Breakage Rules Finalized for Prepaid Cards

On March 8, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-04, *Liabilities – Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products*. The prepaid card industry is a $500 billion industry and growing, and many consumers fail to redeem the entire balance on these cards. "Breakage" refers to money received from prepaid cards but never redeemed by consumers. This ASU clarifies treatment of the liability existing between the card issuer and the consumer before redemption and eliminates current diversity in practice. The ASU incorporates the breakage guidance in the new revenue recognition standard, which would allow entities to derecognize the liability for outstanding balances when the likelihood of customer redemption becomes remote.

Background

Prepaid card arrangements have a wide variety of structures. In general, when a card issuer sells a prepaid card directly to a consumer, a liability is recognized for the issuer's obligation to provide the consumer with the ability to purchase goods or services at a merchant (either a single merchant or multiple unrelated merchants). When the consumer redeems the card, the liability between the card issuer and the consumer is extinguished. At the same time, the card issuer incurs a liability to the merchant, which is usually settled within a few days.

Previously, most prepaid cards were subject to front-end or back-end fees; card issuers used these to recognize card balances (including breakage) into income. As a result, additional guidance on derecognition of card liabilities was not needed. However, these practices are becoming more limited due to consumer preference and state consumer protection regulation that has banned issuers from charging back-end fees or instituting expiration dates on these cards. In addition, 32 states have exempted prepaid cards from unclaimed property escheatment rules.

Accounting Guidance

There is current diversity in practice in how card issuers classify prepaid card transactions. Some issuers separate the transaction into two obligations; the obligation to the merchant is settled in cash and would meet the definition of a financial liability, while the issuer's obligation to the customer is settled through the delivery of goods and services, which would not meet the definition of a financial liability. Other issuers view the activities as a single transaction—cash settled with the merchant—which would meet the definition of a financial liability.

Extinguishment of Liabilities

The current guidance in Accounting Standards Codification (ASC) 405-20-40, *Extinguishment of Liabilities*, covers both financial and nonfinancial liabilities. Derecognition is permitted for a liability "if and only if it has been extinguished." However, the threshold for extinguishment is high: delivery of cash or other financial assets, goods or services or being legally released either by the creditor or judicially. Prepaid product breakage, absent expiration dates or escheatment law, doesn't meet these criteria. This leaves some issuers with a growing "immortal" liability balance for unredeemed cards.

Revenue Recognition Guidance

In May 2014, FASB issued Topic 606, *Revenue from Contracts with Customers*, which includes authoritative breakage guidance effective for public companies beginning in 2018. The new revenue guidance requires an entity expecting to be entitled to breakage to recognize the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the cardholder. If an entity doesn't expect to be entitled to breakage, it would recognize the expected breakage amount as revenue when the likelihood of the cardholder exercising its remaining rights becomes remote. However, the scope of the revenue guidance excludes financial instruments covered by ASC 405. Upon the effective date of Topic 606, a card issuer's classification of the liability as either financial or nonfinancial would determine whether and how the issuer could account for the breakage.

For financial liabilities, Topic 405 would continue to apply; for nonfinancial liabilities, the less restrictive breakage guidance in Topic 606 would apply.

Scope

The original proposal's scope was narrowly drawn, as FASB expressly didn't want to include similar breakage issues related to airline points and rewards programs. Feedback favored broadening the scope, and the final standard reflects a more principle-based approach with specific scope exclusions. The ASU defines prepaid stored-value products in physical and digital forms with stored monetary values redeemable for goods, services or cash at the product issuer or third-party locations. This would include, among other items, prepaid gift cards, e-cards, phone calling cards and traveler's checks. Scope exclusions include products covered by escheatment laws, debit cards and products that can be redeemed only for cash. Examples of items redeemable only for cash and excluded from the standard include nonrecourse debt instruments, bearer bonds and trade payables. The ASU wouldn't apply to customer loyalty programs or transactions within the scope of other guidance such as revenue recognition.

Breakage Recognition

The ASU addresses the current and potential diversity in practice related to breakage on prepaid products by clarifying that liabilities related to certain prepaid stored-value products are financial liabilities. In addition, the update creates a scope exception within ASC 405-20 to require that breakage be accounted for in a manner consistent with the guidance in the revenue recognition standard:

> *If an entity expects to be entitled to a breakage amount for a liability resulting from the sale of a prepaid stored-value product, the entity shall derecognize the amount related to the expected breakage in proportion to the pattern of rights expected to be exercised by the card holder only to the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently occur. If an entity does not expect to be entitled to a breakage amount for prepaid stored-value products, the entity shall derecognize the amount related to breakage when the likelihood of the customer exercising its remaining rights becomes remote.*

Entities would be required to disclose the methodology used and significant judgments made in calculating breakage. The prepaid liability would be subject to the disclosure requirements for financial liabilities in Topic 825, *Financial Instruments*, but entities are excluded from the fair value disclosure requirements.

Transition & Effective Date

The ASU can be applied on a modified retrospective or full retrospective basis. For a modified retrospective transition, a cumulative catch-up adjustment would be made to retained earnings as of the beginning of the annual period of adoption. An entity applying a full retrospective transition also could take advantage of any practical expedients provided in the revenue standard.

The ASU has the same effective dates as the revenue recognition standard. For public business entities, adoption is required for annual and interim reports beginning after December 15, 2017. All other entities would apply the guidance to annual reporting periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019. Early adoption is permitted, including adoption prior to the adoption of the revenue standard. For additional information, contact your BKD advisor.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com