



Project	Revenue Recognition
Topic	Accounting for product warranties

Purpose and staff recommendation

1. This paper seeks the Boards' views on whether an entity should allocate revenue to all product warranties and, if not, to which warranties an entity should allocate revenue. In other words, the paper seeks the Boards views on whether an entity should account for a product warranty as a separate performance obligation (in accordance with the revenue standard) or as a warranty obligation (in accordance with other standards).
2. The staff recommends that:
 - (a) An entity should account for a product warranty as a separate performance obligation in accordance with the revenue standard if the warranty provides a service to the customer in addition to assurance that the delivered product is as specified in the contract.
 - (b) An entity should account for a product warranty as a separate warranty obligation in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, or *FASB Accounting Standards Codification*[®] Topic 450, *Contingencies*, if the warranty provides the customer with assurance that the delivered product is as specified in the contract.
3. This paper is organized as follows:

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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- (a) Proposals in the Exposure Draft (paragraphs 4–8)
- (b) Feedback on the Exposure Draft (paragraphs 9–13)
- (c) Reconsidering whether all warranties are performance obligations (paragraphs 14–19)
- (d) Determining which warranties should be accounted for as a separate warranty obligation (paragraphs 20–28).

Proposals in the Exposure Draft

- 4. In the Exposure Draft, *Revenue from Contracts with Customers*, the Boards proposed to account for a product warranty depending on the warranty’s objective. An entity would assess whether the warranty’s objective was to provide coverage for either:
 - (a) Defects that exist when the product is transferred to the customer (a “quality assurance warranty”); or
 - (b) Faults that arise after the product is transferred to the customer (an “insurance warranty”).
- 5. The former is a warranty that the product is free from defect at the time of sale. The Boards proposed that this type of warranty does not provide the customer with a service in addition to the promised product. Hence, it would not give rise to a separate performance obligation. For this type of warranty, paragraph IG16 of the Exposure Draft specifies that an entity would recognize revenue only for products (or components of products) that are transferred to customers in the condition promised to customers. Otherwise, the entity would not have satisfied its performance obligations.

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6. In contrast, paragraph IG17 of the Exposure Draft states the latter type of warranty gives rise to a performance obligation for warranty services in addition to the performance obligation to transfer the promised product. Therefore, an entity would allocate the transaction price (on a relative standalone selling price basis) between the promised product and the promised warranty service.

Background

7. The reason for the proposed distinction between the two types of warranties was because of the feedback on the December 2008 Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*. The Discussion Paper proposed that all product warranties give rise to a separate performance obligation to which revenue would be attributed—the promised asset being the service of warranty coverage. The view was that all product warranties result in the same obligations for an entity—to stand ready to replace or repair the product over the term of warranty.
8. Some respondents to the Discussion Paper acknowledged that a standard warranty may, in concept, be a separate performance obligation. However, most respondents disagreed that all warranties give rise to separate performance obligations and argued that some product warranties are different from others.

Feedback on the Exposure Draft

9. Some respondents to the Exposure Draft agree, in concept, with the proposed distinction between quality assurance warranties and insurance warranties. However, almost all respondents stated that it may be difficult in practice to determine *when* a fault has arisen in a product. For example,
 - (a) In the manufacturing industry, products often go through rigorous inspection processes before delivering a good to the customer and an entity may not be aware of faults at the time of delivery.

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- (b) In the software industry, it is not clear how an entity would determine whether a software bug fix is repairing a latent defect or a defect that occurred after the product was transferred to the customer.
10. Some respondents noted that because an amount of revenue is deferred for either type of warranty, it would not be cost beneficial to distinguish between the two types. In addition, some respondents highlighted potential differences in the subsequent accounting for each type of product warranty.
11. Other respondents argued that revenue deferral does not represent the underlying economics of some warranties, specifically standard warranties. The following comment letters noted:
- ... the fact remains the customer will often have the full use and benefit of the product during virtually the entire warranty period. Deferring all related revenue and product costs during some or all of the warranty period does not reflect the true underlying economics of the sales transaction and supports the more appropriate view that standard warranties should be accounted for as costs of the sale of the product. [CL #316]
- Accordingly, we do not view the provision of the (standard) warranties as a revenue generating activity; rather, that these warranties are an inherent cost of providing our products to our customer. Our process for ensuring product quality includes the screening, testing and removal of defective products. Increases or decreases in quality levels impact the cost of our products, not the revenue generating opportunities. [CL #108]
12. A few respondents noted their support for deferral of revenue for all warranties by accounting for all warranties as separate performance obligations. However, most respondents instead suggested that the Boards make a distinction between both of the following:
- (a) A standard warranty, which should be accounted for as a warranty obligation (cost accrual) in accordance with existing standards (that is, IAS 37, and Topic 450); and

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- (b) An extended warranty that is separately priced, which should be accounted for as a separate performance obligation consistently with the guidance on separately priced extended warranties in Section 605-20-25.
13. Most respondents consider an extended warranty that is separately priced to be a separate performance obligation because it clearly is a separate service to the customer. In contrast, many respondents do not consider a standard warranty to be a separate performance obligation. They argue that an entity only has a performance obligation to transfer the product to the customer. Any subsequent repairs or replacements are additional costs of providing the product and, therefore, relate to an entity's past performance.

Reconsidering whether all warranties are performance obligations

14. The staff agrees with respondents' concerns that the proposal in the Exposure Draft is overly complex because it would require an entity to distinguish between different types of warranties even though the overall effect of the accounting is largely similar (that is, revenue deferral). It is also complex for an entity to continue to recognize "inventory" for products that have been delivered to customers. Therefore, the staff notes that there are two alternatives on how an entity should account for warranties:
- (a) Account for all warranties as a separate performance obligation (allocate revenue to the warranty); or
 - (b) Account for some warranties as a separate warranty obligation (do not allocate revenue to the warranty).

Account for all warranties as a separate performance obligation

15. This alternative is consistent with the Boards' preliminary view in the Discussion Paper that all warranties result in separate performance obligations. Hence, an entity would allocate a portion of the transaction price to that performance

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obligation. Because many respondents are concerned about the practicality of that proposal, the Boards could clarify how an entity would apply the requirement. For instance, for many short-duration warranties, an entity would not need to estimate a standalone selling price for the warranty. Instead, the entity could estimate the costs to fulfill the warranty obligation and in addition apply either the total contract margin percentage to those costs or an appropriate profit margin.

16. This alternative would:
 - (a) Eliminate the difficulty of an entity distinguishing between warranties based on the warranty's objective. Thus, an entity would no longer have the challenge of determining when a defect occurs.
 - (b) Result in consistent accounting for all product warranties.

Account for some warranties as a separate warranty obligation

17. This alternative would maintain the proposal in the Exposure Draft that not all contractual promises described as warranties are the same and, consequently, not all warranties result in separate performance obligations. However, it would result in some warranties being accounted for as a separate warranty obligation rather than as a separate performance obligation. In other words, no revenue would be attributed to those warranties. Instead, when an entity transfers the related product to the customer, it would recognize a warranty obligation and a corresponding expense. The warranty obligation would be measured in accordance with Topic 450 under U.S. GAAP and IAS 37 under IFRSs.
18. This alternative would:
 - (a) Be consistent with current practice. In U.S. GAAP and IFRSs, warranties that are not separately priced (U.S. GAAP) or deemed to be a "separately identifiable component" (IFRSs) have no revenue attributed to them. This alternative therefore would allow for easier implementation.

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- (b) Result in an entity recognizing not only all of the revenue but also probably the entire margin in the contract once the product has been transferred to the customer (assuming there are no remaining performance obligations).

Staff recommendation

19. Of these two alternatives, the staff recommends the second alternative. In particular the staff notes the following:
 - (a) If the first alternative is selected, the Boards would need to develop simplifying guidance to make the alternative more practical for many short-duration warranties (for example, a typical one-year manufacturer's warranty that is not sold separately). If that guidance is developed, the staff questions, on a cost-benefit basis, the additional value of the incremental information that would be provided under the first alternative.
 - (b) Many warranties that an entity would account for using a warranty obligation are relatively short term and a small part of the overall transaction. Therefore, it is questionable whether it would be worthwhile to attribute some of the transaction price to such warranties, especially because many respondents do not view them as part of the revenue transaction. However, the portfolio of remaining warranties at any reporting date would likely be material and, therefore, would need to be reflected in the statement of financial position. The second alternative would achieve this in a practical way.
 - (c) Similarly, although the second alternative would result in the entity recognizing the entire margin on the contract when the product is transferred to the customer, this would be unlikely to result in any significant distortion of the recognition of the overall contract margin.

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Question for the Boards

Question 1

The staff recommends that an entity account for some product warranties as a separate warranty obligation rather than a performance obligation. Do the Boards agree?

Determining which warranties should be accounted for as a separate warranty obligation

20. If the Boards agree that an entity should account for some warranties as a separate warranty obligation, then the staff thinks there are two alternatives for determining which warranties should be accounted for on that basis:
- (a) Warranties that are not separately priced; or
 - (b) Warranties that the entity deems to be “quality assurance” rather than insurance.

Warranties that are not separately priced

21. Under this alternative, warranties not priced separately in the contract would be accounted for as a warranty obligation (cost accrual). A separately priced warranty (for example, an extended warranty) would be treated as a performance obligation in the contract with revenue attributed to it. For example:

ApplianceCo sells a microwave with a four-year warranty. ApplianceCo sells this microwave (inclusive of the warranty) for CU660. A competitor sells an identical microwave with a one-year warranty for CU630, while an unrelated company offers an extended three-year warranty on the competitor’s microwave for CU45.

Under this alternative, when ApplianceCo transfers the microwave to the customer, it would recognize revenue of CU660 and recognize a warranty liability and expense.

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22. This alternative would be consistent with existing U.S. GAAP. Many respondents stated that the current guidance for warranties is straightforward and well understood by users of financial statements.

Warranties that the entity deems to be “quality assurance”

23. Under this alternative, the entity would judge, on the basis of all the available evidence, whether the objective of the warranty is:
- (a) To provide the customer with assurance that the promised product is as specified in the contract; or
 - (b) To provide a service to the customer in addition to the delivered product as specified in the contract.
24. This alternative, therefore, would carry forward the principles in the Exposure Draft for distinguishing between different types of warranties. However, the accounting for a product warranty would differ depending on the warranty’s objective.
25. If the objective of the warranty is to provide the customer with assurance that the delivered product is as promised in the contract, the entity would account for the warranty as a warranty obligation (cost accrual). If the objective of the warranty is to provide a service to the customer in addition to providing the product as promised in the contract, the entity would recognize a separate performance obligation with revenue attributed to it.
26. The staff notes that in many cases, the results under the two proposed alternatives would be the same because warranties that provide a service in addition to the promised product are typically an optional extra and, hence, separately priced. However, in some cases, the second alternative would result in an entity identifying a separate performance for the warranty even though it is not a separately priced part of the contract. For example:

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The facts are the same as above.

Under this alternative, ApplianceCo would assess the objective of the warranty considering:

- (a) Whether similar appliances come with a one-year warranty; and
- (b) Whether other entities sell the additional warranty separately.

If similar appliances come with a one-year warranty and other entities sell additional warranty coverage separately, that would suggest that ApplianceCo has promised a service in addition to a product. Hence, ApplianceCo would recognize two separate performance obligations—one for the microwave with the one-year warranty and one for the extended three-year warranty.

ApplianceCo would allocate the transaction price to the two performance obligations. It would allocate CU616 ($660 \times 630 / (630 + 45)$) to the microwave and CU44 ($660 \times 45 / (630 + 45)$) to the warranty.

The revenue attributed to the microwave would be recognized when the microwave is transferred to the customer because ApplianceCo has fulfilled that performance obligation. In addition, a warranty expense and liability would be recognized for the initial one-year warranty. However, the revenue attributed to the extended warranty would be deferred and recognized over the related three-year period.

27. This alternative would:

- (a) Remove the bright line in U.S. GAAP of distinguishing between different types of warranties based solely on whether the warranty is separately priced. Hence, the entity could not structure the warranty to achieve the desired accounting.
- (b) Result in the same accounting under current guidance for most warranties.

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Staff recommendation

28. Of the two alternatives, the staff recommends the second because it would result in a clear principle that allows an entity to account for economically similar warranties in a similar manner, regardless of whether the warranties are separately priced.

Question for the Boards

Question 2

The staff recommends that:

- (a) An entity should account for a product warranty as a separate performance obligation in accordance with the revenue standard if the warranty provides a service to the customer in addition to assurance that the delivered product is as specified in the contract.
- (b) An entity should account for a product warranty as a separate warranty obligation in accordance with IAS 37 or Topic 450 if the warranty provides the customer with assurance that the delivered product is as specified in the contract.

Do the Boards agree?