Project **Revenue Recognition**

Topic **Obligations for product warranties and product liability**

Introduction

Purpose

1. The purpose of this paper is to:

   (a) reconsider whether all product warranties give rise to separate performance obligations, as proposed in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*;

   (b) consider whether product liability laws give rise to performance obligations.

Summary of recommendations

2. This paper recommends that:

   (a) if the objective of a warranty is to provide a customer with cover for defects that *exist when* the asset is transferred to the customer, that warranty does not give rise to a separate performance obligation. Instead it acknowledges the possibility that the entity has not satisfied its performance obligation to transfer the asset specified in the contract. Therefore, on the basis of all the available evidence, the entity must determine at the end of the reporting period the likelihood and extent of defects in the assets it has sold to customers and, hence, the amount of

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unsatisfied performance obligations with respect to those assets. Therefore:

(i) if the entity will be required to replace defective assets, it does not recognise revenue for those assets;

(ii) if the entity will be required to repair defective assets, it does not recognise the portion of revenue that can be attributed to components that need to be replaced in the repair process.

(b) if the objective of a warranty is to provide a customer with cover for faults that *arise after* the product is transferred to the customer, that warranty gives rise to a separate performance obligation. Therefore, the entity allocates part of the transaction price to that warranty performance obligation.

(c) if the law requires an entity to pay compensation if its products cause harm or damage, that requirement does not give rise to a performance obligation. The entity accounts for such obligations in accordance with ASC Subtopic 450-20 *Loss Contingencies* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Structure of the paper

3. This paper is organised as follows:

(a) Background (paragraphs 4–7)

(b) Feedback from respondents (paragraphs 8–9)

(c) Reconsidering whether all warranties are the same (paragraphs 10–15)

(d) Accounting implications (paragraphs 16–26)

(e) Drawing the line between the two types of warranty (paragraphs 27–32)

(f) Product liability (paragraphs 33–35).

Background

4. The Discussion Paper proposed that all product warranties (whether described as a manufacturer's warranty, a standard warranty or an extended warranty) give rise to a separate performance obligation for an entity—the promised asset being the service of warranty coverage. That is because all such warranties were viewed as resulting in the same obligations for an entity—to stand ready to replace or repair the product over the term of warranty.

5. In particular, the Discussion Paper emphasised that a manufacturer's or standard warranty (ie a warranty that is not sold separately) gives rise to a separate performance obligation.

6. Consequently, the Discussion Paper proposed that:

    (a) in any contract for the sale of a product including a warranty, an entity would be required to determine the standalone selling price of that warranty to allocate some of the transaction price to it, even if that warranty is never sold separately by the entity or other entities.

    (b) the amount of the transaction price allocated to the warranty would be recognised as revenue only when the promised warranty services are transferred to the customer.

7. The Discussion Paper noted that these proposals would change current practice.

    (a) In US GAAP, a warranty is treated as a performance obligation in the contract with revenue attributed to it only if it is a 'separately priced extended warranty'.[1] Otherwise, no revenue is attributed to the warranty. Instead, when an entity transfers the related product to the customer, it recognises a warranty obligation and a corresponding expense in accordance with ASC paragraphs 460-10-25-5 to 25-7 on

[1] ie an agreement under which the customer has the option to buy 'warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty' for 'an expressly stated amount separate from the price of the product' (ASC Master Glossary).

warranty obligations incurred in connection with the sale of goods or services (formerly FAS 5 *Accounting for Contingencies*).

(b) In IFRSs, a warranty is treated as a performance obligation only if deemed to be a 'separately identifiable component' of the contract. Otherwise, similarly to the treatment in US GAAP, an entity recognises a warranty obligation and a corresponding expense in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Feedback from respondents

8. Comments from some respondents implied that they agreed that a manufacturer's or standard warranty may in concept be a separate performance obligation. Nonetheless, these respondents questioned whether the cost and effort involved in the resulting accounting would be justified in terms of providing useful information, especially if the warranty period is relatively short. In particular, respondents were concerned about the need to determine the standalone selling price of a warranty that is never sold separately.

9. But most respondents who commented on this topic disagreed that all warranties give rise to separate performance obligations. Many commented similarly to the following:

> … it seems to us that some [warranties] may meet the definition of a performance obligation while others may not. For example, under a contract to supply goods, a warranty that the quality of goods is as agreed in the contract does not appear to be a separate performance obligation. The only performance obligation is to deliver goods of the agreed quality. If this has not been done, the performance obligation relating to the goods has not been satisfied. Conversely, some 'extended warranties' should be regarded as separately identifiable components of a revenue transaction, because they create potential obligations to the customer that will not exist if the customer chooses to buy goods without taking an extended warranty. (Deloitte)

Reconsidering whether all warranties are the same

10. The staff agrees that not all promises described as warranties in contracts are the same. That is because it could be argued that there is a distinction between:

    (a) a warranty in which the objective is to provide the customer with cover for manufacturing defects, ie defects that *exist when* the product is transferred to the customer (a 'quality assurance warranty'); and

    (b) a warranty in which the objective is to provide the customer with cover for faults that *arise after* the product is transferred to the customer (an 'insurance warranty').

11. The former is a warranty in the general sense of the words, ie 'an assurance, promise, or guarantee by one party that a particular statement of fact is true and may be relied upon by the other party'.[2] In this context, the warranty is a promise that the product is free from defect at the time of sale. However, that promise does not provide any additional service (utility) for the customer: the entity and the customer entered into a contract for the transfer of a product that was not defective.

12. In contrast, with the latter, the entity is providing a service in addition to the promise to provide a product that was not defective at the time of sale. The entity is promising to repair or replace the product if it breaks down within a specified period (normally subject to some conditions). This additional service is an insurance contract (often marketed to retail customers as 'buying peace of mind' and often provided by separate entities, which in some cases are regulated insurers).

13. In some cases, the law requires entities to provide warranties with the sale of their products. The law might state that an entity is required to repair or replace products that develop faults within a specified period from the date of sale. That might suggest that the law is requiring the entity to provide an insurance

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[2] West's *Encyclopedia of American Law*

warranty on the sale of its products, because the warranty appears to cover faults arising *after* the date of sale, not just defects existing *at* the date of sale.

14. However, in many such cases, the law can be viewed as simply operationalising a quality assurance warranty. In other words, the *objective* of the warranty remains the same: to protect the customer against the risk of purchasing a defective product. But rather than having to determine whether the product was defective at the point of sale, it is *presumed* that if a fault arises within a specified period (which can vary depending on the nature of the product) then the product was defective at the point of sale.[3]

15. The key distinction for the accounting between the two types of warranties is that:

    (a) for the insurance warranty, after transfer of the product to the customer, the entity *definitely* has an obligation to provide warranty coverage (ie to stand ready to repair or replace product)—the event on which the ultimate outflow of resources is conditional is a *future event*, a fault arising.

    (b) in contrast, with the quality assurance warranty, whether the entity has an obligation is conditional on a *past event*, ie a manufacturing defect. After transferring a product, the entity *possibly* has an obligation—ie if the product was defective on transfer the entity has an obligation, if it was not defective, the entity does not. Typically, the entity would have data that would indicate the likely number of defective products that have been transferred to customers.

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[3] These alternative ways of analysing warranties are consistent with those identified in a paper on stand-ready obligations prepared by the IAS 37 project team and discussed by the Board in June 2009. Paragraph 52 of that paper (Paper 4D) noted that any conclusion on how entities should account for statutory warranties might depend on whether the terms of the warranties were such that their effect was to remedy manufacturing defects or protect against later faults.

Accounting implications

16. If the boards agree that a distinction can be drawn between a quality assurance warranty and an insurance warranty, how would that affect the accounting under the proposed model?

Insurance warranty

17. For the insurance warranty, the entity has (a series of) performance obligations to provide warranty coverage. Those performance obligations would constitute a contract segment. The entity would allocate some of the transaction price to that segment relative to the standalone selling price of the warranty. The entity would then recognise revenue over time as it provides the warranty coverage. The accounting would therefore be as proposed in the Discussion Paper.

Quality assurance warranty

18. For the quality assurance warranty, there might be two ways of viewing the entity's position after transferring the product:

    (a) recognise a separate warranty obligation; or

    (b) recognise an unsatisfied performance obligation.

Recognise separate warranty obligation

19. Under this view, the entity would be considered to have satisfied its performance obligation once the product has been transferred to the customer. The entity would then judge, on the basis of all the available evidence, whether or not the product was defective and, if so, recognise a liability for its obligation to replace or repair that product. For example:

> Suppose ElectronicsCo has sold 1000 televisions in the previous six months. ElectronicsCo is required to replace any televisions that were defective at the time of sale. In ElectronicsCo's jurisdiction, the law presumes that any television that develops a fault within six months of sale was defective at the date of sale.
>
> ElectronicsCo's past experience suggests that manufacturing defects arise in 1% of its televisions. (For simplicity assume that ElectronicsCo does not repair the defective televisions and resell them as refurbished or 'nearly new' televisions. That scenario is considered in the Appendix.)
>
> Under this view ElectronicsCo would recognise revenue for the sale of 1000 televisions and recognise a liability for the obligation that it judges that it has incurred (ie to replace 10 televisions).
>
> (Whether ElectronicsCo recognises all of the margin from the sale of the televisions depends on how that liability is measured (ie whether the measurement includes a margin).)

20. This view would be:

    (a) similar to current practice for warranties relating to contracts for the sale of goods that are not considered a separately identifiable component of the contract (IFRSs) or that are not separately priced extended warranties (US GAAP); and

    (b) supported by many respondents. These respondents note that most such warranties are a small part of the contract and may even be immaterial to the contract. It therefore might be impractical to attribute some of the transaction price to each warranty. However, the outstanding portfolio of warranties at any financial statement date is likely to be material and, therefore, needs to be reflected in the statement of financial position.

Recognise an unsatisfied performance obligation

21. Under this view, the uncertainty about whether the product was defective when transferred to the customer means that it is uncertain whether the entity satisfied its performance obligation, ie whether the entity has, in fact, transferred to the customer a product that was not defective. The entity would judge, on the basis

of all the available evidence, whether or not the product was defective and, if so, continue to recognise the performance obligation for that product. For example:

The facts are the same as above. Under this view ElectronicsCo would recognise revenue for the sale of 990 televisions (ie for the performance obligation that it judges that it has satisfied) and recognises a contract liability for the 10 performance obligations that it judges remaining outstanding. Hence revenue and profit from the sale of 10 televisions is deferred until the remaining performance obligations are satisfied.

Analysis

22. Of these two views, the staff thinks the second view is more consistent with the proposed model. In particular the staff notes:

    (a) At contract inception, the entity incurred a performance obligation to transfer a working product to the customer. That obligation is not satisfied if the entity has transferred a defective product to the customer—the sale has failed.

    (b) If the entity has transferred a defective product to the customer, it has not satisfied its performance obligation. However, if it recognises a separate warranty obligation and measures that obligation at cost (as it would at present under ASC Topic 460 *Guarantees* (formerly FAS 5) and might at present under IAS 37), then the entity has recognised not only all of the revenue but also all of the margin in the contract. Although some respondents argue that the entity should recognise manufacturer's or standard warranties at the expected *cost* to replace or repair the products, the staff thinks it is inappropriate to recognise all of the margin before all the performance obligations in a contract have been satisfied.

    (c) Treating performance obligation as unsatisfied in products with manufacturing defects is consistent with the accounting for a construction contract under IAS 11 *Construction Contracts*. This specifies that contract costs include 'the estimated costs of rectification

and guarantee work, including expected warranty costs'.[4] Hence, an entity applying percentage of completion accounting using the proportion of contract costs incurred to date to estimated total contract costs does not recognise all of the revenue (and margin) from a construction contract until it expects to incur no more rectification, guarantee and warranty costs.

(d) Although a cost-based approach might be the simplest way of accounting for warranties, the staff thinks that the failed sale approach would also be more intuitive and simpler for some warranties than the separate performance obligation approach proposed in the Discussion Paper. In particular, entities would not have to estimate the standalone selling price of such warranties—which are never sold separately—they just have to determine what proportion of performance obligations have not been satisfied.

Obligation to repair the product

23. The above examples of quality assurance warranties assume that the entity replaces the supplied product. There was therefore a failed sale for the whole set of performance obligations relating to the product and, accordingly, all of the revenue on the sale of a defective product was deferred.

[4] IAS 11, paragraph 17(g)

24. In other cases, instead of having failed to satisfy the whole set of performance obligations, the entity will have failed to satisfy only some of its performance obligations relating to the product. Typically in such cases, the entity will rectify those unsatisfied performance obligations (rather than replace the whole product). For instance:

> Homebuilder enters into a contract for the sale of a house. The house transfers to the customer on 31 December.
>
> Homebuilder is required to rectify any defects from its construction work.

25. In cases similar to the above example, entities would typically have satisfied most of their performance obligations in the contract—only a few performance obligations would remain. For instance, Homebuilder may have installed some defective piping or there may have been poor workmanship on some tiling. Hence, Homebuilder would judge, on the basis of its experience, which performance obligations have not been satisfied and defer some of the revenue accordingly. In concept that would require Homebuilder to determine the standalone selling price of the goods and services to be replaced and allocate the transaction price accordingly. In practice, Homebuilder might be able to achieve the same outcome by estimating the costs and adding a margin.

26. Similarly, in a continuous-delivery contract for the construction of a 100-mile highway, at completion of the construction, the constructor's experience might suggest that one mile of the highway needs to be resurfaced because some of the tarmac was of poor quality. The constructor would therefore judge that it has not satisfied all of its performance obligations and would defer some of the revenue.

Drawing the line between the two types of warranty

27. As noted above, at present under US GAAP, an entity identifies warranties that should be treated as separate performance obligations on the basis of whether they are separately priced extended warranties. In IFRS, an entity determines

whether the warranty is a separately identifiable component of the contract, ie whether it is a service delivered separately from the product.

28. The staff thinks that in the proposed model the entity must determine the objective of the warranty:

    (a) If the objective is to provide a customer with cover for defects that *exist when* the asset is transferred to the customer, then the warranty does not give rise to a separate performance obligation.

    (b) If the objective is to provide a customer with cover for faults that *arise after* the product is transferred to the customer, then the warranty gives rise to a separate performance obligation.

29. In most cases determining the objective of the warranty should be straightforward. For instance, if the warranty is required by law, then typically it would be expected that its objective is the former—to provide cover for defects that exist at the point of sale. If the warranty is an optional extra in the contract, then typically it would be expected to be the latter.

30. More difficult cases might arise if an entity sells as part of an overall package a longer duration warranty. For example:

> As part of a year-end promotion, ElectronicsCo sells televisions with a five-year warranty for CU1,000. (No part of the warranty is offered as an optional extra nor separately priced.)

31. In such cases, an entity would need to exercise judgement to determine the type of warranty being provided. For instance, in the above example, ElectronicsCo might consider the normal terms and conditions of sales of televisions and conclude that since warranties for manufacturing defects in its contracts normally cover only a year, part of the warranty is an insurance warranty. Therefore, although ElectronicsCo did not offer the warranty as a separately-priced optional extra, it has included an insurance warranty in its contract and, hence, would treat that warranty as a separate performance obligation.

32. In contrast, consider an entity that sells specialised machinery on which it provides a warranty for five years. The entity might conclude that it is

warranting that the machine has been built to last for at least five years and, therefore, that the warranty is a quality assurance warranty rather than an insurance warranty.

Staff recommendation and question for the boards

Question 1

The staff recommends that:

(a) if the objective of a warranty is to provide a customer with cover for defects that *exist when* the asset is transferred to the customer, that warranty does not give rise to a separate performance obligation. Instead it acknowledges the possibility that the entity has not satisfied its performance obligation to transfer the asset specified in the contract. Therefore, on the basis of all the available evidence, the entity must determine at the end of the reporting period the likelihood and extent of defects in the assets it has sold to customers and, hence, the amount of unsatisfied performance obligations with respect to those assets. Therefore:

(i) if the entity will be required to replace defective assets, it does not recognise revenue for those assets;

(ii) if the entity will be required to repair defective assets, it does not recognise the portion of revenue that can be attributed to components that need to be replaced in the repair process.

(b) if the objective of a warranty is to provide a customer with cover for faults that *arise after* the product is transferred to the customer, that warranty gives rise to a separate performance obligation. Therefore, the entity allocates part of the transaction price to that warranty performance obligation

Do the boards agree?

Product liability

33. A related issue to consider, and one raised by a number of respondents, is whether product liability laws give rise to performance obligations. For example:

> ElectronicsCo sells televisions in a jurisdiction in which the law specifies that electrical products must be 'fit for purpose'. Accordingly, if a television were to cause damage to property or harm to people (for instance if it were to explode), ElectronicsCo would be liable for damages.
>
> Does ElectronicsCo's sales contract for televisions include a (stand ready) performance obligation for product liability—ie to pay damages?

34. The staff thinks that the requirement for ElectronicsCo to pay compensation if one of its products caused harm or damage is not a performance obligation because:

    (a) ElectronicsCo's performance obligation in the contract is to provide a television that is not defective. ElectronicsCo fulfils that obligation by either supplying a television that is not defective or, if it supplies a defective television, replacing it with another one that is not defective.

    (b) the possible need for ElectronicsCo to pay compensation for the damage or harm that its television causes is separate from the performance obligation. It arises from the general duty imposed in ElectronicsCo's jurisdiction to conduct one's activities without damaging property or harming people. This duty is a general duty owed by all members of society. Only a breach of this duty gives rise to a present obligation that is specific to ElectronicsCo.

    (c) ElectronicsCo's exposure to product liability arises whenever it releases defective televisions into the public domain—it does not arise only because it enters into contracts with customers. For instance, ElectronicsCo could be liable if its televisions caused harm while on display in a shop.

35. In this example, if ElectronicsCo has released *defective* televisions into the public domain (by sale or otherwise), ElectronicsCo has an unconditional (stand ready) obligation[5] to pay any compensation that results from that release. ElectronicsCo would account for that obligation separate from the contract with the customer and in accordance with IAS 37 and ASC Subtopic 450-20 *Loss Contingencies*.

Question 2

The staff recommends that if the law requires an entity to pay compensation if its products cause harm or damage, that requirement does not give rise to a performance obligation. The entity accounts for such obligations in accordance with ASC Subtopic 450-20 *Loss Contingencies* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Do the boards agree?

[5] The conditional future event in this stand ready is the damage that a defective television that has been released might cause. In practice, this liability would typically be quite small because as soon as Entity had evidence that it released defective televisions, it would be likely to trigger a product recall.

Appendix

A1. In the examples in paragraph 21, it was assumed that ElectronicsCo replaced the defective televisions that it had supplied to customers and did not subsequently repair those televisions.

A2. However, ElectronicsCo may repair the defective televisions and subsequently sell them as refurbished televisions. In such cases, how should it account for the inventory?

A3. This paper recommends that if an entity has transferred a defective product and will replace that product, it has not satisfied its performance obligations with respect to that product. Because the boards concluded that an entity has satisfied a performance obligation only when the customer obtains control of the asset, it could be argued that a customer that receives a defective asset has not obtained control of the asset and, accordingly, it remains an asset of the entity. For instance:

> Suppose ElectronicsCo has sold 1000 televisions in the previous six months for CU1,000 each.
>
> Its production cost of each television is CU400.
>
> ElectronicsCo's past experience suggests that it will need to replace 1% of televisions sold. After refurbishing each television, ElectronicsCo sells them as refurbished televisions.

A4. In this example, ElectronicsCo judges that it has transferred 10 defective televisions, hence it recognises:

(a) Revenue: CU990,000 (ie 990 x CU1,000)

(b) Cost of goods sold: CU396,000 (ie 990 x CU400)

A5. ElectronicsCo has a remaining inventory balance of CU4,000 (ie 10 x CU400). Electronics would need to test that this amount (after reflecting the costs to repair the televisions) does not exceed the net realisable value of the televisions.