HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
May 06, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2011

OR

o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

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

90 Nassau Street, Princeton, New Jersey 08542
(Address of principal executive offices) (Zip Code)
(609) 683-3831
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o YES o NO

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 the definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	o	Accelerated filer	x

Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o

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

As of May 2, 2011, there were 38,543,605 shares of the registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION
Item 1. Condensed Financial Statements
Heartland Payment Systems, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In thousands, except share data)
(unaudited)

	March 31, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$43,873	$41,729
Funds held for payroll customers	41,908	36,523
Receivables, net	179,855	175,530
Investments held to maturity	2,253	1,516
Inventory	11,680	11,058
Prepaid expenses	9,902	7,721
Current tax asset	15,088	18,652
Current deferred tax assets, net	9,447	7,250
Total current assets	314,006	299,979
Capitalized customer acquisition costs, net	57,316	59,251
Property and equipment, net	105,601	102,248
Goodwill	75,041	68,319
Intangible assets, net	31,471	31,160
Deposits and other assets, net	903	507
Total assets	$584,338	$561,464
Liabilities and stockholders' equity		
Current liabilities:		
Due to sponsor banks	$82,431	$72,573
Accounts payable	40,070	42,126
Deposits held for payroll customers	41,908	36,523
Current portion of borrowings	30,245	38,286
Current portion of accrued buyout liability	5,733	5,560
Processing liabilities and loss reserves	35,102	28,740
Accrued expenses and other liabilities	29,213	27,171
Reserve for processing system intrusion	1,676	1,618
Total current liabilities	266,378	252,597
Deferred tax liabilities, net	25,593	21,714
Reserve for unrecognized tax benefits	1,415	1,309
Long-term portion of borrowings	81,250	85,000
Long-term portion of accrued buyout liability	22,509	23,250
Total liabilities	397,145	383,870
Commitments and contingencies (Note 12)	—	—
Stockholders' equity		
Common Stock, $0.001 par value, 100,000,000 shares authorized, 38,501,063 and 38,415,199 shares issued and outstanding at March 31, 2011 and December 31, 2010	39	38

Additional paid-in capital	188,650	185,689
Accumulated other comprehensive income	245	37
Accumulated deficit	(2,196)	(8,471)
Total stockholders’ equity	186,738	177,293
Noncontrolling interests	455	301
Total equity	187,193	177,594
Total liabilities and equity	$584,338	$561,464

See accompanying notes to condensed consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiaries
Condensed Consolidated Statements of Income and Comprehensive Income
(In thousands, except per share data)
(unaudited)

	Three months ended March 31,	
	2011	2010
Total revenues	$467,646	$411,156
Costs of services:		
Interchange	320,799	281,050
Dues, assessments and fees	34,150	26,270
Processing and servicing	52,556	57,018
Customer acquisition costs	11,658	13,365
Depreciation and amortization	3,875	3,754
Total costs of services	423,038	381,457
General and administrative	30,046	27,100
Total expenses	453,084	408,557
Income from operations	14,562	2,599
Other income (expense):		
Interest income	41	31
Interest expense	(1,192)	(1,101)
(Provision for) recovery of processing system intrusion costs	(303)	20,364
Other, net	(437)	945
Total other (expense) income	(1,891)	20,239
Income before income taxes	12,671	22,838
Provision for income taxes	4,809	8,594
Net income	7,862	14,244
Less: Net income attributable to noncontrolling interests	47	16
Net income attributable to Heartland	$7,815	$14,228
Net income	$7,862	$14,244
Other comprehensive income:		
Unrealized gains on investments, net of income tax of $2 and $13	5	25
Unrealized losses on derivative financial instruments	(46)	—
Foreign currency translation adjustment	356	326
Comprehensive income	8,177	14,595
Less: Comprehensive income attributable to noncontrolling interests	154	16
Comprehensive income attributable to Heartland	$8,023	$14,579
Earnings per common share:		
Basic	$0.20	$0.38
Diluted	$0.20	$0.36
Weighted average number of common shares outstanding:		
Basic	38,455	37,628

Diluted	39,738	38,998

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries
Condensed Consolidated Statements of Stockholders' Equity
(In thousands)
(unaudited)

	Heartland Stockholders' Equity						
	Common Stock						
	Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Gain (Loss)	(Accumulated Deficit) Retained Earnings	Noncontrolling Minority Interests	Total Equity
Three Months Ended March 31, 2010:							
Balance, January 1, 2010	37,524	$38	$171,736	$(546)	$(41,487)	$214	$129,955
Issuance of Common Stock– options exercised	246	—	1,783	—	—	—	1,783
Excess tax benefit on stock options exercised	—	—	647	—	—	—	647
Stock-based compensation	—	—	1,557	—	—	—	1,557
Accumulated other comprehensive income (loss):							
Unrealized gains on available for sale investments	—	—	—	25	—	—	25
Foreign currency translation adjustment	—	—	—	326	—	—	326
Dividends on Common Stock	—	—	—	—	(377)	—	(377)
Net income for the period	—	—	—	—	14,228	16	14,244
Balance March 31, 2010	37,770	$38	$175,723	$(195)	$(27,636)	$230	$148,160
Three months Ended March 31, 2011:							
Balance, January 1, 2011	38,415	$38	$185,689	$37	$(8,471)	$301	$177,594
Issuance of Common Stock – options exercised	86	1	650	—	—	—	651
Excess tax benefit on stock options exercised	—	—	341	—	—	—	341
Stock-based compensation	—	—	1,970	—	—	—	1,970
Accumulated other comprehensive income (loss):							
Unrealized gains on available for sale investments	—	—	—	5	—	—	5
Unrealized losses on derivative financial instruments	—	—	—	(46)	—	—	(46)
Foreign currency translation	—	—	—	249	—	107	356

adjustment							
Dividends on Common Stock	—	—	—	—	(1,540)	—	(1,540)
Net income for the period	—	—	—	—	7,815	47	7,862
Balance March 31, 2011	38,501	$39	$188,650	$245	$ (2,196)	$455	$187,193

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flow
(In thousands)
(unaudited)

	Three months ended March 31,	
	2011	2010
Cash flows from operating activities		
Net income attributable to Heartland	$7,815	$14,228
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of capitalized customer acquisition costs	12,381	14,048
Other depreciation and amortization	7,072	6,285
Addition to loss reserves	1,489	3,300
Provision for doubtful receivables	700	157
Stock-based compensation	1,970	1,557
Deferred taxes	1,675	19,111
Net income attributable to noncontrolling interests	47	16
Exit costs for service center	464	—
Write downs on fixed assets and system development costs	46	—
Other	—	13
Changes in operating assets and liabilities:		
Increase in receivables	(4,731)	(6,320)
(Increase) decrease in inventory	(606)	374
Payment of signing bonuses, net	(7,116)	(4,971)
Increase in capitalized customer acquisition costs	(3,330)	(3,810)
(Increase) decrease in prepaid expenses	(2,177)	1,190
Decrease (increase)in current tax asset	3,904	(5,226)
(Increase) decrease in deposits and other assets	(406)	1,125
Excess tax benefits on options exercised	(341)	(647)
Increase in reserve for unrecognized tax benefits	106	209
Increase in due to sponsor bank	9,857	1,308
Decrease in accounts payable	(2,075)	(2,582)
Increase (decrease) in accrued expenses and other liabilities	769	(4,191)
Increase (decrease) in processing liabilities and loss reserves	4,831	(834)
Increase (decrease) in reserve for processing system intrusion	58	(57,143)
Payouts of accrued buyout liability	(3,175)	(1,903)
Increase in accrued buyout liability	2,607	3,127
Net cash provided by (used in) operating activities	31,834	(21,579)
Cash flows from investing activities		
Purchase of investments held to maturity	(1,947)	(581)
Maturities of investments held to maturity	1,233	626
Increase in funds held for payroll customers	(5,379)	(1,633)
Increase in deposits held for payroll customers	5,385	1,672
Acquisition of business, net of cash acquired	(7,598)	—
Purchases of property and equipment	(9,071)	(4,172)
Net cash used in investing activities	(17,377)	(4,088)
Cash flows from financing activities		
Proceeds from borrowings	—	53,000

Principal payments on borrowings	(11,791)	(2,137)
Proceeds from exercise of stock options	650	1,783
Excess tax benefits on options exercised	341	647
Dividends paid on common stock	(1,540)	(377)
Net cash (used in) provided by financing activities	(12,340)	52,916
Net increase in cash	2,117	27,249
Effect of exchange rates on cash	27	23
Cash at beginning of year	41,729	32,113
Cash at end of period	$43,873	$59,385
Supplemental cash flow information:		
Cash paid (received) during the period for:		
Interest	$931	$998
Income taxes	(876)	(5,500)

See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements
(unaudited)

1. Organization and Operations

Basis of Financial Statement Presentation— The accompanying consolidated financial statements include those of Heartland Payment Systems, Inc. (the "Company," "we," "us," or "our") and its wholly-owned subsidiaries, Heartland Payroll Company ("HPC"), Debitek, Inc. ("Debitek") and Heartland Acquisition LLC ("Network Services"), and its 70% owned subsidiary Collective POS Solutions Ltd. ("CPOS"). The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company's subsidiaries have been eliminated upon consolidation.

The accompanying condensed consolidated financial statements are unaudited. In the opinion of the Company's management, the unaudited condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of the Company's financial position at March 31, 2011, its results of operations, changes in stockholders' equity and cash flows for the three months ended March 31, 2011 and 2010. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ending December 31, 2011. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2010. The December 31, 2010 condensed consolidated balance sheet was derived from the audited 2010 consolidated financial statements.

Business Description—The Company's principal business is to provide payment processing services related to bankcard transactions for merchants throughout the United States and Canada. In addition, the Company provides certain other merchant services, including check processing, the sale and rental of terminal equipment, gift and loyalty card processing, and the sale of terminal supplies. HPC provides payroll and related tax filing services throughout the United States. Debitek provides prepaid card and stored-value card solutions throughout the United States and Canada. The Company and Debitek also provide campus payment solutions throughout the United States and Canada. The Company provides K to 12 School Services in the United States through its acquired school services businesses previously operated by Lunchbox, Comalex and mySchoolBucks. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions.

Over 90% of the Company's revenue is derived from processing and settling Visa and MasterCard bankcard transactions for its merchant customers. Because the Company is not a "member bank" as defined by Visa and MasterCard, in order to process and settle these bankcard transactions for its merchants, the Company has entered into sponsorship agreements with member banks. Visa and MasterCard rules restrict the Company from performing funds settlement or accessing merchant settlement funds and require that these funds be in the possession of the member bank until the merchant is funded. A sponsorship agreement permits the Company to route Visa and MasterCard bankcard transactions under the member bank's control and identification numbers to clear credit bankcard transactions through Visa and MasterCard. A sponsorship agreement also enables the Company to settle funds between cardholders and merchants by delivering funding files to the member bank, which in turn transfers settlement funds to the merchants' bank accounts. These restrictions place the settlement assets and obligations under the control of the member bank.

The sponsorship agreements with the member banks require, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard networks, and certain of the bank sponsors require a certificate of deposit or a cash balance in a deposit account. If the Company breaches a sponsorship agreement, the bank sponsor may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative bank sponsor. The Company is dependent on its bank sponsors, Visa and MasterCard for notification of any compliance breaches. As of March 31, 2011, the Company has not been notified of any such issues by its bank sponsors, Visa or MasterCard.

The Company is currently party to three bank sponsorship agreements. The Company entered into a sponsorship agreement with KeyBank, National Association on April 1, 1999 and the agreement expires in March 2012. In 2007, the Company entered into a sponsor bank agreement with Heartland Bank (an unrelated third party), which is based in Saint Louis, Missouri. Our agreement with Heartland Bank involves substantially the same terms as apply with KeyBank and it has been renewed through September 2013. In November 2009, the Company entered into a sponsorship agreement with The Bancorp Bank to sponsor the Company's large national and mid-tier merchants processed by Network Services. The agreement with The Bancorp Bank expires in November 2014.
Following is a breakout of the Company’s total Visa and MasterCard settled bankcard processing volume for the

month ending March 31, 2011 by percentage processed under its individual bank sponsorship agreements:

Sponsor Bank	% of March 2011 Bankcard Processing Volume
KeyBank, National Association	71%
Heartland Bank	12%
The Bancorp Bank	17%

Processing System Intrusion—On January 20, 2009, the Company publicly announced the discovery of a criminal breach of its payment systems environment (the “Processing System Intrusion”). The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by the Company during the transaction authorization process. The Company believes the breach did not extend beyond 2008. See Note 3, Processing System Intrusion for further detail and related events.

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements—(Continued)
(unaudited)

2. Summary of Significant Accounting Policies

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

Cash and Cash Equivalents—At March 31, 2011, cash included approximately $31.6 million of processing-related cash in transit and collateral, compared to approximately $25.6 million of processing-related cash in transit and collateral at December 31, 2010.

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

The Company's primary receivables are from its bankcard processing merchants. These receivables result from the Company's practice of advancing interchange fees to most of its small and midsized merchants (referred to as Small and Midsized Enterprises, or “SME”) during the month and collecting those fees at the beginning of the following month, as well as from transaction fees the Company charges its merchants for processing transactions. The Company does not advance interchange fees to its Network Services merchants.

Generally, the Company uses cash available for investment to fund these advances to SME merchants; when available cash has been expended, the Company directs its sponsor banks to make these advances, thus generating a payable to the sponsor banks. We pay our sponsor banks the prime rate on these payables. At March 31, 2011, the Company used $28.4 million of its available cash to fund merchant advances and at December 31, 2010, the Company used $29.5 million of its cash to fund merchant advances. The amount due to sponsor banks for funding advances was $77.5 million at March 31, 2011 and $63.2 million at December 31, 2010. The payable to sponsor banks is repaid at the beginning of the following month out of the fees the Company collects from its merchants. Receivables from

merchants also include receivables from the sale of point of sale terminal equipment and check processing terminals. Unlike the SME merchants, Network Services' customers are invoiced monthly, on payment terms of 30 days net from date of invoicing.

Receivables also include amounts resulting from the pre-funding of Discover and American Express transactions to our merchants and are due from the related bankcard networks. These amounts are recovered over the following two business days from the date of processing the transaction.

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

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements—(Continued)
(unaudited)

Investments and Funds Held for Payroll Customers—Investments, including those carried on the Consolidated Balance Sheet as Funds Held for Payroll Customers, consist primarily of fixed income bond funds and certificates of deposit. Funds Held for Payroll Customers also include overnight bank deposits. The majority of investments carried in Funds Held for Payroll Customers are available-for-sale and recorded at fair value based on quoted market prices. Certificates of deposit are classified as held to maturity and recorded at cost. In the event of a sale, cost is determined on a specific identification basis. At March 31, 2011, Funds Held for Payroll Customers included cash and cash equivalents of $40.6 million and investments available for sale of $1.3 million.

Capitalized Customer Acquisition Costs, net—Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company's sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the estimated cost of buying out the commissions of vested sales employees. Capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.
The up-front signing bonus is based on the estimated gross margin for the first year of the SME merchant contract. The signing bonus, amount capitalized, and related amortization are adjusted after one year to reflect the actual gross margin generated by the merchant contract during that year. The deferred customer acquisition cost asset is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, as described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying SME merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. The Company believes that no impairment has occurred as of March 31, 2011 and December 31, 2010.

Processing Liabilities and Loss Reserves—The majority of the Company's processing liabilities include funds in transit associated with bankcard and check processing. In addition, the Company maintains merchant deposits to offset potential liabilities from merchant chargeback processing. Disputes between a cardholder and a merchant periodically arise due to the cardholder's dissatisfaction with merchandise quality or the merchant's service, and the disputes may not always be resolved in the merchant's favor. In some of these cases, the transaction is "charged back" to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company's obligation to stand ready to perform is minimal. The Company maintains a deposit or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to recent bankcard processing volume levels. The Company believes that the liability recorded as loss reserves approximates fair value.
Accrued Buyout Liability—The Company's historic focus has been on SME merchants, and it has a sales compensation arrangement in this market that has been essentially unchanged since its inception. Under this approach, Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly SME merchant processing activity. The Company has the right, but is not obligated, to buy out some or all of these commissions, and intends to do so periodically. Such purchases of the commissions are at a fixed multiple of the last twelve months' commissions. Because of the Company's intent and ability to execute purchases of the residual

commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount that it would have to pay (the "settlement cost") to buy out non-servicing related commissions in their entirety from vested Relationship Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a SME merchant contract, the Company also records a related deferred acquisition cost asset for currently vested Relationship Managers and sales managers. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin are included in the same income statement caption as customer acquisition cost amortization expense.

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements—(Continued)
(unaudited)

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

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

Revenue—Revenues are mainly comprised of gross processing revenue, payroll processing revenue and equipment-related income. Gross processing revenue primarily consists of discount fees and per-transaction and periodic (primarily monthly) fees from the processing of Visa, MasterCard, American Express and Discover bankcard transactions for merchants. The Company passes through to its customers any changes in interchange or network fees. Gross processing revenue also includes fees for servicing American Express and Discover accounts, customer service fees, fees for processing chargebacks, termination fees on terminated contracts, check processing fees, gift and loyalty card fees and other miscellaneous revenue. Payroll processing revenue includes periodic and annual fees charged by HPC for payroll processing services, and interest earned from investing tax impound funds held for our customers. Revenue is recorded as bankcard and other processing transactions are processed or payroll services are performed. Equipment-related income includes revenues from the sale, rental and deployment of bankcard and check processing terminals, from the sale of hardware, software and associated services for prepaid card and stored-value card payment systems, and campus payment solutions. Revenues are recorded at the time of shipment, or the provision of service.

Loss Contingencies and Legal Expenses—The Company records a liability for loss contingencies when the liability is probable and reasonably estimable. Legal fees associated with loss contingencies are recorded when the legal fees are incurred.
The Company records recoveries from its insurance providers when cash is received from the provider.

Other Income (Expense)- Other income (expense) consists of interest income on cash and investments, the interest cost on our borrowings, the gains or losses on the disposal of property and equipment and other non-operating income or expense items. For the three months ended March 31, 2011, other income (expense) included pre-tax charges of $0.5 million reflecting the estimated liability for costs (primarily accrued staff termination costs and fixed asset write downs) associated with closing of the Company's Johnson City, Tennessee service center. Other, net for the three months ended March 31, 2010 reflected a net legal settlement received during that period

Other income (expense) also includes the pretax charges or recoveries related to the Provision for Processing System Intrusion. See Note 3. Processing System Intrusion for more detail.

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

The provision for/(benefit from) income taxes for the three months ended March 31, 2011 and 2010 and the resulting effective tax rates were as follows:

	Three months ended March 31,	
	2011	2010
	(In thousands)	
Provision for income taxes	$4,809	$8,594
Effective tax rate	38.0 %	37.6 %

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements—(Continued)
(unaudited)

The Company maintains valuation allowances when it is more likely than not that all or a portion of a deferred tax asset will not be realized. In determining whether a valuation allowance is warranted, the Company evaluates factors such as prior earnings history, expected future earnings, carry back and carry forward periods and tax strategies that could potentially enhance the likelihood of the realization of a deferred tax asset.

The Company regularly evaluates its tax positions for additional unrecognized tax benefits and associated interest and penalties, if applicable. There are many factors that are considered when evaluating these tax positions including: interpretation of tax laws, recent tax litigation on a position, past audit or examination history, and subjective estimates and assumptions, which have been deemed reasonable by management. However, if management's estimates are not representative of actual outcomes, the Company's results could be materially impacted. The Company does not expect any material changes to unrecognized tax benefits in the next twelve months. At March 31, 2011, the reserve for unrecognized tax benefits related to uncertain tax positions was $1.4 million, of which $0.9 million would, if recognized, impact the effective tax rate.

Stock–Based Compensation—In the second quarter of 2009, the Company's Board of Directors approved grants of 930,000 stock options subject to multiple vesting conditions. Under these stock options, the employee must provide continuous service over four years and a market price condition must be satisfied within those four years. These stock options have a five-year term and could vest in equal amounts in 2010, 2011, 2012 and 2013 only if, during the four-year service period, the price of the Company's common stock as reported by the New York Stock Exchange exceeds two or three times the exercise price for 30 consecutive trading days. The grant date fair values of these multiple vesting condition options are recognized as compensation expense over their four-year service periods. At March 31, 2011, none of the 930,000 stock options have vested.
In the fourth quarter of 2010, the Company's Board of Directors approved grants of 508,800 performance-based Restricted Share Units. These Restricted Share Units are share awards which would vest 50% in 2013, 25% in 2014, and 25% in 2015 only if, over the term of these Restricted Share Units, the following diluted earnings per share targets for the years ended December 31, 2012, 2013 and 2014 are achieved:

	2012	2013	2014
Diluted Earnings Per Share [(a)]	$1.48	$1.74	$2.04

(a) Calculated on a Pro Forma basis to exclude non-operating gains and losses, if any, and excluding the after-tax impact of Stock Compensation Expense.

As of March 31, 2011, management believes that achieving these performance targets was not “more likely than not” to occur; therefore, no share-based compensation expense was recorded for these Restricted Share Units. The evaluation of the likelihood of achieving these performance targets will be repeated quarterly, and if vesting of some or all of the Restricted Share Units becomes more likely than not, share-based compensation expense will be recorded. The closing price of the Company's common stock on the grant date equals the grant date fair value of these nonvested Restricted Share Units awards and would be recognized as compensation expense over their vesting periods.

Diluted earnings per share for the three months ended March 31, 2011 and 2010 were computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, where dilutive.
Derivative Financial Instruments—The Company utilizes derivative instruments to manage interest rate risk on its borrowings under its Second Amended and Restated Credit Agreement. The Company recognizes the fair value of derivative financial instruments in the Consolidated Balance Sheets in investments, or accrued expenses and other liabilities. Changes in fair value of derivative instruments are recognized immediately in earnings unless the derivative is designated and qualifies as a hedge of future cash flows. For derivatives that qualify as hedges of future cash flows,

the effective portion of changes in fair value is recorded in other comprehensive Income and reclassified into interest expense in the same periods during which the hedged item affects earnings. Any ineffectiveness of cash flow hedges would be recognized in other income (expense) in the Consolidated Statements of Income during the period of change.

In January 2011, the Company entered into fixed-pay amortizing interest rate swaps having an initial notional amount of $50 million as a hedge of future cash flows on the variable rate debt outstanding under its Term Credit Facility. These interest rate swaps convert the related notional amount of variable rate debt to fixed rate. At March 31, 2011, the remaining notional amount of these interest rate swaps was $48.1 million and the fair value, $46,000, was recorded as a liability in accrued expenses and other liabilities.

Foreign Currency—The Canadian dollar is the functional currency of CPOS, which operates in Canada. CPOS'

revenues and expenses are translated at the average exchange rates prevailing during the period. The foreign currency assets and liabilities of CPOS are translated at the period-end rate of exchange. The resulting translation adjustment is allocated between the Company and CPOS' noncontrolling interests and is recorded as a component of other comprehensive income or noncontrolling interests in total equity. At March 31, 2011, the cumulative foreign currency translation reflected a gain of $0.2 million and at March 31, 2010 reflected a loss of $0.3 million. The Company intends to indefinitely reinvest undistributed earnings of CPOS and has not tax affected the cumulative foreign currency translation gain or loss. Determination of the amount of unrecognized deferred tax liability related to indefinitely reinvested profits is not material.

Noncontrolling Interests— Noncontrolling interests represent noncontrolling minority stockholders' share of the equity and after-tax net income or loss of consolidated subsidiaries. Noncontrolling minority stockholders' share of after-tax net income or loss of consolidated subsidiaries is included in “Net income attributable to noncontrolling interests” in the Consolidated Statement of Income. The minority stockholders’ interests included in “noncontrolling interests” in the March 31, 2011 and December 31, 2010 Consolidated Balance Sheet were $455,000 and $301,000, respectively, and reflect the original investments by these minority shareholders in the consolidated subsidiaries, along with their proportionate share of the earnings or losses of the subsidiaries.

Subsequent Events—The Company evaluated subsequent events with respect to the Consolidated Financial Statements as of and for the three months ended March 31, 2011.

New Accounting Pronouncements—In October 2009, the FASB issued an accounting standard update on multiple deliverable revenue arrangements to establish the accounting for certain revenue arrangements in which the vendor or service provider will perform multiple revenue generating activities (e.g., contracts that require an up-front fee along with fees that recur over the life of the arrangement). Specifically, the update addresses how to separate deliverables and how to measure and allocate arrangement consideration to one or more units of accounting. This update will be effective for revenue arrangements that are entered into or materially altered after January 1, 2011. The implementation of this update did not have a material effect on the Company's consolidated financial statements.

3. Processing System Intrusion

On January 20, 2009, the Company publicly announced the discovery of a criminal breach of its payment systems environment (the “Processing System Intrusion”). The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by the Company during the transaction authorization process. The Company believes the breach did not extend beyond 2008.

Since its announcement of the Processing System Intrusion on January 20, 2009 and through March 31, 2011, the Company has expensed a total of $146.4 million, before reducing those charges by $31.2 million of total insurance recoveries. The majority of the total charges, or approximately $114.7 million, related to settlements of claims. Approximately $31.7 million of the total charges were for legal fees and costs we incurred for investigations, defending various claims and actions, remedial actions and crisis management services.

During the three months ended March 31, 2011, the Company incurred approximately $0.3 million, or less than one cent per share, for legal fees and costs it incurred for defending various claims and actions for the Processing System Intrusion. During the three months ended March 31, 2010, the Company recovered from its insurance providers approximately $26.8 million of the costs it had previously incurred for the Processing System Intrusion and expensed approximately $6.4 million for accruals, legal fees and costs we incurred for defending various claims and actions, resulting in a net recovery of $20.4 million, or $0.32 per share for that period.

During 2009 and 2010, the Company settled the following claims and disputes related to the Processing System Intrusion:

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On December 17, 2009, the Company entered into a settlement agreement and release with American Express and paid approximately $3.5 million in full and final satisfaction of any and all claims of American Express and its issuers arising from or relating to the Processing System Intrusion. The Company paid this settlement from its available cash.

- On January 7, 2010, the Company, Heartland Bank, KeyBank National Association ("KeyBank," and, together with Heartland Bank, the "Sponsor Banks"), and Visa U.S.A. Inc., Visa International Service Association and Visa Inc. (collectively, "Visa") entered into a settlement agreement to resolve potential claims and other disputes related to the Processing System Intrusion and on February 18, 2010 it paid $58.6 million for that settlement,

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after a $0.8 million credit for fines previously collected by Visa during 2009. The Company obtained loans totaling $53.0 million from Sponsor Banks, the proceeds of which were used to partially fund the settlement amount. See Note 11 Credit Facilities for a discussion of the $28.0 million Bridge Loan and $25.0 million Increased Credit Commitment, both entered into on February 18, 2010 and repaid on November 24, 2010 when the Company entered into a Second Amended and Restated Credit Agreement.

- On May 19, 2010, the Company entered into a settlement agreement with MasterCard to resolve potential claims and other disputes related to the Processing System Intrusion and in September 2010 it agreed to pay a maximum of $34.8 million for that settlement, after a $6.6 million credit for fines previously collected by MasterCard during 2009. The Company paid this settlement from our available cash.
- On August 31, 2010, the Company entered into a settlement agreement with Discover to resolve potential claims and other disputes with respect to the Processing System Intrusion and on September 2, 2010, it paid Discover $5.0 million in full and final satisfaction of any and all claims of Discover, its affiliates and certain of its issuers. The Company paid this settlement from our available cash.

These settlement amounts were previously provided for in the Company's Provision for Processing System Intrusion and carried in its Reserve for Processing System Intrusion. The Company is prepared to vigorously defend itself against any unsettled claims relating to the Processing System Intrusion that have been asserted against it and its sponsor banks to date. The Company feels it has strong defenses to all the claims that have been asserted against it and its sponsor banks relating to the Processing System Intrusion. Additional costs the Company expects to incur for legal fees and costs for defending various claims and actions associated with the Processing System Intrusion will be recognized as incurred. Such costs, together with any amounts payable related to the unsettled claims, could be material and could adversely impact its results of operations, financial condition and cash flow.

4. Acquisitions

The Company initiated its K to 12 School Services product through its acquisitions of the school services businesses operated by Lunchbox, Comalex and mySchoolBucks. Lunchbox, Comalex and mySchoolBucks serve approximately 4,400, 3,700 and 900 schools, respectively. The combined K to 12 School Services will develop, manufacture, sell, service and maintain computer software designed to facilitate accounting and management functions of school food service operations. These acquisitions will also enable the Company to offer Internet payment capability, which enables on-line deposits of funds into student accounts and enables schools to operate more efficiently. The Company plans to consolidate the individual platforms and products of Lunchbox, Comalex and mySchoolBucks to optimize synergies, cost efficiencies and product offerings to customers.

The acquisitions of Lunchbox, Comalex and mySchoolBucks are not expected to have a material impact on earnings in the near term. Details of the individual acquisition transactions follow:

Lunchbox

On December 30, 2010, the Company purchased for a $7.7 million cash payment the net assets of the K to 12 School Services business previously operated by Lunchbox. The acquisition was financed through a combination of cash on hand and our credit facilities.

Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning December 30, 2010, Lunchbox's results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: $5.9 million to goodwill, $2.0 million to intangible assets and $0.2 million to net tangible liabilities. The

fair values of the Lunchbox assets acquired and liabilities assumed were estimated as of their acquisition date. The fair values are preliminary, based on estimates, and may be adjusted as more information becomes available and valuations are finalized. The entire amount of goodwill is expected to be deductible for income tax reporting.

Comalex, Inc.
On January 12, 2011, the Company purchased for a $6.1 million cash payment the net assets of Comalex, Inc. The acquisition was funded with cash on hand.

Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning January 12, 2011, Comalex's results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: $4.9 million to goodwill, $1.8 million to intangible assets and $0.6 million to net tangible liabilities. The fair values of the Comalex

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assets acquired and liabilities assumed were estimated as of their acquisition date. The fair values are preliminary, based on estimates, and may be adjusted as more information becomes available and valuations are finalized. The entire amount of goodwill is expected to be deductible for income tax reporting.

mySchoolBucks LLC.
On February 4, 2011, the Company purchased for a $1.5 million cash payment the net assets of mySchoolBucks, LLC. The acquisition was funded with cash on hand.

Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning February 4, 2011, mySchoolBucks' results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: $1.0 million to goodwill and $0.4 million to intangible assets. The fair values of the assets acquired were estimated as of their acquisition date. The fair values are preliminary, based on estimates, and may be adjusted as more information becomes available and valuations are finalized. The entire amount of goodwill is expected to be deductible for income tax reporting.

5. Receivables
A summary of receivables by major class was as follows at March 31, 2011 and December 31, 2010:

	March 31, 2011	December 31, 2010
	(In thousands)	
Accounts receivable from merchants	$158,373	$154,295
Receivables from bankcard networks	20,077	19,978
Accounts receivable from others	2,303	1,940
	180,753	176,213
Less allowance for doubtful accounts	(898)	(683)
Total receivables, net	$179,855	$175,530

Included in accounts receivable from others are amounts due from employees which are $0.6 million and $0.7 million at March 31, 2011 and December 31, 2010, respectively. Accounts receivable related to bankcard networks are primarily amounts which were pre-funded to merchants for processing Discover and American Express bankcard transactions.
A summary of the activity in the allowance for doubtful accounts for the three months ended March 31, 2011 and 2010 was as follows:

	Three months ended March 31,	
	2011	2010
	(In thousands)	
Beginning balance	$683	$459
Additions to allowance	700	157
Charges against allowance	(485)	(69)
Ending balance	$898	$547

6. Funds Held for Payroll Customers and Investments
A summary of Funds Held for Payroll Customers and Investments, including the cost, gross unrealized gains (losses) and estimated fair value for investments held to maturity and investments available-for-sale by major security type and class of security were as follows at March 31, 2011 and December 31, 2010:

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	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
March 31, 2011				
Funds Held for Payroll Customers:				
Fixed income bond fund	$968	$203	$—	$1,171
Corporate bonds	165	3	—	168
Total investments available-for-sale	1,133	206	—	1,339
Cash held for payroll customers	40,569	—	—	40,569
Total Funds Held for Payroll Customers	$41,702	$206	$—	$41,908
Investments:				
Investments held to maturity – Certificates of deposit	$2,253	$—	$—	$2,253
Total investments	$2,253	$—	$—	$2,253

(a)Certificates of deposit have remaining terms ranging from 3 months to 18 months.

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
December 31, 2010				
Funds Held for Payroll Customers:				
Fixed income bond fund	$968	$195	$—	$1,163
Corporate bonds	165	5	—	170
Total investments available-for-sale	1,133	200	—	1,333
Cash held for payroll customers	35,190	—	—	35,190
Total Funds Held for Payroll Customers	$36,323	$200	$—	$36,523
Investments:				
Investments held to maturity – Certificates of deposit	$1,516	$—	$—	$1,516
Total investments	$1,516	$—	$—	$1,516

The Company’s framework for measuring fair value provides a three-level hierarchy, which prioritizes the factors (inputs) used to calculate the fair value of assets and liabilities as follows:

- Level 1. Level 1 inputs are unadjusted quoted prices, such as a New York Stock Exchange closing price, in active markets for identical assets. Level 1 is the highest priority in the hierarchy.
- Level 2. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as other significant inputs that are observable at commonly quoted intervals, such as interest rates, foreign exchange rates, and yield curves.
- Level 3. Level 3 are unobservable inputs which are based on company assumptions due to little, if any, observable market information. Level 3 is the lowest priority in the hierarchy.

At March 31, 2011 and December 31, 2010, all investments in available-for-sale securities held by the Company were measured using Level 1 inputs and all held to maturity investments held by the Company were measured using Level 2 inputs.

During the three months ended March 31, 2011, the Company did not experience any other-than-temporary losses on its investments. During the twelve months ended December 31, 2010, the Company recognized a realized gain of $25,000 in conjunction with the sale of corporate debt and equity securities.
The maturity schedule of all available-for-sale debt securities and held to maturity investments along with amortized cost and estimated fair value as of March 31, 2011 is as follows:

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	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$2,891	$3,097
Due after one year through five years	495	495
	$3,386	$3,592

7. Capitalized Customer Acquisition Costs, Net

A summary of net capitalized customer acquisition costs as of March 31, 2011 and December 31, 2010 was as follows:

	March 31, 2011	December 31, 2010
	(In thousands)	
Capitalized signing bonuses	$96,060	$101,246
Less accumulated amortization	(52,692)	(56,481)
	43,368	44,765
Capitalized customer deferred acquisition costs	38,260	38,709
Less accumulated amortization	(24,312)	(24,223)
	13,948	14,486
Capitalized customer acquisition costs, net	$57,316	$59,251

A summary of the activity in capitalized customer acquisition costs, net for the three month periods ended March 31, 2011 and 2010 was as follows:

	Three months ended March 31, 2011	2010
	(In thousands)	
Balance at beginning of period	$59,251	$72,038
Plus additions to:		
Capitalized signing bonuses, net	7,116	4,971
Capitalized customer deferred acquisition costs	3,330	3,810
	10,446	8,781
Less amortization expense on:		
Capitalized signing bonuses, net	(8,514)	(9,973)
Capitalized customer deferred acquisition costs	(3,867)	(4,075)
	(12,381)	(14,048)
Balance at end of period	$57,316	$66,771

Net signing bonus adjustments from estimated amounts to actual were $(0.2) million and $(0.7) million, respectively, for the three months ended March 31, 2011 and 2010. Net signing bonus adjustments are netted against additions in the table above. 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 and would be paid to the relevant salesperson. Negative signing bonus adjustments result from the prior overpayment of signing bonuses and would be recovered from the relevant salesperson.

Fully amortized signing bonuses of $12.3 million and $10.7 million respectively, were written off during the three month periods ended March 31, 2011 and 2010. In addition, fully amortized customer deferred acquisition costs of $3.8 million and $3.5 million, respectively, were written off during the three months ended March 31, 2011 and 2010.

The Company believes that no impairment of capitalized customer acquisition costs has occurred as of March 31, 2011 and December 31, 2010.

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8. Intangible Assets and Goodwill

Intangible Assets — Intangible assets consisted of the following as of March 31, 2011 and December 31, 2010:

	March 31, 2011			
	Gross Assets	Accumulated Amortization	Net Asset	Amortization Life and Method
	(In thousands)			
Finite Lived Assets:				
Customer relationships	$29,884	$3,892	$25,992	3 to 18 years—proportional cash flow
Merchant Portfolio	3,345	1,356	1,989	7 years—proportional cash flow
Software	10,063	7,888	2,175	2 to 5 years—straight line
Non-compete agreements	2,059	869	1,190	3 to 5 years—straight line
Other	656	531	125	2 to 9 years—straight line
	$46,007	$14,536	$31,471	

	December 31, 2010			
	Gross Assets	Accumulated Amortization	Net Asset	Amortization Life and Method
	(In thousands)			
Finite Lived Assets:				
Customer relationships	$28,665	$3,452	$25,213	3 to 18 years—proportional cash flow
Merchant Portfolio	3,345	1,180	2,165	7 years—proportional cash flow
Software	9,705	7,149	2,556	3 to 5 years—straight line
Non-compete agreements	1,840	768	1,072	3 to 5 years—straight line
Other	616	462	154	2 to 9 years—straight line
	$44,171	$13,011	$31,160	

Amortization expense related to the intangible assets was $1.5 million and $1.3 million, respectively, for the three months ended March 31, 2011 and 2010. The estimated remaining amortization expense related to intangible assets in twelve month increments is as follows:

For the Twelve Months Ended March 31,	
	(In thousands)
2012	$3,711
2013	3,253
2014	3,056
2015	2,771
2016	2,582
Thereafter	16,098
	$31,471

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Goodwill — The changes in the carrying amount of goodwill for the three months ended March 31, 2011 and 2010 were as follows:

	Three months ended March 31,	
	2011	2010
	(In thousands)	
Beginning balance	$68,319	$60,962