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Attn: Technical Director - File Reference 1820-100

Card Compliant¹ appreciates the opportunity to comment on the joint Financial Accounting Standards Board/International Accounting Standards Board's (the "Boards") Exposure Draft, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers* (the "ED").

Currently, the accounting for gift card breakage² not subject to escheatment is fairly unregulated and highly subjective. As we understand it, current U.S. GAAP allows an entity to recognize revenue on the sale of a gift card at the time of redemption³. The entity would only be allowed to recognize the portion which was redeemed (i.e. if a gift card holder purchases product worth \$20 with a gift card carrying a \$50 balance, the entity would only be allowed to recognize the \$20 which was presented for redemption). While this accounting practice works, it neglects to address when to recognize the portion of a card which is never redeemed ("breakage"). There is an SEC speech⁴ from December 2005 which addresses the recognition of breakage. This speech allows an entity to derecognize a gift card liability when there is a remote chance the liability will be called upon. The speech also provides examples of acceptable and unacceptable methods for derecognizing the liability. Each of these facets of gift card accounting will be discussed throughout this comment letter.

This comment letter will revolve around the application of the ED to the gift card industry as we feel the standard inadequately addresses the necessary aspects of revenue recognition for gift card accounting.

¹ Card Compliant is a stored-value card compliance company servicing major stored-value card programs, including gift card programs. Card Compliant offers an automated approach to gift card and stored-value card accounting, escheatment as well as compliance with all applicable rules and regulations.

² Gift card breakage is the unspent portion of a gift card, resulting in a remaining balance on the card. If the gift card is not subject to escheatment, the issuer of the gift card would hold the liability on their financials until (a) the card is subsequently redeemed, or (b) the liability is derecognized.

³ A redemption occurs when a gift card holder presents a gift card as tender in exchange for a product or service.

⁴ The speech was delivered at the December 5, 2005 AICPA National Conference on Current SEC and PCAOB Developments by Pamela Schlosser (Professional Accounting Fellow, U.S. SEC).

Question 1: Paragraphs 12-19 propose a principle to help an entity determine whether to (a) combine two or more contracts and account for them as a single contract, (b) segment a single contract and account for it as two or more contracts, and (c) account for a contract modification as a separate contract or as part of the original contract. Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

As it relates to gift cards, Card Compliant asks the Boards to clearly stipulate whether or not a gift card contract would need to be segmented, and if so, what method should be used to segment. Card Compliant believes a gift card contract should not be segmented as the good or service in the contract is the single gift card being purchased and not the goods or services provided at redemption. If the Boards believe the goods or services being purchased are the goods or services provided at redemption, the Boards should determine the contract must be segmented. Card Compliant would propose the segmentation be based upon redemptions. As redemptions are future events, Card Compliant would recommend the analysis of specific card program redemption history to forecast redemptions. This redemption forecast would then be used to segment a contract. If this method is recommended by the Boards, additional guidance would be necessary in order to stipulate how to account for actual redemptions (actual segments) which are out of line with the forecasted redemptions (segments previously established). Regardless of whether the contract should be segmented, the Boards should address whether a reload, return, and other similar activities would be considered a contract modification.

Question 2: The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

As it relates to gift cards, the proposed principle is unclear. Regarding attribute A, the entity would sell an identical or similar good or service separately as an entity typically sells many gift cards in a variety of denominations. Additionally, regarding attribute B, the entity could sell the good or service separately as it has both a distinct function and a distinct profit margin. Where the principle is unclear, as it relates to gift cards, is whether or not the entity has promised to transfer more than one good or service. The good or service which a gift card transfers is tender when a card is presented for redemption in exchange for a product or service. Gift cards do not have a regulation which states you can only redeem the card one time. In fact, most gift cards experience many redemptions over the life of the card. As such, we would like to see the principle be clearer regarding whether or not a gift card has a promise to transfer more than one good or service.

Question 3: Do you think that the proposed guidance in paragraphs 25-31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

As it relates to gift cards, the proposed principle is unclear. For a gift card, there are 3 potential points when a performance obligation could be satisfied: when the card is issued, as each redemption occurs, and when the entire card has been redeemed. If the performance obligation is deemed to be satisfied when the card is issued, each card would only have one performance obligation (assuming it is a non-reloadable card). Card Compliant believes this would lead to an overstatement of revenue as the entity holds a customer's cash, but has done nothing in return other than issue a gift card. If paragraph 27 was followed in determining whether or not the performance obligation had been satisfied, one could make the argument the customer has the ability to direct the use of the good or service (the gift card), and as such, should be able to recognize the revenue. Additionally, a gift card appears to satisfy 3 of the 4 indicators found in paragraph 30: the customer has an unconditional obligation to pay (the money would have already been collected if a gift card is issued); the customer has legal title (ownership of the gift card); and the customer has physical possession (of the card). This would allow a company to make a strong argument the revenue should be recognized at the time of issuance⁵. The positive to the performance obligation being deemed satisfied upon issuance is the accounting is simplified. Currently, revenue from the sale of gift cards does not occur until a portion has been redeemed. At that time, revenue can only be recognized on the redeemed portion. Card Compliant does not advocate for the Boards to determine the satisfaction of the performance obligation occurs at issuance as we believe while the customer has performed their obligation; the entity's performance is satisfied upon redemption.

If the performance obligation is deemed to be satisfied upon each redemption, each card would likely have multiple performance obligations. Determining the performance obligations upfront would require statistical forecasting based upon historical data. It would be impossible to know exactly how each card will behave as each card has a completely different set of variables (i.e., different card holder, different terms, different type of gift card, etc.). This method aligns with current U.S. GAAP standards regarding recognition of gift card revenue, thus it would not require a complete overhaul of gift card accounting in the U.S.. It appears to be the best method for accurately reflecting revenue as well as gift card liabilities on a company's financial statements. On the other hand, this method offers no alternative for recognizing revenue on the unredeemed portion of gift cards. Not recognizing revenue on the unredeemed portion of gift cards over time causes a significant build up of liabilities which will likely never be called upon, causing gift card liabilities to be significantly overstated, and revenue to be significantly understated. If the Boards decide a performance obligation has been satisfied with each redemption, they would need to address how to account for money on cards which are not redeemed.

⁵ Note, this argument is dependent on the fact that the "good or service" is the gift card. If the "good or service" is found to be the product/service which is purchased when the gift card is presented for redemption, the performance obligation could not be deemed satisfied at issuance. Card Compliant believes a gift card should not be considered the good or service as at the time of issuance, the entity has not performed their obligation, rather the customer has.

Card Compliant is a proponent of this model but would like to see additional guidance to address the treatment of unredeemed balances (i.e. gift card breakage).

Finally, if the performance obligation is deemed to be satisfied upon total redemption of a card, each card would have only one performance obligation. It is important to note that a significant percentage of cards are never fully redeemed. Additionally, on average, a card has a 24-48 month life and experiences redemptions throughout that entire period, most of which occur in the first few months. To not allow revenue recognition until the point of full redemption would likely lead to an understatement of revenue. Card Compliant does not advocate for the Boards to determine the satisfaction of the performance obligation occurs upon full redemption as we believe the entity performs their obligation upon each redemption.

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price. Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

As it relates to gift cards, the proposed principle has no direct impact as a gift card will always have a fixed transaction price.

Question 5: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

As it relates to gift cards, the proposed principle has no direct impact as the company issuing the gift card receives the money prior to issuing the card. As such, the customer's credit risk has no impact on the transaction price.

Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

As it relates to gift cards, the proposed principle has no direct impact as the company issuing the gift card receives the money prior to issuing the card. As such, promised consideration is not a part of the contract between the card issuer and the card holder, thus, the time value of money principle would not impact the accounting for gift cards.

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

As it relates to gift cards, we partially agree and disagree that the transaction price should be allocated to all separate performance obligations. If this principle is adopted by the Boards, an entity should recognize revenue upon redemption, in an amount equal to the redemption⁶. In our opinion, this treatment results in the most accurate financial statements, as compared to other previously mentioned methods. However, this principle fails to address when to recognize revenue on a performance obligation which is not called upon by the customer (i.e. gift card breakage). In order to properly account for the unredeemed portion of gift cards, an entity should be allowed to record revenue on said breakage when the risk of redemption is remote. The SEC provided guidance in a speech⁷, which addressed the accounting for breakage. In the speech, the SEC indicated recognizing gift card breakage at the point redemption becomes remote may be an acceptable method. They added that recognizing gift card breakage in proportion to gift card redemptions is an acceptable approach. An entity taking this approach would be required to “not only reasonably and objectively determine the amount of gift card breakage, but also reasonably and objectively determine the estimated time period of actual gift card redemption.”

A second approach to recognizing gift card breakage, when the risk of redemption is remote, is to immediately recognize the breakage. If an entity has strong statistical support showing X% of each gift card issued will not be redeemed, the entity should not be required to hold a gift card liability on their books in excess of the fair value of the gift card liability⁸. As such, the revenue should be recognized at the time of issuance on the portion forecasted to break.⁹

A final approach to recognizing gift card breakage is to recognize it in one lump-sum once the card reaches the age where it has been deemed “statistically expired.” This point is determined by examining the history of the card portfolio and calculating the age at which future redemptions are remote. Once the card reaches the calculated age the card is “statistically expired.” Card Compliant is an advocate of each of these models for recognizing gift card breakage as revenue and would like to see the Boards adopt one of the principles.

⁶ This response assumes the Boards determine a performance obligation to be satisfied at the time of each redemption.

⁷ The speech was delivered at the December 5, 2005 AICPA National Conference on Current SEC and PCAOB Developments by Pamela Schlosser (Professional Accounting Fellow, U.S. SEC).

⁸ The fair value of the gift card liability is the value of expected redemptions, discounted for the time value of money while awaiting redemptions, and a premium for the risk that redemptions may be higher than anticipated. This will roughly equal the value of expected redemptions.

⁹ If an entity can statistically prove there is a remote possibility the liability will be called upon, it is our belief that under International Financial Reporting Standards this contingent liability should not be recognized nor disclosed, resulting in immediate recognition of the breakage.

Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, *Intangible Assets*), an entity should recognize an asset only if those costs meet specified criteria. Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

As it relates to gift cards, we think the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient.

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

As it relates to gift cards, we agree with the costs specified.

Question 10: The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

As it relates to gift cards, we believe the proposed disclosure requirements will meet the stated objective, if disclosed in the aggregate.

Question 11: The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

As it relates to gift cards, we agree with the proposed disclosure requirement, but would kindly ask the Boards to add to the requirement the ability to disclose in the aggregate. Not disclosing in the aggregate would require an entity to disclose a large amount of insignificant detail, and would prove to be too burdensome.

Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

As it relates to gift cards, we agree an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. For example, there are many types of gift cards which an entity could issue. Depending on the situation, it may be necessary to disaggregate revenue into categories based on the type of gift card, type of customer, etc.

Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

As it relates to gift cards, we agree an entity should apply the proposed guidance retrospectively.

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

As it relates to gift cards, we do not believe the proposed implementation guidance is sufficient to make the proposals operational. As previously mentioned, additional guidance would be needed in the following areas: should the contract be segmented; would a reload, return, and other similar activities be considered a contract modification; what is considered a transfer of a good or service; when the performance obligation is deemed to be satisfied; when revenue can be recognized on a performance obligation which hasn't and likely never will be called upon; and the ability to disclose contract components in the aggregate.

Question 15: The Boards propose that an entity should distinguish between the following types of product warranties: (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract; and (b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract. Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

As it relates to gift cards, the proposed distinction of and accounting for product warranties does not have a direct impact as gift cards typically do not have associated product warranties.

Question 16: The Boards propose the following if a license is not considered to be a sale of intellectual property: (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license. Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

As it relates to gift cards, the proposed patterns of revenue recognition do not have a direct impact as gift card customers are not typically granted licenses to use the entity's intellectual property.

Question 17: The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

As it relates to gift cards, the Boards proposal for the accounting treatment for a gain or loss on the sale of some nonfinancial assets would not have a direct impact.

Question 18: Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Card Compliant believes the proposed guidance, as it relates to gift cards, should not be different for nonpublic entities. Applying the proposed guidance to nonpublic entities would create a universal gift card accounting principle. Additionally, implementing the proposed guidance, as it relates to gift cards, should not prove to be too burdensome for nonpublic entities.

We appreciate the opportunity to comment on the ED.

Sincerely,

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