

HEARTLAND PAYMENT SYSTEMS INC  
Form 10-K/A  
May 11, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, DC 20549

**FORM 10-K/A**  
(Amendment No. 2)

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year ended December 31, 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 **(I.R.S. Employer**  
**incorporation or organization)** **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)

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
<b>Common Stock, \$0.001 par value</b>	<b>New York Stock Exchange</b>

**Securities registered pursuant to Section 12(g) of the Act:**

**NONE**

(title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. " YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. " YES  NO

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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.  YES  NO

Indicate by check mark if disclosure of delinquent filer pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  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  NO

The aggregate market value of the voting and non-voting common stock held by non-affiliates computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2008 was approximately \$674 million.

As of March 4, 2009, there were 37,442,292 shares of the registrant's common stock, \$0.001 par value, outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

None.

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**EXPLANATORY NOTE**

This Amendment No. 2 to Form 10-K on Form 10-K/A (the "Amended Filing") amends and restates the Annual Report on Form 10-K for the year ended December 31, 2008, originally filed on March 16, 2009 and Amendment No. 1 to Form 10-K on Form 10-K/A filed on April 30, 2009 (collectively, the "Original Filing"), of Heartland Payment Systems, Inc. (the "Company"). The primary purpose of this amendment is to supplement the Original Filing in response to comments received from the Securities and Exchange Commission on April 1, 2009 and on April 27, 2009 in connection with its review of the Original Filing. The Original Filing was amended to revise: (i) the second paragraph under the subheading HPS Exchange of the Technology section of Item 1 to conform the paragraph to make it consistent with the other disclosures in the Original Filing, (ii) the first paragraph of Note 8 of the Notes to Consolidated Financial Statements to reflect the scope of management's reliance on the information provided by the independent valuation firms in deriving the relevant valuations used for financial reporting purposes in connection with asset acquisitions, (iii) the disclosure in the Management Annual Report on Internal Control over Financial Reporting in Item 9A, Controls and Procedures, to include a statement that the independent registered public accounting firm that audited our financial statements has issued an attestation report on our internal control over financial reporting, (iv) Note 22 to Consolidated Financial Statements (Subsequent Events) to reflect material events that have occurred since December 31, 2008, (v) the total compensation of Sanford Brown in the Summary Compensation Table to reflect the correct amount, and (vi) the Exhibit Index to include references to (A) the Amended and Restated Credit Agreement dated as of May 30, 2008, among the Company, the Lenders party thereto from time to time, and JPMorgan Chase Bank, N.A., as Administrative Agent as Exhibit 10.43, (B) the Membership Interest and Asset Purchase Agreement dated May 2, 2008 among the Company, Heartland Acquisition, LLC, Alliance Data Network Services LLC, ADS Alliance Data Systems, Inc. and Alliance Data Systems Corporation as Exhibit 10.44 and (C) the Form of Employee Incentive Stock Option Agreement Under 2008 Equity Incentive Plan as Exhibit 10.45.

In accordance with Rule 12b-15 under the Exchange Act of 1934, as amended, each item of the Original Filing that is amended by this Amended Filing is also restated in its entirety, and this Amended Filing is accompanied by currently dated certifications on Exhibits 31.1 and 32.1 by the Company's Chief Executive Officer and Exhibits 31.2 and 32.2. by the Company's Chief Financial Officer. Except as described above, this Amended Filing does not amend, update, or change any items, financial statements, or other disclosures in the Original Filing, and does not reflect events occurring after the date of the Original Filing. Information not affected by the changes described above is unchanged and reflects the disclosures made at the time of the Original Filing. Accordingly, this Amended Filing should be read in conjunction with the Original Filing and our other reports filed with the Securities and Exchange Commission subsequent to the filing of the Original Filing, including any amendments to those filings.

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**Heartland Payment Systems, Inc.**

**Annual Report on Form 10-K/A**

**For the Year Ended**

**December 31, 2008**

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FORWARD LOOKING STATEMENTS

Unless the context requires otherwise, references in this report to the Company, we, us, and our refer to Heartland Payment Systems, Inc. and our subsidiaries.

Some of the information in this Annual Report on Form 10-K may contain forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include the information concerning our possible or assumed future results of operations, the impact of the systems breach of our processing system, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by the use of forward-looking terminology such as the words believe, expect, anticipate, intend, plan, estimate or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. You should understand that many important factors, in addition to those discussed elsewhere in this report, could cause our results to differ materially from those expressed in the forward-looking statements. Certain of these factors are described in Item 1A. Risk Factors and include, without limitation, the significantly unfavorable economic conditions facing the United States, the results and effects of the systems breach of our processing system including the outcome of our investigation, the extent of cardholder information compromised and the consequences to our business, including the effects on sales and costs in connection with the system breach, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our bank sponsor, our reliance on other bank card payment processors, our inability to pass increased interchange fees along to our merchants, economic conditions, system failures and government regulation.

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**PART I**

**ITEM 1. BUSINESS**

**Overview of Our Company**

*Delaware Corporation*

We were incorporated in Delaware in June 2000. Our headquarters are located at 90 Nassau Street, Princeton, NJ 08542, and our telephone number is (609) 683-3831.

*Bank Card Payment Processing*

Our primary business is to provide bank card payment processing services to merchants in the United States and Canada. This involves facilitating the exchange of information and funds between merchants and cardholders financial institutions, providing end-to-end electronic payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant assistance and support and risk management. Our merchant customers primarily fall into two categories: our core small and mid-sized merchants (referred to as Small and Midsized Enterprises, or SME ) and large national merchants, primarily in the petroleum industry. We also provide additional services to our merchants, such as payroll processing, gift and loyalty programs, paper check processing, and we sell and rent point-of-sale devices and supplies.

At December 31, 2008, we provided our bank card payment processing services to approximately 168,850 active SME bank card merchants located across the United States. This represents a 9.1% increase over the 154,750 active SME bank card merchants at December 31, 2007. At December 31, 2008, we provided bank card payment processing services to approximately 82 large national merchants with approximately 55,761 locations. Our total bank card processing volume for the year ended December 31, 2008 was \$66.9 billion, a 28.9% increase from the \$51.9 billion processed during the year ended December 31, 2007. Bank card processing volume for 2008 includes \$8.7 billion for large national merchants acquired with Network Services. Additionally, we provided bank card processing services to approximately 5,600 merchants in Canada.

On January 20, 2009, we announced the discovery of a criminal breach of our payment systems environment (referred to as the Processing System Intrusion in this document) that apparently had occurred during some portion of 2008. 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 Heartland during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. Card data that was affected 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 we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008. Our investigation of the Processing System Intrusion is ongoing. See Processing System Intrusion for more detail.

While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claims as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow.

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According to The Nilson Report, in 2007 we were the 6th largest card acquirer in the United States ranked by purchase volume, which consists of both credit and debit Visa and MasterCard transactions. This ranking represented 2.4% of the total bank card processing market. In 2008, 2007 and 2006, our bank card processing volume was \$66.9 billion, \$51.9 billion and \$43.3 billion, respectively.

In May 2008, we acquired the net assets of the Network Services Business unit ( Network Services ) of Alliance Data Network Services LLC ( Alliance ), for a cash payment of \$92.5 million. The acquisition was financed through a combination of cash on hand and our credit facilities. Network Services provides processing of credit and debit cards to large national merchants, primarily in the petroleum industry. Network Services settled 604 million transactions representing over \$17 billion of total annual Visa and MasterCard processing volume in 2007, and 600 million transactions representing \$16.7 billion of bank card processing volume in 2008. In addition to settling Visa and MasterCard transactions, Network Services processes a wide range of payment transactions for its predominantly petroleum customer base, including providing approximately 2.6 billion transaction authorizations through its front-end card processing systems (primarily for Visa and MasterCard) in 2007. Network Services has added \$8.7 billion to our bank card processing volume on 317 million transactions from the date we acquired it through December 31, 2008. Additionally, Network Services generated revenues on 1.6 billion transactions it authorized through its front-end card processing systems from the date we acquired it through December 31, 2008.

In March 2008, we acquired a majority interest in Collective Point of Sale Solutions Ltd. ( CPOS ) for a net cash payment of \$10.1 million. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions. This acquisition added approximately 5,100 Canadian merchants to our customer base and provides us an entrance into the Canadian credit and debit card processing market. We are now able to service merchants that have locations in both the United States and Canada.

Our bank card processing revenue is recurring in nature. We typically enter into three-year service contracts with our SME merchants that, in order to qualify for the agreed-upon pricing, require the achievement of agreed bank card processing volume minimums from our merchants. Our SME gross bank card processing revenue is largely driven by Visa and MasterCard volume processed by merchants with whom we have processing contracts; as such, we also generally benefit from consumers' increasing use of bank cards in place of cash and checks, and sales growth (if any) experienced by our retained bank card merchants. Most of our SME revenue is from gross processing fees, which are primarily a combination of a percentage of the dollar amount of each Visa and MasterCard transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card issuing banks through Visa and MasterCard and dues and assessment fees to Visa and MasterCard, and we retain the remainder of the revenue. For example, the allocation of funds resulting from a \$100 transaction is depicted below.

Our bank card processing revenue from our large national merchants is also recurring in nature. In contrast to SME merchants, our processing revenues from large national merchants generally consist of a flat fee per transaction and thus are driven primarily by the number of transactions we process (whether settled, or only authorized), not bank card processing volume.



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In December 2007, we signed a sales and servicing program agreement ( OnePoint ) with American Express Travel Related Services Company, Inc. ( American Express ) under which we will sign up and service new merchants on behalf of American Express. Under the terms of the program, we will act as American Express 's agent in: (a) providing solicitation services by signing merchants directly with American Express; and (b) providing transactional support services on behalf of American Express. OnePoint became available to our sales organization effective January 1, 2009. Under OnePoint, we will provide processing, settlement, customer support and reporting to merchants, in effect consolidating a merchant 's American Express card acceptance into the services we currently provide for their Visa and Master Card transactions. OnePoint also is open to our existing bank card merchants who do not currently accept American Express cards and who desire to add American Express card acceptance, so that we become their single point of contact for card processing.

In June 2008, we signed an agreement with DFS Services, LLC (formerly known as Discover Financial Services, LLC and referred to as Discover in this document) to offer bank card merchants a streamlined process that enables them to accept Discover Network cards on our processing platform. We plan to offer our new and existing customers an integrated processing solution that includes card acceptance pricing, funding, statement processing and customer service on one platform. Previously, to accept Discover Network cards, our merchants had to deal with two separate platforms - one for Discover and one for all other cards. Merchants who sign up for our program will, in turn, be able to offer their customers the added benefit of Discover Network card acceptance with greater ease. We expect this program to be available in the second quarter of 2009. Additionally, we will purchase the current Discover Network merchants that process through Heartland and convert them to the streamlined process mentioned previously.

Under our new agreement with Discover, which is expected to be implemented in the second quarter of 2009, our revenue model will be similar to Visa and MasterCard. The terms of the new American Express agreement have a compensation model which provides us a percentage-based residual on the American Express volume we process, plus fees for every transaction we process.

We sell and market our bank card payment processing services through a nationwide direct sales force of 1,725 sales professionals. Through this sales force we establish a local sales and servicing presence, which we believe provides for enhanced referral opportunities and helps mitigate merchant attrition. We compensate our sales force solely through commissions, based upon the performance of their merchant accounts. We believe that our sales force and our experience and knowledge in providing payment processing services gives us the ability to effectively evaluate and manage the payment processing needs and risks that are unique to these merchants. In 2008, our sales force generated over 63,500 bank card merchant applications and installed over 55,000 new bank card merchants. In 2007, our sales force generated over 62,500 bank card merchant applications and installed over 57,000 new bank card merchants.

We focus our sales efforts on low-risk bank card merchants and have developed systems and procedures designed to minimize our exposure to potential merchant losses. In 2008, 2007 and 2006, we experienced losses of 0.88 basis points (0.0088%), 0.54 basis points (0.0054%) and 0.45 basis points (0.0045%) of SME merchant bank card processing volume, respectively. We have developed significant expertise in industries that we believe present relatively low risks as the customers are generally present and the products or services are generally delivered at the time the transaction is processed. These industries include restaurants, brick and mortar retailers, convenience and liquor stores, automotive sales, repair shops and gas stations, professional service providers, lodging establishments and other. As of December 31, 2008, approximately 28.8% of our SME bank card merchants were restaurants, approximately 19.4% were brick and mortar retailers, approximately 10.9% were convenience and liquor stores, approximately 9.1% were automotive sales, repair shops and gas stations, approximately 9.0% were professional service providers and approximately 3.6% were lodging establishments. The Processing System Intrusion was the result of the insertion of malicious software into our processing system, and we believe that it was not the result of any failure of our sales efforts or systems and procedures described in this paragraph.

Since our inception, we have developed a number of proprietary Internet-based systems to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our sales force, our merchant base and our customer service staff. In 2001, we began providing authorization and data capture services to our SME bank card merchants through our own front-end processing system, HPS Exchange. In 2006, we began providing clearing, settlement and merchant accounting services through our own internally developed back-end processing system, Passport, to substantially all of our SME bank card merchants. Passport enables us to customize these services to the needs of our Relationship Managers and merchants. Currently, we are further developing HPS Exchange and Passport to process the large national merchants which we acquired with Network Services.

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During the years ended December 31, 2008, 2007 and 2006, approximately 83%, 75% and 64%, respectively, of our SME merchant transactions were processed through HPS Exchange, which has decreased our operating costs per transaction. At December 31, 2008 and 2007, approximately 98% of total SME merchants were processing on Passport. At December 31, 2008, our internally developed systems are providing substantially all aspects of a merchant's processing needs, excluding Network Services.

### *Payroll Processing Services*

Through our wholly-owned subsidiary, Heartland Payroll Company, we operate a full-service nationwide payroll processing service, including check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation. At December 31, 2008, 2007 and 2006, we processed payroll for 7,738, 6,209 customers and 4,216 customers, respectively.

Our nationwide direct sales force also sells our payroll processing services solely on a commission basis. Beginning in 2006, we began providing additional training regarding our payroll processing products and increased the focus of our sales force on selling these products. As a result, in 2008, 2007 and 2006, we installed 4,406, 4,395 and 3,140 new payroll processing customers, respectively, compared to 1,117 new installs in 2005.

### *Other Products and Services*

Other products and services which we offer, such as Electronic Check Processing Services and Micropayment and Campus Solutions, are discussed in Our Services and Products.

## **Processing System Intrusion**

In late October of 2008, we were alerted by Visa of suspicious activity surrounding certain cardholder accounts that appeared to certain card issuers to have been subjected to fraudulent activity shortly after those cards were used to make legitimate transactions that we processed. Our IT team worked with the major card brands (i.e., Visa, MasterCard, American Express, and Discover) (collectively, the Card Brands) to try to match the suspicious transactions with our processing activities, and we engaged multiple forensic auditors to investigate our payment card processing system. Ultimately, on January 12, 2009, information that one of those auditors had provided our team with led us to the discovery of suspicious files, and on January 13, 2009, we discovered the malicious software that apparently had created those files. We promptly reported this discovery to law enforcement authorities and the Card Brands, and we continue to cooperate with the Card Brands and the criminal investigations relating to the Processing System Intrusion.

On January 20, 2009, we publicly announced 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 us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. We had received confirmation of our 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 in April 2008. Card data that was affected 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 we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008. Our investigation of the Processing System Intrusion is ongoing.

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To date, we have had several lawsuits filed against us and we expect additional lawsuits will be filed. These include lawsuits which assert claims against us by cardholders (including various putative class actions seeking in the aggregate to represent all cardholders in the United States whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), and banks that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion (including various putative class actions seeking to represent all financial institutions that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), seeking damages allegedly arising out of the Processing System Intrusion and other related relief. The actions generally assert various common-law claims such as claims for negligence and breach of contract, as well as, in some cases, statutory claims such as violation of the Fair Credit Reporting Act, state data breach notification statutes, and state unfair and deceptive practices statutes. The putative cardholder class actions seek various forms of relief including damages, injunctive relief, multiple or punitive damages, attorney's fees and costs. The putative financial institution class actions seek compensatory damages, including recovery of the cost of issuance of replacement cards and losses by reason of unauthorized transactions, as well as injunctive relief, attorney's fees and costs. In addition, we have been advised by the SEC that it has commenced an informal inquiry and we have been advised by the United States Attorney for the District of New Jersey that it has commenced an investigation, in each case to determine whether there have been any violations of the federal securities laws in connection with our disclosure of the Processing Systems Intrusion and the alleged trading in our securities by certain of our employees, including certain executive officers. A putative class action has been commenced against us and certain of our executive officers alleging violations of the federal securities laws in connection with our disclosures relative to the Processing System Intrusion and our computer system security and the alleged trading in our securities by four of our officers. The plaintiff in the putative federal securities law class action seeks to represent all purchasers of our securities between August 5, 2008 and February 23, 2009 and seeks to recover losses such purchasers allegedly incurred by reason of their purchases, as well as related costs and expenses. We also have been contacted by the Federal Financial Institutions Examination Council and informed that it will be making inquiries into the Processing System Intrusion, and the Federal Trade Commission, by letter dated February 19, 2009, has requested that we provide information about our information security practices. Additionally, we have received written or telephonic inquiries relating to the Processing System Intrusion from a number of state Attorneys General's offices, including a Civil Investigative Demand from the Louisiana Department of Justice Office of the Attorney General, the Canadian Privacy Commission, and other government officials. We are cooperating with the government officials in response to each of these inquiries and investigations. We expect that additional lawsuits may be filed against us relating to the Processing System Intrusion and that additional inquiries from governmental agencies may be received or investigations by government agencies may be commenced.

Although we intend to defend the lawsuits, investigations and inquiries described above vigorously, we cannot predict the outcome of such lawsuits, investigations and inquiries. Apart from damages claimed in such lawsuits and/or in other lawsuits relating to the Processing System Intrusion that may be filed, we may be subject to fines or other obligations as a result of the government inquiries and investigations described above and/or other governmental inquiries or investigations relating to the Processing System Intrusion, and the Card Brands are also expected to assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. In that regard, we have been advised by Visa Inc. that based on Visa's investigation of the Processing System Intrusion, Visa believes we are in violation of the Visa operating regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, intends to seek to impose fines on our sponsor banks, which fines (if successfully imposed) our sponsor banks could in turn seek to recover from us, intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system, and intends to treat some or all of the Visa accounts that Visa considers to have been placed at risk of compromise in the Processing System Intrusion as being eligible for Visa's Account Data Compromise Recovery and Data Compromise Recovery Solution processes, which processes could result in Visa's seeking to recover from our sponsor banks (and our sponsor banks in turn seeking to recover from us) amounts in respect of fraud losses and operating expenses that Visa believes Visa issuers to have incurred by reason of the Processing System Intrusion.

While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claims as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow. It is also possible that the publicity surrounding the Processing System Intrusion and the efforts of our competitors to capitalize on the Processing System Intrusion could have a material adverse impact on our ability to obtain new merchant

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customers and retain existing merchant customers which, in turn, could have a material adverse impact on our results of operations and financial condition.

Although we have insurance that we believe may cover some of the costs and losses that we may incur in connection with the above-described pending and potential lawsuits, inquiries, investigations and claims, we cannot now confirm that such coverage will, in fact, be provided or the extent of such coverage, if it is provided.

It is also possible that the publicity surrounding the Processing System Intrusion and the efforts of our competitors to capitalize on the Processing System Intrusion could have a material adverse impact on our ability to obtain new merchant customers and retain existing merchant customers which, in turn, could have a material adverse impact on our results of operations and financial condition.

### **Payment Processing Industry Overview**

The payment processing industry provides merchants with credit, debit, gift and loyalty card and other payment processing services, along with related information services. The industry continues to grow as a result of wider merchant acceptance, increased consumer use of bank cards and advances in payment processing and telecommunications technology. According to The Nilson Report, total expenditures for all card type transactions by U.S. consumers were \$3.3 trillion in 2007, and are expected to grow to \$4.8 trillion by 2012.

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From 2002 to 2007, the compound annual growth rate of card payments was 7%, and this rate is expected to increase to 8% for 2008 to 2012. The proliferation of bank cards has made the acceptance of bank card payments a virtual necessity for many businesses, regardless of size, in order to remain competitive. This use of bank cards, enhanced technology initiatives, efficiencies derived from economies of scale and the availability of more sophisticated products and services to all market segments has led to a highly competitive and specialized industry.

### *Segmentation of Merchant Service Providers*

The payment processing industry is dominated by a small number of large, fully-integrated payment processors that sell directly to, and handle the processing needs of, the nation's largest merchants. Large national merchants (i.e., those with multiple locations and high volumes of bank card transactions) typically demand and receive the full range of payment processing services at low per-transaction costs.

Payment processing services are generally sold to the SME merchant market segment through banks and Independent Sales Organizations that generally procure most of the payment processing services they offer from large payment processors. It is difficult, however, for banks and Independent Sales Organizations to customize payment processing services for the SME merchant on a cost-effective basis or to provide sophisticated value-added services. Accordingly, services to the SME merchant market segment historically have been characterized by basic payment processing without the availability of the more customized and sophisticated processing, information-based services or customer service that is offered to large merchants. The continued growth in bank card transactions is expected to cause SME merchants to increasingly value sophisticated payment processing and information services similar to those provided to large merchants.

The following table sets forth the typical range of services provided directly (in contrast to using outsourced providers) by fully integrated transaction processors, traditional Independent Sales Organizations and us.

- (a) HPS Exchange: 84% of our bank card merchants
- Passport: 98% of our bank card merchants

We believe that the card-based payment processing industry will continue to benefit from the following trends:

### *Growth in Card Transactions*

The proliferation in the uses and types of cards, including in particular debit and prepaid cards, the rapid growth of the Internet, significant technological advances in payment processing and financial incentives offered by issuers have contributed greatly to wider merchant acceptance and increased consumer use of such cards. The following chart illustrates the growth for card transactions for the periods indicated.

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Source: The Nilson Report. Card purchase volume includes VISA / MasterCard (debit and credit), American Express, Discover and Diners Club.

Note: Percentages inside bar represent year-over-year growth.

According to The Nilson Report and the New York State Forum for Information Resource Management, sources of increased bank card payment volume include:

increasing acceptance of electronic payments by merchants who previously did not do so, such as quick service restaurants, government agencies and businesses that provide goods and services to other businesses;

increasing consumer acceptance of alternative forms of electronic payments, as demonstrated by the dramatic growth of debit cards, electronic benefit transfer, and prepaid and gift cards; and

continued displacement of checks with the use of cards and other methods of payment, including electronic, at the point of sale, as shown below.

Source: The Nilson Report

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### *Technology*

At present, many large payment processors provide customer service and applications via legacy systems that are difficult and costly to alter or otherwise customize. In contrast to these systems, recent advances in scalable and networked computer systems, and relational database management systems, provide payment processors with the opportunity to deploy less costly technology that has improved flexibility and responsiveness. In addition, the use of fiber optic cables and advanced switching technology in telecommunications networks and competition among long-distance carriers, and the dramatic increase in merchants' use of the Internet to process their transactions, further enhance the ability of payment processors to provide faster and more reliable service at lower per-transaction costs than previously possible.

Advances in personal computers and point-of-sale terminal technology, including integrated cash registers and networked systems, have increasingly allowed access to a greater array of sophisticated services at the point of sale and have contributed to the demand for such services. These trends have created the opportunity for payment processors to leverage technology by developing business management and other software application products and services.

### *Consolidation*

The payment processing industry has undergone significant consolidation. The costs to convert from paper to electronic processing, merchant requirements for improved customer service, the risk of merchant fraud, and the demand for additional customer applications have made it difficult for community and regional banks to remain competitive in the merchant acquiring industry. Many of these providers are unwilling or unable to invest the capital required to meet these evolving demands, and have steadily exited the payment processing business or otherwise found partners to provide payment processing for their customers. Despite this consolidation, the industry remains fragmented with respect to the number of entities selling payment processing services, particularly to SME merchants.

## **Our Competitive Strengths**

We believe our competitive strengths related to Bank Card Payment Processing include the following:

### *Large, Experienced, Efficient, Direct Sales Force*

While many of our competitors rely on Independent Sales Organizations that often generate merchant accounts for multiple payment processing companies simultaneously, we market our services throughout the United States through our direct sales team of 1,725 Relationship Managers, Account Managers and sales managers who work exclusively for us. Our Relationship Managers have local merchant relationships and industry-specific knowledge that allow them to effectively compete for merchants. Our Relationship Managers are compensated solely on commissions, receiving signing bonuses and ongoing residual commissions for generating new merchant accounts. These commissions are based upon the gross margin we estimate that we will receive from their merchants, calculated by deducting interchange fees, dues, assessments and fees and all of our costs incurred in underwriting, processing, servicing and managing the risk of the account from gross processing revenue. Our Relationship Managers have considerable latitude in pricing a new account, but we believe that the shared economics motivate them to sign attractively priced contracts with merchants generating significant bank card processing volume. The residual commissions our Relationship Managers receive from their merchant accounts give them an incentive to maintain a continuing dialogue and servicing presence with their merchants; these relationships are also supported by our 293 Account Managers, who are focused on installing new merchants and responding to any ongoing servicing needs. We believe that our compensation structure is atypical in our industry and contributes to building profitable, long-term relationships with our merchants. Our sales compensation structure and marketing activities focus on recruiting and supporting our direct sales force, and we believe that the significant growth we have achieved in our merchant portfolio and bank card processing volume are directly attributable to these efforts.

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### *Recurring and Predictable Revenue*

We generate recurring revenue through our payment processing services. Our revenue is recurring in nature because we typically enter into three-year service contracts that require minimum volume commitments from our merchants to qualify for the agreed-upon pricing. Our recurring revenue grows as the number of transactions or dollar volume processed for a merchant increases or as our merchant count increases. In 2008, approximately 87% of our bank card processing volume came from merchants we installed in 2007 and earlier.

### *Internal Growth*

While many of our competitors in the payment processing industry had relied on acquisitions to expand their operations and improve their profitability, from 2001 through 2007 we grew our business primarily through internal expansion by generating new merchant contracts submitted by our own direct sales force. Every merchant we processed during that time was originally underwritten by our staff, and we have substantial experience responding to their processing needs and the risks associated with them. We believe this both enhances our merchant retention and reduces our risks. We believe that internally generated merchant contracts generally are of a higher quality and generally are more predictable than contracts acquired from third parties, and the costs associated with such contracts are lower than the costs associated with contracts generally acquired from third parties.

While we continue to pursue internal growth, we were able to take advantage of acquisition opportunities in 2008 and expand into other markets that we previously did not have the technical capabilities to support. See *Pursue Strategic Acquisitions* and *Our Services and Products* later in this section for descriptions of these acquisitions.

### *Strong Position and Substantial Experience in Our Target Markets*

As of December 31, 2008, we were providing payment processing services to approximately 168,850 active SMEs located across the United States. We believe our understanding of the needs of SMEs and the risks inherent in doing business with them, combined with our efficient direct sales force, provides us with a competitive advantage over larger service providers that access this market segment indirectly. We also believe that we have a competitive advantage over service providers of a similar or smaller size that may lack our extensive experience and resources and which do not benefit from the economies of scale that we have achieved.

### *Industry Expertise*

Historically, we have focused our sales efforts on SME merchants who have certain key attributes and on industries in which we believe our direct sales model is most effective and the risks associated with bank card processing are relatively low. These attributes include owners who are typically on location, interact with customers in person, value a local sales and servicing presence and often consult with trade associations and other civic groups to help make purchasing decisions.

To further promote our products and services, we have entered into sponsoring arrangements with various trade associations, with an emphasis on state restaurant and hospitality groups. We believe that these sponsorships have enabled us to gain exposure and credibility within the restaurant industry and have provided us with opportunities to market our products to new merchants. In December 2008, the restaurant industry represented approximately 37.5% of our SME bank card processing volume and 52.1% of our SME transactions. In December 2007 and December 2006, the restaurant industry represented approximately 38.8% and 40.3% of our bank card processing volume and 53.3% and 54.8% of our transactions, respectively. We believe that the restaurant industry will remain an area of focus, though its growth will likely approximate the growth in the overall portfolio. Restaurants represent an attractive segment for us: according to a report by the National Restaurant Association, restaurant industry sales are expected to reach approximately \$566 billion in 2009, which would represent a 2.5% increase over projected industry sales for 2008 and the eighteenth consecutive year of growth. The projected restaurant industry growth for 2009 is in spite of a challenging economy and this steady growth profile, combined with the industry's low seasonality, makes restaurant merchant bank card processing volume very stable and predictable. In addition, the incidence of chargebacks is very low among



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restaurants, as the service typically is provided before the card is used. Our industry focus not only differentiates us from other payment processors, but also allows us to forge relationships with key trade associations that attract merchants to our business. Our industry focus also allows us to better understand a merchant's needs and tailor our services accordingly.

Although we have historically focused significant sales and marketing efforts on the restaurant industry, our SME merchant base also includes a broad range of brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores and professional service providers. See [Our Merchant Base](#) for detail on December 2008 bank card processing volume by merchant category.

Our historical focus on SME merchants has diversified our merchant portfolio and we believe has reduced the risks associated with revenue concentration. In 2008, no single SME merchant represented more than 0.56% of our total bank card processing volume. In 2007 and 2006, no single merchant represented more than 0.44% and 0.26% of our total bank card processing volume, respectively.

Our May 2008 acquisition of Network Services has further diversified our total merchant portfolio adding a substantial base of large national merchants, primarily in the petroleum industry.

### *Merchant Focused Culture*

We have built a corporate culture and established practices that we believe improve the quality of services and products we provide to our merchants. This culture spans from our sales force, which maintains a local market presence to provide rapid, personalized customer service, through our service center which is segmented into regionalized teams to optimize responsiveness, and to our technology organization, which has developed a customer management interface and information system that alerts our Relationship Managers to any problems a merchant has reported and provides them with detailed information on the merchants in their portfolio. Additionally, we believe that we are one of the few companies that discloses and adheres to our pricing policies to merchants. Visa and MasterCard alter their interchange and other fees once or twice per year; we believe that we are one of the few companies that does not use such adjustments to increase our own margins. We think this is the best approach to building long-term merchant relationships. During 2006, we developed and endorsed The Merchant Bill of Rights, an advocacy initiative that details ten principles we believe should characterize all merchants' processing relationships. The Merchant Bill of Rights allows our sales team to differentiate our approach to bank card processing from alternative approaches, and we believe that a focus on these principles by our merchants will enhance our merchant relationships. We believe that our culture and practices allow us to maintain strong merchant relationships and differentiate ourselves from our competitors in obtaining new merchants.

### *Scalable Operating Structure*

Our scalable operating structure allows us to expand our operations without proportionally increasing our fixed and semi-fixed support costs. In addition, our technology platform, including both HPS Exchange and Passport, was designed with the flexibility to support significant growth and drive economies of scale with relatively low incremental costs. Most of our operating costs are related to the number of individuals we employ. We have in the past used, and expect in the future to use, technology to leverage our personnel, which should cause our personnel costs to increase at a slower rate than our bank card processing volume.

### *Advanced Technology*

We employ information technology systems which use the Internet to improve management reporting, enrollment processes, customer service, sales management, productivity, merchant reporting and problem resolution.

In 2001, we began providing authorization and data capture services to our merchants through our internally-developed front-end processing system, HPS Exchange. This system incorporates real time reporting tools through, and interactive point-of-sale database maintenance via, the Internet. These tools enable merchants, and our employees, to change the messages on credit card receipts and to view sale and return transactions

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entered into the point-of-sale device with a few second delay on any computer linked to the Internet. During the years ended December 31, 2008, 2007 and 2006, approximately 83%, 75% and 64%, respectively, of our SME transactions were processed through HPS Exchange.

In 2005, we began providing clearing, settlement and merchant accounting services through our own internally developed back-end processing system, Passport. Passport enables us to customize these services to the needs of our Relationship Managers and merchants. We completed converting substantially all of our SME bank card merchants to Passport during the second quarter of 2006. At December 31, 2008 and 2007, approximately 98% of total SME bank card merchants were processing on Passport. At December 31, 2008 and 2007, our internally developed systems have been providing substantially all aspects of a merchant's processing needs for most of our SME merchants.

HPS Exchange, Passport and our other technology efforts have contributed to a reduction of our per-transaction processing costs and to a reduction of our costs of services as a percentage of our revenue. Many existing merchants will remain on TSYS Acquiring Solutions ( TSYS ) systems and those of our other third-party processors for front-end services for the duration of their relationship with us. However, we intend to install 85% to 95% of our new merchants on HPS Exchange, and to convert to HPS Exchange as many merchants on third party front ends as possible. Our Internet-based systems allow all of our merchant relationships to be documented and monitored in real time, which maximizes management information and customer service responsiveness. We believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems.

*Comprehensive Underwriting and Risk Management System*

Through our experience in assessing risks associated with providing payment processing services to small- and medium-size merchants, we have developed procedures and systems that provide risk management and fraud prevention solutions designed to minimize losses. Our underwriting processes help us to evaluate merchant applications and balance the risks of accepting a merchant against the benefit of the bank card processing volume we anticipate the merchant will generate. We believe our systems and procedures enable us to identify potentially fraudulent activity and other questionable business practices quickly, thereby minimizing both our losses and those of our merchants. As evidence of our ability to manage these risks, we experienced losses of no more than 0.88 basis points of SME bank card processing volume for each of the years ended December 31, 2008, 2007 and 2006, which we believe is significantly lower than industry norms. The risks discussed in this paragraph are not the types of fraudulent card activity that has apparently resulted from the Processing System Intrusion.

*Proven Management Team*

We have a strong senior management team, each with at least a decade of financial services and payment processing experience. Our Chief Executive Officer, Robert O. Carr, was a founding member of the Electronic Transactions Association, the leading trade association of the bank card acquiring industry. Our management team has developed extensive contacts in the industry and with banks and value-added resellers. Our sales leaders have all sold merchant services for us prior to assuming management roles, and many have been with us throughout most of our first decade of existence. We believe that the strength and experience of our management team has helped us to attract additional sales professionals and add additional merchants, thereby contributing significantly to our growth.

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### **Our Strategy**

Our current growth strategy is to increase our market share as a provider of payment processing services to merchants in the United States and Canada. We believe that the increasing use of bank cards, combined with our sales and marketing approaches, will continue to present us with significant growth opportunities. Additionally, we intend to continue growing our payroll processing business, and enhance our other products such as Electronic Check Processing, Micro Payments and Campus Solutions. Key elements of our strategy include:

#### *Expand Our Direct Sales Force*

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we have built a direct, commission-only sales force. We have grown our sales force from 952 Relationship Managers as of December 31, 2006, to 1,117 and 1,166 Relationship Managers as of December 31, 2007 and 2008, respectively. We anticipate continued growth in our sales force in the next few years in order to increase our share of our target markets, and have targeted achieving a level of 2,000 Relationship Managers within the next three to four years. Our sales model divides the United States into four primary markets overseen by Executive Directors of Sales, and further into 17 primary geographic regions overseen by Regional Directors. The Regional Directors are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Our Regional Directors' compensation is directly tied to the compensation of the Relationship Managers in their territory, providing a significant incentive for them to grow the number and productivity of Relationship Managers in their territory.

#### *Further Penetrate Existing Target Markets and Enter Into New Markets*

We believe that we have an opportunity to grow our business by further penetrating the SME market through our direct sales force and alliances with local trade organizations, banks and value-added resellers. During 2007, according to The Nilson Report, we processed approximately 2.4% of the dollar volume of all Visa and MasterCard transactions in the United States, up from approximately 2.3% in 2006, 2.2% in 2005, 1.8% in 2004 and 1.4% in 2003. In December 2008, the restaurant industry represented approximately 37.5% of our bank card processing volume and 52.1% of our transactions. Our bank card merchant base also includes a wide range of merchants, including brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores and professional service providers. We believe that our sales model, combined with our community-based strategy that involves our Relationship Managers building relationships with various trade groups and other associations in their territory, will enable our Relationship Managers to continuously add new merchants. We intend to further expand our bank card processing sales efforts into new target markets with relatively low risk characteristics, including markets that have not traditionally accepted electronic payment methods. These markets include governments, schools and the business-to-business market. In addition, the scale economies we have achieved by converting to our own platforms now allows us to profitably compete for the business of larger merchants, and we are now targeting merchants with annual processing volumes of up to \$1 billion, compared to our prior maximum of \$50-\$100 million in processing volume.

#### *Expand Our Services and Product Offerings*

In recent years, we have focused on offering a broad set of payment-related products to our customers. In addition to payroll processing services (see [Our Services and Products Payroll Services](#) for a description of these services), our current product offerings include check processing services that allow merchants to computerize paper checks, and prepaid, gift and loyalty card product solutions. In 2006, we added electronic check services (see [Our Services and Products Electronic Check Processing Services](#) for a description of these services) and micropayment systems (see [Our Services and Products Micropayment Systems](#) for a description of these services) to our products. In 2007, we added Campus Solutions (see [Our Services and Products Campus Solutions](#) for a description of these services) to our products. In 2008, we added Collective Point of Sale Solutions Ltd., Network Services and Chockstone, Inc. (see [Our Services and Products Large National Merchant Bank Card processing, Collective Point of Sale Solutions Ltd., and Chockstone](#) for more information).

We also distribute products that will help our merchants reduce their costs and grow their businesses, such as age verification services that track driver's license data to verify an individual's age and identity. We may develop new products and services internally, enter into arrangements with third-party providers of these products or selectively acquire new technology and products. Many of these new service offerings are designed to work on the same point-of-sale devices that are currently in use, enabling merchants to purchase a greater volume of their services from us and eliminating their need to purchase additional hardware. We believe that these new products and services will enable us to leverage our existing infrastructure and create opportunities to cross-sell our products and services among our various merchant bases, as well as enhance merchant retention and increase processing revenue.



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### *Leverage Our Technology*

We intend to continue to leverage our technology to increase our operating efficiencies and provide real-time processing and account data to our merchants, Relationship Managers, Account Managers and customer service staff. Since our inception, we have been developing Internet-based systems to improve and streamline our information systems, including detailed customer-use reporting, management reporting, enrollment, customer service, sales management and risk management reporting tools. We are seeking to develop a significant initiative that will allow merchants to integrate their payment processing data into any of the major small business accounting software packages. We have also made significant investments in our payment processing capabilities, which we believe will allow us to offer a differentiated payment processing product that is faster and less expensive than many competing products.

### *Enhance Merchant Retention*

By providing our merchants with a consistently high level of service and support, we strive to enhance merchant retention. While increased bank card use helps maintain our stable and recurring revenue base, we recognize that our ability to maintain strong merchant relationships is important to our continued growth. We believe that our practice of fully disclosing our pricing policies to our merchants creates goodwill. For example, in 2003, we believe we were one of the few companies that passed along to small- and medium-sized customers a reduction in debit interchange fees that resulted from the settlement of the so-called Wal-Mart lawsuit against Visa and MasterCard. During 2006, we developed and endorsed The Merchant Bill of Rights, an advocacy initiative that details ten principles we believe should characterize all merchants processing relationships. The Merchant Bill of Rights allows our sales team to differentiate our approach to bank card processing from alternative approaches, and we believe that a focus on these principles by our merchants will enhance our merchant relationships.

As discussed in Sales, we have built a group of Account Managers who are teamed with Relationship Managers and handle field servicing responsibilities. We have developed a customer management interface that alerts our Relationship Managers and Account Managers to any problems an SME merchant has reported and provides them with detailed information on the merchants in their portfolio. In addition, we believe that the development of a more flexible back-end processing capability, such as Passport provides, will allow us to tailor our services to the needs of our sales force and merchants, which we believe will further enhance merchant retention. Passport will also allow us to enhance the information available to our merchants, and to offer new services to them.

### *Pursue Strategic Acquisitions*

Although we intend to continue to pursue growth through the efforts of our direct sales force, we may also expand our merchant base or gain access to other target markets by acquiring complementary businesses, products or technologies, including other providers of payment processing. Our 2006 acquisition of Debittek, Inc. and 2007 acquisition of General Meters Corp. are examples of expanding by acquiring complementary businesses. In 2008, we acquired Collective Point of Sale Solutions Ltd., a Canadian provider of payment processing services and secure point-of-sale solutions that provided us with an entrance into the Canadian credit and debit card processing market. We are now able to service merchants that have locations in both the United States and Canada. In 2008, we also acquired the Network Services unit of Alliance Data Systems that handles a wide range of payment transactions for its predominantly petroleum customer base. Our latest acquisition of Chockstone in 2008 provided for expansion into the loyalty marketing and gift card solutions market.

## **Our Services and Products**

### *SME Merchant Bank Card Payment Processing*

We derive the majority of our SME processing revenues from fee income relating to Visa and MasterCard payment processing, which is primarily comprised of a percentage of the dollar amount of each transaction we process, as well as a flat fee per transaction. The percentage we charge is typically a fixed margin over interchange, which is the percentage set by Visa and MasterCard depending on the type of card used and the

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way the transaction is handled by the merchant. On average, the gross revenue we generate from processing a Visa or MasterCard transaction equals approximately \$2.47 for every \$100 we process. We also receive fees from American Express, Discover, and JCB for facilitating their transactions with our SME merchants. The terms of our new American Express agreement have a compensation model which provides us percentage-based residual on the American Express volume we process, plus fees for every transaction we process. Under our new agreement with Discover, which is expected to be implemented in the second quarter of 2009, our revenue model will be similar to Visa and MasterCard.

We receive revenues as compensation for providing bank card payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant support and chargeback resolution. In 2005, we began providing clearing, settlement and accounting services through Passport, our own internally developed back-end processing system. Passport enables us to customize these services to the needs of our Relationship Managers and merchants. At December 31, 2008 and 2007, approximately 98% of our SME bank card merchants were processing on Passport. In addition, we sell and rent point-of-sale devices and supplies and provide additional services to our merchants, such as gift and loyalty programs, paper check authorization and chargeback processing. These payment-related services and products are described in more detail below:

*Merchant Set-up and Training* After we establish a contract with a merchant, we create the software configuration that is downloaded to the merchant's existing, newly purchased or rented point-of-sale terminal, cash register or computer. This configuration includes the merchant identification number, which allows the merchant to accept Visa and MasterCard as well as any other cards, such as American Express, Discover and JCB, provided for in the contract. The configuration might also accommodate check verification, gift and loyalty programs and allow the terminal or computer to communicate with a pin-pad or other device. Once the download has been completed by the Relationship Manager or Account Manager, we conduct a training session on use of the system. We also offer our merchants flexible low-cost financing options for point-of-sale terminals, including installment sale and monthly rental programs.

*Authorization and Draft Capture* We provide electronic payment authorization and draft capture services for all major bank cards. Authorization generally involves approving a cardholder's purchase at the point of sale after verifying that the bank card is not lost or stolen and that the purchase amount is within the cardholder's credit or account limit. The electronic authorization process for a bank card transaction begins when the merchant swipes the card through its point-of-sale terminal and enters the dollar amount of the purchase. After capturing the data, the point-of-sale terminal transmits the authorization request through HPS Exchange or the third-party processor to the card-issuing bank for authorization. The transaction is approved or declined by the card-issuing bank and the response is transmitted back through HPS Exchange or the third-party processor to the merchant. At the end of each day, and, in certain cases, more frequently, the merchant will batch out a group of authorized transactions, transmitting them through us to Visa and MasterCard for payment.

We introduced HPS Exchange, our internally developed front-end processing system, in August 2001. During the years ended December 31, 2008, 2007 and 2006, approximately 83%, 75% and 64%, respectively, of our SME transactions were processed through HPS Exchange. The remainder of our front-end processing is outsourced to third-party processors, primarily TSYS Acquiring Solutions, but also including First Data Corporation, Chase Paymentech Solutions and Global Payments Inc. Although we will continue to install new SME merchants on TSYS and other third-party processors' systems, we anticipate that the percentage of SME transactions that are outsourced to third-party processors will decline as we install a high percentage of new merchants on HPS Exchange, and convert merchants on third party systems to HPS Exchange.

*Clearing and Settlement* Clearing and settlement processes, along with Merchant Accounting, represent the back-end of a transaction. Once a transaction has been batched out for payment, the payment processor transfers the merchant data to Visa or MasterCard who then collect funds from the card issuing banks. This is typically referred to as clearing. After a transaction has been cleared, the transaction is settled by Visa or MasterCard by payment of funds to the payment processor's sponsor bank the next day. The payment processor creates an electronic payment file in ACH format for that day's cleared activity and sends the ACH file to its sponsor bank. The ACH payments system generates a credit to the merchant's bank accounts for the value of the file. The merchant thereby receives payment for the value of the purchased goods or services, generally two business days after the sale. Under the terms of the new Agreement with American Express and Discover, the

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process will be substantially similar to the Visa and MasterCard process, and the merchant will receive one deposit for all cards accepted, in contrast to the existing arrangement, where an acceptor of Visa and MasterCard, American Express and Discover will receive three deposits.

Passport, our internally developed back-end system, enables us to customize these services to the needs of our merchants and Relationship Managers. For example, Passport enables us to provide Next Day Funding to our SME merchants who have banking relationships with certain banks. In January 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with TD BankNorth (acquired Commerce Bank, N.A.), in July 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Bremer Bank, in December 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Heartland Bank (an unrelated third party), in September 2008, we commenced Next Day Funding for merchants who maintain a deposit relationship with Central Pacific Bank, and in December 2008, we commenced Next Day Funding for merchants who maintain a deposit relationship with Gateway Bank. Under Next Day Funding, these merchants are paid for their transactions one day earlier than possible when we were processing on a third party back-end platform.

*Merchant Accounting* Utilizing Passport, we organize our SME merchants' transaction data into various files for merchant accounting and billing purposes. We send our SME merchants detailed monthly statements itemizing daily deposits and fees, and summarizing activity by bank card type. These detailed statements allow our SME merchants to monitor sales performance, control expenses, disseminate information and track profitability. We also provide information related to exception item processing and various other items of information, such as volume, discounts, chargebacks, interchange qualification levels and funds held for reserves to help them track their account activity. SME merchants may access this archived information through our customer service representatives or online through our internet-based customer service reporting system.

*Merchant Support Services* We provide merchants with ongoing service and support for their processing needs. Customer service and support includes answering billing questions, responding to requests for supplies, resolving failed payment transactions, troubleshooting and repair of equipment, educating merchants on Visa and MasterCard compliance and assisting merchants with pricing changes and purchases of additional products and services. We maintain a toll-free help-line 24 hours a day, seven days a week, which is staffed by our customer service representatives and during 2008 answered an average of approximately 110,000 customer calls per month. The information access and retrieval capabilities of our intranet-based systems provide our customer service representatives prompt access to merchant account information and call history. This data allows them to quickly respond to inquiries relating to fees, charges and funding of accounts, as well as technical issues.

*Chargeback Services* In the event of a billing dispute between a cardholder and a merchant, we assist the merchant in investigating and resolving the dispute as quickly and accurately as possible with card issuers or the bank card networks, which determine the outcome of the dispute. In most cases, before we process a debit to a merchant's account for the chargeback, we offer the merchant the opportunity to demonstrate to the bank card network or the card issuer that the transaction was valid. If the merchant is unable to demonstrate that the transaction was valid and the dispute is resolved by the bank card network or the card issuer in favor of the cardholder, the transaction is charged back to the merchant. After a merchant incurs three chargebacks in a year, we typically charge our merchants a \$25 fee for each subsequent chargeback they incur.

### *Large National Merchant Bank Card Payment Processing*

In May 2008, we acquired Network Services from Alliance Data Systems Corporation. Network Services is a provider of payment processing solutions, serving large national merchants in a variety of industries such as petroleum, convenience store, parking and retail. Services include payment processing, prepaid services, POS terminal, helpdesk services and merchant bank card services. This acquisition provides us with a substantial portfolio of merchants in the petroleum industry segment. In addition to Visa and MasterCard transactions, Network Services handles a wide range of payment transactions for its predominantly petroleum customer base. Network Services continues to process authorizations of large national merchants transactions through Alliance Data Systems Corporation and processes settlement of large national merchant transactions through Fifth Third Bank.

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Our bank card processing revenue from large national merchants is recurring in nature. In contrast to SME merchants, our processing revenues from large national merchants generally consist of a flat fee per transaction and thus are primarily driven by the number of transactions we process (whether settled, or only authorized), not processing volume.

*Authorization and Draft Capture* Network Services provides electronic payment authorization and draft capture for all major bank cards, client private label cards and fleet cards. Authorization generally involves approving a cardholder's purchase at the point of sale after verifying that the card is not lost or stolen and that the purchase amount is within the cardholder's credit or account limit. The electronic authorization process for a card transaction begins when the merchant swipes the card through its point-of-sale terminal and enters the dollar amount of the purchase. Network Services offers two front-end processing hosts, VAPS and NWS. After capturing the data, the point-of-sale terminal transmits the authorization request through the VAPS or NWS hosts or the third-party processor to the card-issuing entity for authorization. The transaction is approved or declined by the card-issuing entity and the response is transmitted back through the VAPS/NWS host or the third-party processor to the merchant. At the end of each day, and, in certain cases, more frequently, the merchant will batch out a group of authorized transactions, transmitting them through us to Visa and MasterCard for payment.

VAPS and NWS provide distinct functionality and processing options for our large corporate customers. These hosts provide efficient transaction payment processing and real-time authorizations using fully redundant routing paths. Our merchants can rely on quick response times and high availability. We maintain two redundant data centers for our large national merchant transaction processing. If one site fails, the other site is capable of supporting 100% of the workload so this assures uninterrupted transaction processing. Each data center maintains direct connections to Visa, MasterCard, Discover, Fiserv and American Express. The Fiserv connection is our gateway for debit and EBT processing.

*Clearing and Settlement* Clearing and settlement processes represent the back-end of a transaction. Once a transaction has been batched out for payment, we transfer the completed transaction detail file to Fifth Third Bank, which is our outsourced processor for clearing and settlement. During the clearing process, the transaction detail is split out and sent to Visa or MasterCard who then collect funds from the card issuing banks. After a transaction has been cleared, the transaction is settled by Visa or MasterCard by payment of funds to our sponsor bank, Sun Trust, the next day. HPS then creates an electronic payment file in ACH format for that day's cleared activity and sends the ACH file to its sponsor bank. The ACH payments system generates a credit to the merchants' bank accounts for the value of the file.

We provide deposit information to our large national merchants each day via our Internet-based settlement reporting system. Deposits are broken out by card type and show gross sales, less chargebacks, interchange, and miscellaneous adjustments.

*Merchant Boarding* The Merchant Support area supports new site setup requests, changes to existing locations, and any deletions. In addition, we provide large national merchants with a web-based system, Prometheus, that allows merchants to manage their sites' data in the mainframe database after their initial setup has been completed. The benefits of Prometheus include reducing complexity, decreasing delay in boarding, allowing merchants to control their data entry, and minimizing the learning curve and data entry. The only requirements are Windows and a user ID. Boarding merchants using Prometheus access allows direct connect into Prometheus through a TCP/IP connection.

*Merchant Reporting* We provide three types of reporting options to large national merchants.

*Data Warehouse* Merchants interested in flexible reporting alternatives have been satisfied with our Data Warehouse. A data warehouse is an architecture that consists of various technologies, which include relational and multi-dimensional databases, file servers, extraction and transformation programs, user query and reporting tools, and more. Other than a suitable web browser, no additional software is required to access Data Warehouse. Users can access Data Warehouse from any location anywhere and at any time from any PC that has access to the Internet.

*Doc Web* Provides multiple reports with multiple filtering options. There is no investment in new hardware or software required to view reports only a Web browser that supports HTML. Availability for filtered reports for quick adaptation to changing market conditions is available to merchants 24 hours a day, seven days a week.



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**Direct Settlement Reporting** Direct is a java based application that links the merchant directly with the settlement processing systems for viewing transaction and chargeback data.

**Help Desk Services** The Help Desk manages merchant trouble ticket initiation, escalation and resolution. The Help Desk also provides vendor and technician support, password resets, completes supply orders, and special projects.

Our Help Desk's operating philosophy focuses on providing the highest level of quality support to our customers. To provide this high level of support, we train our Help Desk agents to focus on resolving the caller's issue or concern during the first call. As a result, our agents are not limited by restrictive and unproductive talk time limits so that they can focus on delivering a working solution to the caller. Our merchant Help Desk is open 24 hours a day, seven days a week with full Help Desk support.

The Help Desk provides three possible levels of support on all point-of-sale (POS) solutions that are certified to process on our network:

1<sup>st</sup> level support includes full support of all of the POS functions, downloading of the POS, and replacement of the POS (when applicable), as well as all of the support functions provided at 2<sup>nd</sup> and 3<sup>rd</sup> level.

2<sup>nd</sup> level support includes full support of the communication between the POS and the HPS network and minor support of the POS functions, mostly limited to those functions related to communication or network identification, as well as any support provided at 3<sup>rd</sup> level.

3<sup>rd</sup> level support includes research and analysis of data being sent by the POS to the HPS network.

**Chargeback Services** Visa, MasterCard and Discover chargebacks for large national merchants are sent to Fifth Third Bank as part of the daily interchange confirmation files from the card networks. Fifth Third provides a number of reports that help the merchant manage chargebacks. All merchants utilizing settlement services have access to these reports. Fifth Third Bank processes chargebacks in compliance with card network rules, determines the validity of the chargeback, and to the extent possible, resolves the chargeback without involving the merchant. Merchants are notified of chargebacks and requested to submit any information regarding the transaction within 15 days to Fifth Third Bank to facilitate resolution of the chargeback. During this time, the merchant is not debited for a chargeback. If Fifth Third Bank does not receive the required information within the timeframe allowed, the merchant will be debited for the chargeback.

### *Collective Point of Sale Solutions Ltd.*

In March 2008, we acquired a majority interest in Collective Point of Sale Solutions Ltd. ( CPOS ), a Canadian provider of bank card payment processing services and secure point-of-sale solutions. This acquisition provides us with an entrance into the Canadian credit and debit bank card processing market. We are now able to service merchants that have locations in both the United States and Canada. CPOS employs call center and field sales personnel to sign new processing relationships.

### *Payroll Processing Services*

Through our wholly-owned subsidiary, Heartland Payroll Company, we operate a full-service nationwide payroll processing service. Our payroll services include check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation. In addition, we offer a PayAdvantage card, which provides employees the opportunity to have all, or a portion, of their payroll deposited to a Visa debit card account. In order to improve operating efficiencies and ease-of-use for our customers and to decrease our own processing costs, we offer electronic and paperless payroll processing that allows an employer to submit its periodic payroll information to us via the Internet or through a personal computer-based, direct-connect option. If a customer chooses either of these online options, all reports and interactions between the employer and us can be managed electronically, eliminating the need for cumbersome paperwork. Approximately 50% of our payroll customers currently submit their information electronically. However, if a customer chooses not to submit their payroll data online, they may submit such information via phone or facsimile. Regardless of input method, clients can choose to have Heartland print and ship their payroll package or to receive this information electronically. As of December 31, 2008, 2007 and 2006, we provided payroll processing services to 7,738, 6,209 and 4,216 customers, respectively.



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### *Electronic Check Processing Services*

We offer electronic check processing services, which we refer to as Express Funds, to merchants. Express Funds allows our merchants to quickly and easily scan all of their checks at their place of business, using a scanner sold or rented by us, to capture the image of the front and back of the check, store those images, and transmit the image to us for clearing through banking channels. Our merchants do not have to change their local banking arrangements. We clear checks on their behalf, and deposit collected funds at their own bank as soon as the next banking day. Express Funds also performs security checks and ensures that the image file is balanced before it is sent to us. Merchants often benefit from checks clearing faster and receiving a return notification earlier. The merchant no longer has to manually prepare a deposit slip, photocopy checks, balance all deposits by store, lane, and cashier, or go to the bank to make the deposit. We also offer a late deposit deadline and comprehensive reporting on the status of all checks and deposits. We are currently enhancing this product to automatically post check activity to the merchant's small business accounting software, which we believe would represent significant improvement in work simplification, particularly for merchants with multiple deposits.

### *Micropayments*

We began providing payment solutions within the small value transaction market in 2006. We also manufacture and sell electronic cash systems utilizing smart (chip) card and off-line magnetic stripe card technology. Our electronic cash systems serve coin-operated vending machines and cash registers within closed-loop environments, such as corporate and university food cafeterias and penitentiaries, and in multi-vendor/multi-application environments. These systems offer consumers convenient ways to either purchase or reload electronic cash cards, ways to spend the value on the card for small value purchases in both attended and unattended point of sale locations, and offer merchants financial settlement between the value (electronic cash card) issuer and the vendor/merchant who accepts the card as payment. We believe that there is increasing consumer demand for, and merchant interest in, card-based solutions for small denomination transactions, and expect to make additional investments in the future in developing solutions in this area.

### *Campus Solutions*

We initiated our campus solutions product in 2007. Our campus solutions product establishes an open network payments solution for a campus to efficiently process electronic transactions. In addition to providing processing and tracking of electronic payments transactions, personal identification and door access (including security), and data accumulation, our campus solutions are combined with our Give Something Back Network to offer convenient financial services to the students, faculty, staff and community merchants of an educational institution. The Give Something Back Network provides an Internet and phone accessible debit account to store funds. Our campus solution product uses improved technology to replace traditional plastic identification cards with a Give Something Back Network OneCard and a contactless cell phone tag. These cards and tags can be used to access meal plans, enter buildings, and make cashless payments at campus stores, vending machines, laundry machines, copiers, and at participating merchants in the community. We also manufacture some of the equipment used in our campus solutions products.

In October 2007, we acquired the assets, business and campus customers of General Meters Corporation, a provider of multi-purpose card systems for college and university campuses. This acquisition provides us with a ready customer base of colleges and universities for our campus solutions product, as well as some of the software and systems required for a complete campus solutions product line.

### *Chockstone, Inc.*

In November 2008, we acquired Chockstone, Inc., a provider of gift card programs and loyalty solutions with the necessary software needed to service the business. Our acquisition of this premier niche provider expands our ability to equip businesses nationwide with enhanced gift card and loyalty programs. Chockstone delivers its processing services to merchant locations through real-time communications with the merchant point-of-sale, enabling us to leverage existing installations across our merchant base. Chockstone historically focused on larger, national brands, including Subway® Restaurants and Ticketmaster Entertainment Inc.

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**Sales**

We sell and market our products and services to our SME merchants exclusively through our sales force. As of December 31, 2008, we employed 1,725 Relationship Managers, Account Managers and sales managers in 50 states plus the District of Columbia. We have implemented a geographic sales model that divides the United States into four primary markets overseen by Executive Directors of Sales subdivided into seventeen regions overseen by Regional Directors, who are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Regional Directors may manage their territories through Division Managers and Territory Managers. Division Managers do not sell our products and services. Instead, their sole responsibility is to hire, train and manage Relationship Managers in their territory. In contrast, Territory Managers are Relationship Managers who are also responsible for hiring and training a small number of Relationship Managers in their territory. Our Relationship Managers employ a community-based strategy that involves cold calling, obtaining referrals from existing merchants and building relationships with various trade groups, banks and value-added resellers to create sales opportunities.

The following graphic sets forth the number of Relationship Managers, Account Managers, sales managers and other sales persons we employed by state as of December 31, 2008. Additionally, CPOS employs nine salespersons in Canada.

Our compensation structure is designed to motivate our Relationship Managers to establish profitable long-term relationships with low-risk merchants and create a predictable and recurring revenue stream. Compensation for Relationship Managers is entirely commission-based, as a percentage of the financial value of new merchant accounts installed, which are measured in terms of the gross margin we estimate we will receive from the merchant accounts installed, calculated by deducting interchange fees, dues, assessments and fees and all of our costs incurred in underwriting, processing and servicing an account from gross processing revenues. Relationship Managers are permitted to price accounts as they deem appropriate, subject to minimum and maximum gross margin guidelines. The expected volume, pricing and other relevant details are entered into an online margin calculator, which calculates the estimated annual gross margin on the account.

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We pay our Relationship Managers, Territory Managers, Division Managers, and Regional Directors a percentage of the gross margin we derive from the payments we process for the SME merchant accounts they generate and service. Typically, when a new merchant account is signed at an acceptable estimated gross margin level, the Relationship Manager will be paid a signing bonus equal to 50% of the first 12 months' estimated gross margin. The Relationship Manager will also receive 15% of the gross margin generated from the merchant each month as residual commissions for as long as the merchant remains our customer, and in situations where there is no Account Manager assigned to the merchant account, 5% of gross margin is paid for the Relationship Manager's continued servicing of the account. In addition, the Division Manager will receive an amount equal to 25% of the amount paid to the Relationship Manager, and the Regional Director will receive an amount equal to 25% of the amount paid to the Division Manager. For example, if a merchant account has \$1,000 of estimated annual gross margin for the first twelve months and estimated monthly gross margin of \$83.33, our sales force would be compensated as follows:

<b>Signing Bonus</b>		
Estimated Gross Margin for first 12 months	\$ 1,000	
<b>Signing bonus paid to:</b>		
Relationship Manager	\$ 500	50.0%
Division Manager	\$ 125	12.5%
Regional Director	\$ 31	3.125%
<b>Residual Commission:</b>		
Estimated monthly Gross Margin	\$ 83.33	
<b>Monthly residual commission paid to:</b>		
Relationship Manager	\$ 12.50	15.00%
Division Manager	\$ 3.12	3.75%
Regional Director	\$ 0.78	0.94%

In certain cases, no signing bonus will be paid to a Relationship Manager, but the residual commission is 30% (excluding the 5% servicing fee) of the ongoing monthly gross margin generated by such merchant.

When a Relationship Manager has established merchant relationships that generate the equivalent of \$10,000 of monthly gross margin, he or she will be deemed to have a vested equity interest (known as portfolio equity), and will be guaranteed the owned portion (all but the 5% servicing portion) of the ongoing monthly gross margin generated by such merchants for as long as the merchant processes with us. See Management's Discussion And Analysis of Financial Condition And Results of Operations Critical Accounting Policies Accrued Buyout Liability for more information regarding portfolio equity. At the end of the first 12 months of processing for a new merchant, we compare the actual gross margin generated from that merchant with the estimated gross margin used to calculate the signing bonus. If the merchant was more profitable than expected, we increase the signing bonus amount paid to the Relationship Manager. However, if the merchant was less profitable than anticipated, the Relationship Manager must return a pro-rata portion of his or her signing bonus to us. See Management's Discussion And Analysis of Financial Condition And Results of Operations Critical Accounting Policies Capitalized Customer Acquisition Costs for more information regarding signing bonuses.

In 2007, we established the Executive Director of Sales position to provide additional infrastructure and senior sales management support. We have four specific Executive Director territories in the United States (South East, North East, South West/Central, and West Coast / Pacific Northwest). The Executive Directors have responsibility for executing our sales strategies, and recruiting and training new sales professionals in their respective territories. We compensate our Executive Directors on a commission-only basis. Commission levels are based on the year-over-year growth rates achieved in terms of installed gross margin.

Since late 2004, we have built a group of Account Managers who are teamed with one or more Relationship Managers to handle the new merchant installation requirements, as well as other servicing responsibilities, for those Relationship Managers. The majority of the Account Manager's compensation represents a shift of the 5% servicing portion associated with the merchants he or she is servicing and is paid to

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the Account Manager. We believe that the creation of the Account Manager role allows the Relationship Managers to leverage his or her sales efforts, while allowing us to offer merchants two local relationship contacts including an Account Manager who is more attuned to the merchants' service needs. At December 31, 2008 and 2007, we had 293 and 240 Account Managers, respectively.

In late 2008, we established a small team of sales professionals to directly solicit mid-market and large national accounts. At the end of 2008, this team consisted of one Senior Director of National Accounts and three national account sales representatives. The national account sales representatives include two individuals who previously held Relationship Manager positions and one individual from Network Services. The former Relationship Managers are on a commission plan that includes Signing Bonus compensation and relationship management compensation. Signing Bonuses are determined after calculating the cost and internal support requirements to support each large national account's custom needs, which is then deducted from the traditional gross margin calculations before commissions are paid. The individual from Network Services maintained the salary and bonus compensation structure that was in place at the time of the Network Services acquisition for the balance of 2008, but will convert to the commission plan that includes Signing Bonus compensation and relationship management compensation.

In addition to our commission-based compensation structure, we use various sales contests to reward strong sales performance. Sales compensation in connection with these contests includes stock options, trips and incentive points. In 2007, we implemented a points based incentive program. Under this program, we award our salespersons and sales managers specific point values for achieving exemplary year-over-year sales growth in installed gross margin and for achieving targets for multi-product sales. These points are redeemable for custom rewards, such as travel, personal goods, and business tools. We also award stock options to our sales persons and sales managers who achieve significant, targeted growth in the realized gross margin in their territory. During the years ended December 31, 2008, 2007 and 2006, our Board of Directors authorized and issued options to purchase an aggregate of 60,424, 49,233 and 112,878 shares of our common stock, respectively, to some of our sales persons and sales managers as part of these contests. Options granted in connection with these contests in 2008 represented 2.2% of the total options awarded, in 2007 represented 15.6% of the total options awarded, and in 2006 represented 53.1% of the options awarded.

## **Marketing**

Our marketing efforts have historically focused on industry verticals and marketing partnerships. We focus our marketing efforts on industries in which we believe our direct sales model is most effective and on merchants with certain key attributes. These attributes include owners who are typically on location, interact with customers, value a local sales presence, and consult with trade associations and other civic groups to make purchasing decisions. We also determine which additional markets to enter into based on the following criteria:

average potential customer revenue;

number of locations to be serviced;

underwriting risk; and

required technological upgrades.

We have focused significantly on the hospitality industry and, in particular, independent restaurants. The number of independent restaurants to which we provide our products and services were 48,600 as of December 31, 2008 and 46,700 as of December 31, 2007. In December 2008, the restaurant industry represented approximately 37.5% of our SME bank card processing volume and 52.1% of our SME transactions. In December 2007 and December 2006, the restaurant industry represented approximately 38.8% and 40.3% of our bank card processing volume and 53.3% and 54.8% of our transactions, respectively. In addition to restaurants, our merchant base includes brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores, and professional service providers.

We have historically had success in marketing our products and services through relationships with key trade associations, agent banks and value-added resellers.



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### *Trade Associations*

As of December 31, 2008, we had preferred partner agreements with 150 trade associations, the majority of which are in the hospitality industry. Of these partnerships, 34 are state restaurant associations and another 37 are state lodging associations. Our agreements with trade associations typically include our commitment to be a member of the association, a sponsor of the association's events and an advertiser in the association's publications. In exchange for an association's recommendation of our products and services to their members, upon the installation of a new merchant that is a member of the association we pay to the trade association a portion of the signing bonus or residual payments that otherwise would be paid to the Relationship Manager responsible for that merchant. In 2008, several associations have migrated from that revenue sharing model to a business development model, under which we act as a distributor for our association partner by selling their association memberships to our prospective merchants.

### *Agent Banks*

Many community banks find it difficult to provide their merchant servicing personnel with the training and support they need to serve their customer base, and to assume transaction risk. As a result, some of these banks enter into arrangements with payment processors to service their merchant portfolios. As of December 31, 2008, we currently provided these services to over 311 community banks in the United States. In exchange for a bank's endorsement of our products and services, upon the installation of a new merchant referred by the bank we typically pay the bank a portion of the signing bonus or residual payment that otherwise would be paid to the Relationship Manager responsible for that merchant.

Additionally, we have entered into arrangements with Heartland Bank (St. Louis, MO), Bremer Bank (St. Paul, MN), Central Pacific Bank (Honolulu, HI) and Gateway Bank (Chapel Hill, NC) providing for the conversion, in some cases, of their existing merchant processing customers onto our processing systems. In each case, these relationships are cross-referral, so that we and the banks benefit from these arrangements by gaining access to new customers. The banks retain existing deposit relationships and add new deposit relationships as new merchants are signed up. Merchants who maintain deposit relationships with these banks gain Next Day Funding for their bank card transaction processing. Under Next Day Funding, these merchants are paid for their transactions one day earlier than is typically available.

### *Value-Added Resellers and Third-Party Software Providers*

In order to further market our products and services, we enter into arrangements with value-added resellers and third-party software developers. Value-added resellers typically sell complementary products and services such as hardware and software applications and point-of-sale hardware, software and communication network services to merchants in markets similar to ours. Our agreements with value-added resellers provide that, in exchange for their endorsement of our products and services and upon the installation of a new merchant referred by them we will pay the value-added reseller a portion of the signing bonus and residual payment that otherwise would be paid to the Relationship Manager responsible for that merchant. As we continue to expand our product offerings, we intend to introduce capabilities that will allow our systems to be compatible with those of our value-added resellers and other third-party software developers, enabling them to embed our payment modules within their systems. As of December 31, 2008, we had arrangements with over 1,400 value-added resellers and referral services providers, including agreements with many third-party developers in the hospitality industry. From time to time, we have also entered into direct alliances with original equipment manufacturers and vendors.

In 2008, in addition to the above-focused marketing efforts, we continued to enhance the visibility of The Merchant Bill of Rights, an advocacy initiative that educates business owners about the complexities and costs of card acceptance. In launching and endorsing The Merchant Bill of Rights in 2006, we committed to supporting full disclosure regarding pricing and the existence of any transaction middlemen, and for provision of dedicated customer support and high levels of security and fraud monitoring. This initiative has been very well received in the merchant community, and many organizations have endorsed its principles. We believe we are uniquely positioned to commit to such high customer service standards, and that our focus on this approach will continue fostering success at establishing a payment processing brand that is not easily duplicated by competitors using indirect sales models, or who do not match our focus.



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### **Relationships with Sponsors and Processors**

In order to provide payment processing services for Visa and MasterCard transactions, we must be sponsored by a financial institution that is a principal member of the Visa and MasterCard networks. The sponsor bank must register us with Visa as an Independent Sales Organization and with MasterCard as a Member Service Provider. We also contract with third-party processors to provide critical payment processing services.

#### *Sponsor Banks*

Our primary sponsor bank for SME merchant processing is KeyBank, National Association, referred to as *KeyBank* in this document. We currently have an agreement with KeyBank to sponsor us for membership in the Visa and MasterCard networks. Under this agreement, KeyBank settles bank card transactions for our SME merchants, and also funds our merchants the portion of our daily interchange expenses that we do not fund from our own cash. Either KeyBank or we can terminate the agreement if the other party materially breaches the agreement, including non-payment of fees due for processing our monthly settlement of transactions. The agreement may also be terminated if the other party enters bankruptcy or files for bankruptcy, if either party is required to discontinue performing its services under the agreement based upon a final order of a state or federal court or regulatory body or if there is a change in the majority ownership of the other party. KeyBank may terminate the agreement with us if we breach the by-laws and regulations of Visa or MasterCard, if either our registration or KeyBank's membership with Visa or MasterCard terminates, if any federal or state regulatory authority requests that the agreement be terminated or that KeyBank terminate its services or if applicable laws or regulations change to prevent KeyBank from performing its services under the agreement. Upon termination of the agreement for any reason, we will have 180 days to convert to another sponsor bank. Although we expect that we would be able to secure a new sponsor bank, the cost of entering into a new sponsorship agreement may be different than under our current agreement with KeyBank. The agreement, which we entered into with KeyBank on April 1, 1999, expires in March 2012. As a result of the Processing System Intrusion, Visa and/or MasterCard may determine that we have failed to comply with their operating regulations. If such a determination is made, it may provide KeyBank with a basis to terminate its agreement with us. If our agreement is terminated for this reason, it could be difficult for us to find another sponsor bank. Visa has advised us that based on Visa's investigation of the Processing System Intrusion, Visa believes we are in violation of the Visa operating regulations.

In 2007, we entered into a second sponsor bank agreement, this one with Heartland Bank, which is based in Saint Louis, Missouri. Heartland Bank is not related to, or associated with Heartland Payment Systems. Our agreement with Heartland Bank involves substantially the same terms as apply with KeyBank and it expires in September 2010.

In 2008, the acquisition of Network Services resulted in the addition of World Financial Network National Bank ( *WFNNB* ) as the sponsor bank for Network Services' large national merchant processing. In August 2008, we entered into a sponsorship agreement with SunTrust Bank. In February 2009, we transferred the required BINs and ICAs from WFNNB to SunTrust Bank to replace World Financial Network National Bank as our sponsor bank for Network Services' large national merchant processing. Our agreement with SunTrust Bank expires in June 2012.

We may enter into additional sponsor bank relationships in the future.

#### *Third-Party Processors*

We have agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. These third-party processors include Fifth Third Bank, Alliance Data Systems Corporation, TSYS, First Data Corporation, Chase Paymentech Solutions and Global Payments, Inc. Our agreements with third-party processors require us to submit a minimum monthly number of transactions or volume for processing. If we submit a number of transactions or volume that is lower than the minimum, we are required to pay them the fees that they would have received if we had submitted the required minimum number or volume of transactions. The majority of our agreements with third-party processors may be terminated by the third-party processors if we materially breach certain sections of the agreements, including our failure to pay fees due, and we do not cure the breach within 30 days, if our registration with Visa or MasterCard terminates, or if we enter bankruptcy or file for bankruptcy.

**Table of Contents****Our Merchant Base**

Our merchant customers primarily fall into two categories; our core small and mid-sized merchants (referred to as Small and Midsized Enterprises, or SME ) and large national merchants, primarily in the petroleum industry. At December 31, 2008, we provided our bank card payment processing services to approximately 168,850 active SME bank card merchants located across the United States. This represents a 9.1% increase over the 154,750 active SME bank card merchants at December 31, 2007. At December 31, 2008, we provided bank card payment processing services to approximately 82 large national merchants with approximately 55,761 locations.

*SME Merchant Base*

While restaurants represent a significant portion of our SME merchant base, we also provide payment processing services to a wide variety of merchants, with a focus on those merchants whose typical customer is present when using a bank card to pay for products or services. We define SME merchants as generating annual Visa and MasterCard bank card processing volume between \$50,000 and \$5,000,000. With the added functionality and costs benefits that our back-end processing system, Passport, affords us, we have begun marketing to merchants with processing volume above \$5,000,000.

The following chart summarizes our SME processing volume by merchant category for the month of December 2008, compared to the months of December 2007 and December 2006.

**Processing Volume by Merchant Category****December 2008**

	Month of December		
	2008	2007	2006
Restaurants	37.5%	38.8%	40.3%
Retail	18.9%	20.1%	21.2%
Convenience, Fast Food & Liquor	10.6%	9.7%	9.2%
Automotive	8.8%	9.1%	8.6%
Professional Services	5.7%	4.7%	4.1%
Lodging	4.8%	4.9%	4.9%
Other	13.7%	12.7%	11.7%
<b>Total SME processing volume</b>	<b>\$ 4.8 billion</b>	<b>\$ 4.7 billion</b>	<b>\$ 4.1 billion</b>

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No single SME merchant accounted for more than 0.56% of our total SME bank card processing volume in 2008, and during 2008, our top 25 merchants represented only 3.1% of our bank card processing volume and 2.5% of our gross processing revenue. In 2007 and 2006, no single merchant represented more than 0.44% and 0.26% of our total bank card processing volume, respectively. In both 2007 and 2006 our top 25 merchants represented only 2.7% and 2.6%, respectively, of our bank card processing volume and 2.5% and 2.3%, respectively, of our gross processing revenue.

In December 2008, SME merchants in California represented 12.3%, in New York represented 6.6%, in Texas represented 5.3%, in Florida represented 4.5%, in New Jersey represented 4.4%, and in Colorado represented 4.1% of our SME bank card processing volume. No other state represented more than 4% of our total bank card processing volume. Our geographic concentration tends to reflect the states with the highest economic activity, as well as certain states where we have historically maintained a stronger sales force, including North Carolina and Minnesota. This merchant and geographic diversification makes us less sensitive to changing economic conditions in any particular industry or region. We believe that the loss of any single merchant would not have a material adverse effect on our financial condition or results of operations.

Generally, our agreements with SME merchants are for three years and automatically renew for additional one-year periods unless otherwise terminated. Our sponsor bank is also a party to these agreements. The merchants are obligated to pay for all chargebacks, fines, assessments, and fees associated with their account, and in some cases, annual fees. Our sponsor bank may terminate a merchant agreement for any reason on 30 days' notice, and the merchant may terminate the agreement at any time without notice, subject to the payment of any applicable early termination fees. Typically, the agreement may also be terminated immediately upon a breach by the merchant of any of its terms. The agreement may not be assigned by the merchant without the prior written consent of the sponsor bank and us.

### *Large National Merchants*

At December 31, 2008, we provided bank card payment processing services to approximately 82 large national merchants with approximately 55,761 locations. Our large national merchant portfolio was acquired in the May 2008 acquisition of Network Services.

Network Services provides processing of credit and debit cards to large national merchants, primarily in the petroleum industry. For the month of December 2008, approximately 85% of Network Services large national merchant processing volume was in the petroleum industry. In addition to settling Visa and MasterCard transactions, Network Services processes a wide range of payment transactions, including providing approximately 1.6 billion transaction authorizations through its front-end card processing systems (primarily for Visa and MasterCard) from the date we acquired it through December 31, 2008. Network Services has added \$8.7 billion to our bank card processing volume on 317 million transactions from the date we acquired it through December 31, 2008.

### **Risk Management**

We believe that we have significant experience in assessing the risks associated with providing payment processing services to small- and medium-sized merchants. These risks include the limited operating history of many of the small- and medium-sized merchants we serve and the risk that these merchants could be subject to a higher rate of insolvency, which could adversely affect us financially. We apply varying levels of scrutiny in our application evaluation and underwriting of prospective merchant accounts, ranging from basic due diligence for merchants with a low risk profile to a more thorough and detailed review for higher risk merchants.

Merchant attrition is expected in the payment processing industry in the ordinary course of business. During 2008, 2007, and 2006, we experienced average annual attrition of 17.3%, 12.6%, and 11.1% respectively of our SME bank card processing volume. Much of our attrition is related to business closures, which accelerated in 2008 due to weak economic conditions, and in 2008 our volume attrition was significantly impacted by overall contraction in same store sales. See [Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview - General](#) for a discussion of same store sales.

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As a result of our exposure to potential liability for merchant fraud, chargebacks, reject and other losses created by our merchant services business, we view our risk management and fraud avoidance practices as integral to our operations and overall success. We believe that the risks associated with our merchant base are generally not significant as our merchants consist primarily of companies conducting card-present transactions and whose chargeback levels are generally not significant as a percentage of their sales volume. As a result of their low risk profile, we can employ underwriting and set-up procedures that are less extensive than if these merchants had higher risk profiles and can typically ensure that these merchants will be approved and set up on our systems within 24 hours of our receiving their application.

However, for our merchants conducting card-not-present transactions, which we view as having a higher risk profile, we employ an extended underwriting and due diligence period and special account monitoring procedures. The underwriting process for these merchants' applications may take three to five days while we evaluate the applicants' financials, previous processing history and credit reports/OFAC (Office of Foreign Assets Control).

Effective risk management helps us minimize merchant losses for the mutual benefit of our merchants and ourselves. Our risk management procedures also help protect us from fraud perpetrated by our merchants. We believe our knowledge and experience in dealing with attempted fraud has resulted in our development and implementation of effective risk management and fraud prevention systems and procedures for the types of fraud discussed in this section. In 2008, 2007 and 2006, we experienced losses of no more than 0.88 basis points of our SME bank card processing volume.

We employ the following systems and procedures to minimize our exposure to merchant and transaction fraud:

### *Underwriting*

Our Relationship Managers send new applications for low-risk merchants to their regional service team for scoring and account set up. Higher-risk applications are routed to our underwriting department for review and screening. Our underwriting department's review of these applications serves as the basis for our decision whether to accept or reject a merchant account. The review also provides the criteria for establishing cash deposit or letter of credit requirements, processing limits, average transaction amounts and pricing, which assist us in monitoring merchant transactions for those accounts that exceed those pre-determined thresholds. The criteria set by our underwriting department also assist our risk management staff in advising merchants with respect to identifying and avoiding fraudulent transactions. Depending upon their experience level, our underwriting staff has the authority to render judgment on new applications or to take additional actions such as adjusting processing limits supported by obtained processing history, analyzing average charge per transaction information or defining cash deposit/letter of credit, reserves, and delayed funding requirements for new and existing merchants. Our underwriting department prepares accounts that are risk sensitive for our credit committee review. The Credit Committee consists of a Manager of Underwriting, Manager of Risk Review and Director of Core Support Group. Merchant accounts that exceed certain committee thresholds are reviewed by either our CEO, COO, CFO or Chief Portfolio Officer. Our sponsor bank also reviews and approves our merchant underwriting policies and procedures to ensure compliance with Visa and MasterCard operating rules and regulations.

### *Merchant Monitoring*

We employ several levels of merchant account monitoring to help us identify suspicious transactions and trends. Daily merchant activity is obtained from two sources, HPS Exchange (where the information is downloaded from HPS Exchange to our monitoring systems) and TSYS (where the information is downloaded from our third-party processors onto TSYS' risk system and then accessed by us on the Internet), and is sorted into a number of customized reports by our systems. Our risk management team reviews any unusual activity highlighted by these reports, such as larger than normal transactions or credits, and monitors other parameters that are helpful in identifying suspicious activity. We have a daily window of 10:00 a.m. to 6:00 p.m. Eastern time to decide if any transactions should be held for further review, which provides us time to interview a merchant or issuing bank to determine the validity of suspicious transactions. We have also developed a fraud management system for HPS Exchange that is fully integrated with our internal customer relationship management software and has detailed review capabilities to further streamline our monitoring of those transactions. We also place merchants who require special monitoring on alert status and assign special account identifiers to our Internet merchants to designate these accounts for special monitoring.

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### *Investigation and Loss Prevention*

If a merchant exceeds any parameters established by our underwriting and/or risk management staff or violates regulations established by the applicable bank card network or the terms of our merchant agreement, one of our investigators will identify the incident and take appropriate action to reduce our exposure to loss and the exposure of our merchant. This action may include requesting additional transaction information, withholding or diverting funds, verifying delivery of merchandise or even deactivating the merchant account. Additionally, Account Managers or Relationship Manager may be instructed to retrieve equipment.

### *Collateral*

We require some of our merchants to establish cash deposits or letters of credit that we use to offset against liabilities we may incur. We hold such cash deposits or letters of credit for as long as we are exposed to a loss resulting from a merchant's payment processing activity. In addition, we maintain a 5-day delayed deposit policy on transactions processed by our Internet merchants and newly established merchants who have not previously processed bank cards to allow for additional risk monitoring. We also place a hold on batches containing questionable transactions, diverting the funds to a separate account pending review. As of December 31, 2008, these cash deposits, delayed and held batches, and letters of credit totaled approximately \$16.3 million.

### **Technology**

We have developed a number of systems that are designed to improve the effectiveness of our sales force, customer service and the management of our business. In 2008, 2007 and 2006 we spent \$5.9 million, \$4.2 million and \$2.5 million, respectively, on capitalized software development costs. Many of the following systems are accessible over the Internet through [www.e-hps.com](http://www.e-hps.com). Each of these systems is regularly updated, with new releases of software scheduled every six weeks:

#### *Portfolio Manager*

Portfolio Manager is designed to allow each of our Relationship Managers to manage many aspects of his or her business, including portfolio monitoring and management, compensation review, training and professional development and the ability to communicate with others within our company. Portfolio Manager consists of a set of merchant relationship management tools. These tools include detailed merchant data, such as historical bank card processing volume, updates on merchant contracts that will soon expire, losses, merchants who may have attrited and data that can be used by our Relationship Managers to assist merchants in understanding interchange fee structures and the risks associated with certain types of transactions. Portfolio Manager also includes an estimated gross margin calculator and a merchant profitability analysis that allows Relationship Managers to optimize gross margin generated from a new SME merchant account. In addition, Portfolio Manager provides our Relationship Managers with the ability to view their residual commission stream from their merchant portfolio, track their productivity and compare their sales statistics with those of other Relationship Managers.

#### *Merchant Center*

Merchant Center is designed to improve our merchants' efficiency, cash management and dispute resolution by providing them with real-time access to their transaction data, including clearinghouse records, deposits and transactions. Merchant Center can replace paper merchant statements and provide automated customer self-service. Approximately 53% of our SME merchants, as of December 31, 2008, had signed up for this product. Affiliate Manager also provides similar information tools to our strategic relationships, such as trade associations, banks and value-added resellers.

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### *Client Manager*

Information regarding all of our interactions with our SME merchants and all of their documents and transaction records are immediately available to our customer service department and management through Client Manager. Each new account is entered into this database during the initial application and underwriting process, and all documents regarding a merchant are scanned into the database. Subsequently, all of a merchant's transactions and statements, and records of all calls to our customer service representatives as well as their resolution, are maintained in the database. Client Manager is also the tool by which we make any pricing adjustments and manage any equipment-related transactions. Integrating many of our customer management tools into one database provides service center employees with the same information regarding a merchant, which enables us to provide consistent, rapid problem resolution and optimal customer service. We believe that reliance on the system has allowed considerable productivity gains in recent years.

### *HPS Exchange*

Our front-end system, HPS Exchange, provides us greater control of the electronic transaction process, allows us to offer our merchants (through our Relationship Managers) a differentiated product offering, and offers economies of scale that we expect will increase our long-term profitability.

On January 20, 2009, we publicly announced the discovery of the Processing System Intrusion, which apparently had occurred during some portion of 2008. 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 us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. Card data that was affected 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 we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008. Our investigation of the Processing System Intrusion is ongoing. We have taken a number of steps, since discovering the Processing System Intrusion, to further enhance the security of our computer system.

During 2008, approximately 83% of the transactions of our SME merchants were processed on HPS Exchange, and 87% of all merchant accounts established in 2008 were placed on the system. When a merchant uses HPS Exchange on certain hardware platforms, the resulting authorization speed for dial-up transactions can be six seconds or less, which we believe is faster than industry norms for comparable terminals. This increased speed not only benefits the merchant but also reduces the telecommunications costs we incur in connection with a transaction.

HPS Exchange enables us to provide more customized solutions to SME merchants, target larger merchants that demand customized front-end solutions and take advantage of new terminal hardware platforms as they become available. HPS Exchange is customized for each merchant and will allow us to provide our merchants with differentiated value-added features, including the following:

*Merchant/Cardholder Selected Debit or Credit.* Merchants have the ability to convert a Visa Check or Master Money card to a pin-based debit transaction, which is typically less expensive for the merchant.

*Real-Time Transaction Monitoring.* Using their personal computers, merchants using Merchant Manager can observe open batches of payment transactions at any of their locations, allowing early detection of problem transactions, such as abnormally large tickets or credits, and changes in business volume.

*Cash Back on Debit.* Merchants have the ability to offer a cash-back option to their customers for pin-based debit transactions.

*On-line Download Maintenance.* On-line Download Maintenance is an Internet interface to a merchant's point-of-sale terminal download system that allows a merchant to change the



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parameters that control how its point-of-sale terminal functions as opposed to having to call the service center to request such changes. This enables a merchant to more easily change its receipt message each day and assists a merchant in preventing employee fraud by setting parameters that restrict the actions that can be taken by various employees.

While we will continue to utilize third-party front-end systems, we plan to continue incorporating additional functionality into HPS Exchange and to install an increasing percentage of new merchants onto HPS Exchange.

We believe that we are one of the first payment processors to develop all of our systems to take advantage of recent technological advancements in network and distributed computing, such as relational databases and Internet technologies. This offers significant benefits to us in terms of cost, data manipulation and distribution, flexibility and scalability. We further believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems. With more widespread availability and usage of the internet, increasing numbers of merchants are using the web as a transport medium. In December 2008, 39% of all transactions processed through HPS Exchange were transmitted through the Internet. These transactions represent a significantly lower overall cost to HPS, since no dial up costs are incurred.

### *Passport*

Our internally-designed back-end processing system, Passport, provides us with significant cost savings and results in greater economies of scale, by replacing third party processors' per-transaction charges with more of a fixed-cost structure. This structure allows per-transaction savings as increasing numbers of transactions are processed on Passport. In addition, our conversion to Passport provides us with the opportunity over time to offer our merchants significantly greater amounts of information regarding their processing characteristics, in more usable formats and to offer our services to larger merchants. In July 2005, we commenced converting bank card merchants to Passport, and we completed the conversion of substantially all of our SME bank card merchants to Passport in the second quarter of 2006. At December 31, 2008 and 2007, approximately 98%, respectively, of our SME merchants were processing on Passport.

### **Network Services Technology**

We operate Network Services' platforms in two geographically dispersed data centers that are the focal point for hosting all Network Services transaction processing and network activity. We establish system service level thresholds based on our large national merchants' requirements. System availability of 99.5% uptime is our standard large national merchant metric. To achieve this standard, transactions are mirrored between data centers and each center has the capacity to handle our full merchant transaction load. This ensures uninterrupted transaction processing during maintenance windows and other times processing may not be available.

*Authorization* We route authorization and capture transactions through Access Engine, where it is assigned to one of two payment engines: VAPS and NWS. After routing a transaction to the appropriate payment engine, it is then sent to Auth Engine which passes the transaction to the card networks for authorization.

*Settlement* For those large national merchants whose NWS and VAPS authorized transactions we settle, we have a contract with Fifth Third Bank to process settlement. A file of transactions is created and sent to Fifth Third Bank, which sends the transactions to the Card Brands. The Card Brands collect settlement funds from the card issuing banks, forward those funds to Fifth Third Bank, which then sends the funds to the sponsor bank to ultimately pay the large national merchants.

### **Network Security**

In the course of our operations, we compile and maintain a large database of information relating to our merchants and their transactions. We have placed significant emphasis on maintaining a high level of security in order to attempt to protect the information of our merchants and their customers. We maintain current updates of network and operating system security releases and virus definitions, and have engaged a third party to regularly test our systems for vulnerability to unauthorized access. Further, we encrypt the cardholder numbers that are stored in our databases using triple-DES protocols, which represent the highest commercially available standard for encryption.



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Our internal network configuration provides multiple layers of security to isolate our databases from unauthorized access and implements detailed security rules to limit access to all critical systems. In November 2003, we were certified by Visa as having successfully completed their Cardholder Information Security Program (CISP) review of our payment processing and Internet-based reporting systems. In 2004, the Visa CISP requirements were combined with security guidelines of the other card networks into a comprehensive Payment Card Initiative Data Security Standard (PCI-DSS). We received confirmation of our compliance with PCI-DSS from a third party assessor in April 2008. Notwithstanding our implementation and utilization of the network security measures described in this section, we suffered the Processing System Intrusion described elsewhere in this annual report. We have been advised by Visa that, based on Visa's investigation of the Processing System Intrusion Visa believes we are in violation of the Visa Operating Regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, and intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system.

Visa, Star, NYCE and other debit card networks have established security guidelines for PIN-based debit transaction processing that is based upon ANSI standards that are published as the ASC X9 TG-3 PIN Security Compliance Guideline. We have regularly scheduled Security Review of our Key Management Procedures against this standard that is performed by an external auditor.

We also have engaged external auditors to perform an annual SAS-70 review and publish our Report on Controls Placed in Operation and Tests of Operating Effectiveness. In addition, we have undertaken an independent Cyber-Risk Assessment.

## **Disaster Recovery and Back-up Systems**

We have implemented a disaster recovery plan for HPS Exchange to ensure business continuity in the event of a system failure. As part of this plan, we have established an alternate processing site in Houston, Texas that has the same functionality as our primary data center in Allen, Texas. In the event of a failure at our Allen data center, we would switch our processing immediately to the Houston data center. During 2008, we leveraged this alternate processing site and extended its use for business continuity for our back-end platform, Passport.

We also rely on connections to the systems of our third-party front-end and back-end processing providers. In many cases, they have installed or developed communications circuits with backup connectivity to overcome telecommunications problems. In addition, our service center has installed redundant power sources and our administrative systems are backed up and archived daily.

## **Competition**

The payment processing industry is highly competitive. We compete with other providers of payment processing services on the basis of the following factors:

quality of service;

reliability of service;

ability to evaluate, undertake and manage risk;

speed in approving merchant applications; and

price.

We compete with both small and large companies in providing payment processing and related services to a wide range of merchants. Our competitors sell their services either through a direct sales force, generally concentrating on larger accounts, or through Independent Sales

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Organizations, telemarketers or banks, generally concentrating on smaller accounts.

There are a number of large payment processors, including First Data Corporation, Bank of America Corporation, Global Payments Inc., Fifth Third Bank, Chase Paymentech Solutions and Elavon, Inc., a subsidiary of U.S. Bancorp, that serve a broad market spectrum from large to small merchants; further, certain of these provide banking, ATM and other payment-related services and systems in addition to bank card payment processing. There are also a large number of smaller payment processors that provide various services to small- and medium-sized merchants.

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Some of our competitors have substantially greater capital resources than we have and operate as subsidiaries of financial institutions or bank holding companies, which may allow them on a consolidated basis to own and conduct depository and other banking activities that we do not have the regulatory authority to own or conduct. Since they are affiliated with financial institutions or banks, these competitors do not incur the costs associated with being sponsored by a bank for registration with card networks and they can settle transactions quickly for their own merchants. We do not, however, currently contemplate acquiring or merging with a financial institution in order to increase our competitiveness. We believe that our specific direct sales focus on SME merchants, in addition to our understanding of the needs and risks associated with providing payment processing services to those merchants, gives us a competitive advantage over larger competitors, which do not have our focus, and over competitors of a similar or smaller size that may lack our experience and sales resources. With our acquisition of Network Services, we are also expanding into national accounts.

## **Intellectual Property**

We own or are pursuing several patents with the United States Patent and Trademark Office. In addition, we own various trademarks and have applied for numerous others. In connection with our acquisition of the Network Services business of Alliance Data Systems Corporation and Chockstone, Inc., we acquired rights to certain patents and trademarks. Most of our services and products are based on proprietary software that is updated to meet merchant needs and remain competitive. Protecting our rights to our proprietary software is critical, as it allows us to offer distinctive services and products to merchants, which differentiates us from our competitors.

## **Employees**

As of December 31, 2008, we employed 2,979 full- and part-time personnel, including 702 customer service, risk management, financial and operations support and underwriting employees, 226 systems and technology employees, 96 payroll services employees, 71 electronic cash systems employees, 159 accounting and administration employees and 1,725 sales and marketing employees. None of our employees are represented by a labor union, and we have experienced no work stoppages. We consider our employee relations to be good.

## **WHERE YOU CAN GET ADDITIONAL INFORMATION**

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy our reports or other filings made with the SEC at the SEC's Public Reference Room, located at 100 F Street, N.W., Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You can also access these reports and other filings electronically on the SEC's web site, [www.sec.gov](http://www.sec.gov).

In addition, certain of our SEC filings, including our annual reports on Form 10-K, our quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, can be viewed and printed from the investor information section of our website at [www.heartlandpaymentsystems.com](http://www.heartlandpaymentsystems.com), as soon as reasonably practicable after filing with the SEC. Certain materials relating to our corporate governance, including our senior financial officers' code of ethics, are also available in the investor relations section of our website.

The information on the websites listed above, is not and should not be considered part of this Annual Report on Form 10-K and is not incorporated by reference in this document. These websites are, and are only intended to be, inactive textual references.

In June 2008, we submitted to the New York Stock Exchange the CEO certification required by Section 303A.12(a) of the New York Stock Exchange Listed Company Manual without qualification.

## **ITEM 1A. RISK FACTORS**

*An investment in our common stock involves a high degree of risk. You should consider carefully the following risks and other information contained in this Annual Report on Form 10-K and other SEC filings before you decide whether to buy our common stock. If any of the events contemplated by the following discussion of risks should occur, our business, results of operations and financial condition could suffer significantly. As a result, the market price of our common stock could decline, and you may lose all or part of the money you paid to buy our common stock.*

### **Risks Relating to Our Business**

**Unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems (such as the Processing System Intrusion) or otherwise, could expose us to liability and protracted and costly litigation.**

On January 20, 2009, we announced the Processing System Intrusion, which apparently had occurred during some portion of 2008. 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 us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. Card data that was affected 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). Although, we have taken a number of steps to contain the Processing System Intrusion and to further enhance the security of our computer system. Nevertheless, there can be no assurance that we will not suffer an additional security breach in the future.

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The Processing System Intrusion has resulted in numerous lawsuits having been filed against us and will likely result in additional lawsuits against us in the future. Several government agencies have either made inquiries to us or initiated investigations of us related to Processing System Intrusion. For more information concerning these lawsuits and government inquiries and investigations, see Item 3. Legal Proceedings. We expect that the Card Brands will assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. By these claims, we expect the Card Brands to seek to recover from us, or from our sponsor banks (who would in turn seek to recover from us), assessments in respect of fraud losses and operating expenses (including card reissuance costs and non-ordinary-course account monitoring expenses) that the Card Brands believe either themselves or their issuers to have incurred by reason of the Processing System Intrusion, as well as fines and/or penalties by reason of our alleged failure to comply with the Card Brands' operating regulations. The amounts of the claims we expect to be asserted by the Card Brands and amounts we may be required to pay as a result of, or in order to defend, the lawsuits, Card Brand claims, and government investigations and inquiries described above is likely to be substantial. It is possible that the amounts required to resolve and defend the claims by the Card Brands and these lawsuits and government inquiries and investigations could exceed our ability to pay such amounts from our cash flow and we may be required to seek financing to make such payments. Given the current state of the financial markets and the impact the Processing System Intrusion may have on our business and financial condition, we cannot provide any assurance that we will be able to obtain such financing on reasonable terms or at all.

We collect and store sensitive data about merchants, including names, addresses, social security numbers, driver's license numbers and checking account numbers. In addition, we maintain a database of cardholder data relating to specific transactions, including bank card numbers, in order to process the transactions and for fraud prevention. Any loss of cardholder data by us or our merchants could result in significant fines and sanctions by Visa, MasterCard or governmental bodies, which could have a material adverse effect upon our financial position and/or results of operations. In addition, a significant breach could result in our being prohibited from processing transactions for Visa and MasterCard.

Our computer systems have been, and could in the future, be subject to penetration by hackers and our encryption of data may not prevent unauthorized use. In this event, we may be subject to liability, including claims for unauthorized purchases with misappropriated bank card information, impersonation or other similar fraud claims. We could also be subject to liability for claims relating to misuse of personal information, such as unauthorized marketing purposes. These claims also could result in protracted and costly litigation. In addition, we could be subject to penalties or sanctions from the Visa and MasterCard networks.

Although we generally require that our agreements with our service providers who have access to merchant and customer data include confidentiality obligations that restrict these parties from using or disclosing any customer or merchant data except as necessary to perform their services under the applicable agreements, we cannot assure you that these contractual measures will prevent the unauthorized use or disclosure of data. In addition, our agreements with financial institutions require us to take certain protective measures to ensure the confidentiality of merchant and consumer data. Any failure to adequately enforce these protective measures could result in protracted and costly litigation.

**If we fail to comply with the applicable requirements of the Visa and MasterCard bank card networks, Visa or MasterCard could seek to fine us, suspend us or terminate our registrations. Fines could have an adverse effect on our operating results and financial condition, and if these registrations are terminated, we will not be able to conduct our business.**

If we are unable to comply with Visa and MasterCard bank card network requirements, Visa or MasterCard could seek to fine us, suspend us or terminate our registrations. On occasion, we have received notices of non-compliance and fines, which have typically related to excessive chargebacks by a merchant or data security failures on the part of a merchant. If we are unable to recover fines from our merchants, we would experience a financial loss. The termination of our registration, or any changes in the Visa or MasterCard rules that would impair our registration, could require us to stop providing Visa and MasterCard payment processing services, which would make it impossible for us to conduct our business.

We have been advised by Visa that, based on Visa's investigation of the Processing System Intrusion, Visa believes we are in violation of the Visa operating regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, intends to seek to impose fines on our sponsor banks, which fines (if successfully imposed) our sponsor banks could in turn seek to recover from us, intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system, and intends to treat some or all of the Visa accounts that Visa considers to have been placed at risk of compromise in the Processing System Intrusion as being eligible for Visa's Account Data Compromise Recovery and Data Compromise Recovery Solution processes, which processes could result in Visa's seeking to recover from our sponsor banks (and our sponsor banks in turn seeking to recover from us) amounts in respect of fraud losses and operating expenses that Visa believes Visa issuers to have incurred by reason of the Processing System Intrusion.

**We are subject to the business cycles and credit risk of our merchants, which could negatively impact our financial results.**

A recessionary economic environment could have a negative impact on our merchants, which could, in turn, negatively impact our financial results, particularly if the recessionary environment disproportionately affects some of the market segments that represent a larger portion of our bank card processing volume, like restaurants. If our merchants make fewer sales of their products and services, we will have fewer transactions to process, resulting in lower revenue. In addition, we have a certain amount of fixed and semi-fixed costs, including rent, processing contractual minimums and salaries, which could limit our ability to quickly adjust costs and respond to changes in our business and the economy.

In a recessionary environment our merchants could also experience a higher rate of business closures, which could adversely affect our business and financial condition. During the recession prior to the current recession, we experienced a slowdown in the rate of same-store sales growth and an increase in business closures. During the current recession, we have for the first time experienced a reduction in same-store sales when compared to last year, and we could experience a higher rate of merchant closures. In the event of a closure of a merchant, we are unlikely to receive our fees for any transactions processed by that merchant in its final month of operation.

While we service a broad range of merchants, restaurants represent a significant portion of our merchant base. The failure rate of restaurants is typically high, which increases our merchant attrition and reject losses. A reduction in consumer spending, particularly at restaurants, would further increase our rate of merchant attrition and reject losses.

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**The payment processing industry is highly competitive and we compete with certain firms that are larger and that have greater financial resources. Such competition could increase, which would adversely influence our prices to merchants, and as a result, our operating margins.**

The market for payment processing services is highly competitive. Other providers of payment processing services have established a sizable market share in the small- and medium-size merchant processing sector. Maintaining our historic growth will depend on a combination of the continued growth in electronic payment transactions and our ability to increase our market share. The current recession could cause future growth in electronic payment transactions to slow compared to historical rates of growth and the Processing System Intrusion could negatively impact our ability to increase our market share. According to The Nilson Report, we accounted for approximately 2.4% of the 2.1 trillion of total purchase volume (which we refer to as bank card processing volume) processed by all bank card acquirers in 2007. This competition may influence the prices we are able to charge. If the competition causes us to reduce the prices we charge, we will have to aggressively control our costs in order to maintain acceptable profit margins. In addition, some of our competitors are financial institutions, subsidiaries of financial institutions or well-established payment processing companies, including First Data Corporation, Bank of America Corporation, Global Payments, Inc., Fifth Third Bank, Chase Paymentech Solutions and Elavon, Inc., a subsidiary of U.S. Bancorp. Our competitors that are financial institutions or subsidiaries of financial institutions do not incur the costs associated with being sponsored by a bank for registration with the card networks and can settle transactions more quickly for their merchants than we can for ours. These competitors have substantially greater financial, technology, management and marketing resources than we have. This may allow our competitors to offer more attractive fees to our current and prospective merchants, or other products or services that we do not offer. This could result in a loss of customers, greater difficulty attracting new customers, and a reduction in the price we can charge for our services.

**We have faced, and will in the future face, chargeback liability when our merchants refuse or cannot reimburse chargebacks resolved in favor of their customers, and reject losses when our merchants go out of business. We cannot accurately anticipate these liabilities, which may adversely affect our results of operations and financial condition.**

In the event a billing dispute between a cardholder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant and the purchase price is credited or otherwise refunded to the cardholder. If we or our clearing banks are unable to collect such amounts from the merchant's account, or if the merchant refuses or is unable, due to closure, bankruptcy or other reasons, to reimburse us for the chargeback, we bear the loss for the amount of the refund paid to the cardholder. The risk of chargebacks is typically greater with those merchants that promise future delivery of goods and services rather than delivering goods or rendering services at the time of payment. We may experience significant losses from chargebacks in the future. Any increase in chargebacks not paid by our merchants may adversely affect our financial condition and results of operations.

Reject losses arise from the fact that we collect our fees from our SME merchants on the first day after the monthly billing period. This results in the build-up of a substantial receivable from our customers, which significantly exceeds the receivables of any of our competitors which assess their fees on a daily basis. If a merchant has gone out of business during the billing period, we may be unable to collect such fees. In addition, if our sponsor bank is unable, due to system disruption or other failure, to collect our fees from our merchants, we would face a substantial loss.

We incurred charges relating to chargebacks and reject losses of \$5.3 million, \$2.8 million and \$1.9 million in the years ended December 31, 2008, 2007 and 2006, respectively.

**We have faced, and will in the future face, merchant fraud, which could have an adverse effect on our operating results and financial condition.**

We have potential liability for fraudulent bank card transactions initiated by merchants. Merchant fraud occurs when a merchant knowingly uses a stolen or counterfeit bank card or card number to record a false sales transaction, processes an invalid bank card or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. Examples of merchant fraud we have faced include a manager of a franchised motel who applied for a merchant account that proved to be a second account for that motel, and processed duplicate charges in his office, and an antique repair service owner who continued accepting deposits on cards for repairs, but stopped doing the repairs. We have established systems and procedures designed to detect and reduce the impact of merchant fraud, but we cannot assure you that these measures are or will be effective. It is possible that incidents of fraud could increase in the future. Failure to effectively manage risk and prevent fraud would increase our chargeback liability. Increases in chargebacks could have an adverse effect on our operating results and financial condition.

**Our actual losses and costs to mitigate the Processing System Intrusion could be a material amount, which could have a material adverse effect on our operating results, financial condition and cash flow.**

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While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claim as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs could be material and could adversely impact our results of operations, financial condition and cash flow.



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**If publicity surrounding the Processing System Intrusion and the efforts of our competitors to capitalize on the Processing System Intrusion have a material adverse impact on our ability to obtain new customers and retain existing customers, our results of operations, financial condition and cash flow would experience a material adverse impact.**

The Processing System Intrusion has resulted in significant negative publicity and we believe that our competitors are using the occurrence of the Processing System Intrusion and the attendant negative publicity to compete against us for merchants. It is possible that publicity surrounding the Processing System Intrusion and the efforts of our competitors to capitalize on the Processing System Intrusion could have a material adverse impact on our ability to obtain new merchant customers and retain existing merchant customers which, in turn, could have a material adverse impact on our results of operations, financial condition and cash flow.

**Increased merchant attrition that we cannot offset with increased bank card processing volume or new accounts would cause our revenues to decline.**

We experience attrition in merchant bank card processing volume resulting from several factors, including business closures, transfers of merchants' accounts to our competitors and account closures that we initiate due to heightened credit risks relating to, or contract breaches by, merchants, and when applicable same store sales contraction. During 2008, 2007, and 2006, we experienced average annual attrition of 17.3%, 12.6%, and 11.1% respectively. Substantially all of our processing contracts may be terminated by either party on relatively short notice. We cannot predict the level of attrition in the future, and it could increase. Increased attrition in merchant bank card processing volume may have an adverse effect on our financial condition and results of operations. If we are unable to establish accounts with new merchants or otherwise increase our bank card processing volume in order to counter the effect of this attrition, our revenues will decline.

**We rely on sponsor banks, which have substantial discretion with respect to certain elements of our business practices, in order to process bank card transactions. If these sponsorships are terminated and we are unable to secure new bank sponsors, we will not be able to conduct our business.**

Substantially all of our revenue is derived from Visa and MasterCard bank card transactions. Because we are not a bank, we are not eligible for membership in the Visa and MasterCard networks and are, therefore, unable to directly access the bank card networks, which are required to process Visa and MasterCard transactions. Visa and MasterCard operating regulations require us to be sponsored by a bank in order to process bank card transactions. We are currently registered with Visa and MasterCard through KeyBank, which has maintained that registration since 1999, Heartland Bank, which has been a sponsor since December 2007, and SunTrust Bank, which has been a sponsor since August 2008 (but only started processing in February 2009). If our sponsorships are terminated and we are unable to secure another bank sponsor or sponsors, we will not be able to process Visa and MasterCard transactions. Furthermore, our agreements with KeyBank and Heartland Bank give them substantial discretion in approving certain aspects of our business practices, including our solicitation, application and qualification procedures for merchants, the terms of our agreements with merchants and our customer service levels. Our sponsor banks' discretionary actions under these agreements could be detrimental to our operations. It is possible that our sponsor banks could claim that the Processing System Intrusion gives them the right to terminate our agreements with them.

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### **Current or future bank card network rules and practices could adversely affect our business.**

We are registered with the Visa and MasterCard networks through our bank sponsor as an Independent Sales Organization with Visa and a Member Service Provider with MasterCard. We are currently a sales agent for Discover and American Express. Under the new American Express agreement we will remain a sales agent however, under the new Discover agreement we will be registered as an Acquirer. The rules of the bank card networks are set by their boards, which may be strongly influenced by member banks and, in the case of Discover and American Express, by the card issuers, and some of those banks and issuers are our competitors with respect to these processing services. Many banks directly or indirectly sell processing services to merchants in direct competition with us. These banks could attempt, by virtue of their membership in the network, to alter the networks' rules or policies to the detriment of non-members like us. The bank card networks or issuers who maintain our registrations or arrangements or the current bank card network or issuer rules allowing us to market and provide payment processing services may not remain in effect. The termination of our registration or our status as an Independent Sales Organization or Member Service Provider, or any changes in card network or issuer rules that limit our ability to provide payment processing services, could have an adverse effect on our bank card processing volumes, revenues or operating costs. In addition, if we were precluded from processing Visa and MasterCard bank card transactions, we would lose substantially all of our revenues.

### **Our systems and our third-party providers' systems may fail due to factors beyond our control, which could interrupt our service, cause us to lose business and increase our costs.**

We depend on the efficient and uninterrupted operation of our computer network systems, software, data center and telecommunications networks, as well as the systems of third parties. Our systems and operations or those of our third-party providers could be exposed to damage or interruption from, among other things, fire, natural disaster, power loss, telecommunications failure, unauthorized entry and computer viruses. Our property and business interruption insurance may not be adequate to compensate us for all losses or failures that may occur. Defects in our systems or those of third parties, errors or delays in the processing of payment transactions, telecommunications failures or other difficulties could result in:

loss of revenues;

loss of merchants, although our contracts with merchants do not expressly provide a right to terminate for business interruptions;

loss of merchant and cardholder data;

harm to our business or reputation;

exposure to fraud losses or other liabilities;

negative publicity;

additional operating and development costs; and/or

diversion of technical and other resources.

### **Adverse conditions in markets in which we obtain a substantial amount of our bank card processing volume, such as our largest SME merchant markets of California, New York, Texas, Florida, Colorado, and New Jersey, could negatively affect our results of operations.**

Adverse economic or other conditions in California, New York, Texas, Florida, Colorado, and New Jersey would negatively affect our revenue and could materially and adversely affect our results of operations. In December 2008, SME merchants in California represented 12.3%, in New

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York represented 6.6%, in Texas represented 5.3%, in Florida represented 4.5%, in New Jersey represented 4.4%, and in Colorado represented 4.1% of our SME bank card processing volume. As a result of this geographic concentration of our merchants in these markets, we are exposed to the risks of downturns in these local economies and to other local conditions, which could adversely affect the operating results of our merchants in these markets. No other state represented more than 4% of our SME bank card processing volume in December 2008.

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**If we lose key personnel or are unable to attract additional qualified personnel as we grow, our business could be adversely affected.**

We are dependent upon the ability and experience of a number of our key personnel who have substantial experience with our operations, the rapidly changing payment processing industry and the selected markets in which we offer our services. It is possible that the loss of the services of one or a combination of our senior executives or key managers, particularly Robert O. Carr, our Chief Executive Officer, would have an adverse effect on our operations. Our success also depends on our ability to continue to attract, manage and retain other qualified middle management and technical and clerical personnel as we grow. We may not continue to attract or retain such personnel.

**If we are unable to attract and retain qualified sales people, our business and financial results may suffer.**

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we rely on a direct sales force whose compensation is entirely commission-based. Through our direct sales force of approximately 1,166 Relationship Managers, we seek to increase the number of merchants using our products and services. We intend to significantly increase the size of our sales force. Our success partially depends on the skill and experience of our sales force. If we are unable to retain and attract sufficiently experienced and capable Relationship Managers, our business and financial results may suffer.

**If we cannot pass increases in bank card network interchange fees along to our merchants, our operating margins will be reduced.**

We pay interchange fees and other network fees set by the bank card networks to the card issuing bank for each transaction we process involving their bank cards. From time to time, the bank card networks increase the interchange fees and other network fees that they charge payment processors and the sponsoring banks. At its sole discretion, our sponsoring bank has the right to pass any increases in interchange fees on to us and it has consistently done so in the past. We are allowed to, and in the past we have been able to, pass these fee increases along to our merchants through corresponding increases in our processing fees. However, if we are unable to do so in the future, our operating margins will be reduced.

**Any acquisitions or portfolio buyouts that we make could disrupt our business and harm our financial condition.**

We expect to evaluate potential strategic acquisitions of complementary businesses, products or technologies. We may not be able to successfully finance or integrate any businesses, products or technologies that we acquire. Furthermore, the integration of any acquisition may divert management's time and resources from our core business and disrupt our operations. We may spend time and money on projects that do not increase our revenue. To the extent we pay the purchase price of any acquisition in cash, it would reduce our cash reserves, and to the extent the purchase price is paid with our stock, it could be dilutive to our stockholders. While we from time to time evaluate potential acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any acquisitions.

We also regularly buy out the residual commissions of our Relationship Managers and sales managers, at multiples that typically amount to 2 to 2<sup>1/2</sup> years of such commissions. If the merchants included in the portfolios we purchase do not generate sufficient incremental margin after the purchase, we will not achieve a positive return on the cash expended.

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### **Governmental regulations designed to protect or limit access to consumer information could adversely affect our ability to effectively provide our services to merchants.**

Governmental bodies in the United States and abroad have adopted, or are considering the adoption of, laws and regulations restricting the transfer of, and safeguarding, non-public personal information. For example, in the United States, all financial institutions must undertake certain steps to ensure the privacy and security of consumer financial information. While our operations are subject to certain provisions of these privacy laws, we have limited our use of consumer information solely to providing services to other businesses and financial institutions. We limit sharing of non-public personal information to that necessary to complete the transactions on behalf of the consumer and the merchant and to that permitted by federal and state laws. In connection with providing services to the merchants and financial institutions that use our services, we are required by regulations and contracts with our merchants to provide assurances regarding the confidentiality and security of non-public consumer information. These contracts require periodic audits by independent companies regarding our compliance with industry standards and best practices established by regulatory guidelines. The compliance standards relate to our infrastructure, components, and operational procedures designed to safeguard the confidentiality and security of non-public consumer personal information shared by our clients with us. Our ability to maintain compliance with these standards and satisfy these audits will affect our ability to attract and maintain business in the future. The cost of such systems and procedures may increase in the future and could adversely affect our ability to compete effectively with other similarly situated service providers.

### **Our operating results are subject to seasonality, which could result in fluctuations in our quarterly net income.**

We have experienced in the past, and expect to continue to experience, seasonal fluctuations in our revenues as a result of consumer spending patterns. Historically our revenues have been strongest in our second and third quarters, and weakest in our first quarter.

### **We may become subject to additional U.S., state or local taxes that cannot be passed through to our merchants, which could negatively affect our results of operations.**

Companies in the payment processing industry, including us, may become subject to taxation in various tax jurisdictions on our net income or revenues. Application of these taxes is an emerging issue in our industry and taxing jurisdictions have not yet adopted uniform positions on this topic. If we are required to pay additional taxes and are unable to pass the tax expense through to our merchants, our costs would increase and our net income would be reduced.

### **We may need to raise additional funds to finance our future capital needs, which may prevent us from growing our business.**

We may need to raise additional funds to finance our future capital needs, including funding costs associated with the Processing System Intrusion, completing the build out of our new service center, developing new products and technology, and operating expenses. We may need additional financing earlier than we anticipate if we:

experience material costs to mitigate the impacts of, and resolve the claims originating from, the Processing System Intrusion;

expand faster than our internally generated cash flow can support;

purchase portfolio equity (the portion of our commissions that we have committed to our sales force for as long as the merchant processes with us, which we may buy out at an agreed multiple) from a large number of Relationship Managers or sales managers;

add new merchant accounts faster than expected;

need to reduce pricing in response to competition;

repurchase our common stock; or

acquire complementary products, businesses or technologies.

If we raise additional funds through the sale of equity securities, these transactions may dilute the value of our outstanding common stock. We may also decide to issue securities, including debt securities that have rights, preferences and privileges senior to our common stock. We may be unable to raise additional funds on terms favorable to us or at all. If financing is not available or is not available on acceptable terms, we may be unable to fund our future needs. This may prevent us from increasing our market share, capitalizing on new business opportunities or remaining competitive in our industry.

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### **Risks Related to Our Company**

#### **Borrowings under our Amended and Restated Credit Agreement could adversely affect our financial condition, and the related debt service obligations may adversely affect our cash flow and ability to invest in and grow our businesses.**

We funded our acquisition of Network Services by borrowing under our Amended and Restated Credit Agreement. The interest rates on this debt are floating based on the LIBOR rate; accordingly, if the LIBOR rate increases, our interest expense would be higher. We intend to fulfill our total debt service obligations primarily from cash generated by our operations. Such funds will not be available to use in future operations, or investing in our businesses. This may adversely impact our ability to expand our businesses or make other investments.

If we are unable to meet our debt obligations, we could be forced to restructure or refinance our obligations, to seek additional equity financing or to sell assets, which we may not be able to do on satisfactory terms or at all. As a result, we could default on those obligations and in the event of such default, our lenders could accelerate our debt or take other actions that could restrict our operations. If we incur significant costs to defend, or are required to book a significant reserve for, claims arising out of the Processing System Intrusion, such costs or reserve could cause us to violate certain of the financial covenants in our Amended and Restated Credit Agreement.

#### **Future sales of our common stock, or the perception in the public markets that these sales may occur, could depress our stock price.**

Sales of substantial amounts of our common stock in the public market, or the perception in the public markets that these sales may occur, could cause the market price of our common stock to decline. This could also impair our ability to raise additional capital through the sale of our equity securities. At December 31, 2008, we had 37,675,543 shares of our common stock outstanding. In addition, as of December 31, 2008, we had outstanding options to purchase a total of 5,308,173 shares under our 2008 Incentive Stock Option Plan and our 2000 Incentive Stock Option Plan, of which 2,358,443 were vested. Assuming the exercise of all outstanding options to acquire our common stock, our current stockholders would own on a fully-diluted basis 87.7% of the outstanding shares of our common stock, and the number of shares of our common stock available to trade could cause the market price of our common stock to decline. In addition to the adverse effect a price decline could have on holders of our common stock, such a decline could impede our ability to raise capital or to make acquisitions through the issuance of additional shares of our common stock or other equity securities.

#### **Provisions in our charter documents and Delaware law could discourage a takeover that our shareholders may consider favorable or could cause current management to become entrenched and difficult to replace.**

Provisions in our amended and restated certificate of incorporation, in our bylaws and under Delaware law could make it more difficult for other companies to acquire us, even if doing so would benefit our stockholders. Our amended and restated certificate of incorporation and bylaws contain the following provisions, among others, which may inhibit an acquisition of our company by a third party:

advance notification procedures for matters to be brought before stockholder meetings;

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a limitation on who may call stockholder meetings;

a prohibition on stockholder action by written consent; and

the ability of our Board of Directors to issue up to 10 million shares of preferred stock without a stockholder vote.

If any shares of preferred stock are issued that contain an extraordinary dividend or special voting power, a change in control could be impeded.

We are also subject to provisions of Delaware law that prohibit us from engaging in any business combination with any interested stockholder, meaning, generally, that a stockholder who beneficially owns more than 15% of our stock cannot acquire us for a period of three years from the date this person became an interested stockholder unless various conditions are met, such as approval of the transaction by our Board of Directors. Any of these restrictions could have the effect of delaying or preventing a change in control.

**We may be unable or we may decide not to pay dividends on our common stock at a level anticipated by shareholders, which could depress our stock price.**

The payment of dividends on our common stock in the future will be at the discretion of our Board of Directors and will depend on, among other factors, our earnings, stockholders' equity, cash position and financial condition. No assurance can be given that we will be able to or will choose to pay any dividends in the foreseeable future.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not Applicable.

**ITEM 2. PROPERTIES**

At December 31, 2008, we owned one facility and leased eleven facilities which we use for operational, sales and administrative purposes.

Our principal executive offices are located in approximately 9,300 square feet of leased office space on Nassau Street in Princeton, New Jersey. The Nassau Street lease expires in May 2013.

We own 35 acres of land in Jeffersonville, Indiana, on which we completed constructing 96,000 square feet of office space for the first phase of our new service center, which opened for operation in December 2007, and 30,000 square feet of space for our equipment deployment area, which opened in December 2008. We are currently building an additional 95,000 square feet of multi-use space on the site of our Jeffersonville service center.



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We lease the following facilities as of December 31, 2008:

Location	Square Feet	Expiration
Alpharetta, Georgia	3,008	November 30, 2010
Chattanooga, Tennessee	9,461	January 31, 2009
Cleveland, Ohio	17,696	June 30, 2012 for 15,940 square feet. 1,756 square feet of the total are on a month-to-month commitment.
Colorado Springs, Colorado	10,431	December 31, 2009
Jeffersonville, Indiana	27,040	between March 31, 2009 and April 30, 2009
Johnson City, Tennessee	45,000	October 22, 2010
Phoenix, Arizona	1,284	March 31, 2010
Plano, Texas	49,015	May 31, 2015
Portland, Oregon	14,203	September 30, 2010
West Windsor Township, New Jersey	5,288	May 31, 2013
Woodbridge, Ontario, Canada	2,205	February 28, 2010

Each of these leases is renewable. The Chattanooga, TN lease was extended to June 30, 2014. The leased facility in Jeffersonville, IN is being replaced by our new service center.

We believe that our facilities are suitable and adequate for our current business operations and, if necessary, could be replaced with little disruption to our company. We periodically review our space requirements and may acquire new space to meet our business needs or consolidate and dispose of or sublet facilities which are no longer required.

**ITEM 3. LEGAL PROCEEDINGS*****Processing System Intrusion Legal Proceedings***

To date, we have had several lawsuits filed against us and we expect additional lawsuits will be filed. These include lawsuits which assert claims against us by cardholders (including various putative class actions seeking in the aggregate to represent all cardholders in the United States whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion) and banks that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion (including various putative class actions seeking to represent all financial institutions that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), seeking damages allegedly arising out of the Processing System Intrusion and other related relief. The actions generally assert various common-law claims such as claims for negligence and breach of contract, as well as, in some cases, statutory claims such as violation of the Fair Credit Reporting Act, state data breach notification statutes, and state unfair and deceptive practices statutes. The putative cardholder class actions seek various forms of relief including damages, injunctive relief, multiple or punitive damages, attorney's fees and costs. The putative financial institution class actions seek compensatory damages, including recovery of the cost of issuance of replacement cards and losses by reason of unauthorized transactions, as well as injunctive relief, attorney's fees and costs. We have filed a motion with the Judicial Panel on Multidistrict Litigation seeking to have these cases consolidated for pre-trial proceedings before the United States District Court for the Southern District of Texas.

The putative consumer class acting and putative financial institution class actions filed against us through March 13, 2009 are described below.

Putative Consumer Class Actions:

Name of the Court	Date Filed	Principal Parties
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United States District Court for the District of New Jersey	January 23, 2009	<i>Sansom and Engel v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00335
United States District Court for the Northern District of Florida	January 26, 2009	<i>Read v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00035
United States District Court for the District of Arizona	January 29, 2009	<i>Swenka v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00179
United States District Court for the District of Kansas	January 29, 2009	<i>Barrett v. Heartland Payment Systems, Inc. et al.</i> , 09-cv-2053
United States District Court for the District of New Jersey	January 29, 2009	<i>Merino v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00439
United States District Court for the Middle District of Alabama	February 2, 2009	<i>Brown, Latham and Spencer v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00086
United States District Court for the Eastern District of California	February 2, 2009	<i>Hilliard v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-00179
United States District Court for the District of New Jersey	February 2, 2009	<i>Kaissi v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00540
United States District Court for the Northern District of Ohio	February 3, 2009	<i>McGinty and Carr v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-00244
United States District Court for the Southern District of Texas	February 4, 2009	<i>Watson v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-00325
United States District Court for the Eastern District of Wisconsin	February 4, 2009	<i>Anderson and Hoven v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00113
United States District Court for the Southern District of Florida	February 6, 2009	<i>Balloveras v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-20326
United States District Court for the District of New Jersey	February 10, 2009	<i>Hinton v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00594
United States District Court for the Southern District of California	February 25, 2009	<i>Mata v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00376
United States District Court for the Western District of Missouri	February 26, 2009	<i>McLaughlin v. Heartland Payment Systems, Inc. et al.</i> , 6:09-cv-3069
United States District Court for the District of New Jersey	February 27, 2009	<i>Rose v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00917

### Putative Financial Institution Class Actions:

Name of the Court	Date Filed	Principal Parties
United States District Court for the District of New Jersey	February 6, 2009	<i>Lone Summit Bank v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00581
United States District Court for the District of New Jersey	February 13, 2009	<i>TriCentury Bank et al. v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00697
United States District Court for the Southern District of Texas	February 16, 2009	<i>Lone Star National Bank v. Heartland Payment Systems, Inc. et al.</i> , 7:09-cv-00064
United States District Court for the District of New Jersey	February 20, 2009	<i>Amalgamated Bank et al. v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00776

A putative class action was commenced against us and certain of our executive officers alleging violations of the federal securities laws in connection with our disclosures relative to the Processing System Intrusion and our computer system security and the alleged trading in our

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securities by four of our officers. This case, *Davis v. Hartland Payment Systems, Inc, Robert O. Carr and Robert H.B. Baldwin, Jr.*, commenced on March 6, 2009 in the United States District Court for the District of New Jersey. The plaintiff in the putative federal securities law class action seeks to represent all purchasers of our securities between August 5, 2008 and February 23, 2009 and seeks to recover losses such as purchasers allegedly incurred by reason of their purchases, as well as related costs and expenses.

We have been advised by the SEC that it has commenced an informal inquiry, and we have been advised by the United States Attorney for the District of New Jersey that it has commenced an investigation, in each case to determine whether there have been any violations of the federal securities laws in connection with our disclosure of the Processing Systems Intrusion and the alleged trading in our securities by certain of our employees, including certain executive officers.

We have been contacted by the Federal Financial Institutions Examination Council and informed that it will be making inquiries into the Processing System Intrusion, and the Federal Trade Commission, by letter dated February 19, 2009, has requested that we provide information about our information security practices. Additionally, we have received written or telephonic inquiries relating to the Processing System Intrusion from a number of state Attorneys General's offices, including a Civil Investigative Demand from the Louisiana Department of Justice Office of the Attorney General, the Canadian Privacy Commission, and other government officials. We are cooperating with the government officials in response to each of these inquiries. We expect that additional lawsuits may be filed against us relating to the Processing System Intrusion and that additional inquiries from governmental agencies may be received or investigations may be commenced.

Although we intend to defend the lawsuits, investigations and inquiries described above vigorously, we cannot predict the outcome of such lawsuits, investigations and inquiries. Apart from damages claimed in such lawsuits and in other lawsuits relating to the Processing System Intrusion that may be filed, we may be subject to fines or other obligations as a result of the government inquiries and investigations described above and additional governmental inquiries or investigations relating to the Processing System Intrusion that may be commenced. The card brands may also assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. In that regard, we have been advised by Visa that based on Visa's investigation of the Processing System Intrusion Visa believes we are in violation of the Visa Operating Regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, intends to seek to impose fines on our sponsor banks, which fines (if successfully imposed) our sponsor banks could in turn seek to recover from us, intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa Operating Regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system, and intends to treat some or all of the Visa accounts that Visa considers to have been placed at risk of compromise in the Processing System Intrusion as being eligible for Visa's Account Data Compromise Recovery and Data Compromise Recovery Solution processes, which processes could result in Visa seeking to recover from our sponsor banks (and our sponsor banks in turn seeking to recover from us) amounts in respect of fraud losses and operating expenses that Visa believes Visa issuers to have incurred by reason of the Processing System Intrusion. We expect the other Card Brands will assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. By these claims, we expect the other Card Brands to seek to recover from us, or from our sponsor banks (who would in turn seek to recover from us), assessments in respect of fraud losses and operating expenses (including card reissuance costs and non-ordinary-course account monitoring expenses) that the other Card Brands believe either themselves or their issuers to have incurred by reason of the Processing System Intrusion, as well as fines and/or penalties by reason of our alleged failure to comply with the other Card Brands' operating regulations. The amounts of the Card Brand claims described above are expected to be material, and the amounts we are required to pay to defend against and/or resolve those claims could have a material adverse effect on our results of operations and financial condition.

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While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claim as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow.

Although we have insurance that we believe may cover some of the costs and losses that we may incur in connection with the above-described pending and potential lawsuits, inquiries, investigations and claims, we cannot now confirm that such coverage will, in fact, be provided or the extent of such coverage, if it is provided.

### ***Other Legal Proceedings***

On December 16, 2008, a putative class action was filed against us in the Superior Court of California, County of San Diego, *Ryan McInerney, Hossein Vazir Zand v. Heartland Payment Systems, Inc.* The plaintiffs purport to represent a putative class of individuals who allegedly were not reimbursed by us for business expenses and whose compensation was allegedly reduced for their costs of doing business. The plaintiffs seek unspecified monetary damages, penalties, injunctive and declaratory relief, and attorney's fees and costs.

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. We believe that the outcome of the proceedings to which we are currently a party will not have a material adverse effect on our financial position, results of operations or cash flows.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our shareholders during our fourth quarter ended December 31, 2008.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market Information**

Our common stock trades on the New York Stock Exchange under the ticker symbol HPY. The following table sets forth the high and low sales prices of our common stock and dividend paid per share for the four quarters during the years ended December 31, 2007 and 2008:

	High	Low	Dividend Per Share
<b><u>2007</u></b>			
Quarter Ended:			
March 31, 2007	\$ 29.01	\$ 23.40	\$ 0.05
June 30, 2007	\$ 29.60	\$ 23.66	\$ 0.05
September 30, 2007	\$ 33.00	\$ 24.99	\$ 0.075
December 31, 2007	\$ 33.00	\$ 25.37	\$ 0.075
<b><u>2008</u></b>			
Quarter Ended:			
March 31, 2008	\$ 27.01	\$ 19.44	\$ 0.09
June 30, 2008	\$ 27.77	\$ 20.63	\$ 0.09
September 30, 2008	\$ 33.00	\$ 20.54	\$ 0.09
December 31, 2008	\$ 27.04	\$ 12.01	\$ 0.09

**Holders of Common Stock**

The number of shareholders of record of our common stock as of March 4, 2009 was 43.

**Dividends**

Until the third quarter of 2006, we had not paid any cash dividends on our common stock. On August 1, 2006, our Board of Directors declared the first quarterly cash dividend on our common stock. On February 20, 2009, the Company's Board of Directors declared a quarterly cash dividend of \$0.025 per share of common stock, payable on March 16, 2009 to stockholders of record as of March 9, 2009.

Our Board of Directors believed it prudent to establish a new dividend rate in light of the current difficulties in the financial markets and potential claims related to the Processing System Intrusion. The payment of dividends on our common stock in the future will be at the discretion of our Board of Directors and will depend on, among other factors, our earnings, stockholders' equity, cash position and financial condition.

**Securities Authorized For Issuance Under Equity Compensation Plans**

We maintain the Heartland Payment Systems, Inc. 2008 Equity Incentive Plan under which shares of our common stock are authorized for issuance. For more information on this plan, see Note 14 to Notes to Consolidated Financial Statements. Information regarding the common stock issuable under this plan as of December 31, 2008 is set forth in the following table:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and	Weighted- average exercise price of outstanding options,	Number of securities remaining available for future issuance under equity compensation plans (excluding securities

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	rights	warrants and rights	reflected in the first column)
Equity compensation plans approved by security holders	5,308,173	\$ 17.38	4,745,078
Equity compensation plans not approved by security holders	None	N/A	None
Total	5,308,173	\$ 17.38	4,745,078

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### **Purchases of Equity Securities by the Issuer**

On January 13, 2006, our Board of Directors authorized management to repurchase up to the lesser of (a) 1,000,000 shares of our common stock or (b) \$25,000,000 worth of our common stock in the open market. On August 1, 2006, our Board of Directors authorized management to repurchase up to 1,000,000 shares of our common stock in the open market using the proceeds from the exercise of stock options. On May 3, 2007, the Board of Directors eliminated the restriction in the August 1, 2006 repurchase authorization which required management to use only proceeds from the issuance of stock options for repurchases, and increased the total remaining authorized number of shares to be repurchased to 2,000,000. 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 through, February 28, 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.

### **Performance Graph**

The following graph compares the percentage change in cumulative total stockholder return on our common stock from August 10, 2005, the date our common stock was priced in connection with our initial public offering, through December 31, 2008 with the cumulative total return over the same period of (i) the S&P 500 Index and (ii) the S&P Information Technology Index.

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The below comparison assumes \$100 was invested on August 10, 2005 in our common stock and in the S&P 500 Index and the S&P Information Technology Index, and assumes reinvestment of dividends, if any. Historical stock prices are not indicative of future stock price performance.

	Base Period		Period Ended		
	08/10/05	12/31/05	12/31/06	12/31/07	12/31/08
Heartland Payment Systems, Inc.	100.00	120.33	157.23	150.48	99.92
S&P 500	100.00	102.39	118.57	125.08	78.80
S&P Information Technology Index	100.00	101.53	110.08	128.03	72.80



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The following table sets forth our selected historical consolidated financial information and other data for the years ended December 31, 2008, 2007, and 2006, which are derived from our consolidated financial statements included elsewhere in this report. Historical consolidated financial information for 2005 and 2004 are derived from our consolidated financial statements for those years (not included herein). The information in the following table should be read together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes included elsewhere in this report.

	Year Ended December 31,				
	2008	2007	2006	2005	2004
	(in thousands, except per share data)				
<b>Statement of Operations Data:</b>					
Total revenues	\$ 1,544,902	\$ 1,313,846	\$ 1,097,041	\$ 834,824	\$ 602,851
<b>Costs of Services:</b>					
Interchange	1,093,546	962,025	804,267	611,736	438,738
Dues, assessments and fees	67,648	57,050	47,122	36,602	26,317
Processing and servicing	173,743	126,599	111,554	82,557	67,263
Customer acquisition costs	48,522	44,193	35,451	28,025	18,908
Depreciation and amortization	11,006	6,806	6,042	5,685	3,912
Total costs of services	1,394,465	1,196,673	1,004,436	764,605	555,138
General and administrative	79,828	57,404	47,787	37,761	31,501
Total expenses	1,474,293	1,254,077	1,052,223	802,366	586,639
Income from operations	70,609	59,769	44,818	32,458	16,212
<b>Other income (expense):</b>					
Interest income	755	1,934	1,225	477	80
Interest expense	(3,206)	(785)	(753)	(1,553)	(1,385)
Losses on investments	(395)	(1,650)			
Exit costs for Service Center		(1,267)			
Fair value adjustment for warrants with mandatory redemption provisions				(2,912)	(509)
Gain on settlement of financing arrangement				5,140	
Other, net	(5)	(841)	(669)	198	833
Total other income (expense)	(2,851)	(2,609)	(197)	1,350	(981)
Income before income taxes	67,758	57,160	44,621	33,808	15,231
Provision for income taxes	25,918	21,290	16,077	14,715	6,376
Net income	41,840	35,870	28,544	19,093	8,855
Income allocated to Series A Senior Convertible Participating Preferred Stock				(4,728)	(4,263)
Net income attributable to Common Stock	\$ 41,840	\$ 35,870	\$ 28,544	\$ 14,365	\$ 4,592
<b>Earnings per common share:</b>					
Basic	\$ 1.12	\$ 0.95	\$ 0.78	\$ 0.62	\$ 0.28
Diluted	\$ 1.08	\$ 0.90	\$ 0.71	\$ 0.50	\$ 0.26

Weighted average number of common shares outstanding:

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Basic	37,521	37,686	36,394	23,069	16,408
Diluted	38,698	39,980	39,943	37,879	33,786
Cash dividends declared per common share	\$ 0.36	\$ 0.25	\$ 0.05		

**Other Data:**

Number of active bank card merchants serviced (at period end - in thousands)	230	155	133	110	89
Bank card processing volume for the period (in millions)	66,925	51,936	43,294	33,722	24,987

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	2008	2007	As of December 31, 2006		2005	2004
			(in thousands)			
<b>Balance Sheet Data:</b>						
Cash and cash equivalents	\$ 27,589	\$ 35,508	\$ 16,054	\$ 8,724	\$ 4,376	
Receivables, net	140,145	122,613	107,154	93,756	64,325	
Total assets	463,619	329,189	251,768	183,685	133,926	
Due to sponsor banks	68,212	49,798	27,253	34,530	45,153	
Accounts payable	25,864	20,495	16,936	14,736	17,692	
Current portion of borrowings	58,522		174	261	5,286	
Long term portion of borrowings	16,984			173	7,808	
Total liabilities	284,375	163,520	112,475	103,634	127,827	
Total Stockholders Equity	179,244	165,669	139,293	80,051	6,099	

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements and the risk factors included elsewhere in this report.

**Overview****General**

Our primary business is to provide bank card payment processing services to merchants in the United States and Canada. This involves facilitating the exchange of information and funds between merchants and cardholders' financial institutions, providing end-to-end electronic payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant assistance and support and risk management. Our merchant customers primarily fall into two categories; our core small and mid-sized merchants (referred to as Small and Mid-sized Enterprises, or SME) and large national merchants, primarily in the petroleum industry. We also provide additional services to our merchants, such as payroll processing, gift and loyalty programs, and paper check processing, and we sell and rent point-of-sale devices and supplies.

On January 20, 2009, we publicly announced the Processing System Intrusion, which apparently had occurred during some portion of 2008. See Processing System Intrusion for more detail.

At December 31, 2008, we provided our bank card payment processing services to approximately 168,850 active SME bank card merchants located across the United States. This represents a 9.1% increase over the 154,750 active SME bank card merchants at December 31, 2007. At December 31, 2008, we provided bank card payment processing services to approximately 82 large national merchants with approximately 55,761 locations. Our total bank card processing volume for the year ended December 31, 2008 was \$66.9 billion, a 28.9% increase from the \$51.9 billion processed during the year ended December 31, 2007. Bank card processing volume for 2008 includes \$8.7 billion for large national merchants acquired with Network Services. For the years ended December 31, 2006 and 2005, our bank card processing volume was \$43.3 billion and \$33.7 billion, respectively.

In May 2008, we acquired the net assets of the Network Services Business unit (Network Services) of Alliance Data Network Services LLC (Alliance), for a cash payment of \$92.5 million. The acquisition was financed through a combination of cash on hand and our credit facilities. Network Services provides processing of credit and debit cards to large national merchants, primarily in the petroleum industry. Network Services settled 604 million transactions representing over \$17 billion of total annual Visa and MasterCard bank card processing volume in 2007. In addition to settling Visa and MasterCard transactions, Network Services processes a wide range of payment transactions for its predominantly petroleum customer base, including providing approximately 2.6 billion transaction authorizations through its front-end card processing systems (primarily for Visa and MasterCard) in 2007. Network Services added \$8.7 billion to our bank card processing volume on 317 million settled transactions since its acquisition through December 31, 2008. Additionally, Network Services generated revenues on 1.6 billion transactions it authorized through its front-end card processing systems since its acquisition through December 31, 2008.

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In March 2008, we acquired a majority interest in Collective Point of Sale Solutions Ltd. ( CPOS ) for a net cash payment of \$10.1 million. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions. This acquisition added approximately 5,100 Canadian merchants and provides us an entrance into the Canadian credit and debit card processing market. We are now able to service merchants that have locations in both the United States and Canada. We do not expect the acquisition of CPOS to have a material impact on our 2009 revenues or net income.

In November 2008, we acquired the net assets of Chockstone, Inc. ( Chockstone ) for a net cash payment of \$4.1 million. The Chockstone acquisition expands our ability to equip merchants nationwide with enhanced gift card and loyalty programs. Chockstone's loyalty platform helps businesses of all sizes identify their most profitable customers and market to their unique needs - thereby increasing the frequency of their visits and the size of their average purchases. Chockstone's loyalty marketing and gift card solutions are used by leading brands in more than 65,000 restaurants, convenience stores, and other retail locations in North America. We do not expect the acquisition of Chockstone to have a material impact on our 2009 revenues or net income.

We have developed a number of proprietary payment processing systems to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our merchant base, our sales force and our customer service staff. In 2001, we began providing authorization and data capture services to our SME merchants through our own front-end processing system, which we call HPS Exchange. In 2005, we began providing clearing, settlement and merchant accounting services through our own internally developed back-end processing system, which we call Passport. Passport enables us to customize these services to the needs of our Relationship Managers and SME merchants. Currently, we are further developing HPS Exchange and Passport to process the large national merchants which we acquired with Network Services.

During the years ended December 31, 2008, 2007 and 2006, approximately 83%, 75% and 64%, respectively, of our SME transactions were processed through HPS Exchange, which has decreased our operating costs per transaction. At December 31, 2008 and 2007, approximately 98% of our active SME merchants were processing on Passport, which also has contributed to decreasing our operating costs per transaction. With our conversion to Passport, our internally developed systems are providing substantially all aspects of most of our merchants' processing needs, excluding Network Services. Previously, we relied on third party vendors for many of these services including bank card authorization and data capture services, settlement and merchant accounting services. We will continue to process a minority of our transactions through third party front-end systems.

The bank card revenue we earn in our SME business is recurring in nature, as we typically enter into three-year service contracts with our card processing merchants that, in order to qualify for the agreed-upon pricing, require the merchant to achieve bank card processing volume minimums. Most of our SME revenue is payment processing fees, which are a combination of a fee equal to a percentage of the dollar amount of each Visa or MasterCard transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card-issuing banks through Visa and MasterCard and dues, assessments and other network fees to Visa and MasterCard. Our SME gross bank card processing revenue is largely driven by Visa and MasterCard volume processed by merchants with whom we have processing contracts; as such, we also generally benefit from consumers' increasing use of bank cards in place of cash and checks, and sales growth experienced by our retained bank card merchants. In contrast, Network Services revenues are largely driven by the number of transactions it processes (whether settled, or only authorized), not its processing volume, as the larger merchants which comprise Network Services' customer base pay on a per transaction basis for processing services.

Significant increases in our sales force have led to significant growth in the number of SME merchants for whom we process. Our sales managers are compensated based on their success in growing the sales force and increasing the total SME bank card, payroll and check processing merchants in their regions. Our number of total Relationship Managers grew from 952 at December 31, 2006 and 1,117 at December 31, 2007, to 1,166 at December 31, 2008. We measure the production of our sales force by gross margin installed, which reflects the expected annual gross profit from a merchant/customer contract after deducting processing and servicing costs associated with that revenue. In 2008, our installed gross margin increased 13% over 2007 levels, which in turn represented a 22% increase over 2006 levels. The number of total SME bank card, payroll and check processing merchants we installed during year ended December 31, 2008 was 60,164 new merchants installed, compared to

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61,502 new merchants installed during the year ended December 31, 2007 and 54,099 new merchants installed during the year ended December 31, 2006. Our installed margin has grown faster than merchant count due both to installing larger merchants, and increases in margin per dollar processed.

As a result of our commission-only compensation system for our sales force, we are able to increase the size of our sales force with minimal upfront costs. However, since we pay signing bonuses and commissions approximating 92% of the gross margin generated by a SME merchant in its first year, growth in installed margin consumes significant capital, as it typically takes approximately one year's processing to cover the outlays for signing bonuses, commissions and payroll taxes.

In our SME business, same store sales growth, which represents the change in bank card processing volume for all bank card merchants that were processing with us in the same month a year earlier, contracted by 2.1% on average in 2008, compared to growth of 3.0% on average in 2007 and 4.2% on average in 2006. Same store sales growth or contraction results from the combination of the increasing use by consumers of bank cards for the purchase of goods and services at the point of sale, and sales growth or contraction experienced by our retained SME bank card merchants. The following table compares our same store sales growth or contraction for the 2008, 2007 and 2006 full years and by quarter during 2007 and 2008:

	<b>Same Store Sales Growth (Contraction)</b>
<b>By Full Year</b>	
2006 full year	4.2%
2007 full year	3.0%
2008 full year	(2.1)%
<b>By Quarter 2007 and 2008</b>	
2007 first quarter	3.4%
2007 second quarter	3.3%
2007 third quarter	3.6%
2007 fourth quarter	2.1%
2008 first quarter	0.6%
2008 second quarter	(0.1)%
2008 third quarter	(2.0)%
2008 fourth quarter	(6.8)%

We attribute the declining rates of same store sales growth percentages in our SME business, including the increasing contraction rates we experienced during the second, third and fourth quarters of 2008, to declining economic conditions including impacts from severely contracted credit markets, a weak housing market, historically low consumer and investor confidence and a soft labor market leading to higher unemployment rates. Management believes that all of these factors have negatively impacted consumer confidence, disposable income, spending and behavior, which has impacted the businesses of our SME merchants. In addition, Management believes that the current challenging economic conditions and depressed consumer confidence, as well as the general contraction in credit availability, may continue to negatively impact our business.

We also derive recurring revenue from our payroll processing services, American Express and Discover processing, and maintenance fees on micro payment and campus solutions. Other revenues include sales of card processing and micro payment equipment and fees for additional services we provide, such as fees for handling merchants' chargebacks.

We provide payroll processing services throughout the United States. At December 31, 2008, we processed payroll for 7,738 customers, an increase of 24.6% from 6,209 payroll customers at December 31, 2007.

***Processing System Intrusion***

On January 20, 2009, we publicly announced 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 us during the transaction authorization process. Such data is not required to be encrypted while in transit under current



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payment card industry guidelines. We had received confirmation of our 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 in April 2008. Card data that was affected 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 we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008. Our investigation of the Processing System Intrusion is ongoing.

We have been advised by Visa Inc. that based on Visa's investigation of the Processing System Intrusion, Visa believes we are in violation of the Visa operating regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, intends to seek to impose fines on our sponsor banks, which fines (if successfully imposed) our sponsor banks could in turn seek to recover from us, intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system, and intends to treat some or all of the Visa accounts that Visa considers to have been placed at risk of compromise in the Processing System Intrusion as being eligible for Visa's Account Data Compromise Recovery and Data Compromise Recovery Solution processes, which processes could result in Visa's seeking to recover from our sponsor banks (and our sponsor banks in turn seeking to recover from us) amounts in respect of fraud losses and operating expenses that Visa believes Visa issuers to have incurred by reason of the Processing System Intrusion.

While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claims as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs could be material and are expected to adversely impact our results of operations, financial condition and cash flow.

***2008 Financial Highlights***

For 2008, we recorded net income of \$41.8 million, or \$1.08 per diluted share, increases of 16.6% and 20.0%, respectively, from \$35.9 million, or \$0.90 per diluted share, in 2007. The increases were primarily driven by revenues added by the growth in our transaction processing volume and efficiencies realized in processing and servicing costs. Net income for 2008 included pre-tax charges of \$0.4 million for losses on investments. Net income for 2007 included pre-tax charges of \$1.7 million for the write off of an investment, \$1.3 million to record the costs associated with exiting our old service center, and \$0.8 million to record our liability from a legal proceeding under an indemnification we had provided to an insurer. The following is a summary of our financial results for 2008:

New installed gross margin increased by 13% over 2007.

Bank card processing volume during 2008 increased 28.9% to \$66.9 billion from \$51.9 billion during 2007; however, 2008 included \$8.7 billion of processing volume from Network Services. Excluding Network Services processing volume, we received percentage-based revenues on processing volume of \$57.9 billion, an increase of 11.6% over the \$51.9 billion processed in 2007. This 11.6% increase in SME bank card processing volume was primarily attributable to a net increase in SME merchant accounts and installed gross margin. Additionally, Network Services generated revenues on the 317 million transactions it settled, and the 1.6 billion transactions it authorized through its front-end card processing systems since we acquired that business.

Net revenue, which we define as total revenues less interchange fees and dues, assessments and fees, increased 30.2% to \$383.7 million during 2008 from \$294.8 million during 2007. The increase in net revenue was driven by the year-over-year increases in active merchants

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and processing volume, as well as the addition of revenues from Network Services. Excluding Network Services revenue, our net revenue grew by 15.3% during 2008.

Our processing and servicing costs for 2008 increased to 11.2% of our total revenues, from 9.6% of total revenues for 2007. The increase in processing and servicing expense included \$25.1 million for Network Services and an increase of \$3.5 million in merchant losses during the year ended December 31, 2008 as we incurred increased losses primarily related to merchants that had gone out of business due to weak economic conditions. The increase was also due to costs associated with the increased bank card processing volume, equipment costs of sales and the costs of operating our service center, particularly the costs of support personnel including field Account Managers and depreciation and amortization.

Our income from operations, which we also refer to as operating income, grew to \$70.6 million for 2008 from \$59.8 million for 2007. Our operating margin, which is measured as operating income



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divided by net revenue, was 18.4% for 2008, compared to 20.3% for 2007. Network Services' operating margin is significantly lower than that of our historic business, and will materially reduce our combined operating margins in future periods.

Our effective income tax rate for 2008 was 38.3%, which compares to an effective tax rate of 37.2% for 2007. The higher effective tax rate for the year was due to increases in state income tax rates.

### ***Components of Revenues and Expenses***

**Revenues.** Our revenues fall into three categories: gross card processing revenue, payroll processing revenue and equipment-related income. Our gross card processing revenue primarily consists of discount, per-transaction (Network Services prices its card processing fees entirely on a per transaction basis) and periodic (primarily monthly) fees from the processing of bank card transactions, primarily Visa and MasterCard transactions, for merchants and authorization of transactions by Network Services. These fees are negotiated by our Relationship Managers with each merchant. Gross card 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. Revenues are recorded at the time service is provided.

Payroll processing revenue includes fees charged by our subsidiary, Heartland Payroll Company, for payroll processing services, including check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation and interest income earned on funds held for customers. Revenues are recorded at the time service is provided.

Equipment-related income includes revenues from the sale, rental and deployment of bank card and check processing terminals. Since January 1, 2006, our equipment-related income also includes revenues from the sale of hardware, software and associated services for prepaid card and stored-value card payment systems. Beginning October 19, 2007, we added revenues from the sale of hardware, software and associated services for campus payment solutions to our equipment-related income. Equipment revenues are recorded at the time of shipment, or the provision of service. Most of these revenue items will tend to grow with our merchant growth.

**Expenses.** Our most significant expense is interchange fees, which are set by the Visa and MasterCard card networks, and are paid to the card issuing banks. For our SME bank card processing, we do not offset bank card processing revenues and interchange fees because our business practice is to advance the interchange fees to most of our merchants when settling their daily transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. As Network Services does not advance interchange fees to its merchants, we record its portion of our processing revenues net of interchange fees. Interchange fees are calculated as a percentage of the dollar volume processed plus a per transaction fee. We also pay Visa and MasterCard network dues, assessments and fees, which are a combination of a percentage of the dollar volume processed and per transaction fees. Interchange fees and dues, assessments and fees are recognized at the time transactions are processed. It is our policy to pass along to our merchants any changes in interchange fees and card network dues, assessments and fees. Since the card networks regularly adjust those rates, our gross processing revenue will increase or decrease, but all the impact will be paid to the card issuing banks and our income from operations will not be affected.

Costs of services also include processing and servicing costs, customer acquisition costs, and depreciation and amortization. Processing and servicing costs include:

processing costs, which are either paid to third parties, including our bank sponsors, or represent the cost of our own authorization/capture and accounting/settlement systems. During 2008, third party costs represented about 74% of our processing costs and increased due to our addition of Network Services, with internal costs representing the remainder. During 2007, third party costs represented about 69% of our processing costs, compared to 74% during 2006. Approximately 17% of our third-party processing costs in 2008 were paid to Alliance Data Systems Corporation for processing Network Services Transactions. Approximately 35%, 66% and 71%, respectively, of our third-party processing costs in 2008, 2007 and 2006 were paid to TSYS Acquiring Solutions;

residual commission payments to our Relationship Managers, sales managers, trade associations, agent banks and value-added resellers, which are a percentage of the gross margin we generated from our merchant contracts during the accounting period;

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the costs of operating our service center, including telecommunications costs, personnel costs, occupancy costs, losses due to merchant defaults, depreciation and amortization, and other direct merchant servicing costs; and

the costs of bank card terminals, prepaid card and stored value hardware deployed, and merchant supplies.

Customer acquisition costs reflect the amortization over the initial three-year contract term of the cash signing bonus paid and the deferred acquisition costs for vested Relationship Managers and sales managers, as well as changes in the accrued buyout liability, which reflect the impact of buying out residual commissions (see Critical Accounting Estimates Accrued Buyout Liability ) and volume attrition.

Depreciation and amortization expenses are primarily recognized on a straight-line basis over the estimated useful life of the asset. We have made significant capital expenditures for computer hardware and software and such costs are generally depreciated over three to five years.

General and administrative expenses include salaries and wages and other administrative expenses. The two most significant elements in these expenses are our information technology infrastructure costs and our marketing expenses. Beginning January 1, 2006, general and administrative expenses also include expenses recorded for share-based compensation under SFAS No. 123R.

Other income (expense) consists of interest income on cash and investments, the interest cost on our borrowings, losses on investments, the gains or losses on the disposal or write down of property, plant and equipment and other non-operating income or expense items.

## **Critical Accounting Estimates**

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results could differ from those estimates. Our significant accounting policies are more fully described in note 2 to our consolidated financial statements included elsewhere in this report. The critical accounting estimates described here are those that are most important to the depiction of our financial condition and results of operations, including those whose application requires management's most subjective judgment in making estimates about the effect of matters that are inherently uncertain. The line items on our income statement and balance sheet impacted by management's estimates are described below.

### ***Revenues***

Historically, we have paid 70% to 75% of our gross processing revenue as interchange fees to the card issuing banks. Certain of our competitors report their revenue net of interchange fees. This is because the issuing banks make their payments to these competitors net of those interchange fees, and these acquirers pay this reduced amount to their merchants. We do not offset gross processing revenue and interchange fees because our business practice is to fund the interchange fee or to arrange for our sponsor bank to advance the interchange fees to most of our merchants when settling their transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. We believe this policy aids in new business generation, as our merchants benefit from bookkeeping simplicity. However, this results in our carrying a large receivable from our merchants at each period-end, and a corresponding but smaller payable to our sponsor bank, both of which are settled on the first business day after the period-end. As we are at risk for the receivables, we record the associated revenues on a gross processing revenue basis in our consolidated income statements. Since the acquisition of Network Services, we record a portion of our processing revenues net of interchange fees because the daily cash settlement with the Network Services merchants is net of interchange fees.

### ***Capitalized Customer Acquisition Costs***

Capitalized customer acquisition costs consist of (1) up-front signing bonuses paid to Relationship Managers and sales managers, referred to as the salesperson or salespersons, for the establishment of new merchant relationships, and (2) deferred acquisition cost representing the estimated cost of buying out the commissions of vested salespersons at some point in the future. Pursuant to Staff Accounting Bulletin Topic 13,

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*Revenue Recognition*, and the 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 SME 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 amount of the up-front signing bonus paid for new SME bank card, payroll and check processing accounts is based on the estimated gross margin for the first year of the merchant contract. The gross signing bonuses paid during 2008, 2007 and 2006 were \$43.8 million, \$43.6 million and \$32.6 million, respectively. The signing bonus paid, amount capitalized, and related amortization are adjusted at the end of the first year to reflect the actual gross margin generated by the merchant contract during that year. The net signing bonus adjustments made during 2008, 2007 and 2006 were positive \$1.7 million, \$1.1 million and \$1.1 million, respectively. Positive signing bonus adjustments occur when the actual gross margin generated by the merchant contract during the first year exceeds the estimated gross margin for that year, resulting in the underpayment of the up-front signing bonus. Negative signing bonus adjustments could result from prior overpayments of up-front signing bonuses, and would be recovered from the relevant salesperson. The amount of signing bonuses paid which remained subject to adjustment at December 31, 2008 and 2007 was \$41.2 million and \$41.8 million, respectively.

The deferred acquisition cost component is accrued for vested salespersons over the first year of bank card merchant processing, consistent with the build-up in the accrued buyout liability, which is 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. We have not recognized an impairment loss in 2008, 2007 or 2006.

***Accrued Buyout Liability***

We pay our salespersons residual commissions based on the gross margin generated from the monthly processing activity of SME merchants signed by them. We refer to these residual commissions as the owned portion of such commissions, or portfolio equity. The salesperson has no obligation to perform additional services for the merchant for so long as the merchant continues processing with us. We accrue the buyout liability, which represents the estimated current settlement cost of buying out all vested and expected-to-vest salespersons for the owned portion of such commissions. We also record a deferred acquisition cost asset related to those buyouts, and amortize that asset as an expense over the initial 3-year contract term.

We consider a salesperson to be vested once they have established merchant relationships that generate the equivalent of \$10,000 of monthly gross margin. Vested status entitles the salesperson to his or her residual commissions for as long as the merchant processes with us, even if the salesperson is no longer employed by us.

The accrued buyout liability is based on the SME merchants we have under contract at the balance sheet date, the gross margin we generated from those accounts in the prior twelve months, the owned commission rate, and the fixed buyout multiple of 2.5 times the commissions. 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.

For unvested salespersons, the accrued buyout liability is accrued over the expected vesting period; however, no deferred acquisition cost is capitalized as future services are required in order to vest. In calculating the accrued buyout liability for unvested salespersons, we have assumed that 31% of unvested salespersons will vest in the future, which represents our historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested salespersons by \$0.2 million at December 31, 2008 and 2007.

Buyout payments made to salespersons reduce the outstanding accrued buyout liability. Given our view of the duration of the cash flows associated with a pool of merchant contracts, we believe that the benefits of

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such buyouts significantly exceed the cost, which typically represents 2 to 2 1/2 years of commissions. If the cash flows associated with a pool of bought out contracts does not exceed this cost, we will incur an economic loss on our decision to buyout the contracts. During 2008, 2007 and 2006, we made buyout payments of approximately \$7.0 million, \$8.8 million and \$10.7 million, respectively. We expect to make significant buyout payments in the future, subject to available cash, as such buyouts reduce the monthly payments we will have to make to our salespersons for such merchants in the future.

### ***Reserve for Processing System Intrusion***

The Processing System Intrusion requires us to make assumptions and estimates concerning the outcomes and related costs and losses in connection with various lawsuits, claims, and investigations. We make our estimates of costs based on our best judgments and anticipated outcomes of these lawsuits, claims, and investigations. While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any such claims as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow.

### ***Merchant Deposits and Loss Reserves***

Disputes between a cardholder and a merchant periodically arise as a result of, among other things, the cardholder's dissatisfaction with merchandise quality or merchant services. Such disputes may not be resolved in the merchant's favor. In these cases, the transaction is charged back to the merchant, which means the purchase price is refunded to the customer by the card-issuing bank and charged to the merchant. If the merchant is unable to fund the refund, we must do so. We also bear the risk of reject losses arising from the fact that we collect our fees from our merchants on the first day after the monthly billing period. If the merchant has gone out of business during such period, we may be unable to collect such fees. We maintain cash deposits or require the pledge of a letter of credit from certain merchants, generally those with higher average transaction size where the card is not present when the charge is made or the product or service is delivered after the charge is made, in order to offset potential contingent liabilities such as chargebacks and reject losses that would arise if the merchant went out of business. At December 31, 2008 and 2007, we held SME merchant deposits totaling \$15.8 million and \$14.1 million, respectively. Most chargeback and reject losses are charged to processing and servicing as they are incurred. However, we also maintain a loss reserve against losses including major fraud losses, which are both less predictable and involve larger amounts. The loss reserve was established using historical loss rates, applied to recent bank card processing volume. At December 31, 2008 and 2007, our loss reserve totaled \$1,097,000 and \$663,000, respectively. Aggregate bank card merchant losses, including losses charged to operations and the loss reserve, were \$5.1 million, \$2.8 million and \$1.9 million for 2008, 2007 and 2006, respectively. As percentages of SME processing volume, in 2008, 2007 and 2006, we experienced losses of 0.0088%, 0.0054% and 0.0045%, respectively.

Chargebacks originating from large national merchant bank card processing are processed and carried by Fifth Third Bank, which is our third-party outsourced processor for settling large national merchant accounts.

### ***Stock Options***

We adopted SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS No. 123R ) on January 1, 2006. This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB No. 25 ), and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under the fair value method. Pursuant to SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. We elected to adopt the modified-prospective-transition

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method, as provided by SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this transitional method, the Company is required to record compensation expense for all awards granted after the date of adoption using grant-date fair value estimated in accordance with the provisions of SFAS No. 123R and for the unvested portion of previously granted awards using the grant-date fair value estimated in accordance with the provisions of SFAS No. 123.

In the third quarter of 2008, our Board of Directors approved a performance-based stock option program. Under this program, we granted 2.5 million performance-based stock options to our 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 our 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 therefore, no share-based compensation expense has been recorded for these stock options in 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.

We estimate the grant date fair value of the stock options we issue using a Black-Scholes valuation model. Our assumption for expected volatility is based on our historical volatility for those option grants whose expected life fall within a period we have sufficient historical volatility data related to market trading of our own Common Stock. For those option grants whose expected life is longer than we have sufficient historical volatility data related to market trading of our own Common Stock, we determine an expected volatility assumption by referencing the average volatility experienced by a group of our public company peers. For plain-vanilla stock options, we estimate the expected life of a stock option based on the simplified method as provided by the staff of the SEC in Staff Accounting Bulletins 107 and 110. The simplified method is used because, at this point, we do not have sufficient historical information to develop reasonable expectations about future exercise patterns. For the performance-based options, the expected life is estimated based on the average of three possible performance condition outcomes. Our dividend yield assumption is based on actual dividends expected to be paid over the expected life of the stock option. Our risk-free interest rate assumption for stock options granted is determined by using U.S. treasury rates of the same period as the expected option term of each stock option. The weighted-average fair value of options we granted during 2008, 2007 and 2006 were \$6.11, \$7.64 and \$9.25, respectively. The fair value of options granted during 2008, 2007 and 2006 was estimated at the grant date using the following weighted average assumptions:

	Year Ended December 31,		
	2008	2007	2006
Expected volatility	35%	31%	41%
Expected life	2.5 to 4.0 years	2.5 to 3.75 years	2.5 to 3.75 years
Expected Dividends	1.36%	0.90%	0.40%
Risk-free interest rate	2.98%	4.29%	4.79%

Prior to adopting SFAS No. 123R, we accounted for stock options using the intrinsic value method under APB No. 25 in which no compensation expense has been recognized for share-based compensation plans. Amounts we recognized in our financial statements during the years ended December 31, 2008, 2007 and 2006 with respect to share-based compensation plans were as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Compensation expense recognized on share-based plans before income tax benefit	\$ 1,517	\$ 1,747	\$ 1,323
Related income tax benefit recognized in the income statement	572	651	320
Cash received from stock option exercises	3,075	9,955	27,658
Excess tax benefit recorded for tax deductions resulting from the exercise of stock options	710	7,623	28,603
Tax benefit realized as reductions of estimated tax payments during the period	1,400	23,232	10,775



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Additionally, SFAS No. 123R amended SFAS No. 95, *Statement of Cash Flows* ( SFAS No. 95 ), to require the excess tax benefits to be reported as a financing cash inflow rather than a reduction of taxes paid, which is included within operating cash flows. Accordingly, cash provided by operating activities decreased and cash provided by financing activities increased by \$0.7 million and \$7.6 million, respectively, related to excess tax benefits from share-based awards in the years ended December 31, 2008 and 2007. In 2008, we realized \$1.4 million as reductions of estimated tax payments and realized \$11.4 million as reductions of estimated tax payments made during 2007 and \$11.8 million from tax refunds we received in 2007 from the recapture of income taxes paid in 2005. The excess tax benefits result from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options.

The application of SFAS No. 123R had the following effects on reported amounts relative to amounts that we would have reported using the intrinsic value method under APB No. 25 for the year ended December 31, 2006 (in thousands, except per share data):

	Year Ended December 31, 2006	
	Following APB No. 25	After Effect of Adopting SFAS No. 123R
Income from operations	\$ 46,141	\$ 44,818
Income before income taxes	45,944	44,621
Net income	29,547	28,544
Earnings per common share:		
Basic	\$ 0.81	\$ 0.78
Diluted	\$ 0.74	\$ 0.71
Net cash provided by (used in) operating activities	\$ 13,977	\$ (3,851)
Net cash provided by financing activities	11,281	29,109

**Income Taxes**

We account for income taxes pursuant to the provisions of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are recorded to reflect the future tax consequences attributable to the effects of differences between the carrying amounts of existing assets and liabilities for financial reporting and for income tax purposes. Judgments are required in determining the amount and probability of future taxable income, which in turn is critical to a determination of whether a valuation reserve against the deferred tax asset is appropriate.

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. An uncertain tax position exists if it is unclear how a transaction will be treated under tax law. FIN No. 48 was effective for fiscal years beginning after December 15, 2006.

We adopted FIN No. 48 on January 1, 2007 and as a result, recognized a \$0.8 million reserve for unrecognized tax benefits related to uncertain tax positions as a liability on our consolidated balance sheet, increased deferred tax assets by \$0.3 million and recorded a cumulative effect adjustment to Retained Earnings of \$0.5 million. The Company had approximately \$1.7 million of total gross unrecognized tax benefits as of December 31, 2008, approximately \$1.3 million of which would impact the effective tax rate.

**Table of Contents****Results of Operations****Year Ended December 31, 2008 Compared to Year Ended December 31, 2007**

The following table shows certain income statement data as a percentage of revenue for the year ended December 31, 2008 compared to the year ended December 31, 2007 (in thousands of dollars):

	2008	% of Total Revenue	2007	% of Total Revenue	Change	
					Amount	%
Total Revenues	\$ 1,544,902	100.0%	\$ 1,313,846	100.0%	\$ 231,056	17.6%
Costs of Services:						
Interchange	1,093,546	70.8%	962,025	73.2%	131,521	13.7%
Dues, assessments and fees	67,648	4.4%	57,050	4.3%	10,598	18.6%
Processing and servicing	173,743	11.2%	126,599	9.6%	47,144	37.2%
Customer acquisition costs	48,522	3.1%	44,193	3.4%	4,329	9.8%
Depreciation and amortization	11,006	0.7%	6,806	0.5%	4,200	61.7%
Total costs of services	1,394,465	90.3%	1,196,673	91.1%	197,792	16.5%
General and administrative	79,828	5.2%	57,404	4.4%	22,424	39.1%
Total expenses	1,474,293	95.4%	1,254,077	95.5%	220,216	17.6%
Income from operations	70,609	4.6%	59,769	4.5%	10,840	18.1%
Other income (expense):						
Interest income	755		1,934	0.1%	(1,179)	(61.0)%
Interest expense	(3,206)	(0.2)%	(785)	(0.1)%	(2,421)	(308.4)%
Other, net	(400)		(3,758)	(0.3)%	3,358	89.4%
Total other (expense) income	(2,851)	(0.2)%	(2,609)	(0.2)%	(242)	(9.3)%
Income before income taxes	67,758	4.4%	57,160	4.3%	10,598	18.5%
Provision for income taxes	25,918	1.7%	21,290	1.6%	4,628	21.7%
Net income	\$ 41,840	2.7%	\$ 35,870	2.7%	\$ 5,970	16.6%

*Total Revenues.* Total revenues increased by 17.6%, from \$1,313.8 million in 2007 to \$1,544.9 million in 2008, primarily as a result of a \$221.3 million, or 17.2%, increase in our bank card processing revenues. The breakout of our total revenues for the years ended December 31, 2008 and 2007 was as follows (in thousands of dollars):

	Year Ended December 31,		Change from Prior Year	
	2008	2007	Amount	%
Bank card processing revenues, gross	\$ 1,504,381	\$ 1,283,065	\$ 221,316	17.2%
Payroll processing revenues	12,790	10,205	2,585	25.3%
Equipment-related income	27,731	20,576	7,155	34.8%
Total Revenues	\$ 1,544,902	\$ 1,313,846	\$ 231,056	17.6%



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The increase in our gross bank card processing revenues from \$1,283.1 million in 2007 to \$1,504.4 million in 2008 was primarily due to higher bank card processing volume. Our bank card processing volume in 2008 increased 28.9% to \$66.9 billion, compared to \$51.9 billion in 2007; however, the increase included \$8.7 billion of settled processing volume from Network Services, which earns revenues on a per transaction basis. Excluding Network Services processing volume, we received percentage-based revenues on processing volume of \$57.9 billion, an increase of 11.6% over the \$51.9 billion processed in 2007. The increase in bank card processing volume was primarily attributable to a net increase in bank card merchant accounts, with the number of SME bank card merchant accounts growing by approximately 9.1% from 154,750 as of December 31, 2007 to 168,850 as of December 31, 2008, as well as growth in our average account size. The increase in new bank card merchant accounts was primarily the result of the growth in our sales force, combined with improved production from our existing sales force as previous additions to the sales force gain experience and seasoning. At December 31, 2008, we employed 1,166 Relationship Managers, up from 1,117 Relationship Managers at December 31, 2007. In addition, Network Services generated revenues of \$55.5 million on the 317 million transactions it

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settled, and the 1.6 billion transactions it authorized through its front-end card processing systems, during the seven months ended December 31, 2008. We report Network Services bank card processing revenues net of interchange and dues, assessments and fees because the daily cash settlement with Network Services merchants is on a net basis.

Payroll processing revenues increased by 25.3%, from \$10.2 million in 2007 to \$12.8 million in 2008, primarily due to the 24.6% increase in the number of payroll processing customers. Payroll processing customers increased from 6,209 at December 31, 2007 to 7,738 at December 31, 2008. Payroll processing revenues include processing fees and the interest income we earn on funds held for customers. Payroll processing fees increased by 35% from \$9.2 million in 2007 to \$12.4 million in 2008, offset partially by a decrease in interest income earned on funds held for customers from \$833,000 in 2007 to \$370,000 in 2008 primarily due to lower interest rates in the current period and the application of available interest earning balances to offset bank fees.

Equipment-related income increased by 34.8%, from \$20.6 million in 2007 to \$27.7 million in 2008, due to the addition of equipment-related revenues from our campus payments solutions business acquired in October 2007, the addition of revenues from our May 2008 acquisition of Network Services, and growth in equipment sale revenues to new SME bank card merchants.

*Costs of services.* Costs of services increased 16.5% from \$1.2 billion in 2007 to \$1.4 billion in 2008, due primarily to an increase in interchange fees and processing and servicing costs. Costs of services represented 90.3% of total revenues in 2008, down slightly from 91.1% in 2007.

Interchange fees increased 13.7% from \$962.0 million in 2007 to \$1,093.5 million in 2008, and represented 70.8% of total revenues in 2008, compared to 73.2% of total revenues in the prior year period. The increase in interchange fees was primarily due to higher bank card processing volume in 2008. However, interchange fees as a percentage of total revenues declined due to the nature of Network Services bank card processing settlement practices. We report Network Services bank card processing revenues net of interchange fees because our daily cash settlement with Network Services merchants is on a net basis.

Dues, assessments and fees increased 18.6% from \$57.1 million in 2007 to \$67.6 million in 2008, also as the result of increased bank card processing volume. Dues, assessments and fees were 4.4% of total revenues in 2008, compared to 4.3% in 2007.

Net revenue, which we define as total revenues less interchange fees and dues, assessments and fees, increased 30.2% from \$294.8 million in 2007 to \$383.7 million in 2008. The increase in net revenue was driven by the addition of net revenue from Network Services and by the year-over-year increases in active merchants and processing volume. Excluding Network Services net revenue addition, our net revenue would have grown by 15.3% in the year ended December 31, 2008.

Processing and servicing expense for 2008 increased by \$47.1 million, or 37.2%, compared with 2007. The increase in processing and servicing expense included \$25.1 million for Network Services and an increase of \$3.5 million in merchant losses during the year ended December 31, 2008 as we incurred increased losses primarily related to merchants that had gone out of business possibly due to weak economic conditions. The increase in processing and servicing expense was also due to costs associated with the increased bank card processing volume, equipment costs of sales and increases in the costs of operating our Jeffersonville, Indiana service center, particularly the costs of support personnel, and depreciation and amortization.

As a percentage of total revenue, processing and servicing expense increased to 11.2% in 2008 compared with 9.6% in 2007. The increase in processing and servicing as a percentage of total revenue for 2008 reflects the addition of Network Services processing and servicing costs, partially offset by continued leveraging of our lower cost internally developed front-end processing system, HPS Exchange, and cost savings associated with our back-end processing system, Passport. Transactions processed on HPS Exchange represented approximately 83% of our total SME processing transactions during 2008, compared to 75% during 2007. We expect the increasing share of HPS Exchange in our total SME bank card merchant base to continue in the future. Included in processing and servicing expense was \$3.8 million of payroll processing costs in 2008, an increase of 41.8% from \$2.7 million recorded in 2007.

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Customer acquisition costs increased 9.8% from \$44.2 million in 2007 to \$48.5 million in 2008. An increase in amortization of signing bonuses, mostly as a result of growth in new merchant accounts, was primarily responsible for the increase in the customer acquisition costs. Customer acquisition costs for the years ended 2008 and 2007 included the following components (in thousands of dollars):

	Year Ended December 31,	
	2008	2007
Amortization of signing bonuses, net	\$ 38,749	\$ 31,450
Amortization of capitalized customer deferred acquisition costs	14,983	13,741
Increase in accrued buyout liability	10,307	13,286
Capitalized customer deferred acquisition costs	(15,517)	(14,284)
<b>Total Customer Acquisition Costs</b>	<b>\$ 48,522</b>	<b>\$ 44,193</b>

Depreciation and amortization expenses increased 61.7%, from \$6.8 million in 2007 to \$11.0 million in 2008. The increase for 2008 was primarily due to recording amortization of \$2.5 million on the intangible assets acquired in the acquisitions of Network Services, CPOS and Chockstone, and depreciation expense recorded on information technology equipment to support the network and the continuing development of HPS Exchange and Passport. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked on internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over expected lives of three to five years. The amount capitalized increased from \$4.2 million in 2007 to \$5.9 million in 2008. The total amount of capitalized costs for projects placed in service in 2008 and 2007 was \$5.4 million and \$2.3 million, respectively.

In December 2007, we completed the construction of, and moved into, approximately 96,000 square feet of office space for Phase 1 of our new service center and in December 2008 our equipment deployment group exited the former leased service center and has moved into the additional 125,000 square feet of multi-use space on the site of our new service center as the first part of Phase 2. The total amount of capitalized costs for the new service center placed in service in 2008 was \$9.3 million.

*General and administrative.* General and administrative expenses increased 39.1%, from \$57.4 million in 2007 to \$79.8 million in 2008. The increase was primarily due to the addition of Network Services' general and administrative expenses, and adding other personnel costs and marketing initiatives to continue building our corporate, information technology and marketing infrastructure, which are necessary to support our growth and our product development initiatives.

General and administrative expenses as a percentage of total revenue were 5.2% for 2008 and 4.4% for 2007. SFAS No. 123R share-based compensation expense was \$1.5 million and \$1.7 million in 2008 and 2007, respectively. Our payroll operation's general and administrative expenses increased by 21.4%, from \$4.2 million in 2007 to \$5.1 million in 2008.

*Income from operations.* For the reasons described above, our income from operations, which we also refer to as operating income, improved from \$59.8 million for 2007 to \$70.6 million for 2008. Our operating margin, which is measured as operating income divided by net revenue, was 18.4% for 2008, compared to 20.3% for 2007. Network Services' operating margin is significantly lower than that of our historic business, and will materially reduce our combined operating margins in future periods.

*Interest income.* Interest income decreased from \$1.9 million in 2007 to \$0.8 million in 2008, due primarily to the use of cash to acquire Network Services and CPOS, as well as lower interest rates. (see Liquidity and Capital Resources for more detail on the use of cash).

*Interest expense.* Interest expense of \$3.2 million was recorded in 2008, an increase from \$785,000 in 2007. The increase in interest expense for 2008 was due to higher payables to our sponsor banks and borrowings we incurred to fund the acquisition of Network Services. Interest expense which we recorded on payables to our sponsor banks resulted from our practice of having our sponsor banks advance interchange fees to most of our merchants. Generally, when we have cash available for investment we fund these advances to our merchants first with our cash, then by incurring a payable to our sponsor banks when that cash has been expended. We pay our sponsor banks the prime rate on these payables. See Liquidity and Capital Resources' Credit Facility for more detail on the borrowings.



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*Other, net.* Other, net for 2008 included a loss on the sale of a debt security and write downs on a fixed-income bond fund.

Other, net for 2007 included:

A pre-tax charge in December 2007 of \$1.3 million reflecting the estimated liability for costs (primarily accrued lease costs and property and equipment write offs) associated with exiting our former service center.

A pre-tax charge of \$1.7 million equal to our full cost basis investment in Parcxmart Technologies, Inc. Due to significant concerns about the investee's ability to continue as a going concern, including negative cash flows from operations, working capital deficiencies and its inability to raise additional capital to supplement its cash position, we recognized an impairment loss.

A charge of \$0.8 million reflecting our liability in a legal proceeding under an indemnification we provided to an insurer.

*Income Tax.* Income taxes for 2008 were \$25.9 million, reflecting an effective tax rate of 38.3%. This compares to an effective tax rate of 37.3% for 2007, which resulted in income tax expense of \$21.3 million. The higher effective tax rate for the year ended December 31, 2008 was due to FIN 48 changes and state income tax increases.

*Net income.* As a result of the above factors, net income increased from \$35.9 million in 2007 to \$41.8 million in 2008.

**Year Ended December 31, 2007 Compared to Year Ended December 31, 2006**

The following table shows certain income statement data as a percentage of revenue for the year ended December 31, 2007 compared to the year ended December 31, 2006 (in thousands of dollars):

	2007	% of Total Revenue	2006	% of Total Revenue	Change	
					Amount	%
Total Revenues	\$ 1,313,846	100.0%	\$ 1,097,041	100.0%	\$ 216,805	19.8%
Costs of Services:						
Interchange	962,025	73.2%	804,267	73.3%	157,758	19.6%
Dues, assessments and fees	57,050	4.3%	47,122	4.3%	9,928	21.1%
Processing and servicing	126,599	9.6%	111,554	10.2%	15,045	13.5%
Customer acquisition costs	44,193	3.4%	35,451	3.2%	8,742	24.7%
Depreciation and amortization	6,806	0.5%	6,042	0.6%	764	12.6%
Total costs of services	1,196,673	91.1%	1,004,436	91.6%	192,237	19.1%
General and administrative	57,404	4.4%	47,787	4.4%	9,617	20.1%
Total expenses	1,254,077	95.5%	1,052,223	96.0%	201,854	19.2%
Income from operations	59,769	4.5%	44,818	4.1%	14,951	33.4%
Other income (expense):						
Interest income	1,934	0.1%	1,225	0.1%	709	57.9%
Interest expense	(785)	(0.1)%	(753)	(0.1)%	(32)	(4.2)%
Other, net	(3,758)	(0.3)%	(669)		(3,089)	(461.7)%
Total other (expense) income	(2,609)	(0.2)%	(197)	0.0%	(2,412)	(1224.4)%

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Income before income taxes	<b>57,160</b>	<b>4.3%</b>	44,621	4.1%	12,539	28.1%
Provision for income taxes	<b>21,290</b>	<b>1.6%</b>	16,077	1.5%	5,213	32.4%
Net income	<b>\$ 35,870</b>	<b>2.7%</b>	\$ 28,544	2.6%	\$ 7,326	25.7%

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*Total Revenues.* Total revenues increased by 19.8%, from \$1,097.0 million in 2006 to \$1,313.8 million in 2007, primarily as a result of a \$212.1 million, or 19.8%, increase in our bank card processing revenues. The breakout of our total revenues for the years ended December 31, 2007 and 2006 was as follows (in thousands of dollars):

	Year Ended December 31,		Change from Prior Year	
	2007	2006	Amount	%
Bank card processing revenues, gross	\$ 1,283,065	\$ 1,070,939	\$ 212,126	19.8%
Payroll processing revenues	10,205	6,422	3,783	58.9%
Equipment-related income	20,576	19,680	896	4.6%
<b>Total Revenues</b>	<b>\$ 1,313,846</b>	<b>\$ 1,097,041</b>	<b>\$ 216,805</b>	<b>19.8%</b>

The increase in our gross bank card processing revenues from \$1,070.9 million in 2006 to \$1,283.1 million in 2007 was primarily due to higher bank card processing volume. Our bank card processing volume in 2007 increased 20.0% to \$51.9 billion, compared to \$43.3 billion in 2006. The increase in bank card processing volume was primarily attributable to a net increase in bank card merchant accounts, with the number of bank card merchant accounts growing by approximately 16.2% from 133,200 as of December 31, 2006 to 154,750 as of December 31, 2007, as well as growth in our average account size. The increase in new bank card merchant accounts was primarily the result of the growth in our sales force, combined with improved production from our existing sales force. At December 31, 2007, we employed 1,117 Relationship Managers, up from 952 Relationship Managers at December 31, 2006.

Payroll processing revenues increased by 58.9%, from \$6.4 million in 2006 to \$10.2 million in 2007, primarily due to the 47.3% increase in the number of payroll processing customers from 4,216 at December 31, 2006 to 6,209 at December 31, 2007. Payroll processing revenues include processing fees and the interest income we earn on funds held for customers. Payroll processing fees increased by 56.5% from \$5.9 million in 2006 to \$9.2 million in 2007 and interest income earned on funds held for customers increased by 53.8% from \$542,000 in 2006 to \$833,000 in 2007.

Equipment-related income increased by 4.6%, from \$19.7 million in 2006 to \$20.6 million in 2007, primarily due to growth in equipment sale revenues to new bank card merchants and the addition of revenues from our October 19, 2007 acquisition of the General Meters Corporation campus payments solutions business. Revenues from prepaid card and stored-value card systems at our Debitex, Inc. subsidiary declined from 2006.

*Costs of services.* Costs of services increased 19.1% from \$1.0 billion in 2006 to \$1.2 billion in 2007, due primarily to an increase in interchange fees. Costs of services represented 91.1% of total revenues in 2007, down slightly from 91.6% in 2006.

Interchange fees increased 19.6% from \$804.3 million in 2006 to \$962.0 million in 2007, and represented 73.2% of total revenues in 2007, compared to 73.3% of total revenues in the prior year period. The increase in interchange fees was primarily due to higher bank card processing volume in 2007.

Dues, assessments and fees increased 21.1% from \$47.1 million in 2006 to \$57.0 million in 2007, also as the result of increased bank card processing volume. Dues, assessments and fees were 4.3% of total revenues in both 2007 and 2006.

Net revenue, which we define as total revenues less interchange fees and dues, assessments and fees, increased 20.0% from \$245.7 million in 2006 to \$294.8 million in 2007.

Processing and servicing expense for 2007 increased by \$15.0 million, or 13.5%, compared with 2006. The increase in processing and servicing expense was due primarily to costs associated with processing the increased bank card processing volume, and increases in the costs of operating our service center, particularly the costs of support personnel, including field Account Managers, and depreciation and amortization.

As a percentage of total revenue, processing and servicing expense decreased to 9.6% in 2007 compared with 10.2% in 2006. The decrease in processing and servicing as a percentage of total revenue for 2007 was driven by leveraging the lower costs of our internally developed front-end processing system, HPS Exchange, and cost savings associated with our back-end processing system, Passport. Transactions processed on HPS Exchange represented approximately 75% of our total processing transactions during 2007, compared to 64% during 2006. We expect the increasing share of HPS Exchange in our total bank card merchant base to continue in the future. In addition, we completed our conversion to

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our internally developed back-end processing system, Passport, on May 1, 2006, which is resulting in cost savings in providing back-end services. Included in processing and servicing expense was \$2.7 million of payroll processing costs in 2007, an increase of 59.4% from \$1.7 million recorded in 2006.



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Customer acquisition costs increased 24.7% from \$35.5 million in 2006 to \$44.2 million in 2007. An increase in amortization of signing bonuses, mostly as a result of growth in new merchant accounts, was primarily responsible for the increase in the customer acquisition costs. Customer acquisition costs for the years ended 2007 and 2006 included the following components (in thousands of dollars):

	Year Ended December 31,	
	2007	2006
Amortization of signing bonuses, net	\$ 31,450	\$ 22,891
Amortization of capitalized customer deferred acquisition costs	13,741	12,932
Increase in accrued buyout liability	13,286	15,483
Capitalized customer deferred acquisition costs	(14,284)	(15,855)
<b>Total Customer Acquisition Costs</b>	<b>\$ 44,193</b>	<b>\$ 35,451</b>

Depreciation and amortization expenses increased 12.6%, from \$6.0 million in 2006 to \$6.8 million in 2007. The increase was primarily due to the purchase of information technology equipment to support the network and the continuing development of HPS Exchange and Passport. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked on internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over three to five years. The amount capitalized increased from \$2.5 million in 2006 to \$4.2 million in 2007. The total amount of capitalized costs for projects placed in service in 2007 and 2006 was \$2.3 million and \$1.7 million, respectively.

In December 2007, we completed the construction of, and moved into, approximately 96,000 square feet of office space for Phase 1 of our new service center. As of December 31, 2007, all but our equipment deployment group has exited the former leased service center. We are currently building an additional 125,000 square feet of multi-use space on the site of our new service center. The total amount of capitalized costs for the new service center placed in service in 2007 was \$28.4 million.

*General and administrative.* General and administrative expenses increased 20.1%, from \$47.8 million in 2006 to \$57.4 million in 2007. The increase was primarily due to added personnel, marketing, consulting and legal costs to continue building our corporate, information technology and marketing infrastructure which are necessary to support our growth and our marketing and product development initiatives.

General and administrative expenses as a percentage of total revenue for 2007 and 2006 were 4.4%. SFAS No. 123R share-based compensation expense was \$1.7 million and \$1.3 million in 2007 and 2006, respectively. Our payroll operation's general and administrative expenses increased by 37.4%, from \$3.1 million in 2006 to \$4.2 million in 2007. General and administrative expenses in 2007 included \$186,000 for matching payroll tax expense related to gains employees realized on their exercise of non-qualified stock options, compared to \$1.2 million in 2006.

*Income from operations.* For the reasons described above, our income from operations, which we also refer to as operating income, improved from \$44.8 million for 2006 to \$59.8 million for 2007. Our operating margin, which is measured as operating income divided by net revenue, was 19.7% for 2007, compared to 17.8% for 2006. Our operating income and operating margin for 2006 was unfavorably impacted by the \$2.0 million recorded for the change in estimate of debit interchange expense; excluding that amount, our operating margin would have been 18.4% for 2006.

*Interest income.* Interest income increased from \$1.2 million in 2006 to \$1.9 million in 2007, due primarily to an increase in the amount of cash available for investment and higher interest rates.

*Interest expense.* Interest expense of \$785,000 recorded in 2007 increased slightly from \$753,000 in 2006. Most of our interest expense arises from the practice of having our sponsor bank advance interchange fees to most of our merchants. These advances to our merchants are funded first with our cash available for investment, then by incurring a payable to our sponsor bank when that cash has been expended. We pay the sponsor bank the prime rate on these payables.

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*Other, net.* Other, net for 2007 included:

A pre-tax charge in December 2007 of \$1.3 million reflecting the estimated liability for costs (primarily accrued lease costs and property and equipment write offs) associated with exiting our former service center.

A pre-tax charge of \$1.7 million equal to our full cost basis investment in Parcxmart Technologies, Inc. Due to significant concerns about the investee's ability to continue as a going concern, including negative cash flows from operations, working capital deficiencies and its inability to raise additional capital to supplement its cash position, we recognized an impairment loss.

A charge of \$0.8 million reflecting our liability in a legal proceeding under an indemnification we provided to an insurer. Other, net for 2006 included income of \$0.8 million reflecting a gain for the proceeds received from a legal settlement.

*Income Tax.* Income taxes for 2007 were \$21.3 million, reflecting an effective tax rate of 37.3%. This compares to an effective tax rate of 36.0% for 2006, which resulted in income tax expense of \$16.1 million. The lower effective tax rate for 2006 was due to revising state income sourcing approaches in the third quarter of 2006. As a result of revising state income sourcing approaches in the third quarter of 2006, we realized reductions of our 2005 state income tax expense and our 2006 estimated effective annual state tax rates.

*Net income.* As a result of the above factors, net income increased from \$28.5 million in 2006 to \$35.9 million in 2007.

**Balance Sheet Information**

	December 31,	
	2008	2007
	(in thousands)	
<b>Selected Balance Sheet Data</b>		
Cash and cash equivalents	\$ 27,589	\$ 35,508
Funds held for payroll customers	22,002	24,201
Receivables, net	140,145	122,613
Capitalized customer acquisition costs, net	77,737	70,498
Property and equipment, net	75,443	50,248
Goodwill and intangible assets, net	94,909	5,970
Total assets	463,619	329,189
Due to sponsor bank	68,212	49,798
Accounts payable	25,864	20,495
Deposits held for payroll customers	22,002	24,201
Borrowings:		
Current portion	58,522	
Long term portion	16,984	
Accrued buyout liability:		
Current portion	10,547	11,521
Long term portion	30,493	26,252
Total liabilities	284,375	163,520
Total stockholders' equity	179,244	165,669

**December 31, 2008 Compared to December 31, 2007**

Total assets increased \$134.4 million, or 40.8%, to \$463.6 million at December 31, 2008 from \$329.2 million at December 31, 2007, primarily due to increases in receivables, capitalized customer acquisition costs, property and equipment, net and goodwill and intangible assets, net. Cash and cash equivalents decreased by



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\$7.9 million or 22.3% primarily as the result of using cash in our investing activities, specifically our 2008 acquisitions and investments in property and equipment (see [Liquidity and Capital Resources](#) for more detail).

The \$53.0 million increase in goodwill at December 31, 2008 and the \$36 million increase in intangible assets at December 31, 2008 were due to our May 2008 acquisition of Network Services for a net cash payment of \$92.5 million, our March 2008 acquisition of CPOS for a net cash payment of \$10.1 million, and our November 2008 acquisition of Chockstone for a net cash payment of \$4.0 million. We recorded goodwill of \$43.7 million and intangible assets of \$34.4 million in the Network Services acquisition, goodwill of \$9.4 million and intangible assets of \$2.1 million in the CPOS acquisition, and goodwill of \$1.6 million and intangible assets of \$2.4 million in the Chockstone acquisition. The allocations of the Network Services, CPOS and Chockstone purchase prices are not final and may be adjusted in accordance with Statement of Financial Accounting Standards No. 141, *Business Combinations*, as more information becomes available.

Our receivables primarily are due from our bank card processing merchants and result from our practice of advancing interchange fees to most of our SME merchants during the processing month and collecting those fees from our merchants at the beginning of the following month, as well as from transaction fees we charge merchants for processing transactions. Generally, these advances to our SME merchants are funded first with our cash available for investment, then by incurring a payable to our sponsor banks when that cash has been expended. At December 31, 2008 and December 31, 2007, we used \$17.5 million and \$37.9 million, respectively, of our available cash to fund merchant advances. The decline in the amount of merchant advances we funded with our cash at December 31, 2008, from the December 31, 2007 level, was primarily attributable to using cash to fund our 2008 acquisitions. The amount due to our sponsor banks for funding advances was \$68.2 million at December 31, 2008 and \$49.8 million at December 31, 2007. The payable to our sponsor banks is repaid at the beginning of the following month out of the fees we collect from our merchants.

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. Our total receivables increased \$17.5 million, or 14.3%, to \$140.1 million at December 31, 2008 from \$122.6 million at December 31, 2007 mostly due to receivables added by Network Services. Network Services merchants are invoiced monthly, on payment terms that are typical for large national accounts.

Capitalized customer acquisition costs increased \$7.2 million, or 10.3%, from December 31, 2007 as a result of increases in the number of SME merchants we service. Property and equipment increased \$25.2 million, or 51.1%, primarily due to spending \$16.7 million during 2008 on the construction of our new service center in Jeffersonville, Indiana. We completed constructing 96,000 square feet of office space for the Phase 1 of the new service center and opened it for operation in December 2007; in December 2008 our processing equipment deployment group moved into a portion of an additional 125,000 square feet of multi-use space constructed on the site. We also continued building our technology infrastructure, primarily hardware and software needed for the expansion of HPS Exchange and Passport.

Our borrowings at December 31, 2008 included \$75.0 million under our May 30, 2008 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](#) provides for a revolving credit facility in the aggregate amount of up to \$50 million (the [Revolving Credit Facility](#)) and a term credit facility in the aggregate amount of up to \$25 million (the [Term Credit Facility](#)). See [Liquidity and Capital Resources - Credit Facility](#) for more information on the [Amended and Restated Credit Agreement](#).

On May 30, 2008, we borrowed \$50 million under the [Revolving Credit Facility](#) and \$25 million under the [Term Credit Facility](#). We applied all of the proceeds from these borrowings to finance the acquisition of Network Services. At December 31, 2008, there was \$50 million outstanding under the [Revolving Credit Facility](#) and \$25 million outstanding under the [Term Credit Facility](#). Of the combined \$75 million outstanding, \$58.3 million was included in current borrowings and \$16.7 million was included in long-term borrowings at December 31, 2008. At December 31, 2008, our borrowings also included short-term capital lease obligations of \$0.2 million and long-term capital lease obligations of \$0.3 million, both acquired with Chockstone. We had no borrowings outstanding at December 31, 2007.

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Total stockholders' equity increased \$13.6 million from December 31, 2007 primarily due to our net income of \$41.8 million recorded for 2008, proceeds received from the exercise of employee stock options, which amounted to \$3.1 million, and tax benefits recorded in additional-paid-in capital related to employees' exercise of stock options and related tax benefits, which contributed \$0.7 million. Stockholders' equity was reduced by \$18.0 million for the cost of purchasing treasury shares, \$13.5 million for dividends declared on common stock and \$2.1 million for foreign currency translation adjustments we recorded on our CPOS assets and liabilities. On February 28, 2008, our Board of Directors resolved to retire all common shares repurchased and include the retired shares in our authorized and unissued shares. 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.

## **Liquidity and Capital Resources**

**General.** Liquidity and capital resource management is a process focused on providing the funding we need to meet our short and long-term cash and working capital needs. We have used our funding sources to build our merchant portfolio and our technology platforms with the expectation that these investments will generate cash flows sufficient to cover our working capital needs and other anticipated needs for capital.

Our cash requirements include funding payments to salespersons for signing bonuses, residual commissions and residual buyouts, paying interest expense and other operating expenses, including taxes, constructing our new service center and investing in building our technology infrastructure. We expect that our future cash requirements will include material amounts required to defend against claims arising from the Processing System Intrusion and could include material amounts required to resolve such claims. At times, we have used cash to repurchase our common stock. We could in the future use cash for other unspecified acquisitions of related businesses or assets.

Other than borrowings we used to fund our May 2008 acquisition of Network Services, we fund our cash needs primarily with cash flow from our operating activities and through our agreements with our sponsor banks to fund SME merchant advances. Additionally, we could seek to raise cash by financing our owned service center in Jeffersonville, Indiana. We believe that our current cash and investment balances, cash generated from operations and our agreements with our sponsor banks to fund SME merchant advances will provide sufficient liquidity to meet our anticipated needs for operating capital for at least the next twelve months. However, we may face a liquidity challenge, particularly in light of current conditions in the financial markets, if we are unable to meet cash requirements arising from the Processing System Intrusion from our operating cash flow. See [Overview - Processing System Intrusion](#) for more detail.

On December 31, 2008, we were fully borrowed on our credit facilities, which total \$75.0 million. However, the revolving credit facility provides for an increase of \$25 million upon the prior approval of the administrative agent. See [Credit Facility](#) for more details.

**2008 Acquisitions.** As of May 31, 2008, we acquired the net assets of the Network Services Business unit of Alliance Data Network Services LLC, for a cash payment of \$77.5 million plus the net working capital of Network Services on the closing date, for a total purchase price of \$92.5 million. The acquisition was financed through a combination of cash on hand and our credit facilities. Network Services provides processing of credit and debit cards to large national merchants, primarily in the petroleum industry. On March 3, 2008, we acquired a majority interest in Collective Point of Sale Solutions Ltd. ( CPOS ) for a net cash payment of \$10.1 million. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions. On November 14, 2008, we acquired Chockstone, Inc. for a net cash payment of \$4.0 million. Chockstone provides loyalty marketing and gift card solutions to restaurant, convenience store, and other retail locations in North America. The acquisitions of CPOS and Chockstone are not expected to have a material impact on earnings in the near term.

**2007 Acquisitions.** On October 19, 2007, we acquired the assets of General Meters Corporation, a provider of multipurpose card systems for college and university campuses, for a net cash payment of \$6.0 million. The General Meters acquisition provided us with a customer base of colleges and universities for our campus card product. General Meters was combined with our subsidiary Debitek Inc., which we acquired in February 2006. This acquisition is not expected to have a material impact on earnings in the near term.

**2006 Acquisitions.** We acquired Debitek, a prepaid card and stored-value card solutions provider, in February 2006 for a net cash payment of \$3.5 million. The acquisition of Debitek provided us with a proven platform in the stored-value and prepaid cards market, particularly with respect to small-dollar payment applications. This acquisition is not expected to have a material impact on earnings in the near term.

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At December 31, 2008, we had cash and cash equivalents totaling \$27.6 million, compared to cash and cash equivalents of \$35.5 million at December 31, 2007 and \$16.1 million at December 31, 2006.

Our working capital, defined as current assets less current liabilities, was negative at December 31, 2008 primarily due to funding the Network Services acquisition with cash and predominately current borrowings. Our working capital was positive at December 31, 2007 and 2006.

Each funding source and use is described in more detail below.

***Cash Flow Provided by (Used in) Operating Activities.*** We reported net cash provided by operating activities of \$87.5 million in 2008, compared to \$72.6 million in 2007. In 2006, we used \$3.9 million in operating activities.

The most significant contributor to the increase in cash provided by operating activities for 2008 was our net income for 2008 as adjusted for depreciation and amortization, additions to loss reserves, provision for doubtful receivables, share-based compensation expense, and deferred taxes. Also contributing favorably to cash provided by operating activities was an increase in due to sponsor banks. The increase in the amounts due to sponsor banks was mostly due to using available cash, which otherwise would have been available to fund merchant advances, to fund the acquisitions of Network Services, CPOS and Chockstone, as well as treasury stock purchases during 2008.

The 2007 improvement over 2006 in cash provided by operating activities was also due to an increase in the amount due to sponsor banks and increased net income for 2007, as adjusted for depreciation and amortization, additions to loss reserves, provision for doubtful receivables, share-based compensation expense, other non-cash charges and deferred taxes.

Other major determinants of operating cash flow each year are net signing bonus payments, which consume increasing amounts of operating cash as our new merchant installation activity rises, and payouts on the accrued buyout liability, which represent the costs of buying out residual commissions owned by our salespersons. See Critical Accounting Estimates Capitalized Customer Acquisition Costs and Critical Accounting Estimates Accrued Buyout liability for more information. Net signing bonuses of \$45.5 million, \$44.7 million and \$33.7 million, respectively, were paid in 2008, 2007 and 2006. In 2008, 2007 and 2006, we reduced the accrued buyout liability by making buyout payments of \$7.0 million, \$8.8 million and \$10.7 million, respectively.

Contained within other changes in operating assets and liabilities are the changes in our receivables and due to sponsor banks. Our receivables primarily are due from our bank card processing merchants and result from our practice of advancing interchange fees to most of our SME merchants during the processing month and collecting those fees from our merchants at the beginning of the following month, as well as from transaction fees we charge merchants for processing transactions. Generally, these advances to our SME merchants are funded first with our cash available for investment, then by incurring a payable to our sponsor banks when that cash has been expended. The payable to the sponsor banks is repaid at the beginning of the following month out of the fees we collect from our merchants. At December 31, 2008, we had used \$17.5 million of cash to fund merchant advances, compared to \$37.9 million at December 31, 2007 and \$44.6 million at December 31, 2006. The amount due to sponsor banks for funding advances was \$68.2 million, \$49.8 million and \$27.3 million, respectively, at December 31, 2008, 2007 and 2006. During 2008, our receivables from SME merchants were down slightly from December 31, 2007, while we increased our payable to sponsor banks by \$18.4 million. The increase in the payable to sponsor banks was applied in funding the purchase prices to acquire Network Services, CPOS and Chockstone, and the \$18.0 million cost to repurchase treasury stock during 2008.

Our reported cash flow from operating activities for 2008, 2007 and 2006 was impacted by the cash flow reporting requirements of SFAS No. 123R and SFAS No. 95, *Statement of Cash Flow*, as amended. These statements require the amount of tax benefits resulting from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options in excess of the amount of SFAS No. 123R compensation cost recognized (referred to as excess tax benefits in this document), to be classified as a cash inflow from financing activities on our Statement of Cash Flow and a

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cash outflow from operating activities. In 2008, 2007 and 2006, our operating cash flow was reduced by the classification of \$0.7 million, \$7.6 million and \$28.6 million, respectively, of excess tax benefits as cash inflow from financing activities.

**Cash Flow Used in Investing Activities.** Net cash used in investing activities was \$142.5 million in 2008, compared to \$42.3 million in 2007 and \$17.9 million in 2006. During each period, we used cash to fund capital expenditures and acquisitions. Total capital expenditures for 2008 were \$35.0 million, compared to \$34.2 million invested in 2007 and \$14.0 million invested in 2006. Included in capital expenditures was \$16.7 million, \$24.5 million and \$5.9 million, respectively, for construction of our new service center facility. Construction commenced in 2006 and we completed 96,000 square feet of office space for Phase 1 of the new service center and opened it for operation in December 2007. In December 2008 our processing equipment deployment group moved into a portion of an additional 125,000 square feet of multi-use space constructed on the site. See [Contractual Obligations](#) for more detail regarding cumulative cash outlays and expected future funding requirements related to our new service center. We also continued building our technology infrastructure, primarily for hardware and software needed for the expansion of HPS Exchange and Passport. To further develop our technology, we anticipate that these expenditures will continue near current levels. Additionally, our technology expenditures could be increased by measures we implement after the Processing System Intrusion to further enhance the security of our computer system.

During the years ended December 31, 2008, 2007 and 2006, we invested in the following acquisitions: March 2008, we acquired CPOS for a net cash payment of \$10.1 million; May 2008, we acquired Network Services for a cash payment of \$92.5 million; November 2008, we acquired Chockstone, Inc. for a net cash payment of \$4.0 million; October 2007, we acquired General Meters Corporation for a net cash payment of \$6.0 million; and February 2006, we acquired Debitex, Inc. for a net cash payment of \$3.5 million.

In January 2006, we made a \$0.5 million investment in convertible preferred stock issued by Parcsmart Technologies, Inc. ( [Parcsmart](#) ) and in June 2007, we made an additional investment of \$1.2 million in Parcsmart convertible preferred stock. In December 2007, due to significant concerns about Parcsmart's ability to continue as a going concern, including negative cash flows from operations, working capital deficiencies and inability to raise additional capital to supplement its cash position, we recognized an impairment loss equal to our full \$1.7 million investment.

**Cash Flow Provided By (Used in) Financing Activities.** Net cash provided from financing activities was \$47.3 million in 2008, compared to net cash used in financing activities of \$10.9 million in 2007, and net cash provided by financing activities of \$29.1 million in 2006. Cash flow from financing activities in 2008 was positive primarily due to proceeds from borrowings under our Credit Facility. See [Credit Facility](#) for more details on these borrowings and the application of funds borrowed. We also used cash to repurchase our common stock and for dividend payments. See [Common Stock Repurchases](#) for more information on our common stock repurchases authorization. Cash flow from financing activities in 2007 was negative primarily due to our common stock repurchases and dividend payments.

Cash flow from financing activities in 2006 was positive primarily due to the proceeds received from employees exercising stock options and from excess tax benefits. However, most of the cash proceeds received from the exercise of employee stock options in 2006 were used to repurchase shares of our common stock.

During 2008 and 2007, employees exercised stock options generating cash in the aggregate amount of \$3.1 million and \$10.0 million, respectively. Offsetting the cash provided from employees' exercise of stock options in 2008 and 2007 was the use of \$18.0 million and \$18.9 million of cash to repurchase 781,584 shares and 731,500 shares, respectively, of our common stock. See [Common Stock Repurchases](#) for more information. During 2006, employees exercised their stock options and PEPSHares Plan options generating cash in the aggregate amount of \$27.7 million.

On September 21, 2007, we closed a public offering of 6,348,767 shares of our common stock. The offering price was set at \$26.34 per share, the closing price of our 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 us. We received only the proceeds from the shares we sold in the offering, or \$615,000, which we used to cover \$590,000 of expenses from the offering.

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Financing cash activities for each year were favorably impacted by excess tax benefits which resulted from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options. During 2008, 2007 and 2006, we reported as a financing cash inflow, \$0.7 million, \$7.6 million and 28.6, respectively, of excess tax benefits resulting from employees exercising stock options. We actually realized cash tax benefits of \$1.4 million, \$23.2 million and 10.8 million, respectively, in 2008, 2007 and 2006 for excess tax benefits resulting from employees exercising stock options. See Cash Flow Provided by (Used in) Operating Activities for more detail.

**Credit Facility.** On May 30, 2008, we 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.

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, we 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 us 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 our maintenance of certain leverage and fixed charge coverage ratios, limitations on our indebtedness, liens on our properties and assets, our investments in, and loans to, other business units, our ability to enter into business combinations and asset sales, and certain other financial and non-financial covenants. These covenants also apply to our subsidiaries. As of December 31, 2008, we were in compliance with these covenants. If we record a reserve for, or otherwise incur significant costs or losses related to, the Processing Systems Intrusion, it could cause us to violate these covenants.

Under the terms of the Amended and Restated Credit Agreement, we may borrow, at our option, at interest rates equal to one, two, three or nine 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 our current leverage ratio.

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 our 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 Network Services. At September 30, 2008, there was \$50 million outstanding under the Revolving Credit Facility and \$25 million outstanding under the Term Credit Facility.

We had no outstanding obligations under any credit facility at December 31, 2007 or 2006.

**Common Stock Repurchases.** On January 13, 2006, our Board of Directors authorized management to repurchase up to the lesser of (a) 1,000,000 shares of our common stock and (b) \$25,000,000 worth of our common stock in the open market. On August 1, 2006, our Board of Directors authorized management to repurchase up to an additional 1,000,000 shares of our common stock in the open market using proceeds from the issuance of stock options. On May 3, 2007, the Board of Directors eliminated the restriction in the August 1, 2006 repurchase authorization which required management to use only proceeds from the issuance of stock options for repurchases, and increased the total remaining authorized number of shares to be repurchased to



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2,000,000. We intend 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 use cash to take advantage of declines in the Company's stock price. We have 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 general corporate funds.

Under these authorizations, we repurchased an aggregate of 2,574,284 shares of our common stock during the years ended December 31, 2006, 2007 and 2008 at a cost of \$61.9 million, or average cost of \$24.04 per share.

During the years ended December 31, 2008, 2007 and 2006, we repurchased 781,584 shares, 731,500 and 1,061,200 shares, respectively, of our common stock at average per share costs of \$23.02, \$25.78 and \$23.59. At December 31, 2008, we have remaining authorization to repurchase up to 525,716 additional shares of our common stock.

**Dividends on Common Stock.** On August 1, 2006, our Board of Directors declared the first quarterly cash dividend on our common stock. The following table summarizes quarterly cash dividends declared and paid on our common stock:

<b>Date Declared</b>	<b>Record Date</b>	<b>Date Paid</b>	<b>Amount Paid Per Common Share</b>
<b>Twelve Months Ended December 31, 2006:</b>			
August 1, 2006	August 25, 2006	September 15, 2006	\$ 0.025
November 2, 2006	November 24, 2006	December 15, 2006	\$ 0.025
<b>Twelve Months Ended December 31, 2007:</b>			
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
<b>Twelve Months Ended December 31, 2008:</b>			
February 13, 2008	February 28, 2008	March 15, 2008	\$ 0.09
April 30, 2008	May 23, 2008	June 15, 2008	\$ 0.09
August 5, 2008	August 22, 2008	September 15, 2008	\$ 0.09
November 4, 2008	November 24, 2008	December 15, 2008	\$ 0.09

On February 20, 2009, our Board of Directors declared a quarterly cash dividend of \$0.025 per share of common stock, payable on March 16, 2009 to stockholders of record as of March 9, 2009. Our Board of Directors believed it prudent to establish a new dividend rate in light of the current difficulties in the financial markets and potential claims related to the Processing System Intrusion.

**Contractual Obligations.** 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. If the merchant incurring the chargeback is unable to fund the refund to the card issuing bank, we must do so. As the majority of our SME transactions involve the delivery of the product or service at the time of the transaction, a good basis to estimate our exposure to chargebacks is the last four months' bank card processing volume on our SME portfolio, which was \$18.7 billion, \$17.9 billion and \$15.1 billion for the four months ended December 31, 2008, 2007 and 2006, respectively. However, during the four months ended December 31, 2008, 2007 and 2006, we were presented with \$10.2 million, \$10.5 million and \$8.4 million, respectively, of chargebacks by issuing banks. In 2008, 2007 and 2006, we incurred merchant credit losses related to chargebacks of \$5.1 million, \$2.8 million and \$1.9 million, respectively, on total SME dollar volume processed of \$57.9 billion, \$51.9 billion and \$43.3 billion, respectively. These credit losses are included in processing and servicing expense in our consolidated statements of income.

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Chargebacks originating from large national merchant bank card processing are processed and carried by Fifth Third Bank, which is our third-party outsourced processor for settling large national merchant accounts.

The following table reflects our significant contractual obligations as of December 31, 2008:

Contractual Obligations	Total	Payments Due by Period			
		Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
		(in thousands)			
Processing providers (a)	\$ 10,757	\$ 5,978	\$ 4,779	\$	\$
Telecommunications providers	8,505	5,194	3,311		
Office and equipment leases	17,677	4,598	6,522	3,345	3,212
Term Loan Facility	25,000	8,333	16,667		
Land, construction and equipment (b)	6,864	6,864			
Capital lease obligations	571	246	325		
	\$ 69,374	\$ 31,213	\$ 31,604	\$ 3,345	\$ 3,212

- (a) We have agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. Our agreements with third-party processors require us to submit a minimum monthly number of transactions or volume for processing. If we submit a number of transactions or volume that is lower than the minimum, we are required to pay the third party processors the fees that they would have received if we had submitted the required minimum number or volume of transactions.
- (b) These amounts relate to contractual commitments we have for constructing our new service center in Jeffersonville, Indiana. Additional contractual commitments will be entered into as we progress with the development of this site. Through December 31, 2008, we have spent approximately \$48.2 million of our cash on our new service center, including \$1.7 million to acquire land, and over the next twelve months we expect to spend approximately \$13.6 million more on its development, including the contractual obligations in the above table. In addition, we record a payable to our sponsor banks each month in conjunction with our monthly processing activities. This amount was \$68.2 million and \$49.8 million as of December 31, 2008 and 2007, respectively. This amount is repaid on the first business day of the following month out of the fees collected from our merchants.

**Unrecognized Tax Benefits.** At December 31, 2008, we had gross tax effected unrecognized tax benefits of approximately \$1.7 million. See Critical Accounting Estimates – Income Taxes. As of December 31, 2008, we are unable to make reasonably reliable estimates of the period of cash settlement with the respective taxing authority, hence the unrecognized tax benefits have been excluded from the above commitment and contractual obligations table.

**Off-Balance Sheet Arrangements**

We have not entered into any transactions with third parties or unconsolidated entities whereby we have financial guarantees, subordinated retained interest, derivative instruments, or other contingent arrangements that expose us to material continuing risks, contingent liabilities, or other obligations other than for chargebacks and reject losses described under Critical Accounting Estimates.

**Legal and Regulatory Considerations****Processing System Intrusion Legal Proceedings**

To date, we have had several lawsuits filed against us and we expect additional lawsuits will be filed. These include lawsuits which assert claims against us by cardholders (including various putative class actions seeking in the aggregate to represent all cardholders in the United States whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), and banks that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion (including various putative class actions seeking to represent all financial institutions that issued payment cards to cardholders whose

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transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), seeking damages allegedly arising out of the Processing System Intrusion and other related relief. The actions generally assert various common-law claims such as claims for negligence and breach of contract, as well as, in some cases, statutory claims such as violation of the Fair Credit Reporting Act, state data breach notification statutes, and state unfair and deceptive practices statutes. The putative cardholder class actions seek various forms of relief including damages, injunctive relief, multiple or punitive damages, attorney's fees and costs. The putative financial institution class actions seek compensatory damages, including recovery of the cost of issuance of replacement cards and losses by reason of unauthorized transactions, as well as injunctive relief, attorney's fees and costs. We have filed a motion with the Judicial Panel on Multidistrict Litigation seeking to have these cases consolidated for pre-trial proceedings before the United States District Court for the Southern District of Texas. The putative consumer class actions and putative financial institution class actions filed against us through March 13, 2009 are described in Legal Proceedings Processing System Intrusion Legal Proceedings .

A putative class action was commenced against us and certain of our executive officers alleging violations of the federal securities laws in connection with our disclosures relative to the Processing System Intrusion and the alleged trading of our securities by four Heartland insiders. This case, *Davis v. Heartland Payment Systems, Inc., Robert O. Carr and Robert H.B. Baldwin, Jr.*, was commenced on March 6, 2009 in the United States District Court for the District of New Jersey. The plaintiff in the putative federal securities law class action seeks to represent all purchasers of our securities between August 5, 2008 and February 23, 2009 and seeks to recover losses such purchasers allegedly incurred by reason of their purchases, as well as related costs and expenses.

We have been advised by the SEC that it has commenced an informal inquiry and we have been advised by the United States Attorney for the District of New Jersey that it has commenced an investigation, in each case to determine whether there have been any violations of the federal securities laws in connection with our disclosure of the Processing Systems Intrusion and the alleged trading in our securities by certain of our employees, including certain executive officers.

We have been contacted by the Federal Financial Institutions Examination Council and informed that it will be making inquiries into the Processing System Intrusion, and the Federal Trade Commission, by letter dated February 19, 2009, has requested that we provide information about our information security practices. Additionally, we have received written or telephonic inquiries relating to the Processing System Intrusion from a number of state Attorneys General's offices, including a Civil Investigative Demand from the Louisiana Department of Justice Office of the Attorney General, the Canadian Privacy Commission, and other government officials. We are cooperating with the government officials in response to each of these inquiries. We expect that additional lawsuits may be filed against us relating to the Processing System Intrusion and that additional inquiries from governmental agencies may be received or investigations may be commenced.

Although we intend to defend the lawsuits, investigations and inquiries described above vigorously, we cannot predict the outcome of such lawsuits, investigations and inquiries . Apart from damages claimed in such lawsuits and in other lawsuits relating to the Processing System Intrusion that may be filed, we may be subject to fines or other obligations as a result of the government inquiries and investigations described above and additional governmental inquiries or investigations relating to the Processing System Intrusion that may be commenced. The Card Brands may also assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. In that regard, we have been advised by Visa that based on Visa's investigation of the Processing System Intrusion Visa believes we are in violation of the Visa Operating Regulations and that, based on that belief, Visa has removed us from Visa's published list of PCI-DSS compliant service providers until such time as we are re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification has been reviewed and approved by Visa, intends to seek to impose fines on our sponsor banks, which fines (if successfully imposed) our sponsor banks could in turn seek to recover from us, intends to place us in a probationary status during the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa Operating Regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system, and intends to treat some or all of the Visa accounts that Visa considers to have been placed at risk of compromise in the Processing System Intrusion as being eligible for Visa's Account Data Compromise Recovery and Data Compromise Recovery Solution processes, which processes could result in Visa's seeking to recover from our sponsor banks (and our sponsor banks in turn seeking to recover from us) amounts in respect of fraud losses and operating expenses that Visa believes Visa issuers to have incurred by reason of the Processing System Intrusion. We expect the other Card Brands will assert claims seeking to impose fines, penalties, and/or other assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. By these claims, we expect the other Card Brands to seek to recover from us, or from our sponsor banks (who would in turn seek to recover from us), assessments in respect of fraud losses and operating expenses (including card reissuance costs and non-ordinary-course account monitoring expenses) that the other Card Brands believe either themselves or their issuers to have incurred by reason of the Processing System Intrusion, as well as fines and/or penalties by reason of our alleged failure to comply with the other Card Brands' operating regulations. The amounts of the Card Brand claims described above are expected to be material, and the amounts we are required to pay to defend against and/or resolve those claims are expected to be material could have a material adverse effect on our results of operations and financial condition.

While we have determined that the Processing System Intrusion has triggered a loss contingency, to date an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we 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 with respect to any

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such claim as of December 31, 2008. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such unfavorable outcome is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow. Costs we incurred related to investigations and remedial actions performed in December 2008 were not significant. Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2008 will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow.

Although we have insurance that we believe may cover some of the costs and losses that we may incur in connection with the above-described pending and potential lawsuits, inquiries, investigations and claims, we cannot now confirm that such coverage will, in fact, be provided or the extent of such coverage, if it is provided.

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***Other Legal Proceedings***

On December 16, 2008, a putative class action was filed against us in the Superior Court of California, County of San Diego, *Ryan McInerney, Hossein Vazir Zand v. Heartland Payment Systems, Inc.* The plaintiffs purport to represent a putative class of individuals who allegedly were not reimbursed by us for business expenses and whose compensation was allegedly reduced for their costs of doing business. The plaintiffs seek unspecified monetary damages, penalties, injunctive and declaratory relief, and attorney's fees and costs.

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. We believe that the outcome of the proceedings to which we are currently a party will not have a material adverse effect on our financial position, results of operations or cash flows.

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### **Quantitative and Qualitative Disclosures About Market Risk**

**Interest Rate Risk.** Our primary market risk exposure is to changes in interest rates.

We have interest rate risk related to our payable to our sponsor banks. During each month, KeyBank and Heartland Bank advance interchange fees to most of our merchants. We fund these advances first by applying a portion of our available cash and then by incurring a significant payable to our sponsor banks, bearing interest at the prime rate. At December 31, 2008, our payable to our sponsor banks was \$68.2 million. This payable is repaid on the first business day of the following month out of fees collected from our merchants. During the quarter ended December 31, 2008 the average daily interest-bearing balance of that payable was approximately \$22.1 million. The outstanding balance of our payable to our sponsor banks is directly related to our bank card processing volume and also will fluctuate depending on the amount of our available cash. A hypothetical 100 basis point change in short-term interest rates applied to our average payable to sponsor banks would result in a change of approximately \$221,000 in annual pre-tax income.

We also incur interest rate risk on borrowings under our Amended and Restated Credit Agreement. The Amended and Restated Credit Agreement provides for a Revolving Credit Facility in an aggregate amount of up to \$50 million and a Term Credit Facility in an aggregate amount of up to \$25 million. 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. 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 nine 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. During the quarter ended December 31, 2008, the average daily interest-bearing balance outstanding under the Amended and Restated Credit Agreement was \$75.0 million. A hypothetical 100 basis point increase in short-term interest rates applied to our average outstanding balance under the Amended and Restated Credit Agreement would result in a decline of approximately \$750,000 in annual pre-tax income.

While the bulk of our cash and cash-equivalents are held in checking accounts or money market funds, we do hold certain fixed-income investments with maturities within three years. At December 31, 2008, a hypothetical 100 basis point increase in short-term interest rates would result in an increase of approximately \$48,000 in annual pre-tax income from money market fund holdings, but a decrease in the value of fixed-rate investments of approximately \$60,000. A hypothetical 100 basis point decrease in short-term interest rates would result in a decrease of approximately \$48,000 in annual pre-tax income from money market funds, but an increase in the value of fixed-rate instruments of approximately \$60,000.

**Foreign Currency Risk.** While substantially all of our business is conducted in U.S. dollars, our Canadian processing subsidiary, CPOS, conducts its operations in Canadian dollars. Consequently, a portion of CPOS' revenues and expenses may be affected by fluctuations in foreign currency exchange rates. We are also affected by fluctuations in exchange rates on assets and liabilities related to our CPOS subsidiary. We have not hedged our translation risk on foreign currency exposure. For year ended December 31, 2008, foreign currency exposures had an immaterial impact on our revenues and our net income. At December 31, 2008, fluctuations in exchange rates on CPOS' assets and liabilities reduced our Other Comprehensive Income by \$2.1 million.

We do not hold or engage in the trading of derivative financial, commodity or foreign exchange instruments.

### **Recent 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

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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. We adopted 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 was effective for the Company on January 1, 2008. The adoption of SFAS No. 157 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities* ( SFAS No. 159 ). SFAS No. 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (the Fair Value Option ). Unrealized gains and losses on items for which the Fair Value Option has been elected are reported in earnings. The Fair Value Option is applied instrument by instrument (with certain exceptions), is irrevocable (unless a new election date occurs) and is applied only to an entire instrument. The effect of the first re-measurement to fair value is reported as a cumulative-effect adjustment to the opening balance of Retained earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted, subject to certain conditions. The adoption of SFAS No. 159 did not have any effect on our consolidated financial position, results of operations or cash flows and therefore, was not elected by the company.

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. SFAS No. 141 (R) will impact our Consolidated Financial Statements prospectively in the event of any business combinations entered into after the effective date in which we are the acquirer.