HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
May 11, 2009
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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 March 31, 2009

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ¨ 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 May 4, 2009, there were 37,459,930 shares of the registrant s Common Stock, $0.001 par value, outstanding.

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PART I CONDENSED FINANCIAL STATEMENTS

Item 1. Financial Statements

Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(In thousands, except share data)

(unaudited)

	March 31, 2009	December 31, 2008
Assets		
Current assets:		
Cash	**$ 26,013**	$ 27,589
Funds held for payroll customers	**29,291**	22,002
Receivables, net	**142,147**	140,145
Investments held to maturity	**1,371**	1,410
Inventory	**8,415**	8,381
Prepaid expenses	**4,692**	6,662
Current tax asset	**4,396**	2,440
Current deferred tax assets, net	**5,416**	6,723
Total current assets	**221,741**	215,352
Capitalized customer acquisition costs, net	**76,551**	77,737
Property and equipment, net	**83,492**	75,443
Goodwill	**58,414**	58,456
Intangible assets, net	**35,077**	36,453
Deposits and other assets, net	**152**	178
Total assets	**$ 475,427**	$ 463,619
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor banks	**$ 61,355**	$ 68,212
Accounts payable	**27,067**	25,864
Deposits held for payroll customers	**29,291**	22,002
Current portion of borrowings	**58,535**	58,522
Current portion of accrued buyout liability	**10,177**	10,547
Merchant deposits and loss reserves	**31,817**	16,872
Accrued expenses and other liabilities	**23,554**	26,196
Reserve for processing system intrusion	**7,681**	
Total current liabilities	**249,477**	228,215
Deferred tax liabilities, net	**5,386**	6,832
Reserve for unrecognized tax benefits	**1,719**	1,732
Long-term portion of borrowings	**14,836**	16,984
Long-term portion of accrued buyout liability	**30,532**	30,493
Total liabilities	**301,950**	284,256

Commitments and contingencies (Note 11)

Equity		
Common Stock, $0.001 par value, 100,000,000 shares authorized, 37,442,938 and 37,675,543 shares issued at March 31, 2009 and December 31, 2008; 37,442,938 and 37,675,543 shares outstanding at March 31, 2009 and December 31, 2008	**38**	38
Additional paid-in capital	**166,782**	167,337
Accumulated other comprehensive loss	**(2,414)**	(2,145)
Retained earnings	**8,977**	14,014
Total stockholders equity	**173,383**	179,244
Noncontrolling minority interests	**94**	119
Total equity	**173,477**	179,363
Total liabilities and equity	**$ 475,427**	$ 463,619

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)

(In thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Total Revenues	**$ 372,172**	$ 339,619
Costs of Services:		
Interchange	**257,372**	245,277
Dues, assessments and fees	**16,280**	14,503
Processing and servicing	**46,500**	34,768
Customer acquisition costs	**12,575**	11,450
Depreciation and amortization	**3,734**	1,910
Total costs of services	**336,461**	307,908
General and administrative	**26,589**	17,169
Total expenses	363,050	325,077
Income from operations	**9,122**	14,542
Other income (expense):		
Interest income	**29**	300
Interest expense	**(541)**	(346)
Provision for processing system intrusion	**(12,590)**	
Other, net	**2**	(80)
Total other income (expense)	**(13,100)**	(126)
Income (loss) before income taxes	**(3,978)**	14,416
Provision for (benefit from) income taxes	**(1,501)**	5,434
Net income (loss)	**(2,477)**	**8,982**
Less: Net income (loss) attributable to noncontrolling minority interests	**(22)**	5
Net income (loss) attributable to Heartland	**$ (2,455)**	$ 8,977
Net income (loss)	**$ (2,477)**	$ 8,982
Other comprehensive income:		
Unrealized gains (losses) on investments, net of income tax of $(7) and $12	**(11)**	21
Foreign currency translation adjustment, net of income tax of $(161) in 2008	**(258)**	(259)
Comprehensive income (loss)	**(2,746)**	8,744
Less: Net Income (loss) attributable to noncontrolling minority interests	**(22)**	5

Comprehensive income (loss) attributable to Heartland	**$ (2,724)**	$ 8,739
Earnings (loss) per common share:		
Basic	**$ (0.07)**	$ 0.24
Diluted	**$ (0.06)**	$ 0.23
Weighted average number of common shares outstanding:		
Basic	**37,535**	37,542
Diluted	**37,842**	38,863

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Stockholders Equity

(In thousands)

(unaudited)

	Heartland Stockholders Equity							
	Common Stock							
	Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	(Accumulated Deficit) Retained Earnings	Treasury Stock	Noncontrolling Minority Interests	Total Equity
Three Months Ended March 31, 2008:								
Balance, January 1, 2008	37,990	$ 40	$ 173,346	$ (62)	$ 36,729	$ (44,384)	$	$ 165,669
Issuance of Common Stock options exercised	103		806					806
Excess tax benefit on stock options exercised under SFAS No. 123R			5					5
Repurchase of Common Stock	(782)					(17,995)		(17,995)
Retirement of Treasury Stock		(2)	(11,312)		(51,065)	62,379		
Stock-based compensation under SFAS No. 123R			404					404
Accumulated other comprehensive income:								
Unrealized losses on available for sale investments				21				21
Foreign currency translation adjustment				(259)			(5)	(264)
Dividends on Common Stock					(3,357)			(3,357)
Noncontrolling minority interests in subsidiary acquired							117	117
Net income for the period					8,977		5	8,982
Balance March 31, 2008	37,311	$ 38	$ 163,249	$ (300)	$ (8,716)	$	$ 117	$ 154,388
Three Months Ended March 31, 2009:								
Balance, January 1, 2009	37,676	$ 38	$ 167,337	$ (2,145)	$ 14,014	$	$ 119	$ 179,363
Issuance of Common Stock options exercised	117		398					398
Excess tax benefit on stock options exercised under SFAS No. 123R			317					317
Repurchase of Common Stock	(350)					(3,202)		(3,202)
Retirement of Treasury Stock			(1,556)		(1,646)	3,202		
Stock-based compensation under SFAS No. 123R			286					286
Accumulated other comprehensive income:								
Unrealized losses on available for sale investments				(11)				(11)
Foreign currency translation adjustment				(258)			(3)	(261)
Dividends on Common Stock					(936)			(936)
Net income (loss) for the period					(2,455)		(22)	(2,477)
Balance March 31, 2009	37,443	$ 38	$ 166,782	$ (2,414)	$ 8,977	$	$ 94	$ 173,477

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flow

(In thousands)

(unaudited)

	Three Months Ended March 31, 2009	2008
Cash flows from operating activities		
Net income attributable to Heartland	**$ (2,455)**	$ 8,977
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of capitalized customer acquisition costs	**14,129**	12,522
Other depreciation and amortization	**4,902**	2,673
Provision for processing system intrusion	**12,590**	
Addition to loss reserves	**1,529**	1,829
Provision for doubtful receivables	**(4)**	260
Stock-based compensation	**285**	404
Deferred taxes	**(120)**	498
Net income (loss) attributable to noncontrolling minority interests	**(22)**	5
Loss on investments		103
Other		2
Changes in operating assets and liabilities:		
Increase in receivables	**(2,007)**	(1,240)
(Increase) decrease in inventory	**(38)**	591
Payment of signing bonuses, net	**(9,007)**	(11,433)
Increase in capitalized customer acquisition costs	**(3,936)**	(3,734)
Decrease in prepaid expenses	**1,970**	56
(Increase) decrease in current tax asset	**(1,663)**	4,775
Decrease (increase) in deposits and other assets	**26**	(10)
Excess tax benefits on options exercised under SFAS No. 123R	**(317)**	(255)
Decrease in reserve for unrecognized tax benefits	**(13)**	(43)
(Decrease) increase in due to sponsor bank	**(6,856)**	18,244
Increase (decrease) in accounts payable	**1,237**	(2,108)
Decrease in accrued expenses and other liabilities	**(7,532)**	(1,655)
Increase (decrease) in merchant deposits and loss reserves	**13,416**	(807)
Payouts of accrued buyout liability	**(2,712)**	(1,210)
Increase in accrued buyout liability	**2,381**	2,663
Net cash provided by operating activities	**15,783**	31,107
Cash flows from investing activities		
Purchase of investments held to maturity	**(562)**	(25)
Maturities of investments held to maturity	**589**	
Decrease (increase) in funds held for payroll customers	**(7,303)**	(2,617)
(Decrease) increase in deposits held for payroll customers	**7,289**	2,560
Acquisition of business, net of cash acquired		(9,988)
Purchases of property and equipment	**(11,806)**	(3,438)
Net cash used in investing activities	**(11,793)**	(13,508)
Cash flows from financing activities		

Proceeds from borrowings				20,000
Principal payments on borrowings		**(2,135)**		(20,000)
Proceeds from exercise of stock options		**398**		806
Excess tax benefits on options exercised under SFAS No. 123R		**317**		255
Repurchase of common stock		**(3,202)**		(17,995)
Dividends paid on common stock		**(936)**		(3,357)
Net cash used in financing activities		**(5,558)**		(20,291)
Net decrease in cash		**(1,568)**		(2,692)
Effect of exchange rates on cash		**(8)**		(315)
Cash at beginning of year		**27,589**		35,508
Cash at end of period	**$**	**26,013**	$	32,501
Supplemental cash flow information:				
Cash paid during the period for:				
Interest	**$**	**532**	$	294
Income taxes		**268**		40

See accompanying notes to condensed consolidated financial statements.

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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 wholly-owned subsidiaries, Heartland Payroll Company (HPC), Debitek, Inc. (Debitek) and Heartland Acquisition LLC (Network Services), and its 70% owned subsidiary Collective POS Solutions Ltd. (CPOS). 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 March 31, 2009, its results of operations, changes in stockholders equity and cash flows for the three months ended March 31, 2009 and 2008. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ended December 31, 2009. 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, as amended for the year ended December 31, 2008. The December 31, 2008 condensed consolidated balance sheet was derived from the audited 2008 consolidated financial statements.

In 2008, certain amounts for prior periods have been reclassified to conform with current presentation. Prior period amounts presented on the consolidated income statements reflect a change in classification of certain charges from VISA and MasterCard from Processing and Servicing expenses, to Dues, Assessments and Fees. This classification reflects the nature of these additional VISA and MasterCard bank card transaction authorization fees, which the Company passes through to its merchants. The Company believes that this change in presentation provides a more meaningful measure of its net revenue, which is a useful measure of profitability and operating performance. The Company defines net revenue as total revenues less interchange fees and dues, assessments and fees. These reclassifications had no effect on reported consolidated income before income taxes, net income or per share amounts. The amounts of Processing and Servicing expenses, which have been reclassified to Dues, Assessments and Fees for the three months ended March 31, 2008 were $2.2 million.

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 cards 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 agreement 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 agreement also enables the Company to settle funds between cardholders and merchants by delivering 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.

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

The sponsorship agreements with the member banks require, 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 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.

The Company entered into the sponsorship agreement with KeyBank on April 1, 1999 and the agreement expires in March 2012. The acquisition of Network Services in May 2008 resulted in the addition of World Financial Network National Bank as the sponsor bank for Network Services large national merchant processing. In August 2008, the Company entered into a sponsorship agreement with SunTrust Banks to replace World Financial Network National Bank as its sponsor bank for Network Services large national merchant processing. In February 2009, the sponsorship of the large national merchants processing was transferred from World Financial Network National Bank to SunTrust Banks.

In 2007, the Company enter a sponsor bank agreement with Heartland Bank, which is based in Saint Louis, Missouri. Heartland Bank is not affiliated with Heartland Payment Systems. Our agreement with Heartland Bank involves substantially the same terms as apply with KeyBank and it expires in September 2010.

Of the Company s total Visa and MasterCard bank card processing volume for the month of March 2009, 68.1% was processed under its sponsorship agreement with KeyBank N.A., 18.6% was processed under its sponsorship agreement with Heartland Bank (an unrelated third party), and 13.3% was processed under its sponsorship arrangement with SunTrust Banks.

Processing System Intrusion On January 20, 2009, the Company publicly announced the discovery of a criminal breach of its payment systems environment (the Processing System Intrusion). The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by the Company during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. The Company had received confirmation of its compliance with the Payment Card Initiative Data Security Standard (PCI-DSS) from a third-party assessor each year since the standard was announced, including most recently before the discovery of the Processing System Intrusion in April 2008. Subsequent to such confirmation, we were advised by Visa that based on Visa s investigation of the Processing System Intrusion, Visa removed us from Visa s published list of PCI-DSS compliant service providers. In April 2009, we were re-certified as PCI-DSS compliant and the assessor s report attesting to such re-certification has been reviewed and approved by Visa. As such, the Company was returned to Visa s Global List of PCI-DSS Validated Service Providers. Card data that could have been exposed by the Processing System Intrusion included card numbers, expiration dates, and certain other information from the magnetic stripe on the back of the payment card (including, for a small percentage of transactions, the cardholder s name). However, the cardholder information that the Company processes does not include addresses or Social Security numbers. Also, the Company believes that no unencrypted PIN data was captured. The Company believes the breach has been contained and did not extend beyond 2008. Its investigation of the Processing System Intrusion is ongoing.

For the three months ended March 31, 2009, the Company recorded various expenses and accruals totaling $12.6 million, or about $0.20 per share, associated with the Processing System Intrusion. The majority of these charges relate to a fine imposed by MasterCard in April 2009 due to the Company allegedly not taking appropriate action subsequent to learning of the possibility of the Processing System Intrusion. The Company believes that it responded appropriately to all information that it learned regarding the possibility of a system breach and that, upon discovering the intrusion, it took immediate and extraordinary action to address the intrusion. Moreover, the Company believes that throughout the events of 2008 and 2009 it has fully cooperated with MasterCard s investigation of first the suspicion, and later the fact, that an intrusion had occurred. The Company, therefore, considers the MasterCard fine to be in direct violation of both the MasterCard rules and applicable law, and intends and is prepared to vigorously contest (and it has recommended to its sponsor banks that they vigorously contest) through all available means, including litigation if necessary, any liability that may be asserted or imposed against the Company or its sponsor banks by reason of that fine. Additional fines were assessed by Visa against our sponsor banks, which fines our sponsor banks are contesting. The accrual of these fines resulted in the Company recording a $7.7 million Reserve for Processing System Intrusion at March 31, 2009.

The remainder of the expenses and accruals related to the Processing System Intrusion recorded in the three months ended March 31, 2009 were primarily for legal fees and costs we incurred for investigations, remedial actions and crisis management services.

While the Company has determined that the Processing System Intrusion has triggered other loss contingencies, to date an unfavorable outcome is not believed by it to be probable on those claims that are pending or have been threatened against it, or that the Company considers to be probable of assertion against it, and the Company does not have sufficient information to reasonably estimate the loss it would incur in the event of an unfavorable outcome on any such claim. Therefore, in accordance with SFAS No. 5, *Accounting for Contingencies,* no reserve/liability has been recorded as of March 31, 2009 with respect to any such claim, except for fines actually assessed by MasterCard and Visa. As more information becomes available, if the Company should determine that an unfavorable outcome is probable on such a claim and that the amount of such probable loss that it will incur on that claim is reasonably estimable, it will record a reserve for the claim in question. If and when, the Company records such a reserve, it could be material and could adversely impact its results of operations, financial condition and cash flow.

Additional costs the Company expects to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion will be recognized as incurred. Such costs are expected to be material and could adversely impact the Company s results of operations, financial condition and cash flow.

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

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 small and midsized merchants (referred to as Small and Midsized Enterprises, or SME) during the month and collecting those fees at the beginning of the following month, as well as from transaction fees the Company charges its merchants for processing transactions. The Company does not advance interchange fees to its Network Services merchants.

Generally, the Company uses cash available for investment to fund these advances to SME merchants; when available cash has been expended, the Company directs its sponsor banks to make these advances, thus generating a payable to the sponsor banks. We pay our sponsor banks the prime rate on these payables. To help fund the purchase price for Network Services, during the second quarter of 2008 we suspended using our available cash to fund merchant advances and borrowed $75.0 million. During the first quarter of 2009, we re-established our practice of partially funding merchant advances with our cash, but at reduced amounts. At March 31, 2009, the Company used $23.2 million of its available cash to fund merchant advances and at December 31, 2008, the Company used $17.5 million of its cash to fund merchant advances. The amount due to sponsor banks for funding advances was $61.4 million at March 31, 2009 and $68.2 million at December 31, 2008. 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 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. Funds Held for Payroll Customers also include overnight bank deposits. The majority of investments carried in Funds Held for Payroll Customers are available-for-sale and recorded at the fair value based on quoted market prices. Certificates of deposit are classified as held to maturity and recorded

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

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 March 31, 2009, Funds Held for Payroll Customers included cash and cash equivalents of $28.0 million and investments available for sale of $1.3 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 SME 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 SME 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 March 31, 2009 and December 31, 2008.

Merchant Deposits and Loss Reserves The Company maintains merchant deposits to offset potential liabilities from merchant chargeback processing, which is discussed below, as well as deposits representing debit processing and check processing funds in transit. Previously, the debit processing funds in transit were netted against receivables. 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. 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 The Company s historic focus has been on SME merchants, and it has a sales compensation arrangement in this market that has been essentially unchanged since its inception. Under this approach, Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly SME 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

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

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 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 SME 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 SME 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 SME 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, check processing fees, gift and loyalty card fees and other miscellaneous revenue. Payroll processing revenue includes periodic and annual fees charged by HPC for payroll processing services, and interest earned from investing tax impound funds held for our customers. Revenue is recorded as bank card and other processing 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 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.

The provision for/(benefit from) income taxes for the three months ended March 31, 2009 and 2008 was $(1.5) million and $5.4 million, respectively, resulting in an effective tax rate of 37.7% and 37.7%, respectively.

At March 31, 2009, our reserve for unrecognized tax benefits related to uncertain tax positions was $1.7 million, of which $1.3 million would, if recognized, impact the effective tax rate.

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

Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

(unaudited)

In the third quarter of 2008, the Company s Board of Directors approved a performance-based stock option program. Under this program, the Company granted 2.5 million performance-based stock options to its employees. These stock options were granted to those employees who the Board of Directors determined could have significant impact on successfully integrating the recently acquired Network Services business and effectively executing the Company s growth plan. These stock options have a five-year term and will vest in equal amounts in 2011, 2012 and 2013 only if, over the term of the stock options, both of the following performance conditions are achieved:

Consolidated net revenue grows at a compound annual rate of at least 15%; and

Fully diluted EPS grows at a compound annual rate of at least 25%.

Management believes that achieving these performance conditions is not more likely than not to occur as of the August 6, 2008 grant date; therefore, no share-based compensation expense has been recorded for these stock options in the third quarter of 2008. The evaluation of the likelihood of achieving these performance conditions will be repeated quarterly, and at such point that vesting of some or all of the options becomes more likely than not, share-based compensation expense will be recorded.

Diluted earnings per share for the three months ended March 31, 2009 and 2008 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. 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. At March 31, 2009, the cumulative foreign currency translation loss was $2.4 million. The Company intends to indefinitely reinvest undistributed earnings of CPOS and has not tax affected the cumulative foreign currency translation loss. Determination of the amount of unrecognized deferred tax liability related to indefinitely reinvested profits is not material.

Noncontrolling Minority Interests Noncontrolling minority interests represent noncontrolling minority stockholders share of the equity and after-tax net income or loss of consolidated subsidiaries. Noncontrolling minority stockholders share of after-tax net income or loss of consolidated subsidiaries is included in Net income (loss) attributable to noncontrolling minority interests in the Consolidated Income Statement. The minority stockholders interests included in Noncontrolling minority interests in the March 31, 2009 Consolidated Balance Sheet were $94,000 and reflect the 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 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 p