

# How Choice of Incoterms Affects Revenue Recognition

By Frank Reynolds

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Most U.S. export and import pros use Incoterms 2000 in their international sales and purchase contracts for tangible goods. There is also a growing trend toward using Incoterms for domestic purchase and sales contracts. There are obvious advantages in using a single set of shipment-delivery terms for all activities regardless of the direction they take: import, export, and domestic. How does your choice of Incoterms affect the all-important question of revenue recognition? What do Incoterms have to say (or not say) regarding delivery and ownership transfer—the key criteria for revenue recognition?

## Revenue Recognition

For our purposes, revenue recognition can be simply defined as when and under what circumstances does an account receivable become a sale. This is an important issue for publicly traded U.S. companies, and guidelines are found in Topic 13 on the Securities and Exchange Commission's web site ([www.sec.com](http://www.sec.com)).

As every export-import professional knows by now, the Sarbanes Oxley Act (SOX) imposes financial integrity on publicly traded companies by making senior management personally responsible for accounting accuracy. Needless to say, the result has been focused attention and rigorous monitoring.

There are many revenue recognition case studies, but—as noted above—two criteria apply throughout:

1. Delivery, and
2. Ownership transfer.

## Delivery

In everyday speech, we often use the word “delivery” to mean arrival, as in the letter was delivered. However, “delivery” has a somewhat different meaning in contract law by referencing the place where the seller's responsibility for the condition of the contract goods ends. Contracts for the sale of tangible goods come in two categories, “shipment contracts” and “destination contracts.” In shipment contracts, sellers deliver by handing over the goods to a carrier, at which point their responsibility ends. In destination contracts, delivery happens when the goods arrive, so sellers remain responsible for the goods during transportation.

## Ownership

Most domestic business-to-business sales of tangible goods are covered by one or another state's version of the Official Uniform Commercial Code (UCC). Although the former shipment and delivery terms have been deleted from the Official UCC, Article 2-401 remains. This article acts as a “gap-filler” for contracts that are otherwise silent on this issue and provides that ownership will pass when the seller delivers. However, sellers and buyers are free to specify some other means of ownership transfer, and if this is done it will trump Article 2-401.

International sales contracts are covered by whichever body of law the parties agree applies. Again, ownership passage may be specified in the contract or covered by whatever the selected law has to say.

## Incoterms

As mentioned above, the former domestic shipment and delivery terms have been written out of the Official UCC and will likely be deleted from each state's version over time. When and as that occurs, Incoterms will become the universal shipment and delivery terms for both domestic and international transactions.

Each Incoterms clearly defines the point where delivery takes place. Incoterms are silent on ownership transfer. This can happen wherever sellers and buyers specify in their contracts or by default at delivery under UCC Article 2-401 or whatever other law may apply.

## Incoterms and Revenue Recognition

Let's now apply what we've seen to revenue recognition under Incoterms for publicly traded companies. We'll assume that the sellers want to recognize revenue at the earliest possible moment (to meet or exceed shareholder expectations, among other reasons). We can get rid of the ownership issue by assuming that sellers and buyers also agree that ownership should pass at the earliest possible moment. Specifying this in contracts avoids Article 2-401 for UCC-based contracts or similar provision on other bodies of law. These assumptions leave us to consider the revenue recognition delivery test in isolation.

Incoterms 2000 are divided into four groups:

1. Departure (EXW);
2. Main Carriage Unpaid (FCA, FAS, and FOB);
3. Main Carriage Paid (CFR, CIF, CPT, CIP); and
4. Arrival (DAF, DES, DEZ, DDU, and DDP).

Each group reflects varying degrees of seller cost and risk.

The first three groups - Departure, Main Carriage Unpaid, and Main Carriage Paid Incoterms—are all **shipment** contracts. The seller delivers by handing over the contract goods to a carrier somewhere on the seller's side. Depending on the terms, the place could be the seller's premises, a carrier's terminal, a forwarder's warehouse, or alongside or on board a ship. Revenue can be recognized as soon as this happens.

The "C" terms are the most seller friendly, as they give sellers carrier and forwarder selection. They are accompanied by places on the buyer's side as the seller pays for main carriage. Unfortunately, senior management and accountants often take this to imply destination contracts and mistakenly prohibit their use in the name of prompt revenue recognition.

The fourth group—Arrival Incoterms—are **destination** contract terms as the seller delivers somewhere on the buyer's side. (DAF when used with a location on a border of the seller's country is hybrid, as the seller delivers on the seller's side, it is definitely a destination contract term when used with any other border." Delivery on the buyer's side means deferred revenue recognition. It also theoretically implies tracing every shipment to determine the date physical delivery takes place. Revenue recognition rules provide an unfortunate unintended consequence, particularly for DDU, by either depriving sellers of an otherwise useful term or imposing delayed revenue recognition.

## Help or Hope

The SEC revenue recognition guidelines were written around the now-deleted Official UCC shipment and delivery terms, which, as mentioned earlier, coupled ownership, transfer to delivery. Again, Incoterms do not address ownership transfer at all. The question becomes whether both delivery and ownership transfer must take place for revenue recognition under terms that do not automatically transfer ownership. If so, why? If not, which event is the more important revenue recognition trigger?

The International Chamber of Commerce's U.S. affiliate, the U.S. Council for International Business (USCIB), raised this issue with the SEC early last year. There has been no reply. This issue will likely be raised again, as more and more publicly traded U.S. companies find themselves at a disadvantage in both export and domestic sales vis-à-vis foreign competition and all privately traded firms.

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