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Accounting for Gift Cards: A Demonstration of the Need for a New Accounting Standard

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ACCOUNTING FOR GIFT CARDS: A DEMONSTRATION OF THE NEED FOR A NEW ACCOUNTING STANDARD

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ABSTRACT

BEN W. VAN LANDUYT: Accounting for Gift Cards: A Demonstration of the Need for a New Accounting Standard
(Under the direction of Dr. Rick Elam)

This thesis concerns the current accounting environment and methodology related to gift cards, and proposes a new accounting standard. The lack of authoritative guidance for companies that issue gift cards has led to disparities in gift card financial treatment and disclosure. Of particular concern is the treatment of revenue resulting from unredeemed gift cards. Companies generally adhere to one of two basic methods of calculating said revenue. The first method calculates revenue from unredeemed gift cards as an annual percent reduction of the gift card liability. An alternative method recognizes revenue from unredeemed gift cards with the passage of time. Thesis research included analysis of Form 10-Ks, testing of data from companies who issue gift cards, and simulated models to determine various ways in which revenue from unredeemed gift cards can effect financial reporting. The accounting concepts of comparability, consistency, revenue recognition, matching, materiality, and conservatism were considered in relation to gift card accounting methodology. It was concluded that a new, authoritative standard is needed. This standard should require revenue from unredeemed gift cards be recognized based on the passage of time, and mandate complete financial reporting of pertinent gift card information.

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Introduction

The sale of gift cards is a common marketplace transaction. Stored value cards and certificates redeemable from the retailers and restaurants that sell them are appreciated by consumers for their convenience and gift giving potential. Issuing companies enjoy several tangible and intangible benefits from offering gift cards. One benefit, revenue associated with gift cards that are never redeemed, raises some interesting accounting questions. Consumer Reports found at the end of 2007, that 27% of those who received a gift card in 2006 had not used it (Consumer Reports). The material amount of unredeemed gift cards are a boon for companies as they represent revenue with no associated good that must be transferred or service that must be rendered. Lack of accounting standards on the topic has led to financial reporting that lacks consistency, comparability, and transparency of financial statements, and has resulted in practices divergent with accounting principles. The following study will illustrate the current problems with accounting for gift cards, test alternative standards, and propose a new standard.

Reliably quantifying for accounting purposes the benefits to a company of a gift card going unredeemed, a "non-event", is a difficult proposition. Accounting standards-setting authorities have issued very little procedural guidance on the issue. As a result, companies' gift card accounting practices vary to a large extent. The revenue that results from gift cards going unredeemed, also known as "breakage" revenue, has the potential to impact companies' financial statements in ways that are to the detriment of financial statement users. Investors, creditors, government entities, and other external users cannot make satisfactory decisions based on financial statements that are not comparable, consistent, transparent, and reliable.

Gift cards sold by retailers and restaurants are recorded as a liability until their redemption. Limited guidance on how to deal with revenue resulting from unredeemed gift cards, breakage, has led to a variety of accounting approaches by gift card issuing companies, resulting in varying effects to financial statements. Accounting variations and theoretical flaws incumbent to the current gift card accounting environment limit the usefulness of effected financial statements, and should therefore be addressed by new, authoritative, and comprehensive accounting standards.

To date, there has been only one significant research study devoted to gift card accounting. That study examined 167 gift card issuing companies to evaluate how companies treat gift cards and breakage revenue. The study found that of the 167 companies, fifty-three disclosed their breakage policy in a footnote to their financial statements, and only eight provided the specific amount of breakage revenue they recognized from unredeemed gift cards. This indicates that the majority of companies either did not recognize any breakage revenue or buried the amount in an account like Other Revenue with no explanation in footnotes (Kile).

Despite numerous discrepancies in accounting practices, two general methods of breakage computation have emerged among gift card issuing companies. Some companies compute revenue from unredeemed gift cards by annually reducing their gift card liability by a fixed percent. Others estimate breakage based on the passage of time, or the age of the liability.

When assessing current accounting practices and considering a potential accounting standard, it is important to address the accounting conceptual framework. In particular, comparability, consistency, revenue recognition, matching, materiality, and conservatism are concepts that must be reconciled with and satisfied by any new standard for gift card accounting.

The hypothesis that a new accounting standard is needed is supported if the following can be demonstrated. First, the lack of accounting standards undermine financial statement comparability and consistency; second, that breakage revenue is a material component of information reported in financial statements; third, current accounting for breakage revenue is often contrary to the revenue recognition and matching principles; fourth, gift card accounting practices create divergences between the matching principle and conservatism.

The validity of these assertions will be established through testing of data from companies that report an amount for breakage revenue. The results will indicate if a new accounting standard is needed. Computation of the percent change in companies' income before tax tests the materiality of breakage. Analysis of current gift card related Form 10-K footnote disclosures will illustrate a lack of comparability and consistency. Exploration of common gift card accounting practices will reveal other violations of accounting principles.

Having established the need for a new standard this study will test which of two alternatives may best satisfy relevant accounting concepts and principles. The examination of current reporting practices identified two approaches to computing and recognizing breakage revenue being employed currently. One approach is based on an annual percent reduction of the gift card liability; the other is based on recognizing breakage after a gift card has gone unredeemed for a certain length of time. A new standard will likely require that only one of these approaches be used by all companies that issue gift cards. This study will test through simulation whether mandating the percent reduction method or the passage of time method would best satisfy the pertinent accounting principles.

To successfully ensure reconciliation with financial accounting concepts and promote financial statement integrity, a new standard must meet certain requirements. Even if the new standard is based in principle, rather than rule, it should provide comprehensive guidance to ensure reasonable treatment of gift cards and estimation of breakage. Such a standard should ensure that financial statement reporting practices are uniform among and within companies and in accordance with proper accounting theory. It should be mandated that financial statement disclosures related to gift cards present sufficient information to convey the financial effects of gift cards. These considerations in a new accounting standard would help make certain that the effects of gift cards and associated breakage revenue clearly and consistently meet the objectives of financial statement users.

Section I. Background and Previous Research

History of Accounting for Gift Cards

In recent years, consumers have become infatuated with the giving of gift cards. In 2006, United States' November and December holiday sales of gift cards alone totaled an estimated $75 billion (Kile). Gift cards are popular with consumers for their convenience as gifts, but are especially popular with retailers for numerous reasons. The sale of gift cards are typically accompanied by "increased sales, marketing opportunities, improved cash flow and inventory management and a stronger bottom line as the result of unredeemed gift cards" (Kile).

The ambiguities of financial accounting for gift cards, coupled with their widespread use, has raised some interesting accounting questions. Companies have difficulties determining when the earnings process for gift cards is complete. That makes it problematic for companies to accurately, consistently, and transparently reflect the economic effects of gift card sales in their financial statements. What's more, the Securities and Exchange Commission has offered minimal guidance on the subject, and the Financial Accounting Standards Board has taken no position whatsoever. In particular, the problem of dealing with unredeemed gift cards, called breakage, especially complicates financial reporting.

There are two types of gift cards. The first type is usually backed by a credit card company such as Visa or MasterCard. These are referred to as bank cards, are prepaid, have a preset spending limit, can be used anywhere that accepts credit cards, and fall under the jurisdiction of federal banking laws.

The second type of gift card is issued by, and purchased from, individual retailers. This variety of gift card causes financial reporting and disclosure difficulties, and is the focus of this study. Referred to as non-bank, closed system, or closed loop cards, these types of cards have applications beyond retail gift giving including "telephone calls, restaurants, grocery stores, movie theaters, coffee shops, vending, and even payroll" (Marden). Many colleges and universities also use this type of system for meal plans and student expenses.

The basic bookkeeping procedure for the sale of a gift card is to debit an asset (usually cash) and credit a liability. Upon redemption of a gift card, a company debits the gift card liability, and credits a revenue account. Unless a gift card is redeemed, the liability would theoretically stay on the books indefinitely. A material portion of gift cards go unredeemed, and it is certainly reasonable for companies to write off a portion of their gift card liability and recognize breakage as revenue. How and when to recognize revenue from unredeemed gift cards, breakage revenue, is not clear-cut because there is no transaction or event which signals that the card will never be redeemed. This circumstance is at the heart of the difficulties present when accounting for gift cards.

The only current guidance for the accounting treatment of retail gift cards, especially with regard to gift card breakage, comes from the Securities and Exchange Commission's Staff Accounting Bulletins numbers 101 and 104, issued on 3 December 1999, and 17 December 2003. As summarized in a statement by SEC Staff representative, Pamela R. Schlosser at the 2005 American Institute of Certified Public Accountants

Conference for current SEC and PCAOB developments, the SEC's accounting for gift cards guidelines are not specific or authoritative enough to allow for the appropriate level of confidence in financial reporting.

In that statement, the SEC explained their stance on, what is chiefly, the question of when the liability associated with the selling of gift cards can be derecognized. That is, the liability removed and recognized as revenue. The SEC's position is that it is inappropriate to recognize revenue immediately upon the sale of a gift card based on a predetermined, estimated percentage of unredeemed gift cards. For example, companies may not record 10% of all gift card sales as revenue if they estimate that 10% of gift cards will go unredeemed. (Schlosser)

Revenue may be recognized when the gift card vendor is legally released from their obligation. That occurs upon redemption or expiration of the gift card. To account for breakage, the SEC allows companies to recognize revenue at a point when the redemption of gift cards becomes remote. They offer no guidance or commentary on the determination of that point, however.

Another allowable method of revenue recognition for gift card breakage is to recognize breakage revenue in proportion to gift card redemption. "Gift cards sold over a certain period of time would be considered on a homogenous pool basis. The value of gift cards expected to go unused would then be recognized over the period of performance, that is, as the remaining gift card values are redeemed." This requires companies to "reasonably and objectively" determine both the amount of gift cards to go unredeemed and the time period in which gift cards that are to be redeemed are actually redeemed. For example, if a company estimates that 10% of gift cards will go unredeemed and that the remainder will be redeemed, proportionally, over the next twelve months, then 10% of gift card sales may be recognized ratably as revenue over the twelve month period. Again, the SEC offers no guidance, commentary, or standard method of making the determinations and estimations. Further, the SEC is open to other options for gift card treatment as unique circumstances might dictate. (Schlosser)

The SEC's stance on computing and recognizing breakage revenue provides somewhat of a loose framework for what could eventually become a principles-based accounting standard. In the wake of the major corporate accounting scandals of the early 21st century, which resulted in the Sarbanes-Oxley Act, there has been a push by many in the accounting community for a shift from the rules-based accounting system currently required for United States based companies, known as Generally Accepted Accounting Principles, to more of a principles-based system. The International Accounting Standards Committee promotes the use of a principles-based system called International Financial Reporting Standards, and the SEC has outlined a timetable for convergence of US GAAP with that system.

The principles-based approach focuses on establishing the "objectives of good reporting and then provides guidance explaining the objective and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation" (Shortridge). GAAP is based on rules that include specific mandates and specifications, commonly known as "bright lines". Given the current accounting environment in the United States, it is reasonable to expect that if accounting authorities issued a comprehensive gift card accounting standard, it would be rules-based in conformity with GAAP.

The U.S. Financial Accounting Standards Board, the institution with the authority for issuing the most authoritative accounting guidance and standards, has issued no statement regarding the proper treatment of gift cards, and revenue related to breakage. Additionally, the Emerging Issues Task Force, a subsidiary of the FASB, has no announced plans to investigate the issue. The EITF is the first step for accounting problems to be resolved through the issuance of new standards. Foreign authorities have issued no guidance on accounting for gift cards.

Some general guidance can be gleaned from the revenue recognition principle, as outlined in Statement of Financial Accounting Concepts 5. Revenue is recognized when it is realized or realizable. "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" (SFAC 5). The issue with breakage revenue from gift cards is not determining if revenue has been realized, it is determining when the earnings process has been actually completed. That is, when the gift card actually goes unredeemed.

The lack of Generally Accepted Accounting Principles guidance for gift cards poses several problems. What little guidance has been offered is not nearly specific nor authoritative enough to have any meaningful impact on methods employed by companies in gift card related financial reporting. The significant amount of gray area in current standards allows individual companies a remarkable amount of discretion in determining how to account for gift cards and related revenue. At best, it is likely that companies would recognize a slightly disproportionate amount of benefits relative to earnings associated with gift cards. At worst, the potential exists that companies could use this freedom to manage their earnings, alter their bottom line, issue misleading financial statements, and, ultimately, inequitably influence decisions made by investors, creditors, and other users of financial statements.

Generally Accepted Accounting Principles, or the lack thereof, are not the only factors that influence how gift cards are, or should be, accounted for. State laws also dictate how companies report financial information related to gift cards. Many states escheat, turn over, the value of unredeemed gift cards to the state Treasury Department. In Pennsylvania, for example, the value of unredeemed gift cards are escheated five years after the card's sale, or two years after expiration, if applicable. A law passed in January 2007 allows businesses to avoid the escheating process if gift card proceeds are from qualified gift cards. A qualified gift card is defined as one that has no expiration date and does not charge any fees to the cardholder. Other states have similar escheat laws. Unique situations like this, as well as the many states that have legislation banning gift card expiration dates and fees, may cause "issuers of gift cards [to] 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." (Marden)

The abundance of state consumer protection laws restricting gift card expiration dates has effectually eliminated their use by companies that operate in at least one state with such laws. While cards with declining balances or expiration dates would eliminate the problem of calculating and dealing with breakage revenue, such rules are not an option for most companies.

Given the context created by ambiguous guidance and varying state laws, actual, current, gift card accounting and reporting is far from uniform, though some patterns seem to be emerging. One thing that the SEC has made clear through Staff Bulletins 101 and 104 is that immediate recognition of revenue related to gift cards is inappropriate. Gift card sales are always recorded as an unearned or deferred revenue liability until they are redeemed for merchandise or service.

Though this approach certainly conforms to the basic principles of financial accounting, it does pose a couple of interesting issues for the companies that sell the gift cards, and for industry analysts. First, the gift card liability (and lack of any immediate revenue recognition) incurred upon the initial sale of the card fails to reflect any of the several, albeit somewhat intangible, economic benefits that gift card sales afford retailers (i.e. increased sales, marketing opportunities, cash flow and inventory benefits, etc.).

Secondly, the unpredictability and inherent delay of gift card redemption defers reporting the financial benefit of gift card sales, revenue, to future periods, while the tangible benefit of gift card sales, the receipt of cash, occurs when the cards are initially sold. This tends to cause financial statements to understate the actual effects and benefits of, for example, the holiday selling season. In 2006, gift card sales caused industry analysts to "misgauge 2006 holiday sales as being weaker than expected." When January sales, which were stronger than expected due to gift card redemptions, were counted toward the 2006 holiday season, 2006 actually became "a strong year for most retailers" (Kile). A situation like this could potentially have significant economic implications, especially as related to the stock market or economic forecasting.

An area somewhat analogous to gift card accounting is accounting for trading stamps. Trading stamps are a central component of a practice that began in the 1890s. Trading stamp companies would sell stamps to merchants, who would them give them to customers to incite repeat business. Consumers could then redeem the stamps with the trading stamp company for merchandise.

Trading stamps are similar to gift cards in that there is the likelihood for a significant portion of outstanding stamps to go unredeemed. Revenue from unredeemed trading stamps, roughly equivalent to gift card breakage, is recognized in a year-end adjusting entry. For example, if a trading stamp company sold $100,000 worth of trading stamps in the current year, and experience indicates that 95% of outstanding stamps will be redeemed, they would recognize $5,000 in revenue from unredeemed trading stamps.

Unlike gift card breakage revenue, all revenue from unredeemed trading stamps is recognized in the year of sale. This provides some support for the notion the same treatment should be applied to the recognition of gift card breakage (Schroeder). Current SEC guidelines, however, prohibit recognizing revenue from unredeemed gift cards at the point of sale. The focus of this study will be to examine methods currently in use by companies, and reconcile those methods with the SEC guidance and accounting principles to propose a new accounting standard.

Previous Research

Dr. Charles Kile, of Middle Tennessee State University, analyzed the 2006 Form 10-Ks from 167 companies who sell gift cards to determine any trends, or lack thereof, in gift card recording and reporting. Approximately two-thirds of the companies analyzed provided at least some level of gift card relevant information. Of those that did not, most were "Mom and Pop" or, as the researcher termed it, "over-the-counter" operations. Most of the companies reported their revenue recognition policies and the amount of their gift card liability. Many companies disclosed where the liability appears on the balance sheet, usually lumped into "accrued expense or other liabilities" or "deferred revenue". Only nine companies afforded the gift card liability its own separate line item on the balance sheet, and only one company, Ruth's Chris Steakhouse, disclosed the total amount of gift card sales for the year. (Kile)

Because in many cases the amount of gift card breakage is material, it is reasonable and necessary for companies to develop a method of recognizing revenue related to unredeemed gift cards. Technology associated with the issue of most gift cards makes it easy and efficient for companies to track gift card use. It has been demonstrated that the more time that elapses, the less likely redemption becomes. Methods similar to an aging of accounts receivable or the use of historical trends to compute a weighted average gift card breakage estimate allow companies to establish a basis for recognizing unredeemed gift card revenue. The lack of a standard creates difficulties in evaluating the reasonableness of these estimates.

Once some amount of breakage revenue has been determined, companies are faced with the option of how to report it in their financial statements. Kile found that only fifty-three of the 167 companies disclosed their breakage revenue recognition policies, and only thirty-nine identified where that revenue appeared in the income statement. Revenue was most commonly included in "net sales", but "other income" was also used. The researcher concluded that "while an increasing number of companies are providing gift card information, useful quantitative disclosures indicating amounts of annual gift card sales and breakage are rarely provided" (Kile).

Because there are no associated inventory costs, when revenue from unredeemed gift cards is recognized and included in net sales (or as a reduction of cost of goods sold) it tends to overstate various investor sensitive financial trends and ratios related to sales and gross margin. One suggested alternative is to reduce selling, general, and administrative expenses when writing off unredeemed gift cards. This practice, however, is "conceptually flawed and potentially misleading, since the economic benefit does not originate from expense reduction measures" (Kile). Reporting gift card breakage as Other Revenue would at least segregate it from Sales Revenue.

There also exists the problem of how to treat gift cards that have previously been written off but are subsequently redeemed, or (depending on the method used to recognize breakage revenue) gift cards redeemed in excess of the reported gift card liability. The most likely treatment would be to offset gift card revenue at redemption. This contingency, coupled with the lack of required gift card related disclosures, further muddles financial reporting.

Significance of Gift Card Accounting Environment

Given such a lack of restrictions and requirements, companies are not likely to employ methodology, or disclose information related to gift cards and breakage revenue that would harm their financial standing. In 2007, Ruth's Chris Steakhouses said that they expected to "gain an added $2.2 million in operating income this year thanks to unredeemed gift cards" (Rappeport). That amounts to almost 7% of Ruth's Chris Steakhouses' 2007 Operating Income. Because the point at which breakage revenue can be recognized is so subjective, some companies issue gift cards with the hope of creating an additional revenue cushion. A Deloitte and Touche department head commented that, "Some companies depend that people will not use their cards" (Rappeport).

As mentioned previously, the amount of gray in current gift card accounting regulation opens the door for companies to possibly manage earnings to various degrees. While lack of comparability and transparency in financial reporting is undoubtedly a problem under the current discloser conditions, the materiality of gift card sales, redemption, breakage, and revenue make for potentially serious, even unethical, reporting deficiencies.

Conceptual Framework of Accounting

Because of the need for financial accounting and reporting to be relevant and reliable to financial statement users, the Financial Accounting Standards Board has defined a conceptual framework to serve as the basis for setting new standards. The FASB's conceptual framework is "a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements" (Kieso 28). In other words, the FASB has formally defined the basic objectives, concepts, elements, assumptions, principles, and constraints of financial accounting, and uses these definitions as a basis and guide for dealing with specific or emerging accounting problems. The FASB began developing their conceptual framework in 1976 and subsequently issued a series of Statements of Financial Accounting Concepts.

Six principles from the FASB's conceptual framework are of particular concern to the discussion of accounting for gift cards. First are the two qualitative characteristics of accounting information, comparability and consistency. The FASB has declared that financial accounting should strive to produce information that is comparable amongst different companies and consistent from period to period within a single company. Likewise, two basic principles of accounting, the revenue recognition principle and the matching principle, are integral to the problems presented by gift card accounting. Additionally, the accounting constraints of materiality and conservatism apply to an analysis of gift card issues.

Comparability

Comparability requires that all companies follow the same rules when performing a particular accounting function. When this is achieved, financial transactions will have equivalent or consistent effects on different companies' financial statements, allowing a comparison of companies to be relevant. Based on this concept the FASB has created standards, setting rules for a multitude of accounting issues from calculating depreciation to recording pension costs. While many standards are not totally rigid, and may afford some flexibility in approach to an accounting issue, the rule must assure that the information produced by all companies following that standard is equivalent and comparable.

Consistency

Consistency requires that individual companies deal with similar accounting situations with similar accounting practices and methods from period to period. This ensures that certain financial transactions will have equivalent and consistent effects on an individual company's financial statements from period to period. If a company decides to change accounting methods, it must disclose the specifics, justification, and effects of the change in the period of the change. Based on this concept, the FASB must create standards that ensure mandated accounting methodology will have equivalent and consistent effects on a company's financial reporting every period.

Revenue Recognition

When a company should recognize revenue is not always clear cut. Generally, revenue should be recognized when it is realized or realizable, and when it is earned. Revenue is realized or realizable when a company exchanges goods or services for assets or claims to assets. The most common example is when merchandise is sold for cash. If an asset other than cash is accepted as payment, revenue is only realizable if the asset can be easily converted to cash and has a determinable value. Further, revenue must be earned to be recognized. "Revenues are considered earned when the company substantially accomplishes what it must do to be entitled to the benefits represented by the revenues" (SFAC 5). Determining the point at which revenue from unredeemed gift cards is realizable and earned is at the heart of the conceptual problems related to gift card accounting.

Matching

The matching principle is related to the revenue recognition principle in that expenses related to revenue should be matched, or recognized together. Product costs, like material, labor, and overheard, can be associated with a particular product and are not recognized as expenses until revenue is realized from the sale of the associated product. Some costs, such as executives' salaries and administrative expenses, cannot be as easily linked with sources of revenue and must be expensed during the periods in which they occur.

There are some conceptual flaws with the matching principle. Companies can often end up deferring costs that may have no future benefit, and recognizing expenses in periods during which they received no associated revenue. It is interesting to note that with regard to gift card accounting, when revenue is recognized from unredeemed gift cards it is difficult to determine associated costs to match with revenue.

Materiality

The FASB has declared that if an item's inclusion or omission in financial reporting would influence the judgment of a reasonable person, then that item is material. Therefore, the materiality of a financial factor varies from company to company based of the factor's relative size and importance. "Companies and their auditors generally adopt the rule of thumb that anything under 5% of net income is considered immaterial. However, the SEC indicates that a company may use this percentage for an initial assessment of materiality, but it must also consider other factors." Both qualitative and quantitative factors must be considered when determining the materiality of an item. (SEC SAB No. 99)

Conservatism

Finally, the FASB values the convention that when in doubt, the solution to an accounting issue that is least likely to overstate assets and income is the best. That is, if faced with a difficult decision, the alternative that avoids the overstatement of a company's bottom line is the preferred solution. This constraint and guide is known as conservatism. Conservatism does not aim to understate assets or income, only prevent them from being overstated.

The elements of accounting's conceptual framework are important, but not completely rigid. The FASB tries to apply the conceptual framework when setting standards but often ends up with standards that contain loopholes or contradict some principles. It is impossible to completely uphold all the tenets of accounting's conceptual framework in every situation. When setting standards there is some give and take as elements and principles are reconciled and practically applied to real world situations.

Section II. Gift Card Accounting Inconsistencies: Data and Analysis

Hypothesis: A Standard is Needed

Since breakage revenue often does and certainly has potential to significantly affect companies' financial statements, gift card accounting practices need to be reconciled with accounting principles. Adequate and clear gift card disclosures should be required by authoritative standards to ensure that financial statements contain a fair representation of effects from gift cards. The following sections of this study will include analysis of actual gift card accounting practices and examine whether:

H_1) Lack of accounting standards for gift cards is to the detriment of financial statement comparability and consistency.

H_2) Breakage revenue materially impacts financial statements.

H_3) Current accounting for breakage revenue is often contrary to revenue recognition and matching principles.

H_4) Current gift card accounting practices create divergences between the principles of matching and conservatism.

The implications of these conditions denote the problems incumbent to gift card accounting and indicate the need for a clear and definitive standard. Like most standards, it might be impossible to completely reconcile accepted practice to accounting principles, but the issues above must be considered and gift card accounting practices must be standardized and proper disclosures mandated, to ensure that financial statements reasonably reflect the economic effects of gift cards.

Data

Testing the foregoing hypotheses requires gathering financial statement data from companies that have actually reported gift card breakage. That is, somewhere in their financial statements, the company has disclosed a specific number for revenue recognized due to unredeemed gift cards. Using Dr. Kile's data, twenty-one companies were identified as candidates for reporting a dollar amount specifically identified as gift card breakage revenue. For those twenty-one companies, Form 10-K filings for fiscal year ended 2007 and 2006 were retrieved from the SEC's EdgarOnline service. If either of the two year's 10-Ks reported a dollar amount for breakage, prior years' 10-Ks were retrieved until a report that did not include breakage was encountered. Using this method, fifteen companies were identified as having presented a specific breakage dollar amount. One additional company that did not disclose a breakage amount in 2007 or 2006 was identified because of a reference made in Kile's article. Figure A shows these sixteen companies.

Figure 1

Breakage Reporting Companies	
Abercrombie and Fitch	Best Buy
The Children's Place	Golfsmith International Holdings
The Home Depot	J. Alexander Corp.
Limited Brands, Inc.	Sport Chalet, Inc.
Starbucks	The Gap
Stage Stores, Inc.	The Wet Seal Inc.
Hot Topic	The Buckle
Casual Male	Texas Road House

For each company and each fiscal year in which breakage was reported, the following items of information, if available, were gathered:

1. Breakage Recognized
2. Income Before Taxes
3. Gift Card Liability
4. Income Statement
5. Balance Sheet
6. Footnote disclosure regarding revenue recognition and gift cards

Footnote Disclosures

A company's practices and policies concerning gift card accounting are almost exclusively disclosed in the footnotes to their consolidated financial statements in their

Form 10-K. The only place gift card information shows up in the actual financial statements as a separate line item is the gift card liability on the balance sheet. For fiscal year 2006, only nine of 167 companies actually show gift card liability on their balance sheet (Kile).

Gift card information is generally included in companies' Footnote 1: "Nature of Business and Summary of Significant Accounting Policies." Sometimes there is a separate "gift card" heading within this footnote, but usually gift cards are discussed as a component within the "revenue recognition" heading. For companies that actually disclose their calculated amount of breakage, the information presented and language used follows a similar format, but even within this sample, gift card accounting methodology is far from uniform.

Variations in Breakage Computation

Because the SEC has stated that it is inappropriate to recognize any breakage revenue at the time gift cards are sold, companies must initially recognize all gift card sales as a liability. According to the SEC, companies cannot recognize revenue from gift cards until legally released from the liability or the likelihood of redemption becomes remote. As gift cards are redeemed, companies are legally released from their liability, and the liability is converted to revenue. Determining the point at which the likelihood of redemption becomes remote is an ambiguous target for companies to subjectively determine. Based on data gathered for this study, two alternative breakage computation methods have emerged: breakage computed based on an annual percent reduction of the gift card liability, and breakage computed based on the passage of time.

To recognize revenue from unredeemed gift cards, some companies elect to determine a particular rate at which to annually, arbitrarily, reduce their gift card liability. The journal entry would debit a liability and credit a revenue account. The rate is constant from year to year. For example, The Sports Chalet recognizes breakage revenue by "periodically decreasing the carrying value of the Gift Card liability by approximately 5% of the aggregate amount" (2007 10-K).

Alternatively, some companies recognize breakage based on the passage of time, or periods of inactivity. For example, The Gap recognizes the balances of unredeemed gift cards as income after three years have elapsed since the sale of the card (2007 10-K). The specifics of either method are decided upon by company management based on an analysis of historic gift card redemption trends for that company.

The sixteen companies identified as disclosing a gift card breakage number at some point since 2004, exhibit the two prevailing trends for the estimation of breakage. Some companies estimate breakage based on a gift card breakage rate, other companies recognize breakage based on the passage of time, periods of inactivity, or some other factors. It is common for companies to use an analysis of historical redemption trends to estimate breakage under both methods. The following information from the footnotes of the sixteen companies shows how even within the few companies that do make fairly transparent gift card disclosures, there exists a significant lack of comparability and consistency, and other undesirable accounting ramifications.

It is interesting to note that only one company has ever disclosed the discrete dollar amount of gift card sales for the year (Kile). In fiscal year 2006 Ruth's Chris reported total gift card sales for the year, but did not report breakage revenue, and in 2007 disclosed no numbers related to gift card sales, liability, or revenue.

Breakage Rate Examples

Of the sixteen companies studied, five use a gift card breakage rate to determine breakage: Sport Chalet, Stage Stores, Hot Topic, The Casual Male, and The Texas Road House.

Sport Chalet

Sport Chalet began recognizing breakage in 2005 at the time of the issuance of gift cards. This method is disallowed by the SEC, and the company began recognizing breakage at the time of redemption in following periods. Per their 2007 10-K, "breakage is recognized as revenue by periodically decreasing the carrying value of the Gift Card liability by approximately 5% of the aggregate amount." Sport Chalet provides no insight into how they determined to use 5% as the amount by which they reduce their gift card liability.

Stage Stores

Stage Stores combines their gift card liability with their merchandise credit liability, and likewise recognizes breakage for both. From their 2007 10-K, "the Company's gift cards and merchandise credits are considered to be a large pool of homogeneous transactions." They recognized breakage for the first time in 2006 and "included the breakage income related to gift cards sold and merchandise credits issued since the inception of the various programs."

The footnote related to breakage from Stage Stores' 2006 10-K begins with the statement, "Unredeemed gift cards and merchandise credits, net of estimated breakage, are recorded as a liability." This is a violation of SEC guidelines if the associated revenue was recognized at the time the liability was recorded. For 2006, the first time they recognized breakage, revenue was recognized in the fourth quarter by reducing the combined gift card and merchandise credit liability by 4%.

In their 2007 10-K, Stage Stores states that "breakage income is recognized based on usage or actual redemptions as the cards are used." This statement does not clearly convey to the reader when exactly revenue is recognized, but it seems to indicate that breakage is not recognized at the time the liability is incurred. Also in 2007, the company no longer recorded the liability net of estimated breakage.

In their 2005 10-K, Stage Stores reported that their gift card liability at year end 2005 and 2004 was $12.2 million and $10.3 million, respectively. There is no mention of merchandise credits or the liability being recorded net of estimated breakage. They did not disclose their gift card liability in 2006 and beyond.

Hot Topic

According to their 2007 10-K, Hot Topic uses a gift card breakage rate of 5-6% to recognize breakage. They recognized $1.2 million in 2007 and 2006 which indicates that the balance of their gift card liability was nearly identical at year end 2007 and 2006. As with most companies that use a gift card breakage rate, when they recognized breakage for the first time in 2005, it included revenue from unredeemed gift cards issued since the inception of their gift card program.

The Casual Male

The Casual Male first recognized breakage revenue in 2005 based on a gift card breakage rate of 7-8%. 2005 revenue included revenue from unredeemed gift cards issued since the inception of the gift card program. Their 2006 10-K was the last to include any information about gift cards in its footnotes. Their 2007 10-K has no mention whatsoever of gift cards or breakage revenue in the financial statements or footnotes.

Texas Road House

The Texas Road House recognized breakage for the first time in 2004. According to their 2004 10-K, "the Company determined that a 5% breakage estimate, amortized over 3 years, should be recorded for each gift card that is sold, based on historical redemption trends." Rather then recording revenue, they reduce operating expenses by $1.7 million (increasing income before taxes by 6.2% and decreasing their gift card liability by 10.4%). Presumably, this number includes breakage from unredeemed gift cards issued since the inception of their gift card program.

Texas Road House reported in their 2007, 2006, and 2005 10-Ks that they were using the same policy to recognize breakage, or rather, to adjust expenses. They did not, however, disclose the amount of adjustments to expenses for any year except 2004.

Passage of Time Examples

Eleven of the sixteen companies use a passage of time basis for recognizing breakage revenue: Abercrombie and Fitch, Best Buy, The Children's Place, Golfsmith International Holdings, The Home Depot, J. Alexander, Limited Brands, Starbucks, The Gap, The Wet Seal, and The Buckle.

Abercrombie and Fitch

Abercrombie and Fitch discloses gift card information in a footnote to their consolidated financial statements along with other revenue recognition information. Their 2005 10-K was the first to report specific breakage and gift card liability numbers and did so for the fiscal years 2005 and 2004. The footnote states that Abercrombie and Fitch recognized no revenue from breakage in 2003. It is unclear whether or not 2004 was the first year they recognized breakage, but it appears unlikely that Abercrombie recognized multiple past periods' breakage in 2004.

According to their 2005 10-K, "The Company considers the probability of the gift card being redeemed to be remote for 50% of the balance of gift cards at 24 months after the date of issuance and remote for the remaining balance at 36 months after the date of issuance and at that time recognizes the remaining balance as other operating income." Their method of determining breakage, according to their 2007 10-K, has been amended as follows, "The Company determines the probability of the gift card being redeemed to be remote based on historical redemption patterns, and recognizes the remaining balance as other operating income." The latter method provides a considerable amount more flexibility for Abercrombie, and breakage caused a 1.5% change in income before taxes in 2007 compared to a .8% change in 2006.

Best Buy

Best Buy first recognized breakage in fiscal year 2006, and discloses gift card related information in a footnote to their consolidated financial statements. They recognize breakage based on the passage of time. They consider the possibility of redemption remote at twenty-four months after the gift card is issued. Best Buy's income was increased $46 million in 2007 and $43 million in 2006 by gift card breakage. It can be imputed that their total gift card liability was reduced by 8.5% and 8.4% in 2007 and 2006, respectively.

The Children's Place

The Children's Place recognized breakage for the first time in 2005. Their 2005 10-K states that of the "of the $1.3 million adjustment, the Company estimates that approximately $1.0 million relates to fiscal 2004 and prior. The Company did not restate prior years' financial statements since the impact was immaterial." In their 2006 10-K, the company disclosed portions of the $1.3 million applicable to 2005 and 2004 as if those portions had been recognized discretely in those periods. That is, per the 2006 10-K, breakage revenue for 2005 and 2004 was $300,000 and $400,000, respectively, accounting for a .3% and .6% increase in those years respective income before tax. In reality, however, 2005 income was increased by 1.4% through the recognition of the $1.3 million in breakage revenue.

Golfsmith International Holdings

Golfsmith International Holdings recognized breakage revenue from outstanding gift cards and returns credit for the first time in 2005. From their 2007 10-K, "estimated breakage is calculated and recognized as revenue over a 48-month period following the card or credit issuance, in amounts based on the historical redemption patterns of the used cards or credits. Amounts in excess of the total estimated breakage, if any, are recognized as revenue at the end of the 48 months following the issuance of the card or credit."

The Home Depot

The Home Depot reports gift card breakage numbers in a footnote to their consolidated financial statements. They state that they use historical redemption patterns as a basis for determining an amount for which the likelihood of redemption is remote and recognizes that amount as income. The 2007 10-K reports that "Fiscal 2005 was the first year in which the Company recognized gift card breakage income, and therefore, the amount recognized includes the gift card breakage income related to gift cards sold since the inception of the gift card program." In comparison with the other companies from the sample, The Home Depot recognizes exceptionally large dollar amounts for breakage revenue. In years 2005, 2006, and 2007 they recognized $52, $33, and $36 million, respectively. Each of these amounts, however, had a less than 1% impact on net income before tax.

J. Alexander Corporation

When J. Alexander Corporation began issuing gift cards in 2000, they charged the cards (and reduced their liability) with a $2 monthly service charge after twelve months of inactivity. The service charges were recorded as revenue. They discontinued this practice in 2005, likely due to consumer protection laws, and began estimating according to the following policy, "Based on the Company's historical experience, management considers the probability of redemption of a gift card to be remote when it has been outstanding for 24 months." Further, "in 2005, the Company recorded breakage of $168,000 in connection with gift cards that were more than 24 months old and $366,000 in connection with the remaining balance of gift certificates issued prior to 2001."

Limited Brands

Limited Brands, which has several subsidiaries, discloses breakage revenue amounts in their footnotes. In 2005 the company recognized breakage for two subsidiary companies. They recognized $30 million of breakage over thirty-six months based on a gift card breakage rate determined from historical redemption patterns. Limited disclosed the intention to recognize more breakage related to other subsidiaries when adequate historical data existed.

Starbucks

According to the footnote in their 2007 10-K, Starbucks' "management may determine the likelihood of redemption to be remote for certain card and certificate balances due to, among other things, long periods of inactivity", and recognize breakage revenue. Starbucks is the only company from this sample that differentiates between stored value gift cards, and gift certificates. Their gift cards and gift certificates have the same characteristics (with the exception that the card balances can be replenished) and provide exactly the same function. In fiscal year 2007, the company recognized breakage revenue related to both gift cards and certificates. In 2006, which was presumably their first year to recognize breakage, Starbucks recognized only gift card related breakage.

The Gap

The Gap records revenue from unredeemed gift cards after an interval of time has elapsed. In their 2007 10-K they reported that in 2006 they changed their policy from recognizing breakage after five years to three years. They recognized $31 million in fiscal year 2006, causing a 2.5% increase in income before taxes. They do not disclose any breakage information in the 2006 10-K, and it is unclear from the 2007 10-K footnote what exactly the $31 million is. It could be additional breakage recorded in 2006 due to the change accounting policy, or total breakage for that year. No other numbers, or even confirmation breakage was recognized, related to 2007 or any other fiscal year are disclosed in either the 2007 or 2006 10-K.

The Wet Seal

The Wet Seal recognized breakage for the first time in 2007. \$3.7 million of breakage revenue, which included revenue from prior periods, increased their income before taxes by 18.6% and reduced their gift card liability by 37%.

The Buckle

The Buckle includes breakage revenue in Other Income, and disclosed the amounts recognized since 2004 in their 2006 10-K. This was their first disclosure of specific breakage amounts. They do not specifically disclose how they determine breakage but, according to their 2006 10-K, "the amount of the gift certificate liability is determined using the outstanding balances from the prior three years of issuance and the gift card liability is determined using the outstanding balances from the prior four years of issuance." Breakage, then, appears to be calculated as the unredeemed balance of over three years old gift certificates and over four years old gift cards.

Summary of the Significance of Footnote Disclosures

Analysis of the preceding discussion of footnote disclosure practices clearly demonstrates that gift card disclosure is far from uniform. As a result, the effects of gift card breakage revenue on companies' financial statements cannot be satisfactorily measured and compared by potential investors, creditors, or other users of financial statements. This situation raises interesting problems, some of which have not yet been addressed by researchers.

Financial information cannot be accurately compared across all companies for a given time period when gift card accounting practices vary to the extent illustrated above, its not apples to apples. Financial information from one company for a given time period cannot be accurately compared to other periods when gift card accounting practices within a company are not consistent for all time periods. Further, some trends in gift card accounting violate aspects of the matching and revenue recognition accounting principles, and may cause conflict between the constraints of materiality and conservatism.

Certainly, it should not be expected that a realistic and conservative estimate of breakage produce the same percent change in income before taxes for every company, every period. Some companies might truly realize a greater economic benefit from unredeemed gift cards than other companies, and (for smaller companies especially) it might have a greater effect on their bottom line. However, when the use of different methodology produces striking disparities in breakage's effects from company to company and within individual companies, comparability and consistency have been compromised.

Given the extent and effects of these issues, specific standards for the computation and disclosure of breakage revenue is necessary to ensure financial statements that are comparable, consistent, and conform to established accounting principles and practices.

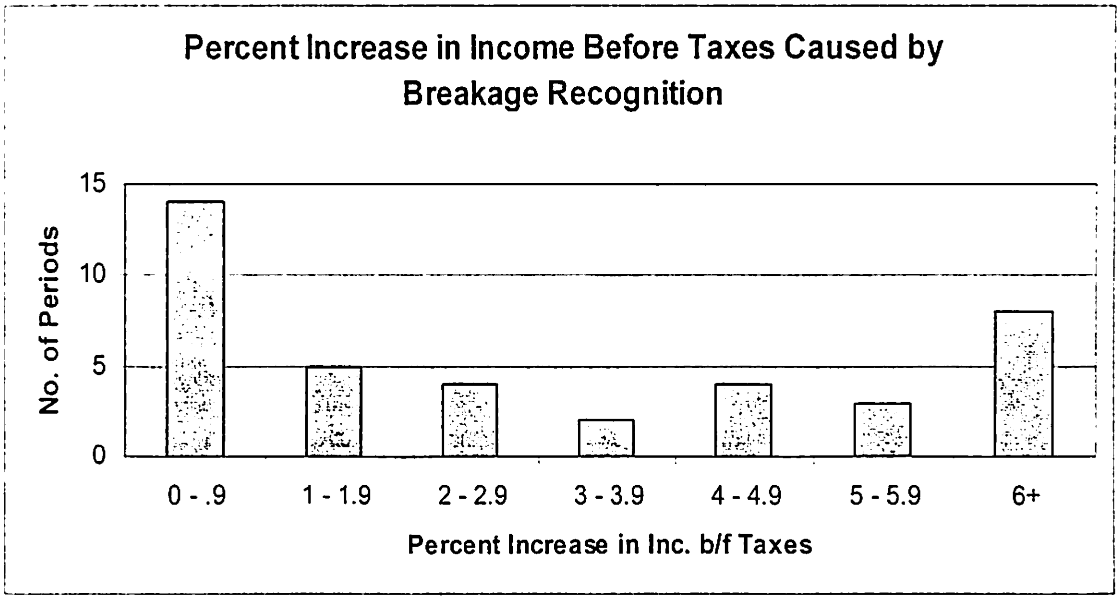
Materiality of Breakage

Despite any potential conflicts with accounting principles incumbent to gift card accounting practices, these issues would be of little concern as long as breakage revenue has a negligible effect on company's bottom line. For time, effort, and resources to be exerted in shaping a new standard and enforcing more diligent gift card accounting practices, it must be demonstrated that revenue from unredeemed gift cards has, or has the potential to have, a significant effect on companies' financial statements.

For the sixteen companies that reported breakage, analyzing the percent change in income before taxes caused by recognized breakage revenue shows the magnitude of breakage's effect on the companies' bottom line. Over a combined 40 fiscal years (the number of individual reporting periods, not span of time) in which those sixteen companies have reported breakage, breakage revenue's impact on income before taxes ranged from less than 1% to more than 36% with an average of approximately 4%. Figure 2 shows that the effects of breakage fall in somewhat of an inverse bell cure. The two tails are less than a 1% increase in income before taxes, and greater then a 5% increase. Five percent is a reasonable threshold at which breakage can be said to have a material effect on companies' financial statements.

Using this criterion, breakage has a material effect almost as often as it causes a less than 1% increase in income: 11 of 40 periods over 5% versus 14 of 40 periods less than 1%. Further, eight of the sixteen companies have experienced at least one fiscal period since 2004 in which breakage increased income before taxes by 5% or more. This exhibits that while breakage is sometimes immaterial, and its effect depends not only upon the magnitude of breakage but also the company's income, it certainly has the potential to and often does have substantial effects on companies' financial statements.

Figure 2



Analysis of specific companies gives further compelling evidence for the potential effects of revenue from unredeemed gift cards. The most significant change to income before tax caused by breakage revenue recognition took place for Golfsmith International Holdings in fiscal year 2005. Nine-Hundred-Thousand dollars of breakage revenue caused a 36.6% increase in their income before tax. The next year, the company reported a loss before taxes which was reduced by 15.0% when they recognized $1,400,000 in breakage revenue.

In 2006, Sport Chalet, Inc. reported taxes in excess of income before taxes. Assuming their revenue from breakage of $397,000 was taxed at a 35% marginal tax rate, then it would have decreased their net loss by 74.7%. Ignoring tax consequences, breakage revenue increased income before taxes by 10.3%.

J. Alexander Corp saw their income before taxes increase by 13.7% from unredeemed gift card revenue in fiscal year 2005. Sport Chalet had an over 10% bump from breakage in fiscal 2006. The Wet Seal recognized breakage in fiscal 2007 causing an 18.6% increase in income before taxes. Hot Topic, in fiscal 2005, saw a 9.4% jump, and also in 2005, the Casual Male experienced a 17.6% increase in income before taxes from breakage. Conversely, six companies over fifteen periods experienced a less than 1% increase in income before taxes from recognizing revenue from unredeemed gift cards.

These specific examples, as well as general observations from the sample group of companies clearly indicate that breakage has the potential to, and often does, materially effect companies' financial statements. For this reason, the concerns raised by the variety of accounting methodology used by issuers of gift cards are worthy of analysis and should be reconciled by a future standard.

First Year Loading of Breakage – Revenue Recognition and Matching Concerns

Seven of the sixteen companies reporting breakage employed an interesting accounting maneuver by including revenue attributable to past periods during their first period to recognize breakage. In other words, when these companies first recognized breakage revenue, they lumped in revenue that they estimated could have been recognized during past periods. This practice violates the revenue recognition and matching principles and impairs comparability and consistency.

The Home Depot is an especially interesting example of this practice because of the magnitude of breakage revenue recognized. Figure 3 shows total breakage revenue recognized in fiscal years 2005, 2006, and 2007. In 2005, The Home Depot recognized 37% more revenue than in 2006, and 31% more than in 2007. Breakage related to prior periods has inflated the effect of breakage revenue on the year in which it is first recognized.

Figure 3

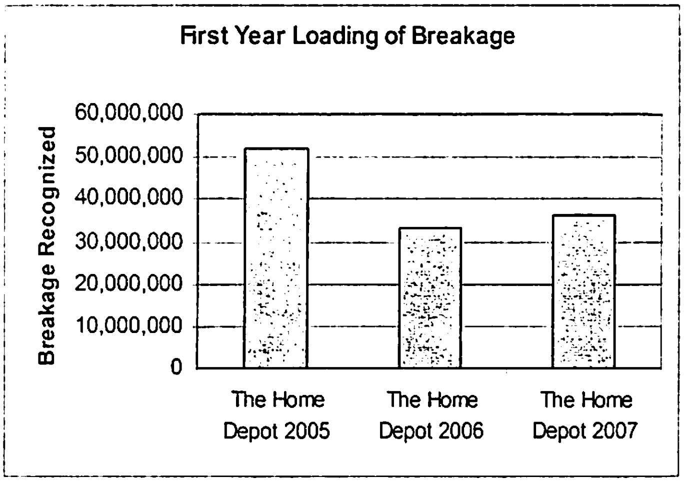
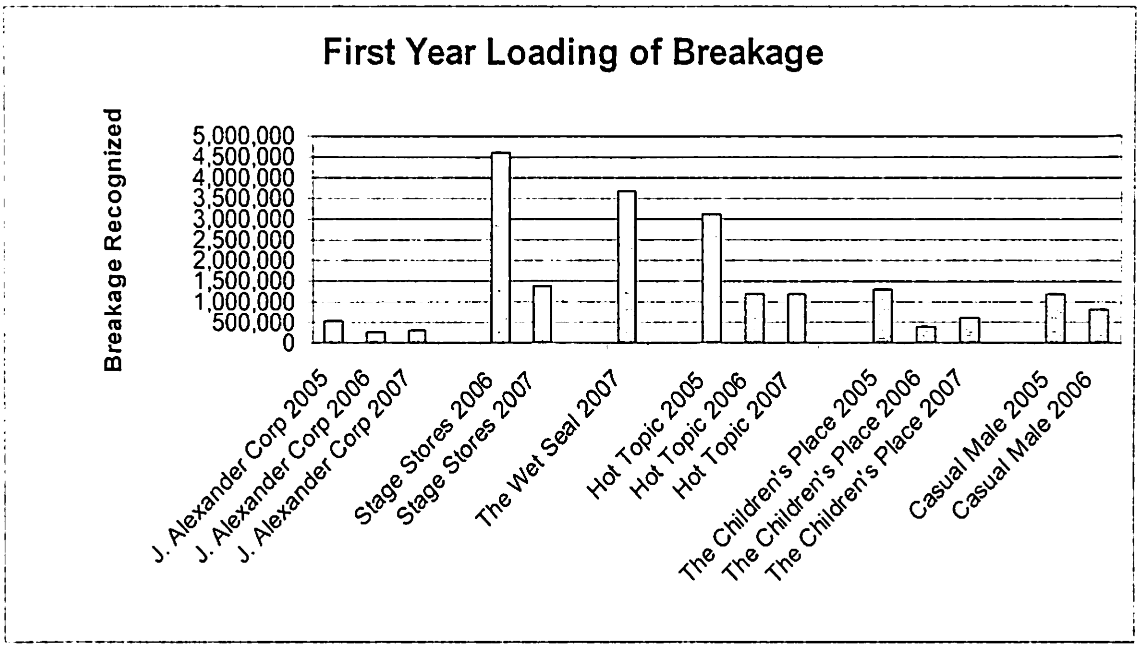


Figure 4 shows the same effect from this "first year loading" of breakage on the remaining six companies. Breakage revenue for the first year J. Alexander Corp recognized breakage is 50% and 43% higher than the subsequent two years. Stage Stores recognized 70% more breakage their first year than the next. The Wet Seal has only had one period in which they have recognized breakage, but did include revenue attributable to prior years. Hot Topic's breakage revenue in their first year to recognize was 61% higher than the subsequent year. The Children's Place saw breakage decrease by 69% and 54% after their first year to recognize. The Casual Male recorded 33% more breakage revenue in their first year, than the next.

Figure 4

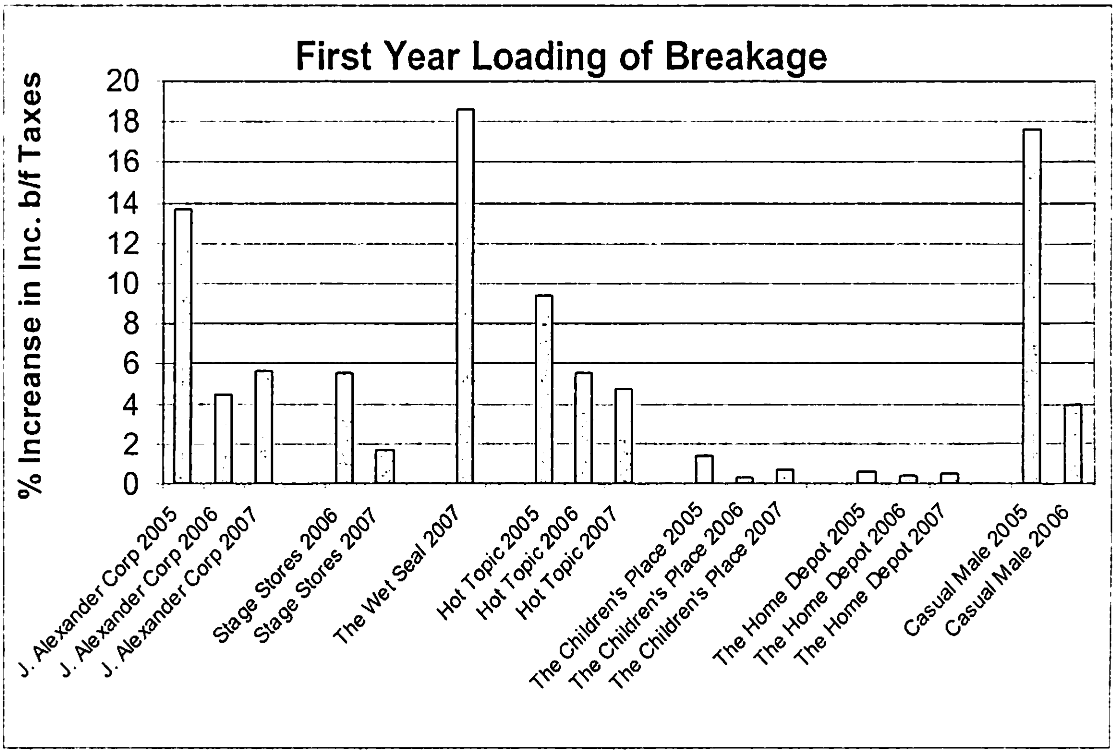


On the surface first year loading of breakage seems reasonable. When companies first decide they can recognize revenue from unredeemed gift cards, using either a breakage recognition rate or the passage of time method, their balance of gift cards likely to go unredeemed is significantly higher than it would have been had they been recognizing breakage all along. Therefore, they reduce their liability and recognize revenue in greater amounts than they will in subsequent periods to account for breakage that could have been recognized previously.

While this does contradict the revenue recognition and matching principles, it would not be a large concern if the additional breakage revenue had an immaterial effect on companies' bottom line. Figure 5, however, shows that this is not the case. For five of the seven companies, first year loading produced a material effect on reported income before taxes. Breakage revenue's effect on income before taxes was at least double the subsequent periods' (or normal periods') effects for all but one of the seven companies.

For some companies, first year loading caused breakage revenue to increase income before taxes in the first year by three or four times as much as in the following years.

Figure 5



First year loading is an aspect of current gift card accounting practice that highlights the overall problems breakage revenue causes with regard to the revenue recognition and matching principles. As stated earlier, determining the point at which revenue from unredeemed gift cards is realizable and earned is what makes a reliable estimation of breakage so difficult. Companies that use a gift card breakage recognition rate do so under the assumption that some annual percentage of their liability is a fair estimation of the amount of gift cards to go unredeemed. Other companies estimate the probability of redemption is remote after a certain amount of time has passed. While both of these methods might prove to be valid means to estimate breakage revenue, neither can explicitly determine when revenue is realizable or earned, i.e. when a gift card actually goes unredeemed. Because this is something that really cannot be determined, standard setters are charged with the task of determining the best way to estimate breakage.

When companies first year load, they clearly breach the matching principle by showing an economic benefit in a period that is different from the period that actually benefited from gift cards going unredeemed. The matching principle says that revenues should be matched with their associated product costs, like material, labor, or overhead. A peculiarity with the recognition of any breakage revenue, not just first year loading, is that there are no associated product costs to unredeemed gift cards. Breakage revenue, then, can almost be thought of as "period revenue", in that it cannot be linked with costs and is recognized in the period in which it is estimated to occur. With this in mind, a new standard should attempt to confine reporting of the economic benefits to periods in which they are estimated to have occurred.

Additionally, first year loading further impairs comparability and consistency of financial statements. Financial statements cannot be considered consistent within individual companies over multiple periods when one period has a disproportionate amount of breakage revenue caused by first year loading. Financial statements for a given year are not comparable across several companies when some companies have disproportionate amounts of breakage revenue caused by first year loading.

Because the current practice of first year loading has a material and significant effect on companies' financial statements, and it violates or impairs important accounting principles and concerns, it should be remedied by a new standard. A possible solution to this problem is to deal with revenue attributable to prior periods retrospectively with an adjustment to beginning retained earnings, sufficient footnote disclosures, and possible restatement of prior year financial statements.

Computation Methods – Conflict between Matching and Conservatism

When a business sells a gift card, they receive cash and establish a liability. When any portion of that gift card is redeemed, the liability is reduced and revenue is recognized. The foregoing has established that revenue from unredeemed gift cards is usually estimated and applied based on one of two basic methods: a reduction of the gift card liability based on an annual percentage of that liability, or an estimation of breakage based on the passage of time since the initial sale of the gift card. The SEC prohibits recognizing a percentage of each gift card sale as revenue at the time of the sale based on an estimation of future breakage.

In comparing the two basic methods of breakage estimation, there appears to be a fundamental conflict between matching and conservatism. Because a gift card going unredeemed is a nonevent, it can never be precisely determined when breakage revenue is actually realized. Companies, then, have no way to be completely accurate in calculating the amount of revenue that is appropriate to recognize for a given period. Contrasting the two general methods for the estimation of breakage exhibits a tradeoff between the principles of matching and conservatism.

When companies use a set rate by which to reduce their gift card liability annually they seem to more closely match revenue with the period benefited than when companies recognize breakage based on the passage of time. Using a gift card breakage recognition rate, however, appears to be a less conservative estimate of when the revenue from unredeemed gift cards is actually earned. That is, revenue recognition based on the passage of time is a better conceptual measure of when gift card redemption becomes remote.

Additionally, the data examined here suggests the percent reduction being the less conservative method, or at least the method most likely to have a significant effect of companies' bottom line. Of the sample of sixteen companies that reported breakage, six estimated it using an annual rate. Of those six, all had at least one period since 2004 in which breakage has had a significant effect (5% or greater increase) on their income before taxes. All six companies experienced at least a 1.8% increase in income before taxes from breakage in 100% (13/13) of the companies' reported periods.

By contrast, of the companies that recognized breakage based on the passage of time, only three of the ten companies experienced at least one period in which breakage had a material effect. Further, 58% (15/26) of reported periods showed an increase in income before tax due to breakage of less than 1%. This shows that for companies who reduce their gift card liability using an annual rate, breakage revenue has had a more substantial effect on income, possibly indicating that breakage estimations based on the passage of time are a more conservative measure of revenue from unredeemed gift cards.

The trend among the sample companies is that over time the gift card liability increases. Therefore, the breakage recognition rate approach best matches revenue from unredeemed gift cards with the tangible economic benefit of the original sale of those gift cards: the receipt of cash. As gift card sales increase and the company receives more cash, using an annual rate will cause the amount of breakage revenue to proportionally increase with the increased sales. This matches revenue recognition with the period that actually receives the economic benefit, the receipt of cash. Calculating breakage using this method, however, may not be the most accurate or conservative measure of the amount of gift cards that actually go unredeemed during that period.

An estimation of breakage based on the passage of time produces a more conservative amount for unredeemed gift card revenue. Estimating breakage based on the passage of time defers increasing economic benefits from breakage due to increasing sales of gift cards to future years. It provides a more realistic estimation of the point in time when the company can reasonably claim that a gift card has gone unredeemed. Therefore, it allows for a more reliable estimate of unredeemed gift cards attributable to the current period. That is, the period in which the gift cards actually go unredeemed. However, it does not match revenues with the receipt of cash: the period which receives the tangible economic benefit of unredeemed gift cards.

When crafting a standard, it must be decided how best to reconcile a reasonable matching of revenue with the period benefited by the receipt of cash and the more conservative and accurate estimate of the amount of gift cards to actually go unredeemed for a period.

Summary and Statement of the Need for a New Standard

In foregoing cases, breakage revenue was shown to have material effects on financial statement numbers that are important to investors, creditors, and other users of financial statements. What's more, these companies actually disclosed, albeit somewhat buried in the footnotes, the extent to which their income was magnified or loss was reduced by breakage. Lack of a standard methodology leaves unanswered the question of whether or not the breakage revenue for those respective periods is reasonable or comparable enough to have such a profound effect on reported earnings.

Companies that actually have reported specific gift card information, including breakage revenue, would seem to be the most responsible and conservative in their estimates, accounting, and disclosures of gift card data. Even among and within these companies there exist immense discrepancies and lack of comparability and consistency. There is no way to know if companies that disclose far less information related to their gift card accounting policies are using breakage to have an even more material effect on their bottom line.

While acknowledging that breakage does not always have a material effect on a company's bottom line, there is potential for it to have an immense effect. At worst, the lack of standardized treatment for and disclosure of breakage revenue and gift card accounting opens the door for the possibility of earnings management, income smoothing and other unscrupulous behavior that can cause misleading financial statements that inequitably influence decisions made by investors and creditors beyond the limitations caused by the failure of financial statements to satisfy accounting principles.

Analysis of the data collected from the sixteen companies studied shows that breakage revenue is a material concern, that there is an unacceptable lack of comparability and consistency in the current reporting environment, and that gift card accounting practices violate important accounting principles. For all these reasons, a new, comprehensive, and authoritative standard must be created and implemented.

Section III. Testing Potential Standards

Aside from reconciling gift card accounting practices to accounting principles, the most immediate and important benefit from a new standard is improvement in the comparability and consistency of financial statements for companies that sell gift cards. When companies use the same method to compute, apply, and disclose breakage, gift cards' fiscal effects will be relative and equivalent when financial statements are compared. As time progresses, individual companies' financial statements will more consistently reflect the effects of revenue from unredeemed gift cards.

A strong case can be made that the preferred method of dealing with breakage revenue would be to recognize it, based on a reliable estimation, at the point of sale. It is not conceptually flawed to argue that estimated breakage revenue is earned and realizable when the gift cards are sold. The remainder of the revenue is earned when the cards are later redeemed. The critical event for the recognition of breakage revenue is the purchase of the card, not the passage of time. The SEC, however, disallows any recognition of revenue from unredeemed gift cards at the point of sale. Therefore, a new standard must determine an alternative approach to dealing with breakage that fits within the constraints of accounting's Conceptual Framework.

Of the two methods currently used to compute breakage, percentage reduction of the liability and passage of time, some variation of either should be adopted as the standard. To measure which method best achieves the desired objectives of a new standard, real world data should be uniformly applied to each method and the results analyzed. Because of limitations in the availability of disclosed gift card data, a proposed standard using either method cannot be applied to the sixteen companies to analyze the effects of the standard. Therefore, proposed standards were tested in this study by application to extensive hypothetical data.

Regardless of which method is used as a basis for the standard, adequate gift card related information disclosures must be compulsory for companies that issue gift cards. Based on data gathered from the sixteen companies, breakage revenue does not have a significant enough effect to be required as a separate line item on the income statement, and could be included as a component of an account like Other Income. Breakage does, however, have sufficient enough effect on financial statements that a section of companies' Footnote 1: Nature of Business and Summary of Significant Accounting Policies should be dedicated to gift card disclosure. This section should at least include the dollar amount of breakage recognized and where breakage is included on the income statement. Likewise, while the gift card liability does not warrant its own line on the balance sheet, it should be disclosed in the footnote.

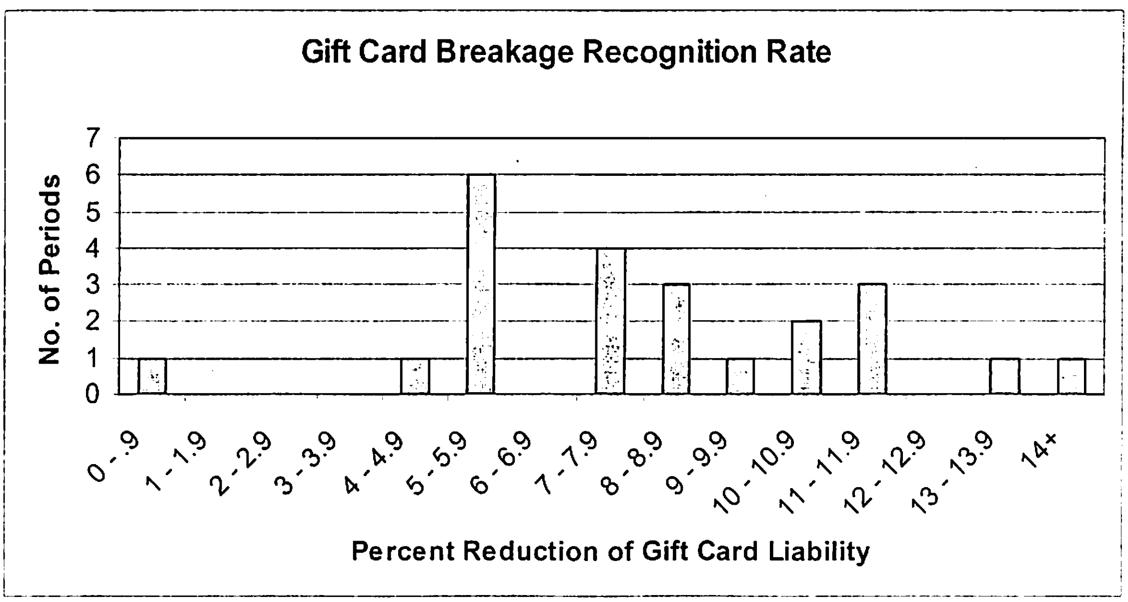
The criteria used to recognize breakage revenue under both computation methods is when the seller can determine the point at which they are legally released from the gift card liability. Each method offers a different approach to computing how much of the liability can be written off. The percent reduction method assumes that a certain percentage of gift cards outstanding go unredeemed every period. The passage of time method assumes that all gift cards over a certain age will go unredeemed.

Percent Reduction Method

Figure 6 shows the distribution of actual disclosed and imputed gift card breakage recognition rates from the sample of companies over the periods in which breakage was recognized. These rates, according to the SEC, should be computed by the individual companies based on historical analysis of gift card redemption trends. Theoretically, they should all be accurate and appropriate for each company, but the lack of standard methodology and the ambiguity of the SEC's requirements for the historical analysis do not lend sufficient credibility to these numbers.

Clearly, there is not a definitive, one-size-fits-all, rate. Regardless, in the interest of better meeting the requirements of accounting concepts, it is reasonable to set a maximum percent by which the gift card liability can be reduced, even if some companies might legitimately calculate that they experience more breakage. Likewise, few companies who would have computed a lower rate would likely complain about a higher standard rate.

Figure 6



For the purposes of this paper, the reduction of the gift card liability due to revenue recognized from unredeemed gift cards will be set at 8%, as this number falls in the middle of reported and imputed rates from the sample companies and seems reasonable (Figure 6).

A hypothetical company illustrates the effects of this standard. Calculations were made based upon the following assumptions:

- Breakage is computed as an 8% annual reduction of the gift card liability.
- Eighty percent of gift cards sold are redeemed within the year in which they are sold.
- Fifty percent of unredeemed gift cards are redeemed in their second year outstanding.
- Twenty percent of unredeemed gift cards are redeemed in their third year outstanding.
- The remaining outstanding gift cards go unredeemed.
- The company has gift card sales of $100,000 during their first year of operations.

If gift card sales increase by $10,000 each period, the gift card liability and amount of breakage recognized will grow every period (Figure 7, Appendix A). Additionally, the incremental increase to breakage revenue and the gift card liability will grow each period. Because the company reduces the liability by a percentage, unredeemed gift cards are never completely removed from the books.

Figure 7

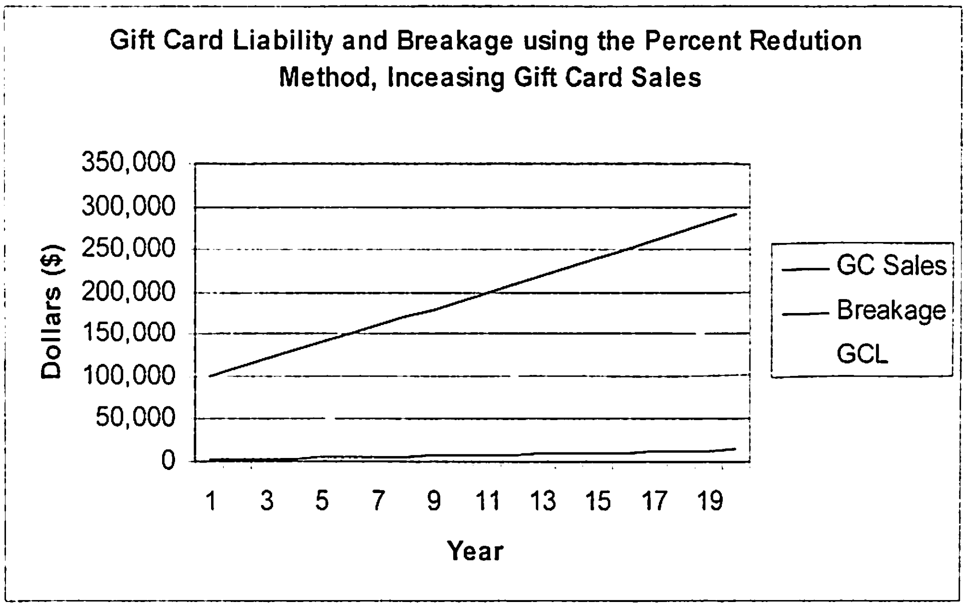


Figure 8 (Appendix B) shows the effects of erratic gift card sales. In this example, despite increases and decreases in gift card sales, the gift card liability and breakage follow a clear increasing trend.

Figure 8

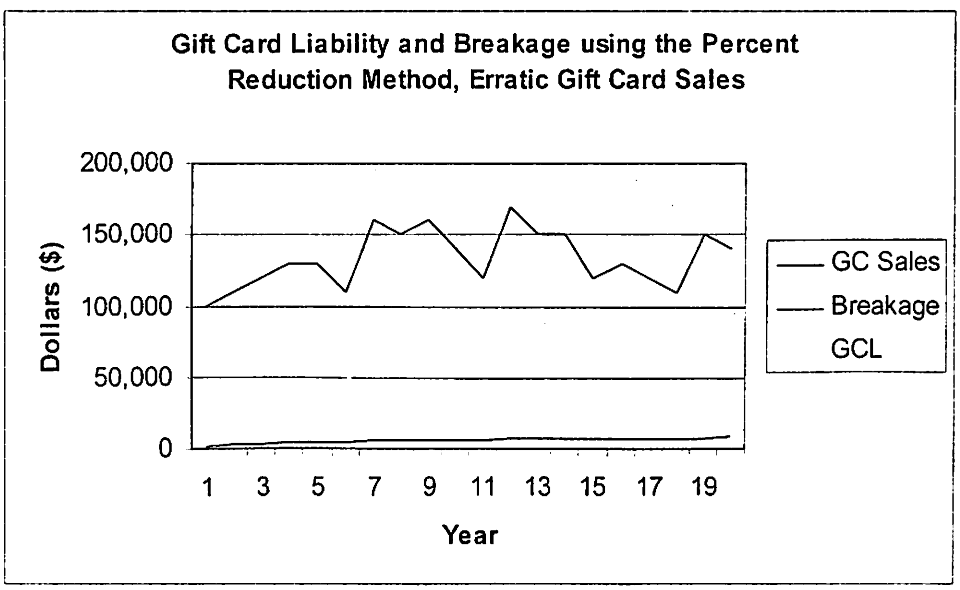
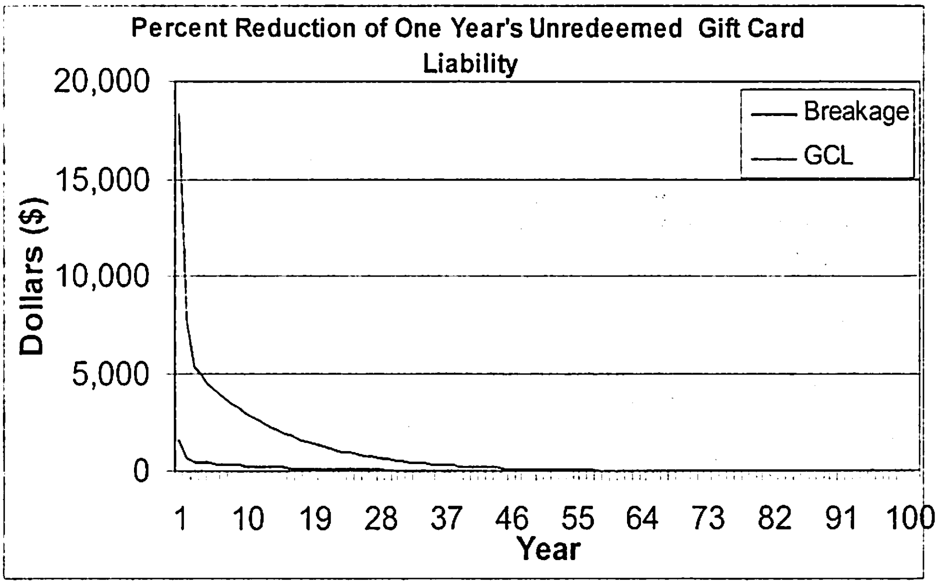


Figure 9 (Appendix E) shows how reducing the gift card liability by a certain annual percent does not allow for the full recognition of the desired amount of breakage,

and leaves unredeemed gift cards on the books for a prolonged period of time, never completely eliminating the liability. The forgoing data suggests that, the method of computing breakage based on a percent reduction of the gift card liability does not fulfill desired objectives of a potential accounting standard.

Figure 9



Passage of Time Method

To recognize revenue based on the passage of time, companies should use historical data to determine the number of periods subsequent to the sale of gift cards at which their redemption becomes remote. Like above, for the purposes of ensuring comparability and consistency a discrete number of years after which companies can recognize breakage is desirable in a standard, even if it might exceed or fall short of some individual companies' estimates. For this hypothetical application, three years falls in the middle of the reported time periods from the sample of companies, and seems reasonable.

A hypothetical company illustrates the effects of this standard. Calculations were made based upon the following assumptions:

- Breakage is computed by writing off the remaining balance of the gift card liability at the end of the third year from the year in which the liability was incurred.
- Eighty percent of gift cards sold are redeemed within the year the in which they are sold.
- Fifty percent of unredeemed gift cards are redeemed in their second year outstanding.
- Twenty percent of unredeemed gift cards are redeemed in their third year outstanding.

If a company sells $100,000 in gift cards their first year, and sales increase by $10,000 each period (Figure 10, Appendix C), their gift card liability will increase by $12,000 in year two, $11,000 in year three, and $3,800 in all subsequent years. Breakage will increase by $800 each period.

Figure 10

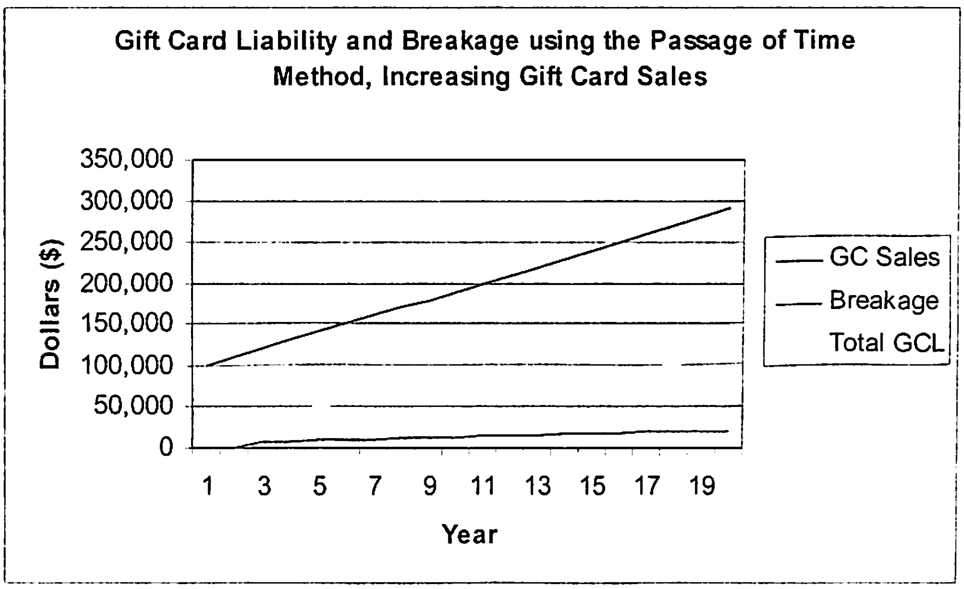
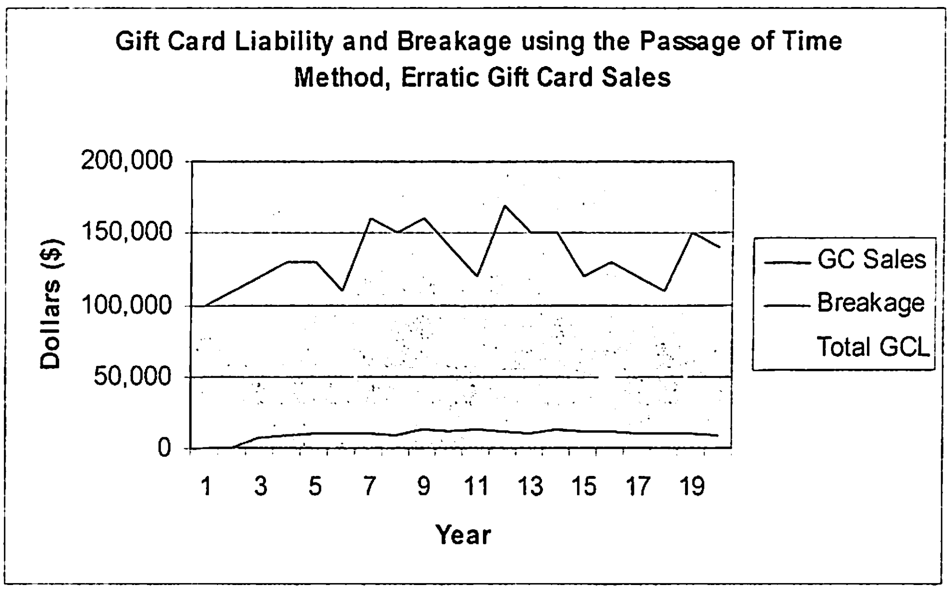


Figure 11 (Appendix D) shows the effects of the same erratic gift card sales experienced in the previous example. In this example, from year four on, the gift card liability remains within approximately a $13,000 window, never increasing or decreasing by more than $8,000 in a single year. Likewise, from year four on, breakage fluctuates by approximately $5,000, never increasing or decreasing during a single period by more than $4,000 and $2,400 respectively. The gift card liability reached its highest point in year nine at $59,800. The highest amount of breakage revenue, $13,600, occurred in year fourteen, year twelve had the highest amount of gift card sales.

Figure 11

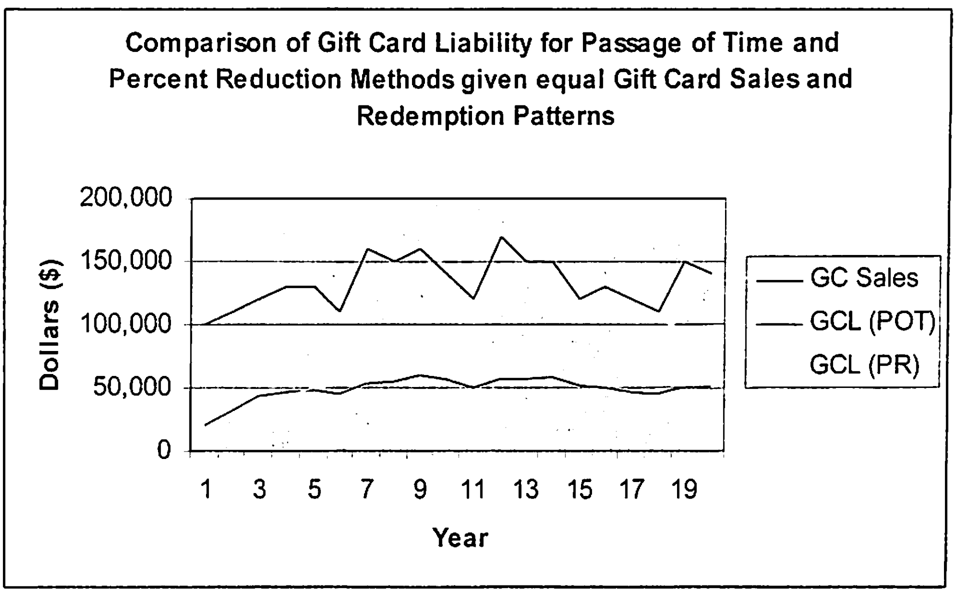


Computing breakage based of the passage of time causes the subsequent revenue and changes to the gift card liability to mirror actual changes in gift card sales. However, effects are deferred by the three years companies must wait to recognize revenue matched with gift card sales made in the current period. By completely writing off the outstanding liability after three years, this method ensures that the gift card liability does not continually increase over time as it does under the percent reduction method.

Comparison

A comparison of these two models for breakage computation indicates that breakage recognized based on the passage of time is the more desirable alternative. Breakage computed using the passage of time method produces financial data with less fluctuation, and more closely correlated (although three years deferred) to changes in sales volume. Most importantly, it completely eliminates the unredeemed liability, and does so at once, not over the course of several periods. This allows for breakage revenue recognition that is more completely correlated with the periods benefited and prevents perpetual growth of the gift card liability (Figure 12).

Figure 12



If the two methods were combined, allowing for an annual percent reduction of the liability with the balance of unredeemed gift cards written off after three years, it would result in the same total breakage but would somewhat smooth the deferral effect caused by the passage of time method. Analyses of the foregoing hypothetical situations indicate that the passage of time computation method should be the basis of any new standard.

Despite the need for conformity of practice, different companies observe different gift card redemption patterns and therefore have the potential to legitimately determine the point of remote gift card redemption at different intervals. For example, if one company has justifiable evidence that all outstanding gift card balances over two years old will go unredeemed, while another company rightfully recognizes breakage after three years, then the breakage revenue recognized in both cases is equally valid. Comparability and consistency of financial statements has not been impaired. In this sense, a standard including a rigid mandate of when redemption becomes remote (three years, for example) seems inappropriate, as redemption patterns vary from company to company.

Because of the variability of different companies' natural business cycles, a principles-based standard, as opposed to a rules-based standard, might seem best suited to address the issues of breakage recognition. The big problem is ensuring that companies fairly, comparably, and consistently estimate when breakage can be recognized. If this cannot be guaranteed, then any standard, either based in principle or rule, cannot be successful as it will not solve the problems caused by a lack of comparability and consistency in financial statements. This is an important topic for future research, and is an issue incumbent to more broad and overreaching accounting dilemmas as the United States' rules-based accounting community begins to move towards convergence with the principles-based international community.

The current SEC guidance for breakage recognition is an effectual principles-based standard, and the forgoing study has illustrated its failures in ensuring proper gift card accounting practices. Unless proven otherwise, some "bright line" is needed to ensure that the standard solves the problems that have been demonstrated to accompany accounting for gift cards and breakage revenue.

Based on these considerations, the following are proposed elements for a successful standard:

- Breakage revenue may be recognized at thirty-six months after the liability was incurred unless a company can demonstrate compelling evidence that the point at which gift card redemption becomes remote occurs sooner.
- Gift card issuing companies must disclose in the footnotes to their consolidated financial statements the amount of their gift card liability, and the amount of breakage revenue recognized in the current fiscal period and where it appears on the income statement.
- When computing breakage under the above constraints for the first time, any revenue from unredeemed gift cards attributable to prior periods (i.e. liabilities over thirty-six months old) must be treated retrospectively with an adjustment to beginning retained earnings.

Summary and Conclusion

The preceding study demonstrates the need for a new accounting standard for gift cards. Resulting changes to accounting for gift cards and breakage revenue will reconcile practice with theory, uphold important financial accounting concepts and principles, and ensure that financial statements best serve the needs of their users.

As gift cards grow in popularity, accounting for breakage revenue is an issue of increasing importance. While it is essential for companies to reflect the financial benefits of unredeemed gift cards in their financial statements, the current regulatory environment affords companies too much financial reporting leeway and results in financial statements that do not fulfill the needs of their users.

The only current guidance for recognition of breakage revenue, contained in two Securities and Exchange Commission Staff Bulletins, does not provide companies with specific or authoritative direction. The Financial Accounting Standards Board, or its Emerging Issues Task Force, to date, has failed to address the issue.

Previous research has established that companies use a variety of accounting presentations when recognizing breakage revenue on their financial statements, and that very few companies provide any specific information that is useful to financial statement users. Previous research stopped short of analyzing any explicit financial effects, or substantially considering how current practices related to accounting theory and concepts.

The research reported here demonstrates the need for a new accounting standard by examining four hypotheses: 1) financial statements for companies with breakage revenue are currently not comparable or consistent, 2) breakage revenue is a material amount for many companies, 3) current practices violate the basic accounting principles of revenue recognition and matching, and 4) practices create divergence between the principles of matching and conservatism.

Analysis of Form 10-Ks since 2004 from sixteen breakage reporting companies illustrated the lack of comparability and consistency caused by gift card accounting in financial statements. Computation of the percent change caused by revenue from unredeemed gift cards in income before taxes for companies that report breakage showed that breakage has the potential to be and often is a material component of a company's bottom line. The common practice of "first year loading" of breakage revenue was found to be in conflict with revenue recognition and matching. And the matching principle and conservatism constraint were not consistently upheld in practice because of varying methods of breakage computation.

To determine how the problems created by current gift card accounting practices could be solved through a new standard, extensive testing of hypothetical situations was used. The two currently used alternative methods of breakage computation (one based on an annual percent reduction of the gift card liability, the other based on the length of time a gift card goes unredeemed) were applied to theoretical companies. The findings indicated that the passage of time method is the more desirable alternative for recognizing breakage.

The overall results of this research indicate that the Financial Accounting Standards Board needs to take action to standardize the accounting for and disclosure of gift cards. The preceding demonstrated that when companies take advantage of SEC allowances to reduce gift card liabilities and recognize revenue, they do so without disclosing the specifics of their methodology. It has been shown how companies' practices impair the integrity of their financial statements, and potentially mislead the users of those statements. Authoritative and specific guidance for the treatment of the various issues related to the use of gift cards, their financial effects, and disclosure is necessary to ensure the consistency, comparability, transparency, and integrity of the financial accounting for relevant entities.

This study shows that such a standard would achieve those objectives and reconcile accounting practice to accounting principle if it included the following prerequisites. First, it must be based on the method of computing breakage based of the passage of time, not a percent reduction of the gift card liability. Second, it must mandate that companies provide complete gift card disclosures that fully inform the financial statement user of pertinent and specific gift card and breakage revenue related information.

The unique characteristics of gift cards and revenue from unredeemed gift cards create some interesting accounting dilemmas. Because breakage revenue can and does significantly affect companies' financial statements, it important that it be computed and stated as fairly as possible and in accordance with established accounting principles. It is clear that to ensure this, and protect those who rely upon applicable financial statements, a sufficient, definitive, and authoritative standard must be promulgated by the appropriate accounting authorities.

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APPENDICES

Appendix A. Percent Reduction Method, Increasing Gift Card Sales

Year	GC Sales	GC Redemptions	Breakage	GCL	Incremental Breakage	Incremental GCL
1	100,000	80,000	1,600	18,400		
2	110,000	98,000	2,432	27,968	832	9,568
3	120,000	110,000	3,037	34,931	605	6,963
4	130,000	119,300	3,650	41,980	613	7,050
5	140,000	128,600	4,270	49,110	620	7,130
6	150,000	137,900	4,897	56,313	626	7,203
7	160,000	147,200	5,529	63,584	632	7,271
8	170,000	156,500	6,167	70,917	638	7,333
9	180,000	165,800	6,809	78,308	643	7,391
10	190,000	175,100	7,457	85,751	647	7,443
11	200,000	184,400	8,108	93,243	651	7,492
12	210,000	193,700	8,763	100,780	655	7,537
13	220,000	203,000	9,422	108,357	659	7,578
14	230,000	212,300	10,085	115,973	662	7,615
15	240,000	221,600	10,750	123,623	665	7,650
16	250,000	230,900	11,418	131,305	668	7,682
17	260,000	240,200	12,088	139,017	671	7,712
18	270,000	249,500	12,761	146,755	673	7,739
19	280,000	258,800	13,436	154,519	675	7,764
20	290,000	268,100	14,114	162,305	677	7,786

Appendix B. Percent Reduction Method, Erratic Gift Card Sales

Year	GC Sales	GC Redemptions	Breakage	GCL	Incremental Breakage	Incremental GCL
1	100,000	80,000	1,600	18,400		
2	110,000	98,000	2,432	27,968	832	9,568
3	120,000	110,000	3,037	34,931	605	6,963
4	130,000	119,300	3,650	41,980	613	7,050
5	130,000	120,600	4,110	47,270	460	5,290
6	110,000	104,900	4,190	48,180	79	910
7	160,000	142,900	5,222	60,058	1,033	11,878
8	150,000	139,300	5,661	65,097	438	5,039
9	160,000	147,800	6,184	71,113	523	6,016
10	140,000	132,500	6,289	72,324	105	1,211
11	120,000	114,800	6,202	71,322	-87	-1,002
12	170,000	152,200	7,130	81,993	928	10,670
13	150,000	140,600	7,311	84,081	182	2,089

14	150,000	140,100	7,518	86,463	207	2,382
15	120,000	115,500	7,277	83,686	-241	-2,777
16	130,000	120,500	7,455	85,731	178	2,045
17	120,000	112,600	7,450	85,680	-4	-50
18	110,000	103,900	7,342	84,438	-108	-1,242
19	150,000	134,600	7,987	91,851	645	7,413
20	140,000	130,300	8,124	93,427	137	1,576

Appendix C. Passage of Time Method, Increasing Gift Card Sales

Year	GC Sales	GC Redemptions	Breakage	GCL	Incremental Breakage	Incremental GCL
1	100,000	80,000		20,000		
2	110,000	98,000		32,000		12,000
3	120,000	109,000	8,000	43,000		11,000
4	130,000	118,200	8,800	46,800	800	3,800
5	140,000	127,400	9,600	50,600	800	3,800
6	150,000	136,600	10,400	54,400	800	3,800
7	160,000	145,800	11,200	58,200	800	3,800
8	170,000	155,000	12,000	62,000	800	3,800
9	180,000	164,200	12,800	65,800	800	3,800
10	190,000	173,400	13,600	69,600	800	3,800
11	200,000	182,600	14,400	73,400	800	3,800
12	210,000	191,800	15,200	77,200	800	3,800
13	220,000	201,000	16,000	81,000	800	3,800
14	230,000	210,200	16,800	84,800	800	3,800
15	240,000	219,400	17,600	88,600	800	3,800
16	250,000	228,600	18,400	92,400	800	3,800
17	260,000	237,800	19,200	96,200	800	3,800
18	270,000	247,000	20,000	100,000	800	3,800
19	280,000	256,200	20,800	103,800	800	3,800
20	290,000	265,400	21,600	107,600	800	3,800

Appendix D. Passage of Time Method, Erratic Gift Card Sales

Year	GC Sales	GC Redemptions	Breakage	GCL	Incremental Breakage	Incremental GCL
1	100,000	80,000		20,000		
2	110,000	98,000		32,000		12,000
3	120,000	109,000	8,000	43,000		11,000
4	130,000	118,200	8,800	46,800	800	3,800
5	130,000	119,400	9,600	48,600	800	1,800
6	110,000	103,600	10,400	45,400	800	-3,200
7	160,000	141,600	10,400	53,400	0	8,000

8	150,000	138,200	8,800	54,800	-1,600	1,400
9	160,000	146,200	12,800	59,800	4,000	5,000
10	140,000	131,000	12,000	56,000	-800	-3,800
11	120,000	113,200	12,800	50,800	800	-5,200
12	170,000	150,800	11,200	57,200	-1,600	6,400
13	150,000	139,400	9,600	56,600	-1,600	-600
14	150,000	138,400	13,600	58,600	4,000	2,000
15	120,000	114,000	12,000	51,000	-1,600	-7,600
16	130,000	119,000	12,000	50,000	0	-1,000
17	120,000	111,400	9,600	46,600	-2,400	-3,400
18	110,000	102,600	10,400	44,400	800	-2,200
19	150,000	133,400	9,600	50,600	-800	6,200
20	140,000	129,200	8,800	51,800	-800	1,200

Appendix E. Percent Reduction of One Year's Unredeemed Liability

Year	GC Sales	GC Redemptions	GCL b/f Breakage	Breakage	GCL
1	100,000	80,000	20,000	1,600	18,400
2	0	10,000	8,400	672	7,728
3	0	2,000	5,728	458	5,270
4	0	0	5,270	422	4,848
5	0	0	4,848	388	4,460
6	0	0	4,460	357	4,103
7	0	0	4,103	328	3,775
8	0	0	3,775	302	3,473
9	0	0	3,473	278	3,195
10	0	0	3,195	256	2,940
11	0	0	2,940	235	2,705
12	0	0	2,705	216	2,488
13	0	0	2,488	199	2,289
14	0	0	2,289	183	2,106
15	0	0	2,106	168	1,938
16	0	0	1,938	155	1,783
17	0	0	1,783	143	1,640
18	0	0	1,640	131	1,509
19	0	0	1,509	121	1,388
20	0	0	1,388	111	1,277
...	...	...	...	...	...
100	0	0	2	0	2