STAFF PAPER

11 November 2014

IFRS Interpretations Committee Meeting

Project	IAS 32 *Financial Instruments: Presentation*		
Paper topic	Classification of liability for prepaid cards issued by a Bank in the Bank's financial statements		
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Background and purpose

1. In November 2012, the IFRS Interpretations Committee ('Interpretations Committee') received a request to clarify the classification of the liability for prepaid cards issued by a Bank in the Bank's financial statements and accounting for the unspent balance of the prepaid cards.[1] The submitter asks whether the liability for the prepaid cards issued by a Bank is a financial liability or a non-financial liability of the Bank.

2. The purpose of this paper is to discuss the questions raised by the submitter. The submission is included as *Appendix A* to this paper.[2]

About prepaid cards

3. A prepaid card is a payment card that is loaded with money that can be used to buy goods and pay for services either at shops, by phone, or over the internet. Prepaid cards are generally marketed as a more convenient and safer way to give money than giving cash. Many types of prepaid cards are available for different purposes with different terms and conditions.

[1] In this paper, references to a 'Bank' should be read to include any financial institution.

[2] The submitter submitted the issue to the IFRS Interpretations Committee and the Emerging Issues Task Force of the FASB. The submission is publicly available on the FASB's website. Click here for the submission.

4. The submitter's questions relate to prepaid cards issued by a Bank with the following features:

   (a) no expiry date;

   (b) cannot be refunded, redeemed or exchanged for cash;

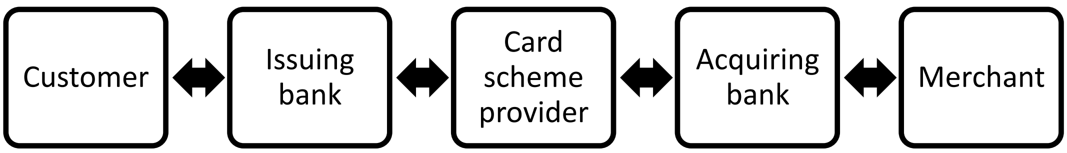
   (c) redeemable for goods or services only;

   (d) redeemable only at selected merchants, and depending upon the card programme, ranges from a single merchant to all merchants that accept a specific card network; and

   (e) no back-end fees, which means that the balance on the prepaid card does not reduce unless spent by the holder.

5. There are instances in which the cardholders do not spend/redeem the entire amount on the prepaid card and consequently unspent balances remain in perpetuity subject to any unclaimed property laws in the jurisdiction in which the Bank operates. These unspent balances are often referred to as breakages. The submitter specifically requested the Interpretations Committee to clarify how (and whether) these breakages could be recognised in profit or loss in accordance with the new revenue recognition standard. We did not consider the submission for discussion at an earlier Interpretations Committee meeting because of the IASB's ongoing deliberations on customers' unexercised rights. IFRS 15 *Revenue from Contracts with Customers* was issued in May 2014. Subsequently, we commenced our work on the submission.

6. Before explaining and analysing the issue, we think that it is important to broadly understand the contractual arrangements that govern the card transactions. A generic contractual structure that governs the card transactions is as follows:



Issuing bank is the bank that issues the prepaid card to the customer. The acquiring bank is the merchant's banker that collects the proceeds from the issuing bank in respect of card transactions accepted by the merchant.

The card scheme provider is the owner of the payment scheme, into which a bank or any other eligible financial institution can become a member. By becoming a member of the scheme, the member then gets the possibility to issue or acquire the transactions performed within the scheme. The card scheme provider sets the rules to be applied within the card network acting as a switch and router between the issuing bank and the acquiring bank.

When making payment to the acquiring bank, the issuing bank retains a portion of the amount towards interchange fee. The acquiring bank retains an additional service fee before making payment to the merchant.

In the above contractual structure, if any one contractual relationship does not exist, then the customer or the cardholder will not be able to use the cards. Consequently, the individual contractual relationships together form one single contractual framework that governs the card transactions.

Summary of the submission

7. To explain the submitter's views and analyse the issue, we have considered the following illustration based on the generic contractual structure explained in paragraph 6 of this paper.

Entity A, a Bank, operates a prepaid card programme. The features of the programme are as follows:

a. Cash must be loaded onto the card by the customer at the time of purchase. In other words, Entity A receives cash from the customer and issues the card with face value equal to the cash received. The card can be used by the cardholder immediately.

b. Entity A has a contract with a card scheme provider under which the cards are issued. Consequently, the prepaid card can be redeemed for goods or services at all merchant locations or over the internet wherever the card scheme is accepted. Entity A receives an interchange fee from the acquiring bank each time the card is accepted by the merchant.

c. Neither Entity A, the card scheme provider nor any acquiring bank will be liable for any defects in any goods or services paid for using the prepaid card.

d. The cardholder cannot withdraw cash using the prepaid card.

e. The prepaid card is transferable by delivery. Unless informed by the customer to the contrary, Entity A will assume that the person who uses the prepaid card at any time is the rightful user of the prepaid card.

f. The customer must treat the prepaid card as if it were cash and ensure that the prepaid card is not lost or stolen. A lost or stolen card can be stopped and the balance transferred to a replacement card for a fee.

g. The prepaid cards have no expiry date and do not carry any back-end or inactive balance charges.

Entity A issues CU1,000 of prepaid cards in a certain period.[3] Based on historical redemption rates, Entity A determined that the prepaid cards would be redeemed over 24 months with 5 per cent of the prepaid cards remaining unspent thereafter. There is no unclaimed property law in the jurisdiction in which Entity A operates to allow Entity A to legally cancel the remaining obligation. Consequently, an obligation for the unspent balance remains with Entity A in perpetuity.

On issue of the prepaid cards, Entity A receives cash from the customers and recognises a liability of CU1,000. This liability reduces on payments to merchants who accept the prepaid card as payment for the goods or services purchased by the cardholder.

Nature of the liability recognised on the issue of the prepaid card

8. There are the following views about the nature of the liability recognised by the Bank when it issues a prepaid card:

(a) *A non-financial liability*. The prepaid card issued by Entity A is not a financial liability because Entity A does not have an obligation to deliver cash to the cardholder. The prepaid card gives right to the cardholder to purchase goods or services. Consequently, these prepaid cards are within the scope of IFRS 15 *Revenue from Contracts with*

[3] All monetary amounts are denominated in 'currency units (CU)'.

Customers (and the corresponding Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, issued by the Financial Accounting Standards Board of the US) and represent a contract liability of Entity A.

(b) *A financial liability*. Entity A has an obligation to pay cash to the acquiring bank when the cardholder uses the card for purchasing goods or services.

Recognition of breakages

9. Prior to the issue of IFRS 15 there was no specific guidance in IFRS on accounting for breakages. Specific guidance on derecognition of liabilities is available in IFRS 9 *Financial Instruments* (IAS 39 *Financial Instruments: Recognition and Measurement*) and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

10. In accordance with paragraph B46 of IFRS 15 'if an entity expects to be entitled to a breakage amount in a contract liability, the entity shall recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity shall recognise the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote'.

11. However, in the US prior to the issue of ASU No. 2014-09, there is an SEC Speech from December 2005 (the SEC Speech) that describes some acceptable and unacceptable methods for recognising prepaid card breakages.[4]

Paper structure

12. The paper is organised as follows:

(a) outreach activities;

(b) assessment against the Interpretations Committee's agenda criteria; and

[4] 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.

(c) staff analysis and recommendation.

Outreach activities

13. We contacted members of the International Forum of Accounting Standard-Setters (IFASS), some securities regulators and the large accounting firms. Outreach participants were asked to indicate:

    (a) whether they are aware of the issue by Banks of prepaid cards of the types described in the submission, ie prepaid cards that can be redeemed at:

        (i) a single merchant; and

        (ii) all merchants that accept a specific card network.

    (b) how is the liability for prepaid cards classified by these Banks, ie as a financial liability or a non-financial liability; and

    (c) how are the breakages in respect of these liabilities accounted for and what is the basis on which the Banks derecognise the liability for prepaid cards.

    They were also asked to provide any examples that illustrate the feedback.

14. Based on the responses received, we noted that issuance by banks of prepaid cards with no expiry is extremely rare in jurisdictions other than the United States of America. Some respondents commented that the liability of the bank for the prepaid cards is a financial liability whether or not the prepaid cards expire, and the liability is derecognised in accordance with IFRS 9 (IAS 39). Some respondents commented that these prepaid cards are not material to the banks. The results of the outreach activities are included in *Appendix B* to this paper.

Assessment against the Interpretations Committee's agenda criteria

15. The staff's assessment of the agenda criteria is included in *Appendix C* to this paper.

Staff analysis

16. The term 'prepaid card' used in the staff analysis refers to the prepaid card as explained in the example in paragraph 7 of this paper.

17. The key question is whether the liability of the issuing Bank for the prepaid cards is a financial liability or a non-financial liability. We are aware of a view that the interchange fee, which is often a very small portion of the liability, is a fee for services provided by the issuing Bank. We have ignored the interchange fee for the purposes of our analysis.

What is the nature of the liability of the Bank for the prepaid cards issued by the Bank?

18. A financial instrument, a financial asset and a financial liability are defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation* as follows:

> A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
>
> A financial asset is any asset that is:
>
> (a) cash
>
> (b) …
>
> (c) a contractual right:
>
> (i) to receive cash or another financial asset from another entity; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
>
> (d) …
>
> A financial liability is any liability that is:
>
> (a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) …

19. Further, paragraph 19 of IAS 32 states that:

> If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability… For example:
>
> (a) …
>
> (b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

20. The prepaid card is a financial instrument that gives rise to a financial liability of the issuing Bank and a financial asset of the customer as explained in paragraphs 21 to 24 of this paper.

21. A Bank that receives cash and issues the prepaid card has a financial liability because the Bank has a contractual obligation to pay cash to the acquiring bank that is conditional upon the cardholder using the prepaid card to purchase goods or services from the merchant. The issuing Bank does not have an unconditional right to avoid delivering cash to the merchant when the cardholder uses the prepaid card for purchasing goods or services from the merchant.

22. The contractual obligation of the issuing Bank is not to deliver goods or services. The issuing Bank is not rendering a service of making the merchant stand ready to provide specific goods or services. The issuing Bank's promise is that the

merchant will accept the card as payment for the goods or services purchased by the cardholder.

23. Prepaid cards are generally marketed as a more convenient and safer way to give money than giving cash. In other words, prepaid cards are similar to currency. The customer does not have the right to receive cash. However, the customer has a right to use the card to settle a financial liability, ie liability to the merchant for purchase of goods or services.

24. A prepaid card by itself does not provide the cardholder with a right to goods or services. A merchant is not under a contractual obligation to stand ready to provide specific goods or services to the customer when the customer walks in with the prepaid card. The merchant, however, is under a contractual obligation to accept the prepaid card as payment for the goods or services purchased by the cardholder. Consequently, the prepaid card gives rise to a financial asset of the cardholder. Once the card is used for purchasing goods or services, the merchant has a financial asset, ie a right to receive cash from the acquiring bank.

25. We are aware of a view that the liability of the issuing Bank for prepaid cards is a *contract liability* within the scope of IFRS 15 because the prepaid card gives rights to goods or services to the cardholder. We think that the liability for prepaid cards is not a contract liability for the following reasons:

   (a) Financial instruments are outside the scope of IFRS 15 (paragraph 5 of IFRS 15).

   (b) As explained in paragraph 24 of this paper, the prepaid card by itself does not provide the cardholder with any right to goods or services.

   (c) Revenue is defined in IFRS 15 as ‘income arising in the course of an entity’s ordinary activities’. A customer is defined as ‘a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration’. The ordinary activities of a Bank do not include sale of goods or services other than the financial services provided by the Bank.

   (d) If we assumed that the ordinary activities of a Bank include sale of goods or services, the issuing Bank would have to apply the guidance in

IFRS 15 on 'Principal versus agent considerations' because another party is involved in providing goods or services. Paragraph B35 of IFRS 15 states that 'an entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer'. Paragraph B36 of IFRS 15 states that:

> An entity is an agent if the entity's performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

Based on the above guidance, an issuing Bank is not the principal in the case of prepaid cards because the issuing Bank does not obtain control of the goods or services before the merchant transfers the goods or services to the cardholder. Further, the issuing Bank is not under an obligation to make the merchant stand ready to provide specific goods or services. The Bank is more like an agent. Consequently, the income for the issuing Bank is the interchange fee that it receives from the acquiring bank.

26. We did not assess the liability for prepaid cards for the definition of a *provision* because our analysis concludes that the liability is within the scope of IAS 32, IFRS 9 (IAS 39).

27. On the basis of our conclusion that the issuing Bank's liability is a financial liability, we note that the liability for prepaid cards is derecognised in accordance with IFRS 9 (IAS 39). Consequently the issuing Bank derecognises the liability when it delivers cash to the merchant.

Staff recommendation

28. We observe that the guidance in IAS 32 and IFRS 15 allows entities to reach an appropriate conclusion on the classification of the liability for prepaid cards in the financial statements of the Bank issuing the prepaid cards. Having reached that conclusion, IFRS 9 provides the guidance needed to conclude on the basis for derecognition of the liability.

29. On the basis of our analysis above and our assessment of the Interpretations Committee's agenda criteria, we think that no further clarification is needed. Consequently, we do not recommend that the Interpretations Committee should take this issue onto its agenda.

30. We have set out proposed wording for the tentative agenda decision in *Appendix D*.

Questions to the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation?
2. Does the Interpretations Committee have any comments on the drafting of the tentative agenda decision?

Appendix A

Submission

A1. Refer to the link on Page 1, Footnote 2.

Appendix B

Results of the outreach activities

A2. We received responses from 8 national standard-setters (4 from Asia-Oceania, 3 from Europe and 1 from Africa), 6 large accounting firms and 1 Securities Regulator.

A3. 3 respondents were aware of the issuance by banks of prepaid cards with features explained in paragraph 4 of this paper and noted that these were extremely rare. Other respondents were either unaware or have limited experience with such prepaid cards. Some respondents observed that the issuances of prepaid cards are not material to the banks. Some respondents that were aware of issuance of prepaid cards by banks observed that:

(a) those cards expired with the unspent balance being forfeited; or

(b) the cardholder was entitled to a refund of the unspent balance; or

(c) the bank is required to deposit any dormant balances in a fund.

A4. On the question about the nature of the liability for prepaid cards, nearly half of the respondents commented that the liability for prepaid cards is a financial liability of the issuing Bank. Out of the remaining respondents, 2 of them observed diversity in practice and another respondent observed that the classification of the liability was based on the specific terms and condition of the cards.

A5. On the question about recognition of breakages, most of the respondents who thought that the liability for prepaid cards is a financial liability of the issuing bank commented that derecognition guidance in IFRS 9 is applied. Some of those respondents observed that the unspent balances on the prepaid cards with features explained in paragraph 4 of this paper will never be derecognised. Another respondent observed that some banks followed the generally accepted accounting principles in the United States to recognise breakages.

A6. Some respondents commented upon prepaid cards issued by entities other than banks and financial institutions. We did not consider those comments because they are not relevant for the issue under discussion.

Appendix C

Staff's assessment of the Interpretations Committee's agenda criteria

A7. The staff's assessment of the agenda criteria is as follows:

Agenda criteria

We should address issues (5.16):	
a) that have widespread effect and have, or are expected to have, a material effect on those affected.	**No**. The outreach responses (see paragraphs A2–A5 of this paper) indicate that this issue is not considered to have a widespread effect.
b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	The outreach responses indicate that there is no significant diversity in practice.
c) that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	Not applicable
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (5.17)	Not applicable
Will it be effective for a reasonable time period (5.21)? Only take on the topic of a forthcoming Standard if short-term improvements are justified.	Not applicable.

Appendix D

Tentative agenda decision

A8. We propose the following wording for the tentative agenda decision.

IAS 32 *Financial Instruments: Presentation*—classification of liability for prepaid cards issued by a bank in the bank's financial statements

The Interpretations Committee received a request to clarify the classification of the liability for prepaid cards issued by a bank in the bank's financial statements and accounting for the unspent balance of the prepaid cards with the following features:

(a) no expiry date;

(b) cannot be refunded, redeemed or exchanged for cash;

(c) redeemable for goods or services only;

(d) redeemable only at selected merchants, and depending upon the card programme, ranges from a single merchant to all merchants that accept a specific card network; and

(e) no back-end fees, which means that the balance on the prepaid card does not reduce unless spent by the holder.

The Interpretations Committee was asked to consider whether the liability for those prepaid cards is a non-financial liability because the issuing bank does not have an obligation to deliver cash to the cardholder.

Based on the responses to the outreach request, the Interpretations Committee observed that the issue is not widespread. The Interpretations Committee also observed that the liability for prepaid cards would meet the definition of a financial liability because the bank has an obligation to deliver cash that is conditional only upon the cardholder using the prepaid card to purchase goods or services. Consequently, a bank would apply the guidance in IFRS 9 (IAS 39) to derecognise the liability for prepaid cards.

The Interpretations Committee therefore concluded that in the light of the existing guidance in IAS 32 and IFRS 9 (IAS 39), neither an Interpretation nor an amendment to a Standard was necessary and consequently [decided] not to add this issue to its agenda.