HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
November 06, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to

Commission File No. 001-32594

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

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

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

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

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

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

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

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

As of November 1, 2012, there were 37,528,918 shares of the registrant's Common Stock, $0.001 par value, outstanding.

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

	September 30, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$45,055	$40,301
Funds held for payroll customers	39,217	42,511
Receivables, net	185,923	176,535
Investments held to maturity	4,455	2,505
Inventory	9,878	11,492
Prepaid expenses	8,349	9,660
Current tax assets	2,790	—
Current deferred tax assets, net	7,021	6,746
Total current assets	302,688	289,750
Capitalized customer acquisition costs, net	56,450	55,014
Property and equipment, net	121,505	115,579
Goodwill	115,902	103,399
Intangible assets, net	35,856	32,498
Deposits and other assets, net	756	681
Total assets	$633,157	$596,921
Liabilities and Equity		
Current liabilities:		
Due to sponsor banks	$53,058	$63,881
Accounts payable	61,989	47,373
Deposits held for payroll customers	39,217	42,511
Current portion of borrowings	18,750	15,003
Current portion of accrued buyout liability	10,152	8,104
Processing liabilities and loss reserves	43,125	30,689
Accrued expenses and other liabilities	51,433	50,884
Current tax liabilities	—	1,408
Total current liabilities	277,724	259,853
Deferred tax liabilities, net	25,476	21,643
Reserve for unrecognized tax benefits	2,494	1,819
Long-term portion of borrowings	55,000	70,000
Long-term portion of accrued buyout liability	24,441	23,554
Total liabilities	385,135	376,869
Commitments and contingencies (Note 11)	—	—
Equity		
Common stock, $0.001 par value, 100,000,000 shares authorized, 41,110,681 and 39,626,846 shares issued at September 30, 2012 and December 31, 2011; 38,657,369 and 38,847,957	41	39

outstanding at September 30, 2012 and December 31, 2011		
Additional paid-in capital	239,992	207,643
Accumulated other comprehensive loss	(353)	(680)
Retained earnings	73,159	29,236
Treasury stock, at cost (2,453,312 and 778,889 shares at September 30, 2012 and December 31, 2011)	(66,044)	(16,828)
Total stockholders’ equity	246,795	219,410
Noncontrolling interests	1,227	642
Total equity	248,022	220,052
Total liabilities and equity	$633,157	$596,921

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30	
	2012	2011	2012	2011
Total revenues	$534,152	$531,904	$1,523,158	$1,525,527
Costs of services:				
Interchange	336,628	369,007	965,318	1,055,013
Dues, assessments and fees	54,121	40,672	150,494	113,373
Processing and servicing	55,601	53,255	169,511	161,170
Customer acquisition costs	10,647	11,834	33,346	35,622
Depreciation and amortization	5,380	3,270	14,272	10,846
Total costs of services	462,377	478,038	1,332,941	1,376,024
General and administrative	38,130	32,244	103,596	91,667
Total expenses	500,507	510,282	1,436,537	1,467,691
Income from operations	33,645	21,622	86,621	57,836
Other income (expense):				
Interest income	45	47	205	129
Interest expense	(938)	(954)	(2,544)	(3,262)
Provision for processing system intrusion costs	(290)	(115)	(528)	(790)
Other, net	(921)	(35)	(925)	(780)
Total other income (expense)	(2,104)	(1,057)	(3,792)	(4,703)
Income before income taxes	31,541	20,565	82,829	53,133
Provision for income taxes	11,974	7,784	31,448	20,098
Net income	19,567	12,781	51,381	33,035
Less: Net income attributable to noncontrolling interests	187	135	446	316
Net income attributable to Heartland	$19,380	$12,646	$50,935	$32,719
Net income	$19,567	$12,781	$51,381	$33,035
Other comprehensive income (loss):				
Unrealized gains (losses) on investments, net of income tax of $10, $(2), $19 and $(1)	15	(6)	30	(1)
Unrealized losses on derivative financial instruments	(19)	(69)	(28)	(651)
Foreign currency translation adjustment	500	(946)	464	(493)
Comprehensive income	20,063	11,760	51,847	31,890
Less: Comprehensive income (loss) attributable to noncontrolling interests	337	(149)	585	168
Comprehensive income attributable to Heartland	$19,726	$11,909	$51,262	$31,722
Earnings per common share:				
Basic	$0.50	$0.32	$1.31	$0.84
Diluted	$0.48	$0.31	$1.26	$0.82
Weighted average number of common shares outstanding:				

Basic	38,813	39,265	38,831	38,841
Diluted	40,352	40,561	40,454	40,145

See accompanying notes to condensed consolidated financial statements.

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

	Heartland Stockholders' Equity							
	Common Stock							
	Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	(Accumulated Deficit) Retained Earnings	Treasury Stock	Noncontrolling Minority Interests	Total Equity
Nine Months Ended September 30, 2011:								
Balance, January 1, 2011	38,415	$38	$185,689	$37	$(8,471)	$—	$301	$177,594
Issuance of common stock– options exercised	932	1	7,916	—	—	—	—	7,917
Issuance of common stock – RSU's vested	59	—	(518)	—	—	—	—	(518)
Excess tax benefit on employee share-based compensation	—	—	2,903	—	—	—	—	2,903
Share-based compensation	—	—	4,970	—	—	—	—	4,970
Other comprehensive loss	—	—	—	(996)	—	—	(149)	(1,145)
Dividends on common stock	—	—	—	—	(4,665)	—	—	(4,665)
Net income for the period	—	—	—	—	32,719	—	316	33,035
Balance September 30, 2011	39,406	$39	$200,960	$(959)	$19,583	$—	$468	$220,091
Nine Months Ended September 30, 2012:								
Balance, January 1, 2012	38,848	$39	$207,643	$(680)	$29,236	$(16,828)	$642	$220,052
Issuance of common stock – options exercised	1,400	2	16,826	—	—	—	—	16,828
Issuance of common stock – RSU's vested	83	—	(1,064)	—	—	—	—	(1,064)
Excess tax benefit on		—	6,175	—	—	—	—	6,175

employee share-based compensation								
Repurchase of common stock	(1,674)	—	—	—	—	(49,216)	—	(49,216)
Share-based compensation	—	—	10,412	—	—	—	—	10,412
Other comprehensive income	—	—	—	327	—	—	139	466
Dividends on common stock	—	—	—	—	(7,012)	—	—	(7,012)
Net income for the period	—	—	—	—	50,935	—	446	51,381
Balance September 30, 2012	38,657	$41	$239,992	$(353)	$73,159	$(66,044)	$ 1,227	$248,022

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities		
Net income	$51,381	$33,035
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of capitalized customer acquisition costs	33,758	35,948
Other depreciation and amortization	20,641	20,633
Addition to loss reserves	1,827	4,555
Provision for doubtful receivables	793	2,074
Share-based compensation	10,412	4,970
Deferred taxes	3,558	3,036
Exit costs for service center	—	809
Other	964	87
Changes in operating assets and liabilities:		
(Increase) decrease in receivables	(8,519)	3,030
Decrease (increase) in inventory	1,685	(1,774)
Payment of signing bonuses, net	(22,446)	(21,158)
Increase in capitalized customer acquisition costs	(12,748)	(10,670)
Decrease (increase) in prepaid expenses	1,329	(1,052)
Decrease in current tax assets	1,968	16,767
Increase in deposits and other assets	(81)	(299)
Excess tax benefits on employee share-based compensation	(6,175)	(2,903)
Increase in reserve for unrecognized tax benefits	675	444
Decrease in due to sponsor bank	(10,823)	(15,022)
Increase in accounts payable	14,593	330
Increase in accrued expenses and other liabilities	2,423	1,978
Increase (decrease) in processing liabilities and loss reserves	10,528	(1,002)
Payouts of accrued buyout liability	(9,401)	(8,679)
Increase in accrued buyout liability	12,336	10,344
Net cash provided by operating activities	98,678	75,481
Cash flows from investing activities		
Purchase of investments held to maturity	(5,225)	(2,617)
Maturities of investments held to maturity	3,396	1,626
Decrease (Increase) in funds held for payroll customers	3,344	(2,313)
(Decrease) Increase in deposits held for payroll customers	(3,294)	2,145
Acquisition of business, net of cash acquired	(23,682)	(23,221)
Purchases of property and equipment	(25,029)	(28,983)
Net cash used in investing activities	(50,490)	(53,363)
Cash flows from financing activities		
Proceeds from borrowings	26,000	—
Principal payments on borrowings	(37,253)	(34,536)
Proceeds from exercise of stock options	16,828	7,916
Excess tax benefits on employee share-based compensation	6,175	2,903
Repurchases of common stock	(48,202)	—

Dividends paid on common stock	(7,012)	(4,665)
Net cash used in financing activities	(43,464)	(28,382)
Net increase (decrease) in cash	4,724	(6,264)
Effect of exchange rates on cash	30	(95)
Cash at beginning of year	40,301	41,729
Cash at end of period	$45,055	$35,370
Supplemental cash flow information:		
Cash paid (received) during the period for:		
Interest	$2,257	$2,986
Income taxes	25,184	(114)

See accompanying notes to condensed consolidated financial statements.

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

1. Organization and Operations

Basis of Financial Statement Presentation— The accompanying condensed consolidated financial statements include those of Heartland Payment Systems, Inc. (the “Company,” “we,” “us,” or “our”) and its wholly-owned subsidiaries, Heartland Payroll Company (“HPC”), Debitek, Inc. (“Debitek”) and Heartland Acquisition LLC (“Network Services”), and its 70% owned subsidiary Collective POS Solutions Ltd. (“CPOS”). The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company's subsidiaries have been eliminated upon consolidation. Certain amounts relating to 2011 financial information have been reclassified to conform with the current year presentation.

The accompanying condensed consolidated financial statements are unaudited. In the opinion of the Company's management, the unaudited condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of the Company's financial position at September 30, 2012, its results of operations, changes in stockholders’ equity and cash flows for the nine months ended September 30, 2012 and 2011. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ending December 31, 2012. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2011. The December 31, 2011 condensed consolidated balance sheet was derived from the audited 2011 consolidated financial statements.

In the Consolidated Statements of Cash Flow, the prior period reflects a correction to the presentation of the reconciliation of net income to net cash provided by operating activities. Previously, the reconciliation of net income to net cash provided by operating activities started with net income attributable to Heartland, and net income attributable to noncontrolling interests was included as a reconciling item. As restated, the reconciliation of net income to net cash provided by operating activities starts with net income which includes noncontrolling interests. This change had no effect on reported net cash provided by operating activities.

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

Over 73% of the Company's revenue is derived from processing and settling Visa and MasterCard bankcard transactions for its merchant customers. Because the Company is not a "member bank" as defined by Visa and MasterCard, in order to process and settle these bankcard transactions for its merchants, the Company has entered into sponsorship agreements with member banks. Visa and MasterCard rules restrict the Company from performing funds settlement or accessing merchant settlement funds and require that these funds be in the possession of the member bank until the merchant is funded. A sponsorship agreement permits the Company to route Visa and MasterCard bankcard transactions under the member bank's control and identification numbers to clear credit bankcard transactions through Visa and MasterCard. A sponsorship agreement also enables the Company to settle funds between cardholders and merchants by delivering funding files to the member bank, which in turn transfers settlement funds to the merchants' bank accounts. These restrictions place the settlement assets and obligations under the control of the member bank.

The sponsorship agreements with the member banks require, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard networks, and certain of the Sponsor banks require a certificate of deposit or a cash balance in a deposit account. If the Company breaches a sponsorship agreement, the Sponsor banks may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative Sponsor bank. The Company is dependent on its Sponsor banks, Visa and MasterCard for notification of any compliance breaches. As of September 30, 2012, the Company has not been notified of any such issues by its Sponsor banks, Visa or MasterCard.

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

At September 30, 2012, the Company was processing under four bank sponsorship agreements.

- On February 8, 2012, the Company entered into a sponsorship agreement with Wells Fargo Bank, N.A. ("WFB"). The WFB sponsorship agreement will be in effect until February 8, 2016 and will automatically renew for successive three year periods unless either party provides six months' written notice of non-renewal to the other party. Processing for small and mid-sized merchants (referred to as "Small and Midsized Enterprises," or “SME merchants”) under the WFB sponsorship commenced in August 2012, when that activity was transferred from its previous sponsor, KeyBank, National Association.

- In November 2009, the Company entered into a sponsorship agreement with The Bancorp Bank to sponsor processing for the Company's large national and mid-tier merchants. The agreement with The Bancorp Bank expires in November 2014.

- On March 24, 2011, the Company entered into a sponsorship agreement with Barclays Bank Delaware to sponsor processing for certain of the Company's large national merchants. The agreement with Barclays Bank Delaware expires in March 2016 with an automatic one year renewal.

- In 2007, the Company entered into a sponsorship agreement with Heartland Bank, an unrelated third party, to sponsor SME merchant processing. The agreement with Heartland Bank has been renewed through September 2013.

Following is a breakout of the Company’s total Visa and MasterCard settled bankcard processing volume for the month ending September 30, 2012 by percentage processed under its individual bank sponsorship agreements:

Sponsor Bank	% of September 2012 Bankcard Processing Volume
Wells Fargo Bank, N.A.	62%
The Bancorp Bank	17%
Barclays Bank Delaware	14%
Heartland Bank	7%

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

Since its announcement of the Processing System Intrusion on January 20, 2009 and through September 30, 2012, the Company has expensed a total of $147.6 million, before reducing those charges by $31.2 million of total insurance recoveries. The majority of the total charges of approximately $114.7 million relates to settlements of claims. Approximately $32.9 million of the total charges were for legal fees and costs the Company incurred for investigations, defending various claims and actions, remedial actions and crisis management services.

During the three months ended September 30, 2012, the Company incurred approximately $0.3 million, or less than one cent per share, for legal fees and costs it incurred related to the Processing System Intrusion. During the three months ended September 30, 2011, the Company expensed approximately $0.1 million, or less than one cent per share, related to the Processing System Intrusion. During the nine months ended September 30, 2012, the Company incurred approximately $0.5 million, or $0.01 per share, for legal fees and costs it incurred related to the Processing System Intrusion. During the nine months ended September 30, 2011, the Company expensed approximately $0.8 million, or $0.01 per share, related to the Processing System Intrusion.

2. Summary of Significant Accounting Policies

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

Cash and Cash Equivalents—At September 30, 2012, cash included approximately $27.4 million of processing-related cash in transit and collateral, compared to approximately $28.0 million of processing-related cash in transit and collateral at December 31, 2011.

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

The Company's primary receivables are from its bankcard processing merchants. In addition to receivables for transaction fees the Company charges its merchants for processing transactions, these receivables include amounts resulting from the Company's practice of advancing interchange fees to most of its SME merchants during the month and collecting those fees at the beginning of the following month. The Company does not advance interchange fees to its Network Services Merchants.

Generally, the Company uses cash available for investment to fund these advances to SME merchants; when available cash has been expended, the Company directs its sponsor banks to make these advances, thus generating a payable to the sponsor banks. We pay our sponsor banks the prime rate on these payables. At September 30, 2012, the Company used $41.5 million of its available cash to fund merchant advances and at December 31, 2011, the Company used $40.0 million of its cash to fund merchant advances. The amount due to sponsor banks for funding advances was $43.8 million at September 30, 2012 and $45.2 million at December 31, 2011. 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. Unlike the SME merchants, Network Services Merchants are invoiced monthly, on payment terms of 30 days net from date of invoicing.

Receivables also include amounts resulting from the pre-funding of Discover and American Express transactions to some of the Company's merchants and are due from the related bankcard networks. These amounts are recovered the next business day from the date of processing the transaction.

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

Investments and Funds Held for Payroll Customers—Investments, including those carried on the Condensed Consolidated Balance Sheets as Funds held for payroll customers, consist primarily of fixed income bond funds and certificates of deposit. Funds held for payroll customers also include overnight bank deposits. The majority of investments carried in Funds held for payroll customers are available-for-sale and recorded at fair value based on quoted market prices. Certificates of deposit are classified as held to maturity and recorded at cost. In the event of a sale, cost is determined on a specific identification basis. At September 30, 2012, Funds held for payroll customers included cash and cash equivalents of $38.0 million and investments available for sale of $1.2 million.

Capitalized Customer Acquisition Costs, net—Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company's sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the estimated cost of buying out the commissions of vested sales employees. Capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The up-front signing bonus paid for new SME bankcard, payroll and loyalty marketing accounts 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 SME bankcard merchant processing, consistent

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with the build-up in the accrued buyout liability, as described below. Beginning in June 2012, Relationship Managers and sales managers earn portfolio equity on their newly installed payroll and loyalty marketing merchant accounts based on the residual commissions they earn on those accounts. The accrued buyout liability and deferred acquisition cost asset are developed the same as the SME bankcard merchant portfolio equity.

Management evaluates the capitalized customer acquisition costs for impairment 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 September 30, 2012.

Accrued Expenses and Other Liabilities— Accrued expenses and other liabilities on the Condensed Consolidated Balance Sheet includes deferred revenue of $14.2 million and $8.8 million at September 30, 2012 and December 31, 2011, respectively, which is primarily related to our Heartland School Solutions business.

Processing Liabilities and Loss Reserves—The majority of the Company's processing liabilities include funds in transit associated with bankcard and check processing. In addition, the Company maintains merchant deposits to offset potential liabilities from merchant chargeback processing. Disputes between a cardholder and a merchant periodically arise due to the cardholder's dissatisfaction with merchandise quality or the merchant's service, and the disputes may not always be resolved in the merchant's favor. In some of these cases, the transaction is "charged back" to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company's obligation to stand ready to perform is minimal. The Company maintains a deposit or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to recent bankcard processing volume levels. The Company believes that the liability recorded as loss reserves approximates fair value.

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

Beginning in June 2012, Relationship Managers and sales managers earn portfolio equity on their newly installed payroll and loyalty marketing merchant accounts based on the residual commissions they earn on those accounts. The accrued buyout liability and deferred acquisition cost asset are accrued identically as the SME bankcard merchant portfolio equity.

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

The classification of the accrued buyout liability between current and non-current liabilities on the Condensed Consolidated Balance Sheets is based upon the Company's estimate of the amount of the accrued buyout liability that it

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

reasonably expects to pay over the next twelve months. This estimate is developed by calculating the cumulative annual average percentage that total historical buyout payments represent of the accrued buyout liability. That percentage is applied to the period-end accrued buyout liability to determine the current portion.

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

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

Loss Contingencies and Legal Expenses—The Company records a liability for loss contingencies when the liability is probable and the amount is reasonably estimable. Legal fees associated with loss contingencies are recorded when the legal fees are incurred.

The Company records recoveries from its insurance providers when cash is received from the provider.

Other Income (Expense)— Other income (expense) consists of interest income on cash and investments, the interest cost on our borrowings, the gains or losses on the disposal of property and equipment and other non-operating income or expense items. For the nine months ended September 30, 2012, other income (expense) included pre-tax charges of $0.9 million primarily due to write downs of capitalized information technology development projects. For the nine months ended September 30, 2011, other income (expense) included pre-tax charges of $0.8 million reflecting the costs (primarily accrued staff termination costs and fixed asset write downs) associated with closing of the Company's Johnson City, Tennessee service center.

Other income (expense) also includes the pre-tax charges related to the Provision for processing system intrusion costs.

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

The provision for income taxes for the three and nine months ended September 30, 2012 and 2011 and the resulting effective tax rates were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Provision for income taxes	$11,974	$7,784	$31,448	$20,098
Effective tax rate	38.0 %	37.9 %	38.0 %	37.8 %

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

The Company regularly evaluates its tax positions for additional unrecognized tax benefits and associated interest and penalties, if applicable. There are many factors that are considered when evaluating these tax positions including:

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interpretation of tax laws, recent tax litigation on a position, past audit or examination history, and subjective estimates and assumptions, which have been deemed reasonable by management. However, if management's estimates are not representative of actual outcomes, the Company's results could be materially impacted. The Company does not expect any material changes to unrecognized tax benefits in the next twelve months. At September 30, 2012, the reserve for unrecognized tax benefits related to uncertain tax positions was $2.5 million, of which $1.6 million would, if recognized, impact the effective tax rate. At December 31, 2011, the reserve for unrecognized tax benefits related to uncertain tax positions was $1.8 million, of which $1.1 million would, if recognized, impact the effective tax rate.

Share–Based Compensation—- In the fourth quarter of 2010, the Company's Board of Directors approved grants of 508,800 performance-based Restricted Share Units. These Restricted Share Units are share awards which would vest 50% in 2013, 25% in 2014, and 25% in 2015 only if, over the term of these Restricted Share Units, the following diluted earnings per share targets for the years ended December 31, 2012, 2013 and 2014 are achieved:

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

(a) Calculated on a pro forma basis to exclude non-operating gains and losses, if any, and excluding the after-tax impact of share-based compensation expense.

No share-based compensation expense was recorded on these Restricted Share Units in 2010, the first quarter of 2011, the second quarter of 2011, or the third quarter of 2011. Management subsequently determined that achieving these performance targets was probable to occur and as of December 31, 2011 began recording share-based compensation expense for these Restricted Share Units. The closing price of the Company's common stock on the grant date equals the grant date fair value of these nonvested Restricted Share Units awards and will be recognized as compensation expense over their vesting periods.

In the fourth quarter of 2011, the Company's Board of Directors approved grants of 164,808 performance-based Restricted Share Units. These Restricted Share Units are nonvested share awards which would vest 50% in 2014 and 50% in 2015 only if the Company achieves a diluted earnings per share compound annual growth rate ("CAGR") of seventeen percent (17%) for the two-year period ending December 31, 2013. Diluted earnings per share will be calculated on a pro forma basis to exclude non-operating gains and losses, if any, and exclude the after-tax impact of share-based compensation expense. For each 1% that the CAGR actually achieved by the Company for the two year period ending on December 31, 2013 is above the 17% target, the number of shares underlying the Restricted Share Units awarded would be increased by 3.09%; provided, however, that the maximum increase in the number of shares that may be awarded is 100%. Likewise, for each 1% that the CAGR actually achieved by the Company for the two-year period ending on December 31, 2013 is below the 17% target, the number of shares underlying the Restricted Share Units awarded would be decreased by 1.13%. If the target CAGR is missed by 80% or more, then the number of shares awarded is zero. In the fourth quarter of 2011 and the first quarter of 2012, the Company recorded expense on these Restricted Share Units based on achieving the 17% target.

Management subsequently determined that achieving a CAGR for the two-year period ending December 31, 2013 which would result in earning the maximum 100% increase in the number of shares that may be awarded was probable to occur, and as of June 30, 2012 began recording share-based compensation expense for these Restricted Share Units based on 329,616 shares. The closing price of the Company's common stock on the grant date equals the grant date fair value of these nonvested Restricted Share Units awards and will be recognized as compensation expense over their vesting periods.

Diluted earnings per share for the nine months ended September 30, 2012 and 2011 were computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options and vesting of Restricted Share Units, where dilutive.

Common Stock Repurchases. On October 21, 2011, the Company's Board of Directors authorized the repurchase of up to $50 million worth of the Company's outstanding common stock. Repurchases under this program were completed as of June 30, 2012. On July 27, 2012, the Company's Board of Directors authorized a new program to repurchase up to 50 million of the Company's outstanding common stock. Repurchases under these programs were made through the open market in accordance with applicable laws and regulations. The Company funded repurchases with cash flow from operations, existing cash on the balance sheet, and other sources including the proceeds of options exercises. At September 30, 2012, the Company had $34.0 million remaining under the July 27, 2012 authorization to repurchase its common stock, but in the month of October 2012 the Company completed all of the remaining repurchases authorized under this program. No common stock

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was repurchased in the nine months ended September 30, 2011. A summary of repurchase activity under these authorizations is as follows:

	Three Months Ended			
October 2011 Authorization	December 31, 2011	March 31, 2012	June 30, 2012	Total
Shares Repurchased	778,889	419,249	738,191	1,936,329
Cost of Shares Repurchased	$16.8 million	$11.4 million	$21.8 mi	