CPE Article

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A TALE OF TWO WARRANTIES

Curriculum: Accounting and Auditing

Level: Intermediate

Designed For: CPAs in public accounting and industry

Objectives: To present an overview of accounting for warranties under current practice and the proposed revenue recognition guidance.

Key Topics: Revenue recognition, cost estimate, cost accrual, and deferred revenue accounting.

Prerequisites: None

Advanced Preparation: None

This article will discuss the accounting guidance for warranties under the current Generally Accepted Accounting Principles (GAAP) in the United States and the proposed guidance under the proposed revenue recognition exposure draft. The accounting concepts for warranties have remained mostly unchanged under the proposed exposure draft, but some terminologies have changed and, of course, the framework for revenue recognition under the proposed guidance is different from the current practice.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly issued an exposure draft (ED) in June 2010, *Revenue from Contracts with Customers*, to supersede virtually all existing revenue guidance under U.S. GAAP and International Financial Reporting Standards (IFRS). The comment period for the ED ended in October 2010.

The Boards decided to re-expose their proposal in November 2011, subsequent to deliberations. The comment period for the revised ED was 120 days and ended on March 13, 2012. The Boards received approximately 350 comment letters on the revised proposal – significantly fewer than the nearly 1,000 they received on the original ED issued in June 2010. The Boards continued their re-deliberations on the revised ED.

THE PROPOSED REVENUE RECOGNITION GUIDANCE

In March 2013, the Boards substantially concluded their re-deliberations on their joint 2011 ED and reached decisions on the remaining key issues including disclosures, transition, and effective date. The Boards intend to issue the final standard by the end of the second quarter of 2013. The standard will be effective for the first interim period within annual reporting periods beginning on or after January 1, 2017. Entities will have the option to apply the final standard retrospectively or use a simplified transition method. Entities are not required to restate prior periods if they decide to use the suggested simplified method.

The provision of the final guidance regarding warranties is not expected to differ from the proposed ED and the discussions in this article.

The proposed standard takes a contract-based asset and liability approach, applicable to almost all industries. Revenue is recognized when an entity has satisfied its obligations to its customers, which occurs when control of an asset (a good or service) has been transferred to the customer.

Entities perform the following steps for revenue recognition:

- Identify the contract with the customer.
- Identify the separate performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to distinct performance obligations.
- Recognize revenue when each performance obligation is satisfied.

Companies often sell their products and services with warranties. The objective of such warranties is to provide coverage for the sold products and services, which are intended to be free of any existing and future defects. The proposed ED discusses the accounting for these types of warranties as part of its revenue recognition guidance.

CURRENT U.S. GAAP GUIDANCE

Under the existing U.S. GAAP, revenues and estimated costs to fulfill any warranty obligations are recognized at the time the goods are delivered or services are performed if the warranty is not separately priced. The current guidance distinguishes between the post-sale performance warranties and extended warranties.

Post-sale performance warranties – Accounting Standards Codification (ASC) 450-20 – *Contingencies – Loss Contingencies*, requires an entity to accrue for the costs of the post-sale performance warranties of contracts at the time of sale of the product, rather than at the time that warranty claims are presented. Therefore, entities should record an estimated accrual for their warranty expenses at the time of sale.

Extended warranties – Accounting Standards Codification ASC 605-20 – *Revenue Recognition – Services*, requires that the sellers of extended warranty or product maintenance contracts recognize revenues ratably over the period in which they are obligated to perform the related warranty services.

The current U.S. GAAP requires entities to defer revenues from separately priced extended warranty and product maintenance contracts, and recognize them on a straight-line basis over the contract period – except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract have incurred on other than a straight-line basis. In those circumstances, revenue shall be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

Entities may also sell the extended warranties under multiple-elements arrangement contracts. The existing guidance for revenue arrangements with multiple deliverables (ASC 605-25-2, *Revenue Recognition – Multiple-Element Arrangements*) requires the contract to be divided into separate units. Revenues under multiple-elements arrangement contracts are recognized based on one of the following methods for each accounting unit:

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- Vendor-specific objective evidence (VSOE) (ASC 605-30-6A), which is determined based on the price charged for a deliverable when it is sold separately or, if that is not available, by the price established by management.
- Third-party evidence of selling price (ASC 605-30-6B), which is the price that other vendors or other competitors charge for similar products.
- The best estimate of selling price (ASC 605-30-6C), which is determined based on market conditions and other factors if the product is to be sold separately.

THE PROPOSED GUIDANCE FOR WARRANTIES

The proposed guidance, similar to current GAAP, distinguishes between two different types of warranties:

- Assurance-type warranties that promise the customer to deliver products and services as they are specified in the contract.
- Service-type warranties that provide extended services to the customer, in addition to normal assurance that the delivered product will perform as it is specified in the contract.

The accounting treatment for these two types of warranties differs significantly under the proposal.

An assurance-type warranty would give rise to a warranty obligation (but not a separate performance obligation for revenue recognition purposes) and would be accounted for using a cost accrual approach. A service-type warranty, on the other hand, would be deemed a separate performance obligation and would require a deferral of revenue.

A contract may also contain both an assurance-type warranty and a service-type warranty. Note, however, that if the warranties cannot be reasonably accounted for separately, they should be accounted for together as a single performance obligation, with revenues deferred and recognized ratably over the period the warranty services are provided.

Distinguishing criterion – In assessing whether a contract provides service-type in addition to assurance-type warranties, an entity should consider the following factors (IG 13 ED):

(a) Requirement by law – If the existing laws and regulations require an entity to provide a warranty, the existence of such requirement is an indication that the warranty is not a service-type obligation. These regulatory requirements typically exist to protect customers with assurance-type warranties from the risk of purchasing defective products.

(b) Coverage period – The longer the coverage period, the more likely that the warranty is a service-type obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

(c) Nature of the services – 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.

Allocation of transaction price – An entity should identify separate performance obligations by identifying different goods or services promised in a contract (Paragraph 23 ED), and recognize revenue when it satisfies such performance obligations by transferring a promised good or service to a customer (Paragraph 31 ED).

For a contract that has more than one separate performance obligation, an entity should allocate the transaction price to each separate performance obligation in an amount that reflects the amount of consideration to which the entity expects to be entitled in exchange for satisfying each identified performance obligation. To allocate an appropriate amount of consideration to each separate performance obligation, an entity would determine the standalone selling price at contract inception and allocate the transaction price on a relative standalone selling price basis (Step 4 of revenue recognition ED).

The best evidence of a standalone selling price, however, is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers (Paragraph 72 ED). If that is not available, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity at the time (Paragraph 73 ED).

The ED recommends the following estimation methods (Paragraph 73):

- Adjusted market assessment approach – an entity can evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for such goods or services.
- Expected cost plus a margin approach – an entity can forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- Residual approach – if the standalone selling price of a good or service is highly variable or uncertain, an entity can estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.

Change of estimates – In assurance-type warranties, an entity reflects any revision to its original estimates as an adjustment to the recorded cost accrual. In service-type warranties, however, any changes in original estimates may not only impact the warranty costs but also the warranty revenues.

ILLUSTRATION

The following illustration reflects accounting for warranties under the proposed guidance.

Entity A sells product A for $10,000 at the beginning of the year and provides for the first-year assurance-type warranties. Historically, the average cost of assurance-type warranties during the first year of sale has been about $20 for this type of product.

Entity A has also included a five-year service-type or extended warranty with this sale at no charge to the customer. The standalone selling price of product A is $12,000 and the standalone selling price of service-type or extended warranty for this type of product is $3,000. Therefore, the total selling price is comprised of product selling price for 80 percent and service-type or extended warranty price for 20 percent of the total selling price.

As a result, the selling price of $10,000 should be allocated to product sales for $8,000 (80 percent of total selling price) and to service-type or extended warranties for $2,000 (20 percent of total selling price).

Entity A incurred no costs for assurance-type warranties but $50 costs for service-type or extended warranties during the first year subsequent to sales.

Journal entries for this transaction at the time of initiation of sales are illustrated in Figure 1.

FIGURE 1

Dr. Accounts Receivable	$10,000	
Cr. Product Revenues		$8,000
Cr. Deferred Revenues (service-type warranties) *To record the original sales entry.*		$2,000
Dr. Assurance-Type Warranty Expenses	$20	
Cr. Expense Accruals *To record an accrual estimate for assurance-type warranties.*		$20
Journal entries at the end of the first year are as follows:		
Dr. Expense Accruals	$20	
Cr. Assurance-Type Warranty Expenses *To reverse the accrual for assurance-type warranties since Entity A did not incur any expenses for this type of warranties.*		$20
Dr. Service-Type Warranty Expenses	$50	
Cr. Accounts Payable *To record the extended warranty expenses.*		$50
Dr. Deferred Revenues (service-type warranties)	$400	
Cr. Service-Type Warranty Revenues *To record the straight-line annual amortization of service-type deferred revenues ($2,000 divided by 5).*		$400

The above journal entries remain principally the same under the current GAAP guidance, other than some changes in accounting terminologies. Of course, the framework for revenue recognition is different under the proposed ED from existing GAAP. This difference may impact the determination and allocation of selling price for revenue recognition purposes under the proposed guidance and existing GAAP.

COMMON PRACTICES IN DIFFERENT INDUSTRIES

This section of the article will discuss some of the common practices in different industries related to warranty obligations.

Consumer products companies – Consumer products companies often sell their products with warranties. When a consumer products company sells goods to retailers, and those goods are covered by a warranty, they would most likely have two contracts to consider under the proposed revenue recognition model: (i) a contract to fulfill their products warranty obligations to the retailer, and (ii) a contract to fulfill their warranty obligations to the consumer who buys the products from the retailer.

If a warranty provides a service to the customer in addition to assurance about the agreed-upon specifications, a consumer products company must separately account for both an assurance-type warranty (cost accrual) and a service-type warranty (revenue deferral). Consumer products companies would likely find it challenging to estimate a standalone selling price for service-type warranties since they most often do not sell service-type warranties on a standalone basis.

Furthermore, revenue recognition for service-type warranties for consumer products companies would not begin until the consumer purchases the product from the retailer. This may require these companies to develop and maintain a sophisticated system for tracking the beginning of the warranty period.

Retailers – Even though retailers sell many products with warranties, the warranty obligations are often the responsibility of the manufacturer of the product or a third party. However, in some cases, retailers provide warranty coverage for their products and also may sell service-type or extended warranties for the products they sell.

Retailers that provide warranties would have to determine whether they are the legal obligor under the warranty arrangement to determine the appropriate accounting treatment under the proposal. If retailers are the obligor, they would follow the same considerations outlined above for consumer products companies, including deferring revenue for service-type warranties instead of simply accruing the estimated costs.

Homebuilding industry – It is a common practice in the homebuilding industry for a builder to offer its customer a warranty on the purchase of a home to protect the buyer against latent defects. The term of the warranty period is generally one year, unless statutory or legal requirements prescribe a longer period.

The proposed guidance states that if an entity is required by law to provide a warranty, it should be considered an assurance-type warranty since the warranty exists to protect customers from the risk of purchasing defective products. Homebuilding companies may also provide service-type or extended warranties in addition to assurance-type warranties.

Real estate – Real estate companies may provide their customers with warranties related to properties or services sold and account for them under assurance-type or service-type warranties.

Manufacturing and construction manufacturing – Manufacturing and construction companies also provide service-type or extended warranties in addition to assurance-type warranties. Therefore, they must separately identify and account for them.

Software companies – Software arrangements in which software is physically delivered (e.g., CD, tape, etc.) often contain

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warranties for defective media, such as a malfunctioning CD. These and other warranties generally should be accounted for in conformity with ASC 450, as assurance-type warranties.

Additionally, there may be warranty obligations related to warranties for defective software, including warranties that are routine, short-term and relatively minor. These obligations shall also be accounted for in conformity with Topic 450, as assurance-type warranties. However, if there are significant uncertainties about the extent of possible warranty claims or there is a wide range of possible loss, software companies should consider deferring all the revenues until the warranty period has expired.

Software companies also provide post-contract services (PCS) to their customers. PCS provides for the right to receive services (other than those accounted for separately) or unspecified product upgrades and enhancements on a when-and-if-available basis.

PCS typically includes one or more of the following:

- Telephone support.
- Bug fixes or debugging.
- Unspecified upgrades/enhancements on a when-and-if-available basis.

PCS may be provided by a software vendor even though not evidenced by a written contract (implied PCS).

PCS, or at least part of it, can be considered service-type or extended warranties. PCS revenues should be recognized on a straight-line basis over the life of the contract, whereas the expenses should be recorded on an accrual basis as they incur.

Software companies under the current GAAP guidance can use VSOE to determine the selling price of different components of a multi-elements arrangement contract that includes PCS. Under the proposed guidance, however, they may need to use other methods, such as the best estimate of selling price, to determine the selling price of software and PCS under the proposed guidance.

Automotive industry – Automotive parts suppliers (APSs) and original equipment manufacturers (OEMs) typically provide warranties when they sell their products to customers. Normally, the price of the products includes the product warranty. For example, when purchasing a new vehicle from the dealership, the price includes an assurance-type warranty that the vehicle will operate for a specified period of time (for example, three years and/or 36,000 miles). In addition, certain OEMs may offer extended warranties that the retail consumer can purchase through the dealer. The extended warranty typically provides more comprehensive coverage over a longer period of time (typically five to 10 years/or 50,000 to 100,000 miles).

APSs and OEMs would need to evaluate whether a warranty provided with a product covers only defects that existed at the time of sale or whether it provides an additional service. They should consider the following factors:

- Whether the warranty is required by law.
- The nature of the tasks the entity promises to perform.
- The length of the warranty coverage.

The new guidance requires OEMs to exercise significant judgment when determining whether a long-term warranty period provides any additional services. For example, an OEM might conclude that its five-year warranty on a luxury vehicle is not an additional service because the vehicle is “better” than a standard vehicle. That is, the OEM may believe that the materials used to manufacture the vehicle are of a higher quality than the materials used in a standard vehicle and as a result, any latent defects would take longer to appear.

OEMs would also need to carefully consider how the extended warranties are offered and purchased by the customer. For example, if the vehicle is sold to the dealer without the extended warranty, the purchase of an extended warranty by the customer at a later date is likely to be considered a separate transaction, or if the OEM sells vehicles to a dealer including the extended warranty, the OEM may need to allocate a portion of any discounts to the warranty using the relative standalone selling price method.

SOME IMPACT ON MOST COMPANIES THAT PROVIDE WARRANTIES

Even though the proposed ED would not change the general accounting framework for warranties, the revenue recognition criteria and some terminologies could very well change under the final guidance (e.g., the concept of VSOE may no longer exist under the final guidance). The final guidance may also impose stricter rules in segregating assurance-type warranties from service-type warranties. The new ED on revenue recognition would probably have some impact on all companies across all industries that provide some form of warranties to their customers for products and services.

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(Please check one.) 5=excellent 4=good 3=average
2=below average 1=poor

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5__ 4__ 3__ 2__ 1__.
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A Tale of Two Warranties

BY JOSEF RASHTY, CPA

1 Under existing GAAP, companies recognize revenues ratably over the period in which they are obligated to perform the related warranty services for all extended warranty or product maintenance contracts.

A. True
B. False

2 Under existing GAAP, entities that sell the extended warranties under multiple-elements arrangement contracts can allocate the revenues based on one of the following methodologies:

A. VSOE
B. Third-party evidence of selling price
C. The best estimate of selling price
D. All of the above

3 The proposed guidance discusses the following type(s) of warranties:

A. Assurance-type warranties
B. Service-type warranties
C. All of the above
D. None of the above

4 Service-type warranties under the proposed guidance resemble extended warranties under current GAAP.

A. True
B. False

5 The proposed guidance distinguishes the service-type warranties based on the following criterion (criteria):

A. Requirement by law
B. Coverage period
C. Nature of services
D. All of the above

6 The proposed guidance recommends the following estimation method(s):

A. Adjusted market assessment approach
B. Expected cost plus margin approach
C. Residual approach
D. None of the above
E. All of the above

7 The proposed guidance states the change of estimates will impact revenues in the following types of warranties:

A. Service-type warranties
B. Assurance-type warranties
C. All of the above
D. None of the above

8 The proposed guidance states the change of estimates will impact costs in the following types of warranties:

A. Service-type warranties
B. Assurance-type warranties
C. All of the above
D. None of the above

9 Under the proposed guidance, deferred revenues are usually associated with the following type(s) of warranties:

A. Service-type warranties
B. Assurance-type warranties
C. All of the above
D. None of the above

10 In the software industry, PCS, or at least part of it, can be considered service-type or extended warranties under the proposed guidance.

A. True
B. False

Answers to last issue's self-study exam:
1. a. 2. d. 3. a. 4. c. 5. a. 6. a. 7. d. 8. a. 9. a. 10. b.