Revenue recognition in the payments industry

Navigating the new accounting standard

The bottom line

The payments industry continues to evolve, propelled by technological and operational innovations from established players and new entrants.

Understanding how to apply the new revenue recognition standard, ASC 606, can be complex and heavily depends on each industry participant's role in processing a transaction within the payment ecosystem.

Payments industry executives should consult with their auditors given the significant judgments involved in applying the new accounting standard's numerous, complex elements.

Buying a mocha latte at your local coffeehouse? Filling your tank at the gas station? Clicking “buy now” on that retailer’s website? Every time you swipe, tap, or dip your credit or debit card, data travels through a complex network of participants that provide services that bring payments from the point of purchase to the settlement of funds. Each of these parties extracts a fee (or fees) for the role they play in helping to complete the transaction.

The payments industry is one of the most dynamic ecosystems in financial services. It continues to evolve, propelled by technological and operational innovations from established players and new entrants. Digital payments volume is growing across the globe, giving many participants opportunities to branch out into new services—omnichannel solutions, e-commerce platforms, digital wallets, mobile payments, and others—and tap into new revenue streams.

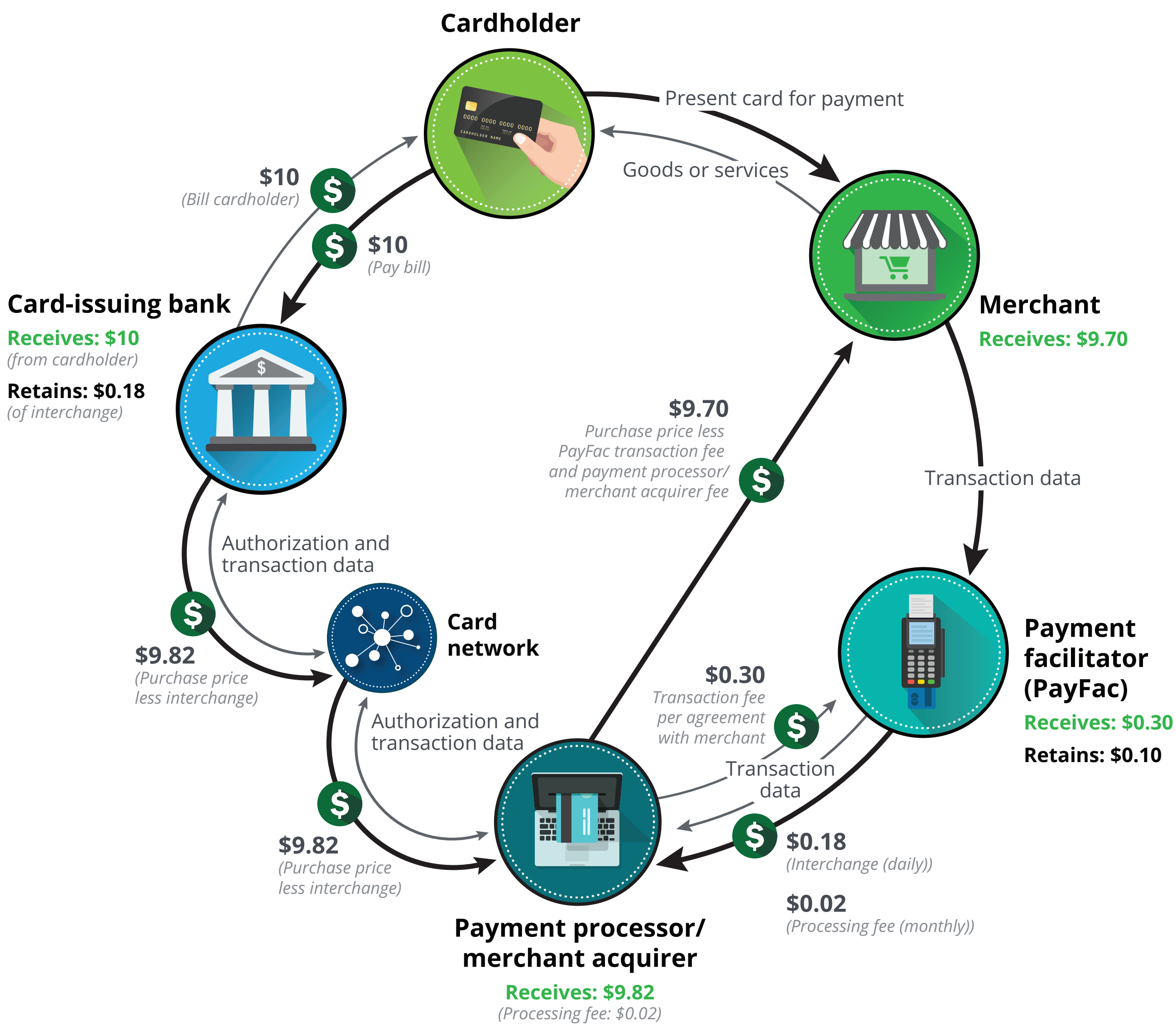
The payments industry also is one in which the application of the new revenue accounting standard, ASC 606, Revenue from Contracts with Customers, requires significant judgments. We will address how some of these judgments can substantially impact the amount of revenue that companies can recognize.

Following the money:

How a payment transaction works

Understanding the payment ecosystem and each participant's role in processing a transaction (Figure 1) is crucial to appropriately applying the new revenue standard. Which role does your organization play?

Figure 1. How a payment transaction works[1]



The participants

- **Cardholder:** Individuals or firms who possess the credit/debit card issued by the card-issuing bank.
- **Merchant:** Retailers and others who accept electronic payments at the point of sale (POS) as a method of remuneration for their goods or services.
- **Payment processor/merchant acquirer:** Companies that process payments for merchants by giving them access to systems necessary to accept payments, securely transmitting payment data, and providing various types of back-office support.
- **Payment facilitators:** Entities that provide the portal through which merchants connect to processors/acquirers. Payment facilitators also offer analytics, merchant reporting, and other services.
- **Card-issuing bank:** Banks that issue cards and extend credit to cardholders. An issuing bank might also be a payment processor/merchant acquirer.
- **Card network:** Companies that route transactions between card-issuing banks and payment processors. They also set interchange fees paid to the issuer and ensure compliance with rules and regulations.

The fees

- **Merchant discount rate:** Total amount paid by the merchant ($0.30 in this illustrative transaction).
- **Interchange fees:** A fixed fee or a percentage of the total transaction amount retained by the issuing bank upon transfer of funds from the issuing bank to the acquirer bank.
- **Card assessment and network fees:** Fees charged by the card network to issuing banks and processors/acquirers based primarily on a percentage of the dollar volume of card transaction activity.
- **Payment processor fees:** Fees charged to merchants by processors for performing transaction processing services.

The process[2]

1. **Authorization.** Back at the coffeehouse for a post-lunch latte, you swipe your credit card on the merchant's POS system and authenticate the transaction with either a signature or personal identification number (PIN). Within moments of your card swipe—even before you take that first delicious sip—the POS system reads the card and sends information to the payment processor, which requests authorization for the transaction from the card network. The network communicates with the issuing bank to make sure sufficient funds are available to cover the transaction, checks that the card is not stolen, and verifies there are no other red flags that would prohibit the transaction. Once the issuing bank confirms the transaction can be processed, it passes this information along to the processor, which sends confirmation to the merchant.
2. **Batching and clearing.** For the coffeehouse to receive funds from this transaction, the merchant must combine daily transactions into a "batch" and clear these to the payment processor. When the processor receives the batch, it requests payment on behalf of the coffeehouse by sharing the day's transaction history with the relevant card networks. The networks further aggregate the batch by requesting funds from the appropriate issuing banks.
3. **Funding.** Only once the merchant batches and out-clears to the processor does the money flow occur. The issuing bank passes the requested amount to the network after withholding interchange fees. The network then passes the funds to the processor or processor's bank. The processor withholds its fees and deposits the remainder in the coffeehouse's account. The timing of funds flow to the processor and merchant often depends on the jurisdictional regulations and terms of the processing agreements. The processor periodically remits assessment fees back to the network after funding has occurred.

Accounting Standard's impact on revenue recognition

How does this complex ecosystem affect revenue recognition?

Some key questions in evaluating the revenue recognition requirements are:

- Who is my customer?
- What are my performance obligations?
- Am I a principal or an agent?

The core principle of the guidance in ASC 606 is that an entity should recognize revenue to reflect the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Who is my customer?

Defining the customer in each arrangement

An entity should identify its customer in each arrangement. ASC 606-10-20 defines a customer as: "A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." For example, in the payments processing ecosystem, a merchant is often the payment processor's customer because the merchant enters into contracts with a payment processor for services in exchange for consideration.

What are my performance obligations?

Promised goods and services

Essential to this analysis is identifying the promised goods or services, including authorization, batching and clearing, and settlement/funding. ASC 606 contains a requirement under which entities must evaluate a good or service to determine whether it is "separately identifiable from other promises in the contract." The objective of this determination is to consider whether the nature of the promise is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.

Individual vs. combined performance obligations

Understanding whether an entity's performance obligations to a customer are distinct and individual services or various services that should be combined into a single performance obligation is critical to determining whether the entity is the principal or agent in a payment processing transaction.

In many cases, some or all of the services an entity provides will be eligible to be accounted for as a single performance obligation constituting a series of distinct services. ASC 606-10-25-14 states:

> "At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:
>
> a) A good or service (or a bundle of goods or services) that is distinct.
> b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."

Given the number of parties involved in a payment transaction, concluding whether an entity is acting as a principal or agent is often complex and requires significant judgment.

In accordance with ASC 606-10-25-15, a series of distinct goods or services is a performance obligation only when the following two criteria are met: (1) each good or service is a performance obligation satisfied over time; and (2) the same method is used to measure progress toward complete satisfaction of each performance obligation. Therefore, the determination about whether a series of distinct goods or services is a single performance obligation relies on understanding when and how to recognize revenue. As a result, an entity would need to understand and determine the timing of revenue recognition before being able to identify whether any of its performance obligations represent a series of distinct services that are, in fact, a single performance obligation.

Am I a principal or an agent?

Principal vs. agent

A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer. If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others. The principal-versus-agent determination is an important one because the conclusion the entity reaches can significantly affect the amount of revenue recognized. A principal of a performance obligation will recognize revenue at the gross amount it is entitled to from its customer, while an agent will recognize revenue at the net amount retained. In other words, an entity acting as a principal will typically present fees paid to other parties in the ecosystem as a cost of revenue, whereas an entity acting as an agent will typically present such fees as a reduction of revenue (contra-revenue).

Control of the service

For each specified service, an entity must determine whether it controls the service prior to it being transferred to the customer. In other words, does the entity have the ability to direct the use of and to obtain substantially all the benefits from the service provided by other parties before that service is transferred to the customer? Factors to consider as part of this determination include the nature of the entity's relationships and performance obligations with the other parties and the entity's potential risks of loss arising from the transaction.

If an entity concludes that it does not control the specified services, the entity is, in effect, acting as an agent to provide such services to the customer. Accordingly, the entity should only record revenue for the net amount of the fee it retains.

Payments industry executives should consult with their auditors given the significant judgments involved in applying the principal-versus-agent guidance and other complex elements of the new revenue accounting standard.

Endnotes

1. Illustrative example.
2. Illustrative example for a card transaction funds flow.

Contacts

Gairy Moore
Audit & Assurance Partner, Payments Leader
Deloitte & Touche LLP
gamoore@deloitte.com

Susan Klink
Audit & Assurance Partner, Audit & Assurance Financial Services Leader
Deloitte & Touche LLP
sklink@deloitte.com

Troy Vollertsen
Audit & Assurance Partner, Audit & Assurance Banking & Capital Markets Co-leader
Deloitte & Touche LLP
tvollertsen@deloitte.com

Sandeep Gupta
Audit & Assurance Partner, Audit & Assurance Fintech Co-leader
Deloitte & Touche LLP
sandgupta@deloitte.com

Kirby Rattenbury
Audit & Assurance Partner, Audit & Assurance Fintech Co-leader
Deloitte & Touche LLP
krattenbury@deloitte.com

Jake Gocke
Audit & Assurance Senior Manager
Deloitte & Touche LLP
jgocke@deloitte.com

Deloitte.