



Refined China accounting treatment for assurance warranty

In brief

- » China has lately issued a new accounting guideline, i.e. CAS Interpretation No. 18, to clarify the accounting treatment for assurance-type product sales warranty, which refer to warranty services for meeting the statutory product quality requirements - representing another important step in China's ongoing convergence with International Financial Reporting Standards (IFRS).
- » The interpretation is particularly relevant for sales of durable goods, machinery and equipment, consumer electronics, automobiles, etc. This article explores the requirements and implications.

Feedback

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In detail

Warranty arrangements are customary—and often obligatory—in particularly for sales of durable goods, machinery and equipment, consumer electronics and automobiles, etc. Consider the following example:

A manufacturer sells machinery at USD 500,000 per unit, including a one-year warranty that covers free repairs for defects within a legally mandated scope. The management estimates the repair costs during the warranty period at 2% of the sale price. Additionally, the manufacturer offers an optional extended warranty for USD 100,000, providing supplementary coverage beyond the agree-upon warranty terms.

In such sales, warranties can be categorized into two types:

- **Assurance-type warranty (A-type):** They are to assure the compliance with mandatory warranty obligations (e.g. the one-year-warranty within the price of USD 500,000 in the example). This type of warranty is a common requirement in most sales and is part of the sales obligation.
- **Service-types warranty (S-type):** They are additional services beyond legal requirements (e.g., extended maintenance or software updates – the 100,000 portion). They are optional and priced separately.

China's accounting treatments for the two types of warranties have evolved under Corporate Accounting Standard (CAS), progressing through:

- CAS 13 (2006) – Contingent Liabilities
- CAS 14 (2006) – Revenue Recognition
- CAS 14 (2017) – Revenue Recognition (revised)
- Interpretation 18 (2024) – Provision and cost recognition for A-type warranty

Changes and implications

The said CAS framework distinguishes between **A-Type warranties** (recognized as part of sales obligations) and **S-Type warranties** (treated as separate service contracts).

- However, prior to Interpretation No. 18 (2024), the income statement treatment of A-Type warranties remained ambiguous under CAS 13 (Contingent Liabilities) and CAS 14 (Revenue). Companies could recognize A-type warranty costs in either "*main business cost*" or "*selling expenses*". This discretion led to less comparability in gross profit reporting across entities for economically similar transactions.
- Interpretation No. 18 brings enhanced precision to the matter concerning A-types warranty, which is considered part of the original sale, due to its obligatory and contingency nature. Therefore, it mandates that in a **balance sheet**, A-type warranty must be recognised as at the time of sale as a provision (liability); in an **income statement**, it should be debited to "*main business cost*" or "*other operating cost*" but not "*selling expenses*", highlighting the accounting treatment towards the fact that A-type warranty is more related to assuring quality delivery other than acquiring sales opportunity.

A summary of the changes and their tax implications is set out below for easy reference.

Subject		Accounting treatment (per CAS)		China tax rules
		Revenue	Expenditures	
CAS 14 (2006)	It emphasizes the need to assess if product sales and warranty service sales can be separated.	If not separable, the A-type warranty should be recognized as part of product value	The cost is booked as liability provision per "CAS No. 13 - Contingencies".	CIT: The provision for services costs is subject to CIT adjustment. VAT: Revenue is subject to 13%. CIT: Cost deduction is allowed on actual incurrence following the accounting bookings. VAT: The service is subject to applicable rate, e.g. 6% or 13%.
		If separable, the revenue for sale of goods and warranty services should be recognized separately.	Warranty cost for additional service is booked as service cost based on its actual amount.	

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Subject		Accounting treatment (per CAS)		PRC tax rules
		Revenue	Expenditures	
CAS 14 (2017)	A-type warranty	Recognized as part of product value.	Cost is booked as a liability provision per CAS 13.	CIT: Provision is subject to adjustment. VAT: Revenue is subject to 13%.
	S-type warranty	Separately recognized on actual or allocation basis.	Costs are booked per the actual expenses incurred.	CIT: Costs on actual basis are deductible. VAT: The service is subject to applicable rate, e.g. 6% or 13%.
Interpretation 18 (2024)	A-type warranty	(N/A)	Cost should be booked as provision and main business cost or other operating costs (instead of selling expenses). Dr. Main business cost - warranty Cr: Anticipated liability - warranty	CIT: Provision is subject to adjustment.
	S-type warranty	(N/A)	(N/A)	(N/A)

Key takeaway

Interpretation 18 is issued to address in particular A-type warranty costs. It resolves the longstanding ambiguity by mandating that A-Type warranty costs must be:

1. Recognized in "*main business cost*" or "*other operating cost*" (not selling expenses), and
2. Disclosed transparently in financial statements.

The implications of the above requirements are that:

- In accounting, the matching and comparable principle should be adhered to. The income for A-type warranty is considered closely tied to the sales and must be recorded in the same period as revenue. Booking them to expenses will cause understatement of operating costs, further lead to overstatement of gross profit and eventually misjudging the profitability of the business.

It should be noted that Interpretation 18 affects CAS-governed entities (excluding SMEs under the "*Medium and Small Enterprises Accounting Standard*").

Further, Interpretation 18 has taken effect from 6 December 2024, applying to 2025 financial statements onward. It requires that, if the prior periods were misclassified by booking to the "*selling expenses*", restatement is mandatory with full disclosure in notes.

WTS China observation

Interpretation 18 represents the continuous effort to maintain the convergence of CAS with IFRS. It specifically clarifies the accounting treatment requirements related to A-type warranty.

Interpretation No. 18 is not just a technical update — it is a call for action to CAS-governed companies and tighten warranty accounting practices. Proactive compliance now could avoid costly corrections later.

Companies are advised to review and rectify their warranty accounting to avoid misclassification risks, especially for A-type warranty.



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