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Revenue Recognition from Gift Cards: What and How?

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Abstract

This case deals with the financial statements' implications issue and taxation issues from the revenue generated from gift cards. This is a fictitious case that deals with the problems faced by companies in recognizing the revenue generated from gift cards. The case revolves around a retail store who wants to introduce the concept of gift cards in their store. The case first talks about the benefits of introducing the concept of gift cards and in the latter part of the case it talks about the problems faced by the finance and accounts department in accounting for the revenue recognized from gift cards. The case is in the form of a story telling mode with a dilemma in the conclusion that has to be addressed by the store. The case requires students to practically apply the accounting principles in real life situations. The case is designed in such a way that the students will be able to apply the relevant accounting concepts to solve the issue. The case is more relevant because of the absence of a written rule or procedure for recording revenue from gift cards in India and moreover the concept is against the principal of the revenue recognition concept. Using this case, students will be able to understand the use of retailer-issued gift cards and also learn the accounting and taxation implications arising thereof. This case can be used to elucidate the application of accounting concepts and conventions especially revenue recognition concept.

Keywords: Accounting Concepts, Breakage Income JEL, Gift Cards, Liability, Revenue Recognition.

JEL classification: M41, M40

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This case presents a scenario where the Managing director(MD) of WS Retail brands Pvt. Ltd, Mr. Sagar Gupta calls for a meeting with all the heads of the department to discuss about a proposal put forth by the Marketing head Mr. Arun Kumar about introducing gift vouchers or gift cards to be sold through their store. The idea of introducing gift cards caught Mr. Gupta's attention when Mr. Kumar mentioned that in the recent past small retailers have been able to increase their sales by 20 percent more than the normal sales only by introducing the concept of gift cards. In 2016, 75 percent of gift card recipients spent nearly \$28 more than the value of the card, up from 69 percent the previous year. When you consider the number of gift cards you can potentially sell and multiply that by \$28, that's a lot of money to be made.

During the meeting the Marketing Head (Mr. Kumar) gave a presentation on the importance and the benefits of gift cards for the sellers and the customers (See Exhibits I). He started the presentation by giving a brief statistics of the sales for the company in the current year after which he introduces the concept of a gift card or gift vouchers. To make the others more familiar to the whole concept he explained a little about the idea and the usage of gift cards.

Mr. Kumar said "There are two essential sorts of types of gift cards; ones issued by Visa, and ones that aren't. Those that aren't issued with MasterCard organizations are called nonbank gift cards or, closed-system gift cards. They get this name since they are utilized just at the retailers that issue them. Notwithstanding retailers; eateries, supermarkets, film theatres and more have all started to utilize these cards. Nonbank gift cards are either circulated by the retailer or by a gift card organization. A gift card organization is a different lawful element that is framed by an organization as a backup for the sole motivation behind controlling the organization's gift card program".

Mr. Kumar indicated that the company is planning to issue closed system of gift cards. In this system the retailer sells a card that contains a specific denomination of stored value which in turn this customer gives it to another person as a gift who will visit the store and spend the stored value. It is always observed that the card holder will anytime spend more than the stored value. But the point to be noted is that this redemption has to happen within a stipulated time.

Mr. Kumar stated that "Gift cards offer purchasers and gift beneficiaries 'variety of product choices yet confine those decisions to a solitary or predetermined number of retail administration suppliers. This buyer vendor trade-off gives a lot of monetary defense to retailers to offer, and even to advance, gift card deals, since retailers stand to infer a few potential financial advantages". Retailers adore gift cards much more than clients do. Gift cards prompt expanded deals, expanded showcasing opportunities, and help with income and stock administration. Gift

cards affect sales. On top of the underlying gift card buy, clients are nearly ensured to spend more than the measure of the gift card when they recover it. The way that valuing works, clients are to a great degree unrealistic to splendidly go through their Gift cards with no abundance paid out of pocket. Experts have demonstrated that according to a recent study conducted in 2016, clients spend a normal of 1.4 times the sum on their cards in the exchange where they reclaim them¹. The pervasiveness of gift cards as occasion endowments viably expands the holiday gift purchasing season, making the January and February blowout deals into probably the most lucrative non-occasion periods for retailers”. He ended his presentation by saying that the revenue generation from gift cards is from two sources: one when the gift cards are redeemed within the period and the other which the gift card has been purchased but customers fail to redeem them within the stipulated time. In this case income is generated but a corresponding sale of merchandise cannot be shown.

By the end of the presentation Mr. Gupta was convinced that the company is all set to introduce this concept in the store.

Post Implementation

Within few months of the presentation the store started to sell gift cards in denominations of Rs 500, Rs 1000 and Rs 5000. In less than few months more Than 20 percent of their sales came from sale of gift vouchers. But the main challenge the company was facing was with regards to reporting the revenue recognized from issue of gift cards because there is no prescribed reporting procedure laid down by GAAP. Each retailer uses their own discretion in deciding on the method of recording the revenue from gift cards in their books of accounts. The usual practice is, generally revenues is recorded when it is earned for financial accounting purposes, and when it is received for tax purposes.

At the point when an organization makes a gift card deal it gets money and creates an unearned revenue liability. At the point when the client redeems the card the retailer can fulfill the liability and recollects all incomes and related costs. In the event that the card goes unredeemed however the retailer can clear the risk and perceive the deal on the date of close, less any relevant escheat rates. Be that as it may if there is no termination date an organization ought to in fact leave the risk on its books inconclusively. Thus there is a huge divide of gift cards that never get

¹Article from https://www.firstdata.com/en_us/all-features/consumer-insights.html#keep-spending. And <https://www.softwareadvice.com/resources/how-to-increase-gift-card-sales/>

reclaimed, and retailers are extremely inspired by having the capacity to recognize this potential revenue. That portion of revenue a retailer earns from unredeemed gift cards are called “breakage” income.

The company’s current procedure to record the revenue from gift cards is to treat it as accounts receivable and thus follow the aging procedure. Estimation of breakage income was made based on the past patterns of unredeemed cards. The said procedure was not accepted by the auditor and a change in procedure was suggested. The accounts department is in a fix because of the absence of a prescribed procedure according to accounting concepts and conventions.

Exhibit I: Showing the main advantages of gift cards to the sellers

- **Increased Sales.** The gift card's product range alternative can induce hesitant purchasers to buy as against they may not generally make. Also, a gift card might instigate extra deals when the card is recovered. The prefixed gift card value will surely transform into a minimal purchase guarantee upon redemption. But there are all chances that the purchaser will spend much more than the redemption value as opposed to leaving a residue on the card.
- **Marketing Opportunities.** At the point when gift cards are utilized as a gift, they create promoting advantages by offering the retailer two client contacts and two deals opportunities, instead of one and only. Gift card exchanges likewise produce incremental data that the organization might have the capacity to decipher into extra future period deals through showcasing and limited time endeavors.
- **Cash Flow and Inventory Management.** Advantages to retailers are not constrained to client impacts. They are acknowledged through different parts of the retail operation. For instance, the postpone in the exchange of merchandise and administrations gives noteworthy and clear working income advantages to the business. This postpones additionally gives stock administration advantages. Since Gift cards are sold amid the Christmas shopping season and much of the time recovered amid off-regular periods, organizations may then give more prominent stock smoothing than would somehow or another be conceivable. Gift cards can likewise diminish general working costs.

- **Bottom Line:** Maybe the best advantage to retailers—and one that has unmistakable bookkeeping suggestions—is that chronicled buyer conduct drifts demonstrate that a parcel of numerous Gift card buys will never be reclaimed. The retail and managing account commercial ventures perceive the propensity of purchasers to leave Gift card adjusts unused and allude to the unspent adjust of a Gift card as breakage. Reported gauges of breakage by buyer investigate assembles change from 10% to 19%. Indeed, even by preservationist gauges, Gift card breakage can possibly essentially impact numerous organizations' main concerns.

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