HEARTLAND PAYMENT SYSTEMS INC
Form 10-K
March 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007

OR

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

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

90 Nassau Street, Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

(609) 683-3831

(Registrant s telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value	New York Stock Exchange

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 x 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 x NO

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The aggregate market value of the voting common stock held by non-affiliates based on the last reported sale price on June 30, 2007: approximately $470 million.

As of March 1, 2008, there were 37,271,249 shares of the registrant s Common Stock, $.001 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Specifically identified portions of the registrant s proxy statement for the 2008 annual meeting of shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K for fiscal year ended December 31, 2007.

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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, 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. These factors include, without limitation, 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, the unauthorized disclosure of merchant data, economic conditions, system failures and government regulation.

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 450 Fifth 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.

In addition, certain of our SEC filings, including our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K can be viewed and printed from the investor information section of our website at 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 May 2007, 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.

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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. 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. 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.

According to The Nilson Report, in 2006 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 2.3% of the total bank card processing market. At December 31, 2007, we provided our bank card payment processing services to approximately 154,750 active merchant locations, referred to as bank card merchants in this document, throughout the United States. In 2007, 2006 and 2005, our bank card processing volume was $51.9 billion, $43.3 billion and $33.7 billion, respectively.

Our bank card processing revenue is recurring in nature, as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the achievement of agreed bank card processing volume minimums from our merchants. Most of our 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 pay interchange fees to card issuing banks and dues and assessments to Visa and MasterCard, and we retain the remainder. For example, the allocation of funds resulting from a $100 transaction is depicted below.

We sell and market our bank card payment processing services through a nationwide direct sales force of 1,602 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 to small- and medium-size merchants gives us the ability to effectively evaluate and manage the payment processing needs and risks that are unique to these merchants. In 2007, our sales force generated over 62,500 bank card merchant applications and installed over 57,000 new bank card merchants. In 2006, our sales force generated over 55,000 bank card merchant applications and installed almost 51,000 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 losses. In 2007, 2006 and 2005, we experienced losses of 0.54 basis points (0.0054%), 0.45 basis points (0.0045%) and 0.36 basis points (0.0036%) of 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, 2007, approximately 30.2% of our bank card merchants were restaurants, approximately 20.2% were brick and mortar retailers, approximately 10.6% were convenience and liquor stores, approximately 8.9% were automotive sales, repair shops and gas stations, approximately 8.1% were professional service providers and approximately 3.7% were lodging establishments.

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 $558 billion in 2008, which would represent a 4% increase over projected industry sales for 2007 and the sixteenth consecutive year of growth. 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 restaurants, as the service 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.

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 bankcard 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 bank card merchants. Passport enables us to customize these services to the needs of our Relationship Managers and merchants.

During the years ended December 31, 2007, 2006 and 2005, approximately 75%, 64% and 53%, respectively, of our transactions were processed through HPS Exchange, which has decreased our operating costs per transaction. At December 31, 2007 and 2006, approximately 98% of total bank card merchants were processing on Passport. At December 31, 2007, our internally developed systems are providing substantially all aspects of a merchant s processing needs.

In December 2007, we signed a sales and servicing program agreement with American Express under which we will sign up and service new merchants on behalf of American Express. Under the terms of the agreement, we will add American Express Card acceptance to the payment processing services we offer to new bankcard merchants beginning in the second half of 2008. 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. The program will also be opened to our existing bankcard merchants who desire to add American Express Card acceptance, so that we will become their single point of contact for card processing.

While we will offer processing and support services to our bankcard merchants, American Express will retain the American Express Card acceptance contract with the merchants, continue to set merchant pricing, perform authorizations, and receive the same transactional information it currently receives.

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, 2007, 2006 and 2005, we processed payroll for 6,209, 4,216 customers and 2,664 customers, respectively.

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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 2007 and 2006, we installed 4,395 and 3,140 new payroll processing customers, respectively, compared to 1,117 new installs in 2005.

Our total merchants, which we define as bank card processing merchants plus payroll customers, increased to 160,959 at December 31, 2007 from 137,416 total merchants at December 31, 2006 and 113,164 total merchants at December 31, 2005.

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 has grown rapidly in recent years 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 $3.0 trillion in 2006, and are expected to grow to $4.8 trillion by 2011. From 2001 to 2006, the compound annual growth rate of card payments was 12%, but this rate is expected to decline to 10% for 2007 to 2011. 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 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 small- and medium-sized 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 small- and medium-sized merchant on a cost-effective basis or to provide sophisticated value-added services. Accordingly, services to the small- and medium-sized 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 small- and medium-sized 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: 79% 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.

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.

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Source: The Nilson Report

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

During the last decade, 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 small- and medium-sized 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 1,602 Relationship Managers, Servicing 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 and assessments 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 240 Servicing 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.

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 2007, approximately 85.5% of our bank card processing volume came from merchants we installed in 2006 and earlier.

Internal Growth

While many of our competitors in the payment processing industry have relied on acquisitions to expand their operations and improve their profitability, from 2001 through 2007 we have grown our business primarily through internal expansion by generating new merchant contracts submitted by our own direct sales force. Every merchant we currently process 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 are of a higher quality and are more predictable than contracts acquired from third parties, and the costs associated with such contracts are lower than the costs associated with contracts acquired from third parties.

Strong Position and Substantial Experience in Our Target Markets

As of December 31, 2007, we were providing payment processing services to approximately 154,750 active small- and medium-sized bank card merchants located across the United States. We believe our understanding of the needs of small- and medium-sized merchants 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

We have focused our sales efforts on 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 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. Although we have historically focused significant sales and marketing efforts on the restaurant industry, our 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.

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 2007, the restaurant industry represented approximately 38.8% of our bank card processing volume and 53.3% of our transactions. In December 2006 and December 2005, the restaurant industry represented approximately 40.3% and 40.2% of our bank card processing volume and 54.8% and 54.3% of our transactions, respectively. We believe that the restaurant industry will continue to represent a significant portion of our bank card processing volume as the industry continues to experience sales growth and we continue to generate new restaurant merchants. According to a report by the National Restaurant Association, restaurant industry sales are expected to reach approximately $558 billion in 2008, which would represent a 4% increase over projected industry sales for 2007 and the sixteenth consecutive year of growth. This steady growth profile, together with the industry s low seasonality, makes restaurant merchant bank card processing volume relatively stable and predictable.

Our historical focus on small- and medium-sized merchants has diversified our merchant portfolio and we believe has reduced the risks associated with revenue concentration. In 2007, no single merchant represented more than 0.44% of our total bank card processing volume. In 2006 and 2005, no single merchant represented more than 0.26% and 0.29% of our total bank card processing volume, respectively.

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 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 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, 2007, 2006 and 2005, approximately 75%, 64% and 53%, respectively, of our 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 bank card merchants to Passport during the second quarter of 2006. At December 31, 2007 and 2006, approximately 98% of total bank card merchants were processing on Passport. At December 31, 2007, our internally developed systems are providing substantially all aspects of a merchant s processing needs for most of our 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 0.54 basis points of bank card processing volume for each of the years ended December 31, 2007, 2006 and 2005, which we believe is significantly lower than industry norms.

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 small- and medium-size merchants in the United States. 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 grow our payroll processing business, and develop and add new payment 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 721 Relationship Managers as of December 31, 2005, to 952 and 1,117 Relationship Managers as of December 31, 2006 and 2007, 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 four to five years. Our sales model divides the United States into 5 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 small- and medium-sized merchant market through our direct sales force and alliances with local trade organizations, banks and value-added resellers. During 2006, according to The Nilson Report, we processed approximately 2.3% of the dollar volume of all Visa and MasterCard transactions in the United States, up from approximately 2.2% in 2005, 1.8% in 2004, 1.4% in 2003 and 1.1% in 2002. In December 2007, the restaurant industry represented approximately 38.8% of our bank card processing volume and 53.3% 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 bankcard 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 electrify 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.

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.

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, Servicing 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. A significant current initiative 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 Servicing 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 Servicing Managers to any problems a 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 grow 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 Debitek, Inc. and 2007 acquisition of General Meters Corp, are examples of expanding by acquiring complementary businesses. We may also consider portfolio acquisitions, especially from commercial banks, which, in an effort to focus on their core competencies, often sell or outsource their payment processing operations.

Our Services and Products

Bank Card Payment Processing

We derive the majority of our 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 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 merchants. Under our new agreement with American Express, our compensation from American Express will change for new merchants signed up to more closely resemble Visa and MasterCard in the second half of 2008.

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 prior years, we have arranged for certain of these services, particularly merchant accounting, clearing and settlement and a significant portion of our authorization and electronic draft capture services, to be performed by third-party processors (primarily TSYS Acquiring Solutions), while we performed the remaining services in-house. 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, 2007 and 2006, approximately 98% of our 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 Servicing 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, 2007, 2006 and 2005, approximately 75%, 64% and 53%, respectively, of our transactions were processed through HPS Exchange. The remainder of our front-end processing is outsourced to third-party processors, primarily TSYS, but also including First Data Corporation, Chase Paymentech Solutions and Global Payments Inc. Although we will continue to install new merchants on TSYS and other third-party processors systems, we anticipate that the percentage of 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 merchants 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.

Passport, our internally developed back-end system, enables us to customize these services to the needs of our merchants and Relationship Managers. For example, in January 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Commerce Bank, N.A., in July 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Bremer Bank and in December 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Heartland Bank (an unrelated third party). 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 merchants transaction data into various files for merchant accounting and billing purposes. We send our merchants detailed monthly statements itemizing daily deposits and fees, and summarizing activity by bank card type. These detailed statements allow our merchants to monitor sales performance, control expenses, disseminate information and track profitability. We also provide information related to exception item processing and various other information, such as volume, discounts, chargebacks, interchange qualification levels and funds held for reserves to help them track their account activity. Merchants may access this archived information through our customer service representatives or online through our intranet-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 2007 answered an average of approximately 303,000 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.

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 Payday card, which provides employees who may not have bank accounts with the opportunity to have 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 have implemented 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. Over 49% 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. As of December 31, 2007, 2006 and 2005, we provided payroll processing services to 6,209, 4,216 and 2,664 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 benefit from checks clearing a day faster and learning about return items as much as a week faster. 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 later 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 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 elements 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.

Sales

We sell and market our products and services to merchants through our sales force. As of December 31, 2007, we employed 1,602 Relationship Managers, Servicing 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 5 primary markets overseen by Executive Directors of Sales subdivided into 17 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, Servicing Managers and sales managers we employed by state as of December 31, 2007.

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 sales, 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 and assessments 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 and pricing are entered into an online margin calculator, which calculates the estimated annual gross margin on the account.

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 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 Servicing 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:

Signing Bonus		
Estimated Gross Margin for first 12 months	$ 1,000	
Signing bonus paid to:		
Relationship Manager	$ 500	50.0%
Division Manager	$ 125	12.5%
Regional Director	$ 31	3.125%
Residual Commission:		
Estimated monthly Gross Margin	$ 83.33	
Monthly residual commission paid to:		
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. For newly hired Relationship Managers, a 75% signing bonus may be paid upon signing a new merchant, but the Relationship Manager will not receive any residual commissions on that merchant s future processing.

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 created five specific Executive Director territories in the United States (South East, North East, South West/Central, Upper Mid-West / Great Lakes, 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 Servicing 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 Servicing Manager s compensation represents a shift of the 5% servicing portion associated with the merchants he or she is servicing and is paid to the Servicing Manager in the form of a base salary and bonus. We believe that the creation of the Servicing Manager role allows the Relationship Managers to leverage his or her sales efforts, while allowing us to offer merchants two local relationship contacts including a Servicing Manager who is more attuned to the merchants service needs. At December 31, 2007 and 2006, we had 240 and 224 Servicing Managers, respectively.

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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 sales persons 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, 2007, 2006 and 2005, our Board of Directors authorized and issued options to purchase an aggregate of 49,233, 112,878 and 455,381 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 2007 represented 15.6% of the total options awarded, in 2006 represented 53.1% of the total options awarded, and in 2005 represented 34.4% 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 46,700 as of December 31, 2007 and 42,700 as of December 31, 2006. In December 2007, the restaurant industry represented approximately 38.8% of our bank card processing volume and 53.3% of our transactions. In December 2006 and December 2005, the restaurant industry represented approximately 40.3% and 40.2% of our bank card processing volume and 54.8% and 54.3% 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.

Trade Associations

As of December 31, 2007, we had endorsement agreements with 130 trade associations, the majority of which are in the hospitality industry. Of these endorsements, over 30 are state restaurant associations and another 30 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 endorsement of our products and services, upon the installation of a new merchant that is a member of the association we pay 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 2007, several associations have migrated from that revenue sharing model to a business development model, under which we act as distribution for our association partner by selling their association memberships to our prospective merchants. In these cases, our Relationship Managers receive commissions for their successful sales efforts paid out of the first year membership dues paid to the association.

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. We currently provide these services to over 325 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 Commerce Bank (Cherry Hill, NJ), Heartland Bank (St. Louis, MO) and Bremer Bank (St. Paul, MN) providing for the conversion of their merchant processing customers onto our processing systems. 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 bankcard 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, 2007, we had arrangements with over 1,200 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 2007, 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.

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 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 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

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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. We entered into the agreement with KeyBank on April 1, 1999 and it expires in March 2009.

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. We expect to 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 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.

Our Merchant Base

While restaurants represent a significant portion of our merchant base, we also provide payment processing services to a wide variety of merchants, primarily those merchants whose typical customer is present when using a bank card to pay for products or services. As of December 31, 2007, we provided bank card payment processing services to approximately 154,750 active bank card merchant locations across the United States, an increase of 16.2% from the approximately 133,200 merchant locations as of December 31, 2006. We focus primarily on small- and medium-sized merchants, which we define 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.

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The following chart summarizes our processing volume by merchant category for the month of December 2007, compared to the months of December 2006 and December 2005.

No single merchant accounted for more than 0.44% of our total bank card processing volume in 2007, and during 2007, our top 25 merchants represented only 2.7% of our bank card processing volume and 2.5% of our gross processing revenue. In 2006 and 2005, no single merchant represented more than 0.26% and 0.29% of our total bank card processing volume, respectively. In both 2006 and 2005 our top 25 merchants represented only 2.6% and 2.9%, respectively, of our bank card processing volume and 2.3% and 2.6%, respectively, of our gross processing revenue.

In December 2007, merchants in California represented 12.9%, in New York represented 6.7%, in Texas represented 4.8%, in Florida represented 4.5%, in Colorado represented 4.4%, and in New Jersey represented 4.2% of our total 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 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

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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.

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 2007, 2006, and 2005, we experienced average annual attrition of 10% to 13% of our total bank card processing volume. Much of our attrition is related to business closures.

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 3 to 5 days while we evaluate the applicants financials, previous processing history and credit reports.

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. In 2007, 2006 and 2005, we experienced losses of no more than 0.54 basis points of our 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, analyzing average charge per transaction information or defining cash deposit/letter of credit requirements for new and existing merchants. Our underwriting department reports to our credit committee, consisting of Manager of Underwriting, Manager of Risk Review Management and Director of Core Support Group. Approval of a merchant by the credit committee is required for all higher risk merchant accounts, and either our CEO, CFO or Chief Portfolio Officer reviews all accounts with bank card processing volume that exceed certain thresholds. 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.

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, instructing a third party to retrieve, withhold or divert funds, verifying delivery of merchandise or even deactivating the merchant account.

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 most of our Internet merchants and newly established merchants who have not previously processed bankcards to allow for additional risk monitoring. As of December 31, 2007, these cash deposits and letters of credit totaled approximately $14.4 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 2007, 2006 and 2005 we spent $4.2 million, $2.5 million and $2.6 million, respectively, on capitalized software development costs. Many of the following systems are accessible over the Internet through 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 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 40% of our merchants, as of December 31, 2007, had signed up for this product. Merchant Center also provides similar information tools to our strategic relationships, such as trade associations, banks and value-added resellers.

Client Manager

Information regarding all of our interactions with our 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 all of our 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. As of December 31, 2007, approximately 79% of our merchants used HPS Exchange, and 84% of all merchant accounts established in 2007 were placed on the system. When a merchant uses HPS Exchange on certain hardware platforms, the resulting authorization speed 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 small- and medium-size 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, through further development, 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 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 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

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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 2007, 31% of all transactions processed through Exchange were TCP/IP based. These transactions represent a significantly lower overall cost to HPS, since no dial costs are incurred.

Passport

Our internally-designed back-end processing system, Passport, provides 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 bank card merchants to Passport in the second quarter of 2006. At December 31, 2007 and 2006, approximately 98%, respectively, of our bank card merchants were processing on Passport.

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 place significant emphasis on maintaining a high level of security in order 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.

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 response to potential security problems with payment processors systems, Visa and MasterCard have implemented new audit procedures to highlight and repair any security weaknesses in payment processors 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 have maintained our compliance to this standard and received recent confirmation of compliance to the standard in February 2007.

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.

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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 plan to leverage this alternate processing site and extend 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 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 NOVA Information Systems, Inc., a subsidiary of U.S. Bancorp, that serve a broad market spectrum from large to small merchants and 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.

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 small- and medium-size 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.

Intellectual Property

We own or are pursuing several patents with the United States Patent and Trademark Office. In addition, we own trademarks for Heartland Payday, Heartland Payment Systems, hLearning, HPS, Instaview, Heartland POS Gateway, Heartland Payment Systems The Highest Standards, Online Merchant Center, Passport and HPS Exchange and have trademark applications pending for, HPS Connect, HPS Web Connect, Merchant Bill of Rights, Instalert, Netselect, Online Merchant, Give Something Back Network, GSB Network, Heartland Give Something Back Network, Heartland Payment Systems the Highest Standards the Most Trusted Transactions and Secure Exchange. In connection with our January 2006 acquisition of Debitek, Inc., we acquired the rights to certain patents and trademarks, including the trademark for Debitek. We have agreed with Heartland Bank and Heartland Card Company that we will not license or contractually permit any third party to use the name Heartland in connection with any financial services business in the State of Missouri. 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, 2007, we employed 2,406 full- and part-time personnel, including 483 customer service, risk management, financial and operations support and underwriting employees, 98 systems and technology employees, 84 payroll services employees, 63 electronic cash systems employees, 76 accounting and administration employees and 1,602 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.

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

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 last recession, we experienced a slowdown in the rate of same-store sales growth and an increase in business 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. According to The Nilson Report, we accounted for approximately 2.3 % of the $1.9 trillion of total purchase volume (which we refer to as bank card processing volume) processed by all bank card acquirers in 2006. 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 Nova Information Systems, 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 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 $2.8 million, $1.9 million and $1.2 million in the years ended December 31, 2007, 2006 and 2005, 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.

Unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise, could expose us to liability and protracted and costly litigation.

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 significant incidents of 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 operations. In addition, a significant breach could result in our being prohibited from processing transactions for Visa and MasterCard.

Our computer systems could be penetrated 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.

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. During 2007, 2006, and 2005, we experienced average annual attrition of 10% to 13%. 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 and Heartland Bank, which has been a sponsor since December 2007. 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.

If we fail to comply with the applicable requirements of the Visa and MasterCard bank card networks, Visa or MasterCard could 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 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.

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. In addition, we are a sales agent for Discover and American Express. 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. Discover and American Express also sell processing services for their cardholders to merchants. 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 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 2007, merchants in California represented 12.9%, in New York represented 6.7%, in Texas represented 4.8%, in Florida represented 4.5%, in Colorado represented 4.4%, and in New Jersey represented 4.2% of our total 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 total bank card processing volume in December 2007.

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 1,117 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 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 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. To date, we have not acquired any significant companies or products. 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 1/2 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.

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 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:

- 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.

Risks Related to Our Company

Our executive officers, directors and principal stockholders have significant control over our business, which could lead to conflicts of interest with other stockholders and could limit your ability to influence corporate matters.

At December 31, 2007, our Chairman and Chief Executive Officer, Robert O. Carr, beneficially owned approximately 23.2% of our outstanding common stock. Mr. Carr and our other executive officers and directors collectively beneficially owned approximately 32.3% of our outstanding common stock. Greenhill Capital Partners, L.P. and its affiliated investment funds owned approximately 4.4% of our outstanding common stock. Two officers, directors, partners or members of Greenhill Capital Partners, L.P. and its affiliated investment funds are members of our Board of Directors. Accordingly, these stockholders, acting individually or together, will have significant influence over all matters requiring stockholder approval, including the election and removal of directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, these stockholders may dictate the day-to-day management of our business. This concentration of ownership could limit your ability to influence corporate matters and could have the effect of delaying, deferring or preventing a change in control, or impeding a merger or consolidation, takeover or other business combination or a sale of all or substantially all of our assets. In addition, the significant concentration of stock ownership may adversely affect the trading price of our common stock due to investors perception that conflicts of interest may exist or arise.

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, 2007, we had 37,989,622 shares of our common stock outstanding. In addition, as of December 31, 2007, we had outstanding options to purchase a total of 3,112,914 shares under our 2000 Incentive Stock Option Plan and our 2002 PEPShares Plan, of which 2,672,208 were vested. Assuming the exercise of all outstanding options to acquire our common stock, our current stockholders would own on a fully-diluted basis 92.4% 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. UNR ESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. PROPERTIES

At December 31, 2007, we owned one facility and leased nine 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. We are currently building an additional 125,000 square feet of multi-use space on the site of our Jeffersonville service center.

We also lease the following facilities as of December 31, 2007:

Location	Square Feet	Expiration
Alpharetta, GA	3,008	November 30, 2010
Chattanooga, Tennessee	9,461	January 31, 2009
Cleveland, Ohio	15,940	June 30, 2012
Colorado Springs, Colorado	11,958	June 30, 2008
Frisco, Texas	18,456	October 31, 2008
Jeffersonville, Indiana	64,351	between March 31, 2009 and April 30, 2009
Phoenix, Arizona	1,284	September 30, 2008
Plano, Texas	26,988	May 31, 2015

Each of these leases is renewable, except Frisco, Texas. The Frisco facility is being replaced by the Plano facility. The leased facility in Jeffersonville is being replaced by our new service center.

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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.

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ITEM 3. LEGAL PROCEEDINGS

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, 2007.

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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. Our common stock began trading on the New York Stock Exchange on August 11, 2005 in conjunction with our initial public offering. Prior to August 11, 2005, our common stock was not publicly traded. The following table sets forth the high and low sales prices of our common stock since August 11, 2005:

	High	Low
2005		
August 11, 2005 through September 30, 2005	$ 27.73	$ 22.20
October 1, 2005 through December 31, 2005	$ 26.50	$ 20.77
2006		
Quarter Ended:		
March 31, 2006	$ 25.62	$ 21.22
June 30, 2006	$ 29.90	$ 24.38
September 30, 2006	$ 29.02	$ 23.12
December 31, 2006	$ 29.44	$ 24.08
2007		
Quarter Ended:		
March 31, 2007	$ 29.01	$ 23.40
June 30, 2007	$ 29.60	$ 23.66
September 30, 2007	$ 33.00	$ 24.99
December 31, 2007	$ 33.00	$ 25.37

Holders of Common Stock

The number of shareholders of record of our common stock as of March 1, 2008 was 49.

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. The following table summarizes quarterly cash dividends declared and paid on our common stock:

Date Declared	Record Date	Date Paid	Amount Paid Per Common Share
Twelve Months Ended December 31, 2006:			
August 1, 2006	August 25, 2006	September 15, 2006	$ 0.025
November 2, 2006	November 24, 2006	December 15, 2006	$ 0.025
Twelve Months Ended December 31, 2007:			
February 12, 2007	February 23, 2007	March 15, 2007	$ 0.05
May 3, 2007	May 25, 2007	June 15, 2007	$ 0.05
July 30, 2007	August 24, 2007	September 15, 2007	$ 0.075
October 31, 2007	November 23, 2007	December 15, 2007	$ 0.075

On February 13, 2008, the Company s Board of Directors declared a quarterly cash dividend of $0.09 per share of common stock, payable on March 15, 2008 to stockholders of record as of February 28, 2008.

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. Amended and Restated 2000 Equity Incentive Plan under which shares of our common stock are authorized for issuance. For more information on this plan, see Note 13 to Notes to Consolidated Financial Statements. Information regarding the common stock issuable under this plan as of December 31, 2007 is set forth in the table below:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	3,092,161	$ 11.97	1,191,600
Equity compensation plans not approved by security holders	None	N/A	None
Total	3,092,161	$ 11.97	1,191,600

Purchases of Equity Securities

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. As of December 31, 2007, we had remaining authorization to purchase 1,307,300 shares of our common stock. 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.

The following table presents information with respect to those purchases of our common stock made during the three months ended December 31, 2007:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs
October 1 31, 2007				
November 1 30, 2007				
December 1 31, 2007	75,000	$ 27.54	75,000	1,307,300
	75,000	$ 27.54	75,000(a)	

(a) Total number of shares purchased as part of a publicly announced plan, since the announcement of that plan, were 1,792,700 shares at an average price of $24.48 per share.

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Stockholder Return Analysis

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

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 Ending*		
	08/10/05	**12/31/05**	**06/30/06**	**12/31/06**	**06/30/07**	**12/31/07**
Heartland Payment Systems, Inc.	100.00	120.33	154.89	157.23	163.88	150.48
S&P 500	100.00	102.39	105.17	118.57	126.82	125.08
S&P Information Technology Index	100.00	101.53	95.58	110.08	120.35	128.03

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ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth our selected historical consolidated financial information and other data for the years ended December 31, 2007, 2006, and 2005, which are derived from our consolidated financial statements included elsewhere in this report. Historical consolidated financial information for 2004 and 2003 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,				
	2007	2006	2005	2004	2003
	(in thousands, except per share data)				
Statement of Operations Data:					
Total revenues	$ 1,313,846	$ 1,097,041	$ 834,824	$ 602,851	$ 422,237
Costs of Services:					
Interchange	962,025	804,267	611,736	438,738	302,057
Dues and assessments	48,529	40,334	31,491	23,348	15,945
Processing and servicing	135,120	118,342	87,668	70,232	50,805
Customer acquisition costs	44,193	35,451	28,025	18,908	13,380
Depreciation and amortization	6,806	6,042	5,685	3,912	2,571
Total costs of services	1,196,673	1,004,436	764,605	555,138	384,758
General and administrative	57,404	47,787	37,761	31,501	25,751
Total expenses	1,254,077	1,052,223	802,366	586,639	410,509
Income from operations	59,769	44,818	32,458	16,212	11,728
Other income (expense):					
Interest income	1,934	1,225	477	80	124
Interest expense	(785)	(753)	(1,553)	(1,385)	(1,188)
Loss on cost basis investment	(1,650)				
Exit costs for Service Center	(1,267)				
Fair value adjustment for warrants with mandatory redemption provisions			(2,912)	(509)	(893)
Gain on settlement of financing arrangement			5,140		
Other, net	(841)	(669)	198	833	(740)
Total other income (expense)	(2,609)	(197)	1,350	(981)	(2,697)
Income before income taxes	57,160	44,621	33,808	15,231	9,031
Provision for income taxes	21,290	16,077	14,715	6,376	(11,102)
Net income	35,870	28,544	19,093	8,855	20,133
Income allocated to Series A Senior Convertible Participating Preferred Stock			(4,728)	(4,263)	(9,843)
Net income attributable to Common Stock	$ 35,870	$ 28,544	$ 14,365	$ 4,592	$ 10,290
Earnings per common share:					
Basic	$ 0.95	$ 0.78	$ 0.62	$ 0.28	$ 0.65
Diluted	$ 0.90	$ 0.71	$ 0.50	$ 0.26	$ 0.62
Weighted average number of common shares outstanding:					
Basic	37,686	36,394	23,069	16,408	15,932
Diluted	39,980	39,943	37,879	33,786	32,231

Cash dividends declared per common share	$ 0.25	$ 0.05			
Other Data:					
Number of active bank card merchants serviced (at period end)	155	133	110	89	67
Bank card processing volume for the period (in millions)	51,936	43,294	33,722	24,987	17,915

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	As of December 31,				
	2007	2006	2005 (in thousands)	2004	2003
Balance Sheet Data:					
Cash and cash equivalents	$ 35,508	$ 16,054	$ 8,724	$ 4,376	$ 8,105
Receivables, net	122,613	107,154	93,756	64,325	44,934
Total assets	329,189	251,768	183,685	133,926	100,742
Due to sponsor banks	49,798	27,253	34,530	45,153	34,225
Accounts payable	20,495	16,936	14,736	17,692	12,214
Total liabilities	163,520	112,475	103,634	127,827	98,656
Series A Senior Convertible Participating Preferred Stock (classified as mezzanine equity)					43,401
Total Stockholders Equity (Deficit)	165,669	139,293	80,051	6,099	(41,315)

ITEM 7. M ANAGEMENT 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 providing bank card-based payment processing services to merchants in the United States. As of December 31, 2007, we provided our payment processing services to approximately 154,750 active bank card merchants located across the United States. This represents a 16.2% increase over the 133,200 active bank card merchants at December 31, 2006. Our bank card processing volume for the year ended December 31, 2007 was $51.9 billion, a 20.0% increase from the $43.3 billion processed during the year ended December 31, 2006. For the years ended December 31, 2005 and 2004, our bank card processing volume was $33.7 billion and $25.0 billion, respectively.

We also provide payroll processing services throughout the United States. At December 31, 2007 we processed payroll for 6,209 customers, an increase of 47.3% from 4,216 payroll customers at December 31, 2006. Our total merchants, which we define as bank card processing merchants plus payroll customers, increased to approximately 160,959 at December 31, 2007. This represents a 17.1% increase over the 137,416 total merchants at December 31, 2006.

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 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 merchants. We completed converting substantially all of our merchants to Passport during the second quarter of 2006.

During the years ended December 31, 2007, 2006 and 2005, approximately 75%, 64% and 53%, respectively, of our transactions were processed through HPS Exchange, which has decreased our operating costs per transaction. At December 31, 2007 and 2006, approximately 98% of our active bank card 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. 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.

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Our bank card processing revenue is recurring in nature, as we typically enter into three-year service contracts with our bank 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 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 and assessment fees to Visa and MasterCard. Our business volume, and consequently gross processing revenue, is largely driven by the cumulative growth in the number of merchants with whom we have processing contracts. This in turn is the result of the number of merchants that we install during a period, offset by the number of merchants who cease processing with us during that period. We also generally benefit from consumers increasing use of bank cards in place of cash and checks.

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.

Significant increases in our sales force have led to significant growth in the number of total merchants for whom we process. Our sales managers are compensated based on their success in growing the sales force and increasing the total merchant base in their regions. Our number of total Relationship Managers grew from 721 at December 31, 2005 and 952 at December 31, 2006, to 1,117 at December 31, 2007. The number of total merchants installed during year ended December 31, 2007 grew by approximately 13.6% to 61,436 new merchants installed, compared to 54,099 new merchants installed during the year ended December 31, 2006 and 45,866 new merchants installed during the year ended December 31, 2005. We measure the production of our sales force by gross margin installed, which reflects the expected annual gross profit from a merchant contract after deducting processing and servicing costs associated with that revenue. In 2007, our installed gross margin increased 22.2% over 2006 levels, which in turn represented a 20.3% increase over 2005 levels. 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 merchant in its first year, growth in merchant accounts consumes significant capital, as it typically takes approximately one year s processing to cover the outlays for signing bonuses, commissions and payroll taxes.

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, was 3.0% on average in 2007, compared to growth of 4.2% on average in 2006 and 7.5% on average in 2005. Same store sales growth 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 experienced by our retained bank card merchants. The following table compares our same store sales growth for the 2007, 2006 and 2005 full years and by quarter during 2006 and 2007:

	Same Store Sales Growth
By Full Year	
2005 full year	7.5%
2006 full year	4.2%
2007 full year	3.0%
By Quarter	
2006 first quarter	7.1%
2006 second quarter	4.8%
2006 third quarter	3.5%
2006 fourth quarter	2.2%
2007 first quarter	3.4%
2007 second quarter	3.3%
2007 third quarter	3.6%
2007 fourth quarter	2.1%

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We attribute the relatively lower same store sales growth percentages we experienced in the 2007 and later 2006 quarters, as compared to the same store sales growth percentages that we experienced early in 2006 and during 2005, to a slowdown in the growth rate of retail sales, which was likely a result of the impacts of higher energy costs and interest rates and more recently a weak housing market and tightening credit on the economy.

2007 Financial Highlights

For 2007, we recorded net income of $35.9 million, or $0.90 per diluted share, increases of 25.7% and 26.8%, respectively, from $28.5 million, or $0.71 per diluted share, in 2006. 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 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. Net income for 2006 included the impacts of a $1.5 million pre-tax write off of purchased software, partially offset by a $0.8 million pre-tax gain for the proceeds received from a legal settlement. The following is a summary of our financial results for 2007:

- During 2007, we installed 57,041 new bank card merchants, including 47,845 on HPS Exchange, which increased the number of active bank card merchants we service to 154,750 at December 31, 2007, an increase of 16.2% over the number of bank card merchants we serviced at December 31, 2006.

- Installed margin increased by 22.2% over 2006, reflecting growth of 21.8% in card processing margin and 29.9% in payroll processing margin.

- Bank card processing volume during 2007 increased 20.0% to $51.9 billion from $43.3 billion during 2006.

- Net revenue, which we define as total revenues less interchange fees and dues and assessments, increased 20.1% to $303.3 million during 2007 from $252.4 million during 2006. The increase in net revenue was driven by the increases in active merchants and processing volume per merchant.

- Our processing and servicing costs for 2007 decreased to 10.3% of our total revenues, from 10.8% of total revenues for 2006.

- Our income from operations, which we also refer to as operating income, grew to $59.8 million for 2007 from $44.8 million for 2006. 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 effective income tax rate for 2007 was 37.2%, which compares to an effective tax rate of 36.0% for 2006. In the third quarter of 2006 we analyzed the approaches we applied for sourcing taxable income to individual states and revised our state income sourcing approaches in certain states. As a result, we realized reductions of our 2005 state income tax expense and our 2006 estimated effective annual state tax rates. We recorded the resulting total state tax benefit of $1.5 million in the third quarter of 2006, of which $0.5 million related to 2005 and $1.0 million related to the nine months ended September 30, 2006, including $0.4 million for the third quarter of 2006.

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 and periodic (primarily monthly) fees from the processing of bank card transactions, primarily Visa and MasterCard transactions, for merchants. 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, 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.

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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. 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 and assessments, which are calculated as a percentage of the dollar volume processed. Interchange fees and dues and assessments 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 and assessments. 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 sponsor, or represent the cost of our own authorization/capture and accounting/settlement systems. During 2007, third party costs represented about 65% of our processing costs, with internal costs representing the remainder. During 2006, third party costs represented about 74% of our processing costs, compared to 75% during 2005. Approximately 55%, 59% and 76%, respectively, of our third-party processing costs in 2007, 2006 and 2005 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;

- 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, the gains or losses on the disposal of property, plant and equipment and other non-recurring 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

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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.

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 and payroll processing relationships, and (2) deferred acquisition cost representing the estimated cost of buying out the commissions on merchant relationships of vested salespersons at some point in the future. Pursuant to Staff Accounting Bulletin Topic 13, *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 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 bank card merchant and payroll processing accounts is based on the estimated gross margin for the first year of the merchant contract. The gross signing bonuses paid during 2007, 2006 and 2005 were $43.6 million, $32.6 million and $24.4 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 2007, 2006 and 2005 were $1.1 million, $1.1 million and $(2.6) million, respectively. Negative signing bonus adjustments result from the prior overpayment of signing bonuses, which are recovered from the relevant salesperson. The amount of signing bonuses paid which remained subject to adjustment at December 31, 2007 and 2006 was $41.8 million and $31.3 million, respectively.

The deferred acquisition cost component is accrued 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 2007, 2006 or 2005.

Accrued Buyout Liability

We pay our salespersons residual commissions based on the gross margin generated from the monthly card processing activity of merchants signed by them. A portion, typically 25% of the residual commissions we owe to the salesperson, is deemed to be a servicing fee and is not accrued as a liability. For the remainder of their residual commissions (referred to as the owned portion of such commissions, or portfolio equity) the salesperson has no obligation to perform services and will receive commissions as 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 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, 2007 and 2006.

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 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 2007, 2006 and 2005, we made buyout payments of approximately $8.8 million, $10.7 million and $13.5 million, respectively. Included in the $13.5 million of buyout payments in 2005 was $3.8 million used by salespersons who participated in the PEPShares Plan to exercise their options to acquire 677,544 shares of our common stock. We expect to make significant buyout payments in the future, subject to cash availability, as such buyouts reduce the monthly payments we will have to make to our salespersons for such merchants in the future.

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, 2007 and 2006, we held merchant deposits totaling $14.1 million and $7.7 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, 2007 and 2006, our loss reserve totaled $663,000 and $468,000, respectively. Aggregate merchant losses, including losses charged to operations and the loss reserve, were $2.8 million, $1.9 million and $1.2 million for 2007, 2006 and 2005, respectively.

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-

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transition 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.

We estimate the grant date fair value of the stock options we issue using a Black-Scholes valuation model. We determine an expected volatility assumption by referencing the average volatility experienced by six of our public company peers. We used an average of a peer group because we do not have sufficient historical volatility data related to market trading of our own common stock. We estimate the expected life of a stock option based on the simplified method for plain-vanilla stock options 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. 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 2007, 2006 and 2005 were $7.64, $9.25 and $5.48, respectively. The fair value of options granted during 2007, 2006 and 2005 was estimated at the grant date using the following weighted average assumptions:

	2007	**2006**	**2005**
Expected volatility	31%	41%	50%
Expected life	2.5 to 3.75 years	2.5 to 3.75 years	3 years
Dividends	0.90%	0.40%	0.00%
Risk-free interest rate	4.29%	4.79%	3.73%

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, 2007, 2006 and 2005 with respect to share-based compensation plans were as follows (in thousands):

	Year Ended December 31,		
	2007	**2006**	**2005**
Compensation expense recognized on share-based plans before income tax benefit	**$ 1,747**	$ 1,323	$
Related income tax benefit recognized in the income statement	**651**	320	
Cash received from stock option exercises	**9,955**	27,658	8,953
Excess tax benefit recorded for tax deductions resulting from the exercise of stock options	**7,623**	28,603	
Tax benefit realized as reductions of estimated tax payments during the period	**23,232**	10,775	

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 $7.6 million and $28.6 million, respectively, related to excess tax benefits from share-based awards in the years ended December 31, 2007 and 2006. We 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, and $10.8 million as reductions of estimated income tax payments during the year ended December 31, 2006. 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.

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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

The following table presents the effects on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for share-based compensation under SFAS No. 123 for the year ended December 31, 2005 (in thousands, except per share data):

Net income	$ 19,093
Deduct: Total share-based employee compensation expense determined under fair value-based method, net of related tax expense	4,747
Pro forma net income	14,346
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock	3,430
Pro forma net income attributable to common stock	$ 10,916
Earnings per share:	
As reported:	
Basic	$ 0.62
Diluted	$ 0.50
Pro forma:	
Basic	$ 0.47
Diluted	$ 0.38

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 $1.2 million of total gross unrecognized tax benefits as of December 31, 2007, approximately $0.8 million of which would impact the effective tax rate. The Company expects the amount of unrecognized tax benefits to decrease approximately $0.2 million within 12 months of the reporting date due to the completion of state tax audits.

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Results of Operations

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	Change %
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 and assessments	**48,529**	**3.7%**	40,334	3.7%	8,195	20.3%
Processing and servicing	**135,120**	**10.3%**	118,342	10.8%	16,778	14.2%
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)		(2,412)	(1224.4)%
Income before income taxes	**57,160**	**4.3%**	44,621	4.1%	12,539	28.1%
Provision for income taxes	**21,290**	**1.6%**	16,077	1.5%	5,213	32.4%
Net income	**$ 35,870**	**2.7%**	$ 28,544	2.6%	$ 7,326	25.7%

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, 2007	2006	Change from Prior Year 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%
Total Revenues	**$ 1,313,846**	$ 1,097,041	$ 216,805	19.8%

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.

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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 Debitek, 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 and assessments increased 20.3% from $40.3 million in 2006 to $48.5 million in 2007, also as the result of increased bank card processing volume. Dues and assessments were 3.7% of total revenues in both 2007 and 2006.

Net revenue, which we define as total revenues less interchange fees and dues and assessments, increased 20.1% from $252.4 million in 2006 to $303.3 million in 2007.

Processing and servicing expense for 2007 increased by $16.8 million, or 14.2%, 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 servicing managers, and depreciation and amortization.

As a percentage of total revenue, processing and servicing expense decreased to 10.3% in 2007 compared with 10.8% 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 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.

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)
Total Customer Acquisition Costs	**$ 44,193**	$ 35,451

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

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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.

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.

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

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

The following table shows certain income statement data as a percentage of revenue for the year ended December 31, 2006 compared to the year ended December 31, 2005 (in thousands of dollars):

					Change	
	2006	**% of Total Revenue**	**2005**	**% of Total Revenue**	**Amount**	**%**
Total Revenues	**$ 1,097,041**	**100.0%**	$ 834,824	100.0%	$ 262,217	31.4%
Costs of Services:						
Interchange	**804,267**	**73.3%**	611,736	73.3%	192,531	31.5%
Dues and assessments	**40,334**	**3.7%**	31,491	3.8%	8,843	28.1%
Processing and servicing	**118,342**	**10.8%**	87,668	10.5%	30,674	35.0%
Customer acquisition costs	**35,451**	**3.2%**	28,025	3.4%	7,426	26.5%
Depreciation and amortization	**6,042**	**0.6%**	5,685	0.7%	357	6.3%
Total costs of services	**1,004,436**	**91.6%**	764,605	91.6%	239,831	31.4%
General and administrative	**47,787**	**4.4%**	37,761	4.5%	10,026	26.6%
Total expenses	**1,052,223**	**96.0%**	802,366	96.1%	249,857	31.1%
Income from operations	**44,818**	**4.1%**	32,458	3.9%	12,360	38.1%
Other income (expense):						
Interest income	**1,225**	**0.1%**	477	0.1%	748	156.8%
Interest expense	**(753)**	**(0.1)%**	(1,553)	(0.2)%	800	(51.5)%
Fair value adjustment for warrants with mandatory redemption provisions			(2,912)	(0.3)%	2,912	100.0%
Gain on settlement of financing arrangement			5,140	0.6%	(5,140)	(100.0)%
Other, net	**(669)**		198		(867)	(437.9)%
Total other (expense) income	**(197)**	**0.0%**	1,350	0.2%	(1,547)	(114.6)%
Income before income taxes	**44,621**	**4.1%**	33,808	4.0%	10,813	32.0%
Provision for income taxes	**16,077**	**1.5%**	14,715	1.8%	1,362	9.3%
Net income	**$ 28,544**	**2.6%**	$ 19,093	2.3%	$ 9,451	49.5%

Total Revenues. Total revenues increased 31.4% from $834.8 million in 2005 to $1,097.0 million in 2006, primarily as a result of a 29.7% increase in our gross card processing revenue from $825.9 million in 2005 to $1,071.0 million in 2006. Our bank card processing volume for 2006 increased 28.4% to $43.3 billion, compared to $33.7 billion for 2005. The increases in gross processing revenue and bank card processing volume were primarily attributable to a net increase in bank card merchant accounts, with the number of bank card merchant accounts growing by approximately 20.5% from 110,500 as of December 31, 2005 to 133,200 as of December 31, 2006. The increase in new bank card merchant accounts during this period 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.

Total revenues also include payroll processing fees and equipment-related income. Payroll processing fees increased by 39.4% from $4.6 million in 2005 to $6.4 million in 2006 primarily due to the 58.3% increase in the number of payroll processing customers from 2,664 at December 31, 2005 to 4,216 at December 31, 2006.

Equipment-related income increased by $15.4 million, from $4.3 million in 2005 to $19.7 million in 2006, primarily due to the increase in the number of new card processing merchants installed and $6.3 million of revenues contributed by Debitek, which we acquired as of January 1, 2006.

Costs of services. Costs of services increased 31.4% from $764.6 million in 2005 to $1,004.4 million in 2006, due primarily to an increase in interchange fees. Costs of services represented 91.6% of total revenues in both 2006 and 2005.

Interchange fees increased 31.5% from $611.7 million in 2005 to $804.3 million in 2006 and represented 73.3% of total revenues in both 2006 and 2005. In addition to increasing due to higher bank card processing volume and April 1, 2005 increases in interchange fees charged by issuing banks, interchange expense for 2006 increased by $2.0 million reflecting a first quarter of 2006 change in our estimate of the amount

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of on-line debit interchange expense we accrue. The change in estimate was based on new information which became available to us. Interchange expense in 2006 also included interchange adjustments we paid to our bank card merchants resulting from our conversion to Passport.

Dues and assessments increased 28.1% from $31.5 million in 2005 to $40.3 million in 2006 also as the result of increased bank card processing volume. As a percentage of total revenue, dues and assessments declined from 3.8% in 2005 to 3.7% in 2006.

Net revenue, which is defined as total revenues less interchange fees and dues and assessments, increased 31.8% from $191.6 million in 2005 to $252.4 million in 2006.

Processing and servicing expense for 2006 increased by $30.7 million, or 35.0%, compared with 2005. The increase in processing and servicing expense was due primarily to (i) costs associated with increased bank card processing volume, (ii) increases in the cost of bank card terminals, prepaid card and stored value hardware deployed (including $3.9 million for the costs of Debitek equipment deployed), (iii) a $6.0 million increase in residual commission payments to our salespersons related to their portion of the growth in our gross margin, and (iv) increases in the costs of operating our service center, particularly the costs of support personnel and depreciation and amortization. As a percentage of total revenue, processing and servicing expense was 10.8% for 2006 compared with 10.5% for 2005. The increase in processing and servicing as a percentage of total revenue for 2006 was driven by the costs of bank card terminals, prepaid card and stored value hardware deployed and the inclusion of service center depreciation and amortization, and was partially mitigated 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 64% of our total processing transactions during 2006 compared to 53% during 2005. We expect the increasing share of HPS Exchange in our total bank card merchant base to continue in the future. As of May 1, 2006, our conversion to our internally developed back-end processing system, Passport, was substantially complete. We expect to realize the lower cost benefits of processing on Passport in future periods. Included in processing and servicing expense was $1.7 million of payroll processing costs in 2006, which increased 48.3% from 2005. The increase in payroll processing costs included $574,000 for commission payments to our salespersons.

Customer acquisition costs increased 26.5% from $28.0 million in 2005 to $35.5 million in 2006. Customer acquisition costs include net amortization of signing bonuses, which increased from $14.7 million in 2005 to $22.9 million in 2006, and amortization of capitalized customer deferred acquisition costs, which grew from $10.0 million in 2005 to $12.9 million in 2006. Increases in new merchant account installations and the related bank card processing volume were primarily responsible for the increases in the amortization of both signing bonuses and capitalized customer deferred acquisition costs.

Depreciation and amortization expenses increased 6.3% from $5.7 million in 2005 to $6.0 million in 2006. 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 decreased from $2.6 million in 2005 to $2.5 million in 2006. The total amount of capitalized projects placed in service in 2006 and 2005 was $1.7 million and $2.8 million, respectively. Beginning January 1, 2006, depreciation and amortization expense associated with our servicing center was included in processing and servicing expense. For 2006, service center related depreciation and amortization expense was $1.5 million.

General and administrative. General and administrative expenses increased 26.6% from $37.8 million in 2005 to $47.8 million in 2006. The increase was primarily due to added costs necessary to continue building our corporate, information technology and marketing infrastructure to support our growth.

Also contributing to the increase in general and administrative expenses in 2006 was $1.2 million we paid for matching payroll tax expense related to gains employees realized on their exercise of non-qualified stock options, $2.3 million of general and administrative expenses incurred by Debitek, and $1.3 million for SFAS No. 123R share-based compensation expense. General and administrative expenses as a percentage of total revenue declined from 4.5% for 2005 to 4.4% for 2006, as revenue growth outpaced the increase in general and administrative expenses. Our payroll operation s general and administrative expenses increased by 44.7% from $2.1 million in 2005 to $3.1 million in 2006.

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Income from operations. For the reasons described above, our income from operations, which we also refer to as operating income, improved from $32.5 million for 2005 to $44.8 million for 2006. Our operating margin, which is measured as operating income divided by net revenue, was 17.8% for 2006, compared to 16.9% for 2005. 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 $477,000 in 2005 to $1.2 million in 2006, due primarily to an increase in the amount of cash available for investment and higher interest rates.

Interest expense. Interest expense decreased from $1.6 million in 2005 to $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. In August 2005, we began using a portion of our available cash to fund these advances. 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. The payable to the sponsor bank is repaid at the beginning of the following month out of the processing fees we collect from our bank card merchants. Interest expense in 2005 also included $107,000 of interest expense recorded on a revolver advance facility and line of credit which we paid off in August 2005 using proceeds from our initial public offering.

Fair value adjustment for warrants with mandatory redemption provisions. We recognized expense of $2.9 million during 2005 to adjust the warrants carrying value to $26.51 per share, the closing price of our common stock on the day prior to the exercise of the warrants. The warrants were exercised on August 16, 2005.

Gain on settlement of financing arrangement. On September 23, 2005, we reacquired the remaining 2,400 merchant contracts we had previously transferred to Certegy Inc. in a transaction accounted for as a financing arrangement. We made a cash payment of $3.0 million, fully extinguishing our obligations under the financing arrangement. The outstanding balance of this financing arrangement at the time of extinguishment was $8.1 million, resulting in a pre-tax gain on the settlement of a financing arrangement of $5.1 million in 2005.

Other, net. Other expense of $669,000 was recorded in 2006, compared to other income of $198,000 in 2005. Other expense in 2006 primarily reflected a $1.5 million write off of purchased software as well as a $0.8 million gain from the proceeds received from a legal settlement in the first quarter of 2006. Other income in 2005 primarily related to a cash settlement we received in connection with a lawsuit against an equipment supplier.

Income Tax. Income taxes for 2006 were $16.1 million reflecting an effective tax rate of 36.0%. This represented a reduction from an effective tax rate of 43.5% for 2005, which resulted in income tax expense of $14.7 million. The reduction in the effective tax rate was due to revising state income sourcing approaches in the third quarter of 2006 and the impact of the fair value adjustment for warrants included in 2005. 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 $19.1 in 2005 to $28.5 million in 2006.

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Balance Sheet Information

	December 31, 2007	December 31, 2006
	(in thousands)	
Selected Balance Sheet Data		
Cash and cash equivalents	**$ 35,508**	$ 16,054
Funds held for payroll customers	**24,201**	16,960
Receivables, net	**122,613**	107,154
Current tax asset	**5,449**	19,227
Capitalized customer acquisition costs, net	**70,498**	56,705
Property and equipment, net	**50,248**	23,135
Total assets	**329,189**	251,768
Due to sponsor bank	**49,798**	27,253
Accounts payable	**20,495**	16,936
Deposits held for payroll customers	**24,201**	16,960
Accrued buyout liability:		
Current portion	**11,521**	11,519
Long term portion	**26,252**	21,774
Total liabilities	**163,520**	112,475
Total stockholders equity	**165,669**	139,293

December 31, 2007 Compared to December 31, 2006

Total assets increased $77.4 million, or 30.8%, to $329.2 million at December 31, 2007 from $251.8 million at December 31, 2006, primarily due to increases in cash and cash equivalents, receivables, funds held for payroll customers, capitalized customer acquisition costs, and property and equipment, net. Cash and cash equivalents increased by $19.5 million or 121.2% as the result of cash flow from operations (see Liquidity and Capital Resources for more detail).

Funds held for payroll customers increased $7.2 million, or 42.7%, to $24.2 million at December 31, 2007 from $17.0 million at December 31, 2006 due to increased tax escrow funds generated in our payroll processing activities. Our liability for deposits held for payroll customers increased by the same amount. At December 31, 2007, we processed payroll for 6,209 customers, an increase of 47.3% over the 4,216 payroll customers at December 31, 2006.

Our receivables primarily result from our practice of advancing interchange fees to most of our merchants during the processing month and collecting those fees from our merchants at the beginning of the following month. We use our available cash to fund a portion of the advances of interchange fees to our merchants; then, as our available cash has been expended, we direct our sponsor banks to make the advances, thus generating a payable to our sponsor banks. At December 31, 2007 and December 31, 2006, we used $37.9 million and $44.6 million, respectively, of our available cash to fund merchant advances. The amount due to our sponsor bank for funding advances was $49.8 million at December 31, 2007 and $27.3 million at December 31, 2006. The payable to our sponsor bank is repaid at the beginning of the following month out of the fees we collect from our merchants. Our total receivables increased $15.5 million, or 14.4%, to $122.6 million at December 31, 2007 from $107.2 million at December 31, 2006 mostly due to higher monthly bank card processing volume in December 2007. For the month of December 2007, our processing volume was $4.7 billion, compared to $4.1 billion of processing volume in the month of December 2006.

Capitalized customer acquisition costs increased $13.8 million, or 24.3%, from December 31, 2006 as a result of increases in the number of merchants we service. Property and equipment increased $27.1 million, or 117.2%, primarily due to spending $25.6 million during 2007 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. As of December 31, 2007, all but our processing equipment deployment group has exited the former leased service center, also in Jeffersonville. We are currently building an additional 125,000 square feet of multi-use space on the site of our new service center. We also continued building our technology infrastructure, primarily hardware and software needed for the expansion of HPS Exchange and Passport.

Our current tax asset was $5.4 million at December 31, 2007, a decrease of $13.8 million from December 31, 2006. The decrease was primarily due to the tax liability we recorded for our income tax provision during 2007, the realization of $11.4 million as reductions of estimated tax payments made during 2007 and $11.8 million of tax refunds we received in 2007 from the recapture of income taxes paid in 2005. Partially offsetting these decreases were tax benefits of $7.6 million we recorded as the result of employee stock option exercises during 2007. These tax benefits reflect tax deductions which accrued to us when our employees exercised non-qualified stock options and made disqualifying dispositions of shares acquired through the exercise of incentive stock options.

Total stockholders equity increased $26.4 million from December 31, 2006 primarily due to our net income of $35.9 million recorded for 2007, proceeds received from the exercise of employee stock options, which amounted to $10.0 million, and tax benefits recorded in additional-paid-in capital related to employees exercise of stock options and related tax benefits, which contributed $7.6 million. Stockholders equity was reduced by $18.9 million for the cost of purchasing 731,500 treasury shares, and $9.4 million for dividends declared on common stock.

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 servicing 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 infrastructure. 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. 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 provides us with a ready customer base of colleges and universities for our campus card product. General Meters will be combined with our subsidiary Debitek Inc., which we acquired in February 2006. We acquired Debitek, a prepaid card and stored-value card solutions provider, for a net cash payment of $3.5 million. The acquisition of Debitek provides us with a proven platform in the stored-value and prepaid cards market, particularly with respect to small-dollar payment applications. These acquisitions are not expected to have a material impact on earnings in the near term.

Our cash needs are funded primarily by cash flow from our operating activities and our agreement with our sponsor bank to fund merchant advances. We believe that our current cash and investment balances, cash generated from operations and our agreement with our sponsor bank to fund merchant advances will provide sufficient liquidity to meet our anticipated needs for capital for at least the next twelve months, and currently anticipate no liquidity challenges over a longer term. On September 5, 2007, we entered into a credit agreement with JPMorgan Chase Bank, N.A., as administrative agent, and certain lenders to create a revolving credit facility. We can use this revolving credit facility to finance our new service center, acquisitions, our other working capital needs and for general corporate purposes. See Revolving Credit Facility for more details.

At December 31, 2007, we had cash and cash equivalents totaling $35.5 million, compared to cash and cash equivalents of $16.1 million at December 31, 2006 and $8.7 million at December 31, 2005.

Our working capital, defined as current assets less current liabilities, was positive at December 31, 2007, 2006 and 2005. At December 31, 2007, our positive working capital was $62.4 million. Each funding source and use is described in more detail below.

Cash Flow (Used in) Provided by Operating Activities. We reported net cash provided by operating activities of $72.6 million in 2007, compared to net cash used in operating activities of $3.9 million in 2006 and $26.0 million in 2005.

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Our reported cash flow from operating activities for both periods 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 cash outflow from operating activities. In 2007 and 2006, our operating cash flow was reduced by the classification of $7.6 million and $28.6 million, respectively, of excess tax benefits as cash inflow from financing activities.

The following table presents the components of our cash flow from operating activities for 2007, 2006 and 2005 including reductions for the amounts of tax benefits actually realized for excess tax benefits generated. The amounts actually realized were $23.2 million and $10.8 million, respectively, in 2007 and 2006. These reductions of our income tax payments would have been classified as a cash outflow from operating activities and a cash inflow from financing activities under the previous cash flow presentation requirements of APB No. 25. Before reducing our cash flows from operating activities for the $7.6 million and $28.6 million current tax receivables generated by excess tax benefits during 2007 and 2006, and including a reduction for the $23.2 million and $10.8 million, respectively, of realized income tax benefits in 2007 and 2006, our cash flow from operations in 2007 and 2006 would have been positive $57.0 million and $14.0 million, respectively. The remaining current tax asset is expected to be recovered as reductions of future period estimated tax payments.

	Year Ended December 31,		
	2007	**2006**	**2005**
		(in thousands)	
Net income	**$ 35,870**	$ 28,544	$ 19,093
Adjustments for non-cash items included in net income:			
Amortization and depreciation	**53,807**	43,380	30,331
Addition to loss reserve	**3,035**	1,970	1,235
Provision for losses on receivables	**1,249**	628	173
Share-based compensation	**1,747**	1,323	
Deferred taxes	**1,020**	(351)	1,811
Other non-cash items included in net income, net	**3,212**	1,754	(2,195)
Adjustments for changes in operating assets and liabilities:			
Payment of signing bonuses, net	**(44,700)**	(33,743)	(21,788)
Payouts of accrued buyout liability	**(8,806)**	(10,664)	(13,481)
Excess tax benefits realized as reductions of actual estimated tax payments	**(23,232)**	(10,775)	
Other changes in operating assets and liabilities, net	**33,780**	(8,089)	(41,143)
Cash flow from operating activities before deduction of the current receivable for excess tax benefits	**56,982**	13,977	(25,964)
Less:			
Decrease (increase) in current receivable for excess tax benefits	**15,609**	(17,828)	
Net cash provided by (used in) operating activities	**$ 72,591**	$ (3,851)	$ (25,964)

We experienced negative cash flow from operating activities in 2005 because we used approximately $32.3 million of the cash proceeds we received from our initial public offering, which was cash provided by a financing activity, to fund advances of interchange fees to our merchants and to pay down our payable to our sponsor bank, both of which derive from an operating activity as described below.

Key sources of operating cash flows were our net income as adjusted for depreciation and amortization, additions to loss reserves, share-based compensation expense, and deferred taxes. Other major determinants of operating cash flow 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 $44.7 million, $33.7 million and $21.8 million, respectively, were paid in 2007, 2006 and 2005. In 2007, 2006 and 2005, we reduced the accrued buyout liability by making buyout payments of $8.8 million, $10.7 million and $13.5 million, respectively. Included in the $13.5 million of buyout payments in 2005 was $3.8 million used by salespersons who participated in the PEPShares Plan to exercise their options to acquire 677,544 shares of our common stock.

Contained within other changes in operating assets and liabilities are the changes in our receivables and due to sponsor banks. We use our available cash to fund a portion of the advances of interchange fees we make to our merchants. Advances of interchange fees, which generate a receivable from our merchants, are funded first from our available cash, then by incurring a payable to our sponsor bank 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. During 2007, our receivables, including those from merchants, increased $16.7 million, while we increased our due to sponsor banks by $22.5 million. All other operating assets and liabilities generated a net increase in operating cash of $6.8 million in 2007. During 2006, our receivables from merchants increased $12.4 million and we reduced our due to sponsor banks by $7.3 million. All other operating assets and liabilities generated a net increase in operating cash of $1.2 million in 2006.

Cash Flow Used in Investing Activities. Net cash used in investing activities was $42.3 million in 2007, compared to $17.9 million in 2006 and $12.3 million in 2005. During each period, we used cash to fund capital expenditures. Total capital expenditures for 2007 were $34.2 million, compared to $14.0 million invested in 2006 and $12.3 million invested in 2005. The increase in capital expenditures was primarily related to construction of our new Service Center facility, which commenced in 2006 and completed Phase I in December 2007. During 2007 and 2006, we spent cash of $24.5 million and $5.9 million, respectively, on our new Service Center. 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. We anticipate that these expenditures will continue near current levels as we further develop our technology.

In January 2006, we made a $0.5 million investment in convertible preferred stock issued by Parcxmart Technologies, Inc. (Parcxmart) and in June 2007, we made an additional investment of $1.2 million in Parcxmart convertible preferred stock. In December 2007, due to significant concerns about Parcxmart 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.

In February 2006, we acquired Debitek, Inc. for a net cash payment of $3.5 million. In October 2007, we acquired General Meters Corporation for a cash payment of $6.0 million.

In addition, our subsidiary, Heartland Payroll Company, has invested a portion of the funds it holds for payroll customers in securities that are classified as investments available for sale. We invest in short-term bond funds and directly in federal, federal agency or corporate debt obligations with maturities of up to four years and no less than a Baa rating or in short-term fixed income mutual funds.

Cash Flow (Used in) Provided By Financing Activities. Net cash used in financing activities was $10.9 million in 2007, compared to net cash provided by financing activities of $29.1 million in 2006 and $42.7 million in 2005. Cash flow from financing activities in 2007 was negative primarily because we used cash to repurchase our common stock. See Common Stock Repurchases for more information on our common stock repurchases authorization. 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.

Net cash provided by financing activities for 2005 was favorably impacted by the net cash proceeds of $41.7 million we received at the closing of our initial public offering on August 16, 2005.

During 2007 and 2006, employees exercised stock options generating cash in the aggregate amount of $10.0 million and $27.7 million, respectively. Offsetting the cash provided from employees exercise of stock options in 2007 and 2006 was the use of $18.9 million and $25.0 million of cash to repurchase 731,500 shares and 1,061,200 shares, respectively, of our common stock. See Common Stock Repurchases for more information. During 2005, employees exercised their stock options and PEPShares Plan options generating cash in the aggregate amount of $9.0 million.

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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.

Financing cash activities for both periods 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 2007 and 2006, we reported as a financing cash inflow, $7.6 million and $28.6 million, respectively of excess tax benefits resulting from employees exercising stock options. We actually realized tax benefits of $23.2 million and $10.8 million, respectively, in 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.

During 2007, 2006, and 2005, we paid down financing arrangements and borrowings in the amounts of $174,000, $261,000 and $7.5 million, respectively. In 2005, we made cash payments of $3.0 million to reacquire 2,400 merchant contracts and fully extinguish our obligations under a related financing arrangement and $2.9 million to repay credit facilities.

On January 8, 2004, a warrant holder elected to exercise their put option, and we redeemed half of the holder s warrants, or 168,906 shares, at the deemed fair value of $6.25 per share. The exercise price of the warrants was $0.005 per warrant and net consideration paid by us was $1.1 million in 2004. On August 16, 2005, the closing date of our initial public offering, the warrant holder exercised its rights to acquire the remaining 168,904 shares at the exercise price of $0.005 per share.

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 2,000,000. The Board of Directors authorized management to purchase up to 1,000,000 shares at purchase prices within management s discretion. 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 1,792,700 shares of our common stock during 2007 and 2006 at a cost of $43.9 million, or $24.48 per share. At December 31, 2007, we have remaining authorization to repurchase up to 1,307,300 additional shares of our common stock. During 2007, we repurchased 731,500 shares of our common stock for $18.8 million, an average per share cost of $25.78. During 2006, we repurchased 1,061,200 shares of our common stock for $25.0 million, an average per share cost of $23.59.

In 2005 we repurchased 22,000 shares of our common stock at a cost of $0.5 million.

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:

Date Declared	Record Date	Date Paid	Amount Paid Per Common Share
Twelve Months Ended December 31, 2006:			
August 1, 2006	August 25, 2006	September 15, 2006	$ 0.025
November 2, 2006	November 24, 2006	December 15, 2006	$ 0.025
Twelve Months Ended December 31, 2007:			
February 12, 2007	February 23, 2007	March 15, 2007	$ 0.05
May 3, 2007	May 25, 2007	June 15, 2007	$ 0.05
July 30, 2007	August 24, 2007	September 15, 2007	$ 0.075
October 31, 2007	November 23, 2007	December 15, 2007	$ 0.075

On February 13, 2008, our Board of Directors declared a quarterly cash dividend of $0.09 per share of common stock, payable on March 15, 2008 to stockholders of record as of February 28, 2008.

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

On September 5, 2007, we entered into a credit agreement (the 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 lenders are currently JPMorgan Chase Bank, N.A., KeyBank National Association and SunTrust Bank. Credit extended under the Credit Agreement is guaranteed by our subsidiaries, Heartland Payroll Company, L.L.C., an Ohio limited liability company, and Debitek, Inc., a Delaware corporation.

The Credit Agreement provides for a five year revolving credit facility in the aggregate amount of up to $50.0 million (the Revolving Credit Facility), of which up to $5.0 million may be used for the issuance of letters of credit and up to $5.0 million is available for swing line loans. Upon the prior approval of the administrative agent, we may increase the total commitments by $25.0 million for a total commitment under the Revolving Credit Facility of $75.0 million. The Revolving Credit Facility is available to us on a revolving basis commencing on September 5, 2007 and ending on September 4, 2012.

The 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.

Under the terms of the Credit Agreement, we may borrow, at our option, at interest rates equal to one, two, three or six month adjusted LIBOR rates or equal to the greatest of prime, the secondary market rate for three month certificates of deposits plus 1.0% and the federal funds rate plus 0.50%, in each case plus a margin determined by our current leverage ratio.

We can use this Revolving Credit Facility to finance our new service center, acquisitions, our other working capital needs and for general corporate purposes.

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 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 portfolio, which was $17.9 billion, $15.1 billion and $12.0 billion for the four months ended December 31, 2007, 2006 and 2005, respectively. However, during the four months ended December 31, 2007, 2006 and 2005, we were presented with $10.5 million, $8.4 million and $6.6 million, respectively, of chargebacks by issuing banks. In 2007, 2006 and 2005, we incurred merchant credit losses related to chargebacks of $2.8 million, $1.9 million and $1.2 million, respectively, on total dollar volume processed of $51.9 billion, $43.3 billion and $33.7 billion, respectively. These credit losses are included in processing and servicing expense in our consolidated statements of income.

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The following table reflects our significant contractual obligations as of December 31, 2007:

		Payments Due by Period			
Contractual Obligations	Total	Less than 1 year	1 to 3 years (in thousands)	3 to 5 years	More than 5 years
Processing providers (a)	$ 14,558	$ 6,583	$ 7,311	$ 664	$
Telecommunications providers	6,861	2,947	3,402	512	
Office and equipment leases	8,960	1,883	2,809	2,494	1,774
Land, construction and equipment (b)	10,779	10,654	125		
	$ 41,158	$ 22,067	$ 13,647	$ 3,670	$ 1,774

(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. These third-party processors include TSYS Acquiring Solutions, KeyBank, N.A., 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 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, 2007, we have spent approximately $30.4 million of our cash on our new Service Center, including $1.7 million to acquire land, and over the next fifteen months we expect to spend approximately $18.0 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 $49.8 million and $27.3 million as of December 31, 2007 and 2006, respectively. This amount is repaid on the first business day of the following month out of the fees collected from our merchants.

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.

Quantitative and Qualitative Disclosures About Market Risk

Our primary market risk exposure is to changes in interest rates. 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, 2007, our payable to our sponsor banks was $49.8 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, 2007 the average daily interest-bearing balance of that payable was approximately $8.9 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 $89,000 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 of up to three years. At December 31, 2007, a hypothetical 100 basis point increase in short-term interest rates would result in an increase of approximately $44,000 in annual pre-tax income from money market fund holdings, but a decrease in the value of fixed-rate investments of approximately $30,000. A hypothetical 100 basis point decrease in short-term interest rates would result in a decrease of approximately $44,000 in annual pre-tax income from money market funds, but an increase in the value of fixed-rate instruments of approximately $30,000.

We do not hold or engage in the trading of derivative financial, commodity or foreign exchange instruments. All of our business is conducted in U.S. dollars.

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 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. We do not believe that the application of SFAS No. 157 will 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 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity makes that choice in the first 120 days of that fiscal year, has not yet issued financial statements for any interim period of the fiscal year of adoption, and also elects to apply the provisions of Statement No. 157, *Fair Value Measurements*. We do not believe that the application of SFAS No. 159 will have a material effect on our consolidated financial position, results of operations or cash flows.

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.

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

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

ITEM 7A. QUANTITATIVE AND QUALITA TIVE DISCLOSURES ABOUT MARKET RISK

See Management s Discussion and Analysis of Financial Condition and Results of Operations Quantitative and Qualitative Disclosures About Market Risk.

ITEM 8. FINANCI AL STATEMENTS AND SUPPLEMENTARY DATA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Heartland Payment Systems, Inc:

We have audited the accompanying consolidated balance sheets of Heartland Payment Systems, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income and comprehensive income, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2007. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123(R) Share-Based Payment.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2008 expressed an unqualified opinion on the Company s internal control over financial reporting.

/s/ Deloitte & Touche LLP

Philadelphia, Pennsylvania
March 10, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Heartland Payment Systems, Inc:

We have audited the internal control over financial reporting of Heartland Payment Systems, Inc. and subsidiaries (the Company) as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing in Item 9A herein. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM (continued)

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2007 of the Company and our report dated March 10, 2008 expressed an unqualified opinion and included an explanatory paragraph regarding adoption of Statement of Financial Accounting Standard (SFAS) No. 123(R) Share-Based Payment on January 1, 2006 on those financial statements.

/s/ Deloitte Touche LLP

Philadelphia, Pennsylvania
March 10, 2008

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Heartland Payment Systems, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

	December 31, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	**$ 35,508**	$ 16,054
Funds held for payroll customers	**24,201**	16,960
Receivables, net	**122,613**	107,154
Investments	**1,119**	1,082
Inventory	**5,383**	2,252
Prepaid expenses	**3,478**	2,030
Current tax asset	**5,449**	19,227
Current deferred tax assets, net	**690**	757
Total current assets	**198,441**	165,516
Capitalized customer acquisition costs, net	**70,498**	56,705
Deferred tax assets, net	**3,878**	4,562
Property and equipment, net	**50,248**	23,135
Goodwill and intangible assets	**5,970**	1,757
Deposits and other assets	**154**	93
Total assets	**$ 329,189**	$ 251,768
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor banks	**$ 49,798**	$ 27,253
Accounts payable	**20,495**	16,936
Deposits held for payroll customers	**24,201**	16,960
Current portion of accrued buyout liability	**11,521**	11,519
Merchant deposits and loss reserves	**14,757**	8,210
Accrued expenses and other liabilities	**15,266**	9,649
Current portion of borrowings and financing arrangements		174
Total current liabilities	**136,038**	90,701
Reserve for unrecognized tax benefits	**1,230**	
Long-term portion of accrued buyout liability	**26,252**	21,774
Total liabilities	**163,520**	112,475
Commitments and contingencies (Note 16)		
Stockholders equity		
Common Stock, $.001 par value, 100,000,000 shares authorized, 39,804,322 and 38,488,880 shares issued at December 31, 2007 and 2006; 37,989,622 and 37,405,680 shares outstanding at December 31, 2007 and 2006	**40**	38
Additional paid-in capital	**173,346**	153,997
Accumulated other comprehensive loss	**(62)**	(21)
Retained earnings	**36,729**	10,804
Treasury stock, at cost (1,814,700 and 1,083,200 shares at December 31, 2007 and 2006)	**(44,384)**	(25,525)
Total stockholders equity	**165,669**	139,293

Total liabilities and stockholders equity	**$ 329,189**	$ 251,768

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Consolidated Statements of Income and Comprehensive Income

(In thousands, except per share data)

	Year Ended December 31, 2007	2006	2005
Total Revenues	**$ 1,313,846**	$ 1,097,041	$ 834,824
Costs of Services:			
Interchange	**962,025**	804,267	611,736
Dues and assessments	**48,529**	40,334	31,491
Processing and servicing	**135,120**	118,342	87,668
Customer acquisition costs	**44,193**	35,451	28,025
Depreciation and amortization	**6,806**	6,042	5,685
Total costs of services	**1,196,673**	1,004,436	764,605
General and administrative	**57,404**	47,787	37,761
Total expenses	**1,254,077**	1,052,223	802,366
Income from operations	**59,769**	44,818	32,458
Other income (expense):			
Interest income	**1,934**	1,225	477
Interest expense	**(785)**	(753)	(1,553)
Loss on cost basis investment	**(1,650)**		
Exit costs for Service Center	**(1,267)**		
Fair value adjustment for warrants with mandatory redemption provisions			(2,912)
Gain on settlement of financing arrangement			5,140
Other, net	**(841)**	(669)	198
Total other (expense) income	**(2,609)**	(197)	1,350
Income before income taxes	**57,160**	44,621	33,808
Provision for income taxes	**21,290**	16,077	14,715
Net income	**35,870**	28,544	19,093
Income allocated to Series A Senior Convertible Participating Preferred Stock			(4,728)
Net income attributable to Common Stock	**$ 35,870**	$ 28,544	$ 14,365
Net income	**$ 35,870**	$ 28,544	$ 19,093
Other comprehensive income, net of tax:			
Unrealized (losses) gains on investments	**(41)**	5	(16)
Comprehensive income	**$ 35,829**	$ 28,549	$ 19,077
Earnings per common share:			
Basic	**$ 0.95**	$ 0.78	$ 0.62

Diluted	**$**	**0.90**	$	0.71	$	0.50
Weighted average number of common shares outstanding:						
Basic		**37,686**		36,394		23,069
Diluted		**39,980**		39,943		37,879

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc . and Subsidiaries

Consolidated Statements of Stockholders Equity

(In thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings (Accumulated Deficit)	Treasury Stock	Total Stockholders Equity
Balance, January 1, 2005	7,619	$ 8	16,438	$ 8	$ 41,065	$ (10)	$ (34,972)	$	$ 6,099
Issuance of Common Stock options exercised			1,523	2	9,178				9,180
Issuance of Common Stock on initial public offering			2,759	3	41,709				41,712
Accumulated other comprehensive loss						(16)			(16)
Conversion of preferred stock	(7,619)	(8)	13,333	13	(5)				
Two for one stock split				8	(8)				
Repurchase of Common Stock			(22)					(495)	(495)
Exercise of warrants			169		4,478				4,478
Net income for the year							19,093		19,093
Balance, December 31, 2005		$	34,200	$ 34	$ 96,417	$ (26)	$ (15,879)	$ (495)	$ 80,051
Issuance of Common Stock options exercised			4,267	4	27,654				27,658
Excess tax benefit on stock options exercised under SFAS No. 123R					28,603				28,603
Repurchase of Common Stock			(1,061)					(25,030)	(25,030)
Share-based compensation under SFAS No. 123R					1,323				1,323
Accumulated other comprehensive income						5			5
Dividends on common stock							(1,861)		(1,861)
Net income for the year							28,544		28,544
Balance, December 31, 2006		$	37,406	$ 38	$ 153,997	$ (21)	$ 10,804	$ (25,525)	$ 139,293
Cumulative effect of change in accounting principal FIN No. 48							(514)		(514)
Issuance of Common Stock secondary offering			24		25				25
Issuance of Common Stock options exercised			1,292	2	10,007				10,009
Excess tax benefit on stock options exercised under SFAS No. 123R					7,570				7,570
Repurchase of Common Stock			(732)					(18,859)	(18,859)
Share-based compensation under SFAS No. 123R					1,747				1,747
Accumulated other comprehensive loss						(41)			(41)
Dividends on common stock							(9,431)		(9,431)

Net income for the year								35,870				35,870
Balance, December 31, 2007	$	37,990	$ 40	$ 173,346	$	(62)	$	36,729	$ (44,384)		$	165,669

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Consolidated Statements of Cash Flow

(In thousands)

	Year Ended December 31,		
	2007	**2006**	**2005**
Cash flows from operating activities			
Net income	**$ 35,870**	$ 28,544	$ 19,093
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Amortization of capitalized customer acquisition costs	**45,191**	35,823	24,636
Other depreciation and amortization	**8,616**	7,557	5,695
Addition to loss reserve	**3,035**	1,970	1,235
Provision for doubtful receivables	**1,249**	628	173
Deferred taxes	**1,020**	(351)	1,811
Share-based compensation	**1,747**	1,323	
Loss on cost basis investment	**1,650**		
Exit costs for Service Center	**1,267**		
Loss on purchased software		1,500	
Fair value adjustment for warrants with mandatory redemption provisions			2,912
Gain on settlement of financing arrangement			(5,140)
Other	**295**	254	33
Changes in operating assets and liabilities:			
Increase in receivables	**(16,701)**	(13,017)	(29,604)
(Increase) decrease in inventory	**(1,737)**	(438)	104
Payment of signing bonuses, net	**(44,700)**	(33,743)	(21,788)
Increase in capitalized customer acquisition costs	**(14,284)**	(15,855)	(11,531)
(Increase) decrease in prepaid expenses	**(1,448)**	(59)	172
Decrease (increase) in current tax asset	**21,401**	10,978	(2,783)
(Increase) decrease in deposits and other assets	**(61)**	23	1
Excess tax benefits on options exercised under SFAS No. 123R	**(7,623)**	(28,603)	
Increase in reserve for unrecognized tax benefits	**463**		
Increase (decrease) in due to sponsor banks	**22,545**	(7,277)	(10,623)
Increase (decrease) in accounts payable	**3,544**	1,325	(2,955)
Increase in accrued expenses and other liabilities	**3,260**	1,958	2,116
Increase (decrease) in merchant deposits and loss reserves	**3,512**	(1,210)	(960)
Payouts of accrued buyout liability	**(8,806)**	(10,664)	(13,481)
Increase in accrued buyout liability	**13,286**	15,483	14,920
Net cash provided by (used in) operating activities	**72,591**	(3,851)	(25,964)
Cash flows from investing activities			
Purchase of investments	**(1,904)**	(2,158)	(1,544)
Maturities of investments	**310**	1,258	487
Increase in funds held for payroll customers	**(7,376)**	(5,972)	(163)
Increase in deposits held for payroll customers	**7,241**	6,357	1,192
Acquisition of business, net of cash acquired	**(6,300)**	(3,453)	
Purchases of property and equipment	**(34,247)**	(13,960)	(12,337)
Proceeds from disposal of property and equipment			27
Net cash used in investing activities	**(42,276)**	(17,928)	(12,338)
Cash flows from financing activities			

Principal payments on borrowings and financing arrangements	**(174)**	(261)	(7,520)
Proceeds from exercise of stock options	**9,955**	27,658	8,953
Excess tax benefits on options exercised under SFAS No. 123R	**7,623**	28,603	
Repurchase of common stock	**(18,859)**	(25,030)	(495)
Dividends paid on common stock	**(9,431)**	(1,861)	
Net proceeds from sale of common stock	**25**		41,712
Net cash (used in) provided by financing activities	**(10,861)**	29,109	42,650
Net increase in cash and cash equivalents	**19,454**	7,330	4,348
Cash and cash equivalents at beginning of year	**16,054**	8,724	4,376
Cash and cash equivalents at end of year	**$ 35,508**	$ 16,054	$ 8,724
Supplemental cash flow information:			
Cash paid (received) during the year for:			
Interest	**$ 670**	$ 747	$ 1,581
Income taxes	**(1,571)**	2,727	11,742
Supplemental schedule of non-cash activities:			
Amortization of other assets	**$**	$ 71	$ 136

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Operations

Basis of Financial Statement Presentation The accompanying consolidated financial statements include those of Heartland Payment Systems, Inc. (the Company) and its wholly-owned subsidiaries, Heartland Payroll Company (HPC) and Debitek, Inc, (Debitek). 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 officers and directors of the Company represent approximately 32% of the outstanding shares of the Company as of December 31, 2007.

All outstanding common shares, average common shares, earnings per common share and conversion amounts related to stock options, warrants and Series A Senior Convertible Participating Preferred Stock for the year ended December 31, 2005 have been adjusted retroactively to reflect a two-for-one stock split on July 26, 2005. On that date, the Company s Board of Directors and stockholders also increased the number of authorized shares of common stock to 100,000,000 and the number of shares authorized under the 2000 Equity Incentive Plan to 11,000,000.

Business Description The Company provides payment-processing services related to bank card transactions for merchants throughout the United States. In addition, the Company provides certain other merchant services, including the sale and rental of terminal equipment, check 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. The Company and Debitek also provide campus payment solutions throughout the United States.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include, among other things, the accrued buyout liability, capitalized customer acquisition costs, loss reserves, certain accounts payable and accrued expenses and certain tax assets and liabilities as well as the related valuation allowances, if any. Actual results could differ from those estimates. Interchange expense for 2006 included $2.0 million of expense recorded in the quarter ended March 31, 2006 for a change in estimate of the amount of on-line debit interchange expense the Company accrues. The change in estimate was based on new information which became available to the Company.

Concentrations Until the Company completed its conversion to Passport, its internally developed back-end bank card processing system, in May 2006, the majority of the Company s merchant processing activity had been processed by a single vendor. That vendor still remains the Company s largest provider of third-party processing services. The Company believes that the vendor maintains appropriate backup systems and alternative arrangements to avoid a significant disruption of processing in the case of an unforeseen event.

Substantially all of the Company s revenue is derived from processing Visa and MasterCard bank card transactions. Because the Company is not a member bank as defined by Visa and MasterCard, in order to process these bank card transactions the Company has entered into sponsorship agreements with two banks. The agreements with the bank sponsors requires, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard networks and maintain a certificate of deposit with the bank sponsors. If the Company breaches the sponsorship agreements, the bank sponsors may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative bank sponsor. The Company is dependent on its bank sponsors, Visa and MasterCard for notification of any compliance breaches. As of December 31, 2007, the Company has not been notified of any such issues by its bank sponsors, Visa or MasterCard. Of the Company s total bank card processing volume for the month of December 2007, 99.7% was processed under its sponsorship agreement with KeyBank N.A. and 0.3% was processed under its sponsorship agreement with Heartland Bank (an unrelated third party).

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The Company processes for merchants throughout the United States. California represented 12.9% of the Company s total bank card processing volume in December 2007. The next largest state represented 6.7%.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents.

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 bank card processing merchants. These receivables result from the Company s practice of advancing interchange fees to most of its merchants during the month and collecting those fees from merchants at the beginning of the following month. The Company uses its available cash to fund a portion of the advances of interchange fees to its merchants; when available cash has been expended, the Company directs its sponsor bank to make the advances, thus generating a payable to the sponsor bank. At December 31, 2007 and 2006, the Company used $37.9 million and $44.6 million, respectively, of its available cash to fund merchant advances. The amount due to our sponsor banks for funding advances was $49.8 million at December 31, 2007 and $27.3 million at December 31, 2006. The payable to sponsor banks is repaid at the beginning of the following month out of the fees the Company collects from its merchants. Receivables from merchants also include receivables from the sale of point of sale terminal equipment and check processing terminals.

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

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

Investments and Funds Held for Payroll Customers Investments, including Funds Held for Payroll Customers, consist primarily of fixed income bond funds, corporate and U.S. Government debt securities, certificates of deposit and cost basis investments. The Company classifies the majority of its investments, including Funds Held for Payroll Customers, as available-for-sale and records them at the fair value of the investments based on quoted market prices. Certificates of deposit are classified as held to maturity and recorded at cost. Cost basis investments are recorded at cost and periodically evaluated for impairment. In the event of a sale, cost is determined on a specific identification basis.

Inventories Inventories consist of point-of-sale terminal equipment held for sale to merchants, check processing terminal equipment for sale to merchants, prepaid card and cashless payment systems hardware for sale to end users, resellers and distributors, and campus payments solutions equipment for sale to end users. Inventories are valued at the lower of cost or market price. Cost is arrived at using the first-in, first-out method. Market price is estimated based on current sales of equipment.

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

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

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

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. The Company believes that no impairment has occurred as of December 31, 2007 or 2006.

Property and Equipment Property and equipment are carried at cost, net of accumulated depreciation. Depreciation for the Company s owned Service Center building is computed straight-line over 39 years. Depreciation is computed straight-line over periods ranging from three to ten years for furniture and equipment. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease. The Company capitalizes the cost of computer software developed for internal use and amortizes such costs over an estimated useful life of three to five years.

Long-Lived Assets The Company evaluates the potential for impairment when changes in circumstances indicate that undiscounted cash flows estimated to be generated by the related assets are less than the carrying amount. Management believes that no such changes in circumstances or impairment have occurred as of December 31, 2007 or 2006.

Goodwill The Company has recorded goodwill in connection with its 2006 acquisition of Debitek, Inc. and its 2007 acquisitions of E-Secure Peripherals, Inc. and General Meters Corp. Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is tested for impairment on an annual basis and between annual tests if an event occurs or changes in circumstances suggest a potential decline in the fair value of the reporting unit. The Company performs its annual goodwill impairment testing in the fourth quarter. Based on the Company s evaluation, no impairment has occurred as of December 31, 2007 or 2006. At December 31, 2007 and 2006, goodwill of $5,489,000 and $1,676,000 was recorded on the Company s Consolidated Balance Sheet.

Merchant Deposits and Loss Reserves Disputes between a cardholder and a merchant periodically arise due to the cardholder s dissatisfaction with merchandise quality or the merchant s service, and the disputes may not always be resolved in the merchant s favor. In some of these cases, the transaction is charged back to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company may have partial recourse to the Relationship Manager originally soliciting the merchant contract, if the Relationship Manager is still receiving income from the merchant s processing activities. Under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Other* (FIN 45), the Company s obligation to stand ready to perform is minimal. The Company maintains deposits 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

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potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to recent bank card processing volume levels. The Company believes that the liability recorded as loss reserves approximates fair value.

Accrued Buyout Liability Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly merchant processing activity. The Company has the right, but is not obligated, to buy out some or all of these commissions, and intends to do so periodically. Such purchases of the commissions are at a fixed multiple of the last twelve months commissions. Because of the Company s intent and ability to execute purchases of the residual commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount that it would have to pay (the settlement cost) to buy out non-servicing related commissions in their entirety from vested Relationship Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a merchant contract, the Company also records for currently vested Relationship Managers and sales managers a related deferred acquisition cost asset. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin, are included in the same income statement caption as customer acquisition cost amortization expense.

The accrued buyout liability is based on the merchants under contract at the balance sheet date, the gross margin generated by those merchants over the prior 12 months, the owned commission rate, and the contractual buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date. The same procedure is applied to unvested commissions over the expected vesting period, but is further adjusted to reflect the Company s experience that 31% of unvested Relationship Managers and sales managers become vested.

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

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

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

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.

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In 2007, other income (expense) includes a pre-tax charge 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 investment in a cost-basis investment in Parcxmart Technologies, Inc., and a charge of $0.8 million reflecting our liability in a legal proceeding under an indemnification we provided to an insurer.

In 2006, other income (expense) includes a $0.8 million gain from the proceeds received from a legal settlement and a $1.5 million charge for the write off of purchased software. In 2005, other income (expense) includes a $5.1 million gain on the settlement of a financing arrangement and $2.9 million in charges for adjustments to the fair value of previously outstanding warrants with mandatory redemption provisions.

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 accounting and tax basis of assets and liabilities using enacted tax rates. The impact on deferred assets and liabilities of a change in tax rates is recognized in income in the period that the rate change is enacted.

The FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN No. 48), in June 2006. FIN No. 48 clarifies the accounting for the recognition and measurement of tax benefits associated with uncertain tax positions and defines criterion that an individual tax position must meet for any part of that position to be recognized or continue to be recognized in the financial statements. FIN No. 48 also adds disclosure requirements for the amounts of unrecognized tax benefits associated with uncertain tax positions. An uncertain tax position exists if it is unclear how a transaction will be treated under tax law. FIN No. 48 is effective for fiscal years beginning after December 15, 2006.

Stock Options The Company 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. The Company elected to adopt the modified-prospective-transition 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 the 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.

Additionally, SFAS No. 123R amends 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 $7.6 million in 2007 and $28.6 million in 2006 related to excess tax benefits from share-based awards. 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.

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The application of SFAS No. 123R had the following effects on reported amounts relative to amounts that the Company 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

Prior to the adoption of SFAS No. 123R, the Company accounted for its stock options using the intrinsic value method in which no compensation expense has been recognized for its share-based compensation plans because the options were granted at an exercise price greater than or equal to the estimated fair value at the grant date. The following table presents the effects on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for share-based compensation under SFAS No. 123 for the year ended December 31, 2005 (in thousands, except per share data):

Net income	$ 19,093
Deduct: Total share-based employee compensation expense determined under fair value-based method, net of related tax expense	4,747
Pro forma net income	14,346
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock	3,430
Pro forma net income attributable to common stock	$ 10,916
Earnings per share:	
As reported:	
Basic	$ 0.62
Diluted	$ 0.50
Pro forma:	
Basic	$ 0.47
Diluted	$ 0.38

Basic earnings per share for the year ended December 31, 2005 was computed and presented under the two-class method and was based on the weighted average number of common shares outstanding and assumes an allocation of net income to the Series A Senior Convertible Participating Preferred Stock (the Convertible Preferred) for the period or portion of the period that the Convertible Preferred was outstanding. The Convertible Preferred automatically converted into 13,333,334 shares of the Company s common stock upon the August 16, 2005 closing of the Company s initial public offering.

Diluted earnings per share for the year ended December 31, 2005 was computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, warrants and conversion of Series A Senior Convertible Participating Preferred Stock, where dilutive. Weighted average shares outstanding and dilutive securities for the year ended December 31, 2005 has been adjusted to reflect a two-for-one stock split on July 26, 2005.

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New Accounting Pronouncements The FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN No. 48), in June 2006. FIN No. 48 clarifies the accounting for the recognition and measurement of tax benefits associated with uncertain tax positions and defines criterion that an individual tax position must meet for any part of that position to be recognized or continue to be recognized in the financial statements. FIN No. 48 also adds disclosure requirements for the amounts of unrecognized tax benefits associated with uncertain tax positions. An uncertain tax position exists if it is unclear how a transaction will be treated under tax law. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adpoted 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. The Company does not believe that the application of SFAS No. 157 will have a material effect on its 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 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity makes that choice in the first 120 days of that fiscal year, has not yet issued financial statements for any interim period of the fiscal year of adoption, and also elects to apply the provisions of Statement No. 157, *Fair Value Measurements*. The Company does not believe that the application of SFAS No. 159 will have a material effect on its consolidated financial position, results of operations or cash flows.

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 the Company s Consolidated Financial Statements prospectively in the event of any business combinations entered into after the effective date in which the Company is the acquirer.

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

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

3. Acquisitions

On October 19, 2007, the Company acquired the assets of General Meters Corp (General Meters) for a net cash payment of $6.0 million. The General Meters acquisition provides the Company with a ready base of colleges and universities for its campus payment solutions. This acquisition is not expected to have a material impact on earnings in the near term. 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 October 19, 2007, General Meters results of operations were included in the Company s results of operations. The total purchase price was allocated as follows: $3.5 million to goodwill, $472,000 to intangible assets and $2.0 million to net tangible assets. The entire amount of goodwill is expected to be deductible for income tax reporting.

On June 1, 2007, the Company acquired the assets of E-Secure Peripherals, Inc. (E-Secure) for a gross cash payment of $0.3 million. This acquisition is not expected to have a material impact on earnings in the near term. 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 June 1, 2007, E-Secure s results of operations were included in the Company s results of operations. The total purchase price was allocated as follows: $278,000 to goodwill and $22,000 to net tangible assets. The entire amount of goodwill is expected to be deductible for income tax reporting.

Effective January 1, 2006, the Company acquired the stock of Debitek, Inc. (Debitek) for a gross cash payment of approximately $5.2 million. The Company acquired Debitek to obtain a proven platform and solutions provider in the prepaid and stored-value cards market, particularly with respect to small-dollar payment applications. 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 1, 2006, Debitek s results of operations were included in the Company s results of operations. The total purchase price was allocated as follows: $1.7 million to goodwill, $121,000 to intangible assets and $3.4 million to net tangible assets, including cash of $1.7 million. The entire amount of goodwill is expected to be deductible for income tax reporting.

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4. Receivables

A summary of receivables by major class is as follows at December 31, 2007 and 2006:

	December 31, 2007	December 31, 2006
	(In thousands)	
Accounts receivable from merchants	**$ 114,585**	$ 103,921
Accounts receivable from others	**8,193**	3,384
	122,778	107,305
Less allowance for doubtful accounts	**(165)**	(151)
	$ 122,613	$ 107,154

Included in accounts receivable from others are $1,642,000 and $1,836,000 which are due from employees at December 31, 2007 and 2006, respectively.

A summary of the activity in the allowance for doubtful accounts for three years ended December 31, 2007, 2006 and 2005 was as follows:

	Year Ended December 31, 2007	2006	2005
	(In thousands)		
Beginning balance	**$ 151**	$ 68	$ 167
Balance of acquired entity allowance		76	
Additions to allowance	**1,249**	628	173
Charges against allowance	**(1,235)**	(621)	(272)
Ending balance	**$ 165**	$ 151	$ 68

5. 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, investments available-for-sale, and cost basis investments by major security type and class of security were as follows at December 31, 2007 and 2006:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
December 31, 2007				
Funds Held for Payroll Customers:				
Fixed income bond fund	**$ 1,174**	**$**	**$ (69)**	**$ 1,105**

Debt securities of the U.S. Government	**249**			**249**
Corporate debt securities	**506**		**(30)**	**476**
Total investments available-for-sale	**1,929**		**(99)**	**1,830**
Cash held for payroll customers	**22,371**			**22,371**
Total Funds Held for Payroll Customers	**$ 24,300**	**$**	**$ (99)**	**$ 24,201**
Investments:				
Investments held to maturity Certificates of deposit	**$ 1,119**	**$**	**$**	**$ 1,119**
Total investments	**$ 1,119**	**$**	**$**	**$ 1,119**

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	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(In thousands)		
December 31, 2006				
Funds Held for Payroll Customers:				
Fixed income bond fund	$ 1,121	$	$ (25)	$ 1,096
Debt securities of the U.S. Government	249		(3)	246
Corporate debt securities	628		(5)	623
Total investments available-for-sale	1,998		(33)	1,965
Cash held for payroll customers	14,995			14,995
Total Funds Held for Payroll Customers	$ 16,993	$	$ (33)	$ 16,960
Investments:				
Investments held to maturity Certificates of deposit	$ 582	$	$	$ 582
Cost basis investments	500			500
Total investments	$ 1,082	$	$	$ 1,082

The cost basis investment at December 31, 2006 was an investment in a small private company for which it was impractical to determine fair value at December 31, 2006. In January 2006, the Company made the initial $0.5 million investment in that investee s convertible preferred stock and in June 2007, the Company made an additional investment of $1.2 million in its convertible preferred stock. In December 2007, due to significant concerns about the investee s ability to continue as a going concern, including negative cash flows from its operations, working capital deficiencies and its inability to raise additional capital to supplement its cash position, the Company recognized an impairment loss equal to the full $1.7 million investment.

As of December 31, 2007, no unrealized losses in available-for-sale investments are considered other-than-temporarily impaired because the Company has the ability and intent to hold these investments for a period of time sufficient for a forecasted recovery in value, which may be upon maturity. The investees continue to have investment grade ratings and solid financial conditions and prospects. These available-for-sale investments have been in an unrealized loss position for twelve months or longer.

The maturity schedule of all available-for-sale and held to maturity investments along with amortized cost and estimated fair value as of December 31, 2007 is as follows:

	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	**$ 2,541**	**$ 2,473**
Due after one year through five years	**507**	**476**
	$ 3,048	**$ 2,949**

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6. Capitalized Customer Acquisition Costs, Net

A summary of the capitalized customer acquisition costs, net is as follows as of December 31, 2007 and 2006:

	December 31,	
	2007	2006