FASB Technical Bulletin No. 90-1

FTB 90-1 Status Page

Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts

December 1990

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

FTB 90-1: Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts

References:

APB Opinion No. 20, *Accounting Changes*, paragraphs 19–21
FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 4 and 24
FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraphs 11, 13, 17, 29, and 32–34
FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, paragraph 6
FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraphs 83 and 84
FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 197

Question

1. How should revenue and costs from a separately priced extended warranty or product maintenance contract be recognized?

Background

2. An *extended warranty* is 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. A *product maintenance contract* is an agreement to perform certain agreed-upon services to maintain a product for a specified period of time. The terms of the contract may take different forms, such as an agreement to periodically perform a particular service a specified number of times over a specified period of time, or an agreement to perform a particular service as the need arises over the term of the contract. Some contracts may provide both extended warranty coverage and product maintenance services. A contract is *separately priced* if the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product.

Response

3. Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income 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 are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

4. Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.

5. A loss should be recognized on extended warranty or product maintenance contracts if the sum of expected costs of providing services under the contracts and unamortized acquisition costs exceeds related unearned revenue. Extended warranty or product maintenance contracts should be grouped in a consistent manner to determine if a loss exists. A loss should be recognized first by charging any unamortized acquisition costs to expense. If the loss is greater than the unamortized acquisition costs, a liability should be recognized for the excess.

Effective Date and Transition

6. The provisions of this Technical Bulletin are effective for separately priced extended warranty and product maintenance contracts sold in fiscal years beginning after December 15, 1990. Earlier application is permitted but not required. At initial application, this Technical Bulletin may (but is not required to) be applied to existing contracts by applying paragraphs 19–21 of Opinion 20, recognizing the cumulative effect of an accounting change and disclosing the effects of adopting this Technical Bulletin.

Appendix: BACKGROUND INFORMATION AND CONSIDERATION OF COMMENTS RECEIVED ON THE PROPOSED TECHNICAL BULLETIN

Background Information

7. Extended warranty and product maintenance contracts provide warranty protection or product services not included in the original price of the product covered by the contracts. The manner of recognizing revenue and costs under the contracts varies in practice depending on analogies drawn to existing literature and practice for other transactions. The FASB's Emerging Issues Task Force addressed certain aspects of the issue in Issue No. 89-17, "Accounting for the Retail Sale of an Extended Warranty Contract in Connection with the Sale of a Product." The Task Force concluded that recognizing all of the revenue at the time the contract is sold would be inappropriate but did not reach a consensus between deferring all or only a portion of the contract revenue, leaving diversity in practice among retailers, manufacturers, and other sellers of the contracts.

8. Warranties are explicitly included within the scope of Statement 5. However, that Statement addresses warranty obligations that are incurred in connection with the sale of the product, that is, obligations that are not separately priced or sold but are included in the sale of the product. This Technical Bulletin addresses extended warranty and product maintenance contracts that are priced and sold separately from the product and concludes that the accounting should recognize the sale of the product and the sale of the contract as separate transactions regardless of the seller's pricing and marketing strategy.

9. This Technical Bulletin concludes that accounting for extended warranty and product maintenance contracts should follow an approach similar to that described in Statement 60 for short-duration insurance contracts. Like short-duration insurance contracts, extended warranty and product maintenance contracts provide coverage against the risk of certain specified claim costs for a specified period. Those claim costs may take the form of repair costs if the product requires repair or service costs if the customer requests that a covered service be performed on the product. Paragraph 13 of Statement 60 indicates that premiums from short-duration insurance contracts should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period. This Technical Bulletin concludes that revenue on extended warranty and product maintenance contracts also should be recognized in income evenly over the contract period except for those circumstances in which sufficient historical evidence indicates that costs of providing services under the contract are incurred in some pattern other than straight line. The pattern of cost incurrence may vary depending on characteristics of the product or may be a function of the coverage provided under the contract.

When the coverage under the contract varies, such as those situations in which the period of the extended warranty partially overlaps the period of the product's original warranty, or the extended warranty contains a graduating deductible, costs of providing services under the contract may vary proportionate to that coverage.

10. Paragraph 83 of Concepts Statement 5 states that revenue is not recognized until earned. Revenue is considered earned when the entity has substantially completed what it must do to be entitled to the benefits represented by the revenue. This Technical Bulletin concludes that sellers of extended warranty or product maintenance contracts have an obligation to the buyer to perform services throughout the period of the contract and, therefore, revenue should be recognized in income over the period in which the seller is obligated to perform. This treatment is consistent with revenue recognition under Statement 60.

11. This Technical Bulletin concludes that costs of providing services under extended warranty and product maintenance contracts should be recognized in a manner similar to the approach required by Statement 60. Paragraph 17 of that Statement states that claim costs should be recognized when insured events occur.

12. Paragraph 29 of Statement 60 states that acquisition costs (such as commissions) should be capitalized and charged to expense in proportion to premium revenue recognized. Both Statements 60 and 91 provide guidance on identifying acquisition costs. This Technical Bulletin concludes that acquisition costs should be identified consistent with guidance in paragraph 6 of Statement 91, which defines acquisition costs in terms of incremental direct costs. Therefore, only the additional costs incurred because a contract is sold are incremental direct acquisition costs under this Technical Bulletin.

13. Paragraphs 32–34 of Statement 60 discuss the accounting for insurance contracts with premium deficiencies. In accounting for contracts with losses, paragraph 5 of this Technical Bulletin requires an approach similar to that described in Statement 60.

Consideration of Comments Received on the Proposed Technical Bulletin

14. A proposed Technical Bulletin, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts,* was released for comment on August 15, 1990. Fifty-two letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

15. Some respondents supported recognizing all or deferring only a portion of the contract revenue at the time of sale. Those who supported full recognition commented that the contract revenue has been earned at the time of sale because the revenue is nonrefundable and contract costs are predictable and may be insignificant. Those who supported deferring only a portion of

the revenue asserted that the sale of the product and the sale of the contract are essentially a single planned transaction because sellers price their products expecting sales of contracts to a significant number of customers. Therefore, in their view, some of the contract revenue should be allocated to the product so that an equal gross profit margin is recognized on the product and on the contract. They commented that the stated contract price does not provide an appropriate basis for deferral. In their view, the amount deferred should include only an amount equal to expected costs under the contract plus a profit margin reflecting the combined sale.

16. This Technical Bulletin concludes that separately priced extended warranty and product maintenance contracts are not incidental to the sale of the product but rather are independent transactions under which the buyer agrees to purchase and the seller agrees to perform certain services. The buyer's decision to purchase a product alone does not entail any obligation to also purchase a contract, nor does it oblige the seller to provide any additional services. This Technical Bulletin acknowledges that some sellers may generally lower product prices in expectation of also selling contracts. However, it is the seller's obligation to perform services, not the seller's pricing and marketing strategy, that determines the appropriate financial reporting of the transactions. Because that obligation extends over a period of time, immediate revenue recognition is inappropriate. Furthermore, a seller's desire to sell a contract along with a product provides no basis for allocating revenue between the product and contract. Such an approach would result in recognizing different profit margins on identical products based on a buyer's independent decision to purchase or decline a contract.

17. Some respondents commented that deferring the stated contract price is inappropriate because expected costs under the contract are insignificant relative to the contract price. As a result, they commented that the balance sheet liability is significantly overstated. However, paragraph 197 of Concepts Statement 6 states that prepayments for services to be provided qualify as liabilities because an entity is required to provide services to those who paid in advance. This Technical Bulletin concludes that the stated price of the contract is the appropriate basis for deferral and rejects the viewpoint that revenue recognition should be accelerated because future contract costs are expected to be insignificant. Revenue is earned over the period in which the enterprise is required to provide services.

18. Some respondents indicated that deferring the contract revenue is misleading to financial statement users because all of the cash from selling the contract has been received and is nonrefundable. This Technical Bulletin relies on a basic premise of generally accepted accounting principles that accrual accounting provides more relevant and useful information than cash basis accounting. Accrual accounting goes beyond cash transactions and recognizes the financial effects of transactions that have past or future cash consequences as those transactions occur, rather than only when cash is received or paid by an entity. This Technical Bulletin reaffirms the position that revenue has not been earned simply because cash has been received, even if nonrefundable. The cash received is, of course, given accounting recognition, but this Technical Bulletin concludes that this is one of many areas in which information about cash flows alone is not sufficient.

19. Paragraph 3 of the proposed Technical Bulletin stated that deferred revenue from separately priced extended warranty and product maintenance contracts should be "recognized in income on a straight-line basis over the contract period except for those circumstances in which the coverage under the contract varies according to a predetermined schedule." Some respondents stated that the proposed Technical Bulletin should not require straight-line amortization for contracts for which sufficient historical experience indicates that costs of providing services under the contracts are incurred on other than a straight-line basis. In their view, revenue recognition should reflect the amount of risk assumed by period, and such risk is best evidenced by the pattern of service costs expected to be incurred over the contract period. Paragraph 13 of Statement 60 discusses insurance contracts for which the period of risk differs significantly from the contract period. For those contracts, Statement 60 permits the recognition of revenue in proportion to the amount of risk assumed by period. Therefore, proportionately higher revenue is recognized in the periods of greatest risk assumption, as evidenced by increased claims activity. The proposed Technical Bulletin's requirement to recognize contract revenue on a straight-line basis was revised accordingly to include this "period of risk" concept provided sufficient historical evidence indicates a pattern of service costs that is other than straight line.

20. The proposed Technical Bulletin defined acquisition costs as those costs that "vary with and are primarily related to the acquisition of contracts." Some respondents questioned whether certain selling expenses, such as a portion of the salaries of employees who sell the contracts, are acquisition costs. This Technical Bulletin concludes that acquisition costs are incremental costs incurred as a result of acquiring a contract and would not have been incurred but for the acquisition of that contract. Therefore, such costs as employees' salaries, advertising, and general and administrative expenses that would have been incurred even if no contract was acquired are not acquisition costs. Paragraph 4 was revised to include the concept of incremental cost.

21. Several respondents questioned whether the proposed Technical Bulletin required loss recognition on an individual contract or a "pool of risk" basis. Paragraph 5 was revised to include the "pool of risk" concept from Statement 60.

22. Some respondents commented that the effective date of this Technical Bulletin should be delayed. Many of the retail entities affected by this Technical Bulletin have fiscal years that end in the first calendar quarter. The effective date was changed to contracts sold in fiscal years beginning after December 15, 1990 so those entities would not be required to adopt the provisions of this Technical Bulletin for the last few months of their current fiscal years. Others commented that entities should be permitted to change their method of accounting for the contracts by reporting the cumulative effect of an accounting change. This Technical Bulletin was revised to allow this option by application of Opinion 20.

The Financial Accounting Standards Board has authorized its staff to prepare FASB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis, pursuant to the procedures described in FASB Technical Bulletin No. 79-1 (Revised), *Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance*. The provisions of Technical Bulletins need not be applied to immaterial items.