HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
August 08, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**22-3755714**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

90 Nassau Street, Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

(609) 683-3831

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x YES ¨ NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). ¨ YES x NO

As of August 4, 2008, there were 37,509,542 shares of the registrant s Common Stock, $0.001 par value, outstanding.

Table of Contents

INDEX

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(In thousands, except share data)

(unaudited)

	June 30, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	**$ 40,142**	$ 35,508
Funds held for payroll customers	**22,651**	24,201
Receivables, net	**156,276**	122,613
Investments held to maturity	**1,141**	1,119
Inventory	**7,721**	5,383
Prepaid expenses	**4,653**	3,478
Current tax asset	**4,739**	5,449
Current deferred tax assets, net	**835**	690
Total current assets	**238,158**	198,441
Capitalized customer acquisition costs, net	**76,376**	70,498
Deferred tax assets, net	**1,517**	3,878
Property and equipment, net	**59,403**	50,248
Goodwill	**58,774**	5,489
Intangible assets, net	**34,352**	481
Deposits and other assets, net	**202**	154
Total assets	**$ 468,782**	$ 329,189
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor banks	**$ 98,182**	$ 49,798
Accounts payable	**26,138**	20,495
Deposits held for payroll customers	**22,651**	24,201
Current portion of borrowings	**56,250**	
Current portion of accrued buyout liability	**11,006**	11,521
Merchant deposits and loss reserves	**19,028**	14,757
Accrued expenses and other liabilities	**22,045**	15,266
Total current liabilities	**255,300**	136,038
Reserve for unrecognized tax benefits	**1,391**	1,230
Long-term portion of borrowings	**18,750**	
Long-term portion of accrued buyout liability	**29,015**	26,252
Total liabilities	**304,456**	163,520
Commitments and contingencies (Note 12)		
Stockholders equity		
Common Stock, $0.001 par value, 100,000,000 shares authorized, 37,448,752 and 39,804,322 shares issued at June 30, 2008 and December 31, 2007; 37,448,752 and 37,989,622 shares outstanding at June 30, 2008 and December 31, 2007	**38**	40

Additional paid-in capital	**165,155**	173,346
Accumulated other comprehensive loss	**(252)**	(62)
(Accumulated deficit) Retained earnings	**(615)**	36,729
Treasury stock, at cost (1,814,700 shares at December 31, 2007)		(44,384)
Total stockholders equity	**164,326**	165,669
Total liabilities and stockholders equity	**$ 468,782**	$ 329,189

See accompanying notes to condensed consolidated financial statements.

1

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Income and Comprehensive Income

(In thousands, except per share data)

(unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Total Revenues	**$ 394,554**	$ 333,445	**$ 734,173**	$ 617,657
Costs of Services:				
Interchange	**282,377**	245,225	**527,654**	450,562
Dues and assessments	**14,152**	12,398	**26,494**	22,857
Processing and servicing	**45,953**	32,764	**82,882**	64,094
Customer acquisition costs	**12,274**	11,383	**23,724**	21,774
Depreciation and amortization	**2,465**	1,661	**4,375**	3,385
Total costs of services	**357,221**	303,431	**665,129**	562,672
General and administrative	**18,289**	13,735	**35,463**	28,034
Total expenses	**375,510**	317,166	**700,592**	590,706
Income from operations	**19,044**	16,279	**33,581**	26,951
Other income (expense):				
Interest income	**169**	517	**469**	976
Interest expense	**(751)**	(233)	**(1,097)**	(345)
Loss on investment			**(103)**	
Other, net	**1**	5	**24**	(90)
Total other income (expense)	**(581)**	289	**(707)**	541
Income before income taxes	**18,463**	16,568	**32,874**	27,492
Provision for income taxes	**6,994**	6,166	**12,428**	10,238
Net income	**$ 11,469**	$ 10,402	**$ 20,446**	$ 17,254
Net income	**$ 11,469**	$ 10,402	**$ 20,446**	$ 17,254
Other comprehensive income:				
Unrealized gains (losses) on investments, net of income tax of $(3), $(4), $9 and $(2)	**(6)**	(7)	**15**	(4)
Foreign currency translation adjustment, net of income tax of $37 and $(124)	**54**		**(205)**	
Comprehensive income	**$ 11,517**	$ 10,395	**$ 20,256**	$ 17,250
Earnings per common share:				
Basic	**$ 0.31**	$ 0.28	**$ 0.55**	$ 0.46
Diluted	**$ 0.30**	$ 0.26	**$ 0.53**	$ 0.43
Weighted average number of common shares outstanding:				
Basic	**37,387**	37,653	**37,464**	37,580

Diluted	**38,688**	39,863	**38,755**	39,919

See accompanying notes to condensed consolidated financial statements.

2

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Stockholders Equity

(In thousands)

(unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	(Accumulated Deficit) Retained Earnings	Treasury Stock	Total Stockholders Equity
Six Months Ended June 30, 2007:							
Balance, January 1, 2007	37,406	$ 38	$ 153,997	$ (21)	$ 10,804	$ (25,525)	$ 139,293
Cumulative effect of change in accounting principal FIN No. 48					(514)		(514)
Issuance of Common Stock options exercised	645	1	4,545				4,546
Excess tax benefit on stock options exercised under SFAS No. 123R			3,820				3,820
Repurchase of Common Stock	(607)					(15,307)	(15,307)
Stock-based compensation under SFAS No. 123R			801				801
Accumulated other comprehensive income				(4)			(4)
Dividends on Common Stock					(3,757)		(3,757)
Net income for the period					17,254		17,254
Balance June 30, 2007	37,444	$ 39	$ 163,163	$ (25)	$ 23,787	$ (40,832)	$ 146,132
Six Months Ended June 30, 2008:							
Balance, January 1, 2008	37,990	$ 40	$ 173,346	$ (62)	$ 36,729	$ (44,384)	$ 165,669
Issuance of Common Stock options exercised	241		1,783				1,783
Excess tax benefit on stock options exercised under SFAS No. 123R			562				562
Repurchase of Common Stock	(782)					(17,995)	(17,995)
Retirement of Treasury Stock		(2)	(11,311)		(51,066)	62,379	
Stock-based compensation under SFAS No. 123R			775				775
Accumulated other comprehensive income:							
Unrealized gains on investments				15			15
Foreign currency translation adjustment				(205)			(205)
Dividends on Common Stock					(6,724)		(6,724)
Net income for the period					20,446		20,446
Balance June 30, 2008	37,449	$ 38	$ 165,155	$ (252)	$ (615)	$	$ 164,326

See accompanying notes to condensed consolidated financial statements.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flow

(In thousands)

(unaudited)

	Six Months Ended June 30, 2008	2007
Cash flows from operating activities		
Net income	**$ 20,446**	$ 17,254
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of capitalized customer acquisition costs	**25,873**	21,253
Other depreciation and amortization	**5,882**	4,254
Addition to loss reserves	**2,767**	1,122
Provision for doubtful receivables	**1,395**	216
Stock-based compensation	**775**	801
Deferred taxes	**2,292**	90
Loss on investment	**103**	
Other	**4**	172
Changes in operating assets and liabilities:		
Increase in receivables	**(15,686)**	(11,558)
Decrease (increase) in inventory	**899**	(625)
Payment of signing bonuses, net	**(24,104)**	(21,639)
Increase in capitalized customer acquisition costs	**(7,647)**	(6,729)
Increase in prepaid expenses	**(600)**	(711)
Decrease in current tax asset	**1,286**	5,284
Increase in deposits and other assets	**(43)**	(9)
Excess tax benefits on options exercised under SFAS No. 123R	**(811)**	(3,820)
Increase in reserve for unrecognized tax benefits	**160**	476
Increase in due to sponsor bank	**48,383**	25,284
Increase in accounts payable	**4,697**	3,165
(Decrease) increase in accrued expenses and other liabilities	**(824)**	1,917
Decrease in merchant deposits and loss reserves	**(706)**	(1,161)
Payouts of accrued buyout liability	**(3,250)**	(4,746)
Increase in accrued buyout liability	**5,498**	7,250
Net cash provided by operating activities	**66,789**	37,540
Cash flows from investing activities		
Purchase of investments held to maturity	**(46)**	(1,330)
Maturities of investments held to maturity	**250**	265
Decrease (increase) in funds held for payroll customers	**1,245**	(3,930)
(Decrease) increase in deposits held for payroll customers	**(1,549)**	3,828
Acquisition of business, net of cash acquired	**(102,544)**	(300)
Purchases of property and equipment	**(12,375)**	(13,993)
Net cash used in investing activities	**(115,019)**	(15,460)
Cash flows from financing activities		
Proceeds from borrowings	**95,000**	
Principal payments on borrowings and financing arrangements	**(20,000)**	(146)
Proceeds from exercise of stock options	**1,783**	4,546

Excess tax benefits on options exercised under SFAS No. 123R	**811**	3,820
Repurchase of common stock	**(17,995)**	(15,307)
Dividends paid on common stock	**(6,724)**	(3,757)
Net cash provided by (used in) financing activities	**52,875**	(10,844)
Net increase in cash and cash equivalents	**4,645**	11,236
Effect of exchange rates on cash	**(11)**	
Cash and cash equivalents at beginning of year	**35,508**	16,054
Cash and cash equivalents at end of period	**$ 40,142**	$ 27,290
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	**$ 959**	$ 245
Income taxes	**8,467**	4,371

See accompanying notes to condensed consolidated financial statements.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

1. Organization and Operations

Basis of Financial Statement Presentation The accompanying condensed consolidated financial statements include those of Heartland Payment Systems, Inc. (the Company) and its subsidiaries, Heartland Payroll Company (HPC), Debitek, Inc. (Debitek), Collective POS Solutions Ltd. (CPOS) and Heartland Acquisition LLC (Network Services). The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company s subsidiaries have been eliminated upon consolidation.

The accompanying condensed consolidated financial statements are unaudited. In the opinion of the Company s management, the unaudited condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of the Company s financial position at June 30, 2008, its results of operations, changes in stockholders equity and cash flows for the six months ended June 30, 2008 and 2007. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ended December 31, 2008. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2007. The December 31, 2007 condensed consolidated balance sheet was derived from the audited 2007 consolidated financial statements.

On May 2, 2008, the Company and Alliance Data Network Services LLC (the Seller), entered into a Membership Interest and Asset Purchase Agreement (the Agreement), under which the Company acquired substantially all of the assets of the network services business unit (Network Services) of the Seller (the Acquisition). Pursuant to the terms of the Agreement, the Company acquired Network Services from the Seller, including tangible personal property, intellectual property, licenses, contracts and related assets, and assumed certain liabilities of the Seller related to Network Services, for a cash payment of $77.5 million plus the net working capital of Network Services on the closing date (approximately $15.0 million). The Acquisition closed as of May 31, 2008.

Business Description The Company provides payment processing services related to bank card transactions for merchants throughout the United States and some parts of Canada. In addition, the Company provides certain other merchant services, including check processing, the sale and rental of terminal equipment, and the sale of terminal supplies. HPC provides payroll and related tax filing services throughout the United States. Debitek provides prepaid card and stored-value card solutions throughout the United States. The Company and Debitek also provide campus payment solutions throughout the United States. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions.

Substantially all of the Company s revenue is derived from processing and settling Visa and MasterCard bank card transactions for its merchant customers. Because the Company is not a member bank as defined by Visa and MasterCard, in order to process and settle these bank card transactions for its merchants the Company has entered into sponsorship agreements with member banks. Visa and MasterCard rules restrict the Company from performing funds settlement or accessing merchant settlement funds and require that these funds be in the possession of the member bank until the merchant is funded. A sponsorship arrangement permits the Company to route Visa and MasterCard bank card transactions under the member bank s control and identification numbers to clear credit bank card transactions through Visa and MasterCard. A sponsorship arrangement also enables the Company to settle funds between cardholders and merchants by deliver funding files to the member bank, which in turn transfers settlement funds to the merchants bank accounts. These restrictions place the settlement assets and obligations under the control of the member bank.

The sponsorship agreements with the member banks requires, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard networks and maintain a certificate of deposit with the bank sponsors. If the Company breaches the sponsorship agreements, the

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

bank sponsors may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative bank sponsor. The Company is dependent on its bank sponsors, Visa and MasterCard for notification of any compliance breaches. As of June 30, 2008, the Company has not been notified of any such issues by its bank sponsors, Visa or MasterCard. Of the Company s total bank card processing volume for the month of June 2008, 66% was processed under its sponsorship agreement with KeyBank N.A., 7% was processed under its sponsorship agreement with Heartland Bank (an unrelated third party), and 27% was processed under a sponsorship arrangement with World Financial Network National Bank for Network Services processing.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include, among other things, the accrued buyout liability, capitalized customer acquisition costs, loss reserves, certain accounts payable and accrued expenses and certain tax assets and liabilities as well as the related valuation allowances, if any. Actual results could differ from those estimates.

2. Summary of Significant Accounting Policies

Receivables Receivables are stated net of allowance for doubtful accounts. The Company estimates its allowance based on experience with its merchants, customers, and sales force and its judgment as to the likelihood of their ultimate payment. The Company also considers collection experience and makes estimates regarding collectability based on trends in aging. Historically, the Company has not experienced significant charge offs for its merchant receivables.

The Company s primary receivables are due from its bank card processing merchants. These receivables result from the Company s practice of advancing interchange fees to most of its merchants during the month and collecting those fees from merchants at the beginning of the following month, as well as from transaction fees the Company charges its merchants for processing transactions.

Until the second quarter of 2008, the advances of interchange fees to merchants were funded first with cash available for investment, then by incurring a payable to sponsor banks when that cash has been expended. The Company pays the sponsor banks the prime rate on these payables. To fund the purchase price for Network Services, during the second quarter of 2008 the Company suspended using its available cash to fund merchant advances. At June 30, 2008, the Company had not used any of its cash to fund merchant advances. At December 31, 2007, the Company used $37.9 million of its available cash to fund merchant advances. The amount due to sponsor banks for funding advances was $98.2 million at June 30, 2008 and $49.8 million at December 31, 2007. The payable to sponsor banks is repaid at the beginning of the following month out of the fees the Company collects from its merchants. Receivables from merchants also include receivables from the sale of point of sale terminal equipment and check processing terminals.

Receivables also include amounts resulting from the sale, installation, training and repair of cashless payment system hardware and software for prepaid card and stored-value card payment systems and campus payment solutions. These receivables are mostly invoiced on terms of 30 days net from date of invoicing and are typically funded from working capital.

Receivables also include amounts advanced to employees, primarily the Company s sales force, to cover certain expenses. These receivables are recovered from sales and residual commissions earned by the sales force.

Investments and Funds Held for Payroll Customers Investments, including those carried on the consolidated balance sheet as Funds Held for Payroll Customers, consist primarily of fixed income bond funds, corporate and U.S. Government debt securities, certificates of deposit and cost basis equity securities. The Company classifies the majority of its investments, including those carried in Funds Held

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

for Payroll Customers, as available-for-sale and records them at the fair value of the investments based on quoted market prices. Certificates of deposit are classified as held to maturity and recorded at cost. Cost basis equity securities are recorded at cost and periodically evaluated for impairment. In the event of a sale, cost is determined on a specific identification basis. At June 30, 2008, Funds Held for Payroll Customers included cash and cash equivalents of $21.1 million and investments available for sale of $1.5 million.

Capitalized Customer Acquisition Costs, net Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company s sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the estimated cost of buying out the commissions of vested sales employees. Pursuant to Staff Accounting Bulletin Topic 13, *Revenue Recognition*, and Financial Accounting Standards Board (FASB) Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The up-front signing bonus is based on the estimated gross margin for the first year of the merchant contract. The signing bonus, amount capitalized, and related amortization are adjusted after one year to reflect the actual gross margin generated by the merchant contract during that year. The deferred customer acquisition cost asset is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, as described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. The Company believes that no impairment has occurred as of June 30, 2008 and December 31, 2007.

Merchant Deposits and Loss Reserves Disputes between a cardholder and a merchant periodically arise due to the cardholder s dissatisfaction with merchandise quality or the merchant s service, and the disputes may not always be resolved in the merchant s favor. In some of these cases, the transaction is charged back to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company may have partial recourse to the Relationship Manager originally soliciting the merchant contract, if the Relationship Manager is still receiving income from the merchant s processing activities. Under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Other* (FIN 45), the Company s obligation to stand ready to perform is minimal. The Company maintains a deposit or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to recent bank card processing volume levels. The Company believes that the liability recorded as loss reserves approximates fair value.

Accrued Buyout Liability Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly merchant processing activity. The Company has the right, but is not obligated, to buy out some or all of these commissions, and intends to do so periodically. Such purchases of the commissions are at a fixed multiple of the last twelve months commissions. Because of the Company s intent and ability to execute purchases of the residual commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount that it would have to pay (the settlement cost) to buy out non-servicing related commissions in their entirety from vested Relationship

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a merchant contract, the Company also records a related deferred acquisition cost asset for currently vested Relationship Managers and sales managers. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin, are included in the same income statement caption as customer acquisition cost amortization expense.

The accrued buyout liability is based on the merchants under contract at the balance sheet date, the gross margin generated by those merchants over the prior twelve months, and the contractual buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date. The same procedure is applied to unvested commissions over the expected vesting period, but is further adjusted to reflect the Company s experience that 31% of unvested Relationship Managers and sales managers become vested.

The classification of the accrued buyout liability between current and non-current liabilities on the consolidated balance sheets is based upon the Company s estimate of the amount of the accrued buyout liability that it reasonably expects to pay over the next twelve months. This estimate is developed by calculating the cumulative annual average percentage that total historical buyout payments represent of the accrued buyout liability. That percentage is applied to the period-end accrued buyout liability to determine the current portion.

Revenue Revenues are mainly comprised of gross processing revenue, payroll processing revenue and equipment-related income. Gross processing revenue primarily consists of discount fees and per-transaction and periodic (primarily monthly) fees from the processing of Visa and MasterCard bank card transactions for merchants. The Company passes through to its customers any changes in interchange or network fees. Gross processing revenue also includes American Express and Discover fees, customer service fees, fees for processing chargebacks, termination fees on terminated contracts, and other miscellaneous revenue. Payroll processing revenue includes periodic and annual fees charged by HPC for payroll processing services, and interest earned from the investment of tax impound funds held for our customers. Revenue is recorded as bank card transactions are processed or payroll services are performed.

Equipment-related income includes revenues from the sale, rental and deployment of bank card and check processing terminals, from the sale of hardware, software and associated services for prepaid card and stored-value card payment systems, and from the sale of hardware, software and associated services for campus payment solutions. Revenues are recorded at the time of shipment, or the provision of service.

Income Taxes The Company accounts for income taxes by recognizing deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted tax rates.

Stock Options The Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R) on January 1, 2006.

Diluted earnings per share for the three and six months ended June 30, 2008 and 2007 were computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, where dilutive.

Foreign Currency The Canadian dollar is the functional currency of CPOS, which operates in Canada. CPOS revenues and expenses are translated at the average exchange rates prevailing during the period. For the three months and six months ended June 30, 2008, such translation gains or losses were not material.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

The foreign currency assets and liabilities of CPOS are translated at the period-end rate of exchange. The resulting translation adjustment is recorded as a component of other comprehensive income and is included in stockholders equity net of tax.

Minority Interests Minority interests represent the minority stockholders share of the equity and after-tax net income or loss of consolidated subsidiaries. Minority stockholders share of after-tax net income or loss of consolidated subsidiaries is included in General and administrative expenses in the Consolidated Income Statement. The minority interests included in Accrued expenses and other liabilities in the June 30, 2008 Consolidated Balance Sheet were $152,000 and reflect the original investments by these minority shareholders in the consolidated subsidiaries, along with their proportionate share of the earnings or losses of the subsidiaries.

New Accounting Pronouncements The FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN No. 48), in June 2006. FIN No. 48 clarifies the accounting for the recognition and measurement of tax benefits associated with uncertain tax positions and defines criterion that an individual tax position must meet for any part of that position to be recognized or continue to be recognized in the financial statements. FIN No. 48 also adds disclosure requirements for the amounts of unrecognized tax benefits associated with uncertain tax positions. An uncertain tax position exists if it is unclear how a transaction will be treated under tax law. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company completed its initial evaluation of the impact of adopting FIN No. 48 on January 1, 2007 and recorded a cumulative effect adjustment of $0.5 million to Retained Earnings to establish reserves for uncertain tax positions.

The FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), in September 2006. SFAS No. 157 establishes a single authoritative definition of fair value in generally accepted accounting principles (GAAP), sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. SFAS No. 157 applies only to fair value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. SFAS No. 157 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The adoption of SFAS No. 157 did not have a material effect on the Company s Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities* (SFAS No. 159). SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity makes that choice in the first 120 days of that fiscal year, has not yet issued financial statements for any interim period of the fiscal year of adoption, and also elects to apply the provisions of Statement No. 157, *Fair Value Measurements*. The adoption of SFAS No. 159 did not have a material effect on the Company s Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) applies the acquisition method to all transactions and other events in which one entity obtains control over one or more other businesses and establishes principles and requirements for how the acquirer recognizes and measures identifiable assets acquired and liabilities assumed, including assets and liabilities arising from contingencies, any noncontrolling interest in the acquiree and goodwill acquired or gain realized from a bargain purchase. SFAS No. 141(R) is effective prospectively for business combinations for which the acquisition date is on or after the first annual reporting period beginning after December 15, 2008. The adoption of SFAS No. 141 (R) will impact the Company s Consolidated Financial Statements prospectively in the event of any business combinations entered into after the effective date in which the Company is the acquirer.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS No. 160), which amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements.* SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, SFAS No. 160 requires a noncontrolling interest in a subsidiary to be reported as equity, separate from the parent s equity, in the consolidated statement of financial position and the amount of net income or loss and comprehensive income or loss attributable to the parent and noncontrolling interest to be presented separately on the face of the consolidated financial statements. Changes in a parent s ownership interest in its subsidiary in which a controlling financial interest is retained are accounted for as equity transactions. If a controlling financial interest in the subsidiary is not retained, the subsidiary is deconsolidated and any retained noncontrolling equity interest is initially measured at fair value. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008 and is to be applied prospectively, except that presentation and disclosure requirements are to be applied retrospectively for all periods presented. The Company is currently evaluating the impact of adopting SFAS No. 160 on its Consolidated Financial Statements.

In December 2007, the SEC issued SAB No. 110, *Certain Assumptions Used in Valuation Methods* (SAB 110). SAB 110 amends SAB 107 to allow the continued use, under certain circumstances, of the simplified method in developing the expected term for stock options. SAB 110 is effective January 1, 2008. The adoption of SAB 110 will impact the Company s Consolidated Financial Statements prospectively in the event circumstances provide for application of the simplified method to future stock option grants made by the Company.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142) in order to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other GAAP. FSP FAS 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008 and is to be applied prospectively to intangible assets acquired after the effective date. Disclosure requirements are to be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. Early adoption is not permitted. The Company is currently evaluating the impact of adopting FSP FAS 142-3 on its Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the accounting principles used in preparing financial statements of nongovernmental entities that are presented in conformity with GAAP. Currently, GAAP hierarchy is provided in the American Institute of Certified Public Accountants U.S. Auditing Standards (AU) Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AU Section 411). SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board s amendments to AU Section 411. The Company does not expect the adoption of SFAS No. 162 to have an impact on its Consolidated Financial Statements.

3. Acquisitions

Network Services

As of May 31, 2008, the Company closed its acquisition of Network Services. Network Services is a provider of payment processing solutions, serving a variety of industries such as petroleum, convenience store, parking and retail. Services include payment processing, prepaid services, POS terminal, helpdesk

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

services and merchant bankcard services. The Network Services acquisition will provide the Company with a substantial portfolio of merchants in the petroleum industry segment. Network Services handled over $17 billion of total annual Visa and MasterCard bank card processing volume and 604 million annual Visa and MasterCard transactions in 2007. In addition to Visa and MasterCard transactions, Network Services handles a wide range of payment transactions for its predominantly petroleum customer base, including providing approximately 2.6 billion transaction authorizations in 2007.

The Company acquired the Network Services business, including tangible personal property, intellectual property, licenses, contracts and related assets, and assumed certain liabilities related to Network Services, for a cash payment of $92.5 million. The Company funded the cash purchase price using $25.0 million it borrowed under its term loan facility, $50.0 million it borrowed under its revolving credit facility, and the balance from its available cash position. Beginning June 1, 2008, Network Services results of operations were included in the Company s results of operations

The acquisition was accounted for under the purchase method of accounting. The fair values of the Network Services assets acquired and the liabilities assumed were estimated at the acquisition date. The fair values are preliminary, based on estimates, and may be adjusted in accordance with Statement of Financial Accounting Standards No. 141(SFAS No. 141), *Business Combinations,* as more information becomes available and valuations are finalized. Accordingly, the final fair value adjustments may be materially different from those presented in this document.

The following table summarizes the allocation of the acquisition costs, including direct transaction costs, to the tangible and intangible assets acquired and the liabilities assumed based on their estimated fair values on May 31, 2008. The excess of the acquisition costs over the fair value of net assets acquired was allocated to goodwill. The goodwill acquired is expected to be deductible for tax purposes.

	Allocation of Acquisition Costs (in thousands)
Net fair value of assets acquired and liabilities assumed:	
Cash	$ 304
Receivables	18,902
Other current assets	3,660
Property and equipment	1,822
Accrued expenses and other liabilities	(7,653)
Total net assets acquired	17,035
Intangible assets acquired:	
Customer relationships	25,372
Software	7,500
Non-competition agreement	500
Total intangible assets	33,372
Goodwill	43,782
Total acquisition costs (a)	$ 94,189

(a) Total acquisition costs include $92.5 million of cash consideration paid, plus $1.7 million of direct transaction costs.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

The following unaudited pro forma operating results for the six months ended June 30, 2008 and 2007 assume that the Network Services acquisition occurred on January 1, 2007. The pro forma results of operations are based on historical results of operations, adjusted for the impacts of purchase price allocations and financing costs, and are not necessarily indicative of the actual results which would have been achieved had the Network Services acquisition occurred as of January 1, 2007, or the results which may be achieved in the future.

	Six Months Ended June 30, 2008	2007
(In thousands, except per share)		
Total revenues	$ 780,278	$ 682,148
Costs of services	700,867	613,295
General and administrative expenses	45,805	40,038
Total expenses	746,672	653,333
Income from operations	33,606	28,816
Net income	19,763	17,690
Diluted earnings per share	$ 0.51	$ 0.44

Collective Point of Sale Solutions Ltd.

On March 3, 2008 the Company acquired a majority interest in Collective Point of Sale Solutions Ltd. (CPOS) for a cash payment of $10.5 million. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions. This acquisition provides the Company an entrée into the Canadian credit and debit card processing market. The Company and CPOS are now able to service merchants that have locations in both the United States and Canada. The Company does not expect the acquisition of CPOS to have a material impact on its 2008 revenues or net income. Pro forma results of operations have not been presented because the effect of the acquisition was not material.

The transaction was accounted for under the purchase method of accounting. Beginning March 3, 2008, CPOS results of operations were included in the Company s results of operations. The preliminary allocation of the total purchase price was as follows: $9.4 million to goodwill, $1.1 million to intangible assets and net tangible assets, which were immaterial. As of June 30, 2008, the allocation of the purchase price was not finalized as the fair value estimates are not complete. The goodwill acquired is expected to be deductible for tax purposes.

4. Receivables

A summary of receivables by major class was as follows at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
	(In thousands)	
Accounts receivable from merchants	**$ 141,123**	$ 114,585
Accounts receivable from others	**15,469**	8,193
	156,592	122,778
Less allowance for doubtful accounts	**(316)**	(165)
Total receivables, net	**$ 156,276**	$ 122,613

12

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

Included in accounts receivable from others are $2.0 million and $1.6 million which are due from employees at June 30, 2008 and December 31, 2007, respectively.

A summary of the activity in the allowance for doubtful accounts for the three and six months ended June 30, 2008 and 2007 was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
Beginning balance	**$ 146**	$ 144	**$ 165**	$ 151
Balance of acquired entity allowance	**87**		**87**	
Additions to allowance	**1,049**	136	**1,309**	216
Charges against allowance	**(966)**	(130)	**(1,245)**	(217)
Ending balance	**$ 316**	$ 150	**$ 316**	$ 150

5. Capitalized Customer Acquisition Costs, Net

A summary of the capitalized customer acquisition costs, net, as of June 30, 2008 and December 31, 2007 was as follows:

	June 30, 2008	December 31, 2007
	(In thousands)	
Capitalized signing bonuses	**$ 110,826**	$ 100,206
Less accumulated amortization	**(49,494)**	(44,443)
	61,332	55,763
Capitalized customer deferred acquisition costs	**36,397**	35,379
Less accumulated amortization	**(21,353)**	(20,644)
	15,044	14,735
Capitalized Customer Acquisition Costs, Net	**$ 76,376**	$ 70,498

A summary of the activity in capitalized customer acquisition costs, net for the three and six month periods ended June 30, 2008 and 2007 was as follows:

	Three Months Ended June 30,	Six Months Ended June 30,

	2008	2007	2008	2007
		(In thousands)		
Balance at beginning of period	**$ 73,143**	$ 59,186	**$ 70,498**	$ 56,705
Plus additions to:				
Capitalized signing bonuses, net	**12,671**	12,151	**24,104**	21,639
Capitalized customer deferred acquisition costs	**3,913**	3,674	**7,647**	6,729
	16,584	15,825	**31,751**	28,368
Less amortization expense on:				
Capitalized signing bonuses, net	**(9,622)**	(7,733)	**(18,535)**	(14,623)
Capitalized customer deferred acquisition costs	**(3,729)**	(3,458)	**(7,338)**	(6,630)
	(13,351)	(11,191)	**(25,873)**	(21,253)
Balance at end of period	**$ 76,376**	$ 63,820	**$ 76,376**	$ 63,820

Net signing bonus adjustments from estimated amounts to actual were $0.9 million and $0.7 million, respectively, for the three months ended June 30, 2008 and 2007, and $0.9 million and $0.4 million, respectively, for the six months ended June 30, 2008 and 2007. Net signing bonus adjustments are netted against additions in the table above.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

Fully amortized signing bonuses of $6.9 million and $6.4 million respectively, were written off during the three month periods ended June 30, 2008 and 2007, and $13.5 million and $11.5 million respectively, were written off during the six month periods ended June 30, 2008 and 2007. In addition, fully amortized customer deferred acquisition costs of $3.6 million and $3.0 million, respectively, were written off during the three month periods ended June 30, 2008 and 2007, and $6.6 million and $5.9 million, respectively, were written off during the six month periods ended June 30, 2008 and 2007.

The Company believes that no impairment of capitalized customer acquisition costs has occurred as of June 30, 2008 and December 31, 2007.

6. Intangible Assets and Goodwill

The fair values of the Network Services and CPOS assets acquired and the liabilities assumed were estimated at their acquisition dates. The fair values are preliminary, based on estimates, and may be adjusted in accordance with SFAS No. 141 as more information becomes available and valuations are finalized. Accordingly, the final fair value adjustments, intangible assets and goodwill may be materially different from those presented in this document. Additionally, the amortization lives and methods may be adjusted as valuations are finalized. See Note 3 for more information on these acquisitions which closed in 2008.

Intangible Assets

Intangible assets consisted of the following as of June 30, 2008 and December 31, 2007:

	June 30, 2008				
	Gross Assets	Accumulated Amortization (In thousands)	Net Asset	Amortization Life and Method	
Finite Lived Assets:					
Customer relationships	$ 27,027	$ 541	$ 26,486	3 to 10 years	proporational cash flow
Software	7,584	208	7,376	3 to 5 years	straight line
Non-compete agreements	500	10	490	5 years	straight line
	$ 35,111	$ 759	$ 34,352		

	December 31, 2007				
	Gross Assets	Accumulated Amortization (In thousands)	Net Asset	Amortization Life and Method	
Finite Lived Assets:					
Customer relationships	$ 593	$ 112	$ 481	3 years	straight line
	$ 593	$ 112	$ 481		

Amortization expense related to the intangible assets was $597,000 and $10,000 for the three months ended June 30, 2008 and 2007, and $647,000 and $20,000 for the six months ended June 30, 2008 and 2007, respectively.

The estimated amortization expense related to intangible assets for the next five years is as follows:

	For Twelve Months Ending June 30, (In thousands)
2009	$ 5,697
2010	5,677
2011	5,206

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

2012	2,654
2013	2,644
Thereafter	12,474
	$ 34,352

Goodwill

The changes in the carrying amount of goodwill for the six months ended June 30, 2008 were as follows:

	(In thousands)
December 31, 2007	$ 5,489
Goodwill acquired during the period	53,345
Effects of foreign currency translation	(163)
Other, primarily final purchase price adjustments	103
June 30, 2008	$ 58,774

7. Merchant Deposits and Loss Reserves

The Company s merchants have the liability for any charges properly reversed by the cardholder through a mechanism known as a chargeback. If the merchant is unable to pay this amount, the Company will be liable to the Visa and MasterCard networks for the reversed charges. Under FIN 45, the Company determined that the fair value of its obligation to stand ready to perform is minimal. The Company requires personal guarantees, merchant deposits and letters of credit from certain merchants to minimize its obligation. As of June 30, 2008 and December 31, 2007, the Company held merchant deposits totaling $18.3 million and $14.1 million, respectively, and letters of credit totaling $513,000 and $300,000, respectively.

The Visa and MasterCard networks generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of the Company s transactions involve the delivery of the product or service at the time of the transaction, a reasonable basis for determining an estimate of the Company s exposure to chargebacks is the last four months processing volume on its portfolio, which was $21.9 billion and $17.9 billion for the four months ended June 30, 2008 and December 31, 2007. However, for the four months ended June 30, 2008 and December 31, 2007, the Company was presented with $11.8 million and $10.5 million, respectively, in chargebacks by issuing banks. In the six months ended June 30, 2008 and the year ended December 31, 2007, the Company incurred merchant credit losses of $2.6 million and $2.8 million, respectively, on total dollar volume processed of $30.3 billion and $51.9 billion, respectively. These credit losses are included in processing and servicing costs in the Company s consolidated statements of income.

The loss recorded by the Company for chargebacks associated with any individual merchant is typically small, due both to the relatively small size and the processing profile of the Company s clients. However, from time to time the Company will encounter instances of merchant fraud, and the resulting chargeback losses may be considerably more significant to the Company. The Company has established a contingent reserve for estimated currently existing credit and fraud losses on its consolidated balance sheets, amounting to $741,000 on June 30, 2008 and $663,000 on December 31, 2007. This reserve is determined by performing an analysis of the Company s historical loss experience applied to current processing volume and exposures.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

A summary of the activity in the loss reserve for the three and six month periods ended June 30, 2008 and 2007 was as follows:

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In thousands)			
Beginning balance	**$ 737**	$ 510	**$ 663**	$ 475
Additions to reserve	**1,288**	595	**2,767**	1,122
Charges against reserve (a)	**(1,284)**	(557)	**(2,689)**	(1,049)
Ending balance	**$ 741**	$ 548	**$ 741**	$ 548

(a) Included in these amounts are payroll segment losses of $19,000 and $12,000, respectively, for the three months ended June 30, 2008 and 2007, and $39,000 and $28,000, for the six months ended June 30, 2008 and 2007.

8. Accrued Buyout Liability

A summary of the accrued buyout liability was as follows as of June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
	(In thousands)	
Vested Relationship Managers and sales managers	**$ 38,974**	$ 36,792
Unvested Relationship Managers and sales managers	**1,047**	981
	40,021	37,773
Less current portion	**(11,006)**	(11,521)
Long-term portion of accrued buyout liability	**$ 29,015**	$ 26,252

A summary of the activity in the accrued buyout liability for the three and six month periods ended June 30, 2008 and 2007 was as follows:

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In thousands)			
Beginning balance	**$ 39,226**	$ 34,448	**$ 37,773**	$ 33,293
Increase in settlement obligation, net	**2,835**	3,866	**5,498**	7,250
Buyouts	**(2,040)**	(2,517)	**(3,250)**	(4,746)

Ending balance	**$ 40,021**	$ 35,797	**$ 40,021**	$ 35,797

The increase in the settlement obligation is due to new merchant account signings, as well as same-store sales growth and changes in gross margin, partially offset by the impact of merchant attrition.

In calculating the accrued buyout liability for unvested Relationship Managers and sales managers at June 30, 2008 and December 31, 2007, the Company has assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents the Company s historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested Relationship Managers and sales managers by $0.2 million at June 30, 2008 and December 31, 2007.

9. Credit Facility

On May 30, 2008, the Company entered into an amended and restated credit agreement (the Amended and Restated Credit Agreement) with JPMorgan Chase Bank, N.A., as administrative agent, and certain lenders who may become a party to the Credit Agreement from time to time. The Amended and Restated Credit Agreement amended and restated in its entirety the previous credit agreement entered into on September 5, 2007 between the same parties that are parties to the Amended and Restated Credit Agreement.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

The Amended and Restated Credit Agreement provides for a revolving credit facility in the aggregate amount of up to $50 million (the Revolving Credit Facility), of which up to $5 million may be used for the issuance of letters of credit and up to $5 million is available for swing line loans. Upon the prior approval of the administrative agent, the Company may increase the total commitments by $25 million for a total commitment under the Revolving Credit Facility of $75 million. The Revolving Credit Facility is available to the Company on a revolving basis commencing on May 30, 2008 and ending on September 4, 2012.

The Amended and Restated Credit Agreement also provides for a term credit facility in the aggregate amount of up to $25 million (the Term Credit Facility). The Term Credit Facility requires amortizing payments in the amount of $2,083,333 on the last business day of each fiscal quarter commencing March 31, 2009. All principal and interest not previously paid on the Term Credit Facility will mature and be due and payable on December 31, 2011. Amounts borrowed and repaid under the Term Credit Facility may not be re-borrowed.

The Amended and Restated Credit Agreement contains covenants, which include the maintenance of certain leverage and fixed charge coverage ratios, limitations on the Company s indebtedness, liens on its properties and assets, investments in, and loans to, other business units, the Company s ability to enter into business combinations and asset sales, and certain other financial and non-financial covenants.

Under the terms of the Amended and Restated Credit Agreement, the Company may borrow, at its option, at interest rates equal to one, two, three or six month adjusted LIBOR rates or equal to the greatest of prime, the secondary market rate for three month certificates of deposits plus 1% and the federal funds rate plus 0.50%, in each case plus a margin determined by the Company s current leverage ratio. For the Revolving Credit Facility that margin is 0.50% and for the Term Credit Facility the margin is 0.75%.

The Revolving Credit Facility may be used to finance future construction projects and acquisitions in accordance with the terms of the Credit Agreement and for other working capital needs and general corporate purposes. On May 30, 2008, the Company borrowed $50 million under the Revolving Credit Facility and $25 million under the Term Credit Facility. All of the proceeds of both such borrowings were applied to finance and pay expenses related to the acquisition of certain assets from ADS Alliance Data Systems, Inc., as described in more detail in Note 3. At June 30, 2008, there was $50 million outstanding under the Revolving Credit Facility and $25 million outstanding under the Term Credit Facility. The weighted average interest rate at June 30, 2008 was 3.1%. Total fees and direct costs paid for Amended and Restated Credit Agreement were $302,000. These costs are being amortized to interest expense over the life of the Amended and Restated Credit Agreement.

Principal payments due under the Term Credit Facility as of June 30, 2008 were as follows:

Twelve Months Ended June 30,	**(In thousands)**
2009	$ 6,250
2010	8,333
2011	8,333
2012	2,084
	$ 25,000

10. Stockholders Equity

Common Stock Repurchases. On January 13, 2006, the Company s Board of Directors authorized management to repurchase up to the lesser of (a) 1,000,000 shares of the Company s common stock or (b) $25,000,000 worth of its common stock in the open market. On August 1, 2006, the Company s Board of Directors authorized management to repurchase up to an additional 1,000,000 shares of its common stock in the open market using the proceeds from the exercise of stock options. On May 3, 2007, the Company s Board of Directors eliminated the restriction in the August 1, 2006 repurchase authorization which required the Company to use only proceeds from the issuance of stock options for repurchases, and increased the total authorized number of shares to be repurchased to 2,000,000. The Board of Directors authorized management to purchase up to 1,000,000 shares at purchase prices within management s discretion.

Management intends to use these authorizations to repurchase shares opportunistically as a means of offsetting dilution from shares issued upon the exercise of options under employee benefit plans, and to

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

use cash to take advantage of declines in the Company s stock price. Management has no obligation to repurchase shares under the authorization, and the specific timing and amount of the stock repurchase will vary based on market conditions, securities law limitations and other factors. The stock repurchase will be executed utilizing the Company s cash resources including the proceeds of stock option exercises.

Under these authorizations, the Company had repurchased an aggregate of 2,574,284 shares of its common stock at a cost of $61.9 million, or an average cost of $24.04 per share. This includes 781,584 shares repurchased at a cost of $18.0 million, or $23.02 per share during the six months ended June 30, 2008 and 606,500 shares repurchased at a cost of $15.3 million, or $25.24 per share during the six months ended June 30, 2007. There were no shares repurchased during the three months ended June 30, 2008.

On February 28, 2008, the Company s Board of Directors resolved to retire all common shares repurchased and include the retired shares in the authorized and unissued shares of the Company. Until February 28, 2008, the final disposition of the repurchased shares had not been decided. The excess of the purchase price of the treasury stock over the stated value was allocated between additional paid-in capital and retained earnings. The pro rata portion of additional paid-in capital related to the treasury stock was not sufficient to fully absorb the cost of the treasury stock and the amount of the resulting charge to retained earnings created an accumulated deficit as of June 30, 2008.

Dividends on Common Stock. During the six months ended June 30, 2008 and the twelve months ended December 31, 2007, the Company s Board of Directors declared the following quarterly cash dividends on common stock:

Date Declared	Record Date	Date paid	Amount Paid Per Common Share	
Six Months Ended June 30, 2008:				
February 13, 2008	February 28, 2008	March 15, 2008	$	0.09
April 30, 2008	May 23, 2008	June 15, 2008	$	0.09
Twelve Months Ended December 31, 2007:				
February 12, 2007	February 23, 2007	March 15, 2007	$	0.05
May 3, 2007	May 25, 2007	June 15, 2007	$	0.05
July 30, 2007	August 24, 2007	September 15, 2007	$	0.075
October 31, 2007	November 23, 2007	December 15, 2007	$	0.075

On August 5, 2008, the Company s Board of Directors declared a quarterly cash dividend of $0.09 per share of common stock, payable on September 15, 2008 to stockholders of record as of August 22, 2008.

Common Stock Offering. On September 21, 2007, the Company closed a public offering of 6,348,767 shares of its common stock. The offering price was set at $26.34 per share, the closing price of the Company s common stock on the New York Stock Exchange on September 17, 2007.

Approximately 99% of the shares sold in the offering were offered by Greenhill Capital Partners, L.P. and its affiliates (2,550,120 total shares), LLR Equity Partners, L.P. and its affiliates (2,216,486 total shares), and members of the Company s management (1,557,820 total shares). The remaining 1%, 24,341 shares, were sold by the Company. The Company received only the proceeds from the shares it sold in the secondary offering. Gross proceeds of $615,000 received by the Company were used to cover the $590,000 of expenses from the offering. After the closing of the offering, the officers and directors of the Company owned approximately 37% of the outstanding shares.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

11. Income Taxes

The provision for income taxes for the three and six month periods ended June 30, 2008 and 2007 consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
Current				
Federal	**$ 4,743**	$ 5,319	**$ 8,952**	$ 9,036
State	**565**	494	**1,124**	843
Foreign	**11**		**21**	
Deferred				
Federal	**1,478**	319	**2,124**	325
State	**161**	34	**171**	34
Foreign	**36**		**36**	
Total provision for income taxes	**$ 6,994**	$ 6,166	**$ 12,428**	$ 10,238

The differences in federal income taxes provided and the amounts determined by applying the federal statutory tax rate of 35% to income before income taxes for the six months ended June 30, 2008 and 2007 were:

	Six Months Ended June 30, 2008		Six Months Ended June 30, 2007	
	%	Amount	%	Amount
	(In thousands)			
U.S. federal income tax at statutory rate	**35.00%**	**$ 11,506**	35.00%	$ 9,622
U.S. state and local income taxes, net	**2.56%**	**841**	2.07%	570
Foreign income taxes	**0.06%**	**20**		
Nondeductible expenses	**0.10%**	**35**	0.17%	46
Other	**0.08%**	**26**		
Provision for income taxes	**37.80%**	**$ 12,428**	37.24%	$ 10,238

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

The net deferred tax asset was comprised of the following at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
	(In thousands)	
Deferred tax assets:		
Merchant contract costs	**$ 27,620**	$ 25,562
Loss reserve and accounts receivable allowance	**361**	313
SFAS No. 123R share-based compensation	**1,232**	921
Property and equipment	**458**	726
Loss on purchased software	**584**	564
FIN No. 48 deferred tax reserve-state tax	**433**	448
Foreign currency translation	**124**	
Other	**57**	332
Deferred tax assets	**30,869**	28,866
Deferred tax liabilities:		
Capitalized signing bonus	**23,884**	21,063
Software development	**4,427**	2,986
Other	**206**	249
Deferred tax liabilities	**28,517**	24,298
Net deferred tax assets	**2,352**	4,568
Less current portion	**(835)**	(690)
Net deferred tax assets non current portion	**$ 1,517**	$ 3,878

At June 30, 2008 and December 31, 2007, the Company has determined that no valuation allowance against the net deferred tax asset was required because it is more likely than not that the net deferred tax asset will be fully realized.

12. Commitments and Contingencies

Litigation The Company is involved in certain legal proceedings and claims, which arise in the ordinary course of business. In the opinion of the Company, the results of any of these matters, individually and in the aggregate, are not expected to have a material effect on its results of operations, financial condition or cash flows.

Leases The Company leases various office spaces and certain equipment under operating leases with remaining terms ranging up to eight years. The majority of the office space lease agreements contain renewal options and generally require the Company to pay certain operating expenses.

Future minimum lease commitments under non-cancelable leases as of June 30, 2008 were as follows:

Twelve Months Ended June 30,	**(In thousands)**
2009	$ 4,520(a)
2010	4,305(a)
2011	3,434(a)
2012	2,221
2013	1,509
Thereafter	3,557
	$ 19,546

(a) Future minimum lease commitments for the twelve months ended June 30, 2009, 2010 and 2011 include $1.3 million, $1.3 million and $1.0 million, respectively, for data warehouse leases entered into in 2008.

Rent expense for leased property was $796,000 and $479,000, respectively, for the three months ended June 30, 2008 and 2007 and $1.2 million and $936,000 for the six months ended June 30, 2008 and 2007.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

Contingencies The Company collects and stores sensitive data about its merchant customers and bank cardholders. If the Company s network security is breached or sensitive merchant or cardholder data is misappropriated, the Company could be exposed to assessments, fines or litigation costs.

13. Segments

The determination of the Company s business segments is based on how the Company monitors and manages the performance of its operations. The Company s operating segments are strategic business units that offer different products and services. They are managed separately because each business requires different marketing strategies, personnel skill sets and technology.

The Company has two reportable segments, as follows: (1) Card, which provides payment processing and related services for bank card transactions; and (2) Other. Since March 3, 2008, the Card segment includes CPOS, our Canadian payments processing subsidiary, and since May 31, 2008, the Card segment includes Network Services. The Other segment includes Payroll, which provides payroll and related tax filing services, and PrepaidCard, which provides prepaid card and stored-value card solutions. The PrepaidCard operating segment was acquired in the 2006 acquisition of Debitek. Neither the Payroll operating segment nor the PrepaidCard operating segment meet the SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information* defined thresholds for determining individually reportable segments. Goodwill and intangible assets resulting from the acquisition of Debitek are reported in the Other segment.

The Company allocates revenues, expenses, assets and liabilities to segments only where directly attributable. The unallocated corporate administration amounts are costs attributed to finance, corporate administration, human resources, legal and corporate services. Reconciling items represent elimination of inter-segment income and expense items, and are included to reconcile segment data to the consolidated financial statements. At June 30, 2008 and 2007, 84% and 62% respectively, of the Other segment s total assets were funds that the Company holds as a fiduciary in its Payroll services activities for payment to taxing authorities. The Company does not have any major individual customers.

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

A summary of the Company s segments for the three and six month periods ended June 30, 2008 and 2007 was as follows:

	Card Segment	Other Segment	Unallocated Corporate Administration Amounts (In thousands)	Reconciling Items	Total Amount
Three Months Ended June 30, 2008					
Total revenues	**$ 388,974**	**$ 5,584**	**$**	**$ (4)**	**$ 394,554**
Depreciation and amortization	**2,804**	**242**	**126**		**3,172**
Interest income	**169**				**169**
Interest expense	**751**				**751**
Net income (loss)	**16,277**	**33**	**(4,841)**		**11,469**
Total assets	**547,386**	**47,351**		**(125,955)**	**468,782**
Three Months Ended June 30, 2007					
Total revenues	$ 329,752	$ 3,741	$	$ (48)	$ 333,445
Depreciation and amortization	1,904	80	139		2,123
Interest income	517				517
Interest expense	233				233
Net income (loss)	13,800	54	(3,452)		10,402
Total assets	274,472	33,092		(11,454)	296,110

	Card Segment	Other Segment	Unallocated Corporate Administration Amounts (In thousands)	Reconciling Items	Total Amount
Six Months Ended June 30, 2008					
Total revenues	**$ 722,257**	**$ 11,925**	**$**	**$ (9)**	**$ 734,173**
Depreciation and amortization	**5,097**	**499**	**250**		**5,846**
Interest income	**469**				**469**
Interest expense	**1,097**				**1,097**
Net income (loss)	**28,681**	**489**	**(8,724)**		**20,446**
Total assets	**547,386**	**47,351**		**(125,955)**	**468,782**
Six Months Ended June 30, 2007					
Total revenues	$ 609,695	$ 8,072	$	$ (110)	$ 617,657
Depreciation and amortization	3,826	150	278		4,254
Interest income	976				976
Interest expense	345				345
Net income (loss)	23,883	633	(7,262)		17,254
Total assets	274,472	33,092		(11,454)	296,110

Table of Contents

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

14. Earnings Per Share

The Company presents earnings per share data in accordance with SFAS No. 128, *Earnings Per Share,* as amended, (SFAS No. 128), which establishes the standards for the computation and presentation of basic and diluted earnings per share data. Under SFAS No. 128, the dilutive effect of stock options is excluded from the calculation of basic earnings per share but included in diluted earnings per share. The following is a reconciliation of the amounts used to calculate basic and diluted earnings per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands, except per share data)			
Basic:				
Net income	**$ 11,469**	$ 10,402	**$ 20,446**	$ 17,254
Weighted average common stock outstanding	**37,387**	37,653	**37,464**	37,580
Earnings per share	**$ 0.31**	$ 0.28	**$ 0.55**	$ 0.46
Diluted:				
Net income	**$ 11,469**	$ 10,402	**$ 20,446**	$ 17,254
Basic weighted average common stock outstanding	**37,387**	37,653	**37,464**	37,580
Effect of dilutive instruments:				
Stock options	**1,301**	2,210	**1,291**	2,339
Diluted weighted average shares outstanding	**38,688**	39,863	**38,755**	39,919
Earnings per share	**$ 0.30**	$ 0.26	**$ 0.53**	$ 0.43

Table of Contents

PART I FINANCIAL INFORMATION (continued)

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations