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Staff Paper

FASB Education Session
February 10, 2011

FASB Agenda reference **137F**

Project **Revenue Recognition**

Topic **Breakage and prepayments for future goods or services**

Purpose and summary of staff recommendations

1. The objective of this paper is to discuss the accounting for a customer's non-refundable prepayment for future goods or services and the portion of the customer's rights that is not exercised (often referred to as breakage).

2. The staff recommends the following:

   (a) If an entity can reasonably estimate breakage, the entity should recognize the expected breakage as revenue in proportion to the pattern of transfer of goods or services to the customer.

   (b) If an entity cannot reasonably estimate breakage, the entity should recognize the expected breakage as revenue when the likelihood of the customer exercising their rights becomes remote.

3. This paper is organized as follows:

   (a) Background (paragraphs 4–10)

   (b) Proposals in the Exposure Draft (paragraphs 11–19)

   (c) Application of the ED to non-refundable prepayments (paragraphs 20–28)

   (d) Alternative view - immediately recognize expected breakage at time of prepayment (paragraphs 29–39)

(e) Appendix A: Discussion of gift cards (or gift certificates)

Background

4. Sometimes customers make a non-refundable prepayment to an entity for the right to receive future goods or services. Those prepayments oblige the entity to stand ready to provide goods or services in the future. Examples of non-refundable prepayments for future goods or services include: gift cards, gift certificates, some airline tickets, prepaid phone cards, and layaway sale deposits.

5. In those cases, the entity has provided the customer with the right to receive goods or services in the future without paying additional consideration (or by paying less consideration than would otherwise be payable for those goods or services). However, there are instances in which customers do not exercise all of their contractual rights to those goods or services. Those unexercised rights are often referred to as breakage.

6. Currently there is limited guidance on the accounting for breakage. In the U.S. there is an SEC Speech from December 2005[1] (the SEC Speech) which describes some acceptable and unacceptable methods for recognizing gift card breakage (or derecognizing the gift card deferred revenue liability).

7. Several comment letter respondents and other constituents requested guidance related to breakage as this topic was not specifically addressed in the Exposure Draft, *Revenue from Contracts with Customers* (ED). One respondent noted:

> A company's contracts provide its customers with the right to a certain volume of products or services in exchange for a fixed fee, but customers may not request the entire amount of products or services to which they are entitled. This is common, for example, with companies that sell gift cards, as a portion of gift cards is invariably not redeemed...We do not believe the exposure draft explains the principle that should apply to the recognition of revenue. [Comment Letter No. 414]

[1] Statement by SEC Staff: Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments by Pamela R. Schlosser, Professional Accounting Fellow, U.S. Securities and Exchange Commission.

8. One respondent's comment letter [No. 38] focused specifically on the application of the ED to the gift card industry (including breakage). Appendix A provides some additional discussion of gift cards.

9. In regards to unredeemed customer balances, an entity might be subject to unclaimed property laws (e.g. escheat laws) based on the jurisdiction(s) in which it operates. Unredeemed customer balances that are subject to such laws often are required to be turned over to the jurisdiction and are therefore not recognized as revenue. The discussion of breakage in this paper relates to unredeemed customer balances that are not subject to such laws.

10. This paper does not address time value of money or disclosures associated with customer prepayments. Those topics will be discussed at future meetings.

Proposals in the Exposure Draft

11. In accordance with the ED, an entity would recognize a contract liability upon receipt of any prepayment from a customer for its performance obligation to provide or to stand ready to provide goods or services in the future. An entity would derecognize that contract liability (and recognize revenue) when it transfers those goods or services.

12. In some cases, a customer makes a non-refundable payment for a right to obtain goods or services in the future (at the customer's discretion or conditional on other events). The staff think that the accounting for those non-refundable prepayments to an entity for future goods or services is similar to the proposed accounting for options.

13. The ED included application guidance on options for additional goods or services [B/IG 24-26]. The Boards proposed that an option is accounted for as a separate performance obligation only if the option provides the customer with a material right that the customer would not receive without entering into that contract. If the option provides a material right, the customer in effect pays the entity in advance

for future goods or services and the entity recognizes revenue when it transfers those future goods or services or when the option expires. Respondents generally were supportive of those proposals.

14. The ED also included application guidance on how an entity would allocate the transaction price when an entity grants a customer an option to acquire goods or services that is determined to be a separate performance obligation [IG 86-88].

15. The ED indicates that the stand-alone selling price for a customer's option often must be estimated and should reflect the discount that the customer would obtain when exercising the option, adjusted for (a) any discount that the customer could receive without exercising the option and (b) the likelihood that the option will be exercised.

16. By incorporating the likelihood of an option being exercised in estimating the stand-alone selling price of that option, the ED implicitly provided guidance on how to account for breakage when there was an option for additional goods or services in a contract. The breakage would be recognized when the future goods or services are transferred because it would be reflected in the amount of consideration attributed to each good or service expected to be transferred. The ED included a specific example to illustrate the guidance in relation to a customer loyalty programme [Example 26].

17. Consider the following example:

> A customer purchases products from an entity and also receives 1,100 customer loyalty points that the customer can redeem for future products. The entity expects that 1,000 points will be redeemed and allocates CU2 to each of those points. The amount allocated to each loyalty point expected to be redeemed reflects the entity's expectation of breakage. Upon the customer redeeming 400 loyalty points for future products, the entity would recognize revenue of CU800 (CU2 per point × 400 points).

18. The example above illustrates how an entity would recognize revenue based on the pattern of redemption of the loyalty points in accordance with the ED.

19. Although the ED provided guidance on breakage, it did so only indirectly by providing guidance on allocating consideration to customer options. The ED did not explain how to deal with breakage in situations when there is only one performance obligation in the contract (i.e. when there is no allocation and, hence, no need to determine a standalone selling price).

Application of the ED to non-refundable prepayments

20. The staff think the guidance provided in the ED on breakage for options could also be applied to situations in which an entity only has one performance obligation, such as with a gift card.

21. The breakage model illustrated in the ED recognizes breakage over the estimated pattern of the customer exercising their rights (i.e. a "proportional model"). Under a proportional model, an entity would need to estimate the amount of breakage as well as the timing and amount of rights exercised by the customer.

22. An entity would recognize as revenue the proportional breakage associated with each transfer of goods or services to the customer. Subsequent changes in the estimate of breakage would be recognized as a cumulative adjustment to revenue and the contract liability.

23. 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)]).

24. Under the proportional model, revenue is recognized proportionally to the entity performing under the contract, which the staff think is the most appropriate pattern of revenue recognition.

25. Recognizing estimated breakage as revenue (in proportion to the transfer of each good or service) could be viewed as effectively increasing the selling price of the goods or services transferred to the customer. If an entity thought customers would exercise all of their rights, the entity might increase the price of its goods and services. For example, with non-refundable airline tickets, the airline presumably would charge a higher price per ticket if there was no breakage such that those customers who use their tickets benefit from those who do not.

Estimating breakage

26. The proportional model of recognizing breakage would require an entity to estimate the timing and amount of breakage. However, in some cases an entity may not be able to reasonably estimate breakage.

27. If an entity cannot reasonably estimate breakage, the staff think that an entity should recognize expected breakage as revenue when the likelihood of the customer exercising their rights becomes remote (i.e. a “remote model”). If the prepayment has a contractual expiration date, an entity may deem that date as the point at which the likelihood of redemption becomes remote.

28. Consider the following example:

> Assume an entity cannot reasonably estimate the timing and amount of breakage on its prepaid phone cards that expire two years from the date of issuance. Hence, the entity would recognize revenue for breakage on prepaid phone cards when each phone card expires.

Alternative view - immediately recognize expected breakage at time of prepayment

29. As an alternative to the proportional and remote models of recognizing breakage, an entity could recognize estimated breakage as revenue immediately upon each prepayment received from a customer (assuming the entity can reasonably estimate breakage).

30. Consider the following example:

> An airline's historical experience with sales of non-refundable tickets indicates that 5% of tickets are not redeemed by ticketholders. Hence, the airline would recognize revenue for 5% of each ticket sale in that reporting period.

31. Proponents of this alternative think that it results in the most faithful depiction of the entity's remaining obligation on the date of issuance (assuming the entity can reasonably estimate the amount of breakage on its customer prepayments).

32. Those proponents note that for the breakage amount, the entity no longer expects to provide goods or services and, therefore, should no longer recognize a liability. Consequently it should recognize revenue once it can reasonably estimate the breakage amount.

33. As noted in paragraph 25, it could be argued that the expected breakage is reflected in the pricing of airline tickets (i.e. without breakage, the entity would charge more for those tickets). Accordingly, reflecting the effects of breakage on the sale of each airline ticket would understate the entity's contract liabilities.

34. The staff note that this alternative was not deemed an acceptable approach to recognize breakage in the context of gift cards in the SEC Speech because there was no performance by the entity (i.e. the delivery criterion of revenue recognition in SEC Staff Accounting Bulletin Topic 13 would not have been met).

35. If an entity has not performed by providing goods or services, some people think that breakage should be presented as a gain rather than as revenue in the statement of comprehensive income. However, the staff think that presenting some breakage as revenue and other breakage as a gain would be unnecessarily complex. In addition, recognizing breakage as revenue is more consistent with the predominant current practice.

Staff recommendation

36. The staff recommends recognizing expected breakage as revenue in proportion to the pattern of rights being exercised by the customer (proportional model) if an entity can reasonably estimate breakage. The staff think this is the most appropriate revenue recognition because the entity recognizes revenue as the entity provides goods or services to the customer. In addition, the staff think that this model is consistent with the proposed accounting for options in the ED (which most respondents support).

37. If an entity cannot reasonably estimate breakage, the staff recommends recognizing breakage when the likelihood of the customer exercising their rights becomes remote (remote model).

38. The staff note that both the proportional and remote models discussed above were acknowledged in the SEC Speech as acceptable approaches to recognize breakage on gift cards.

39. In addition, the staff note that this recommendation would not be expected to change the current practice of recognizing breakage in the airline industry for non-refundable tickets. Specifically, the AICPA Audit and Accounting Guide – Airlines provides two acceptable approaches to recognizing breakage, either at ticket expiration (remote model) or departure date (proportional model).

Question for the Boards
The staff recommend the following: (a) If an entity can reasonably estimate breakage, the entity should recognize the expected breakage as revenue in proportion to the pattern of transfer of goods or services to the customer. (b) If an entity cannot reasonably estimate breakage, the entity should recognize the expected breakage as revenue when the likelihood of the customer exercising their rights becomes remote. Do the boards agree?

Appendix A: Discussion of gift cards (or gift certificates)

A1. Gift cards are often sold by retailers to their customers. Gift cards provide the customer with stored value that can be exchanged for future purchases of goods or services at that retailer.

A2. Gift cards are slightly different from the other prepayments discussed in this paper, such as prepaid phone cards, because 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 ED or whether they should be accounted for as a financial liability.

A3. The staff note that an entity's obligation from the sale of a gift card does not meet the definition of a "financial liability"[2] 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.

A4. Because of the close relationship between gift cards and the provision of goods and services, the staff think that revenue is the most logical standard to provide guidance on accounting for gift cards.

[2] Accounting Standards Codification Master Glossary and IAS 32, para 11.