Synthetic FOB Destination Sales

What Are They and How Does the New Revenue Recognition Standard Affect Recognition?

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Many manufacturers and distributors ship their goods using “free on board” (FOB) shipping point terms, where title legally transfers at the time of shipment. But what if — despite the FOB shipping terms — the seller promises, or has a customary practice establishing, that goods lost or damaged in transit will be replaced or credited? In this scenario, even though title transfers upon shipment, the customer is protected from certain losses in a manner similar to FOB destination shipping point terms. Accordingly, such sales are referred to as “Synthetic FOB Destination Sales”.

Old Revenue Recognition Standard

From a revenue recognition perspective, under the old revenue recognition standard (still in effect for non-public companies for periods beginning before December 15, 2018), the seller typically defers revenue recognition until the product has been received by the customer, because this is when the true risks and rewards of ownership are substantively transferred to the customer.

If it is not practical to verify the actual delivery date to customers, typically the seller will estimate the average number of delivery days to determine the amount of deferral. For example, if the seller analyzes the actual delivery data provided by freight carriers, and determines that it takes an average of two days for a shipment to reach a customer, the seller would reverse all shipments made in the last two days of a month, and — instead — recognize that revenue in the following month.

The timing of revenue recognition for these Synthetic FOB Destination Sales may change under the new revenue recognition standard.

New Revenue Recognition Standard

Under the new revenue recognition standard, recognition occurs upon **transfer of control** to the customer, rather than transfer of risks and rewards of ownership. So, with Synthetic FOB Destination Sales, when does control transfer to the customer?

Factors to consider in assessing transfer of control include:

- legal title to the goods or services;
- ability to redirect the goods in transit; and,
- unconditional obligation to pay.

If these factors exist, they imply transfer of control of the goods. What this means under the new standard is that there may be two separate performance obligations associated with each shipment: (1) the transfer of goods, and (2) the coverage of risk of loss during shipping. Management will need to assess contract terms and business practices to make this determination.

If appropriate, the seller must allocate revenue between both performance obligations. The portion allocated to the transfer of goods (presumably the bulk of the sales dollars) would be recognized upon shipment, whereas only the smaller portion of the sale related to the coverage of risk of loss during shipping would be deferred until actual delivery to the customer, resulting in acceleration of revenue recognition by the seller in the period of adoption of the new standard.

Contact Us

If you have questions about the new revenue recognition standard or on any other accounting and auditing matters, please contact the partner in charge of your engagement or either of the partners listed:

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