

## Moving toward integrated payment solutions

**Making payment processing part of the business**

## The bottom line



As the dust settles from upheavals in the payments industry, a new landscape is being revealed, and players are evaluating how to facilitate payments as this ecosystem evolves.



With so many new entrants into the payments space, the delivery models of payment processing services continue to adapt, with more options available than only a few short years ago.



Payments companies struggle to answer several questions: *Who is our end customer? What are our performance obligations? Who controls the services?* Pinning down these answers can be critical in clarifying existing payment systems and developing updates.

Long before COVID-19 struck, companies were shifting more of their businesses online. Working around the limitations the pandemic created, customers quickly pivoted to digital-first, streamlining their transactions and experience, and accelerating the digital road map for countless companies and industries. Consumer-facing businesses that were set up for only a small portion of their

business to be processed online or in a digital environment suddenly found their operating model inadequate for the new normal. New customer and payments data taxed their storage capabilities and secure communications capacity. The emergence of new payments apps, contactless payments, and fintech startups only added complexity to this evolving payments ecosystem.<sup>1</sup>

With the benefit of hindsight, there are many lessons to be learned in this emerging era in payments. And, as the dust settles from upheavals in the industry, a new landscape is being revealed, and players are evaluating how to facilitate payments as this ecosystem evolves.

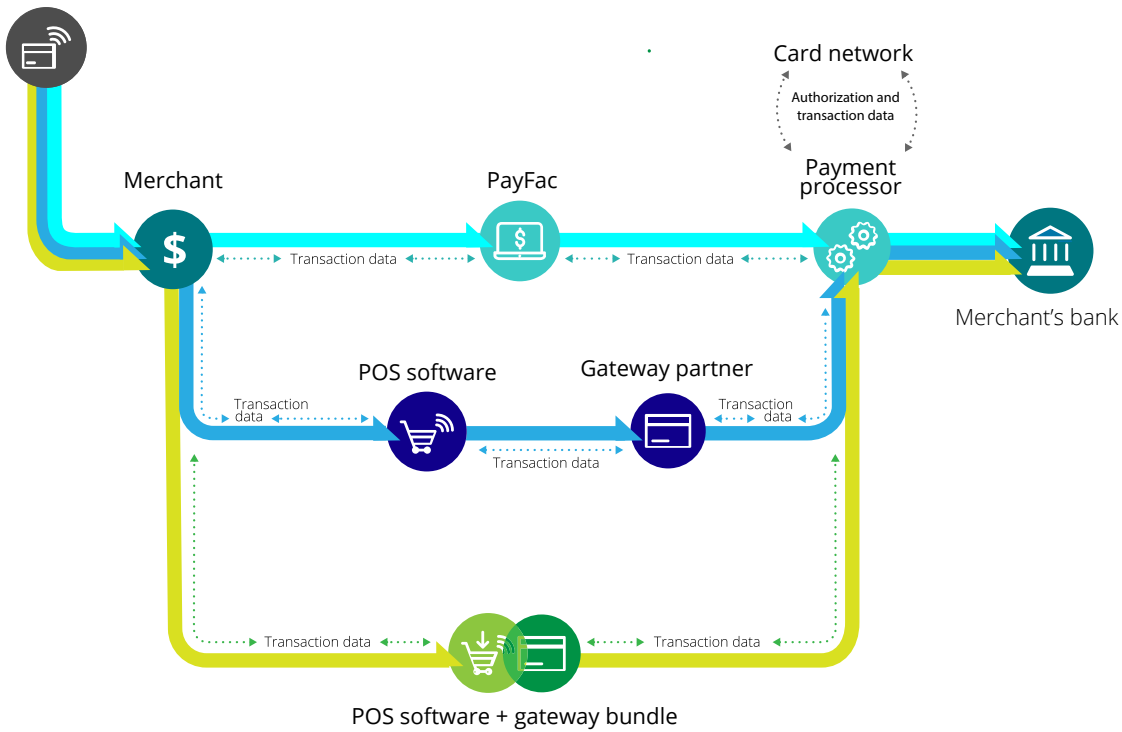
There have been significant changes since 2019, when we last outlined the process of recognizing revenue in the payments technology industry.<sup>2</sup> Payments companies have continued to build out and scale their operating capabilities and reach, accelerating their road maps into new markets and solutions.

The payments ecosystem is expanding through the integration of payments into existing enterprise solutions due to a myriad of new entrants. And more importantly, companies are expanding and differentiating their payment solutions to drive value—as more than mere technology back-office infrastructure.

**Providers are transforming payments from a commoditized solution to a value-added service, creating a stickier customer base by deepening customer relationships and making them more profitable.**

So, what does this all mean? The marketplace is evolving, and players and offerings continue to expand at a rapid pace. This, in turn, drives increased complexity in the payments ecosystem spanning the industry, including the evolving landscape in B2B and embedded finance transactions. As such, now is an appropriate time to take stock of where we've been and where we are headed in the payments industry.

Customer payment



The evolving payments ecosystem

■ Traditional PayFac solutions    
 ■ Gateway payment solutions    
 ■ Fully integrated payment solutions

# The expanding payments ecosystem

For most companies in and out of the financial services and technology industries, payment processing has long been a commoditized offering—a generic back-office service. But increasingly, fintech and technology companies in particular are realizing that there is an opportunity to improve the payments experience in a way that amplifies access, simplifies processes, and generates data and value at scale. They are seeing payment processing as a potential source of value and a source of data within an expanding ecosystem and are finding ways to integrate their individual payments services into a range of broad, holistic solutions, recombining inputs into a single service offering. These solutions, increasingly being offered as-a-service, are often embedded into existing software products and/or repackaged with gateway solutions.

**And with so many new entrants into the space, there continues to be an evolution in the delivery models of payment processing services, with many more options than only a few short years ago.** In the evolving payments ecosystem, cost, convenience, and consumer choice are making subscription-based payment solutions increasingly popular. And integrated solutions offer new revenue streams and create deeper and longer-lasting customer relationships through the combination of payment processing services with existing enterprise solutions.

What does the expanding payments ecosystem—notably, the new players and solutions—mean for legacy payments providers? It is critical that existing payments technology continues to evolve in the face of a more dynamic ecosystem. Of course, the advent of fresh competition, especially from startups, can unsettle any established market. But legacy payments providers can and should continue to adapt to these latest entrants

and their new solutions. Providers are moving toward more integrated payment solutions to grow new revenue streams, lure additional customers, and provide differentiated value-added services.

## IFRS and US GAAP considerations

As companies expand geographically, it is important to recognize the differences between IFRS and US GAAP. Organizations should be mindful of the key differences between IFRS and US GAAP, specifically with respect to the potential impacts on revenue recognition in financial reporting. [Read more >](#)

With payment processing playing a larger role in operations and even business models, businesses face more consequential decisions in choosing how to handle payments. And they have more options than ever, from setting up their own systems to contracting with an established payments processor to purchasing services as part of a software-as-a-service (SaaS) subscription.

**The best solution—in-house, independent, or integrated—will differ for each company.** Making such an assessment requires that organizations understand their current position in the payments ecosystem and are willing to potentially stretch beyond their traditional roles to grow with the market. Of course, it is vital for executives to keep an eye to the future state of the industry. New entrants in this space and increasing competition should drive new thinking about integrated payments and how organizations can take advantage of the evolution. In turn, this can help executives understand and prepare for both the challenges that lay ahead and developing potential solutions.

# The continuing complexity of revenue recognition

Recognized revenue continues to be a key performance indicator for companies and their investors. Because of the continued evolution of the payments ecosystem, companies have grappled with the issue of [revenue recognition](#)—specifically, how to present revenue and the various fees in line with the revenue accounting standard, ASC 606. **A careful evaluation of the guidance is critical, as the ecosystem—and the players—continues to evolve.** Consideration must be given to a delivery model of the services, the parties involved in the payment transactions, and the various components in each fee arrangement. Whether an offering is integrated or independent can have a significant effect on accounting analysis.

With multiple parties involved in every financial transaction, no matter how small, it is a complex challenge to keep track of where fees are coming from—or where they are going—who has risk, and how each transaction is settling out. Therefore, it can be difficult for companies to identify and evaluate these fees in their revenue recognition accounting. It can also be challenging for companies to accurately identify and account for their receivables and payables. These are compiled from complex sets of data and determine the legal ownership and restrictions on bank accounts utilized in the settlement process.

As such, there are several questions that payments companies struggle to answer. Some might seem surprisingly basic at first glance, but they can be far more complex behind the scenes: *Who is our end customer? What are our performance obligations? Who controls the services?* Pinning down answers to these questions can be critical in clarifying existing payment systems and developing updates. Further, the way in which payments companies offer solutions—in-house, independent, or integrated—could have significant effects on their conclusions.

For instance, if you're embedding another company's payment solution into your SaaS solution, an accounting

## Complex data sets

In payment processing, companies are often challenged with understanding and accounting for large volumes of complex data that require careful and timely reconciliation. When data is not received in a timely and standardized manner, it can create:

- Increased risk associated with the accuracy and completeness of key data
- Challenges in reconciling data to reliable internal and third-party sources
- A need for enhanced reconciliation internal controls and consideration of SOC 1 reporting from relevant service organizations

Organizations therefore require a systematic process to ensure the reliability of reconciled data. This is vital for financial reporting and key decision-making within an organization. To get ahead of these issues, organizations must identify the right advisers and tools to recognize and manage their data in a timely manner.

analysis should be performed to determine the performance obligation(s) and the appropriate gross versus net presentation of the various fee components. **Revenue recognition can be complex, especially when it comes to integrated solutions.** And at a time when initial public offerings (IPOs) and special purpose acquisition company (SPAC) transactions are more prevalent than ever, revenue recognition conclusions continue to be a focus of regulators and investors. Reaching the right revenue recognition conclusions is imperative to a timely and successful IPO or SPAC transaction.

# The 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 the promised specified goods or services?
- Am I a principal or an agent?
- What are my performance obligations?

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:

01. Identify the contract(s) with a customer.
02. Identify the performance obligations in the contract.
03. Determine the transaction price.
04. Allocate the transaction price to the performance obligations in the contract.
05. 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(s) 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 payment 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 the promised specified goods or services?

### *Promised goods and services*

Essential to this analysis is identifying the promised goods and services. Some payment processors only provide customers with access to the payment services of the acquiring bank (sometimes referred to as "gateways"), while other payment processors provide services that encompass a fully integrated platform. Those services may include preauthorization, authorization, batching and clearing, routing, reconciling account activities, managing relationships with issuing banks and cards networks, fraud detection and risk review, and settlement/funding.

ASC 606 contains a requirement under which entities must evaluate each promised good or service to determine whether it is "capable of being distinct" and "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 promises*

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. Understanding whether the promises to a customer are distinct is necessary to determine whether the specified services are individual distinct services or various services that should be combined into a single specified service. This assessment is critical to determining whether the entity is the principal or agent in a payment processing transaction.

## Am I a principal or an agent?

### *Principal vs. agent*

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 specified good or service will recognize revenue at the gross amount to which it is entitled 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 in the payment processing ecosystem before that service is transferred to the customer? Determining which party controls the services provided by the other parties in the payment processing ecosystem requires significant judgment and therefore an entity may also evaluate the control indicators in ASC 606 to support its conclusion.

Factors to consider as part of this determination may include:

01. The nature of the entity's contractual arrangements, relationships, and promises with the customer and other parties and the entity's potential risks of loss (e.g., chargebacks, fees due to other parties) arising from the transaction. As part of this analysis, the entity may consider whether it acts as the "merchant of record" for the transactions that it processes.
  02. Any contractual arrangements or relationships between the customer and the other parties in the payment processing ecosystem.
  03. The ability of the entity to direct other parties in the payment processing ecosystem to provide payment processing services on its behalf. As part of this analysis, the entity may consider whether it establishes underwriting guidelines, has the ability to decline transactions or withhold funds, approves customer contracts, provides customer support, and has responsibility over the resolution of customer service issues.
  04. Whether the customer views the entity to be primarily responsible for the payment processing services, including their acceptability.
  05. The ability of the entity to enhance, modify, or discontinue payment processing services.
  06. The ability of the entity to determine and subsequently change the parties that will be used to perform the various payment processing services.
  07. The ability to set the overall price paid by the customer.
  08. Whether the entity provides a significant service of integrating all of the services transferred to the customer.
  09. The entity's obligation to maintain payment processing information on behalf of the merchant, perform preauthorization services, and determine what payment processing information is provided to the other parties in the payment processing ecosystem.
- 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 revenue accounting standard.



### What are my performance obligations?

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, and its performance obligation is to arrange for the other party (or parties) to provide the specified services. Accordingly, the entity should only record revenue for the net amount of the fee it retains.

If, instead, an entity is a principal in providing the specified services, the entity's performance obligation is the specified services themselves. Accordingly, the entity would record revenue for the gross fee it receives from the customer.

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:

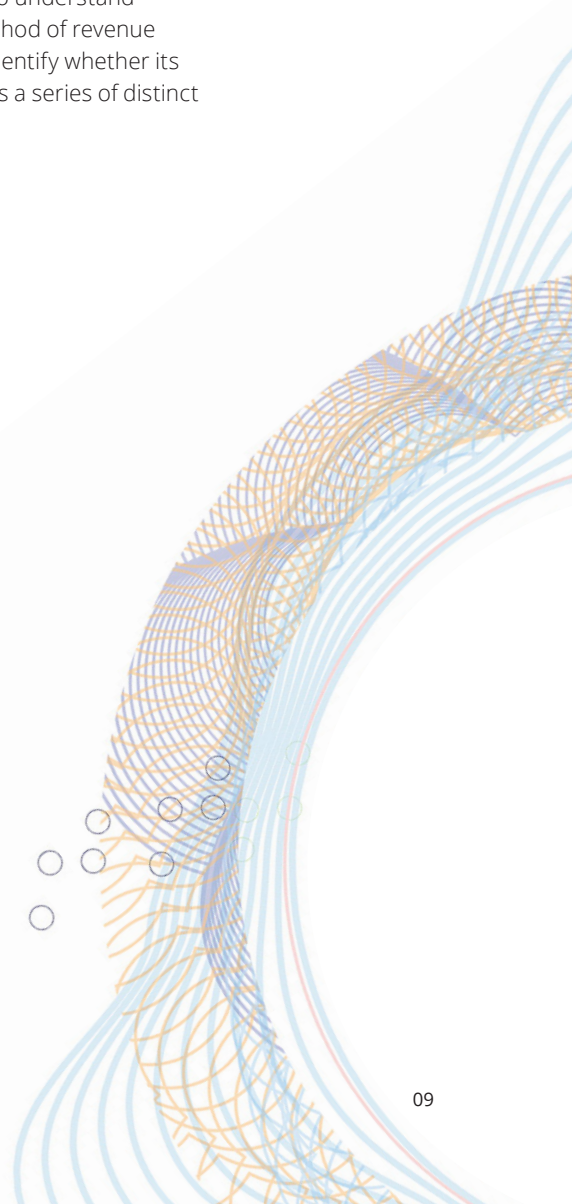
- a. A good or service (or a bundle of goods or services) that is distinct.
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."

In accordance with ASC 606-10-25-14 and 25-15, a performance obligation is a series of distinct goods or services only when the following criteria are met:

01. The distinct goods or services are substantially the same.
02. Each distinct good or service would meet the requirements to be a performance obligation satisfied over time.

03. The same method would be used to measure progress toward complete satisfaction of each distinct good or service.

The determination of whether a single performance obligation represents a series of distinct goods or services depends on understanding when and how to recognize revenue for each distinct good or service. As a result, an entity would need to understand and determine the timing and method of revenue recognition before being able to identify whether its performance obligation represents a series of distinct goods or services.



# What's next for payments?

The payments industry—and the ways in which payment solutions are delivered—are constantly evolving. We anticipate that over the next several years, companies will continue to integrate payment processing into business management and consumer-facing software solutions. As payments shift to predominantly digital and mobile providers, with a broader range of offering possibilities, companies should continue to enhance access to, and experience for, users. Payment processing will increasingly include options to settle in cryptocurrencies, interface with lending and credit

options (e.g., “buy now, pay later” functionality), and provide enhanced fraud detection and prevention through real-time data capabilities.

Other challenges, complications, and new technologies are expected to spark fresh solutions. Companies should continue to assess their current position in the payments ecosystem and how they can more effectively leverage payments technology to enhance and expand their current offerings.

## Endnotes

1. Polly Jean Harrison, [“The growth of contactless payments during the Covid-19 pandemic,”](#) *Fintech Times*, January 12, 2021; Stephanie Walden, [“Banking after Covid-19: The rise of contactless payments in the U.S.,”](#) *Forbes*, June 12, 2020; Paula Buchel, [“Cashless and contactless payments in the time of COVID-19 and beyond,”](#) Deloitte, 2021.
2. Deloitte, [Revenue recognition standard in the payments industry](#), 2019.

# Contacts

**Jake Gocke**

Audit & Assurance Partner, Audit & Assurance Payments Co-leader  
Deloitte & Touche LLP  
[jgocke@deloitte.com](mailto:jgocke@deloitte.com)

**Sandeep Gupta**

Audit & Assurance Partner, Audit & Assurance Fintech Co-leader  
Deloitte & Touche LLP  
[sandgupta@deloitte.com](mailto:sandgupta@deloitte.com)

**Kirby Rattenbury**

Audit & Assurance Partner, Audit & Assurance Fintech Co-leader  
Deloitte & Touche LLP  
[krattenbury@deloitte.com](mailto:krattenbury@deloitte.com)



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