



Gift Card Accounting

by Glenn E. Atkins, CFA

Major retailers, or any retailer for that matter, have a love-hate relationship with the gift-card phenomenon of recent years. Retailers love it because they get cash up front. Conversely, they hate it because it makes sales and inventory planning much more difficult. Too, margins can be negatively affected as expected holiday sales are pushed into January and beyond as customers wait for bargains.

The retailers dilemma is how much and what kind of inventory to stock. Sixty to seventy five percent of gift cards are used within one month according to mall tracker Shopper Track RCT. Conversely, between 2% and 15% of gift cards are never redeemed according to Price Waterhouse. The other piece of good news for retailers is that purchases typically exceed the face value of the card by as much as 15% on average.

"The retailer has a strong profit incentive to keep inventory lower and to resist discounting until the last possible moment."

At first blush an analysis of gift card accounting seems fairly straightforward. However, it can leave retailers with a sense of confusion. When the gift card is purchased, cash comes in as an asset on the balance sheet and a corresponding liability is recorded as deferred sales. The real complicating factor from a financial analysis and accounting perspective is that no sale is recorded until the card is redeemed. So, you have cash in with a corresponding liability and no sales or income to report. Inventory is higher than it would have been if the customer had purchased an actual gift. The trouble is the retailer doesn't know with certainty when the customer will purchase, if at all.

The retailer has a strong profit incentive to keep inventory lower and to resist discounting until the last possible moment. The difficulty from an analyst's perspective is that total sales and comparable same-store sales to some lesser degree, are skewed downward by the change in year-to-year gift card sales, as what would otherwise be holiday sales are pushed into January and beyond.

As gift cards become increasingly important, retailers are initiating several strategies to combat the uncertain nature and timing of future sales when the cards are redeemed. Federated Department Stores, for example, is increasing the amount and accelerating the delivery of spring merchandise into January in the hopes of capturing more immediate, and correspondingly higher margin sales, when the bulk of the cards are redeemed in January. After all, selling fully priced spring merchandise is better for the retailer than selling discounted holiday hold-over merchandise. This brings us full circle to the extreme necessity for retailers to properly manage holiday inventory, sometimes largely without knowing when and what the customer will purchase with their cards. Best Buy is taking a similar approach by increasing the inventory of video games, CD's and videos early in January after analyzing top selling categories from years past.

My best guess is that same-store sales are becoming increasingly less reliable as a metric for tracking retail sales during the holidays. For example, if you don't add back the increase in gift card sales from one year to the next, it seems to me that total (and for that matter same-store, to a lesser degree) sales are under-reported by a like amount. I'm not sure what the analytical answer is to this, but it sure makes financial statement analysis more difficult and muddies the water as far as using same-store sales as a concurrent measure of the retail environment during the crucial holiday shopping period. ■