

University at Albany, State University of New York

## Scholars Archive

---

Accounting

Honors College

---

5-2011

# Revenue Recognition of Gift Cards Complications of Breakage Income

Matthew Hendricksoon

*University at Albany, State University of New York*

Follow this and additional works at: [https://scholarsarchive.library.albany.edu/honorscollege\\_accounting](https://scholarsarchive.library.albany.edu/honorscollege_accounting)



Part of the [Accounting Commons](#)

---

### Recommended Citation

Hendricksoon, Matthew, "Revenue Recognition of Gift Cards Complications of Breakage Income" (2011). *Accounting*. 1.

[https://scholarsarchive.library.albany.edu/honorscollege\\_accounting/1](https://scholarsarchive.library.albany.edu/honorscollege_accounting/1)

This Honors Thesis is brought to you for free and open access by the Honors College at Scholars Archive. It has been accepted for inclusion in Accounting by an authorized administrator of Scholars Archive. For more information, please contact [scholarsarchive@albany.edu](mailto:scholarsarchive@albany.edu).

# Revenue Recognition of Gift Cards

## Complications of Breakage Income

**Matthew Hendrickson**

**May, 2011**

Gift Cards are loved by both companies and customers. They are a large source of income and customers love their ease. However, regulation for reporting gift card income is something companies must pay close attention to. Companies must be concerned with recognition of breakage income as well as state escheatment laws. This paper will examine the current regulatory environment relating to gift card revenue as well as how companies are currently presenting this information to investors.

# Revenue Recognition of Gift Cards

---

## Table of Contents

<b>INTRODUCTION</b> -----	<b>3</b>
General Facts about Gift Cards-----	4
<b>TAX ACCOUNTING IMPLICATIONS</b> -----	<b>7</b>
Recognition-----	7
Gift Card Companies-----	9
Escheatment Laws-----	10
<b>FINANCIAL ACCOUNTING IMPLICATIONS</b> -----	<b>13</b>
Recognition-----	13
Disclosure-----	15
<b>FURTHER RESEARCH</b> -----	<b>20</b>
<b>CONCLUSIONS</b> -----	<b>21</b>
<b>WORKS CITED</b> -----	<b>22</b>

# Introduction

---

*“Gift cards have become an area of both opportunity and risk for retailers. They have come to provide a critical source of earnings, yet at the same time, the regulatory environment, including tax and financial reporting for gift cards, has become increasingly complex. The bottom line is that financial executives within the retail industry cannot afford to be blindsided by tax, regulatory and financial reporting changes in this area;”* Giles Sutton, State and Local Tax (SALT) partner and national Retail Tax practice leader. (Grant Thornton LLP., 2011)

In the recent years gift cards and certificates have become immensely popular with both retailers and customers. Gift card sales for 2010 are currently estimated to have exceeded \$200 billion, with \$25 billion coming from holiday season spending. This can be compared to \$24.1 billion in the 2009 holiday season and \$24.9 billion in 2008. (Duff & Phelps Corp, 2011) The large amount of money that gift cards represent indicates that they must be clearly regulated from both a tax accounting and financial accounting perspective. This is not entirely the case. Tax laws have changed several times over the past decade in regards to gift card revenue recognition and may yet change again. GAAP does not currently have any specific literature regarding how gift card revenue should be recorded and reported. The main issue that is confounding both of these perspectives is what to do with gift cards that are unlikely to be redeemed. It's estimated that the percentage of gift card balances that remain unredeemed, known as breakage, range from 10 to 19 percent. (Grant Thornton LLP., 2011) Accounting for breakage income will be the main topic of this paper.

# Revenue Recognition of Gift Cards

---

## General Facts about Gift Cards

There are two basic types of gift cards; ones issued by credit card companies like Visa, and ones that aren't. Those that aren't issued by credit card companies are called nonbank gift cards or, frequently, closed-system cards. They get this name because they are used only at the retailers that issue them. In addition to retailers; restaurants, grocery stores, movie theaters and more have all begun to use these closed system cards. Nonbank gift cards are either distributed by the retailer or by a gift card company. A gift card company is a separate legal entity that is formed by a company as a subsidiary for the sole purpose of administering the company's gift card program. (Marden & Forsyth, 2007)

Unlike cards from Visa or MasterCard, other gift cards do not come under the jurisdiction of federal banking laws. This lack of legal regulation of nonbank gift cards leads to companies attaching a variety of conditions to their cards. Cards may carry monthly fees, carry activation fees, and may have an expiration date. These attachments aren't as common as they used to be, however, due to customer complaints. The existence of these attachments on some cards however will influence how they are accounted for, as we will discuss later. (Marden & Forsyth, 2007)

Gift cards are prized by both companies and customers. Customers love them for several reasons. They're convenient, easy to use, easy to carry, and everyone appreciates them. There is no worry of getting the wrong gift and they're appropriate for everyone be it family, friend or employee. While customers are limited to one retailer in using the card, they can purchase anything they want from the retailer which can persuade people to buy items they otherwise

## Revenue Recognition of Gift Cards

---

wouldn't have. (Marden & Forsyth, 2007) A recent survey has shown that 57% of adults wished to receive a gift card for the holidays in 2010. (Grant Thornton LLP., 2011)

Companies love gift cards even more than customers do. Gift cards lead to increased sales, increased marketing opportunities, and help with cash flow and inventory management. Gift cards have a huge influence on sales. On top of the initial gift card purchase, customers are almost guaranteed to spend more than the amount of the gift card when they redeem it. The way that pricing works, customers are extremely unlikely to perfectly use up their gift cards with no excess paid out of pocket. Rather than leave a balance on the card, customers are inclined to treat the gift card amount as a minimum purchase price. Studies have shown that customers spend an average of 1.4 times the amount on their cards in the transaction where they redeem them. The prevalence of gift cards as holiday gifts effectively extends the holiday gift buying season, making the January and February clearance sales into some of the most lucrative non-holiday periods for companies. (Marden & Forsyth, 2007)

Marketers love gift cards because they generate two customer contacts and two sales opportunities. Marketers can also use incremental information gathered from gift card transactions to design future marketing plans and promotions. Gift cards benefit inventory management and cash flow in a big way as well. The delay in the transfer of inventory allows for significant operating cash flow benefits to a business by allowing them to purchase inventory over time instead of all at once. This delay also means that since gift cards are predominantly sold during the holiday season and redeemed in the off season, businesses will have smoother COGS expenses over the entire period, instead of huge jumps in COGS at one time. (Kile, 2007)

## Revenue Recognition of Gift Cards

---

As mentioned before, 10 to 19% of the value of all gift cards sold never gets redeemed. Customers may lose a card, or intentionally fail to use it. Some customers forget to use up their balances before the expiration date. Some customers use the card and leave money left on the balance. This remainder is then either forgotten about or disregarded as being immaterial. Whatever the reason, these unredeemed cards can add much to a business's bottom line, should they be allowed to recognize it. (Kile, 2007)

Gift cards do have a downside however. Any retail store that uses gift cards can fall victim to fraud, either due to customers or employees perpetrating the fraud. Customers can shoplift cards, either using the cards themselves or stealing the authorization information from the magnetic strip with an electronic device. Stolen, fake, and empty cards are also frequently sold on auction sites or bargain sites. Employees are just as likely to steal cards, but also have other opportunities to commit fraud. They may pretend a customer's card is empty or deactivated and convince the customer to hand over the card. Or they may use sleight of hand to swap the customer's card with an empty one. Losses from fraud can be significant, but the benefits a company gains from its gift card program often far outweigh the losses. (Marden & Forsyth, 2007)

# Tax Accounting Implications

---

Gift cards pose several problems when related to taxation. Most basic is at what point companies should recognize income for gift card sales for tax purposes? Gift card companies must be sure whether they can claim money received as for gift cards as income at all. When should gift card fees be recognized? How do state escheatment laws impact gift cards? All of these topics will be examined in this section.

### **Recognition**

In general revenues is recorded when it is earned for financial accounting purposes, and when it is received for tax purposes. Retailers that used gift cards understandably were resistant to this. To have all their gift card sales count upfront would make it so that they could not balance out these sales with their related expenses as they would not have been incurred yet. The IRS forbids realizing COGS before the cards is redeemed as it cannot be predicted what product will be purchased with the card. (Suttora & Bender, 2009) If a company can properly use the advance payment deferral rules from Treasury Regulation § 1.451-5 and Revenue Procedure 2004-34 then unredeemed gift card income can be deferred until up to the last day of the second tax year after the card is sold. (Smith, 2009) Treasury Regulation § 1.451-5 defines what an advance payment is, the length of the possible deferral and which types of advance payments are subject to deferral. Namely, transactions where the taxpayer: is accounting for them using the accrual method for financial reporting reasons, cannot determine what goods will be used to



## Revenue Recognition of Gift Cards

---

satisfy the advance payment, and has goods on hand at all time that could satisfy the advance payment. (Treasury Regulations, Subchapter A, Sec. 1.451-5, 2005)

These initial regulations on gift card revenue recognition were a start but were not perfect. The IRS has since made a few clarifications and revisions to its policy regarding gift cards. Examples of the clarifications include the following; that gift cards are the electronic versions of gift certificates and thus are still covered by § 1.451-5; that re-loadable gift cards begin their deferral period when additional funds are added, not on the original purchase date; that any dormancy fees or other fees attached to a gift card must be recorded when they occur; that bulk sales discounts on gift cards should be expensed in relation to the recognition of income from gift cards; that income from gift cards that expire before the 2 year deferral period must be recognized on the expiration date; and that promotional gift cards given away should be treated as deferred advertising expense. (Suttora & Bender, 2009) While some of these may seem self evident, when it comes to taxation and legality, all of these were necessary to have spelled out.

One other concern was how to account for when gift cards are issued in exchange for returned merchandise. Rev. Proc. 2011-17 determined that taxpayers who are retail businesses, and use the accrual method of accounting overall may treat gift cards issued for returned goods as the payment of a cash refund followed by the sale of a gift card to the customer who made the return. The taxpayer may then account for the amount deemed received for the sale of the gift card under Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34, if otherwise eligible. (Grant Thornton LLP., 2011)

# Revenue Recognition of Gift Cards

---

## Gift Card Companies

As stated before, gift card companies are separate legal entities that are formed by a business for the sole purpose of administering its gift card program. These companies earn income through service fees, either related to issuing cards or related to breakage. There are several reasons for a business to use a gift card company, least of which is to increase efficiency by having a whole entity devoted to handling gift cards and any concerns regarding them. Another reason is to avoid unfavorable escheatment laws. These are the laws that state that unclaimed property should be turned over to the state after a certain period of time. In some states, gift cards count as unclaimed property and so basing a gift card company in a more favorable state should avoid this. (Grant Thornton LLP., 2011)

There are two issues involving revenue recognition that arise when a taxpayer uses a gift card company for their cards. First is whether the gift card company should recognize any revenue at all for the sale of gift cards. As the cash from the sales must be forwarded to another company some have argued that this money constitutes a deposit and not income. Unfortunately for them, the IRS has issued a clear statement that these sales do not constitute a deposit and under the claim of right they constitute income. (Suttora & Bender, 2009) The other issue regarding revenue recognition for a gift card company is whether they can make use of the deferral provisions in Treas. Reg. § 1.451-5, and Rev. Proc. 2004-34.

Under Rev. Proc. 2004-34, the IRS initially specified that in order to defer income, the company that issued a gift card must be the same entity that redeems it. As such, this would exclude any retailers that sold their cards through third parties or unconsolidated related companies, as well as companies that issued cards that were redeemable at other establishments.

## Revenue Recognition of Gift Cards

---

Due to the understandable controversy that this proclamation caused, in 2011 the IRS has decided to broaden the definition of qualified advanced payment transactions with Rev. Proc. 2011-18. This includes the new idea of “eligible gift card sales.” This term would be defined as the sale of a gift card if; 1) the taxpayer is primarily liable to the customer (or holder of the gift card); and 2) The gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment (Revision of Section 4.07 of Rev. Proc. 2004-34). This second statement opens up gift card companies to the ability to defer gift card sales. The Rev. Proc. also allows for companies already being audited for gift card revenue to avoid penalization. It has provisions that; 1) Prevent the IRS from raising the issue of whether the deferral method is a permissible method of accounting for gift card sales in any audits for years ending prior to the December 31, 2010 effective date; and 2) Agree not to further pursue the issue of gift card sales on any pending examinations, appeals or matters before the U.S. Tax Court for years ending before December 31, 2010. Taxpayers are also eligible to make an automatic change in accounting method for gift card sales to the deferral method without seeking permission from the IRS; provided they include any necessary information required in their tax return for the first year ending on or after December 31, 2010. (Duff & Phelps Corp, 2011)

### **Escheatment Laws**

About half of all States have laws that treat the balances on gift cards that have not been redeemed for a long period of time as unclaimed property. These States require the card issuer to report and pay to the state this unredeemed balance once the card has been deemed abandoned.

## Revenue Recognition of Gift Cards

---

This happens either after the card has expired or three to five years after issuance, depending on the state. These balances may then be subject to both income tax and be payable to the state under the rule of escheatment. (Smith, 2009)

Though many States like Arizona and Maryland have either fully or partially exempted gift cards from escheatment laws, a number of others have not. In addition, in recent years it has become popular for States to intensify their pursuit of unclaimed property in an attempt to raise revenue. Once the dormancy period, or period before property is claimed abandoned, has expired, most states require the property holder to do their due diligence in attempting to contact the owner and return the property. Gift cards that remain unredeemed must be turned over to the appropriate state, determined by the priority rules established by the Supreme Court. The first priority rule gives the jurisdiction of the owner's last known address the right to claim the property. The second priority rule states that if the owner's address is unknown or if the state of the owner's last address does not have escheatment of property rules, then the jurisdiction of the holder of the property is entitled to the property. As customers addresses are rarely recorded when gift cards are sold, the company's home state is usually the one to have claim on the unredeemed balances. It is for this reason that many companies run their gift card programs through third parties based in friendly states. (Grant Thornton LLP., 2011)

One State that includes unredeemed gift cards in its escheatment laws is North Carolina. Gift cards that are left unredeemed for 3 years become legally unclaimed property. If the card has an expiration date then retailers are allowed to keep 40% of the money on the cards; the other 60% goes to the state. If the card has no expiration date, the retailer is allowed to keep all the money. Prior to 2007 in New York businesses had to turn over to the states any cards that went

## Revenue Recognition of Gift Cards

---

unredeemed for five years after the date of issuance or two years after the expiration date, if one was used. In 2007, a new law went into effect exempted “qualified” gift cards from escheatment. Eligible gift cards are ones that do not carry an expiration date and do not charge any fees to the card holder. Now New York businesses can avoid escheatment or keep using fees and expirations on their cards, as long as they are willing to pay the price. (Marden & Forsyth, 2007)

The State of New Jersey went one step farther in 2010 with an amendment to its Uniform Unclaimed Property Act. This amendment added unredeemed gift cards to the types of property subject to escheatment. It also added in a controversial place-of-purchase provision to that act. This provision states that gift card issuers must obtain the name and address of anyone who purchases a gift card or at least a ZIP code for them. If no address is recorded then it will be assumed that the address of the New Jersey business where the card was purchased is the correct address. In addition this provision would be applied retroactively so that the state could claim all unredeemed balances of cards issued in New Jersey both before and after the announcement. Immediately after this proclamation was issued the State of New Jersey was sued by several separate establishments seeking an injunction to bar this provision from going into effect. A preliminary injunction was granted in November of 2010, with the court stating that the provision was trying to pre-empt the Supreme Court’s priority rules. This will be an important court case to follow regarding gift card revenue. Should New Jersey be able to get its provision upheld it will set a precedent for other states who are desperate for revenue. (Grant Thornton LLP., 2011)

# Financial Accounting Implications

---

When a company makes a gift card sale it receives cash and creates an unearned revenue liability. When the customer redeems the card the company can satisfy the liability and recognize all revenues and related expenses. If the card goes unredeemed but has an expiration date, the company can clear the liability and recognize the sale on the date of expiration, less any applicable escheat percentages. However if there is no expiration date a company should technically leave the liability on its books indefinitely. As we know, there is a significant portion of gift cards that never get redeemed, and companies are very interested in being able to recognize this potential income. This section will examine how companies are going about doing so and how they are reporting this on their financial statements.

### **Recognition**

Not all companies recognize gift card sales the same way. The recent general trend is to treat gift card sales similarly to accounts receivable and its aging procedure. Companies use prior experience to determine when it's unlikely for a card to be redeemed. Generally if a card is unredeemed for 2 or 3 years, or if it's a card with a miniscule balance, companies feel safe to remove these cards from their unearned revenue accounts and recognize the income. Just like with accounts receivable aging, there can be cards that were written off that are later redeemed,

## Revenue Recognition of Gift Cards

---

but if a company is conservative, then the amount should be immaterial. (Marden & Forsyth, 2007)

The fact that it takes time and experience for companies to accurately establish breakage patterns means that companies usually recognize 2 phases of gift card breakage adjustments. First they must establish an initial large recognition adjustment to cover the period of years that were needed to establish breakage estimations. This accumulated adjustment of multiple years of breakage can be problematic to the financial reports. The timing of this adjustment is subject to manipulation and can be used to mask problems in the reports. The second phase of adjustments is periodic future adjustments to keep breakage estimates accurate. (Kile, 2007)

An example of this process comes from Home Depot in 2005. During that year Home Depot recognized a \$43 million dollar adjustment for gift card breakage. This adjustment would cover all prior periods up to the debut of their gift card program. Following breakage adjustments were only \$9 million, a large amount but not nearly as large as the initial adjustment. (Kile, 2007)

Though there is no clear GAAP ruling on how to recognize breakage, the SEC staff has described 2 acceptable methods. The first is specific identification. Companies must recognize breakage income when the chance of a specific card being redeemed is remote. As most cards loaded electronically, it is not terribly difficult to keep track of when specific cards are issued and redeemed. The SEC does not specify how long a company should wait before recognizing breakage, but 2 years is typical. (Grant Thornton LLP., 2011)

## Revenue Recognition of Gift Cards

---

The second method advocated by the SEC is the homogenous pool method. Using this method companies will estimate the how much of a pool of cards value will end up being unredeemed. They will then recognize this breakage income in proportion to the amount redeemed over the cards useful life. There are several conditions that must be met to use this method. 1) All of the cards in the pool must be homogenous, 2) there must be a remote likelihood that 100% of the cards' value will be used, 3) The breakage amount can be reasonably and objectively determined, and 4) the estimated useful life of the cards can be reasonably and objectively determined. (Grant Thornton LLP., 2011)

Companies must also worry about escheatment when accounting for breakage on their financial reports. Any amounts that are turned over to the government under escheat rules will not be recognized as breakage income under GAAP. The unearned revenue will be debited to remove the claimed balances and cash will be debited to pay the state. (Grant Thornton LLP., 2011)

### **Disclosure**

When it comes to how and where to disclose information about gift cards there is no specific literature to guide companies. Some companies will disclose every facet of how they handle gift card sales, how they recognize breakage, and where these numbers are described on the balance sheet and income statement, while others will mention the bare minimum. In this section we will look at some of the options companies have for where they classify gift card



## Revenue Recognition of Gift Cards

---

related information in their financial statements and we will look at several examples from 2010 Annual Reports.

Any business that has a gift card program should have some mention of it in their annual reports. Even on the off chance that gift card sales are immaterial, this fact should still be mentioned somewhere in the report. Ideally a company should include a description of their gift card program, including expiration dates and monthly fees, their policy for dealing with breakage income, how they handle escheatment laws, the amount of breakage income recognized during the year, the amount of unredeemed cards, and where on the income statement breakage income is included. (Grant Thornton LLP., 2011)

Unredeemed gift cards constitute a liability, this is self evident, but companies will differ on how exactly they will report this number. Most companies include unredeemed gift cards as a separate line item either on the balance sheet or in the supporting section where they explain their other liabilities section. Some companies lump unredeemed gift cards with their accrued expenses, their deferred revenue or their accounts payable. All are technically correct, but the first way is probably the best way to handle disclosure.

Breakage income is not always acknowledged in a company's annual report, though breakage itself may be. Most companies when detailing how they handle breakage will include where they report breakage income in that description. Generally it is included in the overall revenue or sales account. Sometimes however it is included as a reduction to Selling, General and Administrative expenses. It has been reported however that the SEC has asked for clarification from more companies that include breakage income in any non revenue accounts than those that do not. (Grant Thornton LLP., 2011)

## Revenue Recognition of Gift Cards

---

Two companies that do their due diligence in reporting all of the details related to gift card sales are Best Buy, and The Cheesecake Factory. Best Buy has a separate section in its Notes to the Consolidated Financial Statements devoted to explaining its gift card policies that reads as follows:

*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 2010, 2009 and 2008:*

	2010	2009	2008
<i>Gift Card Breakage Income</i>	<i>\$43</i>	<i>\$38</i>	<i>\$34</i>

(Best Buy Co., Inc., 2010)

In this paragraph Best Buy satisfies most of the points made above; they describe of their gift card program, their breakage policy, how they handle escheatment laws, and the amount of breakage income recognized during the year. The paragraph also indicates that breakage income is recognized in their revenue account on the Income Statement. A look at their Balance Sheet shows that they have a separate line item for unredeemed gift cards in their current liabilities section. (Best Buy Co., Inc., 2010)

Cheesecake Factory also satisfies most of the same points. They detail their gift card policy first in their special Gift Card Revenue Recognition section:

## Revenue Recognition of Gift Cards

---

*We recognize a liability upon the sale of our gift cards and recognize revenue when these gift cards are redeemed in our restaurants or on our website. Based on our historical gift card redemption patterns, we can reasonably estimate the amount of gift cards for which redemption is remote, which is referred to as “breakage.” Breakage is recognized in proportion to historical redemption trends and is classified as revenues in our consolidated statement of operations. Utilizing this method, we estimate both the amount of breakage and the time period of redemption. If actual redemption patterns vary from our estimates, actual gift card breakage income may differ from the amounts recorded.*

(The Cheesecake Factory Inc., 2010)

They reiterate some of this information, and include some additional information in their general

Revenue Recognition section:

*We recognize a liability upon the sale of our gift cards and recognize revenue when these gift cards are redeemed in our restaurants or on our website. Based on our historical gift card redemption patterns, we can reasonably estimate the amount of gift cards for which redemption is remote, which is referred to as “breakage.” Breakage is recognized in proportion to historical redemption trends and is classified as revenues in our consolidated statement of operations. We recognized \$2.7 million, \$3.1 million and \$3.1 million of gift card breakage in fiscal years 2010, 2009 and 2008, respectively. Incremental direct costs related to gift card sales, including commissions and credit card fees, are deferred and recognized in earnings in the same pattern as the related gift card revenue.*

(The Cheesecake Factory Inc., 2010)

Between the two sections, and the section of their Notes detailing what constitutes Cheesecake Factory’s other accrued expenses, we can find out everything needed about their gift card policies except for exactly how long they wait before recognizing breakage income, and how they handle any possible escheatment laws. (The Cheesecake Factory Inc., 2010)

More often than not companies disclose their gift card policies in the way that Amazon.com does, with a simple paragraph in the notes:

*Included in “Accrued expenses and other” at December 31, 2010 and 2009 were liabilities of \$503 million and \$347 million for unredeemed gift certificates. We reduce the liability for a gift certificate when it is applied to an order. If a gift certificate is not*

## Revenue Recognition of Gift Cards

---

*redeemed, we recognize revenue when it expires or, for a certificate without an expiration date, when the likelihood of its redemption becomes remote, generally two years from the date of issuance.*

(Amazon.com Inc., 2010)

This statement does not recognize escheatment, does not describe the gift card program, does not describe how much breakage income was recognized in the year and does not reveal where breakage income is included in the Income Statement.

Two of the worst examples of companies disclosing their gift card sales information are Kohl's and Wal-Mart. Kohl's acknowledges that breakage exists but gives no details on how it accounts for it, nor where, and leaves out much of the other information discussed above:

*Revenue from gift card sales is recognized when the gift card is redeemed. Gift card breakage revenue is based on historical redemption patterns and represents the balance of gift cards for which we believe the likelihood of redemption by a customer is remote*

(Kohl's Corporation, 2010)

Wal-Mart on the other hand does not even acknowledge breakage. Wal-Mart doesn't even refer to its gift cards as gift cards, making it difficult for investors to parse how they handle gift cards. Instead it refers to them a "shopping cards":

*Customer purchases of shopping cards are not recognized as revenue until the card is redeemed and the customer purchases merchandise by using the shopping card.*

\ (Wal-Mart Stores, Inc., 2011)

### Further Research

---

Regulators on both the Tax and Financial side of things need to give gift cards a closer look. Over the past decade Tax policy makers have been working to align how gift card revenue is handled for tax purposes with how popular agreement handles it for financial purposes. What they need to do now is establish whether their current legislation is understandable to tax-payers and does not contradict itself. Research needs to be done to ensure that the wording of the regulations is allowing for the intended people to benefit from the deferral rules.

GAAP policy makers need to investigate how companies are currently reporting their gift card revenue and breakage income. By doing so they can assess whether the common trend is capturing the spirit of the rules that are in place for other aspects of revenue recognition. While it makes logical sense for breakage to be treated similarly to aging of accounts receivable, research needs to be done to see if this practice is accurate and is not used to manipulate financial information. FASB needs to find the best way for companies to uphold the principal of financial transparency when it comes to reporting about gift card policies. They must determine the most appropriate place for breakage income to be reported in the statements and must determine what shareholders need to know about gift card policies in order for them to have the information they need to invest.

# Conclusions

---

Gift cards are a huge money maker for businesses and are well loved by customers for how easy they make holiday shopping. Any company that plans to implement a gift card program must be aware that there are many issues that they must be aware of from both a Tax and Financial perspective.

The Tax environment has become clearer over the years but is not perfect. Companies must realize that they cannot automatically defer gift card income as they would in financial accounting, they must make sure they comply with the current Treasury Regulations and Revenue Procedures. Any company that uses a separate gift card company to handle their gift card program must be prepared to satisfy extra conditions in order to be able to defer income. Companies must also be very aware of their State's escheatment laws and should watch the New Jersey case carefully, in case it sets an unfavorable precedent.

The Financial environment is less regulated, but most companies seem to be on the same page in how to handle gift card transactions. Everyone seems to be on the same page about being able to recognize breakage income after a period of time. However it would be helpful if there were more explicit GAAP rules regarding recognizing breakage, and particularly on how breakage and other gift card related information should be disclosed in financial statements.

# Revenue Recognition of Gift Cards

---

## Works Cited

Amazon.com Inc. (2010). *2010 Annual Report*.

Best Buy Co., Inc. (2010). *FY10 Form 10-K*.

Duff & Phelps Corp. (2011, January 10). *Client Alert: New Year Rings in Favorable IRS Rules on Gift Card Income Recognition and Gift Cards Received in Exchange for Returned Merchandise*. Retrieved 2011, from Financial Advisory and Investment Banking Services from Duff & Phelps:  
<http://www.duffandphelps.com/expertise/publications/pages/ArticleDetail.aspx?id=210&list=Articles>

Grant Thornton LLP. (2011). *Gift cards: Opportunities and issues for retailers*.

Kile, C. O. (2007). Accounting for Gift Cards. *Journal of Accountancy* .

Kohl's Corporation. (2010). *Form 10-K*.

Marden, R. E., & Forsyth, T. B. (2007). Gift Cards and Financial Reporting: Unwrapping the Uncertainties of Revenue-Recognition and Other Issues. *The CPA Journal* .

Smith, S. D. (2009, December). *Gift Card Management - When Income Tax and State Unclaimed Property Laws Converge*. Retrieved 2011, from Lorman Education Services:  
[http://www.lorman.com/newsletters/article.php?article\\_id=1416&newsletter\\_id=300&category\\_id=6&topic=CPA](http://www.lorman.com/newsletters/article.php?article_id=1416&newsletter_id=300&category_id=6&topic=CPA)

Suttora, J., & Bender, D. (2009). *What's New in Tax: Gift Card and Gift Certificate Income: Updated IRS Audit Guidelines*. KPMG.

The Cheesecake Factory Inc. (2010). *2010 Annual Report*.

*Treasury Regulations, Subchapter A, Sec. 1.451-5*. (2005, May 11). Retrieved 2011, from TaxAlmanac, A Free Online Resource for Tax Professionals:  
[http://www.taxalmanac.org/index.php/Treasury\\_Regulations,\\_Subchapter\\_A,\\_Sec.\\_1.451-5](http://www.taxalmanac.org/index.php/Treasury_Regulations,_Subchapter_A,_Sec._1.451-5)

Wal-Mart Stores, Inc. (2011). *2011 Annual Report*.