

STAFF PAPER

March 30, 2015

Project	FASB/IASB Joint Transition Resource Group for Revenue Recognition		
Paper topic	Warranties		
CONTACT(S)	Andrew Winters	ajwinters@fasb.org	+1 203 956 5364
	Kristin Floyd	knfloyd@fasb.org	+1 203 956 5384
	Raghava Tirumala	rtirumala@ifrs.org	+44 207 246 6953

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB | IASB Joint Transition Resource Group for Revenue Recognition. It does not purport to represent the views of any individual members of either board or staff. Comments on the application of U.S. GAAP or IFRS do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRS.

Purpose

1. Some stakeholders have questioned how to evaluate whether a warranty is a performance obligation in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the “new revenue standard”), and whether the corresponding accounting is the same as, or if different from, existing revenue guidance. Step 2 of the model in the new revenue standard requires an entity to identify the performance obligations in a contract with a customer, which may include a warranty in certain situations. The staff plan to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) for their views on this topic.

Background

2. Under the new revenue standard, if a customer has an option to purchase a warranty, such as when it is separately priced or negotiated, an entity would account for the warranty as a performance obligation under the new revenue standard (as described below, there are other circumstances in which a warranty would be accounted for as a performance obligation). An entity would allocate a portion of

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB) is an independent standard-setting body of the Financial Accounting Foundation, a not-for-profit corporation. The FASB is responsible for establishing Generally Accepted Accounting Principles (GAAP), standards of financial accounting that govern the preparation of financial reports by public and private companies and not-for-profit organizations in the United States and other jurisdictions. For more information visit www.fasb.org

the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 [73]¹ through 32-41 [86].

3. Under current GAAP in Subtopic 605-20, *Revenue Recognition – Services*, a warranty is accounted for as a deliverable (which is a similar notion to a performance obligation) only if it is a ‘separately priced extended warranty’² or a ‘product maintenance contract’ pursuant to paragraph 605-20-25-1. A warranty is considered separately priced if a customer may purchase the product with or without the warranty, and this determination might require some judgement. If the warranty is not separately priced, no revenue is allocated to the warranty. Rather, when the related product is transferred to the customer, the entity recognizes a warranty obligation and a corresponding expense in accordance with guidance in paragraphs 460-10-25-5 through 25-7 for warranty obligations incurred in connection with the sale of goods or services.
4. Under current IFRSs, to reflect the substance of the transaction, a warranty may be deemed to be a ‘separately identifiable component’ of the contract, pursuant to paragraph 13 of IAS 18 *Revenue*. Because IAS 18 does not provide guidance on when or how to identify whether a transaction consists of separately identifiable components, an entity might evaluate if the customer could reasonably choose to purchase the other components without purchasing the additional components, if the customer could purchase components from different suppliers, or if the warranty provides protection in excess of that provided by normal terms and conditions of the product. IFRS guidance requires an entity to account for warranties that are not a ‘separately identifiable component’ in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which requires an entity to recognize a warranty obligation and corresponding expense for that warranty.
5. However, there are some differences between the new revenue standard and current GAAP and IFRS guidance. Under the new revenue standard, warranties other than those that are separately priced and negotiated or a separately identifiable component may give rise to a performance obligation in certain facts and circumstances. Specifically, an entity will need to evaluate whether the warranty

¹ IFRS 15 references are included in “[XX]” throughout this paper.

² The Master Glossary of the Codification defines this as “An agreement to provide 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.”

provides a *service* “in addition to the assurance that the related product complies with the agreed-upon specifications,” pursuant to paragraph 606-10-55-31 [B30]. This guidance represents a change from current practice in GAAP and may represent a change in some practice under IFRS. The scope of warranties that will need to be accounted for under the new revenue standard has increased, as an entity must now consider whether the warranty provides a service in addition to assurance that the product complies with specifications (rather than simply looking to pricing and negotiations). Therefore, those warranties that are not separately priced or a separately identifiable component, but provide a service in addition to the assurance of product compliance, will have to be accounted for as a performance obligation under the new revenue standard.

6. Overall, a warranty that is accounted for as a deliverable or separate component under existing revenue guidance likely would continue to be accounted for as a performance obligation under the new revenue standard. However, additional warranties might be accounted for as performance obligations under the new revenue standard if the warranty provides the customer with an additional assurance service.

Accounting Guidance

7. Paragraphs 606-10-55-30 [B28] through 55-35 [B33] of the new revenue standard provide guidance for warranties included in contracts with customers. Paragraph 606-10-55-30 [B28] of the new revenue standard states (excerpt):

Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

8. Paragraph 606-10-55-31[B29] provides guidance on separately priced or negotiated warranties and states:

If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation...

9. In addition, paragraph 606-10-55-32 [B30] in the new revenue standard states:

If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with guidance on product warranties in Subtopic 460-10 on guarantees [IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*] **unless the promised warranty, or a part of the promised warranty, provides the customer with a service** in addition to the assurance that the product complies with agreed-upon specifications. **(Emphasis added)**

10. Paragraph 606-10-55-33 [B31] provides the following three *factors* to assess whether a warranty provides a customer with a service:

a. Whether the warranty is required by law—if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

b. The length of the warranty coverage period—the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a

return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

11. According to paragraph 606-10-55-34 [B32], if the promised warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is accounted for as a separate performance obligation. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation. BC376 notes “That accounting ensures that the entity does not overstate the recognition of revenue at the time that the product transfers to the customer and also relieves the entity from identifying and accounting separately for the two components of the warranty coverage.”
12. While the guidance above provides factors for determining if a warranty constitutes a service, paragraph 606-10-55-35 [B33] states:

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, **an entity’s promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity’s products does not give rise to a performance obligation.** The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies. **(Emphasis added)**

13. The difference in accounting for warranties is acknowledged in paragraph BC370:

... the Boards decided to account for some warranties differently from others. The Boards considered

distinguishing warranties on the basis of when the fault in the products arises; however, respondents explained that such a distinction was not operational. Therefore, the Boards decided to distinguish warranties on the basis of whether the warranty provides the customer with a service in addition to the assurance that the related product complies with the agreed-upon specifications. Specifically, the Boards decided that when the warranty provides a service (that is, a service-type warranty), the warranty should be accounted for as a performance obligation.

14. The Boards included an illustrative example that assesses warranties in example 44 to assist entities in application of the implementation guidance for warranties. This example is included in Appendix A of this memo.
15. From a disclosure perspective, paragraph 606-10-50-12 (e) [119(e)] requires that an entity disclose information about its performance obligations in contracts with customers, including “the types of warranties and related obligations.”

Implementation Question

How should an entity evaluate whether a product warranty is a performance obligation in a contract with a customer when the warranty is not separately priced?

16. The new revenue standard requires a warranty that provides a service in addition to the assurance that the product complies with agreed-upon specifications to be accounted for as a separate performance obligation. However, it does not include a bright line on how to make the distinction of when a warranty provides a service if the customer has the option to purchase a warranty, such as when it is separately priced or negotiated. Instead, the new revenue standard provides three factors in paragraph 606-10-55-33 to consider in assessing whether a warranty provides a service. Because the assessment is based on an evaluation of factors, rather than determinative criteria, judgment based on the facts and circumstances will be necessary.
17. Consider the following example:

A luggage company provides a lifetime warranty that states: ***If your baggage is broken or damaged, we will repair it free of charge.***

18. Some stakeholders view the promise made by the luggage company to repair damaged or broken baggage for free for the lifetime of the baggage as a distinct service. This is because the luggage company promises to provide the repair service to the customer regardless of whether the product complies with agreed-upon specifications.
19. Those stakeholders also consider the factors in paragraph 606-10-55-33[B31] for whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, using judgement of facts and circumstances. In order to make this evaluation, the paragraph provides three factors that an entity should consider. The following is a summary of those factors and analysis of each factor in the example above:
 - (a) *If the warranty is required by law* – The indicator states that if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation. In this example, since there is no law that requires the entity to make a promise for the lifetime of the product, this indicator suggests the warranty is a performance obligation.
 - (b) *The length of the warranty coverage* – The indicator states that a longer warranty coverage period increases the likelihood that the warranty is a performance obligation. Since the length of the warranty is for the life of the baggage, this indicator suggests the warranty is a performance obligation.
 - (c) *The nature of the tasks that the entity promises to perform* – In the above example, the nature of the tasks not only includes repairing baggage that does not meet the promised specifications, but also includes replacing broken or damaged baggage for free. Since the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, this indicator suggests the warranty is a performance obligation.

20. For the example above, on the basis of the promise provided and an analysis of the factors included in paragraph 606-10-55-33[B31], the staff think the warranty provided by the baggage company is a service in addition to the assurance that the product complies with agreed-upon specifications. Consequently, the staff think the service should be accounted for as a performance obligation.

Other stakeholder views

Analogy to statutory warranties

21. Some stakeholders think that the warranty in the above example should not be treated as a separate performance obligation. Those stakeholders come to this view by applying the guidance in paragraphs 606-10-55-33(a) [B31(a)] and 606-10-55-35 [B33] by analogy. They note BC377, which states that “statutory warranties may appear to be service-type warranties because they cover faults arising after the time of sale,” and think an analogy should be made that service type warranties should be treated similar to statutory warranties. This is because any claims would likely be due to latent defects (no matter how long it takes those defects to arise) and thus the warranty is not a performance obligation. However, the staff thinks that the guidance in paragraphs 606-10-55-33(a) [B31(a)] and 606-10-55-35 [B33] should not be applied by analogy for warranties that are not required by law and that such an analogy disregards the nature of the promise given to the customer, the factors in paragraph 606-10-55-33 [B31] for determining whether a warranty is a performance obligation, and the overall facts and circumstances of the arrangement.
22. Those stakeholders also argue that the notion of legally-required warranties not being considered performance obligations indicates the length of a warranty should not prohibit the conclusion that a warranty is not a performance obligation. While the staff agrees that the length of the warranty alone is not determinative, the length of the warranty is an important consideration under the new revenue standard. The indicator included in paragraph 606-10-55-33(b) [B31(b)] states the longer the warranty coverage, the more likely the warranty is a performance obligation.

Distinguishing fault for warranties

23. Some stakeholders think in the above example the warranty is not a performance obligation because they view the entity’s obligation as contingent upon the product no longer operating in compliance with agreed-upon specifications that the baggage

will last a lifetime. This view would parallel current US GAAP in many fact patterns, except for those warranties that clearly provide other services to a customer, such as maintenance, training or installation. The staff thinks this interpretation for this example ignores paragraph 606-10-55-31 [B29] since the warranty's specifications are incremental to the *functionality of the product* described in the contract, particularly since all damages are covered. Also, the staff thinks this interpretation conflicts with BC370, which states that the Boards decided not to distinguish warranties on the basis of *when* the fault in the products arises (that is, a manufacturing defect that existed prior to the sale of the product versus an issue that arises based upon customer use of the product). Rather, the Boards decided to distinguish warranties on the basis of whether the warranty provides the customer with a service in addition to the assurance that the related product complies with the agreed-upon specifications.

24. Stakeholders with this view also think that damage that arises after the sale of the product within the stated period of time of the warranty are the result of a defect at the time of sale. The staff thinks that in this example, since the warranty includes *damages*, this a service that goes beyond standard product specifications. Again, the staff thinks this interpretation conflicts with BC370 in terms of distinguishing a warranty on the basis of fault and clearly damages arising sometime after the luggage was sold are unlikely to be due to a latent defect. In addition, the staff thinks this view does not consider all facts and circumstances and does not consider the three factors provided in paragraph 606-10-55-33 [B31].
25. Another view held by other stakeholders is that in the above example, a performance obligation exists for warranties that protect a customer against damage that occurs after the baggage was sold, unless the protection is provided for product damage or failures from normal wear and tear. The staff thinks this argument also conflicts with the basis of conclusions described in BC370 about not distinguishing warranties on the basis of when the fault in the products arises but if the warranty is an additional service. In addition, it does not consider the three factors in paragraph 606-10-55-33 [B31].
26. For the example above, the most significant difference between the staff's view and some stakeholder views, is that agreeing to repair baggage over a long period of

time for things the customer may do (essentially the overall promise and the indicators in paragraphs 606-10-55-33(b) [B31(b)] and 606-10-55-33(c) [B31(c)]), rather than correcting latent defects, suggests the warranty is a service.

27. Overall, an entity should not focus its assessment on when the fault in the product arises. Rather, entities should evaluate if the substance of the warranty reflects an additional service, considering the promise made, and using the factors in paragraph 606-10-55-33 [B31] for assessing if warranties are performance obligations in the new revenue standard.
28. In conclusion, the evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications will require judgement of facts and circumstances. While the example above illustrates a relatively straight forward set of facts and circumstances that demonstrate an instance of when a warranty provides a service, the staff would expect that there are other instances for which more judgement will be required. In those cases, the staff thinks an entity should consider all relevant facts and circumstances in applying the guidance in the new revenue standard, including the factors in paragraph 606-10-55-33 [B31].

Questions for the TRG Members

1. Do the TRG members agree with the staff's analysis in this paper?
2. Are there additional implementation issues related to the question in this paper which should be communicated to the Boards?

Appendix A:

> > Warranties

606-10-55-308 [IE222] Example 44 illustrates the guidance in paragraphs 606-10-55-30 through 55-35 on warranties [B28-B33]. In addition, Example 44 illustrates the guidance in paragraphs 606-10-25-19 through 25-21 [27-29] on identifying performance obligations.

> > > Example 44—Warranties

606-10-55-309 [IE223] An entity, a manufacturer, provides its customer with a warranty with the purchase of a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost.

606-10-55-310 [IE224] The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.

606-10-55-311 [IE225] The product is distinct because it meets both criteria in paragraph 606-10-25-19 [27]. The product is capable of being distinct in accordance with paragraphs 606-10-25-19(a) [27(a)] and 606-10-25-20 [28] because the customer can benefit from the product on its own without the training services. The entity regularly sells the product separately without the training services. In addition, the product is distinct within the context of the contract in accordance with paragraphs 606-10-25-19(b) [27(b)] and 606-10-25-21 [29] because the entity's promise to transfer the product is separately identifiable from other promises in the contract.

606-10-55-312 [IE226] In addition, the training services are distinct because they meet both criteria in paragraph 606-10-25-19 [27]. The training services are capable of being distinct in accordance with paragraphs 606-10-25-19(a) [27(a)] and 606-10-25-20 [28] because the customer can benefit from the training services together with the product that has already been provided by the entity. In addition, the training services are distinct within the context of the contract in accordance with paragraphs 606-10-25-19(b) [27(b)] and 606-10-25-21 [29] because the entity's promise to transfer the training services are separately identifiable from other promises in the contract. The entity does not provide a significant service of integrating the training services with the product (see paragraph 606-10-25-21(a) [29(a)]). The training services are not significantly modified or customized by the product (see paragraph 606-10-25-21(b) [29(b)]). The training services are not highly dependent on, or highly interrelated with, the product as described in paragraph 606-10-25-21(c) [29(c)].

606-10-55-313 [IE227] The product and training services are each distinct and therefore give rise to two separate performance obligations.

606-10-55-314 [IE228] Finally, the entity assesses the promise to provide a warranty and observes that the warranty provides the customer with the assurance that the product will function as intended for one year. The entity concludes, in accordance with paragraphs 606-10-55-30 through 55-35 [B28-B33], that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a performance obligation. The entity accounts for the assurance-type warranty in accordance with the requirements on product warranties in Subtopic 460-10 [IAS 37].

606-10-55-315 [IE229] As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognizes revenue when (or as) those performance obligations are satisfied.