March 12, 2012

Financial Accounting Standards Board
Attn: Technical Director
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 2011-230 Proposed Accounting Standards Update (Revised), Revenue Recognition (Topic 605): Revenue from Contracts with Customers (the "Exposure Draft")

Technical Director:

I appreciate the opportunity to comment on the above-referenced Exposure Draft. The Banking and Financial Services Division of Stinson Morrison Hecker LLP represents a variety of gift card and prepaid, store-value card issuers and servicers, including banks and financial institutions. In most cases, a portion of the balances on the prepaid cards or gift cards sold by such issuers goes unspent. Some of the cardholders fail to exercise their contractual rights to receive goods and services from the issuer (for closed-loop cards) or third parties (for open-loop cards). Proper and uniform accounting for the unspent balances on such cards (generally known as "breakage") is extremely important to such card issuers, especially to banks and their regulators. The Exposure Draft states the method of revenue recognition for such breakage. This comment letter will address our understanding and interpretation of the Exposure Draft's proposed method for recognizing breakage, and requests certain clarifications to the Exposure Draft.

Method for Recognizing Breakage

Paragraph IG27 of the Exposure Draft 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. If an entity is not reasonably assured of a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

Under this proposed language, we would understand that card issuers may recognize the expected breakage as revenue in proportion to the pattern of usage of the card based upon historical cardholder redemption patterns. Card issuers using this proportionate
method first analyze the historical redemption patterns to arrive at an expected breakage amount. They then recognize the expected breakage amount, on a monthly basis, in proportion to the historical redemption patterns of cardholders. We understand this to be generally consistent with prior SEC guidance on recognition of breakage income as explained in further detail below.

SEC Statement

In 2005, the SEC specifically addressed the issue of gift card breakage. The SEC stated that a gift card issuer should apply the derecognition guidance found in what is now FASB ASC 405-20-40-1, but added that “derecognition may also be acceptable in certain circumstances if the vendor can demonstrate that it is remote that the customer will require performance.” Id. The SEC further clarified its position:

Given that immediate recognition of breakage [is] not considered appropriate . . . we were asked what approaches may be acceptable. Consistent with the staff’s previous views, recognizing gift card breakage as the vendor is legally released from its obligation, for example at redemption or expiration, or at the point redemption becomes remote, may both be acceptable methods.

Another approach may be to recognize breakage for unused gift card amounts in proportion to actual gift card redemption. Gift cards sold over a certain period of time would be considered on a homogenous pool basis. The estimated values 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. To utilize this approach, a vendor 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.

Id. We understand that most card issuers view the SEC statement as the accounting standard they should follow for reporting breakage income.

Most large card issuers recognize breakage income using complex statistical models, with varying amounts recognized each month over a 12 to 24 month period after the card is issued. Most card issuers follow the SEC statement and account for breakage based upon pools of homogenous cards and historic redemption patterns. Breakage income is recognized each month on each pool of cards in proportion to usage of the cards. This spreads the expected breakage revenue over the expected life of the cards, based upon a statistical model that can be adjusted for changes in redemption patterns.

Some card issuers without the historic data or capacity to run statistical models recognize breakage income in one lump sum at the end of the expected life of the gift card. This lump sum recognition of the remaining balance can create anomalous income recognition events. This method results in irregular patterns of breakage income ("lumpy earnings") that can distort month-to-month or quarter-to-quarter income. We believe the statistical method for breakage recognition is far superior to the lump sum recognition method and more accurately represents the card issuer's income and liabilities over the recognition period.

Staff Paper Interpretation

The proportionate method described in Paragraph IG27 of the Exposure Draft can be interpreted as consistent with the breakage income recognition method currently in use by large card issuers. Most card issuers do so based upon measurement of homogenous pools of contemporaneously issued cards, consistent with the SEC statement. A Staff Paper published in preparation for the February 10, 2011 FASB Education Session (the "Staff Paper"), however, presents a much different interpretation of the proportionate method described in the Exposure Draft.\(^2\)

The Staff Paper states that "an entity would recognize as revenue the proportional breakage associated with each transfer of goods or services to the customer." The Staff Paper provides 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 Staff Paper asserts that proportional breakage recognition is to be done on a card-by-card basis. That is not how card issuers currently recognize breakage income, and is a material departure from the SEC statement. We believe that card issuers do not account for breakage on a card-by-card basis, and few if any have systems in place to do so. We do not support the Staff Paper's interpretation that proportional breakage is required to be done on a card-by-card basis, and believe that it could have unintended consequences if adopted.

If a card issuer does not have the historic data or reporting system in place to recognize breakage income on a card-by-card basis, then the Staff Paper's approach could have the effect of prohibiting the card issuer from recognizing breakage income until the expiration date, or end of the expected life, of the card. This would undercut the current SEC statement models for breakage recognition, forcing such issuers to revert to the lump sum recognition method. An accounting standard that defers

recognition of all breakage income to the expiration date, or expected life, of the card is just as misleading as the recognition of all breakage income upon the issuance of the card. We oppose such an interpretation of the Exposure Draft's proportional recognition standard.

Large Card Issuer Example

Some gift card issuers sell millions of cards per year. As gift cards have become a preferred method for holiday giving, their sales can be highly seasonal. A seasonal card issuer could easily have 10 to 20 million (or more) gift cards outstanding at any point in time. Based upon years of experience, such a card issuer may be able to accurately predict that 24 months after such cards are issued, 7% of the issue price of the cards will go unspent, and a de minimis amount of cards will be redeemed after such time. With this historic data, the card issuer currently recognizes the expected 7% breakage over such 24-month period. However, if such card issuer cannot track the specific usage of each of the 20+ million cards outstanding, then under the Staff Paper’s interpretation, such card issuer would not recognize any of the 7% breakage income until the 24th month. We do not agree to such accounting treatment because we believe it understates the card issuers income and overstates the card issuer's liabilities during the first 23 months.

It is our understanding that few card issuers would be able to apply the card-by-card approach espoused by the Staff Paper. The ability of issuers to account for breakage on a card-by-card basis is rare, and would be very expensive. We believe that the Exposure Draft should be modified to expressly permit card issuers to account for breakage revenue based upon pools or "buckets" of homogenous cards. At a minimum, it should permit all cards issued during a specific month, or pursuant to an identified promotional period, to be accounted for in one pool. We understand this is the accounting method currently followed by the largest card issuers and is consistent with the SEC statement.

Interpretations of Big Four Accounting Firms

Two of the big four accounting firms have issued publications related to the Exposure Draft addressing recognition of breakage income. We read the publications as supportive of the Staff Paper's interpretation of the Exposure Draft. It is unclear how the two other big four accounting firms interpret the Exposure Draft. We do not believe that most large gift card issuers are currently accounting for breakage on a card-by-card basis as illustrated in the Ernst & Young Technical Line materials and the Staff Paper.

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3 Ernst & Young, LLP has published two Technical Lines which address the issue: (1) No. 2011-24 dated December 12, 2011 titled "Double-exposure: The revised revenue recognition proposal," Illustration 6-10: Gift card breakage, and (2) No. 2011-26 dated December 22, 2011 titled "Revenue recognition proposal — retail and consumer products," Illustration 7 – Gift card. PricewaterhouseCoopers LLP has published a Dataline (No. 2011-35 (supplement) dated November 30, 2011 titled "Revenue from contracts with customers — Retail and consumer industry supplement") which addresses the issue.
To avoid inconsistent interpretations by accounting firms and card issuers, the Board should revise the Exposure Draft to very clearly state how the proportionate method should be applied by card issuers. We recommend that the revision expressly authorize a recognition of breakage using statistical models, and, because of cost concerns, that card-by-card recordkeeping not be required.

**Closed-Loop v. Open-Loop Cards**

Generally speaking, gift cards are either closed-loop or open-loop cards. Typically, a closed-loop gift card is issued by a single company, such as Starbucks, or a third-party servicer on behalf of the company, and can only be used to purchase a product or service from such company. Open-loop cards are generally issued by a bank (or a subsidiary of a bank), and can be used at many locations, such as at any merchant that accepts MasterCard or Visa. The issuer of an open-loop card agrees with the cardholder to pay the third-party merchant that accepts the card, but generally does not permit the cardholder to surrender the card for cash.

Many gift cards impose service or inactivity fees that periodically reduce and eventually eliminate unspent card balances. Other gift cards have expiration dates that eliminate the card issuer's future liability for unspent card balances. However, if a card has no expiration date and no service or inactivity fees, the card balance could continue indefinitely.

Many consumer advocates and state legislatures have objected to service and inactivity fees that consume gift card balances and expiration dates that extinguish card issuer liability. In response to such criticisms, some banks and other issuers of open-loop cards have begun marketing so called "no fee, no expiration" gift cards ("NFNE Cards"). Unspent balances on NFNE Cards are never reduced by fees or extinguished by an expiration date. NFNE Cards are consumer friendly because unspent balances never expire. There will still be breakage on NFNE Cards, however, because some card balances, in fact, will never be spent.

**Exposure Draft Applicable to Both Open-Loop and Closed-Loop Cards**

It is our understanding that the Exposure Draft applies to both closed-loop and open-loop gift cards. Banks and other issuers of NFNE Cards that cannot be redeemed for cash must recognize breakage income, and derecognize the associated liability, just like other card issuers. A white paper that I co-authored explained how banks account for breakage on NFNE Cards as follows:

A bank issuing NFNE Cards will show a liability on its balance sheet for the unspent balances on such cards. An unspent gift card balance is a valid liability of the issuing bank, but the longer such balance remains outstanding, the less likely it becomes that the bank will ever be called upon to pay such obligation. At some point the likelihood that the bank will be required to pay the remaining unspent balance on the NFNE Card becomes so remote that accounting principles require the bank to remove
such liability from its balance sheet. The issuing bank derecognizes this obligation by debiting the card liability account and recognizing a corresponding amount of breakage revenue on its income statement. Failure to do so would (i) overstate the bank's liabilities, (ii) understate the bank's GAAP income (and possibly its taxable income) and (iii) understate the bank's capital ratios. If a cardholder subsequently spends the unused balance that had been written off for accounting purposes, the redeemed amount would be paid by the bank and recorded as an expense on the bank's income statement. Just as the write-off of a nonperforming loan does not extinguish the borrower's debt to the bank, the write-off of the breakage on the gift card does not extinguish the bank's liability (or the cardholder's ability to use the card). In both cases, however, derecognition of the bank's asset and liability must occur so that the bank's financial statements are not inaccurate or misleading.  

Gift Cards Are Not Financial Liabilities

We believe that gift cards, including NFNE Cards, which cannot be redeemed for cash do not meet the definition of a "financial liability." The FASB ACS Master Glossary defines a Financial Liability as "a contract that imposes on one entity an obligation (a) to deliver cash 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). To be a financial liability, the cardholder must have the right to exchange the card for cash. The terms and conditions of the agreement between the card issuer and purchaser of a gift card almost always prohibit the cardholder from redeeming the card for cash (except where specifically required by state law).

Appendix A, paragraph A2 of the Staff Paper raised the issue whether gift cards are a financial liability, 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 Paper further noted:

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 unfavorable 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.

Staff Paper, Appendix A, paragraph A3.

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The Boards should clarify the position related to the recognition of breakage income on gift cards which do not allow the cardholder to redeem the card for cash. Without further clarification, application of the proposed language with respect to such programs could vary widely.

Conclusion

I appreciate the opportunity to comment on the Exposure Draft and I am available to address any questions you may have.

Very truly yours,

STINSON MORRISON HECKER LLP

[Signature]

Mike W. Lochmann

MWL:SMH