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BERKSHIRE BANCORP INC /DE/
Form 10-Q
November 04, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

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 number: 0-13649

BERKSHIRE BANCORP INC.

(Exact name of registrant as specified in its charter)

Delaware	94-2563513
-----	-----
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
160 Broadway, New York, New York	10038
-----	-----
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (212) 791-5362

N/A

(Former name, former address and former fiscal year, if changed since
last report)

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

Indicate by check mark whether the registrant is an accelerated filer (as
defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate by check mark whether the registrant is a shell company (as defined in

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Rule 12b-2 of the Exchange Act). Yes No X
--- ---

As of November 4, 2005, there were 6,886,556 outstanding shares of the issuers Common Stock, \$.10 par value.

BERKSHIRE BANCORP INC. AND SUBSIDIARIES

FORWARD-LOOKING STATEMENTS

Forward-Looking Statements. Statements in this Quarterly Report on Form 10-Q that are not based on historical fact may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "believe", "may", "will", "expect", "estimate", "anticipate", "continue" or similar terms identify forward-looking statements. A wide variety of factors could cause the Company's actual results and experiences to differ materially from the results expressed or implied by the Company's forward-looking statements. Some of the risks and uncertainties that may affect operations, performance, results of the Company's business, the interest rate sensitivity of its assets and liabilities, and the adequacy of its loan loss allowance, include, but are not limited to: (i) deterioration in local, regional, national or global economic conditions which could result, among other things, in an increase in loan delinquencies, a decrease in property values, or a change in the housing turnover rate; (ii) changes in market interest rates or changes in the speed at which market interest rates change; (iii) changes in laws and regulations affecting the financial services industry; (iv) changes in competition; (v) changes in consumer preferences, (vi) changes in banking technology; (vii) ability to maintain key members of management, (viii) possible disruptions in the Company's operations at its banking facilities, (ix) cost of compliance with new corporate governance requirements, and other factors referred to in the sections of this Quarterly Report entitled "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Certain information customarily disclosed by financial institutions, such as estimates of interest rate sensitivity and the adequacy of the loan loss allowance, are inherently forward-looking statements because, by their nature, they represent attempts to estimate what will occur in the future.

The Company cautions readers not to place undue reliance upon any forward-looking statement contained in this Quarterly Report. Forward-looking statements speak only as of the date they were made and the Company assumes no obligation to update or revise any such statements upon any change in applicable circumstances.

BERKSHIRE BANCORP INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands)
(unaudited)

	September 30, 2005	D
	-----	-----
ASSETS		
Cash and due from banks	\$ 7,362	\$
Interest bearing deposits	4,102	
Federal funds sold	6,100	
	-----	-----
Total cash and cash equivalents	17,564	1
Investment Securities:		
Available-for-sale	611,745	63
Held-to-maturity, fair value of \$593 in 2005 and \$633 in 2004	578	
	-----	-----
Total investment securities	612,323	63
Loans, net of unearned income	281,492	28
Less: allowance for loan losses	(3,129)	(
	-----	-----
Net loans	278,363	28
Accrued interest receivable	6,143	
Premises and equipment, net	8,698	
Goodwill, net	18,549	1
Other assets	8,640	
	-----	-----
Total assets	\$950,280	\$ 97
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	\$ 44,069	\$4
Interest bearing	607,844	57
	-----	-----
Total deposits	651,913	61
Securities sold under agreements to repurchase	65,290	12
Long term borrowings	91,719	9
Subordinated debt	22,681	1
Accrued interest payable	4,811	
Other liabilities	3,993	
	-----	-----

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Total liabilities	840,404	86
	-----	----
Stockholders' equity		
Preferred stock - \$.10 Par value:	--	
2,000,000 shares authorized - none issued		
Common stock -- \$.10 par value		
Authorized -- 10,000,000 shares		
Issued -- 7,698,285 shares		
Outstanding --		
September 30, 2005, 6,874,556 shares		
December 31, 2004, 6,751,675 shares	770	
Additional paid-in capital	90,284	8
Retained earnings	32,858	2
Accumulated other comprehensive loss, net	(6,142)	(
Treasury Stock		
September 30, 2005, 823,729 shares		
December 31, 2004, 946,610 shares	(7,897)	(
	-----	----
Total stockholders' equity	109,873	10
	-----	----
	\$950,280	\$ 97
	=====	=====

The accompanying notes are an integral part of these statements

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (In Thousands, Except Per Share Data) (unaudited)

	For The Three Months Ended September 30,		Ni
	2005	2004	2005
	-----	-----	-----
INTEREST INCOME			
Loans	\$ 4,738	\$ 4,652	\$ 14,27
Investment securities	6,452	5,601	19,10
Federal funds sold and interest bearing deposits	60	23	21
	-----	-----	-----
Total interest income	11,250	10,276	33,59
	-----	-----	-----
INTEREST EXPENSE			
Deposits	3,730	2,448	9,84

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Short-term borrowings	849	641	2,62
Long-term borrowings	1,300	1,014	3,81
	-----	-----	-----
Total interest expense	5,879	4,103	16,27
	-----	-----	-----
Net interest income	5,371	6,173	17,31
PROVISION FOR LOAN LOSSES	45	45	13
	-----	-----	-----
Net interest income after provision for loan losses	5,326	6,128	17,18
	-----	-----	-----
NON-INTEREST INCOME			
Service charges on deposits	158	139	43
Investment securities gains	--	173	
Other income	142	143	41
	-----	-----	-----
Total non-interest income	300	455	85
	-----	-----	-----
NON-INTEREST EXPENSE			
Salaries and employee benefits	1,996	1,670	5,97
Net occupancy expense	433	453	1,29
Equipment expense	99	90	29
FDIC assessment	70	37	20
Data processing expense	51	48	14
Other	572	828	1,88
	-----	-----	-----
Total non-interest expense	3,221	3,126	9,79
	-----	-----	-----
Income before provision for taxes	2,405	3,457	8,24
Provision for income taxes	1,108	1,489	3,89
	-----	-----	-----
Net income	\$ 1,297	\$ 1,968	\$ 4,34
	=====	=====	=====
Net income per share:			
Basic	\$.19	\$.29	\$.6
	=====	=====	=====
Diluted	\$.19	\$.29	\$.6
	=====	=====	=====

The accompanying notes are an integral part of these statements.

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For The Nine Months Ended September 30, 2005
(In Thousands)
(unaudited)

	Common Shares -----	Stock Par value -----	Additional paid-in capital -----	Accumulated other comprehensive (loss), net -----	Retained earnings -----	Treasu stoc -----
Balance at December 31, 2004	7,698	\$770	\$89,543	\$ (2,602)	\$28,983	\$ (9,0
Net income					4,346	
Exercise of stock options			741			1,1
Other comprehensive (loss) net of reclassification adjustment and taxes				(3,540)		
Comprehensive income						
Cash dividends					(471)	
Balance at September 30, 2005 (Unaudited)	7,698	\$770 =====	\$90,284 =====	\$ (6,142) =====	\$32,858 =====	\$ (7,8 =====

The accompanying notes are an integral part of this statement.

BERKSHIRE BANCORP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

For

2005

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Cash flows from operating activities:

Net income	\$ 4,3
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	
Realized gains on investment securities	(
Net (accretion) amortization of premiums of investment securities	4
Depreciation and amortization	1
Provision for loan losses	(1
(Increase) in accrued interest receivable	(1
(Increase) in other assets	(2,2
Increase (decrease) in accrued interest payable and other liabilities	2,8

Net cash provided by operating activities	5,4

Cash flows from investing activities:

Investment securities available for sale	
Purchases	(337,5
Sales, maturities and calls	353,2
Investment securities held to maturity	
Maturities	
Net decrease in loans	5,5
Acquisition of premises and equipment	(5

Net cash provided by (used in) investing activities	20,7

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

For The Nine Months Ended
September 30,

	2005	2004
	-----	-----
Cash flows from financing activities:		
Net increase in non interest bearing deposits	1,878	3
Net increase in interest bearing deposits	30,147	17,4
(Decrease) increase in securities sold under agreements to repurchase	(62,457)	28,2
Proceeds from long term debt	20,000	22,0
Repayment of long term debt	(23,886)	(13,5

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Proceeds from issuance of subordinated debentures	7,217	14,7
Acquisition of treasury stock	--	(
Proceeds from exercise of common stock options	1,509	1,1
Cash paid for fractional shares	--	(4
Dividends paid	(471)	(3
	-----	-----
Net cash (used in) provided by financing activities	(26,063)	69,5
	-----	-----
Net increase in cash	181	5,8
Cash - beginning of period	17,383	9,3
	-----	-----
Cash - end of period	\$ 17,564	\$ 15,1
	=====	=====
Supplemental disclosure of cash flow information:		
Cash used to pay interest	\$ 13,983	\$ 11,1
Cash used to pay taxes, net of refunds	\$ 5,558	\$ 4,4

The accompanying notes are an integral part of these statements.

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements September 30, 2005 and 2004

NOTE 1. General

Berkshire Bancorp Inc., a Delaware corporation, is a bank holding company registered under the Bank Holding Company Act of 1956. References herein to "Berkshire", the "Company" or "we" and similar pronouns, shall be deemed to refer to Berkshire Bancorp Inc. and its consolidated subsidiaries unless the context otherwise requires. Berkshire's principal activity is the ownership and management of its wholly owned subsidiary, The Berkshire Bank (the "Bank"), a New York State chartered commercial bank.

The accompanying financial statements of Berkshire Bancorp Inc. and subsidiaries includes the accounts of the parent company, Berkshire Bancorp Inc., and its wholly-owned subsidiaries: The Berkshire Bank, Greater American Finance Group, Inc. and East 39, LLC.

During interim periods, the Company follows the accounting policies set forth in its Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC"). Readers are encouraged to refer to the Company's Form 10-K for the fiscal year ended December 31, 2004 when reviewing this Form 10-Q. Quarterly results reported herein are not necessarily indicative of results to be expected for other quarters or a full fiscal year.

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In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary to present fairly the Company's consolidated financial position as of September 30, 2005 and December 31, 2004 and the consolidated results of its operations for the three and nine month periods ended September 30, 2005 and 2004, and its consolidated stockholders' equity for the nine month period ended September 30, 2005, and its consolidated cash flows for the nine month periods ended September 30, 2005 and 2004. As discussed in Note 2 below, all weighted share and per share information in 2004 has been retroactively restated to reflect the stock split and stock dividend.

NOTE 2. Stock Split and Stock Dividend.

At the Annual Meeting of Stockholders held on May 18, 2004, the Company's stockholders approved an amendment to the Company's Certificate of Incorporation effecting a one-for-ten reverse stock split of the Company's issued and outstanding Common Stock (the "Reverse Split"). Following the effectiveness of the Reverse Split, the Company's Board of Directors declared a thirty-for-one forward stock split in the form of a stock dividend in Common Stock (the "Stock Dividend") which became effective immediately. The Company paid approximately \$463,000 to purchase fractional shares from stockholders as part of the Reverse Split. The Company's Common Stock began trading on May 19, 2004 giving effect to these transactions.

NOTE 3. Trust Preferred Securities.

As of May 18 2004, the Company established Berkshire Capital Trust I, a Delaware statutory trust, ("BCTI"). The Company owns all the common capital securities of BCTI. BCTI issued \$15.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTI's common capital securities, in the Company through the purchase of \$15.464 million aggregate principal amount of Floating Rate Junior Subordinated Debentures (the "2004 Debentures") issued by the Company. The 2004 Debentures, the sole assets of BCTI, mature on July 23, 2034 and bear interest at a floating rate, three month LIBOR plus 2.70%.

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (continued)

NOTE 3. - (continued)

On April 1, 2005, the Company established Berkshire Capital Trust II, a Delaware statutory trust, ("BCTII"). The Company owns all the common capital securities of BCTII. BCTII issued \$7.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTII's common capital securities, in the Company through the purchase of \$7.217 million aggregate principal amount of Floating Rate Junior Subordinated Debentures (the "2005 Debentures") issued by the Company. The 2005 Debentures, the sole assets of BCTII, mature on May 23, 2035 and bear interest at a floating rate, three month LIBOR plus 1.95%.

Based on current interpretations of the banking regulators, the 2004 Debentures and 2005 Debentures (collectively, the "Debentures") qualify under the risk-based capital guidelines of the Federal Reserve as Tier 1 capital, subject to certain limitations. The Debentures are callable by the Company,

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subject to any required regulatory approvals, at par, in whole or in part, at any time after five years from the date of issuance. The Company's obligations under the Debentures and related documents, taken together, constitute a full, irrevocable and unconditional guarantee on a subordinated basis by the Company of the obligations of BCTI and BCTII under the preferred capital securities sold by BCTI and BCTII to investors. FIN46(R) precludes consideration of the call option embedded in the preferred capital securities when determining if the Company has the right to a majority of BCTI and BCTII expected residual returns. Accordingly, BCTI is not and BCTII will not be included in the consolidated balance sheet of the Company.

The Federal Reserve has issued guidance on the regulatory capital treatment for the trust-preferred securities issued by BCTI and BCTII. This rule would retain the current maximum percentage of total capital permitted for Trust Preferred Securities at 25%, but would enact other changes to the rules governing Trust Preferred Securities that affect their use as part of the collection of entities known as "restricted core capital elements." The rule would take effect March 31, 2009; however, a five year transition period starting March 31, 2004 and leading up to that date would allow bank holding companies to continue to count Trust Preferred Securities as Tier 1 Capital after applying FIN-46(R). Management has evaluated the effects of this rule and does not anticipate a material impact on its capital ratios when the proposed rule is finalized.

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements (continued)

NOTE 4. Earnings Per Share

Basic earnings per share is calculated by dividing income available to common stockholders by the weighted average common shares outstanding, excluding stock options from the calculation. In calculating diluted earnings per share, the dilutive effect of stock options is calculated using the average market price for the Company's common stock during the period. The following table presents the calculation of earnings per share for the periods indicated:

	For The Three Months Ended			
	September 30, 2005			
	Income (numerator)	Shares (denominator)	Per share amount	Income (numerator)
(In thousands, except per share)				
Basic earnings per share				
Net income available to common stockholders	\$ 1,297	6,817	\$.19	\$ 1,
Effect of dilutive securities options	--	109	--	--

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Diluted earnings per share				
Net income available to common stockholders plus assumed conversions	\$ 1,297	6,926	\$.19	\$ 1,
	=====	=====	=====	=====
	For The Nine Months Ended			
	September 30, 2005			
	Income (numerator)	Shares (denominator)	Per share amount	Income (numerator)
	-----	-----	-----	-----
	(In thousands, except per share)			
Basic earnings per share				
Net income available to common stockholders	\$ 4,346	6,778	\$.64	\$ 5
Effect of dilutive securities options	--	147	(.01)	
	-----	-----	-----	-----
Diluted earnings per share				
Net income available to common stockholders plus assumed conversions	\$ 4,346	6,925	\$.63	\$ 5
	=====	=====	=====	=====

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

NOTE 5. Investment Securities

The following tables summarize held to maturity and available-for-sale investment securities as of September 30, 2005 and December 31, 2004:

	September 30, 2005			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	F v
	-----	-----	-----	-----
	(In thousands)			
Held To Maturity				
Investment Securities				
U.S. Government Agencies	\$ 578	\$ 28	\$ --	\$
Totals	\$ 578	\$ 28	\$ --	\$

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	=====	=====	=====	=====
	December 31, 2004			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	F v
	-----	-----	-----	-----
	(In thousands)			
Held To Maturity				
Investment Securities				
U.S. Government Agencies	\$ 624	\$ 10	\$ (1)	\$
Totals	\$ 624	\$ 10	\$ (1)	\$
	=====	=====	=====	=====

	September 30, 2005			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	F v
	-----	-----	-----	-----
	(In thousands)			
Available-For-Sale Investment Securities				
U.S. Treasury and Notes	\$ 14,971	\$ --	\$ (136)	\$
U.S. Government Agencies	470,080	--	(6,499)	
Mortgage-backed securities	87,256	173	(1,430)	
Corporate notes	37,094	191	(1,811)	
Municipal Securities	1,973	211	--	
Marketable equity securities and other	9,479	269	(76)	
Totals	\$ 620,853	\$ 844	\$ (9,952)	\$
	=====	=====	=====	=====

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

NOTE 5. - (continued)

	December 31, 2004			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	F v
	-----	-----	-----	-----
	(In thousands)			
Available-For-Sale Investment securities				

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U.S. Treasury and Notes	\$ 24,896	\$ --	\$ (174)	\$
U.S. Government Agencies	471,018	97	(3,844)	
Mortgage-backed securities	109,822	504	(996)	
Corporate Notes	21,089	692	(154)	
Municipal securities	1,307	134	--	
Marketable equity securities and other	6,363	279	(65)	
	-----	-----	-----	-----
Totals	\$ 634,495	\$ 1,706	\$ (5,233)	\$
	=====	=====	=====	=====

NOTE 6. Loan Portfolio

The following table sets forth information concerning the Company's loan portfolio by type of loan at the dates indicated:

	September 30, 2005		December 31,	
	-----		-----	
	Amount	% of Total	Amount	
	-----	-----	-----	
	(Dollars in thousands)			
Commercial and professional loans	\$ 23,755	8.4%	\$ 16,498	
Secured by real estate				
1-4 family	142,168	50.4	155,079	
Multi family	3,022	1.1	4,600	
Non-residential (commercial)	111,019	39.3	109,597	
Consumer	2,281	0.8	1,989	
	-----	-----	-----	
Total loans	282,245	100.0%	287,763	
		=====		
Deferred loan fees	(753)		(784)	
Allowance for loan losses	(3,129)		(2,927)	
	-----		-----	
Loans, net	\$ 278,363		\$ 284,052	
	=====		=====	

BERKSHIRE BANCORP INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

NOTE 7. Deposits

The following table summarizes the composition of the average balances of major deposit categories:

September 30, 2005		December 31,	
-----		-----	
Average	Average	Average	Av

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	Amount -----	Yield -----	Amount -----	Y ---
			(Dollars in thousands)	
Demand deposits	\$ 45,155	--	\$ 38,896	
NOW and money market	42,624	0.54%	47,677	
Savings deposits	237,444	1.93	224,542	
Time deposits	319,140	2.60	309,968	
	-----	-----	-----	---
Total deposits	\$ 644,363	2.04%	\$ 621,083	
	=====	=====	=====	=====

NOTE 8. Comprehensive Income

The following table presents the components of comprehensive income, based on the provisions of SFAS No. 130.:

	For The Nine Months Ended			
	September 30, 2005			Se
	Before tax amount	Tax (expense) benefit	Net of tax Amount	Before tax amount
	-----	-----	-----	-----
			(In thousands)	
Unrealized (losses) gains on investment securities:				
Unrealized holding gains (losses) arising during period	\$ (5,586)	\$ 2,043	\$ (3,543)	\$ (4,80
Less reclassification adjustment for gains realized in net income	5	(2)	3	31
	-----	-----	-----	-----
Other comprehensive (loss), net	\$ (5,581)	\$ 2,041	\$ (3,540)	\$ (4,49
	=====	=====	=====	=====

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BERKSHIRE BANCORP INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

NOTE 9. Accounting For Stock Based Compensation

In December 2004, the Financial Accounting Standards Board (the "FASB") issued Statement No. 123 (Revised), Share-Based Payment, ("FAS 123(R)"). FAS 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured

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based on the fair value of the equity or liability instruments issued. We will be required to apply FAS 123(R) in the first quarter of 2006. The scope of FAS 123(R) includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. FAS 123(R) revises FASB Statement 123, Accounting for Stock-Based Compensation ("FAS 123"), and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees.

At September 30, 2005, the Company has one stock-based employee compensation plan. The Company accounts for that plan under the recognition and measurement principles of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The fair value of each option is estimated on the date of grant using the Black-Scholes options-pricing model using weighted-average assumptions for expected volatility, risk-free interest and expected life of the option. Since all stock options outstanding are vested, proforma net income has not been presented. The Company did not grant stock options during the nine months ended September 30, 2005 and 2004.

NOTE 10. Employee Benefit Plans

The Company has a Retirement Income Plan (the "Plan"), a noncontributory plan covering substantially all full-time, non-union United States employees of the Company. The following interim-period information is being provided in accordance with FASB Statement 132(R).

	For The Three Months Ended September 30,		For The Nine Months En September 30
	2005	2004	2005
Service cost	\$ 79,381	\$ 62,640	\$ 224,762
Interest cost	35,425	30,750	98,850
Expected return on plan assets	(38,940)	(37,550)	(111,880)
Amortization and Deferral:			
Transition amount	--	--	--
Prior service cost	4,593	4,625	13,779
(Gain)/loss	11,228	5,350	28,863
Net periodic pension cost	91,687	65,815	254,374

During the fiscal year ending December 31, 2005, we expect to contribute approximately \$112,000 to the Plan, which amount was paid in July 2005.

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Notes to Consolidated Financial Statements (continued)

NOTE 11. New Accounting Pronouncements

Stock-Based Compensation

In December 2004, the FASB issued FAS 123(R) which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. In accordance with recent guidance from the Securities and Exchange Commission, the Company will be required to apply FAS 123(R) on January 1, 2006.

The scope of FAS 123(R) includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. FAS 123(R) revises FASB Statement 123, Accounting for Stock-Based Compensation ("FAS 123"), and supersedes the Accounting Principles Board (the "APB") Opinion No. 25, Accounting for Stock Issued to Employees ("APB Opinion No. 25").

FAS 123(R) provides two methods for companies to transition to the new standard requiring the expensing of options. Companies may elect to (i) restate results for prior quarters in the fiscal year of adoption of FAS 123(R) to reflect the FAS 123 proforma compensation costs, or (ii) restate results for prior periods, whether annual or quarterly, to reflect the FAS 123 proforma compensation costs. We are in the process of determining which transition approach to use and the effect, if any, such transition approach will have on our financial statements.

The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments

In November 2003, the Emerging Issues Task Force (the "EITF") of the FASB issued EITF Abstract 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments" (EITF 03-1). The quantitative and qualitative disclosure provisions of EITF 03-1 are effective for years ending after December 15, 2003 and were included in the Company's 2003 Form 10-K. In March 2004, the EITF issued a Consensus on Issue 03-1 requiring that the provisions of EITF 03-1 be applied for reporting periods beginning after June 15, 2004 to investments accounted for under SFAS Nos. 115 and 124. EITF 03-1 establishes a three-step approach for determining whether an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. In September 2004, the FASB issued a proposed Board-directed FASB Staff Position, FSP EITF Issue 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF 03-1" ("FSP 115-1")

The proposed FSP 115-1 would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under paragraph 16 of EITF 03-1. The FASB had directed the FASB staff to delay the effective date for the measurement and recognition guidance contained in paragraphs 10-20 of EITF Issue No. 03-1, including steps two and three of the three-step approach for determining whether an investment is other-than-temporarily impaired. However, step one of that approach must still be initially applied for impairment evaluations in reporting periods beginning after June 15, 2004. The delay of the effective date for paragraphs 10-20 of EITF Issue 03-1 will be superseded with the final issuance of proposed FSP EITF Issue 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1."

BERKSHIRE BANCORP INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

NOTE 11. (continued)

In June 2005, the FASB decided to issue proposed FSP 115-1 as final and without providing additional guidance on the meaning of other-than-temporary impairment. The final FSP will be retitled FSP FAS 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," and will supersede EITF 03-1. The final FSP will replace the guidance in paragraphs 10-18 of EITF Issue 03-1 with references to existing other-than-temporary impairment guidance, such as Statement 115, "Accounting for Certain Investments in Debt and Equity Securities," Staff Accounting Bulletin 59, "Accounting for Noncurrent Marketable Equity Securities," and APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." FSP FAS 115-1 will clarify that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made.

At its September 1, 2005 meeting, the FASB decided that it will further discuss whether to provide transition accounting for debt securities subsequent to other-than-temporary impairment and whether to proceed with drafting the final FSP.

The Company is in the process of determining the impact that this FSP will have on its financial statements.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The current objective of the Bank's Internal Control Program is to allow management to comply with FDICIA requirements and with Section 302 of the Sarbanes-Oxley Act of 2002 (the "Act"). Section 302 of the Act requires the CEO and CFO of the Company to (i) certify that the annual and quarterly reports filed with the Securities and Exchange Commission are accurate and (ii) acknowledge that they are responsible for establishing, maintaining and periodically evaluating the effectiveness of the disclosure controls and procedures. Section 404 of the Act requires management to report on internal control over financial reporting. The SEC requires us to comply with Section 404 by the year ending December 31, 2007.

The Committee of Sponsoring Organizations (COSO) methodology may be used to document and test the internal controls pertaining to the accuracy of Company issued financial statements and related disclosures. COSO requires a review of the control environment (including anti-fraud and audit committee effectiveness), risk assessment, control activities, information and communication, and ongoing monitoring.

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RESULTS OF OPERATIONS.

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of Berkshire Bancorp Inc., a Delaware corporation. References herein to "Berkshire", the "Company" or "we" and similar pronouns, shall be deemed to refer to Berkshire Bancorp Inc. and its consolidated subsidiaries unless the context otherwise requires. References herein to per share amounts refer to diluted shares. References to Notes herein are references to the "Notes to Consolidated Financial Statements" of the Company located in Item 1 herein.

Critical Accounting Policies, Judgments and Estimates

The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and general practices within the financial services industry. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and the assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

The Company considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than any of its other significant accounting policies. The allowance for loan losses is calculated with the objective of maintaining a reserve level believed by management to be sufficient to absorb estimated credit losses. Management's determination of the adequacy of the allowance is based on periodic evaluations of the loan portfolio and other relevant factors. However, this evaluation is inherently subjective as it requires material estimates, including, among others, expected default probabilities, loss given default, the amounts and timing of expected future cash flows on impaired loans, mortgages, and general amounts for historical loss experience. The process also considers economic conditions, uncertainties in estimating losses and inherent risks in the loan portfolio. All of these factors may be susceptible to significant change. To the extent actual outcomes differ from management estimates, additional provisions for loan losses may be required that would adversely impact earnings in future periods.

With the adoption of SFAS No. 142 on January 1, 2002, the Company discontinued the amortization of goodwill resulting from acquisitions. Goodwill is now subject to impairment testing at least annually to determine whether write-downs of the recorded balances are necessary. The Company tests for impairment based on the goodwill maintained at each defined reporting unit. A fair value is determined for each reporting unit based on at least one of three various market valuation methodologies. If the fair values of the reporting units exceed their book values, no write-down of recorded goodwill is necessary. If the fair value of the reporting unit is less, an expense may be required on the Company's books to write down the related goodwill to the proper carrying value. As of December 31, 2004, the Company completed its impairment testing, which determined that no impairment write-offs were necessary.

The Company recognizes deferred tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryforwards and tax credits. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. If management determines that the Company may be unable to realize all or part of net deferred tax assets in the future, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount.

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The following table presents the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed in both dollars and rates.

	For The Three Months Ended September			
	2005			
	Average Balance	Interest and Dividends	Average Yield/Rate	Average Balance
	-----	-----	-----	-----
	(Dollars in Thousands)			
INTEREST-EARNING ASSETS:				
Loans (1)	\$ 284,282	\$ 4,738	6.67%	\$ 289,476
Investment securities	646,601	6,452	3.99	628,530
Other (2) (5)	7,982	60	3.01	7,443
	-----	-----	-----	-----
Total interest-earning assets	938,865	11,250	4.79	925,449

Noninterest-earning assets	44,063			43,303
	-----			-----
Total Assets	\$ 982,928			\$ 968,752
	=====			=====
INTEREST-BEARING LIABILITIES:				
Interest bearing deposits	239,469	1,109	1.85%	272,840
Time deposits	353,417	2,621	2.97	309,465
Other borrowings	225,670	2,149	3.81	238,319
	-----	-----	-----	-----
Total interest-bearing liabilities	818,556	5,879	2.87	820,624
		-----	-----	
Demand deposits	44,419			39,048
Noninterest-bearing liabilities	8,182			7,094
Stockholders' equity (5)	111,771			101,986
	-----			-----
Total liabilities and stockholders' equity	\$ 982,928			\$ 968,752
	=====			=====
Net interest income		5,371		
		=====		
Interest-rate spread (3)			1.92%	
			=====	
Net interest margin (4)			2.29%	
			=====	
Ratio of average interest-earning				

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assets to average interest
bearing liabilities

1.15

1.13

=====

=====

-
- (1) Includes nonaccrual loans.
 - (2) Includes interest-bearing deposits, federal funds sold and securities purchased under agreements to resell.
 - (3) Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest bearing liabilities.
 - (4) Net interest margin is net interest income as a percentage of average interest-earning assets.
 - (5) Average balances are daily average balances except for the parent company which have been calculated on a monthly basis.

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For The Nine Months Ended September

	2005			
	Average Balance	Interest and Dividends	Average Yield/Rate	Average Balance
	-----	-----	-----	-----
	(Dollars in Thousands)			
INTEREST-EARNING ASSETS:				
Loans (1)	\$ 286,888	\$ 14,279	6.64%	\$ 292,139
Investment securities	661,744	19,104	3.85	614,828
Other (2) (5)	11,158	212	2.53	4,239
	-----	-----	-----	-----
Total interest-earning assets	959,790	33,595	4.67	911,206

Noninterest-earning assets	43,915			39,465
	-----			-----
Total Assets	\$ 1,003,705			\$ 950,671
	=====			=====
INTEREST-BEARING LIABILITIES:				
Interest bearing deposits	280,068	3,615	1.72%	265,234
Time deposits	319,140	6,230	2.60	316,817
Other borrowings	242,904	6,433	3.53	214,077
	-----	-----	-----	-----
Total interest-bearing liabilities	842,112	16,278	2.58	796,128
		-----	-----	
Demand deposits	45,155			37,864
Noninterest-bearing liabilities	7,308			13,007
Stockholders' equity (5)	109,130			103,672
	-----			-----

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Total liabilities and stockholders' equity	\$ 1,003,705 =====	\$ 950,671 =====
Net interest income	17,317 =====	
Interest-rate spread (3)		2.09% =====
Net interest margin (4)		2.41% =====
Ratio of average interest-earning assets to average interest bearing liabilities	1.14 =====	1.14 =====

-
- (1) Includes nonaccrual loans.
 - (2) Includes interest-bearing deposits, federal funds sold and securities purchased under agreements to resell.
 - (3) Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest bearing liabilities.
 - (4) Net interest margin is net interest income as a percentage of average interest-earning assets.
 - (5) Average balances are daily average balances except for the parent company which have been calculated on a monthly basis.

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Results of Operations

Results of Operations for the Three and Nine Months Ended September 30, 2005
Compared to the Three and Nine Months Ended September 30, 2004.

General. Berkshire Bancorp Inc., a bank holding company registered under the Bank Holding Company Act of 1956, has one wholly-owned banking subsidiary, The Berkshire Bank, a New York State chartered commercial bank. The Bank is headquartered in Manhattan and has nine branch locations, five branches in New York City and four branches in Orange and Sullivan counties New York.

Net Income. Net income for the three-month period ended September 30, 2005 was \$1.30 million, or \$.19 per share, as compared to \$1.97 million, or \$.29 per share, for the three-month period ended September 30, 2004. Net income for the nine-month period ended September 30, 2005 was \$4.35 million, or \$.63 per share, as compared to \$5.40 million, or \$.79 per share, for the nine-month period ended September 30, 2004.

The Company's net income is largely dependent on interest rate levels, the demand for the Company's loan and deposit products and the strategies employed to manage the interest rate and other risks inherent in the banking business. From September 2003 through September 30, 2004, interest rates, as

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measured by the prime rate, remained constant at 4.00%. On July 1, 2004, inflation fighting actions taken by the Federal Reserve Board resulted in a 25 basis point increase in the prime rate to 4.25%, the first such increase in more than four years. Similar 25 basis point moves taken by the Federal Reserve Board during 2004 and 2005, the last occurring in September 2005, have moved the prime rate to its present level of 6.75%.

Net Interest Income. The Company's primary source of revenue is net interest income, or the difference between interest income on earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities such as deposits and borrowings.

For the quarter ended September 30, 2005, net interest income decreased by \$802,000 to \$5.37 million from \$6.17 million for the quarter ended September 30, 2004. The quarter over quarter decrease in net interest income was the result of the 87 basis point increase in the average rate paid on the average amount of interest-bearing liabilities to 2.87% in the 2005 quarter from 2.00% in the 2004 quarter and the smaller, 35 basis point increase in the average yield earned on the average amount of interest-earning assets. Partially offsetting the interest rate factors was the \$2.07 million decrease in the average amount of interest-bearing liabilities to \$818.56 million in 2005 from \$820.62 million in 2004 and \$13.42 million increase in the amount of interest-earning assets to \$938.87 million in 2005 from \$925.45 million in 2004. The interest-rate spread, the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, narrowed by 52 basis points to 1.92% in the 2005 quarter from 2.44% in the 2004 quarter.

For the nine-month period ended September 30, 2005, net interest income decreased by \$604,000 to \$17.32 million from \$17.92 million for the nine-month period ended September 30, 2004. The period over period decrease in net interest income was the result of the 63 basis point increase in the average rate paid on the average amount of interest-bearing liabilities to 2.58% in the 2005 period from 1.95% in the 2004 period, and the smaller, 35 basis point increase in the average yield earned on the average amount of interest-earning assets, and the \$45.98 million increase in the average amount of interest-bearing liabilities to \$842.11 million in the 2005 period from \$796.13 million in the 2004 period. Partially offsetting these factors was the \$48.58 million increase in the amount of interest-earning assets to \$959.79 million in the 2005 period from \$911.21 million in the 2004 period. The interest-rate spread narrowed by 28 basis points to 2.09% in the 2005 period from 2.37% in the 2004 period.

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If interest rates remain at current levels or increase slowly over time, we expect to see only moderate pressure on the Company's interest-rate spread and net interest income. Investment securities in our portfolio that have been sold, matured or called by the issuer during fiscal 2004 have been replaced with securities carrying somewhat lower yields and, by design, shorter maturities to hedge against a rising interest rate environment. Rates paid on deposit accounts are likely to increase in a rising rate environment due to competition for deposits in the market place. The cost of borrowed funds with floating rather than fixed interest rates have and will continue to increase as well.

Net Interest Margin. Net interest margin, or annualized net interest income as a percentage of average interest-earning assets, declined by 38 basis points to 2.29% in the third quarter of 2005 from 2.67% in the third quarter of 2004, and declined by 21 basis points to 2.41% in the nine-month period of 2005 from 2.62%

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in the nine-month period of 2004. We seek to secure and retain customer deposits with competitive products and rates, and to make strategic use of the prevailing interest rate environment to borrow funds at what we believe to be attractive rates. We invest such deposits and borrowed funds in a prudent mix of fixed and adjustable rate loans, investment securities and short-term interest-earning assets which provided an aggregate average yield of 4.79% and 4.67% in the three and nine months ended September 30, 2005, respectively, compared to an aggregate average yield of 4.44% and 4.32% in the three and nine months ended September 30, 2004, respectively. The increased yield is the result of the rising interest rate environment discussed above which triggers the upward rate adjustment in our portfolio of adjustable rate loans and investment securities.

For the three months ended September 30, 2005, the average amounts of loans decreased by \$5.19 million to \$284.28 million from \$289.48 million for the three months ended September 30, 2004. However, the average yield on such loans increased by 24 basis points to 6.67% in the 2005 quarter from 6.43% in the 2004 quarter. In the 2005 quarter, the average amount of investment securities and other interest-earning assets increased by \$18.07 million and \$539,000, respectively, to \$646.60 million and \$7.98 million, respectively, from \$628.53 million and \$7.44 million, respectively, in the 2004 quarter. The average yield on investment securities and other interest-earning increased to 3.99% and 3.01%, respectively, during the three months ended September 30, 2005 from 3.56% and 1.24%, respectively, during the three months ended September 30, 2004.

For the nine month period ended September 30, 2005, the average amounts of loans decreased by \$5.25 million to \$286.89 million from \$292.14 million for the nine month period ended September 30, 2004. However, the average yield on such loans increased by 21 basis points to 6.64% in the first nine months of 2005 from 6.43% in the first nine months of 2004. In the 2005 period, the average amount of investment securities and other interest-earning assets increased by \$46.92 million and \$6.92 million, respectively, to \$661.74 million and \$11.16 million, respectively, from \$614.83 million and \$4.24 million, respectively, in the 2004 period. The average yield on investment securities and other interest-earning increased to 3.85% and 2.53%, respectively, during the nine months ended September 30, 2005 from 3.34% and 1.10%, respectively, during the nine months ended September 30, 2004.

Interest Income. Total interest income for the quarter ended September 30, 2005 increased by \$974,000, or 9.48%, to \$11.25 million from \$10.28 million for the quarter ended September 30, 2004. The increase in total interest income was due to higher average balances and higher average yields on interest-earning assets. Loans and investment securities contributed \$4.74 million and \$6.45 million, respectively, of interest income in the 2005 quarter compared to \$4.65 million and \$ 5.60 million, respectively in the 2004 quarter.

----- Three Months Ended September 30, -----		
2005		2004
-----		-----
Interest Income	% of Total	Interest Income

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(In thousands, except percentages)

Loans	\$	4,738	42.12%	\$	4,652
Investment Securities		6,452	57.35		5,601
Other		60	0.53		23
<hr/>					
Total Interest Income	\$	11,250	100.00%	\$	10,276

Total interest income for the nine months ended September 30, 2005 increased by \$4.06 million, or 13.73%, to \$33.60 million from \$29.54 million for the nine months ended September 30, 2004. The increase in total interest income was due to higher average balances and higher average yields on interest-earning assets. Loans and investment securities contributed \$14.28 million and \$19.10 million, respectively, of interest income in the 2005 period compared to \$14.10 million and \$15.41 million, respectively in the 2004 period.

<hr/>					
Nine Months Ended September 30,					
<hr/>					
	2005			2004	
	<hr/>			<hr/>	
	Interest	% of		Interest	
	Income	Total		Income	
	(In thousands, except percentages)				
Loans	\$	14,279	42.50%	\$	14,097
Investment Securities		19,104	56.87		15,408
Other		212	0.63		35
<hr/>					
Total Interest Income	\$	33,595	100.00%	\$	29,540

Loans, which are inherently risky and therefore command a higher return than our conservative portfolio of investment securities, have declined slightly as a percentage of total average interest-earning assets. During the three and nine months ended September 30, 2005, the average amount of our loan portfolio represented 30.28% and 29.89%, respectively, of total interest-earning assets compared to 31.28% and 32.06%, respectively, for the three and nine months ended September 30, 2004. The average amount of investment securities have increased to 68.87% and 68.95% of total interest-earning assets during the three and nine months of 2005, respectively, compared to 67.92% and 67.47%, respectively, during the three and nine months ended September 30, 2004. While we actively seek to originate new loans with qualified borrowers who meet the Bank's underwriting standards, our strategy has been to maintain those standards, sacrificing some current income to avoid possible large future losses in the loan portfolio.

<hr/>					
Three Months Ended September 30,					
<hr/>					
	2005			2004	
	<hr/>			<hr/>	
	Average	% of		Average	
	Amount	Total		Amount	
	(In thousands, except percentages)				

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Loans	\$	284,282	30.28%	\$	289,476
Investment Securities		646,601	68.87		628,530
Other		7,982	0.85		7,443
<hr/>					
Total Interest-Earning Assets	\$	938,865	100.00%	\$	925,449

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<hr/>					
Nine Months Ended September 30,					
<hr/>					
	2005			2004	
	<hr/>			<hr/>	
	Average Amount	% of Total (In thousands, except percentages)		Average Amount	
Loans	\$ 286,888	29.89%	\$	292,139	
Investment Securities	661,744	68.95		614,828	
Other	11,158	1.16		4,239	
<hr/>					
Total Interest-Earning Assets	\$ 959,790	100.00%	\$	911,206	

Interest Expense. Total interest expense for the quarter ended September 30, 2005 increased by \$1.78 million, or 43.29%, to \$5.88 million from \$4.10 million for the quarter ended September 30, 2004. The increase in interest expense was due primarily to the increase in the average rates paid on such liabilities, 2.87% and 2.00% in the 2005 and 2004 quarters, respectively, partially offset by the \$2.07 million decline in the average amount of interest-bearing liabilities. If and when interest rates move higher, interest expense is likely to increase as we price our deposit products to meet the competition and the adjustable rates paid on other borrowings increase as well. In May 2004 and April 2005, we sold \$15.46 million and \$7.22 million, respectively, of floating rate junior subordinated debentures (the "Debentures") and used the net proceeds to augment the Bank's capital to allow for business expansion. The additional interest expense on these Debentures, which is included in other borrowings was, approximately \$354,000 and \$190,000 during the three months ended September 30, 2005 and 2004, respectively.

<hr/>					
Three Months Ended September 30,					
<hr/>					
	2005			2004	
	<hr/>			<hr/>	
	Interest Expense	% of Total (In thousands, except percentages)		Interest Expense	
Interest-Bearing Deposits	\$ 1,109	18.86%	\$	955	
Time Deposits	2,621	44.59		1,493	
Other Borrowings	2,149	36.55		1,655	

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Total Interest Expense	\$	5,879	100.00%	\$	4,103
------------------------	----	-------	---------	----	-------

Total interest expense for the nine-month period ended September 30, 2005 increased by \$4.66 million, or 40.10%, to \$16.28 million from \$11.62 million for the nine-month period ended September 30, 2004. The increase in interest expense was due primarily to the growth in the average amount of interest-bearing liabilities and the increase in the average rates paid on such liabilities, 2.58% and 1.95% in the 2005 and 2004 nine-month periods, respectively. The interest expense on the Debentures, which is included in other borrowings was, approximately \$903,000 and \$254,000 during the 2005 and 2004 nine-month periods, respectively.

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	Nine Months Ended September 30,		
	2005		2004
	Interest Expense	% of Total (In thousands, except percentages)	Interest Expense
Interest-Bearing Deposits	\$ 3,615	22.21%	\$ 2,704
Time Deposits	6,230	38.27	4,590
Other Borrowings	6,433	39.52	4,325
Total Interest Expense	\$ 16,278	100.00%	\$ 11,619

Non-Interest Income. Non-interest income consists primarily of realized gains on sales of marketable securities and service fee income. For the three and nine months ended September 30, 2005, non-interest income amounted to \$300,000 and \$854,000, respectively, compared to non-interest income of \$455,000 and \$1.12 million for the three and nine months ended September 30, 2004, respectively.

	Three Months Ended September 30,		
	2005		2004
	Non-Interest Income	% of Total (In thousands, except percentages)	Non-Interest Income

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Service Charges on Deposits	\$	158	52.67%	\$	139
Investment Securities gains		--	0.00		173
Other		142	47.33		143
		-----	-----		-----
Total Non-Interest Income	\$	300	100.00%	\$	455

Nine Months Ended September 30,					

	2005			2004	
	-----			-----	
	Non-Interest	% of		Non-Interest	
	Income	Total		Income	
		(In thousands, except percentages)			
Service Charges on Deposits	\$	436	51.05	\$	380
Investment Securities gains		5	0.59		315
Other		413	48.36		429
		-----	-----		-----
Total Non-Interest Income	\$	854	100.00%	\$	1,124

Non-Interest Expense. Non-interest expense includes salaries and employee benefits, occupancy and equipment expenses, legal and professional fees and other operating expenses associated with the day-to-day operations of the Company. Total non-interest expense for the three and nine-month periods ended September 30, 2005 was \$3.22 million and \$9.79 million, respectively, compared to \$3.13 million and \$9.26 million for the three and nine month-periods ended September 30, 2004, respectively. The increases in the 2005 periods are primarily due to the expansion of our business. We have added space and staff to maintain and enhance customer service levels and to insure our compliance with various regulatory matters.

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Other non-interest expense decreased to \$572,000 and \$1.89 million, respectively, in the three and nine month-periods ended September 30, 2005, respectively, from \$828,000 and \$2.80 million in the three and nine month-periods ended September 30, 2004, respectively. The decreases are primarily due to expenses of a non-recurring nature. In July 2004, we settled a cancelled lease for the Bank's former headquarters in an amount which was less than the full amount remaining on the lease, but more than we had estimated and accrued. The Company recorded the remaining \$175,000, in other non-interest expense for the three and nine months ended September 30, 2004, to recognize the full settlement amount which was paid in August 2004. Also in 2004, we engaged legal and accounting professionals to assist the Company with an internal investigation and record approximately \$320,000 of additional non-interest expense in 2004.

Three Months Ended September 30,

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	2005		2004	
	Non-Interest Expense	% of Total (In thousands, except percentages)	Non-Interest Expense	
Salaries and Employee Benefits	\$ 1,996	61.98%	\$ 1,670	
Net Occupancy Expense	433	13.44	453	
Equipment Expense	99	3.07	90	
FDIC Assessment	70	2.17	37	
Data Processing Expense	51	1.58	48	
Other	572	17.76	828	
Total Non-Interest Expense	\$ 3,221	100.00%	\$ 3,126	

	2005		2004	
	Non-Interest Expense	% of Total (In thousands, except percentages)	Non-Interest Expense	
Salaries and Employee Benefits	\$ 5,972	60.99%	\$ 4,865	
Net Occupancy Expense	1,291	13.19	1,129	
Equipment Expense	293	2.99	258	
FDIC Assessment	206	2.10	83	
Data Processing Expense	144	1.47	126	
Other	1,886	19.26	2,799	
Total Non-Interest Expense	\$ 9,792	100.00%	\$ 9,260	

Provision for Income Tax. During the three and nine-month periods ended September 30, 2005, the Company recorded income tax expense of \$1.11 million and \$3.90 million, respectively, compared to income tax expense of \$1.49 million and \$4.25 million, respectively, for the three and nine-month periods ended September 30, 2004. The tax provisions for federal, state and local taxes recorded for the first nine month of 2005 and 2004 represent effective tax rates of 47.28% and 44.04%, respectively.

Common Stock Repurchases

On May 15, 2003, The Company's Board of Directors authorized the purchase of up to an additional 450,000 shares of its Common Stock in the open market, from time to time, depending upon prevailing market conditions, thereby increasing the maximum number of shares which may be purchased by the Company from 1,950,000 shares of Common Stock to 2,400,000 shares of Common Stock. Since

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1990 through December 31, 2004, the Company has purchased a total of 1,844,646 shares of its Common Stock. At September 30, 2005, there were 551,091 shares of Common Stock which may yet be purchased under our stock repurchase plan. The following table sets forth information with respect to such purchases during the periods indicated.

Fiscal Year 2005

	Number of Shares Purchased	Average Price Paid Per Share
	-----	-----
January - September	--	--

Fiscal Year 2004

	Number of Shares Purchased	Average Price Paid Per Share
	-----	-----
January - March	4,263	\$ 16.33
April - December	--	--

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Interest Rate Risk. Fluctuations in market interest rates can have a material effect on the Company's net interest income because the yields earned on loans and investments may not adjust to market rates of interest with the same frequency, or with the same speed, as the rates paid by the Bank on its deposits.

Most of the Bank's deposits are either interest-bearing demand deposits or short term certificates of deposit and other interest-bearing deposits with interest rates that fluctuate as market rates change. Management of the Bank seeks to reduce the risk of interest rate fluctuations by concentrating on loans and securities investments with either short terms to maturity or with adjustable rates or other features that cause yields to adjust based upon interest rate fluctuations. In addition, to cushion itself against the potential adverse effects of a substantial and sustained increase in market interest rates, the Bank has purchased off balance sheet interest rate cap contracts which generally provide that the Bank will be entitled to receive payments from the other party to the contract if interest rates exceed specified levels. These contracts are entered into with major financial institutions.

As additional interest rate management strategy, the Bank borrows funds from the Federal Home Loan Bank, approximately \$91.72 million at September 30, 2005, at fixed rates for a period of one to five years.

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The Company seeks to maximize its net interest margin within an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of the forecasted net interest income that may be gained or lost due to favorable or unfavorable movements in interest rates. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities.

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In the banking industry, a traditional measure of interest rate sensitivity is known as "gap" analysis, which measures the cumulative differences between the amounts of assets and liabilities maturing or repricing at various time intervals. The following table sets forth the Company's interest rate repricing gaps for selected maturity periods:

		Berkshire Bancorp Interest Rate Sensitivity Gap a (in thousands, except fo		
		3 Months or Less	3 Through 12 Months	1 Through 3 Years
Federal funds sold		6,100	--	--
	(Rate)	3.75%		
Interest bearing deposits in banks		4,102	--	--
	(Rate)	2.82%		
Loans (1) (2)				
Adjustable rate loans		44,254	11,631	7,436
	(Rate)	7.90%	5.43%	7.33%
Fixed rate loans		373	6,582	24,003
	(Rate)	7.23%	7.49%	6.75%
Total loans		44,627	18,213	31,439
Investments (3) (4)		80,919	165,794	103,991
	(Rate)	3.35%	3.11%	3.80%
Total rate-sensitive assets		135,748	184,007	135,430
Deposit accounts (5)				
Savings and NOW		200,237	--	--
	(Rate)	1.86%		
Money market		17,741	--	--
	(Rate)	0.73%		
Time Deposits		97,754	269,389	22,708
	(Rate)	2.53%	3.33%	2.94%
Total deposit accounts		315,732	269,389	22,708
Repurchase Agreements		27,408	12,882	25,000
	(Rate)	3.13%	3.35%	2.90%
Other borrowings		508	1,099	59,400

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	(Rate)	1.78%	4.48%	3.54%
		-----	-----	-----
Total rate-sensitive liabilities		343,648	283,370	107,108
		-----	-----	-----
Interest rate caps				(20,000)
Gap (repricing differences)		(207,900)	(99,363)	48,322
		=====	=====	=====
Cumulative Gap		(207,900)	(307,263)	(258,941)
		=====	=====	=====
Cumulative Gap to Total Rate Sensitive Assets		(22.98)%	(33.96)%	(28.62)%
		=====	=====	=====

-
- (1) Adjustable-rate loans are included in the period in which the interest rates are next scheduled to adjust rather than in the period in which the loans mature. Fixed-rate loans are scheduled according to their maturity dates.
 - (2) Includes nonaccrual loans.
 - (3) Investments are scheduled according to their respective repricing (variable rate loans) and maturity (fixed rate securities) dates.
 - (4) Investments are stated at book value.
 - (5) NOW accounts and savings accounts are regarded as readily accessible withdrawal accounts. The balances in such accounts have been allocated among maturity/repricing periods based upon The Berkshire Bank's historical experience. All other time accounts are scheduled according to their respective maturity dates.

Provision for Loan Losses. The Company maintains an allowance for loan losses at a level deemed sufficient to absorb losses, which are inherent in the loan portfolio at each balance sheet date. Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management's assessment of probable estimated losses. The Company's methodology for assessing the appropriateness of the allowance for loan losses consists of several key elements. These elements include a specific allowance for loan watch list classified loans, an allowance based on historical trends, an additional allowance for special circumstances, and an unallocated portion. The Company consistently applies the following comprehensive methodology.

The allowance for loan watch list classified loans addresses those loans maintained on the Company's loan watch list, which are assigned a rating of substandard, doubtful, or loss. Substandard loans are those with a well-defined weakness or a weakness, which jeopardizes the repayment of the debt. A loan may be classified as substandard as a result of impairment of the borrower's financial condition and repayment capacity. Loans for which repayment plans have not been met or collateral equity margins do not protect the Company may also be classified as substandard. Doubtful loans have the characteristics

of substandard loans with the added characteristic that collection or liquidation in full, on the basis of presently existing facts and conditions, is highly improbable. Although the possibility of loss is extremely high for doubtful loans, the classification of loss is deferred until pending factors, which might improve the loan, have been determined. Loans rated as doubtful in whole or in part are placed in nonaccrual status. Loans, which are classified as loss, are considered uncollectible and are charged to the allowance for loan losses.

For the three and nine months ended September 30, 2005, we charged-off loans of \$0 and \$25,000, respectively, and recovered loans of \$3,000 and \$92,000, respectively. For the three and nine months ended September 30, 2004, we charged-off loans of \$0 and \$1,000, respectively, and recovered loans of \$112,000 and \$139,000, respectively. All recovered amounts in 2005 and 2004 were returned to the provision for loan loss reserves.

Loans on the loan watch list may also be impaired loans, which are defined as nonaccrual loans or troubled debt restructurings, which are not in compliance with their restructured terms. Each of the classified loans on the loan watch list is individually analyzed to determine the level of the potential loss in the loan under the current circumstances. The specific reserve established for these criticized and impaired loans is based on careful analysis of the loan's performance, the related collateral value, cash flow considerations and the financial capability of any guarantor. The allowance for loan watch list classified loans is equal to the total amount of potential unconfirmed losses for the individual classified loans on the watch list. Loan watch list loans are managed and monitored by assigned Senior Management.

The allowance based on historical trends uses charge-off experience of the Company to estimate potential unconfirmed losses in the balances of the loan and lease portfolios. The historical loss experience percentage is based on the charge-off history. Historical loss experience percentages are applied to all non-classified loans to obtain the portion of the allowance for loan losses which is based on historical trends. Before applying the historical loss experience percentages, loan balances are reduced by the portion of the loan balances, which are subject to guarantee, by a government agency. Loan balances are also adjusted for unearned discount on installment loans.

The Company also maintains an unallocated allowance. The unallocated allowance is used to cover any factors or conditions, which may cause a potential loan loss but are not specifically identifiable. It is prudent to maintain an unallocated portion of the allowance because no matter how detailed an analysis of potential loan losses is performed these estimates by definition lack precision. Management must make estimates using assumptions and information, which is often subjective and changing rapidly.

Since all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

A loan is placed in a nonaccrual status at the time when ultimate collectibility of principal or interest, wholly or partially, is in doubt. Past

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due loans are those loans which were contractually past due 90 days or more as to interest or principal payments but are well secured and in the process of collection. Renegotiated loans are those loans which terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of the deteriorating financial position of the borrower.

At September 30, 2005 and 2004, we had a total of \$275,000 and \$537,000, respectively, of non accrual or non performing loans, and no loans past due more than 90 days and still accruing interest at either date. Based upon management's evaluations of the overall analysis of the Bank's allowance for loan losses, the year over year decrease in total loans to \$282.25 million from \$288.22 million and the economic conditions in our market area, the provision for the nine months ended September 30, 2005, including net recoveries which are added back to the provision, increased to \$3.13 million from \$2.87 million in the year ago period.

Management believes that the allowance for loan losses and nonperforming loans remains safely within acceptable levels.

The following table sets forth information with respect to activity in the Company's allowance for loan losses during the periods indicated (in thousands, except percentages):

	Three Months Ended September 30,		Nine m Sept
	2005	2004	2005
	----	----	----
Average loans outstanding	\$284,282	\$289,476	\$286,888
	=====	=====	=====
Allowance at beginning of period	3,081	2,709	2,927
Charge-offs:			
Commercial and other loans	--	--	25
Real estate loans	--	--	--
	-----	-----	-----
Total loans charged-off	--	--	25
	-----	-----	-----
Recoveries:			
Commercial and other loans	3	112	92
Real estate loans	--	--	--
	-----	-----	-----
Total loans recovered	3	112	92
	-----	-----	-----
Net recoveries (charge-offs)	3	112	67
	-----	-----	-----
Provision for loan losses			
charged to operating expenses	45	45	135
	-----	-----	-----
Allowance at end of period	3,129	2,866	3,129
	-----	-----	-----
Ratio of net recoveries (charge-offs)			
to average loans outstanding	0.00%	0.00%	0.02%
	=====	=====	=====
Allowance as a percent of total loans	1.11%	0.99%	1.11%
	=====	=====	=====
Total loans at end of period	\$282,245	\$288,221	\$282,245
	=====	=====	=====

Loan Portfolio.

Loan Portfolio Composition. The Company's loans consist primarily of mortgage loans secured by residential and non-residential properties as well as commercial loans which are either unsecured or secured by personal property collateral. Most of the Company's commercial loans are either made to individuals or personally guaranteed by the principals of the business to which the loan is made. At September 30, 2005, we had total gross loans of \$282.25 million, deferred loans fees of \$753,000 and an allowance for loan losses of \$3.13 million. From time to time, the Bank may originate residential mortgage loans and then sell them on the secondary market, normally recognizing fee income in connection with the sale. During the three and nine-month periods ended September 30, 2005, the Bank sold approximately \$0 and \$1.13 million, respectively, of such loans and recorded in other income, gains of \$0 and \$11,000, respectively, on such sales.

The following tables set forth information concerning the Company's loan portfolio by type of loan at the dates indicated:

	September 30, 2005	December 31, 2004
	Amount	Amount
	-----	-----
	(in thousands)	
Commercial and professional loans	\$ 23,755	\$ 16,498
Secured by real estate		
1-4 family	142,168	155,079
Multi family	3,022	4,600
Non-residential (commercial)	111,019	109,597
Consumer	2,281	1,989
	-----	-----
Total loans	282,245	287,763
Less:		
Deferred loan fees	(753)	(864)
Allowance for loan losses	(3,129)	(2,927)
	-----	-----
Loans, net	\$278,363	\$284,052
	=====	=====

It is the Bank's policy to discontinue accruing interest on a loan when it is 90 days past due or if management believes that continued interest accruals are unjustified. At September 30, 2005 and December 31, 2004, the Bank had \$275,000 and \$343,000, respectively, of loans in non-accrual status. The Bank may continue interest accruals if a loan is more than 90 days past due if the Bank determines that the nature of the delinquency and the collateral are such that collection of the principal and interest on the loan in full is

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reasonably assured. When the accrual of interest is discontinued, all accrued but unpaid interest is charged against current period income. Once the accrual of interest is discontinued, the Bank records interest as and when received until the loan is restored to accruing status. If the Bank determines that collection of the loan in full is in reasonable doubt, then amounts received are recorded as a reduction of principal until the loan is returned to accruing status. At September 30, 2005 and 2004, we did not have any loans past due more than 90 days and still accruing interest.

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Capital Adequacy

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and Tier I capital (as defined) to average assets (as defined). As of September 30, 2005, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain certain Total risk-based, Tier I risk-based, and Tier I leverage ratios. There are no conditions or events since the notification that management believes have changed the Bank's category.

The following tables set forth the actual and required regulatory capital amounts and ratios of the Company and the Bank as of September 30, 2005 and December 31, 2004 (dollars in thousands):

	Actual		For capital adequacy purposes		
	-----		-----		
	Amount	Ratio	Amount	Ratio	
	-----	-----	-----	-----	
September 30, 2005					
Total Capital (to Risk-Weighted Assets)					
Company	124,126	32.0%	31,081	>=8.0%	
Bank	94,031	25.6%	29,365	>=8.0%	
Tier I Capital (to Risk-Weighted Assets)					
Company	120,997	31.1%	15,540	>=4.0%	
Bank	90,902	24.8%	14,683	>=4.0%	
Tier I Capital (to Average Assets)					
Company	120,997	12.1%	40,148	>=4.0%	
Bank	90,902	9.7%	37,669	>=4.0%	

	Actual		For capital adequacy purposes		
	-----		-----		
	Amount	Ratio	Amount	Ratio	
	-----	-----	-----	-----	
December 31, 2004					
Total Capital (to Risk-Weighted Assets)					
Company	\$110,063	30.1%	\$29,234	>=8.0%	
Bank	82,970	24.1%	27,533	>=8.0%	
Tier I Capital (to Risk-Weighted Assets)					
Company	107,136	29.3%	14,617	>=4.0%	
Bank	80,042	23.3%	13,766	>=4.0%	
Tier I Capital (to Average Assets)					
Company	107,136	11.2%	38,250	>=4.0%	
Bank	80,042	8.6%	37,240	>=4.0%	

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The recent issuance of trust preferred securities on April 1, 2005 improved the Company's capital ratios in the second and third quarters of 2005. The banking regulators have not issued any guidance that would change the regulatory capital treatment for the trust preferred securities that are now outstanding, based on the adoption of FIN46(R). However, as additional interpretations from the banking regulators become available, management will re-evaluate the potential impact to its Tier 1 capital calculation of such interpretations.

The Company is not under any agreement with regulatory authorities nor is the Company aware of any current recommendations by the regulatory authorities, which, if such recommendations were implemented, would have a material effect on liquidity, capital resources or operations of the Company.

Liquidity

The management of the Company's liquidity focuses on ensuring that sufficient funds are available to meet loan funding commitments, withdrawals from deposit accounts, the repayment of borrowed funds, and ensuring that the Bank and the Company comply with regulatory liquidity requirements. Liquidity needs of the Bank have historically been met by deposits, investments in federal funds sold, principal and interest payments on loans, and maturities of investment securities.

For the Company, liquidity means having cash available to fund operating expenses, to pay shareholder dividends, when and if declared by the Company's Board of Directors and to pay the interest on the Debentures issued in May 2004 and April 2005. The ability of the Company to meet all of its obligations, including the payment of dividends, is not dependent upon the

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receipt of dividends from the Bank. At September 30, 2005, the Company, excluding the Bank, had cash and cash equivalents of approximately \$11.35 million and investment securities available for sale of \$12.22 million.

The Bank maintains financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments, approximately \$30.74 million at September 30, 2005, include commitments to extend credit and stand-by letters of credit.

At September 30, 2005, the Company had outstanding commitments of approximately \$485.99 million. These commitments include \$369.58 million that mature or renew within one year, \$83.64 million that mature or renew after one year and within three years, \$32.01 million that mature or renew after three years and within five years and \$760,000 that mature or renew after five years.

At September 30, 2005, The Company has two unconsolidated subsidiaries, Berkshire Capital Trust I, which was established in May 2004, and Berkshire Capital Trust II, which was established in April 2005.

Impact of Inflation and Changing Prices

The Company's financial statements measure financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increasing cost of the Company's operations. The assets and liabilities of the Company are largely monetary. As a result, interest rates have a greater impact on the Company's performance than do the effects of general levels of inflation. In addition, interest rates do not necessarily move in the direction, or to the same extent as the price of goods and services. However, in general, high inflation rates are accompanied by higher interest rates, and vice versa.

ITEM 4 - CONTROLS AND PROCEDURES

Evaluation of the Company's Disclosure Controls and Internal Control. As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company evaluated the effectiveness of the design and operation of its "disclosure controls and procedures" as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 ("Disclosure Controls"). This evaluation ("Controls Evaluation") was done under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") who is also the Chief Financial Officer ("CFO").

Limitations on the Effectiveness of Controls. The Company's management, including the CEO/CFO, does not expect that its Disclosure Controls and/or its "internal control over financial reporting" as defined in Rule 13(a)-15(f) of the Securities Exchange Act of 1934 ("Internal Control") will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in

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decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Conclusions. Based upon the Controls Evaluation, the CEO/CFO has concluded that the Disclosure Controls are effective in reaching a reasonable level of assurance that information required to be disclosed by the Company is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. In accordance with SEC requirements, the CEO/CFO notes that during the fiscal quarter ended September 30, 2005, no changes in Internal Control have occurred that have materially affected or are reasonably likely to materially affect Internal Control.

PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibit Number -----	Description -----
31	Certification of Principal Executive and Financial Officer pursuant to Section 302 Of The Sarbanes-Oxley Act of 2002.
32	Certification of Principal Executive and Financial Officer pursuant to Section 906 Of The Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

BERKSHIRE BANCORP INC.

(Registrant)

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Date: November 4, 2005

By: /s/ Steven Rosenberg

Steven Rosenberg
President and Chief
Financial Officer

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EXHIBIT INDEX

Exhibit Number -----	Description -----	Sequential Page Number -----
31	Certification of Principal Executive and Financial Officer pursuant to Section 302 Of The Sarbanes-Oxley Act of 2002.	38
32	Certification of Principal Executive and Financial Officer pursuant to Section 906 Of The Sarbanes-Oxley Act of 2002.	39

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STATEMENT OF DIFFERENCES

The greater-than-or-equal-to sign shall be expressed as..... >=

ave a material effect on the Company's Consolidated Financial Statements.

In September 2011, the FASB issued an accounting standard update on testing goodwill for impairment. This guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is more than its carrying amount, the two-step goodwill impairment test is not required. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 (early adoption is permitted). The Company has early

adopted the update and the implementation of this update did not have a material effect on the Company's Consolidated Financial Statements.

In December 2011, the FASB issued an accounting standard update on disclosures about offsetting assets and liabilities. This guidance requires entities to disclose information about offsetting and related arrangements to enable users of financial statements to understand the effect of those arrangements on the entity's financial position. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (i) offset in accordance with current literature or (ii) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with current literature. The update is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The implementation of this update is not expected to have a material effect on the Company's Consolidated Financial Statements.

3. Acquisitions

The Company initiated its K to 12 School Solutions product through its acquisitions of the school solutions businesses operated by Lunchbox, Comalex, mySchoolBucks, and School-Link Technologies. Lunchbox, Comalex, mySchoolBucks, and School-Link Technologies serve approximately 4,400, 3,700, 900 and 10,000 schools, respectively. The combined Heartland School Solutions develops, manufactures, sells, services and maintains computer software designed to facilitate accounting and management functions of school food service operations. These acquisitions provide the Company with the ability to offer Internet payment capability to parents, which facilitates on-line deposits of funds into student accounts and enables schools to operate more efficiently. The Company plans to consolidate the individual platforms and products of Lunchbox, Comalex, mySchoolBucks, and School-Link Technologies to optimize synergies, cost efficiencies and product offerings to customers. Pro forma results of operations have not been presented because the effect of these acquisitions was not material. The entire amount of goodwill is expected to be deductible for income tax reporting. Details of the individual acquisition transactions follow:

Lunchbox

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

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

our credit facilities. Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning December 30, 2010, Lunchbox's results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: \$6.0 million to goodwill, \$1.9 million to intangible assets and \$0.2 million to net tangible liabilities.

Comalex, Inc.

On January 12, 2011, the Company purchased for a \$6.1 million cash payment the net assets of Comalex, Inc. The acquisition was funded with cash on hand. Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning January 12, 2011, Comalex's results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: \$4.9 million to goodwill, \$1.8 million to intangible assets and \$0.6 million to net tangible liabilities.

mySchoolBucks, LLC

On February 4, 2011, the Company purchased for a \$1.5 million cash payment the net assets of mySchoolBucks, LLC. The acquisition was funded with cash on hand. Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting. Beginning February 4, 2011, mySchoolBucks' results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: \$1.0 million to goodwill and \$0.5 million to intangible assets.

School-Link Technologies, Inc.

On September 30, 2011, the Company purchased for a \$15.6 million cash payment the net assets of School-Link Technologies, Inc. The acquisition was funded with cash on hand. The transaction was accounted for under the purchase method of accounting. Beginning October 1, 2011, School Link's results of operations are included in the Company's results of operations. The allocation of the total purchase price was as follows: \$28.7 million to goodwill, \$4.3 million to intangible assets and \$17.4 million to net tangible liabilities. The fair values of the School-Link Technologies' assets acquired and liabilities assumed were estimated as of their acquisition date. The fair values are preliminary, based on estimates, and may be adjusted as more information becomes available and valuations are finalized.

4. Receivables

A summary of receivables by major class was as follows at March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011
	(In thousands)	
Accounts receivable from merchants	\$158,567	\$151,228
Receivables from bankcard networks	23,850	24,301
Accounts receivable from others	2,769	2,457
	185,186	177,986
Less allowance for doubtful accounts	(1,453)	(1,451)
Total receivables, net	\$183,733	\$176,535

Included in accounts receivable from others are amounts due from employees which are \$0.5 million and \$0.6 million at March 31, 2012 and December 31, 2011, respectively. Accounts receivable related to bankcard networks are primarily amounts which were pre-funded to merchants for processing Discover and American Express bankcard

transactions as well as amounts due from Visa for PIN debit transactions.

A summary of the activity in the allowance for doubtful accounts for the three months ended March 31, 2012 and 2011 was as follows:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Beginning balance	\$1,451	\$683
Additions to allowance	83	700
Charges against allowance	(81) (485
Ending balance	\$1,453	\$898

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

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 and investments available-for-sale by major security type and class of security were as follows at March 31, 2012 and December 31, 2011:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
March 31, 2012				
Funds Held for Payroll Customers:				
Fixed income bond fund - available for sale	\$968	\$208	\$—	\$1,176
Cash held for payroll customers	52,408	—	—	52,408
Total Funds Held for Payroll Customers	\$53,376	\$208	\$—	\$53,584
Investments:				
Investments held to maturity – Certificates of deposit (a)	\$2,157	\$—	\$—	\$2,157
Total investments	\$2,157	\$—	\$—	\$2,157

(a) Certificates of deposit have remaining terms ranging from 3 months to 17 months.

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(In thousands)			
December 31, 2011				
Funds Held for Payroll Customers:				
Fixed income bond fund - available for sale	\$968	\$190	\$—	\$1,158
Cash held for payroll customers	41,353	—	—	41,353
Total Funds Held for Payroll Customers	\$42,321	\$190	\$—	\$42,511
Investments:				
Investments held to maturity – Certificates of deposit	\$2,505	\$—	\$—	\$2,505
Total investments	\$2,505	\$—	\$—	\$2,505

During the three months ended March 31, 2012 and during the twelve months ended December 31, 2011, the Company did not experience any other-than-temporary losses on its investments. The maturity schedule of all available-for-sale debt securities and held to maturity investments along with amortized cost and estimated fair value as of March 31, 2012 is as follows:

	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	\$3,025	\$3,233
Due after one year through five years	100	100
	\$3,125	\$3,333

6. Capitalized Customer Acquisition Costs, Net

A summary of net capitalized customer acquisition costs as of March 31, 2012 and December 31, 2011 was as follows:

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

	March 31, 2012	December 31, 2011
	(In thousands)	
Capitalized signing bonuses	\$86,163	\$86,837
Less accumulated amortization	(44,218)	(45,125)
	41,945	41,712
Capitalized customer deferred acquisition costs	36,650	36,564
Less accumulated amortization	(23,256)	(23,262)
	13,394	13,302
Capitalized customer acquisition costs, net	\$55,339	\$55,014

A summary of the activity in capitalized customer acquisition costs, net for the three month periods ended March 31, 2012 and 2011 was as follows:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Balance at beginning of period	\$55,014	\$59,251
Plus additions to:		
Capitalized signing bonuses, net	7,554	7,116
Capitalized customer deferred acquisition costs	3,968	3,330
	11,522	10,446
Less amortization expense on:		
Capitalized signing bonuses, net	(7,321)	(8,514)
Capitalized customer deferred acquisition costs	(3,876)	(3,867)
	(11,197)	(12,381)
Balance at end of period	\$55,339	\$57,316

Net signing bonus adjustments from estimated amounts to actual were \$(0.6) million and \$(0.2) million, respectively, for the three months ended March 31, 2012 and 2011. Net signing bonus adjustments are netted against additions in the table above. Negative signing bonus adjustments occur when the actual gross margin generated by the merchant contract during the first year is less than the estimated gross margin for that year, resulting in the overpayment of the up-front signing bonus and would be recovered from the relevant salesperson. Positive signing bonus adjustments result from the prior underpayment of signing bonuses and would be paid to the relevant salesperson.

Fully amortized signing bonuses of \$8.0 million and \$12.3 million respectively, were written off during the three month periods ended March 31, 2012 and 2011. In addition, fully amortized customer deferred acquisition costs of \$3.9 million and \$3.8 million, respectively, were written off during the three months ended March 31, 2012 and 2011. The Company believes that no impairment of capitalized customer acquisition costs has occurred as of March 31, 2012.

7. Intangible Assets and Goodwill

Intangible Assets — Intangible assets consisted of the following as of March 31, 2012 and December 31, 2011:

	March 31, 2012			
	Gross	Accumulated	Net Asset	Amortization Life and Method
	Assets	Amortization		
	(In thousands)			

Finite Lived Assets:

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Customer relationships	\$33,179	\$6,066	\$27,113	3 to 18 years—proportional cash flow
Merchant portfolio	3,345	1,956	1,389	7 years—proportional cash flow
Software	10,018	8,740	1,278	2 to 5 years—straight line
Non-compete agreements	2,795	1,236	1,559	3 to 5 years—straight line
Other	480	406	74	2 to 9 years—straight line
	\$49,817	\$18,404	\$31,413	

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

	December 31, 2011			
	Gross Assets	Accumulated Amortization	Net Asset	Amortization Life and Method
	(In thousands)			
Finite Lived Assets:				
Customer relationships	\$33,166	\$5,406	\$27,760	3 to 18 years—proportional cash flow
Merchant Portfolio	3,345	1,819	1,526	7 years—proportional cash flow
Software	10,078	8,612	1,466	2 to 5 years—straight line
Non-compete agreements	2,794	1,126	1,668	3 to 5 years—straight line
Other	457	379	78	2 to 9 years—straight line
	\$49,840	\$17,342	\$32,498	

Amortization expense related to the intangible assets was \$1.1 million and \$1.5 million, respectively, for the three months ended March 31, 2012 and 2011. The estimated remaining amortization expense related to intangible assets in twelve month increments is as follows:

For the Twelve Months Ended March 31,

	(In thousands)
2013	\$4,293
2014	3,904
2015	3,471
2016	3,147
2017	2,304
Thereafter	14,294
	\$31,413

Goodwill — The changes in the carrying amount of goodwill for the three months ended March 31, 2012 and 2011 were as follows:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Beginning balance	\$103,399	\$68,319
Goodwill acquired during the period	—	5,987
Effects of foreign currency translation	162	279
Other (a)	—	456
Ending balance	\$103,561	\$75,041

(a) Reflects adjustments to allocations of purchase price.

8. Processing Liabilities and Loss Reserves

The majority of our processing liabilities include funds in transit associated with bankcard and check processing. In addition, we maintain merchant deposits to offset potential liabilities from merchant chargeback processing. A summary of processing liabilities and loss reserves was as follows at March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011
	(In thousands)	
Merchant bankcard processing	\$13,270	\$10,295
Check processing	12,015	8,594
Merchant deposits	9,298	9,839

Loss reserves	1,960	1,961
	\$36,543	\$30,689

The Company's merchants have the liability for any charges properly reversed by the cardholder through a mechanism known as a chargeback. If the merchant is unable to pay this amount, the Company will be liable to the card brand networks for the reversed charges. The Company has determined that the fair value of its obligation to stand ready to perform

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

is minimal. The Company requires personal guarantees and merchant deposits from certain merchants to minimize its obligation.

The card brand 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. As the majority of the Company's SME merchant transactions involve the delivery of the product or service at the time of the transaction, a reasonable basis for determining an estimate of the Company's exposure to chargebacks is the last four months' processing volume on the SME portfolio, which was \$22.6 billion and \$22.3 billion for the four months ended March 31, 2012 and December 31, 2011, respectively. However, for the four months ended March 31, 2012 and December 31, 2011, the Company was presented with \$11.2 million and \$12.2 million, respectively, in chargebacks by issuing banks. In the three months ended March 31, 2012 and 2011, the Company incurred merchant credit losses of \$0.2 million and \$1.3 million, respectively, on total SME bankcard dollar volumes processed of \$16.7 billion and \$15.4 billion, respectively. These credit losses are included in processing and servicing costs in the Company's Condensed Consolidated Statement of Income and Other Comprehensive Income.

The loss recorded by the Company for chargebacks associated with any individual merchant is typically small, due both to the relatively small size and the processing profile of the Company's SME merchants. However, from time to time the Company will encounter instances of merchant fraud, and the resulting chargeback losses may be considerably more significant to the Company. The Company has established a contingent reserve for estimated credit and fraud losses on its Condensed Consolidated Balance Sheet, amounting to \$2.0 million on March 31, 2012 and December 31, 2011. This reserve is determined by performing an analysis of the Company's historical loss experience applied to current processing volume and exposures.

A summary of the activity in the loss reserve for the three month periods ended March 31, 2012 and 2011 was as follows:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Beginning balance	\$1,961	\$1,667
Additions to reserve	267	1,489
Charges against reserve (a)	(268)	(1,417)
Ending balance	\$1,960	\$1,739

(a) Included in these amounts are payroll segment losses of \$12,000 and \$59,000, respectively, for the three months ended March 31, 2012 and 2011.

9. Accrued Buyout Liability

A summary of the accrued buyout liability was as follows as of March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011
	(In thousands)	
Vested Relationship Managers and sales managers	\$32,425	\$30,269
Unvested Relationship Managers and sales managers	1,143	1,389
	33,568	31,658
Less current portion	(8,862)	(8,104)
Long-term portion of accrued buyout liability	\$24,706	\$23,554

In calculating the accrued buyout liability for unvested Relationship Managers and sales managers, the Company has assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents the Company's historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested Relationship Managers and sales managers by \$0.1 million at March 31, 2012 and December 31, 2011.

A summary of the activity in the accrued buyout liability for the three months ended March 31, 2012 and 2011 was as follows:

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Beginning balance	\$31,658	\$28,810
Increase in settlement obligation, net	4,207	2,607
Buyouts	(2,297)	(3,175)
Ending balance	\$33,568	\$28,242

10. Credit Facilities

On November 24, 2010, the Company entered into a Second Amended and Restated Credit Agreement (the “Credit Agreement”) with JPMorgan Chase Bank, N.A., as administrative agent, and certain lenders who are a party to the Credit Agreement. Credit extended under the Credit Agreement is guaranteed by the Company's subsidiaries and is secured by substantially all of its assets and the assets of its subsidiaries. The Credit Agreement amended and restated in its entirety the previous amended and restated credit agreement entered into on May 30, 2008, as amended (the “Previous Credit Agreement”), between the Company and certain of the parties to the Credit Agreement.

The Credit Agreement provides for a revolving credit facility in the aggregate amount of up to \$50 million (the “Revolving Credit Facility”), of which up to \$10 million may be used for the issuance of letters of credit and up to \$5 million is available for swing line loans. Upon the prior approval of the administrative agent, the Company may increase the total revolving commitments by \$50 million for a total commitment under the Revolving Credit Facility of \$100 million. The Revolving Credit Facility is available to the Company on a revolving basis until November 24, 2015. All principal and interest not previously paid on the Revolving Credit Facility will mature and be due and payable on November 24, 2015.

The Credit Agreement also provides for a term credit facility in the aggregate amount of up to \$100 million (the “Term Credit Facility”). The Term Credit Facility requires amortization payments in the amount of \$3.75 million for each fiscal quarter during the fiscal years ended December 31, 2011 and 2012, \$5.0 million for each fiscal quarter during the fiscal years ended December 31, 2013 and 2014, and \$7.5 million for each fiscal quarter during the period commencing on January 1, 2015 through the maturity date on November 24, 2015. All principal and interest not previously paid on the Term Credit Facility will mature and be due and payable on November 24, 2015. Amounts borrowed and repaid under the Term Credit Facility may not be re-borrowed. Principal payments due under the Term Credit Facility as of March 31, 2012 were as follows:

For the Twelve Months Ended March 31,	(In thousands)
2013	\$16,250
2014	20,000
2015	22,500
2016	22,500
	\$81,250

The Credit Agreement contains covenants which include: the Company's maintenance of certain leverage and fixed charge coverage ratios; limitations on its indebtedness, liens on its properties and assets, its investments in, and loans to other business units, its ability to enter into business combinations and asset sales; and certain other financial and non-financial covenants. These covenants also apply to certain of the Company's subsidiaries. The Company was in

compliance with these covenants as of March 31, 2012 and expects it will remain in compliance with these covenants for at least the next twelve months.

Under the terms of the Credit Agreement, the Company may borrow, at its option, at interest rates equal to one, two, three or six month adjusted LIBOR rates, or equal to the greater of the prime rate, the federal funds rate plus 0.50% and the adjusted LIBOR rate plus 1%, in each case plus a margin determined by its current leverage ratio. The weighted average interest rate at March 31, 2012 was 2.5%. Total fees and direct costs paid for the Credit Agreement through March 31, 2012 were \$1.3 million. These costs are being amortized to interest expense over the life of the Amended and Restated Credit Agreement.

At March 31, 2012, there was \$81.3 million outstanding under the Term Credit Facility and no borrowings outstanding under the Revolving Credit Facility.

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements—(Continued)

(unaudited)

11. Commitments and Contingencies

Litigation—The Company is involved in ordinary course legal proceedings, which include all claims, lawsuits, investigations and proceedings, including unasserted claims, which are probable of being asserted, arising in the ordinary course of business and otherwise not described below. The Company has considered all such ordinary course legal proceedings in formulating its disclosures and assessments. In the opinion of the Company, based on consultations with outside counsel, material losses in addition to amounts previously accrued are not considered reasonably possible in connection with these ordinary course legal proceedings.

The Company has also been subject to lawsuits, claims, and investigations which resulted from the Processing System Intrusion. See Contingencies below for a description of the Processing System Intrusion.

Contingencies—The Company collects and stores sensitive data about its merchant customers and bankcard holders. If the Company's network security is breached or sensitive merchant or cardholder data is misappropriated, the Company could be exposed to assessments, fines or litigation costs.

On January 20, 2009, the Company publicly announced the Processing System Intrusion. The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by the Company during the transaction authorization process. See Note 1.

Organization and Operations - Processing System Intrusion for total expenses incurred, including amounts paid for settlement of claims, related to the Processing System Intrusion.

The Company does not consider it a reasonable possibility that losses exceeding the amounts already recognized on the matters subject to the settlement agreements will be incurred. With regard to the unsettled claims related to the Processing System Intrusion, which the Company described in its Annual Report on Form 10-K for the year ended December 31, 2011, the Company determined material losses in addition to those previously expensed are not considered reasonably possible on any such claim disclosed. The Company is prepared to vigorously defend itself against any unsettled claims relating to the Processing System Intrusion that have been asserted against it and its sponsor banks to date. The Company feels it has strong defenses to all the claims that have been asserted against it and its sponsor banks relating to the Processing System Intrusion.

Leases—The Company leases various office spaces and certain equipment under operating leases with remaining terms ranging up to nine years. The majority of the office space lease agreements contain renewal options and generally require the Company to pay certain operating expenses.

Future minimum lease payments for all non-cancelable leases as of March 31, 2012 were as follows:

For the Twelve Months Ended March 31,	Operating Leases (a) (In thousands)
2013	\$7,802
2014	5,452
2015	3,788
2016	1,957
2017	1,866
Thereafter	4,090
Total future minimum lease payments	\$24,955

(a) There were no material capital leases at March 31, 2012.

Rent expense for leased facilities and equipment was \$2.0 million and \$2.2 million, respectively, for the three months ended March 31, 2012 and 2011.

Commitments—Certain officers of the Company have entered into employee confidential information and non-competition agreements under which they are entitled to severance pay equal to their base salary and medical benefits for twelve months and a pro-rated bonus in the event they are terminated by the Company other than for cause. There were no payouts under these agreements in the three months ended March 31, 2012.

The following table reflects the Company's other significant contractual obligations, including leases from above, as of March 31, 2012:

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Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1 to 3 Years	3 to 5 years	More than 5 years
	(In thousands)				
Processing providers (a)	\$25,277	\$9,658	\$11,849	\$3,770	\$—
Telecommunications providers	3,117	3,117	—	—	—
Office and equipment leases	24,955	7,802	9,240	3,823	4,090
Term Credit Facility (b)	81,250	16,250	42,500	22,500	—
	\$134,599	\$36,827	\$63,589	\$30,093	\$4,090

The Company has agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. Our agreements with third-party processors require the Company to submit a minimum monthly number of transactions or volume for processing. If the Company submits a number of transactions or volume that is lower than the minimum, it is required to pay the third-party processors the fees that they would have received if the Company had submitted the required minimum number or volume of transactions.

Interest rates on the Term Credit Facility are variable in nature; however, in January 2011 we entered into fixed-pay amortizing interest rate swaps having an initial notional amount of \$50.0 million and a current notional amount of \$40.6 million. If interest rates were to remain at the March 31, 2012 level, we would make interest payments of \$2.5 million in the next 1 year, \$3.1 million in the next 1 to 3 years and \$0.3 million in the next 3 to 5 years or a total of \$5.9 million including net settlements on the fixed-pay amortizing interest rate swaps. In addition, we had no outstanding amounts under our Revolving Credit Facility at March 31, 2012. The Revolving Credit Facility is available on a revolving basis until November 24, 2015.

12. Segments

The determination of the Company's business segments is based on how the Company monitors and manages the performance of its operations. The Company's operating segments are strategic business units that offer different products and services. They are managed separately because each business requires different marketing strategies, personnel skill sets and technology.

The Company has two reportable segments, as follows: (1) Card, which provides payment processing and related services for bankcard transactions; and (2) Other. The Card segment includes CPOS, our Canadian payments processing subsidiary, and Network Services. The Other segment includes Payroll, which provides payroll and related tax filing services, PrepaidCard, which provides prepaid card, stored-value card and loyalty and gift card solutions, and Heartland School Solutions, which provides point-of-sale platforms designed to facilitate food service operations. None of these Other segments meet the defined thresholds for determining individually reportable segments.

The Company allocates revenues, expenses, assets and liabilities to segments only where directly attributable. The unallocated corporate administration amounts are costs attributed to finance, corporate administration, human resources and corporate services. At March 31, 2012 and 2011, 38% and 45% respectively, of the Other segment's total assets were funds that the Company holds as a fiduciary in its Payroll services activities for payment to taxing authorities. Reconciling items include eliminations of intercompany investments and receivables.

A summary of the Company's segments for the three month periods ended March 31, 2012 and 2011 was as follows:

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(unaudited)

	Card Segment	Other Segment	Unallocated Corporate Administration Amounts	Reconciling Items	Total Amount
	(In thousands)				
Three Months Ended March 31, 2012					
Total revenues	\$447,219	\$23,330	\$—	\$(64)	\$470,485
Depreciation and amortization	6,602	725	56	—	7,383
Interest income	115	—	—	—	115
Interest expense	912	2	—	(64)	850
Net income (loss) attributable to Heartland	16,064	2,090	(4,400)	—	13,754
Total assets	644,491	142,382	—	(162,665)	624,208
Three Months Ended March 31, 2011					
Total revenues	\$454,998	\$12,698	\$—	\$(50)	\$467,646
Depreciation and amortization	6,146	801	125	—	7,072
Interest income	41	—	—	—	41
Interest expense	1,240	2	—	(50)	1,192
Net income (loss) attributable to Heartland	11,495	599	(4,279)	—	7,815
Total assets	646,388	93,400	—	(155,450)	584,338

13. Earnings Per Share

The Company presents earnings per share data following the established standards for the computation and presentation of basic and diluted earnings per share data. Under these standards, the dilutive effect of stock options is excluded from the calculation of basic earnings per share but included in diluted earnings per share. The following is a reconciliation of the amounts used to calculate basic and diluted earnings per share:

	Three Months Ended March 31, 2012 2011 (In thousands, except per share data)	
Basic:		
Net income attributable to Heartland	\$13,754	\$7,815
Weighted average common stock outstanding	38,837	38,455
Earnings per share	\$0.35	\$0.20
Diluted:		
Net income attributable to Heartland	\$13,754	\$7,815
Basic weighted average common stock outstanding	38,837	38,455
Effect of dilutive instruments:		
Stock options and restricted share units	1,723	1,283
Diluted weighted average shares outstanding	40,560	39,738
Earnings per share	\$0.34	\$0.20

14. Fair Value of Financial Instruments

The Company applies a fair value framework in order to measure and disclose its financial assets and liabilities which include fixed income equity securities, interest swap derivatives and certain other financial instruments. The Company determines fair value based on quoted prices when available or through the use of alternative approaches when market quotes are not readily accessible or available. The Company carries its liabilities at fair value, including its derivative liabilities.

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

Level 1 inputs are unadjusted quoted prices, such as a New York Stock Exchange closing price, in active markets for identical assets. Level 1 is the highest priority in the hierarchy.

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Heartland Payment Systems, Inc. and Subsidiaries

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Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as other significant inputs that are observable at commonly quoted intervals, such as interest rates, foreign exchange rates, and yield curves.

Level 3 inputs are unobservable and are based on company assumptions due to little, if any, observable market information. Level 3 is the lowest priority in the hierarchy.

For the three months ended March 31, 2012, there have been no transfers between Level 1 and Level 2 categories. The following tables provide the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2012 and at December 31, 2011:

March 31, 2012	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets:	(In thousands)		
Investments available for sale:			
Fixed income bond fund (a)	\$1,176	\$1,176	\$—
Investments held to maturity:			
Certificates of deposit	2,157	—	2,157
Total Assets	\$3,333	\$1,176	\$2,157
Liabilities:			
Interest rate swaps	\$909	\$—	\$909
Total Liabilities	\$909	\$—	\$909

December 31, 2011	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets:	(In thousands)		
Investments available for sale:			
Fixed income bond fund (a)	\$1,158	\$1,158	\$—
Investments held to maturity:			
Certificates of deposit	2,505	—	2,505
Total Assets	\$3,663	\$1,158	\$2,505
Liabilities:			
Interest rate swaps	\$897	\$—	\$897
Total Liabilities	\$897	\$—	\$897

(a) amounts included in Funds held for payroll customers on the Consolidated Balance Sheet

At March 31, 2012 and December 31, 2011, all investments in available-for-sale securities held by the Company were measured using Level 1 inputs and all held to maturity investments held by the Company were measured using Level 2 inputs.

The Company's liabilities include interest rate swaps that are measured at fair value using observable market inputs including the Company's credit risk and its counterparties' credit risks. Based on these inputs, the interest rate swaps are classified within Level 2 of the valuation hierarchy. Based on the Company's continued ability to enter into these

swaps, the Company considers the markets for its fair value instruments to be active.

The carrying amounts of the Company's cash and cash equivalents and cash held for payroll customers approximate fair value as of March 31, 2012 and December 31, 2011, because they bear interest at market rates and had maturities of less than 90 days at the time of purchase. This fair value measurement is classified as Level 1. The carrying amount of the Company's accounts receivable, accounts payable, and accrued expenses approximates fair value as of March 31, 2012 and December 31, 2011, because of the relatively short timeframe to realization. This fair value measurement is classified as Level 2.

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PART I. FINANCIAL INFORMATION (continued)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the accompanying notes to condensed consolidated financial statements included elsewhere in this report, and the consolidated financial statements, notes to consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and the risk factors contained in our Annual Report on Form 10-K for the year ended December 31, 2011 (the "2011 Form 10-K").

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 Quarterly Report on Form 10-Q 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. Some of these factors are described in Item 1A. Risk Factors of the 2011 Form 10-K and include, without limitation, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our Sponsor banks, our relationships with third-party bankcard payment processors, our inability to pass increased interchange fees along to our merchants, economic conditions, systems failures and government regulation.

Overview

General

Our primary business is to provide bankcard payment processing services to merchants in the United States and Canada. This involves facilitating the exchange of information and funds between merchants and cardholders' financial institutions, providing end-to-end electronic payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant assistance and support, and risk management. Our merchant customers primarily fall into two categories: our core small and mid-sized merchants (referred to as "Small and Midsized Enterprises," or "SME merchants") and Network Services' large national and mid-tier merchants, primarily in the petroleum industry (referred to as "Network Services Merchants"). We also provide additional services to our merchants, such as payroll processing, gift and loyalty programs, paper check processing, and we sell and rent point-of-sale devices and supplies. In addition, we provide closed and open-loop payment solutions, and other transactional services to the college market, and school nutrition and point-of-sale solutions to K to 12 schools.

At March 31, 2012, we provided our bankcard payment processing services to approximately 172,153 active SME merchants located across the United States. This compares to 171,801 active SME bankcard merchants at December 31, 2011, and 174,538 active SME bankcard merchants at March 31, 2011. At March 31, 2012, we provided bankcard payment processing services through Network Services Merchants to 223 merchants with 54,613 locations. Additionally, at March 31, 2012, we provided bankcard payment processing services to over 10,800 merchants in Canada through our 70% owned subsidiary Collective POS Solutions Ltd. ("CPOS"). According to The Nilson Report, in 2011, we were the 6th largest card acquirer in the United States ranked by transaction count and the

9th largest acquirer by processed dollar volume, which consists of both credit and debit Visa, MasterCard, American Express, Discover, Diners Club, and JCB transactions. These rankings represented 2.8 billion transactions and 4% of the total bankcard processing market, respectively.

Our total bankcard processing volume for the three months ended March 31, 2012 was \$23.4 billion, a 25.2% increase from the \$18.7 billion processed during the three months ended March 31, 2011. Our SME bankcard processing volume for the three months ended March 31, 2012 was \$16.7 billion, an increase of 8.3% over the three months ended March 31, 2011 reflecting increases for same store sales growth, new SME merchants installed, and growth in American Express and Discover processing. We include American Express volume in our SME bankcard processing volume only where we receive percentage-

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based residual compensation for that volume. Our bankcard processing volume for the three months ended March 31, 2012 also includes \$6.5 billion of settled volume for Network Services Merchants, compared to \$3.1 billion for the three months ended March 31, 2011. Bankcard processing volume for the three months ended March 31, 2012 and 2011 was as follows:

	Three Months Ended March 31,	
	2012	2011
	(In millions)	
SME merchants	\$16,699	\$15,425
Network Services Merchants	6,517	3,112
Canada	163	136
Total bankcard processing volume (a)	\$23,379	\$18,673

(a) Bankcard processing volume includes volume for credit and signature debit transactions.

Merchant attrition is expected in the card payment processing industry in the ordinary course of business. We experience attrition in merchant bankcard processing volume resulting from several factors, including business closures, transfers of merchants' accounts to our competitors and account closures that we initiate due to heightened credit risks relating to, or contract breaches by, merchants, and (when applicable) same store sales contraction. We measure SME processing volume attrition against all SME merchants that were processing with us in the same month a year earlier. During the three months ended March 31, 2012, we experienced an improved 12.2% average annualized attrition in our SME bankcard processing volume compared to an average attrition of 13.5%, 15.3% and 22.6% for the years ended December 31, 2011, 2010 and 2009, respectively. Historically, much of our attrition has been related to business closures, which accelerated in 2009 due to weak economic conditions.

In our SME business, we measure same store sales growth, or contraction, as the change in bankcard processing volume for all bankcard merchants that were processing with us in the same month a year earlier. During the three months ended March 31, 2012, same store sales grew 3.4% on average, compared to 3.2% in the quarter ended March 31, 2011 and 2.6% on average in 2011. Same store sales growth or contraction results from the combination of the increasing or decreasing use by consumers of bankcards for the purchase of goods and services at the point of sale, and sales growth or contraction experienced by our retained SME bankcard merchants. The following table compares our same store sales growth or contraction during 2012, 2011 and 2010:

Same Store Sales Growth (Contraction)	2012	2011	2010
First Quarter	3.4%	3.2%	(1.5)%
Second Quarter		2.5%	1.1%
Third Quarter		2.3%	2.0%
Fourth Quarter		2.5%	3.8%
Full Year		2.6%	1.3%

Historically, our same store sales experience has tracked overall economic conditions. Management believes that continuing uncertain economic conditions may result in modest near-term improvements in our existing SME merchants' businesses.

We measure the overall production of our sales force by new gross margin installed, which reflects the expected annual gross profit from a merchant contract after deducting processing and servicing costs associated with that revenue. We measure installed margin primarily for our SME card processing, payroll processing and loyalty and gift marketing businesses. Our newly installed gross margin for the three months ended March 31, 2012 increased 15.4% from the gross margin we installed during the three months ended March 31, 2011. We attribute this increase in newly installed gross margin to better economic conditions and improved individual productivity achieved by our salespersons. We expect to drive increases in year-over-year installed margin of future periods principally by increasing our Relationship Manager and Territory Manager count. Our combined Relationship Managers and

Territory Managers count amounted to 790 and 807 at December 31, 2011 and March 31, 2012, respectively.

The bankcard revenue we earn in our SME business is recurring in nature, as we typically enter into three-year service contracts with our card processing SME merchants that, in order to qualify for the agreed-upon pricing, require the merchant to achieve bankcard processing volume minimums. Most of our SME revenue is from payment processing fees, which are a combination of a fee equal to a percentage of the dollar amount of each transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to the card issuer through the card networks and dues, assessments and other network fees to Visa, MasterCard and Discover. Our SME gross bankcard processing revenue is largely driven by the Visa and

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MasterCard volume processed by our merchants. We also realize card processing revenues from processing transactions for our SME merchants accepting American Express and from processing Discover transactions.

In contrast to SME card processing revenues, revenues from our Network Services Merchants are largely driven by the number of transactions we process (whether settled, or only authorized), not our processing volume, as the merchants which comprise Network Services' customer base pay on a per transaction basis for processing services. Additionally, we provide authorization, settlement and account servicing services on our front and back end systems for American Express transactions for larger merchants, and merchants signed to American Express by other processors; for those services we receive compensation from American Express on a per transaction basis. The number of transactions we processed for Network Services Merchants and American Express for the three months ended March 31, 2012 and 2011 were as follows:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Network Services Merchants:		
Settled	223,598	122,931
Authorized	581,311	623,753
American Express	7,732	7,467
Total	812,641	754,151

Our internally-developed front-end authorization systems, HPS Exchange, VAPS and NWS, provide us greater control of the electronic transaction process, allow us to offer our merchants a differentiated product offering, and offer economies of scale that we expect will increase our long-term profitability. During the three months ended March 31, 2012 and 2011, approximately 95% and 90%, respectively, of our SME transactions were processed through HPS Exchange. All of our Network Services transactions were processed through VAPS or NWS. During the three months ended March 31, 2012 and 2011, 97% of all SME merchant accounts established were placed on the HPS Exchange.

We provide 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. At both March 31, 2012 and 2011, approximately 99% of total SME bankcard merchants were processing on Passport and all Network Services' settled transactions were processed on Passport.

We provide payroll processing services throughout the United States. At March 31, 2012, we processed payroll for 12,005 customers, an increase of 1.2% from 11,867 payroll customers at March 31, 2011 and an increase of 1.4% from 11,841 payroll customers at December 31, 2011. In the three months ended March 31, 2012 and the full year 2011, we installed 905 and 3,723 new payroll processing customers, respectively. We developed a new comprehensive payroll management system, which we refer to as PlusOne Payroll, that streamlines all aspects of the payroll process to enable time and cost savings. PlusOne Payroll was made available to new and existing customers beginning in 2010. The PlusOne Payroll platform enables us to process payroll on a large scale and provide customizable solutions for businesses of all sizes.

We also provide school nutrition and point-of-sale solutions to K to 12 schools throughout the United States. At March 31, 2012, we provided K to 12 School Solutions to over 19,000 public and private schools.

First Quarter of 2012 Financial Results

Our financial results for the three months ended March 31, 2012, as compared to the three months ended March 31, 2011, benefited from a higher operating margin, reflecting 14.2% year-over-year growth in net revenue offset by lower increases of 7.9% in processing and servicing costs and 9.4% in general and administrative expenses. For the three months ended March 31, 2012, we recorded net income of \$13.8 million, or \$0.34 per share, compared to \$7.8

million, or \$0.20 per share, in the three months ended March 31, 2011. The following is a summary of our financial results for the three months ended March 31, 2012:

Net revenue, which we define as total revenues less interchange fees and dues, assessments and fees, increased \$16.0 million, or 14.2%, from \$112.7 million in the three months ended March 31, 2011 to \$128.7 million in the three months ended March 31, 2012. The increase in Net revenue was driven by the increased card processing net revenue from our SME merchants and increases in revenues for K to 12 School Solutions, Payroll processing, Loyalty and Gift revenues, and card equipment.

During the three months ended March 31, 2012, our SME processing volume increased 8.3% to \$16.7 billion from \$15.4 billion during the three months ended March 31, 2011. We earn percentage-based revenues on our

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SME processing volume. The year-over-year increase reflects same store sales growth, improved merchant volume attrition, and improvements in the level of new SME merchants installed.

Our processing and servicing expenses increased \$4.2 million, or 7.9%, from \$52.6 million in the three months ended March 31, 2011, to \$56.7 million in the three months ended March 31, 2012 primarily due to increased costs associated with processing and servicing higher SME bankcard processing volume, increased residual commission expense and increased costs of sales and servicing related to the higher K to 12 School Solutions, Payroll processing, Loyalty and Gift and equipment-related revenues. Partially offsetting these increases were reduced merchant losses. Our general and administrative expenses increased \$2.8 million, or 9.4%, from \$30.0 million in the three months ended March 31, 2011 to \$32.9 million in the three months ended March 31, 2012. General and administrative expenses in the three months ended March 31, 2012 included \$1.1 million for our periodic sales and servicing organization summit held in March 2012. Excluding these summit expenses, our general and administrative expenses in 2012 increased \$1.7 million, or 5.8%, primarily due to a \$1.8 million increase in personnel costs, including \$1.0 million for share-based compensation. General and administrative expenses as a percentage of total revenue for the three months ended March 31, 2012 was 7.0%, an increase from 6.4% for the three months ended March 31, 2011. As a result of the 14.2% growth achieved in net revenue and much lower increases in processing and servicing expenses and general and administrative expenses, our income from operations, which we also refer to as operating income, increased \$8.7 million to \$23.2 million for the three months ended March 31, 2012, from \$14.6 million for the three months ended March 31, 2011. Our Operating Margin, which we measure as operating income divided by net revenue, was 18.1% for the three months ended March 31, 2012, compared to 12.9% for the three months ended March 31, 2011.

See “— Results of Operations — Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011” for a more detailed discussion of our first quarter financial results.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations are based on our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States. These condensed consolidated financial statements are unaudited. In our opinion, the unaudited condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of our financial position at March 31, 2012, our results of operations, our changes in stockholders' equity and our cash flows for the three months ended March 31, 2012 and 2011. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ended December 31, 2012. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results could differ from those estimates. Our significant accounting policies are more fully described in Note 2 to our Condensed Consolidated Financial Statements included elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2011. 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, which are impacted by management's estimates, are described below.

Revenue

Our bank card processing revenue is derived from processing and settling Visa, MasterCard, American Express and Discover bank card transactions for our merchant customers. Our most significant expense related to the generation of those revenues is interchange fees, which are set by the card networks, and paid to the card issuing banks. For our SME merchant bank card processing, we do not offset bank card processing revenues and interchange fees because our business practice is to advance the interchange fees to most of our merchants when settling their daily transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. 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 banks, 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. Certain of our competitors report their processing revenue net of interchange fees. This is because the card issuing banks make their payments to these competitors net of those interchange fees, and these acquirers pay this reduced amount to their merchants. Since the acquisition of Network Services, we also record a portion of our processing revenues net of interchange

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fees because the daily cash settlement with Network Services' merchants is net of interchange fees.

Capitalized Customer Acquisition Costs

Capitalized customer acquisition costs consist of (1) up-front signing bonuses paid to Relationship Managers and sales managers, referred to as the salesperson or salespersons, for the establishment of new merchant relationships, and (2) deferred acquisition cost representing the estimated cost of buying out the commissions of vested salespersons at some point in the future. Capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with SME merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The amount of the up-front signing bonus paid for new SME bankcard, payroll and loyalty marketing accounts is based on the estimated gross margin for the first year of the merchant contract. The gross signing bonuses paid during the three months ended March 31, 2012 and 2011 were \$8.2 million and \$7.3 million, respectively, and for the full year ended December 31, 2011 were \$30.5 million. 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 the three months ended March 31, 2012 and 2011 were \$(0.6) million and \$(0.2) million, respectively. Negative signing bonus adjustments occur when the actual gross margin generated by the merchant contract during the first year is less than the estimated gross margin for that year, resulting in the overpayment of the up-front signing bonus and would be recovered from the relevant sales person. Positive signing bonus adjustments result from prior underpayments of up-front signing bonuses, and would be paid to the relevant salesperson. The amount of signing bonuses paid which remained subject to adjustment at March 31, 2012 was \$31.2 million.

The deferred acquisition cost component of capitalized customer acquisition costs is accrued for vested salespersons over the first year of SME bankcard 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 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 for the three months ended March 31, 2012.

Accrued Buyout Liability

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

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

The accrued buyout liability is based on the SME merchants we have under contract at the balance sheet date, the gross margin we generated from those accounts in the prior twelve months, the “owned” commission rate, and the fixed buyout multiple of 2.5 times the commissions. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date.

For unvested salespersons, the accrued buyout liability is accrued over the expected vesting period; however, no deferred acquisition cost is capitalized as future services are required in order to vest. In calculating the accrued buyout liability for unvested salespersons, we have assumed that 31% of unvested salespersons will vest in the future, which represents our historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested salespersons by \$0.1 million at March 31, 2012 and December 31, 2011.

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

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significantly exceed the cost, which typically represents 2½ 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 the three months ended March 31, 2012 and 2011, we made buyout payments of approximately \$2.3 million and \$3.2 million respectively, and during the 2011 full year, we made buyout payments of approximately \$10.4 million.

Processing Liabilities and Loss Reserves

The majority of our processing liabilities include funds in transit associated with bankcard and check processing. At March 31, 2012, these funds in transit totaled \$25.3 million, compared to approximately \$18.9 million at December 31, 2011. In addition, we maintain merchant deposits to offset potential liabilities from merchant chargeback processing.

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 March 31, 2012 and December 31, 2011, we held SME merchant deposits totaling \$9.3 million and \$9.8 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 bankcard processing volume. At both March 31, 2012 and December 31, 2011, our loss reserve totaled \$2.0 million. Aggregate SME bankcard merchant losses, including losses charged to operations and the loss reserve, were \$0.2 million and \$1.3 million for the three months ended March 31, 2012 and 2011.

Chargeback losses originating from Network Services bankcard processing on Passport during the full year 2011 and three months ended March 31, 2012 were insignificant.

Stock-based Compensation

We expense employee share-based payments under the fair value method. 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 estimate the grant date fair value of the stock options we issue using a Black-Scholes valuation model for "plain-vanilla" stock options and performance-based stock options, and we use a lattice valuation model to measure grant date fair value for stock options containing market vesting conditions. Our assumption for expected volatility is based on our historical volatility data related to market trading of our own Common Stock. We base our assumptions for the expected life of new stock option grants on our analysis of the historical exercise patterns of our stock options. Our dividend yield assumption is based on 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 the three months ended March 31, 2012 and the years ended December 31, 2011 and 2010 were \$9.36, \$7.95 and \$6.12, respectively. The fair value of options granted during the three months ended March 31, 2012 and the years ended December 31, 2011 and 2010 was estimated at the

grant date using the following weighted average assumptions:

	Three Months Ended March 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
Expected volatility	55	%	55	%	54	%
Expected life	3.75 years		3.65 years		3.75 years	
Expected Dividends	1.00	%	0.80	%	0.40	%
Risk-free interest rate	0.51	%	0.55	%	1.21	%

In the fourth quarter of 2010, our Board of Directors approved grants of 508,800 performance-based Restricted Share Units. These Restricted Share Units are nonvested 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:

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	2012	2013	2014
Diluted Earnings Per Share ^(a)	\$1.48	\$1.74	\$2.04

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

As of December 31, 2011, management determined that achieving these performance targets was “more likely than not” to occur and began recording share-based compensation expense for these Restricted Share Units. The closing price of our 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, our 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 we achieve 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 Stock Compensation Expense. For each 1% that the CAGR actually achieved 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 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.

As of December 31, 2011, management determined that achieving the 17% two-year CAGR target was “more likely than not” to occur and began recording share-based compensation expense for these Restricted Share Units based on the number of shares which would vest at the 17% two-year CAGR target. The closing price of our 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.

Goodwill

Goodwill represents the excess of acquisition costs over the fair values of net assets acquired in business combinations. We test goodwill for impairment at least annually and between annual tests if an event occurs or changes in circumstances suggest a potential decline in the fair value of the reporting unit. A significant amount of judgment is involved in determining if an indicator or change in circumstances relating to impairment has occurred. Such changes may include, among others: a significant decline in expected future cash flows; a sustained decline in market capitalization; a significant adverse change in legal factors or in the business climate; unanticipated competition; and slower growth rates. We perform annual goodwill impairment testing in the fourth quarter. Our evaluation indicated that no impairment existed as of December 31, 2011. At March 31, 2012 and December 31, 2011, goodwill of \$103.6 million and \$103.4 million, respectively, is recorded on our Condensed Consolidated Balance Sheet. We may be required to record goodwill impairment losses in future periods, whether in connection with our next annual impairment testing in the fourth quarter of 2012 or prior to that, if any such indicators constitute a triggering event in other than the quarter in which the annual goodwill impairment test is performed. It is not possible at this time to determine if any such future impairment loss would result or, if it does, whether such charge would be material.

Income Taxes

We account for income taxes by recognizing deferred tax assets and liabilities, which 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.

We also account for the recognition and measurement of tax benefits associated with uncertain tax positions. This requires evaluations of individual tax positions to determine whether any part of that position can be recognized or continues 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. We had approximately \$2.0 million of total gross unrecognized tax benefits as of March 31, 2012, approximately \$1.3 million of which would impact the effective tax rate.

We have recorded income tax expense (benefit) at U.S. tax rates on all taxable income (loss), except undistributed earnings of CPOS, our Canadian subsidiary. We intend to indefinitely reinvest undistributed earnings of CPOS and

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accordingly, have provided Canadian income tax on those earnings but not U.S. income tax. The amount of undistributed earnings of CPOS for which we have not recorded U.S. income tax was approximately \$2.5 million. In the event of distribution of those earnings in the form of dividends or otherwise, we would be subject to U.S. income taxes subject to an adjustment, if any, for foreign tax credits. Determination of the amount of U.S. income tax liability that would be incurred is not practicable because of the complexities associated with this hypothetical calculation.

Results of Operations

Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

The following table shows certain income statement data as a percentage of revenue for the periods indicated (in thousands of dollars):

	Three Months Ended March 31, 2012	% of Total Revenue		Three Months Ended March 31, 2011	% of Total Revenue		Change Amount	%	
Total Revenues	\$470,485	100.0	%	\$467,646	100.0	%	\$2,839	0.6	%
Costs of Services:									
Interchange	297,948	63.3	%	320,799	68.6	%	(22,851)	(7.1)	%
Dues, assessments and fees	43,868	9.3	%	34,150	7.3	%	9,718	28.5	%
Processing and servicing	56,722	12.1	%	52,556	11.2	%	4,166	7.9	%
Customer acquisition costs	11,436	2.4	%	11,658	2.5	%	(222)	(1.9)	%
Depreciation and amortization	4,386	0.9	%	3,875	0.8	%	511	13.2	%
Total costs of services	414,360	88.1	%	423,038	90.5	%	(8,678)	(2.1)	%
General and administrative	32,882	7.0	%	30,046	6.4	%	2,836	9.4	%
Total expenses	447,242	95.1	%	453,084	96.9	%	(5,842)	(1.3)	%
Income from operations	23,243	4.9	%	14,562	3.1	%	8,681	59.6	%
Other income (expense):									
Interest income	115	—	%	41	—	%	74	180.5	%
Interest expense	(850)	(0.2)	%	(1,192)	(0.3)	%	342	28.7	%
Provision for processing system intrusion costs	(157)	—	%	(303)	(0.1)	%	146	48.2	%
Other, net	—	—	%	(437)	(0.1)	%	437	100.0	%
Total other income (expense)	(892)	(0.2)	%	(1,891)	(0.4)	%	999	52.8	%
Income before income taxes	22,351	4.8	%	12,671	2.7	%	9,680	76.4	%
Provision for income taxes	8,499	1.8	%	4,809	1.0	%	3,690	76.7	%
Net income	13,852	2.9	%	7,862	1.7	%	5,990	76.2	%
Less: Net income attributable to noncontrolling interests	98			47			51		
Net income attributable to Heartland	\$13,754	2.9	%	\$7,815	1.7	%	\$5,939	76.0	%

Total Revenues. Total revenues increased by 0.6% from \$467.6 million in the three months ended March 31, 2011 to \$470.5 million in the three months ended March 31, 2012, primarily as a result of higher revenues from our K to 12 School Solutions business and prepaid card income including loyalty and gift marketing, and a \$1.5 million, or 19.5% increase in equipment-related income. Our gross SME card processing revenues for the three months ended March 31, 2012 were impacted by the "Durbin Amendment," which was part of the July 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act that went into effect on October 1, 2011. SME card processing revenues and the Durbin Amendment are discussed below in —Processing revenues, gross. The breakout of our total revenues for the three

months ended March 31, 2012 and 2011 was as follows (in thousands of dollars):

	Three Months Ended		Change from		
	March 31, 2012	2011	Prior Year Amount	%	
Processing revenues, gross (a)	\$455,024	\$454,256	\$768	0.2	%
Payroll processing revenues	6,279	5,709	570	10.0	%
Equipment-related income	9,182	7,681	1,501	19.5	%
Total Revenues	\$470,485	\$467,646	\$2,839	0.6	%

(a) Includes Visa, MasterCard, AMEX and Discover bankcard processing revenues, AMEX fees, check processing fees, customer service fees, gift card, loyalty, K to 12 School Solutions and other miscellaneous revenue.

Processing revenues, gross. Further breakout of our gross processing revenues for the three months ended March 31,

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2012 and 2011 was as follows (in thousands of dollars):

	Three Months Ended March 31,		Change from Prior Year		
	2012	2011	Amount	%	
Merchant Card Processing Revenue:					
SME card processing	\$409,226	\$416,757	\$(7,531)	(1.8)	%
Network Services card processing	33,193	30,651	2,542	8.3	%
CPOS card processing	2,082	1,774	308	17.4	%
	444,501	449,182	(4,681)	(1.0)	%
K to 12 School Solutions income	5,613	1,052	4,561	433.6	%
Prepaid Card income	4,415	3,512	903	25.7	%
Other miscellaneous revenue	495	510	(15)	(2.9)	%
Total Processing Revenues, Gross	\$455,024	\$454,256	\$768	0.2	%

The \$0.8 million increase in gross processing revenues from \$454.3 million in the three months ended March 31, 2011 to \$455.0 million in the three months ended March 31, 2012 was primarily due to higher revenues from our K to 12 School Solutions business, Network Services card processing, and from prepaid card income including loyalty and gift marketing.

Our gross SME merchant card processing revenues for the three months ended March 31, 2012 reflect a decline as compared to the three months ended March 31, 2011 due to the impact of the Durbin Amendment. The Durbin Amendment places limits on debit card interchange rates that card issuing banks may charge. While not impacting our net revenue (which we present net of interchange, dues and assessments and fees as discussed below in —Net revenue), beginning in the fourth quarter of 2011 there was a decrease in the amount of SME interchange expense we record in our Income Statement as a result of the Durbin Amendment. Since our gross SME card processing revenues include the interchange that we pass through to our merchants, our Total revenues decreased by an equivalent amount. We estimate that the amount of this decrease on our gross SME merchant card processing revenues for the three months ended March 31, 2012 was a reduction of approximately \$41.3 million.

Partially offsetting the impact that the Durbin Amendment had on our gross revenues from SME card processing was the increase in revenue attributable to higher SME bankcard processing volume. For the three months ended March 31, 2012, our SME bankcard processing volume increased 8.3% to \$16.7 billion, compared to \$15.4 billion for the three months ended March 31, 2011, reflecting increases for same store sales growth, new SME merchants installed, and improved SME merchant volume attrition.

Network Services increased its card processing revenues based on the 224 million transactions it settled, representing \$6.5 billion in processing volume, and the 581 million transactions it authorized through its front-end card processing systems during the three months ended March 31, 2012, as compared to the 123 million transactions it settled, representing \$3.1 billion in processing volume, and the 624 million transactions it authorized through its front-end card processing systems during the three months ended March 31, 2011. We report Network Services' settled bankcard processing revenues net of credit interchange and dues and assessments because the daily cash settlement with Network Services' merchants is on a net basis. However, the Durbin Amendment did impact Network Services' settled PIN debit interchange by approximately \$1.7 million for the three months ended March 31, 2012.

Also contributing to our growth in processing revenues for the three months ended March 31, 2012 were the processing revenues generated by our K to 12 School Solutions businesses, and from prepaid card income including loyalty and gift marketing. The increase in K to 12 School Solution processing revenues for the three months ended March 31, 2012 reflects acquisitions we made in 2011 (see "— Liquidity and Capital Resources" for a detail on these acquisitions).

Payroll processing revenues. Payroll processing revenues, which include fees earned on payroll processing services and interest income earned on funds held for customers, increased by 10.0%, from \$5.7 million in the three months ended March 31, 2011 to \$6.3 million in the three months ended March 31, 2012, primarily due to price increases for almost half of our payroll processing customers and a 1.2% increase in the total number of payroll processing customers from 11,867 at March 31, 2011 to 12,005 at March 31, 2012.

Equipment-related income. Equipment-related income increased by \$1.5 million, or 19.5%, from \$7.7 million in the three months ended March 31, 2011 to \$9.2 million in the three months ended March 31, 2012, primarily due to increases in revenues from the sale of card processing terminals, including our proprietary encryption terminals, referred to as E3 Terminals, which benefited from a one-time sale, and from sales of equipment in our K to 12 School Solutions businesses.

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Net revenue. Net revenue, which we define as total revenues less interchange fees and dues, assessments and fees, increased 14.2% from \$112.7 million in the three months ended March 31, 2011, to \$128.7 million in the three months ended March 31, 2012. The increase in net revenue was driven primarily by increases in SME bankcard processing volume, and increases in revenues from K to 12 School Solutions, Payroll processing, Loyalty and Gift and equipment-related income. The following table summarizes our Net Revenue components for the three months ended March 31, 2012 and 2011 (in thousands of dollars):

	Three Months Ended		Change from		
	March 31,	2011	Prior Year	Amount	%
	2012				
Merchant Card Processing Revenue:					
SME card processing	\$409,226	\$416,757			
Less: interchange, dues, assessments and fees	(320,460)	(336,708)			
SME card processing net revenue	88,766	80,049	\$8,717	10.9	%
Network Services card processing	33,193	30,651			
Less: interchange, dues, assessments and fees	(21,356)	(18,241)			
Network Services card processing net revenue	11,837	12,410	(573)	(4.6)	%
CPOS card processing net revenue	2,082	1,774	308	17.4	%
Card processing revenues, net	102,685	94,233	8,452	9.0	%
K to 12 School Solutions income	5,613	1,052	4,561	433.6	%
Prepaid card income	4,415	3,512	903	25.7	%
Other miscellaneous revenue	495	510	(15)	(2.9)	%
Processing revenues, net	113,208	99,307	13,901	14.0	%
Payroll processing revenues	6,279	5,709	570	10.0	%
Equipment-related revenues	9,182	7,681	1,501	19.5	%
Total net revenue	\$128,669	\$112,697	\$15,972	14.2	%

Costs of services. Costs of services decreased 2.1% from \$423.0 million in the three months ended March 31, 2011 to \$414.4 million in the three months ended March 31, 2012, due to the decrease in interchange expense resulting from the Durbin Amendment. Interchange expense decreased 7.1% from \$320.8 million in the three months ended March 31, 2011 to \$297.9 million in the three months ended March 31, 2012, and represented 63.3% of total revenues in the three months ended March 31, 2012 compared to 68.6% in the three months ended March 31, 2011.

Dues, assessments and fees increased 28.5% from \$34.2 million in the three months ended March 31, 2011 to \$43.9 million in the three months ended March 31, 2012, primarily as a result of higher SME bankcard processing volume and Network services transactions. Dues, assessments and fees were 9.3% of total revenues in the three months ended March 31, 2012, compared to 7.3% in the three months ended March 31, 2011.

Processing and servicing expense for the three months ended March 31, 2012 increased by \$4.2 million, or 7.9%, compared with the three months ended March 31, 2011. The increase in processing and servicing expenses was due to increased costs associated with processing and servicing higher SME bankcard processing volume, increased residual commission expense and increased cost of sales and servicing related to higher K to 12 School Solutions, Payroll processing, Loyalty and Gift, and equipment-related revenues. The increase in processing and servicing expense also reflects refined allocations of certain information technology related expenses, previously reported in general and administrative expense, to processing and servicing in the three months ended March 31, 2012. Partially offsetting these increases were reduced merchant losses. As a percentage of total revenue, processing and servicing expense increased to 12.1% for the three months ended March 31, 2012 compared with 11.2% for the three months ended March 31, 2011.

Customer acquisition costs for the three months ended March 31, 2012 decreased by \$0.2 million, or 1.9% compared with the three months ended March 31, 2011. This decline reflects the impacts of the lower signing bonus

amortization as capitalized signing bonuses recorded in periods having higher new gross margin installed run off. Customer acquisition costs for the three months ended March 31, 2012 and 2011 included the following components (in thousands of dollars):

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	Three Months Ended March 31,	
	2012	2011
Amortization of signing bonuses, net	\$7,321	\$8,514
Amortization of capitalized customer deferred acquisition costs	3,876	3,867
Increase in accrued buyout liability	4,207	2,607
Capitalized customer deferred acquisition costs	(3,968)	(3,330)
Total Customer Acquisition Costs	\$11,436	\$11,658

Depreciation and amortization expenses increased 13.2% from \$3.9 million in the three months ended March 31, 2011 to \$4.4 million in the three months ended March 31, 2012. Most of our investments in information technology have been for security-related enhancements and in support of the continuing development of HPS Exchange, Passport and other processing-related initiatives. Depreciation and amortization expense recorded on these investments is included in processing and servicing expense. Additionally, we capitalized salaries, fringe benefits and other expenses incurred by our employees that worked on internally developed software projects and outsourced programming. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over expected lives of three to five years. The amount capitalized increased from \$5.2 million in the three months ended March 31, 2011 to \$8.1 million in the three months ended March 31, 2012. The total amount of capitalized costs for projects placed in service in the three months ended March 31, 2012 and 2011 was \$4.6 million and \$2.2 million, respectively.

General and administrative. General and administrative expenses increased \$2.8 million, or 9.4%, from \$30.0 million in the three months ended March 31, 2011 to \$32.9 million in the three months ended March 31, 2012. General and administrative expenses in the three months ended March 31, 2012 included \$1.1 million for our periodic sales and servicing organization summit held in March 2012. Excluding these summit expenses, our general and administrative expenses in 2012 increased \$1.7 million, or 5.8%, primarily due to a \$1.8 million increase in personnel costs, including a \$1.0 million increase for share-based compensation. General and administrative expenses for the three months ended March 31, 2012 benefited from refined allocations of certain information technology related expenses, previously reported in general and administrative expense, now recorded in processing and servicing expense. General and administrative expenses as a percentage of total revenue for the three months ended March 31, 2012 was 7.0%, an increase from 6.4% for the three months ended March 31, 2011.

Income from operations. As a result of the 14.2% increase in net revenue and much lower increases in processing and servicing expenses and general and administrative expenses, our income from operations, which we also refer to as operating income, improved to \$23.2 million for the three months ended March 31, 2012, from \$14.6 million for the three months ended March 31, 2011. Our operating margin, which we measure as operating income divided by net revenue, was 18.1% for the three months ended March 31, 2012, compared to 12.9% for the three months ended March 31, 2011.

Interest expense. Interest expense for the three months ended March 31, 2012 was \$0.9 million, compared with \$1.2 million for the three months ended March 31, 2011. Interest expense in both periods includes interest incurred under our Credit Facilities and interest we recorded on payables to our sponsor banks. The decline in interest expense reflects lower borrowings due to payments we made on our Term Loan Facility. See “—Liquidity and Capital Resources—Credit Facility” for more detail on our borrowings.

Provision for processing system intrusion costs. On January 20, 2009, we publicly announced the discovery of a criminal breach of our 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 during the transaction authorization process. We believe the breach did not extend beyond 2008.

Since the announcement of the Processing System Intrusion on January 20, 2009 and through March 31, 2012, we have expensed a total of \$147.3 million, before reducing those charges by \$31.2 million of total insurance recoveries. The majority of the total charges, or approximately \$114.7 million, related to settlements of claims. Approximately

\$32.6 million of the total charges were for legal fees and costs we incurred for investigations, defending various claims and actions, remedial actions and crisis management services.

During the three months ended March 31, 2012, we incurred approximately \$0.2 million, or less than one cent per share, for legal fees and costs incurred related to the Processing System Intrusion. During the three months ended March 31, 2011, we expensed approximately \$0.3 million, or less than one cent per share, related to the Processing System Intrusion.

Other income (expense), net. Other, net for the three months ended March 31, 2011 included pre-tax charges of \$0.5 million reflecting the estimated liability for costs (primarily accrued staff termination costs and fixed asset write downs)

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associated with the closing of our Johnson City, Tennessee service center.

Income taxes. Income taxes for the three months ended March 31, 2012 were an expense of \$8.5 million, reflecting an effective tax rate of 38.0%. This compares to income tax expense of \$4.8 million for the three months ended March 31, 2011, and an effective tax rate of 38.0%.

Net income attributable to Heartland. As a result of the above factors, we recorded net income of \$13.8 million for the three months ended March 31, 2012. This compares to a net income of \$7.8 million for the three months ended March 31, 2011.

Balance Sheet Information

	March 31, 2012 (In thousands)	December 31, 2011
Selected Balance Sheet Data		
Cash and cash equivalents	\$49,943	\$40,301
Funds held for payroll customers	53,584	42,511
Receivables, net	183,733	176,535
Capitalized customer acquisition costs, net	55,339	55,014
Property and equipment, net	116,668	115,579
Goodwill	103,561	103,399
Intangible assets, net	31,413	32,498
Total assets	624,208	596,921
Due to sponsor banks	66,334	63,881
Accounts payable	49,999	47,373
Deposits held for payroll customers	53,584	42,511
Borrowings:		
Current portion	16,253	15,003
Long term portion	65,000	70,000
Accrued buyout liability:		
Current portion	8,862	8,104
Long term portion	24,706	23,554
Total liabilities	392,695	376,869
Total stockholders' equity	230,704	219,410

March 31, 2012 Compared to December 31, 2011

Total assets increased \$27.3 million, or 4.6%, to \$624.2 million at March 31, 2012 from \$596.9 million at December 31, 2011, primarily due to increases in cash, funds held for payroll customers, and receivables. Cash increased \$9.6 million, or 23.9%, primarily due to higher balances in processing related cash at March 31, 2012 and our increase in operating cash for the three months ended March 31, 2012 (see “— Liquidity and Capital Resources” for more detail). The \$11.1 million increase in funds held for payroll customers was offset by an equal increase in deposits held for payroll customers.

Our receivables, which increased \$7.2 million or 4.1% from December 31, 2011, are primarily due from our bankcard processing merchants and result in large part from our practice of advancing interchange fees to most of our SME merchants during the month and collecting those fees from our merchants at the beginning of the following month, as well as from transaction fees we charge merchants for processing transactions. Generally, these advances to our SME merchants are funded first with our available cash, then by incurring a payable to our sponsor banks when that cash has been expended. Our receivables from SME bankcard processing merchants increased \$4.0 million from December 31, 2011. At March 31, 2012, we used \$39.3 million of available cash to fund merchant advances and at

December 31, 2011, we used \$40.0 million of cash to fund merchant advances. The amount due to sponsor banks for funding advances was \$46.7 million at March 31, 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 we collect from our merchants. Receivables from merchants also include transaction fees due from Network Services Merchants, up approximately \$3.2 million from December 31, 2011 and receivables from the sale of point of sale terminal equipment. Total receivables also include amounts due from bankcard networks for pre-funding of Discover and American Express transactions to our merchants as well as amounts due from Visa for PIN debit transactions. These amounts are recovered from the networks the following business day from the date of processing the transaction. Total borrowings decreased \$3.8 million, or 4.4%, to \$81.3 million at March 31, 2012 from \$85.0 million at

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December 31, 2011, primarily due to a \$3.8 million quarterly amortization payment due under our Term Credit Facility. See “—Liquidity and Capital Resources” for discussion of Credit Facilities.

Total stockholders’ equity increased \$11.3 million from December 31, 2011 primarily due to recording net income of \$13.8 million for the three months ended March 31, 2012. Other increases in total stockholders’ equity for the three months ended March 31, 2012 included proceeds received from the exercise of stock options, tax benefits related to those stock option exercises and stock-based compensation expense. During the three months ended March 31, 2012, we repurchased \$11.4 million of our outstanding common stock and paid cash dividends of \$2.3 million. See “—Liquidity and Capital Resources” for discussion of Credit Facilities.

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, our servicing technology platforms, and our Jeffersonville, Indiana service center, and to make acquisitions 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, adding to our primary service center, investing in our technology infrastructure, and making acquisitions of businesses or assets. We expect that our future cash requirements will continue to include amounts used to repurchase our common stock.

Other than borrowings we had used to fund certain acquisitions and settlements of claims related to the Processing System Intrusion, we fund our cash needs primarily with cash flow from our operating activities and through our agreements with our sponsor banks to fund SME merchant advances. We believe that our current cash and investment balances, cash generated from operations and our agreements with our sponsor banks to fund SME merchant advances will provide sufficient liquidity to meet our anticipated needs for operating capital for at least the next twelve months.

Working Capital. Our working capital, defined as current assets less current liabilities, was positive by \$41.1 million at March 31, 2012.

At March 31, 2012, we had cash on our Balance Sheet totaling \$49.9 million compared to cash of \$40.3 million at December 31, 2011. Our March 31, 2012 cash balance included approximately \$33.8 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. As of March 31, 2012, we had used \$39.3 million of our available cash to fund SME merchant advances and at December 31, 2011, we had used \$40.0 million of our cash to fund advances.

On March 31, 2012, we had \$50.0 million available to us under our Revolving Credit Facility. See “— Credit Facilities” for more details.

Acquisitions. On January 12, 2011, February 4, 2011 and September 30, 2011, we acquired the K to 12 School Solutions businesses of Comalex, Inc., mySchoolBucks, LLC, and School-Link Technologies, Inc, respectively. We made cash payments of \$6.1 million, \$1.5 million, and \$15.6 million, respectively, for the net assets of these three businesses. These acquisitions, which were funded with cash on hand, enable us to offer school nutrition and point-of-sale solutions including Internet payment capability enabling on-line deposits of funds into student accounts, to a wide base of schools, students and their parents. Comalex, mySchoolBucks and School-Link added approximately 3,700, 900 and 10,000 schools, respectively, to our K to 12 School Solutions product. These acquisitions, added to the December 30, 2010 acquisition of Lunchbox and its approximately 4,400 schools, have given us an almost 20%

market share in this industry. We plan to consolidate the individual platforms and products of Lunchbox, Comalex, mySchoolBucks, and School-Link to optimize synergies, cost efficiencies and product offerings to our customers.

The \$7.7 million cash payment for the Lunchbox acquisition was financed through a combination of cash on hand and our Revolving Credit Facility. We repaid the amount we borrowed under our Revolving Credit Facility in the first quarter of 2011. See “— Credit Facilities” for more details.

Cash Flow Provided By Operating Activities. We reported net cash provided by operating activities of \$25.2 million in the three months ended March 31, 2012, compared to \$31.8 million in the three months ended March 31, 2011. Cash provided by operating activities in the three months ended March 31, 2012 reflects the benefit of our increase in net income for

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the current year, offset by our use of a greater amount of operating cash to fund receivables, including SME merchant advances during the three months ended March 31, 2012. As of March 31, 2012, we had used \$39.3 million of our available cash to fund SME merchant advances, compared to \$28.4 million as of March 31, 2011. Additionally, during the three months ended March 31, 2012 we used cash to pay and reduce accrued expenses.

Other major determinants of operating cash flow are net signing bonus payments, which consume operating cash as we install new merchants, 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. We paid net signing bonuses of \$7.6 million and \$7.1 million, respectively, in the three months ended March 31, 2012 and 2011. The increase in net signing bonuses paid during the three months ended March 31, 2012 reflects a year-over-year improvement in newly installed gross margin. In the three months ended March 31, 2012 and 2011, we reduced our accrued buyout liability by making buyout payments of \$2.3 million and \$3.2 million, respectively.

Cash Flow Used In Investing Activities. Net cash used in investing activities was \$7.0 million for the three months ended March 31, 2012, compared to \$17.4 million for the three months ended March 31, 2011. The amount of cash used in investing activities during the three months ended March 31, 2011 included \$7.6 million for the acquisitions of Comalex, Inc. and mySchoolBucks, LLC.

We made capital expenditures of \$7.4 million during the three months ended March 31, 2012, compared to \$9.1 million in the three months ended March 31, 2011. Capital expenditures in the three months ended March 31, 2011 include costs of \$1.6 million related to additions to our primary service center facility in Jeffersonville, Indiana. We also continue building our technology infrastructure, primarily for hardware and software needed for the development and expansion of our operating platforms. To further develop our technology, we anticipate that these expenditures will continue near current levels.

Cash Flow Used In Financing Activities. Net cash used in financing activities was \$8.6 million for the three months ended March 31, 2012, compared to \$12.3 million for the three months ended March 31, 2011.

In both the three months ended March 31, 2012 and 2011, we made term loan amortization payments of \$3.8 million due under our Term Credit facility and during the three months ended March 31, 2011, we paid down \$8.0 million on our Revolving Credit Facility. See “— Credit Facilities” for more details.

Cash used in financing activities in the three months ended March 31, 2012 included cash for common stock repurchases. See “—Common Stock Repurchases” for more information on our common stock repurchase authorizations. We used \$10.7 million of cash to repurchase 419,249 shares of our common stock during the three months ended March 31, 2012.

Cash dividends paid in the three months ended March 31, 2012 were \$2.3 million, compared to dividends paid of \$1.5 million in the three months ended March 31, 2011. See “— Dividends on Common Stock” for more information on our common stock dividends. During the three months ended March 31, 2012 and 2011, employees exercised stock options generating cash proceeds in the aggregate of \$6.8 million and \$0.7 million, respectively.

Credit Facilities. On November 24, 2010, we entered into a Second Amended and Restated Credit Agreement (the “Credit Agreement”) with JPMorgan Chase Bank, N.A., as administrative agent, and certain lenders who are a party to the Credit Agreement. Credit extended under the Credit Agreement is guaranteed by our subsidiaries and is secured by substantially all of our assets and the assets of our subsidiaries. The Credit Agreement amended and restated in its entirety our previous amended and restated credit agreement entered into on May 30, 2008, as amended (the “Previous Credit Agreement”), between us and certain of the parties to the Credit Agreement.

The Credit Agreement provides for a revolving credit facility in the aggregate amount of up to \$50 million (the “Revolving Credit Facility”), of which up to \$10 million may be used for the issuance of letters of credit and up to \$5 million is available for swing line loans. Upon the prior approval of the administrative agent, we may increase the total revolving commitments by \$50 million for a total commitment under the Revolving Credit Facility of

\$100 million. The Revolving Credit Facility is available to us on a revolving basis until November 24, 2015. All principal and interest not previously paid on the Revolving Credit Facility will mature and be due and payable on November 24, 2015.

The Credit Agreement also provides for a term credit facility in the aggregate amount of up to \$100 million (the “Term Credit Facility”). The Term Credit Facility requires amortization payments in the amount of \$3.75 million for each fiscal quarter during the fiscal years ended December 31, 2011 and 2012, \$5.0 million for each fiscal quarter during the fiscal years ended December 31, 2013 and 2014, and \$7.5 million for each fiscal quarter during the period commencing on January 1, 2015 through the maturity date on November 24, 2015. All principal and interest not previously paid on the Term Credit Facility will

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mature and be due and payable on November 24, 2015.

The Credit Agreement contains covenants which include: maintenance of certain leverage and fixed charge coverage ratios; limitations on our indebtedness, liens on our properties and assets, 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 certain of our subsidiaries. We were in compliance with these covenants as of March 31, 2012 and December 31, 2011 and expect we will remain in compliance with these covenants for at least the next twelve months.

At March 31, 2012, there was \$81.3 million outstanding under the Term Credit Facility and no borrowings outstanding under the Revolving Credit Facility. At December 31, 2011, we had \$85.0 million outstanding under the Term Credit Facility and no borrowings outstanding under the Revolving Credit Facility.

Common Stock Repurchases. On October 21, 2011, our Board of Directors authorized the repurchase of up to \$50 million worth of our common stock. Repurchases under this program will be made through the open market, or in privately

negotiated transactions, from time to time in accordance with applicable laws and regulations. We intend to fund any repurchases with cash flow from operations, existing cash on the balance sheet, and other sources including the proceeds of

options exercises. The manner, timing and amount of repurchases, if any, will be determined by our management and will

depend on a variety of factors, including price, corporate and regulatory requirements, market conditions and other corporate

liquidity requirements. The repurchase program may be modified or discontinued at any time.

Under authorization from our Board of Directors, during the three months ended March 31, 2012 and the year ended December 31, 2011, respectively, we repurchased an aggregate of 419,249 shares of our common stock at a total cost of \$11.4 million, at an average cost of \$27.16 per share, and 778,889 shares of our common stock at a total cost of \$16.8 million, at an average cost of \$21.61 per share. At March 31, 2012, we have remaining authorization to repurchase up to \$21.8 million worth of our common stock.

Dividends on Common Stock. The following table summarizes quarterly cash dividends declared and paid on our common stock during 2012 and 2011:

Date Declared	Record Date	Date Paid	Amount Paid Per Common Share
Three Months Ended March 31, 2012:			
February 8, 2012	March 2, 2012	March 15, 2012	\$0.06
Twelve Months Ended December 31, 2011:			
February 16, 2011	March 4, 2011	March 15, 2011	\$0.04
May 13, 2011	May 24, 2011	June 15, 2011	\$0.04
August 2, 2011	August 24, 2011	September 15, 2011	\$0.04
October 21, 2011	November 24, 2011	December 15, 2011	\$0.04

On May 1, 2012, our Board of Directors declared a quarterly cash dividend of \$0.06 per share of common stock, payable on June 15, 2012 to stockholders of record as of May 24, 2012.

Contractual Obligations. The card brand networks generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. If the merchant incurring the chargeback is unable to fund the refund to the card issuing bank, we must do so. As the majority of our SME transactions involve the delivery of the product or service at the time of the transaction, a good basis to estimate our exposure to chargebacks is the last four months' bankcard processing volume on our SME portfolio, which was \$22.6 billion for the four months ended March 31, 2012 and \$22.3 billion for the four months ended December 31, 2011. However, during the four months ended March 31, 2012 and December 31, 2011, we were presented with \$11.2 million and \$12.2 million, respectively, of chargebacks by issuing banks. In the three months ended March 31, 2012 and the year ended December 31, 2011, we incurred merchant credit losses of \$0.2 million and \$5.1 million, respectively, on total SME bankcard dollar volumes processed of \$16.7 billion and \$63.1 billion, respectively. These credit losses are included in processing and servicing expense in our Consolidated Statement of Income. The following table reflects our significant contractual obligations as of March 31, 2012:

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Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
	(In thousands)				
Processing providers (a)	\$25,277	\$9,658	\$11,849	\$3,770	\$—
Telecommunications providers	3,117	3,117	—	—	—
Office and equipment leases	24,955	7,802	9,240	3,823	4,090
Term Credit Facility (b)	81,250	16,250	42,500	22,500	—
	\$134,599	\$36,827	\$63,589	\$30,093	\$4,090

(a) We have agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. Our agreements with third-party processors require us to submit a minimum monthly number of transactions or volume for processing. If we submit a number of transactions or volume that is lower than the minimum, we are required to pay the third-party processors the fees that they would have received if we had submitted the required minimum number or volume of transactions.

Interest rates on the Term Credit Facility are variable in nature; however, in January 2011 we entered into fixed-pay amortizing interest rate swaps having an initial notional amount of \$50.0 million and a current notional amount of \$40.6 million. If interest rates were to remain at the March 31, 2012 level, we would make interest (b) payments of \$2.5 million in the next 1 year, \$3.1 million in the next 1 to 3 years and \$0.3 million in the next 3 to 5 years or a total of \$5.9 million including net settlements on the fixed-pay amortizing interest rate swaps. In addition, we had no outstanding amounts under our Revolving Credit Facility at March 31, 2012. The Revolving Credit Facility is available on a revolving basis until November 24, 2015.

Unrecognized Tax Benefits. At March 31, 2012, we had gross tax-effected unrecognized tax benefits of approximately \$2.0 million. See “— Critical Accounting Estimates — Income Taxes.” As of March 31, 2012, we are unable to make reasonably reliable estimates of the period of cash settlement with the respective taxing authority, hence the unrecognized tax benefits have been excluded from the above commitment and contractual obligations table.

Legal and Regulatory Considerations

The following is a description of material developments that occurred during the quarter ended March 31, 2012 in legal proceedings reported in our Annual Report on Form 10-K for the year ended December 31, 2011.

On June 10, 2009, the Judicial Panel on Multidistrict Litigation (the “JPML”) entered an order centralizing the class action cases for pre-trial proceedings before the United States District Court for the Southern District of Texas, under the caption *In re Heartland Payment Systems, Inc. Customer Data Security Breach Litigation*, MDL No. 2046, 4:09-md-2046. On August 24, 2009, the court appointed interim co-lead and liaison counsel for the financial institution and consumer plaintiffs. On September 23, 2009, the financial institution plaintiffs filed a Master Complaint in the MDL proceedings, which we moved to dismiss on October 23, 2009. On December 1, 2011, the Court entered an order granting in part our motion to dismiss the financial institution plaintiffs' master complaint against us, but allowing the plaintiffs leave to amend to re-plead certain claims. Plaintiffs' amended complaint is currently due on June 4, 2012 and a status conference will be set following the filing of the amended master complaint. On December 18, 2009, we and interim counsel for the consumer plaintiffs filed with the Court a proposed settlement agreement, subject to court approval, of the consumer class action claims. On May 3, 2010, the Court entered an order preliminarily certifying the settlement class, authorizing notice to the class to proceed, and scheduling a fairness hearing for December 10, 2010, which was later adjourned to December 13, 2010. On March 20, 2012, the Court issued a memorandum and opinion granting final approval to the settlement and on April 12, 2012, the Court entered a judgment. The time period for parties to appeal the Court's ruling has not yet expired.

Other actions have been filed against us seeking damages allegedly arising out of the Processing System Intrusion and other related relief on an individual basis. On December 28, 2009, Putnam Bank of Putnam, Connecticut filed a complaint in Connecticut Superior Court, Putnam Bank v. Heartland Payment Systems, Inc., case no. WWM-CV-10-6001208-S. On January 20, 2010, we removed the action to the United States District Court for the District of Connecticut, case no. 3:10-cv-0061 (JBA), and, on January 27, 2010, filed a Notice of Potential Tag-Along Action, requesting centralization of the action with the MDL proceedings. On March 17, 2010, the action was centralized with the MDL proceedings. On February 9, 2010, OmniAmerican Bank filed a complaint in the District Court for Collin County, Texas, Civ. No. 380-00563-2012. The complaint identifies as a party in interest the Federal Insurance Company, which is alleged to have insured plaintiff and reimbursed it for \$1,005,077.50, less a \$100,000 deductible. On March 15, 2010, we filed an answer to the complaint and removed the action to the United States District Court for the Eastern District of Texas, case no. 4:10-cv-114, and, on March 16, 2010, filed a Notice of Potential Tag-Along Action, requesting centralization of the action with the MDL proceedings. On April 29, 2010, the action was centralized with the MDL proceedings. On February 18, 2010, Quad City Bank and Trust filed a complaint in the District Court for Collin County, Texas, Civ. No. 380-00721-2010. The complaint identifies as a party in interest the Federal Insurance Company, which is alleged to have insured plaintiff and reimbursed it for \$432,420.32, less a \$100,000 deductible. On March

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15, 2010, we filed an answer to the complaint and removed the action to the United States District Court for the Eastern District of Texas, case no. 4:10-cv-115 and, on March 16, 2010, filed a Notice of Potential Tag-Along Action, requesting centralization of the action with the MDL proceedings. On April 29, 2010, the action was centralized with the MDL proceedings. On May 5, 2010, Napus Federal Credit Union filed a complaint in the United States District Court for the Southern District of Texas, case no. 4:10-cv-1616, and the action was consolidated with the MDL proceedings on June 9, 2010.

On January 19, 2010, financial institution plaintiffs, including certain of the named plaintiffs in the MDL proceedings, commenced an action against our sponsor banks in the United States District Court for the Southern District of Texas, captioned Lonestar National Bank, N.A. et al. v. KeyBank NA, et al., Civ. No. 4:10-cv-00171. This action against our sponsor banks asserts common-law claims similar to those asserted against us, and likewise seeks to represent all financial institutions that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion. On March 4, 2010, this action was transferred to the judge overseeing the MDL proceedings. On April 9, 2010, our sponsor banks moved to dismiss the complaint. On March 31, 2011, the Court entered an order granting the sponsor banks' motions to dismiss the complaint and invited additional briefing on the effect of the Court's order on our pending motion to dismiss. On May 18, 2011, the plaintiffs filed an amended complaint against KeyBank, NA, which KeyBank, NA moved to dismiss on July 7, 2011. On March 14, 2012, the Court entered an order granting KeyBank's motion to dismiss and entered final judgment dismissing the action with prejudice. On April 18, 2011, in accordance with its order dismissing the claims against Heartland Bank for lack of personal jurisdiction, the court transferred the action against Heartland Bank to the United States District Court for the Eastern District of Missouri. Heartland Bank filed a notice with the Judicial Panel on Multidistrict Litigation on July 27, 2011 designating the transferred action as a potential tag-along action to the MDL proceedings. On August 11, 2011, the action was centralized with the MDL proceedings. The sponsor banks could seek indemnification from us in regard to the claims asserted in this action.

We were contacted by the Federal Financial Institutions Examination Council and informed that it would make inquiries into the Processing System Intrusion, and the Federal Trade Commission, by letters dated February 19, 2009, August 4, 2009, and March 10, 2010, has requested that we provide information about our payment processing services and information security practices. Additionally, we have received written or telephonic inquiries relating to the Processing System Intrusion from a number of state Attorneys General's offices, including a Civil Investigative Demand from the Louisiana Department of Justice Office of the Attorney General, the Canadian Privacy Commission, and other government officials. We have cooperated with the government officials in response to each of these inquiries and have not received any further communications from the above-mentioned government agencies. Additional lawsuits may be filed against us relating to the Processing System Intrusion and that additional inquiries from governmental agencies may be received or investigations may be commenced.

In the ordinary course of our business, we are party to various legal proceedings, 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.

Quantitative and Qualitative Disclosures About Market Risk

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

We have interest rate risk related to our payable to our sponsor banks. Within our amount payable to our sponsor banks are balances which KeyBank and Heartland Bank have advanced to our SME merchants for interchange fees. 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 March 31, 2012, our payable to sponsor banks included \$46.7

million for funding interchange advances to our SME merchants. This payable is repaid on the first business day of the following month out of fees collected from our merchants. During the quarter ended March 31, 2012, the average daily interest-bearing balance of that payable was approximately \$8.6 million. The outstanding balance of our payable to our sponsor banks is directly related to our bankcard 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 \$86,000 in annual pre-tax income.

We also incur interest rate risk on borrowings under our Second Amended and Restated Credit Agreement. The Second Amended and Restated Credit Agreement provides for a Revolving Credit Facility of \$50.0 million and a Term Credit Facility of \$100.0 million. At March 31, 2012, there was \$81.3 million outstanding under the Term Credit Facility and no outstanding balance under the Revolving Credit Facility. The Term Credit Facility requires amortization payments in the amount of \$3.75 million for each fiscal quarter during the fiscal years ended December 31, 2011 and 2012, \$5.0 million for each fiscal quarter during the fiscal years ended December 31, 2013 and 2014, and \$7.5 million for each fiscal quarter during

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the period commencing on January 1, 2015 through the maturity date on November 24, 2015. 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 greater of the prime rate, the federal funds rate plus 0.50% and the adjusted LIBOR rate plus 1%, in each case plus a margin determined by our current leverage ratio. In January 2011, we entered into fixed-pay amortizing interest rate swaps having an initial notional amount of \$50.0 million on the variable rate debt outstanding under the Term Credit Facility. These interest rate swaps convert that initial notional amount to fixed rate. At March 31, 2012, the remaining notional amount of these interest rate swaps was \$40.6 million. The impact which a hypothetical 100 basis point increase in short-term interest rates would have on our outstanding March 31, 2012 balances under the Second Amended and Restated Credit Agreement would be a decline of approximately \$406,000 in annual pre-tax income, including the effect from interest rate swaps.

While the bulk of our cash and cash-equivalents are held in checking accounts or money market funds, we do hold certain fixed-income investments with maturities within three years. At March 31, 2012, a hypothetical 100 basis point increase in short-term interest rates would result in an increase of approximately \$53,000 in annual pre-tax income from money market fund holdings, but a decrease in the value of fixed-rate investments of approximately \$40,000. A hypothetical 100 basis point decrease in short-term interest rates would result in a decrease of approximately \$53,000 in annual pre-tax income from money market funds, but an increase in the value of fixed-rate instruments of approximately \$40,000.

Foreign Currency Risk. While substantially all of our business is conducted in U.S. dollars, our 70% owned Canadian processing subsidiary, CPOS, conducts its operations in Canadian dollars. Consequently, a portion of CPOS' revenues and expenses may be affected by fluctuations in foreign currency exchange rates. We are also affected by fluctuations in exchange rates on assets and liabilities related to our CPOS subsidiary. We have not hedged our translation risk on foreign currency exposure. For the year ended December 31, 2011, foreign currency exposures had an immaterial impact on our revenues and our net income. For the three months ended March 31, 2012, fluctuations in exchange rates on CPOS' assets and liabilities increased our total other comprehensive income and noncontrolling interests by \$0.2 million.

We do not hold or engage in the trading of foreign exchange instruments.

Office Facilities

At March 31, 2012, we owned one facility and leased sixteen 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 constructed our credit card operations and service center. The state-of-the-art facility is comprised of 238,000 square feet of space supporting customer service, operations, deployment, day care, fitness, cafeteria, and large company meetings.

We also leased the following facilities as of March 31, 2012:

Location	Square Feet	Expiration
Auburn, Alabama	2,382	April 30, 2014
Chattanooga, Tennessee	9,461	June 30, 2014
Cleveland, Ohio	24,229	June 30, 2012
Cleveland, Ohio	41,595	June 30, 2019
Colorado Springs, Colorado	9,920	February 28, 2015
Harlan, Kentucky	5,000	May 25, 2014
Johnson City, Tennessee	5,252	April 17, 2014
Phoenix, Arizona	1,284	April 30, 2013

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Phoenix, Arizona	1,930	October 31, 2012
Plano, Texas	53,976	May 31, 2015 for 26,988 square feet. January 14, 2019 for 26,988 square feet.
Plano, Texas	26,020	January 31, 2015
Portland, Oregon	11,564	September 30, 2013
Tempe, Arizona	14,315	September 30, 2014
Toronto, Ontario, Canada	14,094	July 31, 2020
West Windsor Township, New Jersey	5,288	May 31, 2013

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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.

Item 3. Quantitative and Qualitative 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 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), we evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (“the Exchange Act”) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon that evaluation, our CEO and CFO concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective and provided reasonable assurance that the information required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based, in part, upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their goals under all potential future conditions.

Changes in Internal Controls

During the quarter ended March 31, 2012, there was no change in our internal controls over financial reporting (as defined in Rule 13 a-15(f) and 15d-15(e) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Except as disclosed in “Legal and Regulatory Considerations” of Part I of this Quarterly Report on Form 10-Q, there were no material developments that occurred during the three months ended March 31, 2012 in the proceedings reported under Part I, Item 3. Legal Proceedings in our Annual Report on Form 10-K for the year ended December 31, 2011, nor are we aware of any other material legal proceedings initiated against us during the three months ended March 31, 2012.

Item 1A. Risk Factors

There have been no material changes in our Risk Factors as previously reported in our Annual Report on Form 10-K for the year ended December 31, 2011.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None

(b) None

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

On October 21, 2011, our Board of Directors authorized the repurchase of up to \$50 million worth of our common stock. Repurchases under this program will be made through the open market, or in privately negotiated transactions, from time to time in accordance with applicable laws and regulations. We intend to fund any repurchases with cash flow from operations, existing cash on the balance sheet, and other sources including the proceeds of options exercises. The manner, timing and amount of repurchases, if any, will be determined by our management and will depend on a variety of factors, including price, corporate and regulatory requirements, market conditions and other corporate liquidity requirements. The

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repurchase program may be modified or discontinued at any time.

Under authorization from our Board of Directors, during the three months ended March 31, 2012 and the year ended December 31, 2011, respectively, we repurchased an aggregate of 419,249 shares of our common stock at a total cost of \$11.4 million, at an average cost of \$27.16 per share, and 778,889 shares of our common stock at a total cost of \$16.8 million, at an average cost of \$21.61 per share. At March 31, 2012, we have remaining authorization to repurchase up to \$21.8 million worth of our common stock.

The following table presents information with respect to those purchases of our common stock made during the three months ended March 31, 2012:

	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 (In thousands)
January 1— 31, 2012	156,149	\$24.16	156,149	\$29,400
February 1— 29, 2012	30,000	24.83	30,000	28,655
March 1 — 31, 2012	233,100	29.48	233,100	21,784
Total	419,249	\$27.16	419,249	

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Effective April 30, 2012, we entered into an amendment (the “Amendment”) to the Merchant Financial Services Agreement with Wells Fargo Bank, N.A. (“Wells Fargo”) dated February 8, 2012 (the “Agreement”). The Amendment extended the previously disclosed date after which either party may terminate the Agreement on 10 days' notice, if the ACH Agreement has not been signed, from April 30, 2012 to June 30, 2012. We are currently negotiating the terms of the ACH Agreement with Wells Fargo.

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Item 6. Exhibits

Exhibit Number	Description
*10.1	Merchant Financial Services Agreement with Wells Fargo Bank, N.A dated February 8, 2012.
*10.2	Amendment No. 1 to the Merchant Financial Services Agreement between Wells Fargo Bank, N.A. and Heartland Payment Systems, Inc. dated April 30, 2012.
*31.1	Certification of the Chief Executive Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*31.2	Certification of the Chief Financial Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*32.1	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*32.2	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 7, 2012

HEARTLAND PAYMENT SYSTEMS, INC.

(Registrant)

By: /S/ ROBERT O. CARR
Robert O. Carr
Chief Executive Officer
(Principal Executive Officer)

By: /S/ Maria Rueda
Maria Rueda
Chief Financial Officer
(Principal Financial Officer)

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