

November 15, 2012

Ms. Susan M. Cosper Emerging Issues Task Force Chairman Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

Mr. Michael Stewart
Director of Implementation Activities
International Accounting Standards Board
First Floor
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Ms. Cosper and Mr. Stewart:

Thank you for the opportunity to address the EITF and IFRIC regarding an issue of growing importance in the prepaid card and mobile payments industry. We believe you will find the enclosed paper to describe an emerging accounting issue within the prepaid card and mobile payments industry which we believe will have a significant financial statement impact if left unaddressed.

We respectfully request the EITF and the IFRIC closely examine the facts outlined in the paper and comment on the proper classification of prepaid cards and mobile payment instruments which are issued by a financial institution where the right acquired and held by the holder is a right to receive goods and services only from specified merchants. Card Compliant does not believe the liability held by the card issuer is a financial liability and requests the EITF and the IFRIC specifically address the issue.

Card Compliant is available to answer any questions the EITF or the IFRIC may have and look forward to further discussions.

Best Regards,

Victoria Blake, CPA

Sr. Director Accounting Technologies & Operations

Phillip C. Rouse, J.D.

Chairman, General Counsel & Chief Architect



Card Compliant provides technology driven regulatory and accounting compliance solutions for the prepaid card industry. The industry, a \$500B+ load sector of financial services, develops and distributes prepaid cards and mobile payment solutions, such as gift, incentive, rebate, payroll, government benefit, HSA, FSA and general purpose reloadable ("GPR") cards. Industry products range from a closed-loop retail gift card program to a bank or financial institution issued card program that operates using the MasterCard, Visa, AMEX or Discover networks.

## Background

Some of the prepaid cards (i.e., payroll, government benefit, and GPR cards) operate a lot like debit cards in that they are usable to buy goods or services and are redeemable for cash upon demand at ATMs, certain financial institutions or at designated retail outlets. Other prepaid cards (primarily gift cards and promotional cards) are unique in that they are usable only to buy goods and services at designated merchants and are not refundable or redeemable for cash.

This paper is directed only at the later "no-cash" prepaid cards. These cards fall into three subcategories: (1) closed-loop cards that are typically redeemable for goods and services only at a single retailer or franchisees bearing a common brand (such as the Target gift card or the Subway gift card); (2) semi-closed loop cards that are redeemable at a limited number of unaffiliated merchants (such as a shopping center gift card that is redeemable only at the merchants in the shopping center); and (3) open-loop cards that are redeemable at any merchant that operates on the card network (such as a Visa open-loop gift card that is usable only at the merchants on the Visa network). Some of these cards are issued by non-financial institutions and others are issued by financial institutions and banks.<sup>1</sup>

The no-cash prepaid cards fall into three subcategories of cards which usually have the following characteristics: (1) they are recorded on the card issuers books as liabilities when purchased by a consumer; (2) they typically do not have expiration dates which releases the liability<sup>2</sup>; (3) they typically do not have back-end fees which reduce the liability over time<sup>3</sup>; (4) they are redeemable for goods and services only at designated merchants; (5) they are not demand instruments which can be redeemed for cash from the card issuer; (6) they are not redeemable for cash from any third party, merchant or ATM machine; (7) they are not directly attached to a segregated bank account like a debit card or a checking account; and (8) the terms of the contract allows the issuer to settle the obligation by paying a third party to provide the goods or services.

<sup>&</sup>lt;sup>1</sup> Because this paper addresses only the no-cash prepaid cards, throughout this submission, when the phrases "bank issued card program" and "bank issued card" are used, it is assumed the program and/or cards addressed are cards that are redeemable for goods and services only. These cards cannot be redeemed or exchanged for cash.

<sup>&</sup>lt;sup>2</sup> Federal and State regulations have banned or limited the use of expiration dates on gift cards to the point where most gift cards do not have an expiration date. In addition, an expiration free card is a popular consumer card.

<sup>&</sup>lt;sup>3</sup> Back-end fees are fees charged periodically (usually monthly) against the balance of the gift card. Federal and State regulations have banned or limited the use of back-end fees for gift cards to the point where most gift cards do not have back-end fees. In addition, fee free gift cards are popular with consumers.



In the past, a card in a prepaid card program issued by a financial institution was subject to contractual front-end or back-end fees. 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 a front-end fee charged by the card issuer. As another example, if a card purchaser purchases a \$50 card and does not redeem any of the \$50 balance for a designated period of time (typically 12 months), the card issuer may charge a monthly back-end fee against the balance of the card (typically ranging from \$2 to \$3.50). Bank issuers utilized these fees to recognize card balances, including breakage, into income and, thus, there was no need for derecognition of card liabilities. Due to increased regulation over the past couple of years and heavy pressure from consumers, bank card issuers have migrated from fee models and are quickly converting to fee-free models.

These fee-free models operate exactly as promoted: 100% fee free. Having done so, bank issuers have a significant problem 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.

Many of these gift cards are not used by the cardholders, resulting in unexercised customer rights commonly known as "breakage." Typically these gift cards do not have expiration dates or back-end fees which reduce or eliminate the liability overtime. In many jurisdictions, gift cards do not escheat.<sup>4</sup> As a result, there is a question as to when a card issuer can derecognize its prepaid card liability to properly reflect the true nature of the customers unexercised rights (i.e. not reflected as a liability in perpetuity).

### Current Accounting Guidance

Currently, there is limited guidance on the accounting for prepaid card breakage not subject to escheatment. As we understand it, current U.S. GAAP allows an entity to recognize revenue on the sale of a prepaid card at the time of redemption<sup>5</sup>. The entity would only be allowed to recognize the portion which was redeemed (i.e. if a consumer 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 (the "breakage").

<sup>&</sup>lt;sup>4</sup> Depending upon the gift card program, 32 States have exemptions in their unclaimed property laws that exempt all or some portion of the gift card liability from escheat.

<sup>&</sup>lt;sup>5</sup> A redemption occurs when a gift card holder presents a gift card as tender in exchange for a product or service.



The SEC presented a speech<sup>6</sup> in December 2005 (the "SEC speech") which addressed the recognition of prepaid card breakage. The SEC speech allows an entity to derecognize a prepaid card liability when there is a remote chance the liability will be called upon. The SEC speech also provides examples of acceptable and unacceptable methods for derecognizing the liability. Since this speech, it appears that non-bank issuers, whom are SEC Registrants, widely accept that they are able to derecognize stale card liabilities. We also believe that bank issuers, whom are also SEC Registrants, believe they are able to derecognize the stale card liabilities for their card programs, and many are in the practice of doing so. This guidance only applies to those bank issuers whom are SEC Registrants and there is not currently any comparable guidance applicable to non SEC Registrants. The only other guidance to which an issuer arguably could look is ASC 405-20-40, Extinguishment of Liabilities. ASC 405-20-40 provides that a liability shall be derecognized "if and only if it has been extinguished." The threshold for a liability being extinguished is high: delivery of cash, other financial assets, goods, services, or legally released by either the creditor or judicially. Prepaid card breakage arguably does not meet these criteria.

Card Compliant is not aware of any breakage guidance for prepaid cards under IFRS.

# Guidance in the Joint Revenue Recognition Project

In June 2010, the Boards jointly released an initial Exposure Draft as part of the Revenue Recognition Project. Because of concerns regarding the lack of guidance around the accounting treatment of prepaid card breakage, Card Compliant submitted a Comment Letter to the Boards requesting the Boards address the recognition of prepaid card breakage within the proposed Revenue Recognition standard.

In November 2011 the Boards jointly released a revised Exposure Draft ("ED") as part of the Revenue Recognition Project. The ED included a proposal on the revenue recognition of Customer's Unexercised Rights (IG25 – IG28) which included guidance on prepaid cards. At this time it appears the Boards have tentatively decided to incorporate a version of this concept in the final standard.

There appears to be an unintended consequence or an unaddressed issue regarding the proposed guidance specified in the ED. It appears clear that breakage on a prepaid gift card which is not issued by a financial institution can be recognized under the scope of the proposed standard. However, there remains much confusion and disagreement on the issue about whether a bank issuer would also be able to recognize breakage on a prepaid card under the scope of the proposed standard. Bank issuers believe they will no longer be able to derecognize the prepaid card liability for their card programs as it is not apparent whether or not the Boards feel the liability being derecognized is a financial liability<sup>7</sup> and

<sup>&</sup>lt;sup>6</sup> 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).

Per the ED, "an entity shall apply this proposed guidance to all contracts with customers, except...contractual obligations...within the scope of ... Topic 405 on liabilities ... Topic 825 on financial instruments...".



not in the scope of the standard, or is not a financial liability and thus falls under the scope of the standard. They believe the proposed standard has potentially increased the threshold necessary for them to derecognize the breakage and are concerned about the viability of their card programs in an environment where derecognition is not possible.

Card Complaint often receives questions regarding the application of derecognition in a bank issued card program, including questions about the impact of ASC 405-20-40 and whether or not the liability to be derecognized is considered a financial liability. It is Card Compliant's belief that the liability to be derecognized is not a financial liability and should be within the scope of the proposed Revenue Recognition guidance.

The liability to be derecognized in a bank issued card program is a liability to the consumer in possession of the card. In a bank issued card program, the bank issuer holds a liability to the consumer until the consumer redeems the card. At that time, the bank has honored its obligation to the consumer and a new obligation to the entity which honored the redemption is created. The bank issuer settles the obligation to the entity which honored the redemption through the card settlement process. The liability which is being derecognized is not the liability to the entity which honored the redemption, rather the liability being held by the consumer. That liability is a right to the consumer which can only exchanged, or redeemed, for goods and services. The right cannot be exchanged, nor redeemed, for cash.

## Accounting Issue

Card Compliant has had conversations with many of the largest public accounting firms, as well as many of the largest bank card issuers, regarding whether or not a bank issued card should be considered to be a financial liability. The results of our conversations have shown that there is not a consensus on the proper treatment of these card products. Some believe that the bank issuer's liability is a financial liability which can only be derecognized in accordance with ASC 405-20-40. Others believe that the bank issuer's liability is not a financial liability and can be derecognized in accordance with the SEC speech.

Card Compliant believes the prepaid card obligation held by a bank issuer should not be considered a financial liability.

### Why a Prepaid Card Obligation is not a Financial Liability

ASC 405-20-40 states a liability should be derecognized only if "(a) the debtor pays the creditor and is relieved of its obligation for the liability...or (b) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor." The SEC speech provides another option for gift cards. In the December 2005 speech delivered by SEC Professional Accounting Fellow Pamela R. Schlosser regarding the derecognition of breakage, Ms. Schlosser states: "In the past, the staff has stated that a vendor should apply the derecognition guidance found in Statement 140 to these



arrangements, but derecognition may also be acceptable in certain circumstances if the vendor can demonstrate that it is remote<sup>8</sup> that the customer will require performance." Ms. Schlosser goes on to state: "Consistent with staff's previous views, recognizing prepaid 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." The "remote" derecognition technique referenced in this speech has been used by companies derecognizing prepaid card liabilities across the United States for many years.

The FASB Staff presented a paper to the Board which used the SEC Speech as the foundation for the decisions made within the Revenue Recognition Project. Appendix A of the FASB Staff Paper specifically addressed the question as to whether cards<sup>9</sup> are a Financial Liability. Paragraph A2 states "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."

As it relates to financial instrument classification, ASC 825-10-15-4 indicates the following on insurance contracts and warranty obligations:

"(d.) The rights and obligations under an insurance contract that has both of the following characteristics: (1) The insurance contract is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash settlement). (2) The insurance contract's terms permit the insurer to settle by paying a third party to provide those goods or services. (e.) The rights and obligations under a warranty that has both of the following characteristics: (1) The warranty is not a financial instrument (because it requires or permits the warrantor to provide goods or services rather than a cash settlement). (2) The warranty's terms permit the warrantor to settle by paying a third party to provide those goods or services."

The guidance in ASC 825-10-15-4 appears to closely relate to the bank issued prepaid card program whereby (1) the cardholder agreement requires the issuer to provide goods and services rather than a cash settlement and (2) the cardholder agreement permits the issuer to settle the obligation by paying a third party to provide those goods or services.

<sup>&</sup>lt;sup>8</sup> "Remote" is defined in ASC 450-20-20 to mean "The chance of the future event or events occurring is slight."

 $<sup>^{9}</sup>$  It is unclear whether Appendix A of the Staff Paper is addressing bank issued prepaid cards.



ASC 825-10-20 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.) The parameters of most bank issued prepaid card programs, through the agreed terms of the cardholder agreement with the consumer, strictly prohibit the delivery of <u>cash</u> to a cardholder, except where specifically required by state law.

Furthermore, it is important to note the two parties to the cardholder agreement are the card issuer and the cardholder. The redeeming merchant is not a party to the cardholder agreement. This is especially important in identifying the liability which is to be derecognized. It is also important in knowing whether the cardholder, as opposed to the redeeming merchant, is in a position to demand or receive cash.

When a prepaid card liability is derecognized, it is imperative to understand the nature of the liability which is held on the books of the prepaid card issuer. The liability held is the liability to the cardholder and not a liability to the redeeming merchant. A prepaid card issuer and a cardholder enter into an agreement at the time the card is issued. The agreement binds the issuer to honor the card issued when the cardholder presents the card for redemption. In a prepaid program where the issuer is a financial institution, the card issuer is not the same person which will be physically redeeming the card(s) 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. The liability to the redeeming merchant/merchant acquiring bank is not created until the prepaid card is presented for redemption and is not the liability for which there is a question on derecognition. The liability for which derecognition is being questioned is the liability to the cardholder. The right which is being held by the cardholder is a right to redeem the prepaid card for goods and services only and is not a right to exchange the prepaid card for cash.

Paragraph A2 of the Staff Paper states "gift cards can be exchanged for numerous goods or services and are therefore similar to a restricted currency." It is Card Compliant's belief that the use of the term "restricted currency" applies to bank issued prepaid cards as well as retailer issued cards as the term includes dollars which can be spent at multiple retailers and is restricted to retailers whom accept, for example, MasterCard. The prepaid cards can only be exchanged for goods or services at a merchant whom has executed an agreement with the transaction processor identified on the face of the card (i.e. MasterCard, Visa, American Express, Discover). If a cardholder attempted to exchange the right they were holding for goods and services from a merchant whom had not executed an agreement with the



transaction processor on the face of the card, they would be denied. Card Compliant therefore believes bank issued prepaid cards are within the scope of the Revenue Recognition project.

At the February 17, 2011 joint meeting the Boards generally upheld the staff recommendations provided in the Staff Paper. The Boards have since tentatively decided to include the recognition of Unexercised Customer Rights in the final standard. If the final standard is released as expected, it is our belief that a significant divergence in practice will be created regarding the proper treatment of prepaid cards issued by a financial institution.

# Why Additional Guidance is Critical to the Industry

Current industry practice relies upon the SEC speech to support the derecognition of card breakage. When the Revenue Recognition standard is finalized, the new guidance will potentially supersede the SEC speech. Bank card issuers that are now derecognizing stale card liabilities under the SEC speech will not know which guidance to apply: Revenue Recognition (Topic 605) or Liability Derecognition (ASC 405-20-40). Due to the vagueness of the scope of Topic 605, the issuer may determine the obligation is a financial liability and the issuer may only be able to utilize the derecognition guidance within ASC 405-20-40 which states a liability can only be derecognized if the obligation has been extinguished either from (a) the payment to creditor or (b) the debtors legal release of the obligation. Under ASC 405-20-40, the breakage would never be derecognized and would continue to grow over time.

Prepaid cards which are issued by an entity other than a financial institution are clearly within the scope of Topic 605. If it is determined that prepaid cards issued by a financial institution do not fall within the scope of Topic 605, or if the issue is not addressed and it is left vague, the accounting standards will have effectively eliminated a product from the marketplace as the income from derecognizing the breakage is a material component to the business models for bank issued prepaid cards. These cards would likely have no choice but to return to the back-end fees model, and in the face of additional regulation on those back-end fees. These fee'd cards would be at a <a href="https://www.numer.nu

Public policy indicates fees should not exist as they are not "consumer friendly," yet the accounting standards would be forcing fees. A decision by the Boards to not address the issue, or to determine the cards do not fall within the scope of Topic 605, could very well lead to the demise of the open-loop prepaid card, which represents a \$25B industry<sup>10</sup>.

Card Compliant does not believe the liability held by the card issuer is a financial liability. The liability is an obligation to the consumer in possession of the prepaid card and only allows the consumer to

 $<sup>^{10}</sup>$  Per the Mercator Advisory Group's 2012-2015 U.S. Prepaid Cards Market Forecasts, the gift cards segment of the U.S. open-loop market is expected to go from \$14.9B in 2011 to \$24.4B in 2015.



exchange the prepaid card for goods and services. The obligation does not allow the consumer to receive cash. The obligation appears to closely relate to the guidance provided in on insurance contracts and warranties which are not financial instruments as noted in ASC 825-10 Lastly, the prepaid card should be considered a form of a "restricted currency" as the card is only accepted at merchants that operate on the card network.

### Conclusion

Card Compliant believes the Boards should provide guidance to clarify if a bank issued card is a financial liability, and if so, how do we derecognize it.