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Unused gift cards deliver $43 million to Home Depot

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The huge profitability of gift cards to American retailers became clearer than ever June 2, when The Home Depot Inc. said it has taken in $43 million in income from gift cards that are unlikely to be redeemed.

The nation's No. 2 retailer (NYSE: HD) recognized the gain from gift card "breakage" for the first time ever, in a quarterly filing with the Securities and Exchange Commission. Breakage is the balance remaining on gift cards that a retailer can claim when the cards expire, are lost or are unused for a lengthy period.

An estimated $55 billion worth of gift cards were sold in 2004, according to John Gould, director of bank cards at TowerGroup, a financial services consulting group outside of Boston. About 10 percent of the value of gift cards sold in the United States goes unused, as consumers "put them in their back pockets and forget about them," Gould said.

Home Depot tallied gift card breakage from 1998, when it began its gift card program, to 2001, and reported it as income in its June 2 filing.

"Since we had not reported breakage before, this was essentially just catching up," said Home Depot Marketing Manager Diane Linke. "Going forward, there will be additional breakage reports, but not nearly on the magnitude of this quarter."

The company's breakage reporting "will never affect a customer that has an unused gift card," Linke said, because Home Depot's gift cards do not have expiration dates or fees for nonuse. "If there is a remaining balance on the card, the customer will always be able to use that card and be assured that the money is there and available for them to redeem," she said.

The $43 million recognized as gift card breakage "was based upon historical redemption patterns and represents the remaining balance of gift cards for which the company believes the likelihood of redemption by the customer is remote," the company said in the filing.

Seattle-based Starbucks Corp. (Nasdaq: SBUX) sold 21 million gift cards in 2004, worth a total of $312 million, said Nick Davis, company spokesman.

Other retailers, such as Wal-Mart Stores Inc. (NYSE: WMT), the nation's largest retailer, and Best Buy Co. (NYSE: BBY), do not disclose gift card sales, according to company spokesmen.

Retailer liability

But a search of SEC filings shows big retailers carry gift card liabilities on their financial statements. Best Buy reported $410 million in gift card liabilities, meaning the company expects

$410 million worth of gift cards to be redeemed at some point by customers who bought them. Lowe's Cos. (NYSE: LOW) has reported $264 million in gift card liabilities, Target Corp. (NYSE: TGT) $214 million, and Pier 1 Imports Inc. (NYSE: PIR) $63 million.

Home Depot chose to report the gift card breakage as income, Linke said.

"If you don't report breakage, you have to report that as a liability, and we just thought it was time to catch up on that span of years 1998 to 2001," she said in an e-mail statement. "Nothing grander than that."

Gift cards were the No. 1 gift this past holiday season, usurping apparel, said Thomas Miezejeski, vice president of The Pelorus Group, a New Jersey-based research firm.

They're so popular they have affected the way retailers record sales, he said. A customer buys a gift card over the holiday season, but that gift card may not be spent for months to come, Miezejeski said.

"It doesn't show up as a transaction until it gets used," he said. "So they have to record it as a liability. At some time in the future you will present that card."

For some retailers, it meant a nice bump in January sales, which they were not expecting, "because people were using their gift cards," Miezejeski said.

Miezejeski believes the gift card industry is underreported.

If bank-issued gift cards, such as Visa gift cards, are included in industry figures, Miezejeski estimates $94.8 billion worth of gift cards were issued last year. He estimates $109 billion worth will be sold this year and $120 billion worth next year.

"Gift cards have experienced strong growth over the past few years," said Jay Musolf, spokesman for Richfield, Minn.-based Best Buy. "We really believe gift cards are all about convenience."

And gift cards are beginning to become something more like a cash card -- like Starbucks' Duetto reloadable card, Miezejeski said.

"People find these more convenient to use than cash," he said. "With the reloadable [gift] cards, it's like having a bank account. You will always have some money in it."

To fee or not to fee

Consumer advocate Clark Howard said he despises gift cards for the very reasons Home Depot and other retailers love them.

"You are taking American money that is good anywhere, has no fees, no expiration date, and exchanging it for a piece of plastic that may have an expiration date, inactivity fees, and is only good in one store. It is a big con game of the American people."

Some states are putting retailers on notice about inactivity fees and other fees some companies charge for customers to use -- or not to use -- the gift card.

A dozen states have enacted statutes governing gift cards and more than 70 legislative proposals in 31 states are pending, TowerGroup's Gould said in his report.

Georgia legislators recently passed a law requiring retailers to be more upfront about expiration dates for gift cards and dormancy or nonuse fees associated with gift cards, but did not outlaw such fees. The law doesn't go into effect until Oct. 1.

Gift cards purchased at Home Depot, Pier 1 Imports, Best Buy and Wal-Mart do not have expiration dates, nor do they charge inactivity fees or service fees, company representatives said.

Earlier this year, New York Attorney General Eliot Spitzer filed suit against Simon Property Group Inc. (NYSE: SPG), the nation's largest shopping mall owner and operator, over New York's gift card law that went into effect Oct. 18, 2004. New York's law prohibits retailers from charging monthly service fees on gift cards until the card has been unused for 12 months. Simon Property Group, which has 10 malls in New York, had been charging a $2.50 administrative fee on gift cards just seven months after their purchase.

Spitzer and Simon Property Group settled the case less than a month after it was filed, with Simon agreeing to pay New York $100,000 in penalties and $25,000 in costs.

Simon owns six malls in Atlanta, including Phipps Plaza and Lenox Square.

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