WHITE PAPER

MERCHANT ACCOUNT BASICS

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TABLE OF CONTENTS

INTENDED USE 2

BACKGROUND 2

ACCEPTING CREDIT CARDS 3

Why Accept Credit Cards? 3
What Do I Need To Accept Credit Cards? 3
What Is A Merchant Account? 4
Where Do I Get A Merchant Account? 4
Choosing the Right Merchant Account Provider 6
Understanding Your Unique Needs 6
Understanding Merchant Processing Rates and Fees 7
Merchant Account Fee Example 9
What to Look For When Selecting a Merchant Account 10
Signing Up For a Merchant Account 13
Evaluating Your Risk 14
Who to Contact 16
Completing the Application 17

PROCESSING CREDIT CARDS 18

How Does Credit Card Processing Work? 18
Understanding How the Information Flows 20
Understanding How the Funds Flow 20
Availability of Funds 21
Holdbacks and Reserves 21
Chargebacks 22
Processing Options 22
Equipment 23
Software 24
Payment Gateway 24
Virtual Terminal 25
What Information Do I Need To Collect? 26

OTHER CONSIDERATIONS 27

Fraud and Security Considerations 27
Automated Web-Based Invoice Payments 28
Recurring Payments 29

GLOSSARY OF TERMS 31

ABOUT THE AUTHOR 35

INTENDED USE

This paper is intended as an informational guide for individuals and businesses. The primary purpose is to present general information to be considered by merchants when deciding to accept credit cards in a business.

This paper is not intended to recommend a single company or individual solution for the needs of a merchant. It does, however, recommend key criteria to be used when selecting a merchant account provider.

BACKGROUND

If you are planning to accept credit card or debit card transactions for your business, you will need your own merchant account. A merchant account is not a bank account and should not be confused with your existing business checking account. Instead, a merchant account is a business relationship you establish with a merchant account provider, and ultimately with a bank, that allows you to charge your customer's credit cards for their purchases. In this relationship, the bank is responsible for debiting the funds from the customer's credit card account and depositing the funds into your existing business checking account. You, the business operator, are responsible for properly verifying the credit card information supplied by the customer, obtaining the necessary authorization from the customer, and for following all other credit card processing guidelines outlined in the agreement signed with your merchant account provider.

> ***TIP:*** *Never use a third-party to process credit card transactions for your business. For example, if you or a friend of yours also runs a small retail business, never process your credit card transactions through the merchant account for that business. Not only is this a bad business practice, but also the business that processes the transaction will likely be violating the terms of their merchant agreement, which could result in termination of the merchant account and permanently restrict that business and your business from ever accepting credit cards in the future.*

ACCEPTING CREDIT CARDS

Why Accept Credit Cards?

The primary reasons for accepting credits card as a form of payment are convenience and flexibility. Nearly all adults now carry at least one or more credit cards with them at all times. They are easy to use, relatively safe, and provide an excellent audit trail for payment transactions. For consumers, they offer a flexible way to manage personal cash flow and make impulse purchases that can be paid off over time.

For retailers, the benefits of accepting credit cards are clear -- increased sales. For other businesses, such as mail order sales, telephone sales, Internet sales, and online bill payment, credit cards are now the most widely used form of payment, as the handling of cash and paper checks in these businesses is both inconvenient and time consuming.

What Do I Need To Accept Credit Cards?

If you want to accept credit cards, you will need the following items:

- You must obtain a credit card processing merchant account.
- You must be in some sort of business, such as retail, mail order, hospitality, e-commerce, or property management. You cannot obtain a merchant account for personal use.
- If you are opening a merchant account in the US, you will need either a Social Security Number (SSN) or a Federal Tax ID number.
- You must have a bank account from a US bank to receive the funds from your credit card transactions.
- You must have a US mailing address.
- You will need a way to submit credit card transactions to your merchant account provider, such as a point-of-sale (POS) terminal, a credit card processing software program, or a payment gateway.

What Is A Merchant Account?

A merchant account is a relationship you have with a bank or financial institution. As a business operator, a merchant account gives you the ability to charge a customer's credit card for goods and services. The bank, in turn, accepts the responsibility of processing the credit card transaction, debiting the funds from the customer's credit card and depositing them into your business checking or savings account. As a business operator, your obligation is to provide the services being billed to your customers in a timely and professional manner.

Merchant account providers must follow strict industry guidelines when allowing businesses to accept credit cards as a form of payment. Essentially, the merchant account providers act as middle-men between the business and the card associations to ensure that businesses comply with those industry requirements. Because the bank is forwarding money to the business in hopes that it will be collectible from the cardholder, there is a certain amount of risk and liability on the part of the business operator, which must be assessed and continually managed by the merchant account provider.

One or more merchant accounts are required to enable you to accept credit card transactions. In the United States, financial institutions are allowed to be members of both the Visa and Mastercard card associations. This ability is identified by the term "duality". However, obtaining a merchant account that allows you to process both Visa and Mastercard transactions does not automatically give you the ability to also accept American Express and Discover transactions. You must open a separate merchant account with each of those organizations. As a result, you will usually need to obtain more than one merchant account for your business.

Where Do I Get A Merchant Account?

There are many types of merchant account providers available to assist you when looking for a merchant account. The type of provider and the services provided are equally important in making your decision. Having a good understanding of the options will help you make an educated decision when selecting your merchant account provider.

Local Bank - Although your local bank may be a great place to start, most banks are too accustomed to working with retail (card present) merchants and generally consider mail order, telephone order, and

Internet businesses (card not present transactions) too risky for their tastes. Since credit card processing regulations differ between card present and card not present transactions, banks that favor retail businesses are unlikely to be able to provide the necessary support to keep you processing within industry guidelines.

Walk-In Salesperson - If you operate a retail business, you are no doubt familiar with the walk-in merchant processing salesperson claiming to provide a turnkey solution at the lowest rates available anywhere. These salespeople are usually commissioned agents, working for large electronic clearinghouse providers. Unfortunately, they may not always be looking out for your best interests.

TIP: *Beware of any offer from a walk-in merchant account salesperson that sounds too good to be true. It usually is! Merchant account processing is riddled with hidden charges, certainly the last thing a salesperson wants to disclose during a walk-in sales call.*

Internet - Offers for merchant account services sent by e-mail or listed on the Internet are often more risky than those offered by merchant providers who employ walk-in sales people. Acquiring banks often utilize independent sales organizations (ISO's) or sales agents to sell merchant accounts. Because it is inexpensive and easy to operate a small business anonymously on the Internet, individual sales agents often attempt to pass themselves off as large merchant providers. As a result, they are unable to provide the necessary service and support to the clients they attract.

Merchant Processing Specialist - A merchant processing specialist is a professional organization dedicated only to the sales and support operations associated with merchant accounts. A specialist of this type may be a sales and support division of a large acquiring bank, or may be an independent organization with a strong relationship with one or more acquiring banks.

Merchant account specialists often service a unique industry vertical (such as restaurants or catalog houses) or a particular merchant type (such as retail or Internet merchants). They are often capable of providing custom payment processing solutions and tailored services to meet the needs of their merchants.

These organizations typically employ highly trained professionals and knowledgeable support personnel to assist the merchant in all aspects of accepting, processing, and reconciling credit card transactions.

Choosing the Right Merchant Account Provider

Building a sound business means dealing with quality suppliers and service providers. You should carefully select the best merchant account provider to fit your specific business needs, taking into account your business structure, the types of goods or services sold, and the way in which you will accept payments.

Although it may be difficult to sort through the myriad of options available in the marketplace, choosing an incorrect solution, or choosing the cheapest solution may cost you in the long run. Poor customer service, extended downtime, inflexible policies, and outrageous hidden fees are all symptoms of this problem. They could cost you customers and ultimately cost you your business.

Understanding Your Unique Needs

Just as all businesses are not the same, the services offered by the various merchant account providers may be significantly different. A good understanding of your own business needs will help you select the provider that can best meet your credit card processing needs. Knowing the answers to the following questions will be helpful as you begin your search:

- What type of business are you in? (Retail, Mail Order, Internet, etc...)
- Are you providing a physical product or a service?
- Will the credit card be present when accepting the payment?
- Will you have the ability to collect the cardholder's signature?
- What will be the average dollar amount of your transactions?
- How many transactions will you process each month?
- Will you need to process the transactions in real-time (immediately) or can they be processed later in a batch?

Understanding Merchant Processing Rates and Fees

There are a number of important fees to consider when selecting a merchant account. The fees that matter the most are those that apply to each payment you process: the discount rate and the per transaction fee. Understanding these fees will help you make the right selection for your business.

Although there are merchant account providers that claim to offer the best rates or the lowest rates, your actual rates will depend on three factors: risk, average transaction amount (also known as average ticket price) and volume. The accounts with the lowest rates are the ones where the customer is present and the card is swiped. On the other hand, Internet transactions are most risky because neither the card nor the customer is present.

What follows is an explanation of the various fees you might encounter when processing credit cards.

Application Fee – This is the fee for processing your merchant account application and setting up your merchant account. Depending on the provider, these fees can range anywhere from $99 up to about $500.

Transaction Fee – A fixed fee for each transaction typically charged by the merchant account provider to cover their costs of support, including the support of any equipment and services you may use. These fees can range anywhere from a few cents up to $0.50 per transaction. If you are performing a small number of high dollar amount transactions, this fee will mean far less than if you are performing a large number of low priced transactions.

Discount Rate – The discount rate is a fee calculated as a percentage of the total dollar amount of each transaction, including shipping, taxes, and other charges you may add. This discount rate is paid to the card association (Visa, Mastercard, etc...), the issuing bank, the acquiring bank, and the merchant service provider, each of which participates in the transaction. Expect anywhere from 1.5% up to 4% depending on the type of business, the type of transaction, and the type of card used for the payment. Some providers may also charge this fee on refunds but many only assess the discount rate on the net sales (sales less refunds) for the month.

Batch Deposit Fee – All of the transactions processed in a single day are grouped into a batch. Each daily batch is processed as a group, with a single deposit made within a few days. A batch deposit fee refers to a fee you pay each time a deposit is made to your business checking or savings account. These fees range from nothing to approximately $.35 per deposit.

Minimum Monthly Fees – Many merchant account providers will attempt to charge you a minimum fee even if no transactions are processed within a specific month. For example, if your processing fees do not total more than a minimum threshold for the month, you will be charged a flat monthly minimum. These monthly minimums can range from $20 to $50 per month.

Statement Fees – The statement fee, if applicable, is charged by the merchant account provider each month to process and send your statement. Typical statement fees range from $5 to $35 per month.

Chargeback Fees – A chargeback occurs when a customer disputes a charge by contacting the credit card issuer directly. If a customer does not recognize a charge, believes the amount is incorrect, or does not believe they purchased the item from you, they will ask the credit card issuer to initiate a chargeback. Depending on the type of dispute, the card issuer will either issue a retrieval request (a request for proof of the transaction) or immediately issue the chargeback. In addition to losing the full amount of the transaction, and the processing fees originally paid, there is also a chargeback fee of between $10 and $35 per chargeback.

Payment Gateway Fee – If you are using a payment gateway to process transactions in real-time, there may be an additional transaction fee, monthly fee, or monthly minimum fee that applies. Typical payment gateway fees range from $0.10 to $0.30 per transaction, with a monthly fee or monthly minimum of approximately $25.

Address Verification Service (AVS) Fee – Although rare, some merchant account providers actually charge a transaction fee for using the address verification service. If applicable, these fees range from approximately $0.02 per transaction to as much as $0.10 per transaction.

Over Limit Fees – As a fraud protection measure, most merchant accounts have a monthly processing limit, set by either the estimated monthly volume indicated on your merchant account application or by your processing history. If this limit is exceeded, the merchant account provider may suspend delivery of your funds and/or charge an over limit fee until you provide a written explanation for the increase in monthly volume.

Merchant Account Fee Example

Let's say your business could sell 25 units per month to a customer offering to pay with a credit card, each unit selling for an average of $750. You have received proposals from two different merchant account providers, as follows:

	PROPOSAL A	**PROPOSAL B**
Monthly Fee:	$20.00	NONE
Statement Fee:	NONE	$10.00
Monthly Minimum:	NONE	$35.00
Transaction Fee:	$0.10	$0.35
Discount Rate:	2.35%	2.30%

At first glance, Proposal A clearly appears to be the better deal because there is no statement fee, no monthly minimum, and a much lower per transaction fee. However, let's take a closer look:

	PROPOSAL A	**PROPOSAL B**
Monthly Fee:	$20.00	$0.00
Statement Fee:	$0.00	$10.00
Monthly Minimum:	$0.00	Will Not Apply
Transaction Fees: (25 transactions)	$2.50 *(25 x 0.10)*	$8.75 *(25 x 0.35)*
Discount Rate: (25 x $750 = $18,750)	$440.63 *(18,750 x 0.0235)*	$431.25 *(18,750 x 0.0230)*
TOTAL:	**$463.13**	**$450.00**

The above example shows the importance of carefully analyzing each proposal to determine which offer is better for your business. Because the average transaction size in this example is relatively large ($750), the difference in the two discount rates more than makes up for the difference in transaction fees. As the average transaction price starts to fall, the fixed transaction fee will have a larger impact on your overall pricing. Always be sure to consider the proposed rates with a real example, such as the one above, to clearly determine which merchant account provider is offering the best solution for your business.

A final consideration regarding rates is an understanding of the difference between a tiered rate and a blended rate. In a blended rate, you will pay one transaction fee and discount rate for all of your domestic transactions, regardless of the type of transaction or type of payment. In a tiered rate, the transaction price and discount rate fall into three categories, called tiers, similar to the groupings in the following chart:

	Qualified Rate	**Mid-Qualified Rate**	**Non-Qualified Rate**
All Merchants	Close Batches Daily	Close Batches Daily	Not Closing Batches Daily
Retail Merchants	Swiped & Electronically Authorized Charges	Manually Keyed Orders using AVS and Order Numbers	Not using AVS or Not providing Order Numbers on Manually Keyed Transactions
Mail Order Telephone Order Internet Order Merchants	Electronically Authorized Charges using AVS and Order Numbers	NOT AVAILABLE	Not using AVS or Not providing Order Numbers on Manually Keyed Transactions
High Risk Merchants	NOT AVAILABLE	NOT AVAILABLE	All Transactions

NOTE: The above table shows only a sample of how transaction fees may be tiered. Actual tiered structures vary by card association and card type.

What to Look For When Selecting a Merchant Account

Although transaction fees and discount rates vary greatly from one merchant account provider to another, they all provide a common set of standard features as shown in the following table.

	STANDARD FEATURE	**OPTIONAL FEATURE**
The ability to process credit card transactions and issue refunds.	X	
Deposits funds directly to a business checking or savings account.	X	
Provides address verification service (AVS).	X	
Provides customer support for transaction processing issues.	X	
Provides a monthly statement outlining fees and deposits.	X	
Performs chargeback processing.	X	

Sends retrieval requests for transaction verification.	**X**	
Provides processing equipment and/or software.		**X**
Provides supplies for processing equipment.		**X**
Provides customer support for processing equipment.		**X**
Provides for debit card processing.		**X**
Offers processing of Internet transactions.		**X**
Supports business cards, purchasing cards, and commercial cards.		**X**
Supports private label cards.		**X**
Supports Level II and Level III processing.		**X**
Offers multi-currency processing.		**X**
Provides a web-based interface for viewing transactions.		**X**
Provides a virtual terminal feature.		**X**
Provides for online chargeback and retrieval request processing.		**X**

See the Glossary for a more comprehensive description of the above features.

Armed with an understanding of your merchant processing needs, the rates and fees associated with merchant processing, and the optional features available to merchants, you should be able to easily create a list of questions to ask a prospective merchant account provider.

Here is a general list of questions that you should ask of every merchant account provider you are considering. Even if some of the questions don't fit your current business needs, you should still obtain an answer, as your business may change in the future.

1. What is the application fee?

2. Is the application fee refundable if I do not get approved?

3. Is there a fee to terminate the merchant agreement?

4. What credit cards can be processed?

5. What is the transaction fee?

6. What is the discount rate?

7. Does the discount rate apply to every transaction or only to net sales volume (sales less credits)?

8. Is the discount rate a blended rate or a tiered rate?

9. Is the discount rate paid at the end of the month or is it deducted from the daily deposits?

10. How soon after settlement are funds deposited into my bank account?

11. Are there extra fees for processing American Express or Discover transactions?

12. Are there fees for using the address verification (AVS) service?

13. Is there a reserve amount required?

14. Is there a minimum monthly billing requirement?

15. Are there monthly statement fees?

16. Is there a batch deposit fee?

17. What are the chargeback fees?

18. Is voice authorization available? What are the fees?

19. How is customer support obtained and when is it available?

20. Is any equipment required?

21. If equipment is required, what are the costs?

22. What is the equipment warranty?

23. Are there any equipment installation or programming fees?

Regardless of how a merchant account provider may answer the above questions, you should always follow these guidelines when making your final decision:

- Look for merchant providers who deposit funds quickly.

- Look for merchant providers who do not charge extra fees for refunds.

- Look for merchants who take their fees out once per month, not out of the daily deposits.

- Look for a merchant account provider that does not charge for using the AVS service.

- If you will be doing a combination of card present and card not present transactions, be sure to determine whether or not a blended rate is better than a tiered rate.

- Do not work with a merchant account provider that forces you to purchase or lease processing equipment or will not allow you to use your own software or a third-party payment gateway for processing transactions.

- Make sure the merchant provider has other clients similar to you in terms of business model and payment type.

Finally, consider the fact that if you are dealing with a merchant account provider who is willing to quickly lower their monthly fees to get your business, it is likely that they have lowered their fees in the past and have many small clients paying lower fees. Smaller clients tend to consume more customer service resources, thereby burdening the merchant account provider with lower profitability and fewer customer service representatives to assist you when you need service. Ask about their customer service staffing and hours. Good customer service is as important as fair rates. What you may give up in upfront or ongoing fees may cost you dearly when you need customer support because you can't process payments.

> ***TIP:*** *Before making your final selection, verify that the merchant account provider you select is in good standing with the Better Business Bureau. Just because a provider answers your questions adequately, or just because they may appear genuinely interested in your business, does not mean other businesses have not had difficulty in working with them.*

Signing Up For a Merchant Account

Once you've selected the right merchant account provider for your business, the application process is relatively simple and will usually take anywhere from a few days to a few weeks to complete. Once the application is approved, it could take a few more days for your account to be activated.

TIP: *Once your merchant account has been activated, always perform a test transaction on each type of credit card you will be accepting to verify that everything is working properly. Make sure your test includes checking to ensure the funds arrive correctly into your business checking account.*

Because the processing of credit cards and electronic payments is governed by numerous federal regulations and credit card association guidelines, there are elements of risk that will affect both your ability to obtain a merchant account and the fees you will pay. It is important to understand the risks and know how they apply to your business before beginning the application process.

Evaluating Your Risk

The average approval rate for small business merchant accounts is approximately 98%. Keep in mind that the credit card associations, Visa, Mastercard, etc., want you to be able to accept their cards so the cardholders have more places to use them. The small percentage of business owners that do not get approved for a merchant account, are usually declined for one of the reasons discussed in the following sections.

TIP: *If for any reason you think you may not be approved for a merchant account, be sure and find out whether or not the application fee is refundable if you are declined. Not all merchant account providers will refund the fee… some may only refund a portion of the fee or none at all.*

Type of Business - Certain types of businesses are considered high risk because of either the way the business operates or because of the type of products sold. For example, any non-retail business in which the cardholder and/or the credit card are not present at the time of the transaction (such as mail order, telephone order or Internet sales) is considered to have a higher risk. Of even greater risk are businesses that historically have a high degree of fraud, such as adult products (where the cardholder may not want to be known), gaming and other illegal activities, products with a large resale value (electronics and printer ink), products without guaranteed results (such as home remedies, vitamins and diet aids), and any product or service that is not delivered at the time the credit card is charged (travel agencies, etc.).

Use the following diagram to determine how much risk your business may have:

Business Type Risk Scale

MOST RISKY	Internet Transactions	• Customer Is Not Present • Credit Card Is Not Present • Easy to Falsify Buyer's Identity
	Mail Order Telephone Order	• Customer Is Not Present • Credit Card Is Not Present • Valid Shipping Address Is Required • Signature or Voice Makes it More Difficult to Falsify Buyer's Identity. • Credit Card Number Is Manually Keyed
	Travel & Entertainment (Restaurant and Hotels)	• Customer Is Present • Credit Card Is Present • Authorization and Settlement Amount Are Usually Different • Signature Is Captured • Credit Card Is Usually Swiped
LEAST RISKY	Retail	• Customer Is Present • Credit Card Is Present • Amount Is Know At Time of Payment • Signature Is Captured • Credit Card Is Swiped

Business Location – If your business is located outside the United States or if one of the principal business owners lives outside the United States, you will have difficulty obtaining a merchant account.

Processing History – Visa and Mastercard maintain an association-wide list of previously terminated businesses and individuals, called the TMF or terminated merchant file. If you previously encountered a problem with processing credit card transactions, or if you ever had a merchant account terminated for fraudulent transaction processing or failure to deliver services that were paid for by cardholders, you may have been listed on the TMF.

Background – If you have any type of criminal record or if your credit history shows a previous bankruptcy for a business you owned or for yourself individually, your application for a merchant account will most likely be declined.

Meeting one of the above criteria does not necessarily mean you will never get a merchant account. You may need to locate a merchant provider that specializes in providing services to "high risk" merchants.

If you are considered "high risk", the processing bank may require a security deposit or impose a holdback reserve. This lessens the risk taken by the bank because it ensures funds are available if a cardholder disputes a charge. Remember, if you are considered high risk, the card associations still want you to accept payment by credit card, they are simply attempting to minimize their own risk by charging a higher rate or requiring a reserve.

Who to Contact

Visa/Mastercard:

CoVantage Processing, LLC.
6077 Far Hills Avenue
Suite E
Dayton, OH 45459
1-866-788-0865
www.covantageprocessing.com

American Express:

American Express Company
World Financial Center
200 Vesey Street
New York, NY 10285
www.americanexpress.com
1-888-829-7302

Discover:

Discover Financial Services, Inc.
2500 Lake Cook Road
Deerfield, IL 60015
www.discovernetwork.com
1-800-347-6673

Completing the Application

Regardless of the merchant account provider you select, you will always need to complete and sign a merchant account application. The type of information required for the application typically includes the following:

- The Name and Address of Your Business
- Your Social Security Number or Business Federal Tax ID Number
- Type of Ownership (Corporation, Partnership, Sole Proprietorship)
- The Length of Time In Business
- A Description of the Business
- The Internet Address (URL) of Your Business
- Your Method of Advertising
- Your Anticipated Annual Credit Card Volume (in Dollars)
- Your Anticipated Average Amount Per Transaction (Average Ticket)
- A List of The Principal Owners and Their Addresses
- Bank and Business Trade References

In addition to completing the merchant account application, you should also be prepared to provide the following items:

- Business Financial Information
- Personal Financial Information for the Principal Owners
- A Copy of Your Advertising Materials

- A Photograph of Your Location of Business
- A Copy of a Current Business License and/or Articles of Incorporation
- A Voided Business Check
- A Copy of Merchant Accounts Statements From A Previous Merchant Account Provider

Finally, if you are a small business owner and do not have audited financial statements, you will likely be asked to sign a personal guarantee on the funds processed through your merchant account.

PROCESSING CREDIT CARDS

How Does Credit Card Processing Work?

You may wonder why the credit card companies make it so difficult to accept credit card payments or why, as a business owner, you shouldn't automatically have the right to accept credit cards. To answer these questions, you will need a basic understanding of how credit card processing works.

From a purely financial standpoint (in other words from the viewpoint of a bank), credit card processing is simply a form of receivables financing. A bank (in this case your merchant acquiring bank) is forwarding you the payment on the promise that you will deliver the products or services as advertised and on the hope they will later be able to collect the funds from the cardholder. As a result, the bank is accepting certain risks in return for a portion of the payment (your discount rate and transaction fees).

The Highway to understanding the process of a typical credit card transaction

Understanding How the Information Flows

1. The payment information is collected either by having the physical credit card or by obtaining the card number and expiration date from the cardholder. NOTE: If the payment information is collected over the Internet, it must be collected using an SSL (secure socket layer) encrypted web page.

2. The payment details are electronically transmitted to the processing network by using either a dial-up terminal or a payment gateway.

3. The processing network communicates with the issuing bank (or with American Express or Discover directly) to obtain an authorization. The address verification (AVS) information is also returned. It is important to note that an authorization does not automatically cause the funds to be transferred to your bank account.

4. The authorization response is returned electronically to requester.

5. At end of day, the merchant performs a settlement, also known as a capture transaction, to tell the processing network to actually fund the transaction.

6. The processing network instructs the card association to fund the transaction by depositing the transaction payments into the merchant's business bank account.

Tip: *It is important to understand that an authorization or approved transaction is not a guarantee that the credit card is good or that the cardholder is obligated to pay for the purchase. As a result, you may never actually receive payment for the transaction. Read your merchant agreement carefully to understand how the actual funding takes place and how disputes or chargebacks are handled.*

Understanding How the Funds Flow

1. The card association instructs the issuing bank to charge the cardholder's account and move the funds to the merchant's acquiring bank.

2. Funds are transferred from the issuing bank to the acquiring bank.

3. On the following day, once the acquiring bank reconciles its overnight receipts, the acquiring bank initiates an ACH credit to the merchant's business checking account.

4. On the next business day, the funds arrive in the merchant's bank account.

5. The issuing bank is left to collect the funds from the cardholder over time.

Availability of Funds

Depending on the agreement with your merchant processor, funds will be deposited in your business banking account within 2 to 30 days. Again, read your agreement carefully to determine when your transactions will be funded. In most cases, the funds should be available within 2 to 3 business days after the transaction is settled.

Banks will generally fund your transactions at their full value and then deduct their fees once per month. However, there are some merchant service providers that deduct all or a portion of the fees before the deposit is made. It is more difficult to reconcile your deposits if the fees are withdrawn before the deposit is made, so be sure and find out which method is used prior to signing your merchant agreement.

Holdbacks and Reserves

Holdbacks and reserves are a type of security deposit used by merchant service providers to offset risk that may be associated with your transactions. However, just because your business was not identified as "high risk" when you signed up for your merchant account, does not mean you will never be subject to a holdback or reserve. Therefore, it is important to understand what these two terms mean and when they might be used.

A reserve usually refers to a fixed amount held by the acquiring bank or merchant service provider as security to offset potential chargebacks in the future. The amount of the reserve is set based on your average transaction amount, your monthly volume, and the amount of risk on your transactions. A reserve is generally built out of processed funds by lowering your actual deposit.

A holdback is similar to a reserve but instead of setting a fixed amount a holdback is usually implemented as a delay in funding your transactions. For example, a holdback may be initiated on 20% of funds for a period of 3 months. In this case, if you were to process $1,000 worth of transactions today, instead of seeing a $1,000 deposit in 2 or 3 business days, you would only see a deposit for $800. The remaining $200 would not be deposit for another 3 months.

Even if your business was not originally subject to a holdback or reserve, you may be subject to one if there is a dramatic change in your business. Two typical examples would be a rapid increase in sales or a high number of disputed transactions.

> ***TIP:*** *Because there is also a risk of merchant fraud, the acquiring bank and merchant service provider may not be required to provide you with advance notice when a holdback or reserve is established. Be sure to reconcile your deposits on a regular basis, daily or every other day, to ensure that the expected amounts are being deposited.*

Chargebacks

A chargeback is an automatic refund issued to a cardholder for a disputed or fraudulent transaction. Transaction disputes can either be initiated by a cardholder or by an issuing bank and, based on the reason for the dispute, may result in a chargeback. When a chargeback occurs, the transaction amount is automatically deducted from the merchant's business bank account pending the outcome of the dispute. Most often, chargebacks occur as the result of fraud, usually because a cardholder's account is used without his or her knowledge.

The card associations keep a close watch on the chargeback ratio (the dollar value of chargebacks as compared to the dollar value of valid transactions) for each merchant. If a merchant's chargeback ratio reaches 1% or more for an extended period of time, the merchant service provider may initiate a holdback, may levy a fine, or may terminate the merchant account.

Processing Options

After you have selected a merchant service provider, you will need to determine how to process your transactions. Processing refers to the way in which you transmit the credit card transactions to the processing network. The method you choose will be determined by the type of business you conduct. For example, if you are a retail merchant, you will usually employ some type of card swipe or point-of-sale (POS) terminal that will use either a dial-in or dedicated connection to one of the processing networks. Visa and Mastercard will require that you use equipment, software, or gateway providers that are compliant with their processing regulations, so be sure to thoroughly research your options before making a selection.

> ***TIP:*** *You do not have to use the equipment or software suggested by your merchant service provider. Make sure the option you select best fits the needs of your business and meets the Visa and Mastercard processing regulations.*

Equipment

Physical terminals, also know as POS (Point-of-Sale) terminals or swipe terminals, are typically used to process credit cards in a retail environment. These terminals include a numeric keypad, a magnetic reader, and a digital readout or printer. POS terminals connect to any existing phone line and are either purchased or leased from the merchant service provider.

You will also need a printer if you want to generate paper sales receipts and capture customer signatures.

When a mail order or telephone order (MOTO) merchant uses a POS terminal, they must manually key in the credit card number and other purchase information.

Terminal costs can range from $199 to $2,000 or more, even though they are all basically the same. Many merchant account providers require that you purchase or lease equipment from them, including requiring you to purchase supplies, such as paper and ink.

> ***TIP:*** *When using a POS terminal and the credit card is not physically swiped by the machine, make sure you always enter the billing address and an order or invoice number. This reduces the risk of a chargeback and will lower your overall transaction cost.*

Software

When using software to process credit card transactions, you will need a computer and a modem to perform the dial-up and connection to the processing network. Credit card processing software comes in many different configurations and can even be built into larger sales or retail management systems. Basic credit card processing software can usually be purchased for less than the price of a swipe terminal, described above. However, software that is capable of integrating retail, call center, and Internet transactions, and process the transactions in real-time, can run into the hundreds of thousands of dollars.

One of the advantages of using a software application for credit card processing is that they usually have a lower operating cost than POS terminals, since the computer can be used for other functions, such as running your business and accounting applications.

Payment Gateway

What is a Payment Gateway?

One of the most confusing concepts for a merchant to understand is the difference between their merchant account and a payment gateway. A merchant account is always required when processing credit card transactions. A payment gateway account is only required when you need to process payments electronically in real-time, such as from a web site or a call center.

A payment gateway provides a secure, fast and reliable connection to the processing networks. The payment gateway translates information from a merchant's web site, system, or application and converts it into a format that can be understood and processed by the processing networks. It gives merchants the ability to perform real-time credit card processing and check authorizations.

Why Use A Payment Gateway?

There are many reasons why you would want to use a payment gateway but perhaps the most compelling is simply that it makes good business sense. As a small business owner, your primary business is something other than merchant processing but at the same time relies heavily on your ability to collect payments. As you've learned, the card associations and processing networks are highly regulated by the banking industry. Even the slightest misstep could cause your payments to be delayed or worse, not to arrive at all.

Imagine not being able to process transactions on your busiest day of the year. Reliability is one critical reason many merchants choose to make use of a payment gateway. Because the operation of a payment gateway is the primary focus of a gateway provider, they typically have reliability rates above 99.9%, ensuring your ability to process payments during the most demanding of times.

Another reason payment gateways make sense is their inherent redundancy. Not only do payment gateways have high speed dedicated connections into the processing networks, but they generally have redundant connections into each, as well as redundant access points for merchants.

As of September, 2004, all payment gateways are required to pass an annual security audit to ensure their compliance with key industry security practices. The security requirements include encryption of all sensitive payment information, proper network data protection and firewalls, proper screening of employees, and security conscious practices and procedures throughout their organizations. A merchant who chooses not to use a payment gateway is required to meet these stringent security requirements themselves. More information on these industry security practices can be found at www.visa.com/cisp.

Finally, using a payment gateway gives a merchant access to the latest up-to-date technology and allows the merchant to change from one merchant service provider to another without incurring the cost of changing their existing processing systems and equipment.

Virtual Terminal

A virtual terminal is a secure Internet-based interface that allows a merchant to authorize, process and manage credit card transactions from any computer with a web browser and an Internet connection. Virtual terminals are usually provided by either your merchant service provider or by a payment gateway provider.

A virtual terminal conveniently replaces the functionality provided by traditional card swipe terminals and credit card processing software but requires that the information by entered manually instead of through a magnetic card reader. If you are not in an environment where the credit card is physically present during the transaction, a virtual terminal is the best solution for a merchant who manually enters credit card transactions.

A virtual terminal is well suited for businesses of all sizes because it is easy to use, faster and more reliable than standard dial-up connections to processing networks.

To use a virtual terminal, a merchant connects to the web address specified by the virtual terminal provider and logs in. The connection to the virtual terminal is secure and all information entered is encrypted both during transmission and during storage. A virtual terminal usually consists of a simple data entry screen where the merchant enters payment information, such as the credit card number, the expiration date, and the amount of the transaction. The transaction is processed with the simple click of a mouse and the result is usually returned in a few seconds. Behind the scenes, the virtual terminal provider validates the information received and sends it on to the issuing bank using a high speed, secure, proprietary connection.

With a virtual terminal, you can enter and authorize transactions, issue refunds, automatically bill customers for purchases, use the address verification service and access a variety of transaction related reports.

What Information Do I Need To Collect?

The following chart shows the information that should be collected for a typical credit card transaction:

	Retail Swiped	**Retail Manually Keyed**	**MOTO Manually Keyed**	**Internet Manually Keyed**
Swiped Card	Required			
Card Number		Required	Required	Required
Expiration Date		Required	Required	Required
Transaction Date	Required	Required	Required	Required
Transaction Amount	Required	Required	Required	Required
Billing Address		Suggested	Suggested	Suggested
Order Number		Suggested	Suggested	Suggested
Line Item Detail			Optional	Optional
CVV2/CVC2/CID Number		Optional	Optional	Suggested
Cardholder Signature	Required	Required	Optional	Optional

Note that the above chart only shows the basic information that applies to a typical credit card transaction. The credit cad processing networks actually support a wide variety of additional information that may have an impact on the rates and fees paid for processing. This is especially true when processing corporate cards, purchasing cards, and government cards.

OTHER CONSIDERATIONS

Fraud and Security Considerations

There is inherent risk in all credit card transactions. And unfortunately the business owner, or merchant, take most of the responsibility for that risk and suffers most of the loss when it occurs.

However, using a small amount of prudence and common sense when accepting credit card payments will go a long way in helping to deter the risk of credit card fraud. For example, in a retail environment, both the cardholder and the credit card are present. Therefore, a 12 year old boy purporting to be Jane Smith would immediately be suspect. Likewise, in a telephone order situation, there are obvious indicators that a customer may be attempting to defraud you.

Internet transactions are, of course, the most risky of all since neither the cardholder nor the credit card are present. Worse yet, the customer is operating the cash register (or checkout mechanism) themselves. For this reason, Internet based transactions require special scrutiny to avoid fraud. There are a variety of commonly available tools to assist in detecting Internet fraud and two of them should be available from your merchant service provider or payment gateway service. These methods are the address verification service (AVS) and the card identification number (CID).

The address verification service will indicate whether the street address and postal code provided by the customer matches the billing information on file with the credit card issuer. In order to use this service, you must collect and submit the address information along with your transaction. The processing network never provides specific address information, only a match or no-match condition is returned.

The card identification value, sometimes referred to as either the card verification value or card verification code, is a 3-digit number usually located in the signature strip on the back of a credit card. The CID number is used to verify that the person making a payment actually has the credit card physically in his or her possession. Under the credit card processing guidelines, no merchant, web site, processing network, payment gateway, or merchant service provider is allowed to store this value. It is simply passed through to the issuing bank for verification and a match or no-match response is returned. Therefore, this value can only be obtained if the credit card itself is actually stolen.

Be aware that neither of the systems described above are foolproof and not all issuing banks and processing networks support these features. For this reason, many companies have developed even more sophisticated fraud identification systems that are available for use by merchants for an additional fee.

Regardless of whether or not you choose to make use of a fraud detection service, you should make yourself aware of the types of fraud being identified by other businesses in your industry. The following two organizations provide a good source of additional information:

The Merchant Risk Council	www.merchantriskcouncil.com
Merchant 911	www.merchant911.org

Automated Web-Based Invoice Payments

The explosive growth of the Internet in recent years has led to the advent of online bill presentment and payment services that minimize billing costs and reduce collection times. According to market research firm ComScore, online bill payment rose 37 percent in the first quarter of 2004 as compared to the same period a year earlier. Online payment services are now readily available to business owners that collect payments from customers on a regular basis.

The concept is actually quite simple. After accessing a web site specifically tailored for your business, the customer creates a user account, sets up and maintains payment details, and either makes a one-time payment or authorizes the invoice payments to occur automatically from a designated credit card or bank account. As each invoice payment is processed, the customer receives an electronic payment receipt by e-mail and the business receives the funds and payment details for recording in an accounting or business management system. In most cases, online services for invoice payments are available for significantly less than the cost of handling and processing a paper check.

Recurring Payments

In general, the processing of a credit card or electronic funds transfer (EFT) transaction requires an authorization from the cardholder or the account holder each time a payment is processed. However, if your customer pays you on a regular basis, for ongoing services or under the terms of a contract or lease, you may wish to establish an automated recurring payment plan under which a customer is automatically billed each period on a pre-determined schedule.

Implementing a recurring payment plan requires you to establish a relationship with your customer that authorizes you, the business operator, to automatically charge the customer's credit card or debit the customer's bank account on a regular basis over a certain time period, such as the term of a contract or lease agreement. You will need to follow these guidelines when setting up your automated recurring payment plan:

- You must have a written recurring payment authorization form, signed by your customer, indicating the specific amount of each payment, the date on which each payment will be processed, and the specific information required to process the payment (example: credit card number, expiration date, bank account number, name on the account, etc...).

- If accepting recurring credit card payments, you must verify that your merchant account agreement allows for recurring payments and follow all recurring payment requirements outlined in the agreement.

- If accepting recurring EFT transactions, you must verify that the agreement with your EFT processor allows for recurring payments and follow all processing requirements outlined in the agreement.

- You must use industry acceptable policies and practices to ensure the security of the payment details provided to you by your customer. An example of such industry guidelines would include the Visa Cardholder Information Security Program (CISP) found at the following web address: http://www.visa.com/cisp

- You must have a written privacy policy and provide a copy of that policy to your customer. Your privacy policy must include a description of the types of information you will collect for recurring payments, how that information will be used, and most importantly, how the privacy and security of the information will be maintained on an ongoing basis.

GLOSSARY OF TERMS

American Bankers Association (ABA) Trade association of American bankers formed in 1875. Also has the responsibility of assigning the registration authority for identification numbers.

Application Service Provider (ASP) Application Service Providers are third-party entities that manage and distribute software-based services and solutions to customers across a wide area network from a central data center. A Web-based site that provides management of applications such as spread sheets, human resources management, or e-mail to companies for a fee.

Automated Clearing House (ACH) Network An ACH transaction is an electronic fund transfer through the Federal Reserve Bank from a checking or savings account

Acquiring Bank A financial institution that has a business relationship with a merchant and receives credit card transactions from that merchant.

Address Verification Service (AVS) A service that verifies the cardholder's billing address in order to help combat fraud in card-not-present transactions (e.g. mail order, telephone order, internet, etc.).

American Express An organization that issues cards and acquires transactions, unlike Visa and MasterCard which are bank associations.

Average Ticket The average dollar amount of a merchant's credit card sale calculated by dividing the total sales volume by the total number of sales for a specified time period.

Authorization The process in which a credit card is accepted, read and approved for a sales transaction.

B2B Businesses transacting directly with other businesses. Term is primarily applied to internet transactions.

B2C Businesses selling products or services directly to consumers.

Bank Card A credit card issued by a bank.

Bank Identification Number (BIN) The first several numbers on a credit card which identifies the issuing bank.

Batch Processing data in a group, or batch, as opposed to one at a time in “real’ time. Used as a cost-effective means of data processing.

Business Card Credit cards issued by companies to their employees for business expenses.

Capture Converting the authorization amount into a billable transaction record within a Batch.

Card Association A specific credit card company such as Visa, MasterCard, American Express, and Discover

Card Identification Number (CID) A unique value calculated from the data encoded on the magnetic stripe of a credit card which validates card information during the authorization process.

Card Not Present (CNP) Credit card transaction in which the card is not present to be swiped, e.g. phone or internet or postal mail purchases and thus must be manually entered to collect data.

Card Present Credit card transaction in which the credit card’s magnetic stripe can be “read” and data automatically collected.

Card Validation Code (CVC2)/Card Verification Value (CVV2) A unique value calculated from the data encoded on the magnetic stripe of a credit card which validates card information during the authorization process.

Cardholder A person to whom a credit card has been issued.

Chargeback If a previously settled transaction is disputed by the cardholder and the merchant cannot prove that the product or service in question was rendered or delivered as ordered, then the merchant bank debits the amount of the sale from the merchant's account or posts a "chargeback".

Check Card A bankcard that draws against the cardholders "asset account", usually a checking account.

CISP Cardholder Information Security Program. Visa compliance requirement designed to insure a standard of due care for securing Visa cardholder data, wherever it is located.

Commerce Service Provider (CSP) A company that provides e-commerce solutions for retailers.

Commercial Card Cards which are used for businesses/corporations and issued to employees or corporations depending on the use for which it is intended.

Debit Card A plastic card used for purchase or to get cash as an electronic transfer directly from the holder's bank checking or savings account by input of the holder's PIN (personal identification number)

Decline A transaction in which the issuing bank will not authorize the transaction.

Demand Deposit Account (DDA) A checking or savings account.

Discount Rate The interest rate charged in loans by the Federal Reserve Bank.

Discover Network Discover Network is a division of Discover Financial Services, Inc., and operates the largest independent credit card network in the United States.

Duality When a financial institution which can have in both MasterCard and VISA this is called a "duality". In countries outside of the U.S. this is generally not allowed.

E-Commerce Electronic commerce or business conducted via the internet.

Electronic Check Council (ECC) A financial institution's membership dedicated to improving check clearing and collection.

Electronic Check Processing Converts a paper check into an electronic check at the point of sale and then the check is electronically processed through the ACH network.

Electronic Funds Transfer (EFT) Paperless transfer of funds from one account to another.

Expiration Date The date on which coverage ends.

Front-End Network Network provider that authorizes and captures transactions then sends that information to the back-end network.

Gateway – See Payment Gateway Online service that handles credit card transactions through a merchant account provider.

Interchange Rate Percentage of the credit card transaction amount set by the bankcard association to the acquiring banks.

Issuing Bank The bank that issues the credit card to the credit card holder.

Level I Data Includes all data collected during regular credit card capture such as total purchase amount, merchant category code, date and supplier/retailer name.

Level II Data Includes same data as Level I plus sales tax amount, customer's accounting code, merchant's tax ID number, applicable minority- and women-owned business status, and sales outlet zip code.

Level III Data Includes Level I and Level II Data plus: quantities, product codes, product descriptions, ship to zip, freight amount, duty amount, order/ticket number, unit of measure, extended item amount, discount indicator, discount amount, net/gross indicator, tax rate applied, tax type applied, debit or credit indicator, and alternate tax identifier.

Magnetic Stripe The strip of magnetic tape affixed the back of a plastic credit or debit card that holds data relative to the card holder. When “swiped” through a reader, the data are picked up automatically.

Mastercard International Member-owned international bankcard association which licenses members to issue cards or accept merchant drafts under the MasterCard Program. MasterCard owns and operates its own international processing network.

Member Bank Commercial bank that is a member of the Federal Reserve System.

Merchant A retailer or business that accepts credit cards.

Merchant Account An account set up by a merchant with a bank to process credit card orders from customers.

Merchant Bank – See Acquiring Bank A financial institution that has a business relationship with a merchant and receives credit card transactions from that merchant.

Merchant Identification Number (MID) The acquiring/merchant bank assigns this number to a merchant to identify that merchant.

NACHA National Automated Clearing House Association - The national trade association which establishes the rules and regulations for exchange of commercial ACH payments (electronic funds transfer).

Network – See Processing Network The medium of data transport between the merchant application and the processor. This company authorizes and captures credit card transactions.

Payment Gateway Online service that handles credit card transactions through a merchant account provider.

Personal Identification Number (PIN) A numeric “passcode” a cardholder uses to get access to their private account information.

Point of Sale (POS) Terminal A “computerized” online cash register which allows for the ability to record and track customer orders, process credit and debit cards, connect to other systems in a network, and manage inventory.

Private Label Card A credit card issued by a specific retailer to be used at that store only.

Processor A large data center that processes credit card transactions and settles funds to merchants.

Processing Network Company that authorizes and captures credit card transactions.

Purchasing Card **A credit card a business uses for purchasing smaller priced items such as supplies.**

Recurring Transaction A repeat transaction the cardholder has given a merchant permission to periodically charge the cardholder's account.

Referral A message from the issuing bank if an attempt for authorization requires a call to the Voice Authorization Center.

Refund Money returned to a payer.

Retrieval Request Bank request to a merchant for documentation concerning a transaction when there is a customer dispute or an improper sale or return and which can lead to a chargeback.

Reversal A transaction from the acquirer to the card issuer informing the card issuer that the previously initiated transaction cannot be processed as instructed, i.e., is undeliverable, unprocessed or cancelled by the receiver.

Routing Number A nine-digit number that identifies a financial institution.

Settlement As the sales transaction value moves from the merchant to the acquiring bank to the issuer, each party buys and sells the sales ticket. Settlement is what occurs when the acquiring bank and the issuer exchange data or funds during that function.

Shopping Cart An online, virtual “cart” that allows a shopper to add or take out items and hold them in the virtual “cart” until he or she is ready to purchase the items and allows the shopper to see the total cost of purchase before processing the order.

Smart Card A plastic card (like a credit/debit card) which holds information or a value.

Stored Value Card A plastic card that holds cash value for a specific use such as a phone card. The amount is deducted from the card each time it is used.

Terminal Usually just a keyboard and monitor which are linked up with a remote located computer.

Terminal Identification Number (TID) The identification number assigned to a particular terminal.

Transaction The financial activity between a merchant and a cardholder's account.

Virtual Terminal Allows merchants who have internet access to take orders over the phone or mail and manually enter credit card information.

Visa USA An association of 14,000 U.S. financial institutions (Members) that comprise the U.S. operations of the Visa payment brand system.

Voice Authorization Approval response obtained through interactive communication between an issuer and an acquirer through telephone communication.

ABOUT THE AUTHOR

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