dollars and recognized this amount as revenue. It also reported estimates for the

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[228] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), pp. 60–61.

[229] Bala G. Dharan and William R. Bufkins, "Red Flags in Enron's Reporting of Revenues and Key Financial Measures," March 2003, pre-publication draft (http://www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), pp. 7–11.

[230] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), p. 39.

[231] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), p. 127.

costs associated with servicing the contract. Interestingly, at the time of this contract, Indiana had not yet deregulated electricity. Thus, Enron needed to predict when Indiana would deregulate, as well as the impact of the deregulation on the contract valuation.[232]

Enron also extended MTM accounting to other business lines. In another example, Enron signed a 20-year agreement with Blockbuster Video in July 2000 to introduce entertainment on-demand. Enron set up pilot projects in Portland, Seattle, and Salt Lake City to store the entertainment and then distrinute it over its broadband network. Based on these pilot projects, Enron recognized estimated profits of more than $110 million for the Blockbuster deal, although the technical viability and market demand were difficult to predict in these initial, pilot stages.[233] Canceled in March 2001, the Blockbuster deal never reached past the initial, pilot stages.

Case Questions

1. Please consider the Sithe Energies contract described in the case. Does the use of MTM accounting violate the revenue recognition principle of GAAP? Why or why not?
2. Please refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the natural gas trading revenue recognized using MTM accounting as having a "differing level" of inherent risk than other types of revenue recognized by Enron? Why or why not?
3. Refer to Paragraph #74 of PCAOB Auditing Standard No. 2. Can you identify one point in the natural gas revenue recognition process where a member of Enron's management team might be able to perpetrate a fraudulent misstatement related to one of the relevant financial statement assertions? Please identify the assertion and use the case information to provide an example for your answer.
4. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control activity that could be designed to prevent the misstatement (that you identified in Question #3) from occurring. Next, identify one specific control procedure that could be designed to detect the misstatement (that you identified in

[232] Paul M. Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives*, Vol. 17, No. 2, Spring 2003, p. 10.

[233] Paul M. Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives*, Vol. 17, No. 2, Spring 2003, p. 10.

Question #3) from occurring.