

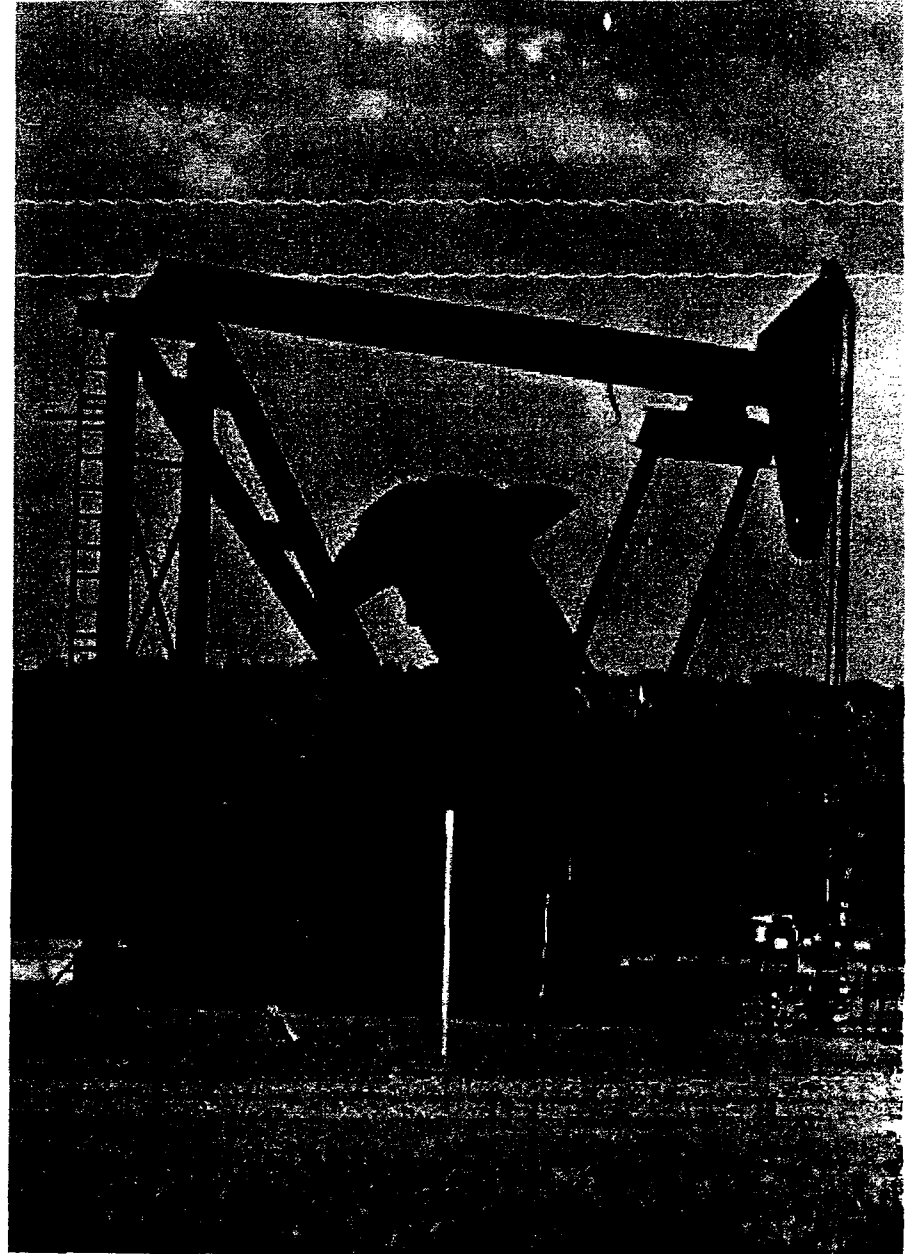
Bill-and-Hold Transactions in the Oilfield Services Sector

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Determining and defining appropriate revenue recognition has been a primary focus of companies, regulators, standard setters, and auditors in recent years. Improper revenue recognition has been one of the leading causes of financial statement restatements. Perhaps no area of revenue recognition has received as much scrutiny as "bill-and-hold" transactions. Also known as "ship-in-place" transactions, these transactions generally refer to scenarios where revenue is recognized after a seller has substantially completed its obligations under an arrangement, but prior to the buyer, or a common carrier, taking physical possession of the goods.

Background

In a recent interview, former SEC Chairman Arthur Levitt referred to recognizing revenue on bill-and-hold transactions as "hocus pocus accounting." He said, "Companies try to boost revenue by manipulating the recognition of revenue. Think about a bottle of wine. You wouldn't pop the cork on that bottle before it was ready. But some companies are doing this with their revenue—recognizing it before a sale is complete,

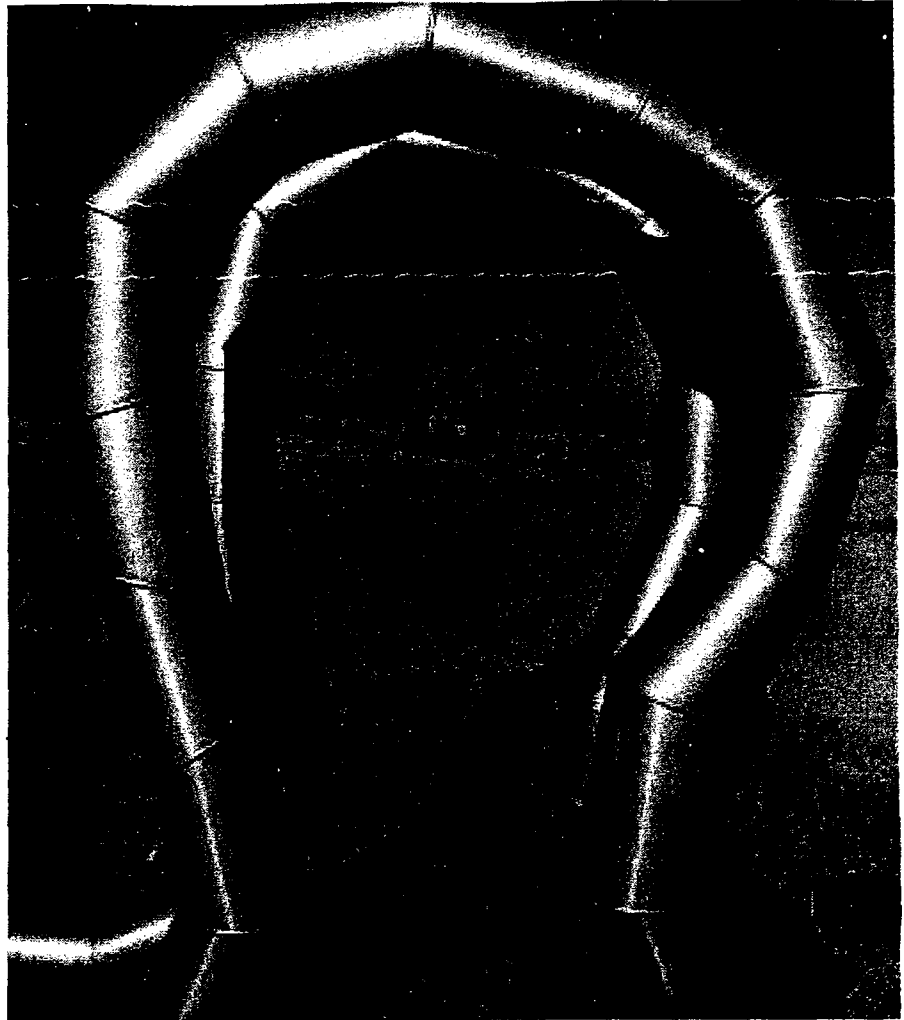


before the product is delivered to the customer, or at a time when the customer still has options to terminate, void, or delay the sale." Although the bill-and-hold transaction in itself is not a

GAAP violation, unfortunately it has long been associated with incidents of financial fraud. In its October 2002 Report on Financial Statement Restatement, the General Accounting Office (GAO) said

that revenue recognition is the largest single issue involved in restatements, more than half of financial reporting frauds involve the overstatement of revenue, and restatements for revenue recognition have resulted in the largest drops in market capitalization compared with any other type of restatements. There remains an intense scrutiny around a company's revenue recognition principles for these types of transactions, and management and auditors should be unusually skeptical about the appropriateness of recording revenue for these transactions.

Bill-and-hold scenarios frequently arise in the oilfield services sector. It is important to note that the form of these transactions is neither illegal nor unethical. In fact, most have very good business or economic purposes. For example, there is currently a trend in the oil and gas industry towards developing fields in the deep waters toward the Gulf of Mexico or other more remote locations throughout the world. Development plans for these large deepwater offshore fields, as well as remote onshore fields throughout the world, will commonly have long timelines; therefore, the oilfield service companies have long lead times for delivery of equipment and products. As the development plan gets under way, many of the original timelines and milestones will change along the way as information about the reservoir becomes better. However, many of the products that the oilfield services



companies manufacture and deliver are extremely capital intensive and will be manufactured and ready for their fixed delivery dates without regard to any changes in the development plan. These products are generally very large built-to-suit equipment such as wellhead connection equipment and completion products.

There are certain criteria that companies must meet in order to recognize revenue on bill-and-hold transactions. These

criteria relate to the risks of ownership, the commitment and request on the part of the buyer, the business purpose of the transaction, the delivery date, and the performance obligations, among others (these criteria are discussed in more detail in the next section). As an example, an oilfield services company may complete the manufacturing of the customer's requested products, have them shipped to a company-owned warehouse, determine a fixed delivery sched-

ule to the customer's well site, obtain a legal acknowledgement from the customer that the risk of loss has been transferred, and have no additional obligations to perform such as installation of the equipment. All of this may take place prior to the particular point in the well development plan that calls for the installation of the product. In this example, the oilfield services company might (although only based on careful analysis of the SEC and FASB guidance related to bill-and-hold transactions) be able to recognize revenue immediately upon completing the manufacturing process and meeting all of the bill-and-hold revenue recognition criteria.

SEC and FASB Guidance on Revenue Recognition and Bill-and-Hold Arrangements

EITF Issue 00-21: Multiple Elements in a Bill-and-Hold Arrangement

Companies must first apply the separation model described in EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*, to determine the number of units of accounting in the bill-and-hold arrangement. Bill-and-hold arrangements in this industry can include both the sale of products and the performance of certain services, such as warehousing for the product if it is shipped to a company-owned warehouse. If the SEC staff's revenue recognition criteria (discussed in the next section) are met for the product element in the bill-and-hold arrangement, rev-

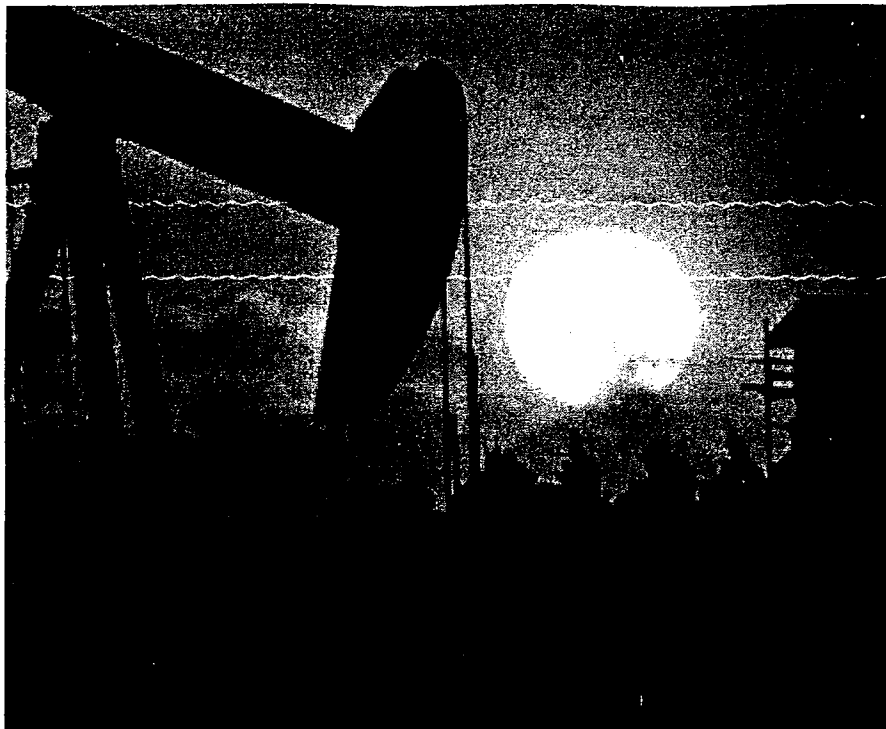
enue may be recognized on the product element when the company has completed the product *only* if it is a separate unit of accounting, or if there are any services involved in the transaction (e.g., warehousing), and those services are inconsequential or perfunctory to one unit of accounting. The company may need to consider whether the services are a separate unit of accounting, if they are inconsequential or perfunctory, and whether there are other performance obligations yet to be performed in determining the appropriate revenue recognition policy for the entire arrangement.

Inconsequential or Perfunctory Element

According to SAB No. 104, *Revenue Recognition*, if the undelivered element is both inconsequential or perfunctory and not essential to the functionality of the delivered element, it would be appropriate to recognize revenue on the arrangement at the time of delivery and accrue the cost of providing the services related to the undelivered element. However, if the undelivered element is neither inconsequential nor perfunctory or is essential to the functionality of the delivered element, the revenue for the delivered element should be deferred and recognized based on the accounting requirements of the undelivered element. The SEC's guidance on the determination of whether an element is inconsequential or perfunctory is related to whether that element is essential to

the functionality of the delivered products. In addition, remaining activities would not be inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting, or a right to a refund or to reject the products delivered. The SEC provided the following factors in SAB No. 104, which are not all-inclusive, as indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

- The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.
- The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another.
- The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.
- The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting.
- The period before the remaining obligation will be extinguished is lengthy.
- The timing of payment of a portion of the sales price is coincident with completing performance of the remaining activity.



Customer Acceptance

The SEC has also established requirements in SAB No. 104 related to customer acceptance. After delivery of a product, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs. Customer acceptance provisions may be included in a contract, among other reasons, to enforce a customer's rights to test the delivered product, require the seller to perform additional services subsequent to delivery of an initial product, or identify other work necessary before accepting the product. The SEC presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Accordingly, when such contractual cus-

tommer acceptance provisions exist, the SEC generally believes that the seller should not recognize revenue until customer acceptance occurs or the acceptance provisions lapse. Since customer acceptance provisions may preclude revenue recognition, companies should review their arrangements for these types of provisions prior to their analysis of the SEC's bill-and-hold revenue recognition criteria in SAB No. 104.

SEC Bill-and-Hold Criteria

The SEC has established specific criteria codified in SAB No. 104 that a seller of goods or equipment must meet to recognize revenue for a bill-and-hold transaction, including:

- The risks of ownership must have passed to the buyer.

- The buyer must have a commitment to purchase, preferably in written documentation.
- The buyer, not the seller, must originate the request that the transaction be on a bill-and-hold basis.
- The buyer must have a substantial business purpose for ordering the goods or equipment on a bill-and-hold basis.
- Delivery must be for a fixed date and on a schedule that is reasonable and consistent with the buyer's purpose (this requirement will generally be difficult for an oilfield services company to meet due to the variable nature of the movement of timelines and milestones for oilfield development).
- The seller must not retain any significant specific performance obligations under the agreement such that the earnings process is not complete.
- The goods or equipment must be segregated from the seller's inventory and may not be subject to being used to fill other orders.
- The goods or equipment must be complete and ready for shipment.

The SEC emphasized that that the above criteria are not a simple checklist. A transaction might meet all of the criteria and still fail the revenue recognition guidelines. The following factors also must be considered:

- The date the seller expects actual payment from the buyer and whether the seller has modified its normal billing and credit terms for the buyer

- The seller's past experiences with bill-and-hold transactions
- Whether the buyer has the expected risk of loss in the goods' or equipment's market value during the bill-and-hold phase
- Whether the seller's custodial risks are insurable and insured.

Once all of these criteria have been considered and documented for an individual arrangement, a company's senior management and audit committee should be made fully aware of the facts and circumstances. This should allow for a sound and proper conclusion on the accounting for the bill-and-hold arrangement.

Audit Committee, Management, and Independent Auditor Involvement

The audit committee, management, and the independent auditors should monitor the accounting for all bill-and-hold agreements. Specifically, management should be aware of and review in detail all significant bill-and-hold customer contracts and their related sales orders, invoices, bills of lading, shipping documents, and credit terms to ensure they are being accounted for appropriately.

Management should inform the audit committee of any significant bill-and-hold arrangements and discuss the key areas of judgment involved in accounting for these transactions.

Some of the more common pitfalls in proper revenue recognition for bill-and-hold arrangements are:

- *Fixed delivery schedule*—the fixed delivery date and the corresponding amount of time that the products may be in storage should be consistent with the company's history for those products, competitors' products, and the industry in general. Oilfield service companies should pay particular attention to this criterion since it is often difficult to designate a fixed date for future delivery of a product to the well site when there are so many variables in the development timeline. This would indicate that meeting this criterion for an oilfield services company might be rare.
- *Customer request*—the customer, not the seller, must request that the transaction be on a bill-and-hold basis (in our example, that the products be held in the warehouse), **preferably in writing**.
- *Risk of loss*—the customer must accept the risk of loss for the products while in warehouse. Careful scrutiny of the relevant legal documents is necessary to make this assessment. With regard to the oilfield services sector, in some cases title of the products will transfer to the customer, although the risk of loss still remains with the seller while the seller is warehousing the products.

- *Multiple elements*—oilfield service companies should pay particular attention to their evaluation of the services that they will perform for the customer related to the products in order to conclude on whether multiple elements of accounting exist.

The expectations from regulators and the public toward audit committees, management, and the independent auditors have increased significantly over the last several years. Consequently, more time is being spent at the top levels of management and in audit committee meetings discussing and scrutinizing company accounting policies and practices.

Since bill-and-hold arrangements in the oilfield services sector generally involve very large and complex products and equipment that carry significant amounts of economic value, and given the level of regulatory scrutiny over





these arrangements, it is expected that audit committee and senior management involvement in the assessment of these arrangements will increase. Senior management should meet regularly with the operational management of the company to gain a better understanding of these transactions and to develop or refine the company's processes for identifying transactions subject to this unique area of accounting. They should understand the key judgments and estimates used in the revenue recognition principles and whether there are any difficulties that exist in the process for accounting for these transactions.

Within the context of the Sarbanes-Oxley Act of 2002, audit committees and senior management should also consider the internal controls surrounding their bill-and-hold transactions and any necessary disclosures and presentation in the company's SEC filings. In a speech at the AICPA National Conference on Current SEC Developments, Michael Schoenfeld, the SEC's Assistant Chief Accountant, mentioned that "the staff encourages a discussion of the risks and uncertainties surrounding bill-and-hold arrangements and their potential impact on the financial statements. Such disclosure might include the company's relationship with distributors, that fixed commitments to purchase goods

are obtained prior to (revenue) recognition, and whether the company has modified its normal billing and credit terms for bill-and-hold inventory."

Action Points

As evidenced in this article, documenting and concluding on the accounting for bill-and-hold arrangements involves reading a lot of literature and having to make several judgmental decisions, making revenue recognition for bill-and-hold arrangements generally a lengthy and complex activity. Therefore, in order to facilitate this process as much as possible, the following are some significant action points to consider for bill-and-hold arrangements (not all-inclusive):

- Senior management and the audit committee should become fully engaged in the process of understanding and documenting proposed bill-and-hold arrangements and conclude on the appropriate accounting prior to entering into such arrangements.
- Companies should consult with their independent auditors about the facts and circumstances of the arrangements and their understanding of the applicable accounting literature.
- Public companies with bill-and-hold arrangements in place should consider pre-clearing proposed revenue recognition models for bill-and-hold arrangements with the SEC. ♦

This article is not intended to be prescriptive or used as guidance for companies, however, it can be used as talking points with directors or management of offfield service companies that have bill-and-hold arrangements to ensure that they will ultimately need to satisfy themselves that the appropriate amount of due diligence has been applied to the transactions, that they understand where the key judgments were applied in the process, and they have made all of the necessary disclosures surrounding the arrangements.