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Accounting for Gift Cards: Issues such as Breakage and Borrowing Cash Interest Free

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Abstract:
This article reports on contracts with customers that an organization creates by selling gift cards. Selling gift cards results in organizations borrowing money without incurring any interest charge on that borrowed money. A brief history is presented of gift cards from having expiration dates and issuing fees to having no expiration date or issuing fees. Presented is the issue surrounding so-called breakage where an organization decides that the gift card is not going to be used so the organization writes off the liability to provide a product or service related to the gift card and recognize revenue in the same amount. The amount of money in essence was borrowed from customers who will never receive the product, service or money back plus no interest is paid for that borrowed money that ends up being kept by the organization. Examples from actual annual reports are presented along with information about State laws (e.g., Delaware) that require the cash associated with expired (i.e., broken, which is what breakage means) gift cards be transferred to the State. Manufacturing firms that typically do not sell gift cards (e.g., Coca Cola) are incorporated in Delaware. Retail firms (e.g., Walmart, Target) plus manufacturing firms that are also retail firms (e.g., Apple) are not incorporated in Delaware.

Keywords: *Gift cards, revenue recognition, liability measurement, contracts with customers*

1. Introduction

1.1. Accounting for Gift Cards

Accounting for gift cards fits in the generic area of accounting for contracts with customers. It has been impacted by the controversy surrounding revenue recognition that grew in significance in the second decade of the 21st century. Part of the growth in significance has been due to advancing globalization, derivatives (and other types of financial instruments including crypto currencies such as Bitcoin) and technology issues plus the focus of this article, which is the growth of unredeemed gift cards. Growth of unredeemed gift cards causes the liability section of the balance sheet to increase having an adverse impact the debt to equity ratio. Often major creditors reserve the right to increase interest rates if a specified debt to equity ratio is not maintained. This motivates organizations to decrease reported debt (e.g., unredeemed gift card obligations) and increase equity (e.g., net income) when possible.

1.2. History

In their 46-page memo issued in 2015, the Financial Accounting Standards Board (FASB) (2015) presented the history and debate surrounding accounting for gift cards. Initially, distributors (e.g., grocery stores) charged the customer an up-front fee of about $2.50 beyond the value of the gift card. When the recipient of the gift card redeemed the gift card, then another fee of about $2.50 was charged. Over time, the fees were eliminated. However, entities (e.g., grocery story) that sold the gift card on behalf of a content (e.g., product or service) or financial (e.g., gift card recipient could redeem the card for cash) would charge a fee. It was and is like a sales commission for the service of selling the card on behalf of the financial institution, store, restaurant or other organization.

The entity selling the gift card would forward the cash less the “sales commission” that would be recognized as revenue by the organization that sold the card to the customer. The organization that owed the customer or the person to whom the customer gave the gift card would recognize the cash received the commission expense and the liability for the full amount of the gift card.

Over the years, the amount of the gift card liability grew as recipients of the gift cards did not redeem or only partially redeemed the amount available on the gift cards. As the 46-page FASB (2015) publication details, requests for guidance regarding this every growing liability were submitted to the FASB. The FASB guidance was that the liability be written off and revenue recognized when the possibility of the gift card being redeemed was determined to be remote. This would be a judgment or estimate based on available data to the end opinions of managers within the organization that had issued the gift card. This was thought to possibly result in diverse measuring and reporting by various organizations thereby making the financial reports less comparable for those using them to make economic decisions (e.g., loan money to an organization, invest in an organization).

"A card with a cash option is not the same as a card without a cash option, but [are] the economics of the arrangements … sufficiently different to justify completely different accounting models" (FASB, 2015, page 12). The liability could remain on the balance sheet indefinitely much like Goodwill subject to remeasurement under the so-called impairment method could remain on the balance sheet indefinitely (Mathew & Gray, 2018).

1.3. State Laws Regarding Unclaimed Property

"Delaware's governor in early February 2017 … [made] sweeping reforms to Delaware's unclaimed property statutes" (KPMG, 2017). These reforms continued the requirement that gift card cash be turned over to the State of Delaware when a gift card expired and/or the possibility became remote that the gift card holder would redeem the gift card. Organizations based in and/or incorporated in the State of Delaware are subject to this State law. Target is incorporated in Minnesota (Target, 2018). According to Target's 2017 annual report (Target, 2018), "revenue from gift card sales is recognized upon gift card redemption. Our gift cards do not expire. Based on historical redemption rates, a small and relatively stable percentage of gift cards will never be redeemed, referred to as 'breakage.' Estimated breakage revenue is recognized over time in proportion to actual gift card redemptions and was not material in any period presented." The State of Minnesota does not have unclaimed property statutes similar to those in the State of Delaware regarding gift cards. Kohls, Walmart, Amazon and Apple are examples of organizations that are not incorporated in Delaware. They sell gift cards as is discussed later in this article.

1.4. United States Federal Income Tax Accounting

The United States (US) federal income tax accounting for gift cards was addressed by the Internal Revenue Service (IRS) (2018). When a taxable entity receives money, then that monetary amount must be included in taxable income. Exceptions are made for monetary amounts received as advance payment and for financial accounting purposes the revenue is deferred until the money is returned, the service or product is delivered or it is deemed that the possibility of either of the aforementioned events occurring is remote. Accounting for gift card monetary amounts fits within the exception. The 2017 income tax law changes did not change the accounting for gift cards (Grant Thornton, 2018).

1.5. Breakage (Also Known as the Estimated Amount of Gift Cards That Will Not Be Redeemed)

When organizations want to write off part of the liability for unredeemed gift cards, they call it breakage. Breakage typically refers to tangible products (e.g., toys, dishware, computers, and equipment) that can actually be broken and thereby no longer can be offered for sale. As of the year 2018, nearly all organizations sell gift cards without an expiration date. Breakage (i.e., writing off part of the liability for unredeemed gift cards) requires making an estimate and/or or judgment call. This is similar to estimates used for Allowance for Doubtful Accounts relative to Accounts Receivable. It is also similar to estimates of useful life and/or salvage value when doing cost allocation (e.g., depreciation, amortization, depletion). Estimates involved with determining potential impairment of the intangible asset Goodwill also involve estimates. These are just a few examples. Estimates can decrease the comparability of financial statements of one organization to other organizations as the managers of each may make different estimates based on their judgment which is a function of their differing levels of expertise (e.g., experience, education).Debate, controversy and potential changes in accounting guidance for all types of estimates continues. The International Accounting Standards Board (IASB) has not yet issued guidance via an International Financial Reporting Standards (IFRS) as to how to measure and report gift card liability when the possibility of redemption is estimated to be remote. This is one example where US Generally Accepted Accounting Principles (GAAP) and IFRS still differ.

"Revenue from Kohl's gift card sales is recognized upon gift card redemption. Income from unredeemed cards (breakage) is recorded in proportion and over the time period gift cards are actually redeemed" (Kohls, 2018, F-10). Kohls (2018) is incorporated in Wisconsin (page 1). Wisconsin does not regulate gift cards (Wisconsin, 2018).

Walmart (2018) reported the following regarding breakage (pages 63-64): "Gift Cards Customer purchases of gift cards, to be utilized in our stores or on our eCommerce websites, are not recognized as revenue until the card is redeemed and the customer purchases merchandise using the gift card. Gift cards in the U.S. and some countries do not carry an expiration date; therefore, customers and members can redeem their gift cards for merchandise indefinitely. Gift cards in some foreign countries where the Company does business have expiration dates. A certain number of gift cards, both with and without expiration dates, will not be fully redeemed. Management estimates unredeemed gift cards and recognizes revenue for these amounts when it is determined the likelihood of redemption is remote. Management periodically reviews and updates its estimates."

Starbucks (2018) calls gift cards "Stored Value Cards" and reports the following about breakage (page 60): "Stored value cards, primarily Starbucks Cards, can be activated at our company-operated and most licensed store locations, online at Starbucks.com or via mobile devices held by our customers, and at certain other third-party locations, such as grocery stores, although they cannot be reloaded at these third-party locations. When an amount is loaded onto a stored value card at any of these locations, we recognize a corresponding liability for the full amount loaded onto the card, which is recorded within stored value card liability on our consolidated balance sheets. Stored value cards can be redeemed at company-operated and most licensed stores. When a stored value card is redeemed at a company-operated store, we recognize revenue by reducing the stored value card liability. When a stored value card is redeemed at a licensed store location, we reduce the corresponding stored value card liability and cash, which is reimbursed to the licensee. In most markets, there are no expiration dates on our stored value cards and we do not charge service fees that cause a decrement to customer balances. While we will continue to honor all stored value cards presented for payment, management may determine the likelihood of redemption, based on historical experience, is deemed to be remote for certain cards due to long periods of inactivity. In these circumstances, if management also determines there is no requirement for remitting balances to government agencies under unclaimed property laws, unredeemed card balances may then be recognized as breakage income, which is included in interest income and other, net on our consolidated statements of earnings. In fiscal 2018, 2017, and 2016, we recognized breakage income of $155.9 million, $104.6 million, and $60.5 million, respectively. Refer to the Recent Accounting Pronouncements section of this footnote for further discussion regarding the expected changes to breakage income in the first quarter of fiscal 2019." Starbucks calls gift cards "Stored Value Cards" and reports the following (page 64): "In March 2016, the FASB (2016) issued guidance for financial liabilities resulting from selling prepaid stored value products that are redeemable at third-party merchants. Under the new guidance, expected breakage amounts associated with these products must be recognized proportionately in earnings as redemption occurs. Our current accounting policy of applying the remote method to all of our stored value cards, including cards redeemable at the third-party licensed locations, will no longer be allowed. We will adopt and implement the provisions of this guidance and the new revenue recognition standard issued by the FASB ... in the first quarter of fiscal 2019."

1.6. Gift Cards as Borrowing Cash without Paying Interest

Gift cards are one way that an organization can "borrow" cash without paying interest. One can imagine the great appeal for organizations to issue gift cards as a form of borrowing money without being charged or having to pay any interest. Small organizations such as a place that does manicures and pedicures would sell gift cards that can only be used at their organization and that cannot be redeemed for cash. Restaurants and other organizations may also sell gift cards that can only be used at their organizations and that cannot be redeemed for cash. Even if the gift card has no expiration date, it could be lost or the gift card holder might postpone using it until the organization goes out of business or the gift card holder moves too far away to reasonably ever use the gift card. While the organization may keep reporting the gift card liability (unless the organization goes out of business), the cash received can be used to pay operating and other expenses and/or distributed in other ways. Fried, Holtzman and Rotenstein (2015) reported that "More than $118 billion in gift cards changed hands during 2013, according to CEB TowerGroup. This is great news for the many retailers that sell gift cards; the retailers receive cash upfront in return for providing goods and services at a later time. Financially, a gift card is essentially an interest-free loan from the consumer to the retailer. In accounting terms, the funds received from customers' amount to unearned revenues, a liability."

2. Conclusions

Accounting for gift cards (or store-valued cards as Starbucks calls them) provides a challenge for organizations that are incorporated in States such as Delaware that require cash associated with "expired" gift cards be transferred to the State as "unclaimed assets." Upon transferring the cash to the State, the organization would reduce both cash and the liability to provide products or services. To avoid obvious expiration of a gift card, most organizations as of the year 2019 do not issue gift cards with an expiration date. Organizations refer to estimated expiration of a gift card as breakage. Breakage is when the organization estimates that redemption of the gift card is remote. This is a judgment call. As noted earlier in this article, annual estimated breakage was reported by Starbucks (2018) as follows: "In fiscal 2018, 2017, and 2016, we recognized breakage income of $155.9 million, $104.6 million, and $60.5 million, respectively." The growth from $60.5 million to $155,9 million two years later could motivate States such as Delaware to look more closely at the financial reports of organizations incorporate in their State. This amount of cash could be very beneficial to a governmental agency. Starbucks (2018) is incorporated in the State of Washington (page 1). The State of Washington (2004) stated that "It is the intent of the legislature to relieve businesses from the obligation of reporting gift certificates as unclaimed property." This results in Starbucks being able to keep the cash and recognize revenue as the liability is written off the financial records as breakage. This decreases the reported debt and increases the reported Owners' Equity, which enhances the debt to equity ratio.

3. Summary

This article provided a brief history of gift cards followed by a discussion of the issue of accounting for the actual and/or estimated expiration (i.e., that redemption of the gift card being remote) of gift cards. While the focus of the article was on measuring and reporting in financial statements (e.g., balance sheet), State and US Federal requirements were touched upon. As there continues to be controversy regarding accounting for gift cards including that the IASB has not yet issued guidance regarding accounting for gift cards, it is expected that the FASB will continue to research the issue. The FASB will probably issue another Proposed Accounting Standards Update (ASU) regarding accounting gift cards and the determination of when potential redemption of the gift cards becomes remote (which currently is a judgment call by the organization that issued the gift card).

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