Case 17-5
Stanley & Sons

Stanley & Sons Inc. (the “Company”) assists clients by designing and implementing solutions that reduce the overall costs of its customers’ supply chains. The Company provides Just-In-Time (JIT) inventory management of spare parts used in its customers’ manufacturing processes to reduce cycle times and lower inventory-related costs.

The Company entered into a supply management contract (the “Agreement”) with Tadduni Partners (the “Customer”), an unrelated third party, to provide spare parts management services, including sourcing, procurement, repair, transport and delivery, and warehouse management.

The key terms of the agreement are as follows:

Purchase Process

- A Customer provides the Company with a plan at the beginning of the year with a forecast of spare parts that it needs as part of its manufacturing process. On the basis of this plan, the Company purchases spare parts from third-party vendors and ships the spare parts directly to the Customer’s location. The Agreement states that the Customer determines the product and service specifications and that no changes or modifications can occur without the Customer’s consent. The Company purchases spare parts directly from vendors. Note that although the Company purchased the spare parts according to the plan, the Customer is not obligated or committed to purchase these spare parts.

- The Company directly purchases from third-party vendors; the Customer is not involved in the purchasing process. Vendors name the Company in their invoices; the Customer is not named in the invoice. The Company is responsible for all payments to its vendors in purchasing the spare parts.

- When space parts are purchased by the Company, the vendor ships the spare parts directly to the Customer’s warehouse; however, the Customer does not purchase and obtain title to the spare parts in its warehouse until it issues a purchase order (P.O.) to the Company. At this point, the title of the inventory for which a P.O. has been authorized transfers from the Company to the Customer.

- The Company is responsible for the quality of the product sold to the Customer, who has the right to return any defective product to the Company.

- Purchase of spare parts by the Company is generally made in advance of receiving a P.O. from the Customer, and the Company is obligated to pay the vendors within the agreed-upon payment terms irrespective of whether the spare parts are sold to the Customer or payment is collected from the Customer.

- The Company has latitude in vendor selection and negotiates pricing with its vendors. The Company sets the price it charges the Customer on the basis of the

Company's cost plus a predetermined mark-up. If the Company is able to achieve certain cost savings for the Customer (on the basis of its ability to negotiate pricing with its vendors), it is entitled to bonus payments that are based on a percentage of such savings. Therefore, the better the Company does in negotiating savings for the Customer, the greater the margin it earns on each sale.

- Spare parts inventory that is not purchased by the Customer as part of the P.O. process (because parts are obsolete or requirements have changed) remain the property of the Company. If the Company is not able to sell the inventory to other parties, the Customer will reimburse the Company for 50 percent of the cost of the unsold parts.

Warehouse Operations

- The spare parts are held in the Customer's warehouse, allowing immediate access to the spare parts, which avoids the cost of storage for the Company.
- Although inventory is held in the Customer's warehouse, risk of loss or damage remains with the Company, and insurance is paid for by the Company.
- The Company has dedicated employees stationed at each Customer's warehouse. These employees handle the day-to-day issues with spare parts received into the warehouse.
- The Company's and Customer's inventory systems are interfaced, allowing the Company to monitor stock levels.

Shipping Terms

- As noted above, the spare parts are shipped directly from the vendors to the Customer's warehouse. The Company retains title and risk of loss during shipping and at the Customer's warehouse until a P.O. is issued by the Customer to purchase the spare parts. After the Customer issues the P.O., the title transfers, and the Company recognizes revenue.

Company Fee

- The Company receives 5.5 percent as a "consumption fee" for spare parts that are consumed (i.e., purchased) by the Customer from the warehouse. In addition, as noted above, the Company earns other fees according to its ability to negotiate favorable pricing on the spare parts.

Required:

- How should the Company report revenue related to this arrangement?