Query No. 12

Subject: ***Recognition of revenue from installation and maintenance services.***[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the Company') is a private limited company which was incorporated on 20th February 2010 under the provisions of the Companies Act, 1956. The Company is the subsidiary of E International, Germany. The ultimate holding company is EGG & Co., Germany.

2. The Company is in the business of manufacturing and trading of bus air-conditioning systems (hereinafter referred as 'the AC system') and related spares and components and also renders installation and maintenance services. The Company is also involved in trading business only to the extent of meeting the after sales requirements (repairs and maintenance including warranty obligation) of products manufactured and sold. The Company has a customer base in and outside India.

3. The AC systems manufactured by the Company are not 100% standard and are based on the bus chassis design, bus horse power, bus body building design and the other specific requirements of the customer. The AC systems require installation on to the bus with many complicated parts and design of the bus before being put to actual use.

4. The querist has stated that Indian Accounting Standards (Ind ASs) are not applicable to the Company; hence, financial statements are prepared as per accounting standards prescribed under section 133 of the Companies Act, 2013 ('Indian GAAP').

The total revenue as per the audited financial statements for the financial year (F.Y.) 2022-23 is Rs. 117.72 crores. The Company sells its products directly to customers and does not qualify for definition of e-commerce companies.

5. The statutory auditors of the Company have raised question on accounting practices followed with regard to:

(i) Revenue recognition of installation charges not separately shown in the sale invoice and

(ii) Revenue recognition of value attributable to warranty period of more than 12 months from the date of installation or 15 months from the date of invoice.

6. *Description of warranty policy and accounting practice:*

(a) As mentioned hereinbefore, the AC systems of the Company are *manufactured* to the requirements of the customers and type of customers (like OEM, tour operators, individual bus owners). Thus, the warranty period varies from customer to customer. *The warranty period is agreed at the time of order booking, i.e., to say pre-manufacturing stage.*

[1] Opinion finalised by the Committee on 21.6.2024.

The main reasons for varying warranty period are:

- Region where product is used, e.g. the region has less dust in the air, then AC system is less prone to failures.
- The AC systems supplied to Original Equipment Manufacturer (OEM). Usually, the AC system supplied to OEM will be put to use only with considerable delay from the date of invoice unlike the AC system supplied to individual bus owners.
- Regularity of customer
- Size of order

(b) Currently, the Company has different warranty periods ranging from 12 months to 48 months. Unless specifically agreed through separate contract, warranty is 12 months from the date of installation or 15 months from the date of invoice. In case of specific agreements, the warranty period and time of start of warranty depends on the terms of the agreement.

(c) Though the Company adds certain amount towards warranty in pricing for discussion, the final price is dependent on negotiation with customer.

(d) It may so happen that very similar product sold to two customers can have different pricing. Hence, once the final price is agreed, amount considered towards warranty loses its specific identity.

(e) The Company *does not sell warranty as a separate product irrespective of period of warranty.* That is, warranty is along with the product *agreed to be manufactured and delivered* with defined period of warranty for a consolidated price. (Distinction has to be drawn from vehicle manufacturers selling extended warranty as a separate product for different price.)

(f) *Warranty services arrangement in case of exports to Israel*

The Company has an arrangement with the service provider located in Israel to procure business and to take care of the warranty. This service provider procures orders for the Company's AC system for buses being built in China. These buses are then exported from China to Israel. The Company gives warranty of 48 months to customers in China who are the bus body builders. The warranty period for these customers in China starts from the date *on which the product arrives at the port of destination in China.* The service provider in Israel takes care of complete warranty expenses for the period of warranty for an agreed percentage. This percentage varies based on the model of the product.

In the agreement with the service provider, the Company has agreed to pay certain percentage of sales value per year towards cost of warranty. But though the warranty in these cases is for four years, service provider is paid for 3 years. For example, if service provider is to be 1.5.% of sale value towards warranty cost and warranty is for 4 years, then service provider is paid lumpsum 4.5% (instead of 6%) in the year of sale. This is because the time of warranty starts from the time product arrived at port in China and sufficient time is lost by the time product (AC system) is fitted onto the bus and then exported from China before being put to actual use in Israel. The history of warranty

expenses proves that the service provider will not be at loss for the amount he gets from the Company and this arrangement is running successfully.

With this arrangement with service provider, the warranty liability is transferred to the service provider and the Company will be responsible for the warranty expenses only in case of default by the service provider.

(g) The Company has a *pre-printed* service handbook which is sent to *all* the customers including customers with whom warranty is agreed for longer period. This book contains user manual, terms and conditions and also mention about warranty policy of 12 months from the date of installation or 15 months from the date of invoice. The warranty mentioned in the service handbook is applicable to cases with whom specific agreement for longer period of warranty is not entered into.

(h) The Company used to *provide for contingent liability which could arise out of unexpired warranty* till F.Y. 2021-22 as below:

(i) The total warranty cost incurred during the year for which financial statements are prepared is considered in arriving at the percentage to be *applied on sales on which warranty is given* to arrive at the provision amount.

(ii) Illustration for calculation of percentage for warranty provision:

Invoice year	Sales on which warranty cost incurred in 2022-23	Cost of warranty incurred in FY 2022-23	Percentage of warranty cost to sales in (b) col
(a)	(b)	(c)	(d)= (c) / (b) x 100
2018-19	1,35,65,357	1,08,368	0.80%
2019-20	3,42,54,044	13,43,641	3.92%
2020-21	2,80,71,896	8,16,114	2.91%
2021-22	4,59,27,820	9,81,276	2.14%
2022-23	3,54,91,220	14,32,668	4.04%
Average of (d) percetage of warranty cost to sales			**2.76%**

It should be noted that percentage calculated above is on the sales where there is a warranty claim during the year 2022-23.

(iii) In case of domestic customers and export customers (other than the cases where warranty liability is transferred to services provider detailed in paragraph 6(f) above) to whom warranty is offered for 12 months to 24 months, provision is created at the rate as mentioned in above illustration on the sales on which the warranty period is active.

(iv) The provision was created every year till the date of expiry of warranty. That is even if warranty period remaining is one day, provision at rates mentioned above is created on whole invoice amount.

(v) In case of export cases, where warranty is taken care of by the service provider detailed in paragraph 6(f), provision was created for the entire amount agreed to be paid. In these cases, the Company will not incur any additional cost unless failure on the part of service provider. This practice was not spelled out in the

accounting policy mentioned in financial statements, as the Company has already accounted for the complete cost of the warranty.

(Emphasis supplied by the querist.)

7. *Description of installation services and accounting practice*

(a) The AC systems manufactured by the Company require installation on the bus before being put to actual use.

(b) The Company has pre-determined rates for installation service and the same are included in price of the final product if customer opts for installation. (To further clarify, customer can buy the AC system without installation services from the Company).

(c) Once the price is agreed inclusive of installation, there will not be any scope for customer to opt out of installation at later point of time.

(d) The installation charges are *not shown separately* in the invoice, i.e., the customer is billed for consolidated price for the AC system inclusive of installation.

(e) Installation involves the assembly of *pre-tested* AC system on to the bus as per design.

(f) The Company gets the installation of the AC system done through the dealer network.

(g) In cases where installation is to be carried out by the Company, terms of payment by the customer does not include 'Subject to installation'.

(h) In case of domestic sales, dealers bill to the Company after the installation based on the rate card provided for installation by the Company. In case of export sales, the Company enters into agreement with foreign dealers for installation specifying the installation charges payable.

(i) The Company provides installation services *only* for AC systems manufactured by the Company, i.e., the AC system installation is not a separate line of business for the Company.

(j) Up to F.Y. 2021-22, the Company used to recognise revenue including the installation charges when goods are transferred to the customer and create provision for installation charges payable till the accounting of dealer invoices for installation charges payable.

(k) The installation charges amount to approx. 5% of the sale value of the AC system.

8. *Views of the Statutory Auditor*

8.1 *Views of the Statutory Auditor on warranty revenue recognition and provisioning*

(i) Statutory auditors are of the view that the warranty in excess of 12 months from the date of installation or 15 months from the date of invoice, is *deemed extended warranty* and accordingly the *consideration attributable* for warranty period in

excess of 12 months from the date of installation or 15 months from the date of invoice need to be recognised on straight line method over the period of warranty. Further, expenses accounted towards liability to service provider mentioned in paragraph 6(f) above should be deferred for the period of warranty.

(ii) The statutory auditors provided following as the basis for their views:

(a) The Company adds 2.5% of sale value per year towards warranty cost while determining price of the product.

(b) In the financial statements, the Company has explicitly made disclosure in the Notes to financial statements that 'the Company generally provides for the warranty of 12 months from the date of installation or 15 months from the date of invoice'.

(c) The Company sends service manual to customers which contains 'Standard warranty policy' wherein it is stated that *'standard warranty of 12 months from the date of installation or 15 months from the date of invoice'.*

(d) Accounting Standard (AS) 9, 'Revenue Recognition' is silent on specific aspect of revenue recognition in case where warranty period varies from customer to customer; thus, *Guidance Note on Accounting by E-commerce Entities,* issued by the Institute of Chartered Accountants of India (ICAI) is applicable.

Extract from Statutory auditors' memo:

"AS 9, 'Revenue Recognition' does not contain sufficient guidance when the consideration includes multiple elements, and hence basis the guidance in Guidance Note on Accounting by E-commerce Entities, issued by ICAI (hereinafter referred to as GN), we have evaluated the following:

a. As the contract consists of both sale of product with standard warranty and additional extended warranty service, the contract is multiple element arrangement as per paragraph 41 of the GN.
b. It is appropriate for entity to unbundle the separate elements of the contract using entity specific fair values as per paragraph 42 of GN.
c. The sale of additional or extended warranty is, in substance, sale of separate service distinct from sale of goods with which they are sold; and is distinct from the original warranties offered as per paragraph 51 of GN.
d. Revenue associated with the extended warranty should be deferred and recognised on a straight-line basis over the period for which extended warranty service is provided basis paragraph 52 of GN (unless there is evidence that some other method better represents the stage of completion).
e. Further, considering that the GN is silent with respect to determination of fair values and the entity does not sell additional warranty separately and hence it is not possible to ascertain the fair value of additional warranty, we have evaluated that the Guidance from paragraph 79 (b) of Ind AS 115, 'Revenue from Contracts with Customers' may be used, wherein an entity could forecast its expected costs of satisfying warranty obligation and then an appropriate margin for that service

should be added and the same shall be recognised as revenue for additional warranty service provided by the Company."

8.2 *Views of the Statutory Auditor on installation service revenue recognition and provisioning*

The value attributable to the installation services contained in the sale invoice as a composite price should be recognised as and when the installation is completed and related expenses towards installation should be accounted as and when liability to pay arises. That is both revenue recognition of value attributable to the installation services and expense accounting should be done after receipt of bills for installation charges from dealers who do the installation.

9. *Views of the Company*

9.1 *Views of the Company on warranty revenue recognition and provisioning*

(i) The Company has been consistently following the accounting practices mentioned here in with respect to revenue recognition and creation of provision from the very beginning. That is, when a product is sold on warranty of whatever period, full value of sales (excluding taxes) is recognised as revenue when risks and rewards are transferred to customers and provision is created for un-expired warranty.

During financial year 2022-23, the Company has changed accounting practice as per statutory auditors' views although the Company is not convinced with the statutory auditors' views.

(ii) The warranty period exceeding 12 months from installation or 15 months from invoice offered to customers *is not a separate contract* so as to deem it as an extended warranty.

(iii) The Company is the manufacturer of products and decides the different warranty period for customers for reasons mentioned hereinbefore.

(iv) The mention of warranty period of 12 months from installation or 15 months from invoice in the accounting policy and in the service manual, does not make longer warranty period as deemed extended warranty or a separate line of revenue.

(v) The Company does not have intention to create a separate line of revenue by offering longer period of warranty.

(vi) The Company is making reasonable provision in its books for the liability which could arise out of the warranty so as to ensure that the Company is not overstating its profits.

(vii) The Guidance Note on Accounting by E-commerce Entities, issued by the ICAI is not applicable to the Company, as the Company is not into E-commerce activities of any sort.

9.2 *Views of the Company on installation service revenue recognition and provisioning*

1. The Company has been consistently following the accounting practices mentioned herein with respect to revenue recognition and creation of provision from the very beginning. That is, when a product is sold with installation, full value of sales (excluding taxes) is recognised as revenue when risks and rewards are transferred to customers and provision is created for installation charges payable.

   During financial year 2022-23, the Company has changed accounting practice as per statutory auditors' views although the Company is not convinced with the statutory auditors' views.

2. The Company is not doing installation services for third party products, but for its own manufactured products and installation agreement originates at the time of order booking.

3. Installation services are neither a separate line of business for the Company nor the Company intends to do the same in future.

4. The Company is making reasonable provision in the books till the installation is completed and charges for installation are paid to the dealers.

5. The acceptance of the product by the customer does not depend on the installation.

6. The Company does not have control over when the customer requires installation. There could be delays in months.

7. The Company does not refund the amount, if customer does not want installation.

10. *The Company's Interpretations of the GN on Accounting by E-commerce Entities, issued by the ICAI*

(a) Paragraphs 1 and 2 (Introduction) of the GN on Accounting by E-commerce Entities, issued by ICAI is applicable specifically to e-commerce companies. The ICAI clearly mentions the reason for releasing the GN.

Below is the text of paragraphs 1 and 2 (Introduction) from the GN***:***

"Introduction

1. This Guidance Note *deals with accounting by e-commerce entities* in respect of certain issues relating to revenue and expense recognition.

2. Some of the accounting issues in e-commerce entities have *arisen due to the new business models being used in such entities.* Some accounting issues, such as those relating to advertising partnerships, rebates, point and loyalty programmes, which are more common in business carried on by e-commerce entities."

(b) Paragraph 12 (Scope) of the GN makes it very clear that GN is for accounting issues unique to the e-commerce and *this GN applies to entities other than e-commerce only*

for recording e-commerce transactions. It also makes the point that *it does not deal with other generic accounting issues commonly faced across industries.*

Below is the text of Paragraph 12 (Scope) from GN*:*

"Scope

12. This Guidance Note aims at providing a perspective on the various *accounting issues which are unique to the e-commerce.* In case of entities normally carrying on *businesses other than e-commerce,* the recommendations contained in this Guidance Note should be applied *for recording e-commerce transactions* undertaken by them.

This Guidance Note applies to companies preparing financial statements under Companies (Accounting Standards) Rules, 2006, as amended, under Section 133 of Companies Act, 2013.

This Guidance Note also applies to entities such as Limited Liabilities Partnership firms and Partnership firms that prepare financial statements under the Accounting Standards issued by the ICAI.

This Guidance Note *deals with specific accounting aspects* and *does not deal with other generic accounting issues commonly faced across industries. This Guidance Note deals with the key issues of e-commerce companies."*

(c) Paragraphs 41 and 42 (Multiple element arrangements) of GN also talks about the various practices which are specific to e-commerce entity. The Company is neither e-commerce entity nor engaged in e-commerce business. The Company is not offering additional products/services, and the warranty offered for longer period is the original warranty which is part of sale contract entered with specific customer and is not an additional product or service.

Below is the text from paragraphs 41 and 42 of GN:

"Multiple element arrangements

41. A multiple element arrangement generally exists where an *e-commerce entity* agrees to deliver more than one product/ service concurrently and deliver certain additional products/services in *future.* These additional products/services may include upgrades, enhancements or maintenance services. It is sometimes customary to bundle such products and services for a *consolidated price.*

42. AS 9 does not provide any specific guidance on multiple-element sale arrangements. However, various past pronouncements of the ICAI have stated that it is appropriate to 'unbundle' the separate elements of the arrangement or contract. For this purpose, entity-specific fair values in respect of which objective evidence is available should be used, i.e., what the entity would have received had it sold each item/ service separately. Entity-specific objective evidence of fair value is determined in respect of transactions with unrelated parties. For example, an e-commerce entity may agree to host another entity's website and also provide web maintenance service for a fixed fee of Rs. 15 lakh for a term of one year and six months, respectively. If the

e-commerce entity has evidence that in its recent transactions, it has charged separate fees for web hosting and web maintenance of Rs. 12 lakh for one year and Rs. 6 lakh for six months, respectively, then revenue in respect of the composite service now being provided should be recognised in the ratio of 2:1, i.e., Rs. 10 lakh from web hosting over one year and Rs. 5 lakh as revenue from web maintenance services over a period of six months."

(d) Paragraphs 51 and 52 of GN clearly distinguish from *manufacturer warranty and warranty offered by other than manufacturer. Warranty offered by manufacturer is the original warranty irrespective of the period for which warranty is offered unless the warranty for additional period is sold as a separate product.*

The GN very clearly clarifies in the *Illustration* that the *retailer* selling extended warranty should recognise revenue only in the period for which the warranty is given. In this illustration, retailer is treating this extended warranty as separate line of business. Retailer revenue is mainly coming from sale of warranty which is for the future period i.e. period after manufacturer warranty expires. Thus, the revenue is also to be accounted for the period for which it pertains to and when liability towards that warranty is likely to arise. GN also clarifies that provision as per AS 29 is required for initial or original manufacturer warranty.

Below is the text from paragraphs 51 and 52 of GN:

"Warranties

51. Such sale of additional or extended warranties are, in substance, sale of separate product/service, distinct from the sale of goods/services with which the same are sold. Also, *such additional or extended warranties are distinct from the original warranties offered by the manufacturer of the products. Initial or original warranties offered by the manufacturer are accounted for by the manufacturer as liability in accordance with Accounting Standard (AS) 29,* Provisions, Contingent Liabilities and Contingent Assets.

52. The accounting treatment of sale of an extended warranty *by an online retailer* is illustrated below:

Example:

A retailer sells electrical goods. The goods come with a manufacturer's one-year warranty. *The retailer also offers customers the option of purchasing an extended warranty to cover a further three-year period after the expiry of the manufacturer's warranty.*

The sales price of the extended warranty is Rs. 120. The retailer typically receives valid warranty claims from 3% of customers during the extended warranty period. The average cost of repairing or replacing the goods under the warranty is Rs. 400 per valid claim.

As per the multiple element arrangement discussion, revenue associated with the extended warranty is deferred and recognised on a straight-line basis over the

period for which the extended warranty service is provided (unless there is evidence that some other method better represents the stage of completion). Accordingly, in the year of sale, revenue of Rs. 120 is not recognised (recognition is deferred) and the same is recognised annually. Thus, annual revenue of Rs. 40 (Rs. 120 divided by 3) is recognised each year as income from services- 'warranty' or as 'other operating income'.

Costs incurred to fulfil the warranty obligation are charged to cost of sales as incurred. The arrangement is monitored to ensure that expected cost of the warranty does not exceed the amount of deferred revenue. If this occurs, the warranty contract will be onerous, and a provision is recognised."

(Emphasis supplied by the querist.)

B. Query

11. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the following issues:

(i) Whether the Company is correct in recognising revenue on warranty in the year of sale irrespective of warranty period and creating provision for unexpired warranty. If not, what should be the correct accounting practice?

(ii) Whether the Company is correct in recognising the revenue pertaining to installation as and when the goods are transferred to the customer while creating the provision for the charges payable for installation. If not, what should be the correct practice?

C. Points considered by the Committee

12. The Committee notes that the basic issue raised by the querist relates to recognition of revenue from installation and maintenance services provided as part of the arrangement for supply of AC systems. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, allocation of contract price to various elements of the arrangement, accounting for trading of the parts required for maintenance services, basis of recognition of revenue over the service period, accounting for costs to be incurred including accounting for arrangements with service providers for maintenance and installation, measurement of provision for warranty cost or installation cost (if any), materiality of the revenue attributable to installation and warranty services, etc. The opinion is purely from accounting perspective and not from taxation (income tax or GST) or legal perspective. The Standards hereinafter referred are Accounting Standards (AS), notified under the Companies (Accounting Standards) Rules, 2021 as the same have been referred by the querist.

13. The Committee notes from the Facts of the Case that the Company is in the business of manufacturing and trading of bus air-conditioning systems ('the AC system') and related spares and components and also renders installation and maintenance services. The maintenance services include the after sales requirements/warranty obligation of products manufactured and sold. The AC systems manufactured by the Company are not 100% standard and are based on specific requirements of the customer. However, it is not clear from

the facts, whether the nature of the contract (eg extent of customization, complexity, time required for manufacture, etc.) is such that the arrangement would qualify as a construction contract to be accounted for as per Accounting Standard 7, 'Construction Contracts'. The Committee further notes that as per requirements of AS 7, construction of complex pieces of plant and equipment can be construction contract. For the purpose of the opinion expressed hereinafter, the Committee has assumed that the manufacture and installation of the AC system does not constitute a construction contract.

14. The Committee further notes that the arrangement under consideration includes manufacture and supply of AC systems, installation and maintenance (including warranty) services, which are within the scope of AS 9. Accordingly, the Committee notes the requirements of AS 9 as follows:

> ***"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied …***
>
> ***11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***
>
> ***(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and***
>
> ***(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.***
>
> ***12. In a transaction involving the rendering of services… Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service."***

The Committee also notes the following from the Illustrations to AS 9:

> ***"Illustrations***
>
> **…**
>
> **A. Sale of Goods**
>
> …
>
> *2. Delivered subject to conditions*
>
> (a) installation and inspection i.e. goods are sold subject to installation, inspection etc.
>
> Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae)."
>
> **"B. Rendering of Services**
>
> *1. Installation Fees*

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer."

The Committee notes from the above that revenue from sales or service transactions should be recognised when the requirements as to performance are satisfied. In case of goods, to recognise revenue, the entity (seller) should have transferred all significant risks and rewards of ownership of the goods to the buyer and retains no effective control of the goods transferred to a degree usually associated with ownership; and in case of services, on performance of the services, as agreed. Thus, AS 9 prescribes recognition of revenue when and to the extent that, goods and services have been provided to the customer. The Committee further notes that AS 9 does not specifically address recognition of revenue in a composite arrangement (often referred to as 'multiple element arrangement') comprising of supply of goods as well as rendering of services, such as installation, maintenance, etc., particularly, as to whether and how to separate various obligations embedded in a contract with a customer while recognising revenue.

In this regard, the Committee also notes a key (and usually the first) step in recognising revenue is to determine the obligations (hereinafter also referred to as 'the components') in the arrangement, i.e., does the arrangement comprises separately identifiable obligations/ components or is it a single obligation/component. If there is more than one component/ obligation, the revenue from the arrangement would need to be allocated to each separately identified component since as stated above, the basic premise of the Standard is to recognise revenue when the requirements as to performance are satisfied. Therefore, the Committee is of the view that in the given case, to determine the timing of revenue recognition, it needs to be assessed whether installation and maintenance represent separate obligations/components.

15. The Committee further notes that AS 9 does not provide detailed guidance on when and how separate components within a contract or agreement should be identified. While in some instances the separate obligations may be evident, there can be arrangements which may require judgement to identify separate obligations. In making the judgement, consideration should be given to substance of the arrangement, for example, if the customer derives value from an item in a contract that is not dependent on receiving other deliverables under the same arrangement and therefore, the customer could have accepted or rejected that item irrespective of the other components it can be considered as a separate component provided its value can be measured reliably.

16. The Committee also notes from the above-reproduced illustrations to AS 9 that if goods are sold *subject to* installation (unless installation process is so simple as envisaged in the above reproduced Illustration of AS 9), it would represent a service which is an integral part of the AC system and in these circumstances, entity should not recognise revenue from sale of AC systems until installation is complete. Further, in cases where installation fees (i.e. revenue pertaining to installation) are *other than incidental* to the sale of product (AC system), the same should be recognised as revenue only when the equipment is installed and accepted by the customer.

17. In the given case, as per the facts provided by the querist, the customer can opt to buy AC system without installation services from the Company (refer paragraph 7(b) above). Thus, the sale of goods is not *subject to* installation (which means that the acceptance of the product by the customer does not depend on the installation). Further, the nature of

installation services is such that it can be provided by another party. Considering these aspects, it seems that the performance in respect of sale of AC system is complete even though installation is pending. It would therefore be appropriate to consider installation as a separate obligation/component in the contract with the customer. Thus, if installation is pending, the Committee is of the view that it would be advisable for the Company to recognise only the revenue from the sale of the AC system; the revenue allocable to installation will be recognised separately as and when the installation services are provided. The above would also require that in case installation charges are received prior to the services being provided, the amount received be recognised as liability and recognised as revenue as per the requirements of AS 9, when installation services are provided.

18. The Committee now considers revenue recognition in respect of the warranty services being provided by the Company. In this regard, the Committee notes the following from the facts supplied by the querist:

- warranty period ranges from 12 months to 48 months;
- warranty period varies from customer to customer due to reasons such as geography of use, size of order, customer relationship;
- *unless specifically agreed through separate contract*, warranty is 12 months from the date of installation or 15 months from the date of invoice. This is also stated in the pre-printed service handbook which is provided to all customers; and
- The Company does not sell warranty as a separate product irrespective of period of warranty.

Based on the above, the Committee's understanding is that a customer does not have a choice to not take the minimum/standard warranty cover (i.e. when warranty is 12 months from the date of installation or 15 months from the date of invoice) though the customer may negotiate for the entire contract price including warranty. However, a warranty arrangement for a period longer than the standard warranty stated in the handbook is entirely at the discretion of the customer even though it may be bundled as part of the overall arrangement and a composite price is negotiated between the parties. Therefore, the Committee is of the view that the ability of the customer to choose, whether to purchase the warranty coverage (other than standard, also often termed as 'extended warranty') provides an objective evidence that the promised warranty provides a separately identifiable service to the customer in addition to the AC system.

19. The Committee further notes that when the selling price of a good includes a warranty (whether standard or extended warranty), it does not normally result in the retention of significant risks and rewards of ownership of goods by the seller, and consequently would not preclude the recognition of revenue from sale of goods (AC systems) in the extant case. However, in cases where the warranty period extends beyond a standard period, reference may be drawn from the following requirements of the Guidance Note on Accounting by E-Commerce Entities, issued by the ICAI, which although applicable for e-commerce industry, lays down general guidance of revenue recognition in respect of warranty services and can be applied by analogy:

> **"Warranties**
>
> 51. Such sale of additional or extended warranties are, in substance, sale of separate product/service, distinct from the sale of goods/services with which the same are sold.

Also, such additional or extended warranties are distinct from the original warranties offered by the manufacturer of the products. Initial or original warranties offered by the manufacturer are accounted for by the manufacturer as liability in accordance with Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets.

52. The accounting treatment of sale of an extended warranty by an online retailer is illustrated below:

Example:

A retailer sells electrical goods. The goods come with a manufacturer's one-year warranty. The retailer also offers customers the option of purchasing an extended warranty to cover a further three-year period after the expiry of the manufacturer's warranty.

The sales price of the extended warranty is ₹120. The retailer typically receives valid warranty claims from 3% of customers during the extended warranty period. The average cost of repairing or replacing the goods under the warranty is ₹ 400 per valid claim.

As per the multiple element arrangement discussion, revenue associated with the extended warranty is deferred and recognised on a straight-line basis over the period for which the extended warranty service is provided (unless there is evidence that some other method better represents the stage of completion). Accordingly, in the year of sale, revenue of ₹ 120 is not recognised (recognition is deferred) and the same is recognised annually. Thus, annual revenue of ₹ 40 (₹ 120 divided by 3) is recognised each year as income from services- 'warranty' or as 'other operating income'.

Costs incurred to fulfil the warranty obligation are charged to cost of sales as incurred. The arrangement is monitored to ensure that the expected cost of the warranty does not exceed the amount of deferred revenue. If this occurs, the warranty contract will be onerous, and a provision is recognised."

Further, the above requirements of the Guidance Note are also specified in the Technical Guide on Accounting Issues in the Retail Sector, issued by the Research Committee of the ICAI as follows:

"Warranties – additional or extended offered by the retailers

5.42 Retailers often sell additional warranties or extended warranties in addition to the one provided by manufacturer at the time of sale of product. An extended warranty is an agreement to provide warranty protection in addition to the scope of coverage of manufacturer's original warranty, or to extend the period of coverage provided by the manufacturer's warranty. They are often sold separately from the product but, may even be included in the price of the product.

5.43 Such sale of additional or extended warranties are, in substance, sale of separate product/service, distinct from the sale of goods/services with which the same are sold.

Also, such additional or extended warranties are distinct from the original warranties offered by the manufacturer of the products. Initial or original warranties offered by the manufacturer are accounted for by the manufacturer as liability in accordance with Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*.

5.44 The accounting treatment of sale of an extended warranty by retailer is illustrated below:

Illustration 10: Extended Warranties sold by the retailer

A retailer sells electrical goods. The goods come with a manufacturer's one-year warranty. The retailer also offers customers the option of purchasing an extended warranty to cover a further three year period after the expiry of the manufacturer's warranty.

The sales price of the extended warranty is Rs. 120. The retailer typically receives valid warranty claims from 3% of customers during the extended warranty period. The average cost of repairing or replacing the goods under the warranty is Rs. 400 per valid claim.

How is this arrangement accounted for?

As per the multiple element arrangement discussion, revenue associated with the extended warranty is deferred and recognised on a straight-line basis over the period for which the extended warranty service is provided (unless there is evidence that some other method better represents the stage of completion). Accordingly, in the year of sale, revenue of Rs. 120 is not recognised (recognition is deferred) and the same is recognised annually. Thus annual revenue of Rs. 40 (Rs.120 divided by 3) is recognised each year as income from services- ‘warranty’ or as ‘other operating income’.

Costs incurred to fulfil the warranty obligation are charged to cost of sales as incurred.

The arrangement is monitored to ensure that the expected cost of the warranty does not exceed the amount of deferred revenue. If this occurs, the warranty contract will be onerous and a provision is recognised.”

In view of the above, the Committee is of the view that it would be advisable for the Company to defer the recognition of revenue from extended warranty at the time of sale of the AC system and recognise the same separately over the period for which the extended warranty service is provided. In case any amount for warranty is received prior to the services being provided, the amount received should be recognised as liability. Further, a provision (liability) for standard warranty should be recognised at the time of revenue recognition from the sale of AC system (which will include the revenue related to standard warranty).

D. Opinion

20. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 11 above:

(i) As discussed in paragraphs 14 to 17 above, installation seems to be a separately identifiable obligation in the given case. Hence, if installation is pending, the Committee is of the view that it would be advisable for the Company to recognise only the revenue from the sale of the AC system; revenue allocable

to installation should be recognised separately as and when the installation services are provided.

(ii) As discussed in paragraphs 18 and 19 above, a provision (liability) for standard warranty should be recognised at the time of revenue recognition from the sale of AC system (which will include the revenue related to standard warranty). Further, it is advisable for the Company to defer the recognition of revenue from extended warranty at the time of sale of the AC system and recognise the same separately over the period for which the extended warranty service is provided. In case any amount for warranty is received prior to the services being provided, the amount received should be recognised as liability, as discussed in paragraph 19 above.

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