

# Obtaining Merchant Status for Your Small Business

## Useful facts

- Nearly 1 in every 3 consumer purchases in the United States is made with a payment card—including credit, debit and prepaid products.
- Of every \$100 spent by consumers, nearly \$40 is in a form other than cash or check.
- Consumers carry more than 1 billion cards worldwide—nearly 450 million of those cards are in the United States.
- U.S. cardholders conduct more than \$1 trillion in annual volume.
- The average ticket for credit card purchases is consistently more.

Did you know that when you accept credit cards, you can expect your sales to increase by an astounding 50 to 400%? You simply can't compete if you don't accept credit cards. Credit Cards can be a powerful tool for attracting new customers and opening doors to stronger sales.

Consumers demand choice and convenience, particularly when it comes to how they pay for goods and services. That means they are increasingly opting for electronic payment methods, not cash or checks.

A good first place to start your search for merchant status is your own bank. Most issue credit cards, and if you have a long-term relationship, that's a big plus. Your bank says no? Try a few other local banks--offering to move *all* your accounts--and you just may be rewarded with merchant status.

## Accepting Credit Cards

If you decide to accept credit cards, you'll have to decide first which ones you want to accept: Visa, MasterCard, Discover, or American Express, for example. The charge you'll pay will vary, depending upon the volume of your sales and the size of your transactions. The average fee usually runs between 2.5 percent and 5.5 percent of your sales, although American Express runs a bit higher.

Your first step is to obtain a credit card account, which will allow you to accept credit cards. To obtain a credit card account, also called a merchant account, you need to go to a bank or other lending institution. If you have an established business reputation or you have a long-standing relationship with your banker, you probably won't have any trouble opening up an account.

**Home and mail order businesses.** If, however, you're just starting out, you have a mail order business, or you work out of your home, you may have some trouble. The reason is that banks and credit card companies are scared to death of fraud, and so they've become

much more cautious in recent years about opening up new accounts. In fact, some larger banks won't even deal with you unless you have a storefront. It's a business decision that they've made. They tend to figure that home and mail order businesses won't do that much business, and so the credit hassles aren't worth the trouble.

If you operate a home or mail order business, start with a medium- or small-sized bank. If possible, find out from other home or mail order businesses where they have their merchant account. In any larger metropolitan area, you should be able to find a medium- or small-sized bank that will do business with you.

## **How Credit Card Transactions Work**

The typical credit card transaction begins when your customer hands you the credit card. What you do with the credit card depends upon the system you have in place. You will either manually imprint the card onto your paper draft, if you still use the older technology, or you'll swipe the card through an electronic terminal, if you use the newer technology.

If the transaction is handled over the telephone or through the mails, it begins when the customer gives you the credit card number. In that case, you'll either fill out a paper draft or key in the number at your terminal.

The next step in the typical transaction is for you to obtain permission from the credit card company to process the sale with the credit card. If you're using the older technology, you'll have to call a special number to obtain an authorization code (typically, this is only required with sales over a certain amount, such as \$50). If you're using the newer technology, the authorization code will be obtained automatically. Once you have the authority, the only step left to take with the customer is to obtain the signature on the receipt (phone sales, obviously, don't require a signature).

Then, you'll send the credit card sales receipts to the bank so that you can get paid. If you use the older technology, you'll have to take the receipts to your bank. If you use the newer technology, you can send the receipts electronically. This process is usually done at the end of the day and is referred to as "settling" your accounts.

Your bank will authorize the charge and notify the credit card company (or some company acting on its behalf) of the charge. The credit card company (or the company acting on its behalf) will collect the money from the bank that issued the card, send it to your bank, and bill your customer. Once your bank has the money, it will put it in your account, minus a processing fee, called the discount rate, which is split between your bank and your credit card company.

When your customer pays the bill, the credit card company sends the money to the bank that issued the card, minus a processing fee...and everyone lives happily ever after.

## **What Banks Want from You**

With credit card fraud topping \$200 million each year, banks and other lenders are understandably skittish about commercial credit card accounts. When you go to your lender to open up a credit card account, you'll need to make a full financial disclosure in the same way that you would if you were asking for a loan. (Or even more so: we know of one small

business owner who was asked to submit to an FBI check before being granted a merchant account!)

The likelihood of obtaining a merchant account from a bank will depend upon the following factors:

- **Your type of business.** Certain types of businesses are considered higher credit risks than others. For example, a home business or a mail order company will have a more difficult time opening a merchant account than will a company with a traditional storefront.
- **The length of time in business.** If you're just starting out, you'll have more difficulty opening a merchant account than will an established business.
- **Your general creditworthiness.** Banks will want to know whether you've ever declared bankruptcy or if you have any judgments or liens against you. If you do, your chances of getting a credit card account are not good. If you're just starting out, the banks will want to look at your personal credit history.
- **Your previous merchant account status.** Banks will want to know if you've ever had a merchant account before because it's a good indication of your creditworthiness.

**What you should do.** You should be prepared to submit all of the financial information you can gather about your business, as well as information about your personal credit history. That would include information about how your business is financed, how it is organized, and how you plan to run it.

Also, you should take this opportunity to request a credit report on yourself. You can obtain one by contacting a credit bureau, such as TRW or Dun & Bradstreet. If anything on the report is wrong, notify the credit reporting company in writing, and keep following up until it is changed. It's important that your report be accurate because the bank may be using it to determine whether to let you open a merchant account.

## Shopping for the Best Rates

Shopping for the best merchant account rate is like shopping for anything else: you want the best value at the lowest price. Don't make the mistake of assuming that you'll get the same rate at every bank. Let's look at some of the terms that are important in credit card transactions.

**Discount rate.** The discount rate is the sum that's deducted and paid to the credit card company and the issuing bank. It usually ranges from 2.5 percent to 5.5 percent of your credit sales, depending upon the volume of your sales and the typical transaction size. The discount rate is comprised of the transaction charges, the interchange rate, and the transmission costs.

**Transaction charge.** The transaction charge is essentially the profit that the processing network makes. It's usually included in the discount rate, but it may be charged separately. The transaction charge is really the only element of the discount rate that you can negotiate. Ask each bank you visit about its transaction charge and then compare the numbers. If one bank has a transaction fee higher than another bank, ask the bank why the fee is higher. You should find out if you get any additional services for the higher fee.

**Interchange rate.** The interchange rate is the cost of processing the charge through the Visa or MasterCard network. The current interchange rate for swiped transactions is 1.30 percent for MasterCard and 1.35 percent for Visa.

**Non-swiped surcharges.** Federal regulations require an additional charge of about 0.30 percent per transaction to the cost of non-swiped transactions. Thus, the total interchange rate for non-swiped transactions is 1.60 percent for MasterCard and 1.65 percent for Visa.

**Transmission costs.** The cost of transmitting the sale information through the processing network is expressed as a cost per ticket, and runs about 18 cents to 23 cents per transaction.

To recap, if you add up the transaction charge plus the interchange rate plus the transmission costs, you get the discount rate.



Here's an example of how it might work.

You'll have to estimate your annual credit card charges and the amount of your average sale. Let's suppose that you estimate your annual charges at \$40,000 and your average sale at \$60. You accept Visa and MasterCard, and all of your transactions are swiped.

We now need to add up the three elements of the discount rate. For the interchange rate, let's use the 1.35-percent Visa rate. We next need to figure out the transmission costs. Let's assume you can only get the 23-cent rate. The transmission cost, converted to a percentage, is 0.46 percent (23 cents, or .23, divided by \$60). The total processor's cost, then, is 1.81 percent (1.35% + 0.46%).

Next comes the processor's profit. What's a fair profit? That's hard to determine, but let's say that you can get your bank to agree that \$500 is a fair profit on \$40,000 of sales. That will add another 1.25 percent ( $500/40,000$ ). Your cost, therefore, will be 3.06 percent per transaction.

Banks are hesitant to give merchant credit card accounts to certain businesses that they deem to be particularly high credit card risks. High-risk businesses are usually those that have a history of fraudulent activities, a history of high chargeback rates, or a high failure rate. Although there is no standard "list," here are a few that are routinely considered to be high-risk businesses (the \* denotes businesses that will have an especially difficult time getting card privileges):

- adult bookstores\*
- airlines\*
- automobile rentals
- bail bondsmen\*

- bars without a restaurant
- businesses without a storefront
- check cashing businesses\*
- collection agencies\*
- credit unions\*
- dating/escort services\*
- gambling facilities\*
- health club memberships\*
- infomercials
- insurance sales
- limousine services
- massage parlors\*
- merchants who have declared bankruptcy within the past 10 years
- pawn shops\*
- real estate-related businesses
- self-improvement courses
- sexually explicit telephone businesses\*
- tour companies
- thrift travel agencies\*

If you fall into one of the categories above, it does not mean that you cannot get a credit card account. It means simply that you're going to have more trouble (in some cases, a lot more trouble) getting an account than most other businesses.

**What to do?** If you're on the list, you may have to shop around more than other businesses, and you may not have as many choices as they do. Also, you're probably going to pay higher fees. The credit card transaction fees range generally from 2.5 percent of sales to 5.5 percent of credit sales. If you're on the list, you're probably going to pay nearer the upper end of the scale or, in some case, above the upper limit.



If your bank won't let you open up a merchant account, consider using an Independent Service Organization. You can contract with the ISO to open a merchant account, and the ISO will contract with the bank. The ISO, in effect, bears the risk of doing business with you.

Of course, the ISO will charge you for its services. Please be careful here. Although there are more than 1,400 ISOs in the U.S., they are not regulated. Make sure that you understand all the extra charges before you enter into an agreement. Sometimes you can be grossly overcharged for the equipment that the ISO provides you and for other hidden charges.

## Credit Card Equipment

Fear of credit-card fraud has not only made merchant accounts more difficult to get, it has also changed the equipment merchants use to record transactions. In the "old" days, the merchant would place the credit card on a special tray, lay the triplicate transaction receipt on

top, and run the imprinter over them both. Today, most merchants simply swipe the credit card through a scanner. While that has helped combat fraud, it has also increased costs for merchants because the scanners are more expensive than the imprinters.

If you still need the imprinter, you can get one for about \$25. You might need the imprinter, for example, if you sell goods some place where you don't have access to a telephone line, such as at a neighborhood art fair.

The scanner terminal, on the other hand, is much more expensive. A four-year lease will usually run about \$50-\$70 a month. You can purchase the equipment, but be careful if you do. Before you purchase the equipment, find out what your bank will charge you to connect your equipment to their system. The extra costs may make renting less expensive than buying.

You may also need a second piece of equipment: a receipt printer. Whether you need one depends upon whether you have face-to-face sales. If you do, you'll probably need one. You can expect to pay about the same for a receipt printer that you have to pay for a scanner terminal.

There is a less expensive option available. If you have a computer, you can buy software that is less expensive than the hardware you would have to buy, but performs all of the functions you'll need. Make sure before you buy the software that it is compatible with your bank's system.

## Chargebacks on Credit Cards

If you get too many [chargebacks](#) you can lose your merchant credit card account. But since you can get a chargeback through no fault of your own, you're not entirely in control of your own destiny. For example, the bank could issue a chargeback in error.

Here's a list of some of the reasons for chargebacks:

- unauthorized use of credit card
- no signature on the receipt
- processing error (for example, same charge processed twice)
- expired credit card
- customer disputes charges (for example, wrong merchandise delivered)

So what can you do? One thing you can do is to take a few precautions against the chargebacks. Here's how, first with procedural chargebacks and then with customer-initiated chargebacks.

**Procedural chargebacks.** Procedural chargebacks occur because you didn't follow all of the rules set by the bank. The first four items in the list above are examples of procedural chargebacks. You can reduce the frequency of these chargebacks by developing a routine that you (and your sales staff, if any) will always follow. For example, take the credit card from the customer, check the expiration date, run it through the electronic terminal, etc. Although you can never completely eliminate procedural chargebacks (how can you always know that the customer has proper authority to use the card?), you can reduce such chargebacks with a carefully planned routine.

You can reduce the chances that the cardholder does not have the proper authority by matching the signature on the credit card against the signature on the receipt. Only the person whose name and signature appear on the card has authority to use it. However, most merchants will accept a credit card used by the named owner's spouse, on the theory that spouses are responsible for each other's debts. Some will also accept a card used by the cardholder's minor child, under the theory that a parent is responsible for the minor's debts.

Phone orders, of course, pose a more serious problem. For phone orders, you should get the caller's home and work phone numbers, in addition to the information you would need to fill the order, such as name and address. If you intend to verify the information before you send your merchandise, then tell the customer that's what you're doing.

**Customer-initiated chargebacks.** Customer-initiated chargebacks occur when customers attempt to cancel the transaction for some reason, usually because the goods were damaged or because they claim the charges were excessive. A chargeback differs from a simple return of your merchandise because the credit card company is involved. In other words, the customer has complained not to you, but to the credit card company. If the customer complains directly to you, you can repay the customer without affecting your chargeback rate.

A good way to combat customer-initiated chargebacks is to have a generous return policy. If your policy is lenient, you may be able to limit your chargeback rate. You'll just have to weigh the benefits of a lower chargeback rate against the chances that some customers may abuse your lenient policy.

**Adequate documentation.** If you want to refute your customer's chargeback attempts, you'll need adequate documentation. Unfortunately, in some cases, you may not find out that your customer sought a chargeback until after the fact. Your bank is supposed to direct the dispute to you before a chargeback is initiated, but some banks don't follow the rules. If you find this happening, ask the bank to send the dispute to you first.

The documentation you need to rebut the claim will depend upon the reason your customer gives for the chargeback. If the reason is that the customer never purchased your goods, the best documentation you can have is the signed sales receipt. If the reason is that the goods were never delivered or were damaged, you need the receipt showing the method of shipment so you can trace it (and potentially collect from the shipping carrier).

You should keep all your records of sales. If you use the electronic terminal or the credit card software, the records will be kept for you automatically. If you don't, the best way to keep track is to develop a consistent approach to what you do with your records after the sale.

**If you're desperate.** It's a good idea to know what your chargeback rate is, as well as the chargeback rate limit set by the credit card company (it's usually about 1 percent of credit sales). If you're getting close to that limit on one of the credit cards you normally accept, you may want to consider asking some customers to pay their bill with one of the credit cards that isn't in danger.

## Violations of Credit Card Policy

The surest way to lose your merchant account forever is to get caught doing something that violates credit card company policy. Here's a look at two areas in particular that you should avoid at all costs.

**Misrepresentation.** When you're filling out your merchant account application, don't fudge on the numbers in order to improve your chances of getting the account. Don't misrepresent the nature of your business or the extent of your business experience. In short, don't intentionally misrepresent anything on the application. If you're caught, you may never get another chance to open an account.

Suppose you fill out your application honestly but business conditions change so that the information is now inaccurate. Do you have a duty to inform the bank? That depends upon what changed. If you represented that you wouldn't be taking any credit card sales over the phone, but now you want to, you probably should tell the bank. On the other hand, if your annual sales drop slightly, you probably don't need to tell the bank. The dividing line for determining whether to tell the bank is whether you believe the information alters the credit risk the bank is taking. If you think it might, you should tell the bank. If you're in doubt, tell the bank.



A good policy for notifying the bank of business changes is to tell it *before* you want to make the change. Get the bank to agree to the change and document the agreement in writing (this may mean simply getting a letter from your banker).

**Factoring.** In this context, factoring is the process of running the charges of another business through your merchant account in order to generate profits. Don't do it; it's wrong, and, in some cases, it's illegal. If you're not swayed by the moral or legal argument, don't do it because it's easy to get caught. All it takes is one customer initiating a chargeback, and you can lose your merchant account forever.

## Accepting Credit Cards on Your Web Page

The number-one question on the minds of new Web site builders is, How do I arrange to accept credit cards for payments?

You may try companies that specialize in issuing accounts to online merchants, including:

- [Cardservice International](#)
- [VeriSign](#)
- [Credit Card Processing Services](#)
- [The Processing Network](#)
- [21st Century Resources](#)

Or log onto Google and search for credit card processing. You'll find many dozens of outfits, large and small, that are on the prowl for start-ups seeking merchant accounts.

Credit cards aren't processed cheaply, however, at least not for a start-up. A typical fee schedule for a small-volume account (fewer than 1,000 transactions monthly) would include start-up fees amounting to around \$200 and monthly processing fees of around \$20.

### **Making Customers Feel Secure**

The one must-have for online credit card processing: secure, encrypted connections. You've seen this many times yourself. Go to virtually any major e-tailer, commence a purchase, and you are put into a "secure server" environment, where transaction data is scrambled to provide a measure of safety against hackers. Truth is, these worries are generally unfounded--the odds of a hacker grabbing an unencrypted credit card number from a nonsecure Web site are pretty slender--but buyers feel reassured when they see they're entering a secure site, and that means you need to provide it.

Is this a technical hassle for you? It shouldn't be. Whatever vendor sells you credit card processing should also, as part of the package, provide a secure transaction environment. If they don't, look elsewhere.

## **Glossory of Terms for Merchant Services**

### **ATM card**

A card that allows the user to withdraw money from a bank account through an Automated Teller Machine.

### **Authorization**

Process of confirming that a credit card is in good standing and funds are available before the sale is finalized.

### **Chargeback**

A transaction returned to the merchant's account from the credit card holder's bank in response to a cardholder dispute or for a merchant's failure to follow appropriate regulations.

### **Credit card**

A card that allows the user to make purchases on credit. The financial institution that issues the credit card charges the user interest on purchases not paid off in full each month.

### **Debit card**

A card that allows the user to withdraw money like an ATM card or make purchases from retail stores by drawing money directly from the user's bank account.

### **Discount rate**

A fee that financial institutions charge merchants for depositing and handling their daily card transactions.

### **Ecommerce (or Electronic Commerce)**

Conducting business online.

### **Electronic check**

An electronic system that takes money directly from a user's checking account.

### **Encryption**

Process of converting information into code that is useless to anyone without the key and decryption software. Encryption is necessary for conducting secure transactions over the Internet.

### **Merchant account**

A bank account opened by a merchant that allows him or her to accept credit cards and receive the proceeds of credit card purchases.

**Payment gateway**

A system that reformats credit card transaction information and routes it to the authorization network. Internet gateways include specialized security measures.

**Purchasing card**

A convenient alternative to paper invoices and purchase orders. These cards contain all the information necessary to track and transmit funds from one business to another.

**Retrieval request**

A request from a customer for more information about a transaction on his or her credit card statement. The cardholder's bank then requests a legible copy of the sales draft used in the transaction.

**Settlement**

Process by which a credit card transaction is completed. The merchant's acquiring financial institution credits the merchant's account for the credit card sale, and the sale is posted to the consumer's credit card account.

**Virtual Cash Register**

A secure Internet payment gateway and merchant account package that allows merchants to conduct and manage their business online.