

Gift Cards and Financial Reporting Unwrapping the Uncertainties of Revenue-Recognition and Other Issues

By Ronald E. Marden and Timothy B. Forsyth

NOVEMBER 2007 - Gift cards come in two basic types: those that are affiliated with credit card companies such as Visa and MasterCard, and those that are not. The nonbank cards, often purchased from retailers, do not come under the jurisdiction of the federal banking laws, and very little GAAP guidance addresses how to account for them. There would appear to be a variety of ways that companies are accounting for the revenues and disclosures associated with nonbank cards, to the detriment of comparability. This article discusses differences in gift-card financial reporting and disclosures, and the possible issues with reporting transparency.

Nonbank gift cards are frequently referred to as closed-system or closed-loop cards because they are used only at the retailers that issue them. (Besides retailing, other types of uses for closed-system cards include telephone calls, restaurants, grocery stores, movie theaters, coffee shops, vending, and even payroll.)

There is not much legal regulation of nonbank gift cards, leading to a variety of conditions attached to the use of this plastic currency. In some cases these cards carry monthly fees, carry activation fees, and have an expiration date that can literally bring the original value of the card down to zero if the card is not used over time. For example, if the card had an original value of \$20 and carried a monthly fee of \$2, the \$2 monthly fees would eventually bring an unused card's value to zero in less than a year. Because these kinds of fees have been the basis of many consumer complaints, many nonbank card issuers have stopped attaching monthly fees or expiration dates. For consumers, another persistent negative aspect of nonbank gift cards is that most issuers will not allow the customer to redeem unused value for cash. Despite these limitations, gift cards have become big business.

Big Business

Companies like gift cards because they are money-makers. According to estimates from the National Retail Federation, 80% of all shoppers purchased at least one gift card in 2006, with total annual gift card sales estimated at around \$53 billion. The 2006 end-of-year holiday sales were some \$27 billion, up almost 34%. During the 2006 holiday season, the average consumer spent about \$116 on gift cards, actually overtaking clothing as the most popular of holiday gifts (Elizabeth Wayke, "Someone's Been Using My Gift Card," *BusinessWeek*, January 15, 2007). Additionally, companies are keen on cards because gift recipients effectively extend the retail holiday season for another month or two. Cards turn the January and February clearance sales into one of the most important nonholiday times of the year for retailers.

Customers are fond of gift cards because they can be handy when one doesn't know what to give "that special someone" for a holiday or other occasion. Gift cards can also be practical for relatives at a distance, especially as an alternative to shipping presents. And, in some cases, love may have nothing to do with it: Many appreciative employers use gift cards as incentives and awards. Either way, most everyone seems to like gift cards because they're convenient, easy to use, flat, lightweight, easily stored, virtually unbreakable, and, perhaps most important, the recipient is saved the predicament of having to return unwanted gifts.

Current Accounting for Gift Cards

One way a company profits from gift cards is the phenomenon of people frequently spending more than the actual amount on the card. According to Providence College marketing professor Daniel R. Horne (in the above-referenced *BusinessWeek* article), consumers, buoyed by a sense of "found money," spend an average of 1.4 times the amount on their cards. If applicable, issuers can profit through monthly service or renewal fees (if

the card has an expiration date). In addition, some purchasers don't use the entire amount on the card, leaving a small balance that is forgotten or disregarded. Some customers may even lose the card before using it at all, and unused cards can add up to substantial amounts.

Interesting questions are raised for auditors, gift card issuers, and financial statement users. If there are no fees or expiration dates, how should a company account for the initial transaction and ultimate disposition of the monies when a customer pays, say, \$100 for a gift card but never uses the card? Assume that the \$100 is recorded as cash and that the company now has a liability (unearned revenue) in the same amount. If the card has no expiration date, will the liability stay on the books indefinitely? At what point can the company decide that the card will indeed never be used for the amount recognized as income (referred to as breakage income)? Keep in mind that while \$100 may not seem material, it's been estimated that as much as 10% of the total value of gift cards sold in the United States goes unused, totaling nearly \$8 billion due to unredeemed value, expiration, or lost gift cards (Cerise A. Valenzuela, "New Fraud Makes Rounds This Holiday Season," Copley News Service, *The Alert Consumer*, December 11, 2006).

Companies account for gift card sales in different ways. Moreover, not all companies disclose their policies for recognizing breakage income. A review of the notes to the 2006 10-Ks of four well-known retail chains that offer gift cards reveals different accounting for each. In all four cases, the cards are very popular because they do not impose expiration dates or fees, they can be used online and in stores, and they can be replaced if lost or stolen.

- In its 2006 10-K, Best Buy states that it recognizes breakage income for unused cards that have been outstanding for 24 months, because at that point, the "likelihood of redemption is deemed to be remote." In this case, breakage income is based on the company's "historical redemption pattern."
- Home Depot discusses its gift cards in the Management Discussion and Analysis (MD&A) and footnotes of its 2006 10-K. Home Depot discloses the amount of breakage income recognized, but it does not provide details about the basis for recognition.
- Circuit City's only mention of gift cards in its 2006 10-K is that the receipts are initially put into deferred revenue as a liability. Circuit City makes no mention of breakage income.
- Wal-Mart states in its 2006 10-K that it recognizes revenue on gift cards only when "the customer purchases merchandise by using the shopping card." Wal-Mart does not mention breakage income.

While these notes offer only a small sample of revenue recognition and disclosures, they illustrate the variety in how gift cards are accounted for. In addition, another interesting item noted in the Best Buy footnote is the statement that the company does "not have a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions." In some states, after a certain period of time, the unredeemed value of the cards reverts back to the state as unclaimed property. For example, according to Mary Lau, president of the Retail Association of Nevada, if a card is not entirely used, the balance is usually turned over by the issuer to the state where the card was purchased; under Nevada law, it is unclaimed property (Valerie Miller, "Gift-Card Purchases Expected to Jump, but Fees and Fraud Remain," *Las Vegas Business Press*, December 11, 2006). In North Carolina, retailers must wait three years and then are allowed to keep 40% of the money on cards that have an expiration date; the other 60% goes to the state. If the card has no Expiration date, the retailer is allowed to keep all the money. In South Carolina, All gift cards are exempt from unclaimed property laws, so retailers get to keep all of the unused money (Nichole Monroe Bell, "And to All a Good Swipe," *Knight Ridder Tribune Business News*, December 23, 2006).

In New York state, lawmakers have taken action on the gift card issue. Prior to 2007, the process for handling gift cards and certificates was something of an annoyance for retailers because the unredeemed value of a gift card or gift certificate had to be escheated, or turned over, to the state Treasury Department five years after the date of issuance or two years after the expiration date, if one was used. In January 2007, a new law went into effect that gives businesses the opportunity to bypass the escheat process by exempting "qualified" gift certificates and cards. The law defines a qualified card or certificate as one that does not carry an expiration date and does not charge any fees to the certificate or card holder. This provision allows businesses to avoid escheat responsibility, but also permits businesses to continue using expiration dates or fees if they so choose

(Jessica Bair, "Law Gives Businesses More Flexibility with Unredeemed Gift Cards," *Central Penn Business Journal*, May 18, 2007).

Consequently, depending on the escheat and other laws of the state in which a company does business, issuers of gift cards may incur additional costs or not reclaim as much as expected in association with unused cards. This, in turn, may influence how the cards are marketed and accounted for.

The Costs of Doing Business

Accounting for unused gift cards can be more costly and cumbersome than one might think. According to the National Retailers Federation, a Washington, D.C.-based trade organization, card programs can have a cost for retailers, particularly when card balances remain outstanding for several years. "It's a matter of accounting issues as well as practicality issues in operating the card-issuing systems," said Craig Shearman, a spokesman for the federation, adding that the longer cards remain unused, the longer an outstanding balance remains on the retailer's books. "The cost of paying for the program, i.e., the actual outlays, employee time it takes to administer the program ... retailers have to justify [operating] the program and how they are going to pay without using money generated from fees" (Sabra Ayres, "Alaska Legislature Considers Gift Card Fees: Under New Law, They Couldn't Expire or Arrive Harnessed With Fees," *Knight Ridder Tribune Business News*, February 10, 2007).

Another potential expense is the cost associated with fraud. Any retail store that uses gift cards can fall victim to fraud. The source of these frauds can be categorized into two basic types: external threats from nonemployees and internal threats from employees, with the occasional collusion between the two.

External threats. One of the easiest forms of fraud is to simply shoplift the cards off the sales racks and try to swap or sell them over the Internet at sites such as eBay.com, Plasticjungle.com, Swapagift.com, or Cardavenue.com. Buyers believe they're getting a bargain that's almost too good to be true, and more often than not, conventional wisdom prevails. In fact, according to Mark Albright, "An audit of 50,000 of one retailer's gift cards sold on auction sites revealed 35,000 were stolen, had no balance or otherwise were bogus" (*Knight Ridder Business News*, January 18, 2007).

Another common scam is for a thief to take some cards from a store and use an electronic device to copy the card's authorization information from the bar code or magnetic strip. The cards are then surreptitiously returned to the sales rack. The thief will then periodically check whether the card has been activated and what its balance is (usually through a toll-free number or website). At this point, the thief can use the stolen authorization codes to purchase items online without needing the card itself.

Internal threats. Fraud can also be perpetrated by individuals within the organization. An employee could be involved in a "checkout" scam, pretending a card is empty or deactivated, then persuading the customer to hand over the "worthless" card. In some cases a cashier can pull a sleight of hand and replace the customer's card with one that had no value on it. The cashier tells the customer that the card must have already been used, and the cashier keeps the card with value.

These types of scams may seem to be few and far between, but they represent significant fraud. According to Richard Hollinger of the University of Florida's Center for Studies in Criminology and Law (see the previously cited *BusinessWeek* article), the center's Annual National Retail Security Survey indicated that out of 150-plus stores surveyed, respondents estimated gift card losses at more than \$120,000 a year. While 26% of the losses were attributed to stolen or counterfeit cards, some 62% were attributed to dishonest employees.

Whether gift card fraud is really material to the bottom line may not address the entire issue. When customers who give or receive these cards are scammed, the store's image can be tarnished even if the store is not directly responsible. This can have a hidden cost if these customers feel resentful and do not return.

Accounting for Gift Cards: A Recommendation

Closed-system gift cards are becoming a large source of both revenue and costs, obvious and hidden. The problem is that gift cards are a relatively new type of significant revenue source for some companies, and the accounting literature offers no specific authoritative guidance for accounting for closed-system gift card revenue. The revenue-recognition principle [Statement of Financial Accounting Concepts (SFAC) 5] can provide some general guidance. SFAC 5, para. 83, states that revenues should be identified whether they are “realized or realizable” and earned; that is, “revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.” The issue with gift cards is not realization, but rather when the earnings process is actually completed.

This determination will be different for each company, depending on its individual experience with gift cards and the applicable state escheat laws. When gift cards are issued, an unearned revenue account (liability) is recorded. Revenues (and related expenses) are recognized as the card is presented to the issuer in exchange for goods and services. If the card has an expiration date, breakage income should be recognized for the remaining balance of the gift card at the expiration date, and that amount should be reduced by any amounts accruing to the state in which the card was issued, based on escheat laws.

Theoretically, if the gift card has no expiration date, the company should report the unused portion on the balance sheet as a liability indefinitely. Because most gift cards being issued currently are electronic, companies can easily (and efficiently) track card usage in a manner similar to aging accounts receivable. Many companies may find that the longer a card is outstanding, the less likely the card will be redeemed for merchandise. Similarly, companies may find that cards that have been used but have relatively small remaining balances are less likely to be redeemed than newer, high-balance cards.

In such cases, one solution could be to recognize breakage income when prior experience provides substantial evidence that cards meeting certain criteria will never be fully redeemed. If, in rare cases, some of the “written off” cards are later redeemed for merchandise, the company can recognize that expense at the date of redemption. If the company has been conservative in determining its breakage income, the subsequent expense recognition should be immaterial. At the very least, companies with material gift-card revenue should be required to disclose their revenue-recognition policies related to their gift cards. Such disclosure would enhance comparability and transparency in their financial reporting.

FASB Action Needed

Currently, there is no standard way of accounting for or disclosing gift card revenues, a large and growing segment of retail and other industries. This presents an interesting situation for accountants. If a given state does not have an unclaimed-property law, it could be up to the company to decide when it believes the unused card values are unredeemable and able to be recognized as income.

Unless the company’s financial statement footnotes disclose, as Best Buy’s did, that “based on our historical information, the likelihood of a gift card remaining unredeemed can be determined 24 months after the gift card is issued,” there’s no telling what process is being used for this estimate. In this case, at least Best Buy lets the financial statement reader know when it has deemed the likelihood of redemption to be remote. The other companies reviewed by the authors provided no indication of when or how they will recognize their cards as breakage income or as an offset to some expense.

Being able to control when, where, and how a substantial amount of revenue can be inserted into the financial statements can be beneficial for management, but can be misleading for financial statement readers and certainly deserves additional scrutiny. Given the simplicity of the issue, FASB might place gift card accounting on the Emerging Issues Task Force (EITF) agenda to enhance comparability and transparency among gift card issuers.

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