

March 13, 2012

Financial Accounting Standards Board Attn: Technical Director, File Reference No. 2011-230 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Card Compliant, LLC ("Card Compliant") appreciates the opportunity to comment on the Proposed Accounting Standards Update (Revised), Revenue Recognition (Topic 605): Revenue from Contracts with Customers (the "ED"). Card Compliant is a stored-value card compliance company servicing major stored-value and prepaid card programs, including gift card programs. Card Compliant offers an automated approach to stored-value card accounting, escheatment as well as compliance with applicable rules and regulations. Card Compliant provides various card accounting services to a variety of prepaid card programs including closed-loop card programs issued by retailers as well as open-loop and RAN card programs issued by banks. This comment letter will discuss: our interpretation of the proposed methods for recognizing customers' unexercised rights (breakage); the application of the standard to an open-loop/bank issued card which does not allow for cash back; and also the proposed disclosure requirements.

Card Compliant's Interpretation of the Proposed Methods for Recognizing Customers' Unexercised Rights (Breakage)

Paragraph IG27 of the ED states "if an entity is reasonably assured of a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer." Card Compliant believes this language is consistent with the language previously provided by the SEC¹. Under the proposed language, Card Compliant would recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer utilizing historical redemption patterns. In other words, Card Compliant would analyze the historical redemption patterns to arrive at an expected breakage amount and then would recognize the expected breakage in proportion to the historical redemption pattern. This is the preferred method as analysts are able to accurately forecast the percentage of cards which will break, but are not able to accurately forecast which cards will break. For example, we know that when Card Issuer A sells 100 \$10 cards that approximately 5% will break. As such, analysts are able to accurately forecast that \$50 will break (100 * \$10 * 5% = \$50); however, analysts are not able to accurately forecast which of the cards will make-up the \$50 breakage. As such, Card Compliant believes breakage should be calculated in dollars and not per card as it would be much more accurate since it is unknown which cards will break, but how many of the dollars sold will break is known. This practice is in-line with how sophisticated

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¹ The SEC previously provided guidance in a speech which 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).



companies are recording breakage income today. Some companies that do not have the ability to perform such an in-depth analysis simply recognize all breakage (remaining balance) at the end of the expected life of the card (similar to the proposed remote approach). Additionally, Card Compliant believes this approach is in-line with the intentions of the SEC Staff when they published the referenced speech. Card Compliant is a supporter of this proportionate approach but has concerns as it relates to the differences noted between the proportionate method as described in the ED and the proportionate method as described in the Staff Paper².

While the verbiage of the Staff Paper is similar to that found in the ED, the inclusion of the sentence "an entity would recognize as revenue the proportional breakage associated with each transfer of goods or services to the customer," in conjunction with the example provided, make the two models very different. The Staff Paper asks its' readers to consider the following example:

An entity sells a CU100 gift card and estimates on the basis of historical experience with similar gift cards that the amount of breakage is 10% or CU10. Unredeemed gift card balances are not subject to escheatment laws. Upon the first gift card redemption of CU45, the entity would recognize revenue of CU50 (revenue from transferring other goods or services of CU45 + breakage of CU5 [CU10 * 45/(100-10)].

The fundamental difference between Card Compliant's interpretation of the ED and the Staff Paper is the use of historical redemption patterns versus actual redemptions on a card by card basis. This is best shown through a continuation of the first example:

Card Issuer A sells a \$100 gift card. Through an analysis of historical redemption patterns, Card Issuer A believes that 3% of the value all gift cards issued will go unredeemed. In month 3, the card is presented for redemption in the amount of \$30. At that time, Card Issuer A would recognize income of \$30 for the redemption and an additional \$0.93 for breakage. If that is the only redemption which occurs on the card, and Card Issuer A believes the life of the cards in their program are 12 months, the remaining \$69.07 would be taken to income 12 months after the issue date.

This practice is not in-line with how the majority of sophisticated companies are recording breakage income today. Due to the serious application issues, Card Compliant is not a supporter of this approach. Take, for example, a Card Issuer that sells 5 million cards annually. The Card Issuer has been selling at these levels for the past 7 years and has sold approximately 35 million cards to date. The Card Issuer knows that the approximate life of their card is 2 years and that historically, 10% of the issued amount

² The Staff Paper was published in February in preparation for the February 10, 2011 FASB Education Session. File Reference: RR-0211b04Fobs



goes unredeemed. Even though the Card Issuer is armed with adequate knowledge of their card program (i.e., approximate life of their card and historical breakage rate), the Card Issuer would not be able to recognize breakage income under the Staff Paper's proposed Proportionate Method as it does not have the ability to track each of the 35 million cards individually. As such, the Card Issuer would not be able to recognize any breakage income until the end of year 2, at which time the company would likely have a very large income event on their financials.

While the inherent operational difficulties in applying the Proportionate Method as proposed in the Staff Paper greatly benefit our company³, Card Compliant is a proponent of our interpretation of the ED's approach as it is our belief that very few, if any, card issuers will actually be able to apply the approach proposed in the Staff Paper. Having the ability to analyze each card on a card by card basis is extremely rare and often times quite a costly endeavor. If Card Compliant's interpretation of the proposed approach was accepted many more Card Issuers would be able to apply the Proportionate Method, thus greater comparability among financial statements would be achieved.

Applicability to an open-loop/bank issued card, and a RAN card, which does not allow for cash back

Card Compliant believes it is the Boards intent the proposed language related to the recognition of breakage income is not restricted to a closed-loop card and would also be applicable to certain open-loop/bank issued cards and RAN cards⁴. In the past, cards in an open-loop program, or a RAN program, would have had a fee associated with it. For example, if a card purchaser purchases a \$50 card, they might have to pay \$52.50 in order to purchase the card. The additional \$2.50 is an up-front fee charged by the card issuer. Another example is if a card purchaser purchases a \$50 card and does not redeem any of the \$50 balance for 15 months. At that time it is noted the balance is no longer \$50, but something less than that. The amount which has been removed from the balance of the card is called a back-end, or inactivity, fee. Open-loop and RAN issuers utilize these fees in order to recognize breakage into income, thus there is no need for derecognition of card liabilities.

Due to increased regulation over the past couple of years, issuers of open-loop and RAN bank issued cards have started going away from a fee model and are quickly converting to fee free models. These fee free models are exactly as they sound: 100% fee free. As such, open-loop and RAN issuers now have

³ Card Compliant is one of the very few who have processing systems sophisticated enough to process on a card by card basis, thus allowing our clients to recognize breakage income under the proportionate method.

⁴ A closed-loop card is a card which, for example, can only be used at Target stores. An open-loop card is a card which, for example, can be used anywhere that accepts MasterCard. Closed-loop cards are typically issued by the retailer, or a third party issuer such as Card Compliant or a Gift Co. Open-loop cards are typically issued by a bank. A third category of cards, RAN (Restricted Access Network) allows a card to be good at select unaffiliated merchants which accept, for example, MasterCard. RAN cards use the bank card networks but are private label and do not bear the bank card brand, such as the MasterCard brand/logo. This is often seen in a shopping center scenario. A consumer can purchase a card that is good at their local mall or shopping center. The card can be used at each of the retailers within the shopping center but not at the same retailer located outside of the shopping center. For example, if a consumer purchased a card to be used at the ABC Shopping Center, the consumer could redeem their card at Retailer A located within ABC Shopping Center. The consumer could not redeem the same card at Retailer A located within XYZ Shopping Center down the road.



the same problems as closed-loop issuers have regarding unredeemed, broken, card balances: inflated card liabilities which will never be reduced even though it is unlikely the cards will ever be presented for redemption. In the United States, state chartered banks are banned by law from charging back-end fees in certain states (i.e. Connecticut). Additionally, some federal banks are becoming reluctant to use the doctrine of preemption to overcome state law bans on back-end fees. In some Canadian provinces (i.e. Saskatchewan), banks are banned by law from charging back-end fees. In many of these same states/territories, the cards do not escheat. As such, the unused card balances will be carried on for perpetuity, therefore the accounting method of derecognition needs to be available.

We would like to further comment on whether open-loop and RAN cards should be treated differently than closed-loop cards for the purpose of the ED. In particular, we would like to address whether the rules apply under the theory that open-loop and RAN cards represent a Financial Liability. Card Compliant has spent some time reviewing the proposed language in the ED as well as the proposed language in the Staff Paper and believe it is the Boards intent that an open-loop and a RAN program also qualifies for derecognition, so long as the program does not allow a card purchaser to redeem their card for cash⁵. It is our belief that when a card purchaser is allowed to redeem their card for cash, the card is a financial instrument and would not qualify for derecognition under Topic 605. We have held numerous conversations with two of the big four accounting firms whom have had questions about our position. They are not sure if the intent of the board is to treat these cards as financial instruments as they could not find direct guidance. One concern we hear from the firms is that the bank issuer has the responsibility for paying cash to the merchant who honors the card when presented for redemption. It is important to note the two parties to the cardholder agreement are the card issuer and the card purchaser. The redeeming merchant is not a party to the cardholder agreement. This is particularly important in identifying the liability to be derecognized, which is the liability to the card purchaser. When a gift card liability is being derecognized, it is imperative to understand the nature of the liability which is held on the books of the card issuer. The liability held is the liability to the cardholder and not a liability to the redeeming merchant. For example, a card issuer and a cardholder enter into an agreement at the time the card is issued. The agreement binds the card issuer to honor the card issued when the cardholder presents the card for redemption. In an open-loop and RAN program, the card issuer is not the same person which will be physically redeeming the card when presented for redemption. Instead, the card issuer is required, via a bank card network such as MasterCard, Visa, American Express, etc., to process the card payment when the card is presented for redemption. At the time the card is presented for redemption, the card issuer incurs a liability to the merchant acquiring bank which is quickly settled by the card issuer within a few business days. Again, the liability to the

⁵ FAS 140, Appendix E, defines a Financial Liability to mean "a contract that imposes on one entity [an] obligation (a) to deliver <u>cash</u> or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity." (Emphasis added.) Card Compliant believes this definition shows that to be a financial liability, a card must be able to be exchanged for cash. The terms and conditions of the agreement between the issuer and the card purchaser in a fee free open-loop program, strictly prohibit the delivery of cash to a cardholder, except where specifically required by state law.



redeeming merchant/merchant acquiring bank is not the liability which is being derecognized, rather the derecognized liability is the liability to the cardholder.

If the card program (whether it be closed-loop, open-loop or RAN) does not allow cash back to be given, Card Compliant believes the card constitutes restricted currency as the holder of the card has to shop at designated merchants in order to redeem the card for its loaded value. Appendix A, paragraph A2 of the Staff Paper specifically addressed the question as to whether gift cards are a Financial Liability by stating "gift cards can be exchanged for numerous goods or services and are therefore similar to a restricted currency. Because of this difference, some question whether gift cards are within the scope of the Exposure Draft or whether they should be accounted for as a financial liability." The staff further notes, in Paragraph A3 "an entity's obligation from the sale of gift cards does not meet the definition of a 'financial liability' under US GAAP or IFRSs as the entity does not have an obligation to either deliver cash or another financial instrument to the customer or to exchange other financial instruments on potentially unfavourable terms with the customer. The entity instead has an obligation to provide the customer with future goods or services in exchange for the value included on the gift card."

Furthermore, Card Compliant believes the Staff's intent regarding the term "restricted currency" was to include dollars which can be spent at multiple retailers. For example, a card which can be used at all places which accept Visa would be an example of restricted currency.

In June 2011, the law offices of Stinson Morrison Hecker LLP released a white paper which addresses the revenue recognition of breakage for bank issued, fee free cards⁶. The paper concludes stating that a bank should recognize breakage income to prevent their financial statements from being "inaccurate and misleading."

Card Compliant requests the Boards clarify their position related to the recognition of breakage income in an open-loop and RAN, fee free card program which does not allow for cash back. Without further clarification, the application of the proposed language with respect to such programs will vary widely across the industry, leading to a lack of financial statement comparability among issuers.

Disclosure Guidance

Card Compliant believes the disclosures required under Topic 605 should be similar to what strong disclosures look like today. Additionally, we believe that the disaggregation of revenue for the period is not necessary as it would provide a large amount of useless data to the financial statement users. Additionally, the terms and conditions of card programs are substantially the same. If there is an

⁶ Mike Lochmann, Karen Garrett, Michael Winkler *White Paper: Breakage Revenue Recognition for Bank Issued "No Fee, No Expiration" Gift Cards, Stinson* Morrison Hecker LLP, June 2011, http://www.stinson.com/Publications/Articles/2011 Articles/Breakage Revenue Recognition for Bank Issued N o Fee, No Expiration Gift Cards.aspx.



instance where the terms and conditions of one program differ greatly from that of another, then disaggregation on a program level may be necessary.

The following is an example of a recent disclosure discussing the recognition of income related to gift cards⁷:

We sell gift cards to our customers in our retail stores, through our Web sites and through selected third parties. We do not charge administrative fees on unused gift cards, and our gift cards do not have an expiration date. We recognize revenue from gift cards when: (i) the gift card is redeemed by the customer, or (ii) the likelihood of the gift card being redeemed by the customer is remote ("gift card breakage"), and we determine that we do not have a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions. We determine our gift card breakage rate based upon historical redemption patterns. Based on our historical information, the likelihood of a gift card remaining unredeemed can be determined 24 months after the gift card is issued. At that time, we recognize breakage income for those cards for which the likelihood of redemption is deemed remote and we do not have a legal obligation to remit the value of such unredeemed gift cards to the relevant jurisdictions. Gift card breakage income is included in revenue in our consolidated statements of earnings.

Gift card breakage income was as follows in fiscal 2011, 2010 and 2009:

	2011	2010	2009
Gift Card Breakage Income	\$53	\$43	\$38

Card Compliant believes a disclosure such as this would be appropriate under the proposed disclosure requirements of the ED. If the Boards disagree, we would kindly request additional clarification in the language to ensure complete understanding of the requirements.

We appreciate the opportunity to comment on the ED and are available to address any questions the Boards may have.

Sincerely,

Card Compliant, LLC

Phillip C. Rouse Tori Blake

Chairman & Chief Architect Sr. Director of Accounting Technologies & Operations

⁷ Best Buy Co., Inc. (2011). FY11 Form 10-K.