Warranty Accounting Under New Revenue Standard Clarified

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) established the Joint Transition Resource Group for Revenue Recognition (TRG) to inform both boards about issues that arise as entities implement the new revenue recognition standard. The TRG met for the fourth time on March 30, 2015, and discussed a wide variety of issues, including warranty accounting under the new standard.

Entities should not assume accounting for warranties will remain unchanged under the new standard. There is a subtle difference between the new revenue standard and current generally accepted accounting principles (GAAP). While warranty accounting remains unchanged, additional warranties may need to be accounted for as separate performance obligations under the new revenue recognition standard if they provide the customer with additional assurance services. Entities will need to evaluate each type of warranty offered to determine proper accounting, including warranties that are not separately priced.

Warranty Accounting

Existing Guidelines

Under current GAAP, a warranty is accounted for as a deliverable—a concept similar to a performance obligation—only if it is a “separately priced extended warranty” or a “product maintenance” contract. A warranty is considered separately priced if a customer may purchase the product with or without the warranty. If the warranty is not separately priced, no revenue is allocated to the warranty; rather, when the product is transferred to the customer, the entity recognizes a warranty obligation and a corresponding expense.

New Standard

Under the new revenue recognition guidance, entities must distinguish between warranties representing assurance of a product’s performance and service-type warranties. Assurance warranties would continue to be accounted for under the cost-accrual guidance in Accounting Standards Codification (ASC) 460, Guarantees. A warranty is a service-type warranty if the customer has the option to purchase it separately or if it provides a service to the customer beyond fixing defects existing at the time of sale. Service-type warranties would be accounted for as a separate performance obligation. If an entity promises both assurance and service-type warranties but cannot reasonably account for them separately, it would account for both together as a single performance obligation.

There is no bright line in the new standard on what constitutes a service-type warranty beyond it being separately priced. However, the standard includes three factors that should be considered in each evaluation:

- Legal requirement – If the intention is to protect the customer from purchasing a defective product, it likely does not represent a separate performance obligation.
- Warranty term – The shorter the coverage period, the less likely a warranty is a separate performance obligation.
- Tasks to be performed under the warranty – If an entity must perform certain tasks to assure the customer the product complies with agreed-upon specifications, those services likely would not constitute a separate performance obligation, e.g., return shipping service for a defective product.
Example

The following is an example situation taken from the TRG resource papers related to the warranty accounting issue:

A luggage company provided a lifetime warranty that states the following: “If your baggage is broken or damaged, we will repair it free of charge.”

Entities should evaluate whether the substance of the warranty reflects additional service, considering the promises made. An entity first would review the three factors for assessing whether a warranty provides a customer with a service in addition to the assurance that the product agrees with agreed-upon specifications:

- Legal requirement – Since there is no law requiring an entity to make a lifetime promise, this suggests the warranty is a performance obligation.
- Length of coverage – The lifetime promise suggests the warranty is a performance obligation.
- Nature of promise – Since the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, this suggests the warranty is a performance obligation.

TRG staff and FASB members agreed that based on the promise made and the three indicators provided in the standard, the warranty provided by the baggage company in the above example is a service in addition to the assurance the product complies with agreed-upon specifications, meaning it should be accounted for as a separate performance obligation.

Some might argue damage arising after the sale but within the warranty coverage period is a result of a defect at the time of sale. An entity should not focus its assessment on when the fault in the product arises; this point of view does not consider all facts and circumstances along with the three indicators noted above. TRG notes that since the warranty includes damages, the service goes beyond standard product specifications, as damages occurring a significant time after the sale are unlikely to be due to a latent defect.

Conclusion

Manufacturers should carefully consider the subtle changes in the new revenue standard versus current practice. Under the new revenue standard, warranties other than those separately priced and negotiated or those that are a separately identifiable component may give rise to a performance obligation in certain cases. An entity will need to evaluate whether the warranty provides a service in addition to the assurance that the related product complies with agreed-upon specifications, rather than simply looking to price and negotiation.

A warranty accounted for as a deliverable or separate component under current GAAP likely would continue to be accounted for as a performance obligation under the new standard. However, additional warranties might be accounted for as performance obligations under the new revenue standard if they offer the customer additional assurance service.

If you have questions about the revenue recognition rules, please contact your BKD advisor.

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