

ELECTRONIC CLEARING HOUSE INC
Form 10-Q
February 14, 2006

**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 December 31, 2005

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number: 0-15245

ELECTRONIC CLEARING HOUSE, INC.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

93-0946274
(I.R.S. Employer Identification No.)

**730 Paseo Camarillo,
Camarillo, California 93010**
(Address of principal executive offices)

Telephone Number (805) 419-8700, Fax Number (805) 419-8682
www.echo-inc.com
(Registrant's telephone number, including area code; fax number; web site address)

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No R

As of February 1, 2006, there were 6,699,005 shares of the Registrant's Common Stock outstanding.

ELECTRONIC CLEARING HOUSE, INC.

INDEX

Page No.

PART I. FINANCIAL INFORMATION

<u>Item 1.</u>	<u>Consolidated Financial Statements (unaudited)</u>	
	<u>Consolidated Balance Sheets</u>	3
	<u>December 31, 2005 and September 30, 2005</u>	
	<u>Consolidated Statements of Operations</u>	4
	<u>Three months ended December 31, 2005 and 2004</u>	
	<u>Consolidated Statements of Cash Flows</u>	5
	<u>Three months ended December 31, 2005 and 2004</u>	
	<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	26
<u>Item 4.</u>	<u>Controls and Procedures</u>	26

PART II. OTHER INFORMATION

<u>Item 1.</u>	<u>Legal Proceedings</u>	27
<u>Item 6.</u>	<u>Exhibits</u>	27
	<u>Signatures</u>	28

Index**PART I. FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements**

**ELECTRONIC CLEARING HOUSE, INC.
CONSOLIDATED BALANCE SHEETS
(Unaudited)**

ASSETS

	December 31, 2005	September 30, 2005
Current assets:		
Cash and cash equivalents	\$ 6,902,000	\$ 6,732,000
Restricted cash	2,007,000	1,448,000
Settlement deposits	24,936,000	17,094,000
Settlement receivables less allowance of \$25,000 and \$25,000	1,461,000	981,000
Accounts receivable less allowance of \$232,000 and \$92,000	2,716,000	2,421,000
Prepaid expenses and other assets	455,000	385,000
Deferred tax asset	228,000	249,000
Total current assets	38,705,000	29,310,000
Noncurrent assets:		
Property and equipment, net	2,357,000	2,337,000
Software, net	9,065,000	8,876,000
Other assets, net	284,000	294,000
Total assets	\$ 50,411,000	\$ 40,817,000

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Short-term borrowings and current portion of long-term debt	\$ 359,000	\$ 426,000
Accounts payable	337,000	305,000
Settlement payable	26,397,000	18,075,000
Accrued expenses	2,238,000	2,467,000
Total current liabilities	29,331,000	21,273,000
Noncurrent liabilities:		
Long-term debt	657,000	705,000
Deferred tax liability	1,497,000	1,067,000
Total liabilities	31,485,000	23,045,000
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$.01 par value, 36,000,000 authorized; 6,723,020 and 6,620,531 shares issued; 6,684,751 and 6,582,262 shares	67,000	66,000

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outstanding, respectively		
Additional paid-in capital	25,716,000	25,574,000
Accumulated deficit	(6,391,000)	(6,983,000)
Less treasury stock at cost, 38,269 and 38,269 common shares	(466,000)	(466,000)
Less unearned stock compensation	-0-	(419,000)
Total stockholders' equity	18,926,000	17,772,000
Total liabilities and stockholders' equity	\$ 50,411,000	\$ 40,817,000

See accompanying notes to consolidated financial statements

Index

ELECTRONIC CLEARING HOUSE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months	
	Ended December 31,	
	2005	2004
REVENUES	\$ 16,926,000	\$ 12,760,000
COSTS AND EXPENSES:		
Processing and transaction expense	11,142,000	8,171,000
Other operating costs	1,341,000	1,333,000
Research and development expense	479,000	448,000
Selling, general and administrative expenses	2,903,000	2,721,000
	15,865,000	12,673,000
Income from operations	1,061,000	87,000
Interest income	47,000	28,000
Interest expense	(25,000)	(28,000)
Income before provision for income tax	1,083,000	87,000
Provision for income taxes	(491,000)	(35,000)
Net income	\$ 592,000	\$ 52,000
Basic net earnings per share	\$ 0.09	\$ 0.01
Diluted net earnings per share	\$ 0.09	\$ 0.01
Weighted average shares outstanding		
Basic	6,627,275	6,427,305
Diluted	6,960,373	6,882,761

See accompanying notes to consolidated financial statements.

Index

ELECTRONIC CLEARING HOUSE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months	
	Ended December 31,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 592,000	\$ 52,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	207,000	183,000
Amortization of software	622,000	407,000
Provisions for losses on accounts and notes receivable	140,000	50,000
Deferred income taxes	451,000	34,000
Stock option compensation	218,000	8,000
Tax benefit from exercise of stock option	3,000	-0-
Changes in assets and liabilities:		
Restricted cash	(559,000)	(236,000)
Settlement deposits	(7,842,000)	3,200,000
Accounts receivable	(435,000)	(167,000)
Settlement receivable	(480,000)	(393,000)
Accounts payable	32,000	79,000
Settlement payable	8,322,000	(2,810,000)
Accrued expenses	(217,000)	665,000
Prepaid expenses and other assets	(70,000)	(174,000)
Net cash provided by operating activities	984,000	898,000
Cash flows from investing activities:		
Other assets	1,000	3,000
Purchase of equipment	(227,000)	(140,000)
Purchased and capitalized software	(802,000)	(939,000)
Net cash used in investing activities	(1,028,000)	(1,076,000)
Cash flows from financing activities:		
Repayment of notes payable	(73,000)	(111,000)
Repayment of capitalized leases	(42,000)	(136,000)
Proceeds from exercise of stock options	291,000	123,000
Tax benefit from exercise of stock options	38,000	-0-
Net cash provided by (used in) financing activities	214,000	(124,000)
Net increase (decrease) in cash	170,000	(302,000)
Cash and cash equivalents at beginning of period	6,732,000	7,576,000
Cash and cash equivalents at end of period	\$ 6,902,000	\$ 7,274,000

See accompanying notes to consolidated financial statements.

Index

ELECTRONIC CLEARING HOUSE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - Basis of Presentation:

The accompanying consolidated financial statements as of the three-month period ended December 31, 2005, are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the financial position and the results of operations for the interim periods. The consolidated financial statements herein should be read in conjunction with the consolidated financial statements and notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005. The results of operations for the three months ended December 31, 2005 are not necessarily indicative of the likely results for the entire fiscal year ending September 30, 2006.

NOTE 2 - Stock-Based Compensation:

Effective October 1, 2005, the Company began recording compensation expense associated with stock options in accordance with SFAS No. 123R, Share-Based Payment. Prior to October 1, 2005, the Company accounted for stock-based compensation related to stock options under the recognition and measurement principles of Accounting Principles Board Opinion No. 25; therefore, the Company measured compensation expense for its stock option plan using the intrinsic value method, that is, as the excess, if any, of the fair market value of the Company's stock at the grant date over the amount required to be paid to acquire the stock, and provided the disclosures required by SFAS Nos. 123 and 148. The Company has adopted the modified prospective transition method provided under SFAS No. 123R, and as a result, has not retroactively adjusted results from prior periods. Under this transition method, compensation expense associated with stock options recognized in the first quarter of fiscal year 2006 includes expense related to the remaining unvested portion of all stock option awards granted prior to October 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. The Company has not issued any stock options since the adoption of SFAS No. 123R.

The adoption of SFAS No. 123R also resulted in certain changes to the Company's accounting for its restricted stock awards, which is discussed below in more detail.

As a result of the adoption of SFAS No. 123R, the Company's net income for the three months ended December 31, 2005, includes \$218,000 of compensation expense and \$3,000 of income tax benefits related to the Company's stock options. Basic and diluted net income per common share for the three-month period ended December 31, 2005 would have been \$0.12 and \$0.11 respectively, had we not adopted SFAS No. 123R, compared to reported basic and diluted net income per share of \$0.09. The compensation expense related to all of the Company's stock-based compensation arrangements is recorded as a component of selling, general and administrative expenses. Prior to the Company's adoption of SFAS No. 123R, the Company presented tax benefits resulting from the disqualified dispositions of stock options as cash flows from operating activities on the Company's consolidated statements of cash flows. SFAS No. 123R requires that cash flows resulting from tax deductions in excess of the cumulative compensation cost recognized for options exercised (excess tax benefits) be classified as cash inflows from financing activities and cash outflows from operating activities.

The Company issues new shares upon the exercise of stock options and the issuance of restricted stock.

Stock Options:

At December 31, 2005, the Company had one stock option plan. Under the Company's current stock option plan, the Board of Directors may grant options to purchase up to 1,150,000 shares of the Company's common stock to officers, key employees and non-employee directors of the Company. At December 31, 2005, options for 248,012 shares remained available for future grant under the plan. Options cancelled due to forfeiture or expiration return to the pool available for grant. The plan is administered by the Board of Directors or its designees and provides that options granted under the plan will be exercisable at such times and under such conditions as may be determined by the Board of Directors at the time of grant of such options, however options may not be granted for terms in excess of ten years. Compensation expense related to stock options granted is recognized ratably over the service vesting period for the entire option award. The total number of stock option awards expensed to vest is adjusted by estimated forfeiture rates. The terms of the plan provide for the granting of options at an exercise price not less than 100% of the fair market value of the stock at the date of grant, as determined by the closing market value stock price on the grant date.

All

Index**NOTE 2: Continued**

options outstanding at December 31, 2005 were issued at 100% of the fair market value of the stock at the date of grant and have five-year vesting terms.

The estimated fair value of each option award granted was determined on the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions for option grants during the three months ended December 31, 2004. There were no options granted during the three months ended December 31, 2005.

**Three Months Ended
December 31, 2004**

Risk-free interest rate	3%
Expected volatility of common stock	76.6%
Dividend yield	-0-
Expected option term	7 year

The computation of the expected term is based on a weighted average calculation combining the average life of options that have already been exercised or cancelled with the estimated life of all unexercised options. The expected volatility is based on the historical volatility of the Company's stock. The risk-free interest rate is based on the implied yield on U.S. Treasury constant maturities with a remaining term equal to the expected term of the option. The dividend yield is projected to be zero.

A summary of the status of the Company's stock option plan as of December 31, 2005 and of changes in options outstanding under the plan during the three months ended December 31, 2005 is as follows:

	Number of Shares	Exercise Price per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at September 30, 2005	1,116,125	\$ 5.51		
Options granted	-0-			
Options exercised	63,550	\$ 4.58		
Options forfeited or expired	-0-			
Options outstanding at December 31, 2005	1,052,575	\$ 5.56	6.9	\$ 4,225,000
Options vested and exercisable at December 31, 2005	561,372	\$ 4.93	6.1	\$ 1,935,000

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Nonvested share activity under our Stock Option Plan for the three-month period ended December 31, 2005 is summarized as follows:

	Nonvested Number Of Shares	Weighted Average Grant-Date Fair Value
Nonvested balance at October 1, 2005	539,094	\$ 6.06
Vested	(47,891)	\$ 5.23
Nonvested balance at December 31, 2005	491,203	\$ 6.14

7

Index**NOTE 2: Continued**

The weighted-average fair value of each option granted during the first quarters of fiscal year 2005, estimated as of the grant date using the Black-Scholes option valuation model, was \$5.20 per option. The total intrinsic value of options exercised was \$91,000 during the first quarters of fiscal year 2005.

As of December 31, 2005, there was \$2,089,000 of unamortized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 8.0 years.

Cash received from stock option exercises for the three months ended December 31, 2005 and 2004 was \$291,000 and \$123,000, respectively. The income tax benefits from stock option exercises totaled \$41,000 and \$-0- for the three months ended December 31, 2005 and 2004, respectively.

For stock options granted prior to the adoption of SFAS No. 123R, the following table illustrates the pro forma effect on net income and earnings per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 in determining stock-based compensation for awards under the plan:

	Three Months Ended December 31, 2004
Net income, as reported	\$ 52,000
Add: Stock-based compensation expense included in reported net income, net of related tax effects	5,000
Deduct: Total stock-based compensation expense determined under fair value-based method for all awards, net of related tax effects	(108,000)
Pro forma net loss	\$ (51,000)
Earnings per common share:	
Basic - as reported	\$ 0.01
Basic - pro forma	\$ (0.01)
Diluted - as reported	\$ 0.01
Diluted - pro forma	\$ (0.01)

Restricted Stock:

Restricted Stock is granted under the 2003 Plan. Compensation expense related to restricted stock issued is recognized ratably over the service vesting period. Restricted stock grants are normally vested over a five-year period.

In accordance with SFAS No. 123R, the fair value of restricted stock awards is estimated based on the closing market value stock price on the date of share issuance. The total number of restricted stock awards expected to vest is adjusted by estimated forfeiture rates. As of December 31, 2005, there was \$770,000 of unamortized compensation cost related to non-vested restricted stock awards, which is expected to be recognized over a remaining weighted-average vesting period of 4.75 years. The unamortized compensation cost related to non-vested restricted

stock awards was recorded as unearned stock-based compensation in shareholders equity at September 30, 2005. As part of the adoption of SFAS No. 123R, such unamortized compensation cost was reclassified as a component of paid-in capital. 4,379 shares vested during the first quarter of fiscal year 2006.

A summary of the status of the Company's restricted stock awards as of December 31, 2005, and of changes in restricted stock outstanding under the plan during the three months ended December 31, 2005 is as follows:

8

Index**NOTE 2: Continued**

	Number Of Shares	Weighted-Average Grant Date Fair Value Per Share
Restricted stock awards outstanding at September 30, 2005	50,000	\$ 8.50
Shares issued	37,588	\$ 10.25
Shares vested	4,379	\$ 9.25
Shares forfeited	-0-	\$ -0-
Restricted stock awards outstanding at December 31, 2005	83,209	\$ 9.25

NOTE 3 - Earnings Per Share:

The Company calculates earnings per share as required by Statement of Financial Accounting Standard No. 128, "Earnings per Share".

	Three Months Ended December 31,	
	2005	2004
Numerator:		
Net income	\$ 592,000	\$ 52,000
Denominator:		
Weighted average shares outstanding for basic earnings per share	6,627,275	6,427,305
Effect of dilutive stock options	333,098	455,456
Adjusted weighted average shares outstanding for diluted earnings per share	6,960,373	6,882,761
Basic net earnings per share	\$ 0.09	\$ 0.01
Diluted net earnings per share	\$ 0.09	\$ 0.01

For the three months ended December 31, 2005 and 2004, 42,500 and 89,500 shares attributable to the exercise of outstanding options were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

NOTE 4 - Supplemental Cash Flow Information:

	Three Months Ended December 31,	
	2005	2004

Cash paid for:

Interest	\$	25,000	\$	28,000
Income taxes		-0-		110,000

9

Index**NOTE 4: Continued**

Significant non-cash transactions for the three months ended December 31, 2005 were as follows:

- Restricted stock valued at \$397,000 was issued to certain executives and employees.

Significant non-cash transactions for the three months ended December 31, 2004 were as follows:

- There were no non-cash transactions for the three months ended December 31, 2004.

NOTE 5 - Segment Information:

The Company primarily operates in two business segments: Bankcard and transaction processing and check-related products, all of which are located in the United States.

The Company's reportable operating segments have been determined in accordance with the Company's internal management structure, which is organized based on the Company's product lines. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is based on the segment's contribution to the Company's future strategic growth.

	Three Months Ended December 31,	
	2005	2004
Revenues:		
Bankcard and transaction processing	\$ 12,580,000	\$ 9,182,000
Check-related products	4,346,000	3,578,000
	\$ 16,926,000	\$ 12,760,000
Operating income:		
Bankcard and transaction processing	\$ 1,982,000	\$ 1,332,000
Check-related products	1,141,000	641,000
Other	(2,062,000)	(1,886,000)
	\$ 1,061,000	\$ 87,000

	December 31, 2005	September 30, 2005
Total assets:		
Bankcard and transaction processing	\$ 10,156,000	\$ 9,452,000
Check-related products	33,518,000	24,719,000
Other	6,737,000	6,646,000
	\$ 50,411,000	\$ 40,817,000

NOTE 6 - Commitments, Contingent Liabilities, and Guarantees:

The Company currently relies on cooperative relationships with, and sponsorship by, one bank in order to process its Visa, MasterCard and other bankcard transactions. The agreement between the bank and the Company requires the Company to assume and compensate the bank for bearing the risk of "chargeback" losses. Under the rules of Visa and

MasterCard, when a merchant processor acquires card transactions, it has certain contingent liabilities for the transactions processed. This contingent liability arises in the event of a billing dispute between the merchant and a cardholder that is ultimately resolved in the cardholder's favor. In such a case, the disputed transaction is charged back to the merchant and the disputed amount is credited or otherwise refunded to the cardholder. If the Company is unable to collect this amount from the merchant's account, and if the merchant refuses or is unable to reimburse the Company for the chargeback due to merchant fraud, insolvency or other reasons, the Company will bear the loss for the amount of the refund paid to the cardholders. The Company utilizes a number of systems and procedures to manage merchant risk. In addition, the Company requires cash deposits by certain merchants, which are held by the Company's sponsoring bank to minimize the risk that chargebacks are not collectible from merchants. A cardholder, through its issuing bank,

Index

NOTE 6: Continued

generally has until the later of up to four months after the date a transaction is processed or the delivery of the product or service to present a chargeback to the Company's sponsoring bank as the merchant processor. Therefore, management believes that the maximum potential exposure for the chargebacks would not exceed the total amount of transactions processed through Visa and MasterCard for the last four months and other unresolved chargebacks in the process of resolution. For the last four months through December 31, 2005, this potential exposure totaled approximately \$507 million. At December 31, 2005, the Company, through its sponsoring bank, had approximately \$113,000 of unresolved chargebacks that were in the process of resolution. At December 31, 2005, the Company, through its sponsoring bank, had access to \$14.4 million in merchant deposits to cover any potential chargeback losses.

For the three-month period ended December 31, 2005 and 2004, the Company processed approximately \$388 million (2005) and \$262 million (2004) of Visa and MasterCard transactions, which resulted in \$2.4 million in gross chargeback activities for the three months ended December 31, 2005 and \$1.6 million for the three months ended December 31, 2004. Substantially all of these chargebacks were recovered from the merchants.

The Company's contingent obligation with respect to chargebacks constitutes a guarantee as defined in Financial Accounting Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantee, Including Indirect Guarantees of Others" ("FIN 45"). FIN 45 requires that guarantees issued or modified subsequent to December 31, 2002 be initially recorded as liabilities in the Statement of Financial Position at fair value. Since the Company's agreement with its sponsoring bank, which establishes the guarantee obligation, was entered into prior to December 31, 2002 and has not been modified since that date, the measurement provisions of FIN 45 are not applicable to this guarantee arrangement.

In accordance with SFAS No. 5, "Accounting for Contingencies", the Company records a reserve for chargeback loss allowance based on its processing volume and historical trends and data. As of December 31, 2005 and 2004, the allowance for chargeback losses, which is classified as a component of the allowance for uncollectible accounts receivable, was \$162,000 and \$71,000, respectively. The expense associated with the valuation allowance is included in processing and transaction expense in the accompanying consolidated statements of income. For the three-month period ended December 31, 2005 and 2004, the Company expensed \$134,000 and \$20,000.

In its check guarantee business, the Company charges the merchant a percentage of the face amount of the check and guarantees payment of the check to the merchant in the event the check is not honored by the checkwriter's bank. Merchants typically present customer checks for processing on a regular basis and, therefore, dishonored checks are generally identified within a few days of the date the checks are guaranteed by the Company. Accordingly, management believes that its best estimate of the Company's maximum potential exposure for dishonored checks at any given balance sheet date would not exceed the total amount of checks guaranteed in the last 10 days prior to the balance sheet date. As of December 31, 2005, the Company estimates that its maximum potential dishonored check exposure was approximately \$1,484,000.

For the quarters ended December 31, 2005 and 2004, the Company guaranteed approximately \$12,088,000 (2005) and \$7,107,000 (2004) of merchant checks, which resulted in \$95,000 (2005) and \$29,000 (2004) of dishonored checks presented to the Company for payments. The Company has the right to collect the full amount of the check from the checkwriter. The Company establishes a reserve for this activity based on historical and projected loss experience. For the quarter ended December 31, 2005 and 2004, the check guarantee loss was \$76,000 (2005) and \$34,000 (2004). The check guarantee loss is included in processing and transaction expense in the accompanying consolidated statements of income.

NOTE 7 - Litigation:

The Company is involved in various legal cases arising in the ordinary course of business. Based upon current information, management, after consultation with legal counsel, believes the ultimate disposition thereof, with the exception of the patent litigation described below, will have no material effect upon either the Company's results of operations, financial position, or cash flows.

In July 2004, LML Patent Corporation, a wholly-owned subsidiary of LML Payment Systems, Inc. ("LML"), filed a patent infringement claim against the Company, its subsidiary, *XPRESSCHEX*, Inc. and others, relating with respect to the Company and its subsidiary, to the alleged infringement by the Company's check conversion processes of three patents held by LML. In September 2005, the patent infringement claims for two (2) of the patents were dropped. The suit was filed in the U.S. District Court for the District of Delaware. A hearing was held on December 19, 2005 to determine the claims underlying the patent that is the subject of this litigation and to hear motions for summary judgment. The judge took the matters under submission and has not yet rendered her decision. The trial is scheduled to commence in the later part of April 2006.

Index

NOTE 7: Continued

The Company was aware of the LML patents prior to LML's initiation of the claims and had previously obtained competent legal opinions from outside patent counsel that neither the Company nor any of its subsidiaries infringe on any valid or enforceable patent rights of LML being asserted in the litigation. No documents came out of the discovery process to alter the Company's original belief that none of its check conversion processes infringe upon any valid or enforceable patent rights of LML, and the Company will continue to vigorously defend its position against the remaining claims made.

Ultimately, the Company expects that it will not be held liable for any of the alleged infringement, including for any treble punitive damages. Should the Company be held liable for any alleged infringement, the ultimate liability the Company may sustain may include a royalty payment primarily calculated on activity commencing in the middle of calendar 2003 for only select conversion activity, as that was the time period in which the Company actively began utilizing the check conversion processes alleged to infringe the LML patents. Despite the relatively short time period involved and the relatively small overall transaction volume arising from the alleged infringing check conversion services in comparison to the Company's total transaction volume, the Company believes that any such alleged damages award could have a significant impact on its results of operations, financial position, or cash flows. Additionally, to the extent that any future royalty payment is ordered, such a payment could negatively impact the Company's results of operations going forward.

NOTE 8 - Effective Tax Rate:

The effective tax rate for the quarter ended December 31, 2005 was 45.3% as compared to 40.2% for the prior year quarter. The increase in the tax rate was primarily due to stock compensation expense which was a non-deductible expense as the Company does not recognize a tax benefit in incentive stock options until a disqualifying disposition occurs.

Index

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

FORWARD-LOOKING STATEMENTS

The discussion of the financial condition and results of operations of the Company should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere herein. This discussion contains forward-looking statements, including statements regarding the Company's strategy, financial performance and revenue sources, which involve risks and uncertainties. The Company's actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth elsewhere herein, and in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

OVERVIEW

Electronic Clearing House, Inc. is an electronic payment processor that provides for the payment processing needs of merchants, banks and collection agencies. We derive the majority of our revenue from two main business segments: 1) bankcard and transaction processing services ("bankcard services"), whereby we provide solutions to merchants and banks to allow them to accept credit and debit card payments from consumers; and 2) check-related products ("check services"), whereby we provide various services to merchants and banks to allow them to accept and process check payments from consumers. The principal services we offer within these two segments include, with respect to our bankcard services, debit and credit card processing, and with respect to our check services, check guarantee (where, if we approve a check transaction and a check is subsequently dishonored by the check writer's bank, the merchant is reimbursed by us), check verification (where, prior to approving a check, we search our negative and positive check writer database to determine whether the check writer has a positive record or delinquent check-related debts), electronic check conversion (the conversion of a paper check at the point of sale to a direct bank debit which is processed for settlement through the Federal Reserve System's Automated Clearing House ("ACH") network), check re-presentation (where we attempt to clear a check on multiple occasions via the ACH network prior to returning the check to the merchant so as to increase the number of cleared check transactions), and check collection (where we provide national scale collection services for a merchant or bank). We operate our services under the following brands:

- MerchantAmerica, our retail provider of all credit card, debit card and check payment processing services to both the merchant and bank markets;
- National Check Network ("NCN"), our proprietary database of negative and positive check writer accounts (i.e., accounts that show delinquent history in the form of non-sufficient funds and other negative transactions), for check verification, check conversion capture services, and for membership to collection agencies;
 - *XPRESSCHEX*, Inc. for check collection services; and
 - *ECHO*, for wholesale credit card and check processing services.

We discuss our services in greater detail below. Overall, our ability to program and oversee the management of a merchant's point-of-sale system, provide credit card and debit card processing, provide multiple services for the processing of checks, provide both electronic and traditional collection services, and fully integrate all of these services into a single Internet-based reporting capability allows us to provide for the majority of the payment processing needs of our customers.

We were incorporated in Nevada in December 1981. Our executive offices are located at 730 Paseo Camarillo, Camarillo, California 93010, and our telephone number is (805) 419-8700. Our common stock is traded on the NASDAQ Capital Market under the ticker symbol "ECHO." Information on our website, www.echo-inc.com, does not

constitute part of this quarterly report.

Overall, our ability to program and oversee the management of a merchant's point-of-sale system, provide credit card and debit card processing, provide multiple check services for the processing of checks, provide both electronic and traditional collection services, and fully integrate all of these services into a single Internet-based reporting capability allows us to provide for the majority of the payment processing needs of our customers.

Bankcard and transaction processing services provide for the majority of our revenues. We typically receive a percentage-based fee on the dollar amount processed and a transaction fee on the number of transactions processed. For the quarter ended December 31, 2005, the bankcard and transaction processing business segment accounted for approximately 74.3% of the Company's total revenue.

We purchased a fully integrated, multi-modular bankcard processing system which, once fully implemented, should provide us with greater flexibility to price our credit card processing services and allow us to offer our services to other third parties. This project has experienced numerous implementation delays, mainly as a result of vendor software delivery issues and the vigorous testing required prior to implementation. Management now anticipates the clearing portion of this system to begin live customer deployment in the second half of 2006.

Index

ECHO has invested significant resources and management focus in its check services business. Check services revenue increased approximately 21.5% from \$3,578,000 in the first fiscal quarter of 2005 to \$4,346,000 for the current fiscal quarter. Revenue from ACH and check conversion continues to increase. Growth has come primarily from four sources: Internet wallet providers, cross-selling electronic checks into the credit card merchant base we already serve, casino check cashing services and the Visa POS Check Program.

Wallet providers allow a customer to fund an online wallet with a lump sum and then the customer can use the wallet at various sites on the Internet. (Probably the best known wallet service on the Internet is PayPal, a service owned by eBay.) *ECHO* is assisting various providers of wallet services to fund the initial wallet transaction. Subsequent transactions of transferring funds from the online wallet are generally not handled by *ECHO* because the payment is typically handled online by the wallet provider themselves.

Approximately 70% of *ECHO*'s credit card processing merchants operate their businesses in non-face-to-face environments such as mail order, phone order and the Internet. These relationships historically have higher margins than those seen with normal retail merchants because of the higher risk of fraud. We are finding good success in selling electronic checks to these merchants because it is a significantly lower cost form of payment.

ECHO has established an integrated processing relationship with the largest check cashing provider to the gaming and casino market. Our services are primarily centered on providing check verification (using our NCN data base), check conversion (moving paper checks to electronic transactions at the check cashing cage in the casino), and several sophisticated risk management services that are used to assist the provider in confidently accepting checks. Through this source, *ECHO* expects to provide these services to several of the largest casinos and gaming customers in the industry.

ECHO is both a Third-Party Processor and an Acquirer Processor for the Visa POS Check Program. Visa officially released its POS Check Service as of December 2002 and several national banks have entered the program since its inception to both sell the service to their merchants and to connect all of their checking accounts to the Visa network. While the transactional growth in 2005 has been slower than expected, Visa's connectivity to checking account balances has increased significantly over the past year, moving nationally from less than 10% to 20%, and 30% and higher in many metropolitan areas. (See the discussion of the Visa POS Check Service program below.)

In addition to being a Third-Party Processor, we are currently certified as an Acquirer Processor with Visa, a role that accepts transactions from the merchant's point-of-sale terminal/systems and reformats them for submission to the Visa network. We were chosen by nine banks currently in the program to serve as their Acquirer Processor. Most banks presently in the Visa Program are large national or regional banks and already had terminal management service providers that could act as Acquirer Processor for the Visa Program. In the future, as smaller banks make the decision to enter the Visa Program, it is expected that many will have no prior relationship with a terminal management provider and therefore, may potentially choose us as their Acquirer Processor.

We derive transaction revenue in our role as a Third-Party Processor and/or Acquirer Processor by negotiating a transaction fee with Visa and/or the bank that chose us as its Third-Party Processor and/or Acquirer Processor. This Third-Party Processor transaction fee averages \$0.07 to \$0.09 per transaction and the Acquirer Processor transaction fee is generally \$0.02 to \$0.04. The party that sells the service to the merchant (usually the bank) enjoys the largest mark-up on the product, offering the service in the range of \$0.20 to \$0.50 per check, with external cost in the \$0.12 to \$0.15 range, depending on what the bank negotiates with Visa and any third-party provider.

We entered into a sponsorship agreement with our primary credit card processing bank, First Regional Bank, to enable us to sell the Visa Program directly to merchants with an obligation to pay a \$0.01 transaction fee per check to the bank. This allows the bank to realize added revenue, allows us to realize higher revenue in a marked-up pricing model,

and a portion of the mark-up to be used to compensate and motivate resellers of our products and services to offer the Visa Program to merchants in the marketplace. The balance of the mark-up after paying the bank and the sales organization would be additional revenue to us. This will also enable us to use our direct sales channels to provide the Visa Program to *ECHO's* current and potential merchant base.

The Visa infrastructure requires *ECHO* to coordinate and integrate its services with several parties and systems. As part of the Visa Program, we have written, tested and installed special merchant terminal software that meets specified Visa Program requirements and certified our terminal and host response code with Vital Processing Services, a major provider of terminal services to many major banks. *ECHO* has also developed special add-on services and reporting for specific banks or select merchants that desired to participate in the Visa Program. Additionally, *ECHO* has designed and implemented several risk management tools that contribute to the significant reduction in net bad debt seen by retailers, making the Visa Program a true competitive alternative to guarantee services.

Index

In fiscal 2005, the Visa POS Check Program has not grown at the pace anticipated but several major marketing hurdles have been addressed. At its initial release in 2002, there were five primary concerns expressed by banks and/or national merchants who were approached to either sell and/or participate in the service. Those concerns were:

- Visa was connected to less than 10% of the nation's checking accounts. The added value that justified the higher cost of the Visa Program was questionable when compared to a simple check verification service that utilizes national negative databases.
 - It was believed that a merchant would have to buy a check imager to participate in the program at a cost of around \$600 for each check-out lane, a major investment for national merchants.
- There was a concern as to how customers would react, positively or negatively, to getting their checks back at the point of sale.
 - There was a concern that the service would slow down the check-out time.
 - There was concern that *ECHO* could perform, being such a small company.

Regarding the first four concerns, Visa has effectively addressed the issue of check coverage by increasing its connectivity nationally to around 20% and in certain areas to 30% or higher; the perceived need for an imager to be used has been disproved by several national merchants who are on the program, being very successful using their existing MICR check reading equipment; check writers have accepted the program very positively; and, there has been no slow-down in the check-out times at the point of sale.

On the final concern of *ECHO*'s performance, several national merchants have come on the Visa POS Check Program and are using *ECHO*. These would include merchants such as Gap, Banana Republic, Old Navy, Burlington Coat Factory, Pearle Vision, Things Remembered and Sheetz Petroleum, to name a few. All these merchants have seen significant cost savings in centralizing their check clearing services into one account (compared to literally thousands of bank accounts in some cases) and all have seen a significant reduction in their bad check losses since moving to the Visa POS Check Program.

With each of the initial concerns about the Visa POS Check Program being adequately addressed, we believe the merchants and/or banks that were initially made aware of the Program should be advised of the progress and encouraged to take another look at participating in the Program. We plan to do this ourselves and, as requested, to assist Visa and any of its member banks in sharing this positive update on the growing effectiveness of the Visa POS Check Program.

Strategy

ECHO's service strategy is to provide merchants, banks and industry-specific resellers with electronic payment services that combine credit card, debit card and electronic check and collection services with quality customer support. *ECHO*'s services enable merchants to maximize revenue by offering a wide variety of payment options, minimize costs by dealing with one source and improve their bad debt collection rates through use of *ECHO*'s integrated collection and risk management services.

Our sales strategy is four-fold: to target providers of point-of-sale systems who serve various industries in the merchant marketplace; to continue to pursue community banks with the combined set of services we currently offer; to focus our direct sales team on specific associations and merchants in industries where both checks and credit cards are common forms of payment; and to continue to support and promote the Visa POS Check Program. We intend to capitalize on our advantage of being a full credit card and check processor by combining our products and using our lower overall processing costs to allow the system provider, community bank or association to enjoy a financial benefit from their customer's processing activity.

Electronic Payment Services for POS System Providers

We believe there are significant opportunities in working closely with those firms that specialize in certain industries and provide a point-of-sale (POS) capability to merchants of some nature. By aligning our processing with these parties, we believe we can leverage our sales activity and have longer term relationships with merchants than are historically the case for most processors. We also believe our full processing capability allows us to include the POS system provider with some economic benefit from the processing volume of the users of its system.

Promote Merchant Payment Processing for Regional and Community Banks

ECHO pursues small regional and community banks for credit card and check payment programs that are characterized by having an asset base in the \$500 million range or less, and/or equity capital in the \$10 to \$50 million range. *ECHO* has developed a service that allows smaller banks to offer credit card and check processing services on a private-label basis using our back-end infrastructure with little or no technical involvement by the bank. Much of the reporting to the merchant utilizes the Internet as a delivery channel, an environment in which we have significant experience and knowledge. Due to the high costs and the perceived high risk, most small banks are either unable or unwilling to compete with national banks in providing credit card and check real time processing services and Internet-based reporting tools to their merchants. We have designed the program to be adopted by a bank at little or no cost while it allows the bank to generate revenue and earnings in competition to those earned by much larger banks that have had to make major investments in the technology.

Index

This merchant payment processing service, which is marketed under the MerchantAmerica name, incorporates all of *ECHO*'s web-based features and functionalities and our full set of services and payment options. We believe that our fully integrated payment and reporting system allows smaller banks to enjoy competitive equality with much bigger banks without making significant investments in technology. We, in turn, benefit from the increased processing and transaction revenue. Additional benefits of the MerchantAmerica program to regional and community banks include the:

- Ability for banks to set processing fees for each merchant;
- Assurance that the bank controls the merchant relationship; and
- Reduction of fraud risk.

In addition to the benefits that the bank receives from the MerchantAmerica program, the bank's merchants also receive numerous benefits, including a retail merchant account for credit cards, debit cards and checks; an online shopping cart and check-out payment system; sales tracking and online transaction history; all returned check being automatically referred to our collection agency; and dedicated customer service available 24 hours a day, seven days a week.

The program was launched in August 2002 and at the end of fiscal 2005 had twenty-four participating banks. *ECHO* estimates that there are 10,000 community banks in the United States and no one provider of services has over 10% of the market. Based on third-party research, we estimate that approximately 6,000 of these banks do not offer any payment solution but refer their merchants to outside providers. The approximately 4,000 banks that are affiliated with a payment service, we believe, will be very responsive to the MerchantAmerica value proposition when a comparison of features and costs is reviewed.

Promote to Associations and Guilds

There are over 8,000 associations and guilds in the United States and many of the 4.1 million merchants belong to one of these organizations. We believe our combination of services and our controlled cost structure will allow us to attract many of these organizations to actively refer their members to us for meeting their payment processing needs.

Promote Visa POS Check Service Program

Given *ECHO*'s role as a "first adopter" in the early stages of the Visa Program and our subsequent investment of significant resources and management focus with respect to the Visa Program, we expect to see increased growth in check services as the marketing efforts of participating banks in the Visa Program become more widely implemented.

A large participating bank sold the Visa Program to the national retailer, Gap, and it deployed the service to all of their stores (Gap, Banana Republic and Old Navy) in June of 2003. Their stores submit check MICR data (the numbers along the bottom of a check) in real time and then return the paper check to the check writer at the point of sale. *ECHO* responds with an approval or decline to the check in less than two seconds and for those it approves, it moves the funds nightly from the customers account to the merchant's account. *ECHO* also coordinates all electronic check representation and collection on returned checks when needed. Gap remains the largest merchant in the Visa Program to date.

The primary source of savings to merchants on the Visa Program are derived from (1) the elimination of having to handle and process paper checks and (2) the net financial benefit seen from the bad check write-off percentage falling below the rates charged by the national guarantee services.

While *ECHO* believes that the Visa Program has the potential to generate significant revenue for us in the future, the market potential of this service is still unproven and its success is largely dependent on the continuing marketing

support of *ECHO*, Visa and Visa's member banks.

Sales and Marketing

16

Index

ECHO offers its payment services through several sales channels.

- *Primary Sales Channels* - Direct sales personnel are dedicated to various industries and/or services. We employ approximately 20 people who serve in either field or office positions that are dedicated to sales.
- *Secondary Sales Channels* - All or a portion of our services are sold through banks who sign up with our MerchantAmerica Agent Bank Program, through banks who are selling the Visa POS Check Program, through authorized resellers, independent sales organizations (ISO's) and through one of our 300 NCN Collection Agency Members. These channels offer lower margins to us due to the added participation in the overall revenue such channels require. Currently *ECHO* has 150 authorized resellers registered to sell *ECHO*'s check products.

Management believes that we are distinctive in the number of payment methods that we allow, the combination of transaction types that we manage directly, our ability to integrate additional services, and our ability to support each merchant through one vertically integrated source.

Our marketing strategy is to build processing relationships with certain providers of POS software/hardware that serve select merchant markets; maximize cross-selling opportunities to our existing base of retail merchants and financial institutions; sell integrated suites of check, credit and debit card processing services through small banks and industry-specific resellers; enhance and market MerchantAmerica.com; and pursue associations aggressively.

Competition

Bankcard processing and check processing services are highly competitive industries and are characterized by consolidation, rapid technological change, rapid rates of product obsolescence and introductions of competitive products often at lower prices and/or with greater functionality than those currently on the market. Credit card and debit card processors have similar direct costs and therefore their products are becoming somewhat of a commodity product where a natural advantage accrues to the highest volume processors. To offset this fact, we have focused on marketing to niche markets where we can maintain the margins we deem necessary to operate profitably but no assurance can be given that this strategy will be successful in the future.

There are a number of competitors in the check services industry, the largest of which are TeleCheck (the leading provider of conversion and guarantee services and a subsidiary of First Data Corporation), SCAN/eFunds (the largest verification provider in the nation), Certegy (recently purchased by Fidelity) and Global Payments. While all four have major national accounts, we have been successful in winning the processing relationships for national accounts from each one. *ECHO* believes that it can effectively compete due to its ownership of the NCN database, its integrated set of check and collection services and the technological advantage of having been certified as both a Third-Party Processor and Acquirer Processor with the Visa POS Check Program.

ECHO is among the top 50 credit card processors in the nation when evaluated by processing volume. *ECHO* is among a much smaller group when evaluated by processing capability. Of the top 50 firms, approximately 40 of them are independent sales organizations or banks that may manage the front-end authorization service but they hire the back-end clearing and settlement services from a full service processor. There are probably 10 or fewer firms capable of full credit card processing and these would include First Data Corporation, Total Systems, NPC (Bank of America), Global Payments, First Horizon, and CSS. We believe we hold the distinction of being the smallest public company who, with the installation of the Oasis Clearing module in 2006, will serve as a full service processor in credit cards. All of our competitors have greater financial and marketing resources than us. As a result, they may be better able to respond more quickly to new or emerging technologies and changes in customer requirements. Competitors also may enjoy per transaction cost advantages due to their high processing volumes that may make it difficult for *ECHO* to compete.

We believe that being the smallest processor also has some advantages. There are many merchants who are sizable to us that the larger processors do not consider to be major merchants. We are finding these merchants appreciate getting preferential treatment from their processor. Also, our willingness to send top management into the field to meet regularly with our major merchants at their location is a perceived distinction and we are using it as a merchant retention tool. While we understand that slightly lower costs can be generated by processing high volumes, we do not think the economic advantages that high volume affords are enough to eliminate *ECHO* as an acceptable and competitive processor in most cases. Despite these potential advantages, we believe that our success will depend largely on our ability to continuously exceed expectations in terms of performance, service, and price, on our ability to develop new products and services, and on how well and how quickly we enhance our current products and introduce them into the market.

Index

RESULTS OF OPERATIONS

Three Months Ended December 31, 2005

Financial highlights for the first quarter of fiscal 2006 as compared to the same period last year were as follows:

- Total revenue increased 32.6% to \$16.9 million
- Gross margins from processing and transaction revenue was 34.2% for the current quarter as compared to 36.0% for the prior year
- Operating income increased to \$1,061,000 from \$87,000
- Diluted earnings per share were \$0.09 as compared to \$0.01 per share
- Bankcard and transaction processing revenue increased 37.0% to \$12.6 million
- Bankcard processing volume increased 47.9% from \$262.0 million to \$387.5 million
- Check-related revenue increased 21.5% to \$4.3 million
- ACH transactions processed increased 11.3% to 9.8 million transactions
- Stock compensation expense increased to \$218,000 from \$8,000 as a result of the Company's adoption of SFAS 123R this fiscal quarter.

Revenue. Total revenue increased 32.6% to \$16,926,000 for the three months ended December 31, 2005, from \$12,760,000 for the same period last year. The increase can be primarily attributed to the 37.0% growth in the bankcard processing revenue and 21.5% growth in the check services business segment as compared to the same period last year. This growth has occurred organically from our existing merchants and from our marketing initiatives.

Cost of Sales. Bankcard processing expenses are directly related to the changes in processing revenue. A major component of the Company's bankcard processing expense, the interchange fees paid to the card issuing banks, is normally fixed as a percentage of each bankcard transaction dollar processed. Processing-related expenses, consisting primarily of data center processing costs, interchange fees, third-party processing fees, and communication expense, increased from \$8,171,000 in the first fiscal quarter of 2005 to \$11,142,000 in the quarter ended December 31, 2005, a 36.4% increase. The increase was primarily attributable to the 32.6% increase in revenue for the current quarter.

Gross margin was 34.2% for the current quarter as compared to 36.0% for the same period last year. The decrease in gross margin was primarily attributable to several high volume merchants who negotiated lower fees due to the size of their accounts.

Expense. Other operating costs such as personnel costs, telephone and depreciation expenses increased slightly, from \$1,333,000 in the first quarter of 2005 to \$1,341,000 for the current fiscal quarter.

Research and development expense increased from \$448,000 in the prior year quarter to \$479,000 in the quarter ended December 31, 2005. Research and development initiatives are critical in order for us to remain competitive with our peers and to strengthen our infrastructure due to growth. Several of these projects are in the final phase of development. We anticipate that this level of investment will continue throughout the remainder of this fiscal year.

Selling, general and administrative expenses increased from \$2,721,000 in the first fiscal quarter of 2005 to \$2,903,000 for the current fiscal quarter, an increase of 6.7%. This \$182,000 increase was primarily attributable to: 1) \$210,000 increase in stock compensation expense as the result of the implementation of SFAS 123R starting this fiscal quarter. The SFAS 123R, Share-Based Payment, requires the expensing of stock options; 2) \$115,000 increase in salaries and commission; 3) \$179,000 increase in legal expense due to the on-going patent litigation; 4) \$76,000 increase in rent and employee recruitment expenses; 5) \$400,000 decrease in legal settlement expense which was incurred in the prior year. As a percentage of total revenue, selling, general and administrative expenses decreased from 21.3% in the prior year quarter to 17.2% in the current quarter.

Operating Income. Operating income for the quarter ended December 31, 2005 was \$1,061,000, as compared to operating income of \$87,000 in the same period last year. The increase in operating income was primarily due to 32.6% increase in revenue.

Index

Interest Expense. Net interest increased to \$22,000 income for the three months ended December 31, 2005, from \$0 for the prior year quarter.

Effective Tax Rate. The effective tax rate for the quarter ended December 31, 2005 was 45.3% as compared to 40.2% for the prior year quarter. The increase in the tax rate was primarily due to stock compensation expense which was a non-deductible expense as the Company does not recognize a tax benefit in incentive stock options until a disqualifying disposition occurs.

Net Income. Net income for the fiscal quarter ended December 31, 2005 was \$592,000, as compared to \$52,000 for the fiscal quarter ended December 31, 2004. This increase was primarily attributable to the 32.6% increase in revenue.

Segment Results

Bankcard and Transaction Processing. Bankcard processing and transaction revenue increased 37.0%, from \$9,182,000 in the first fiscal quarter 2005 to \$12,580,000 for the quarter ended December 31, 2005. This revenue increase was mainly attributable to organic growth from our existing merchants and several new merchants with high processing volume. Bankcard revenue made up 74.3% of total revenue for the current quarter as compared to 72.0% for the same period last year.

Operating income from our bankcard and transaction processing segment was \$1,982,000 for the quarter ended December 31, 2005 as compared to \$1,332,000 in the same period last year. This increase in operating income was primarily attributable to the 37.0% revenue growth and offset by lower margin from the merchants with high processing volume.

Check Related Products. Check-related revenues increased from \$3,578,000 for the prior year quarter to \$4,346,000 for the current fiscal quarter, an increase of 21.5%. This was a combination of the 15.2% increase in ACH processing revenue, a 22.0% increase in verification revenue, and a 72.8% increase in collection revenue.

Check services revenue made up 25.7% of total revenues in the quarter ended December 31, 2005 as compared to 28.0% in the prior year quarter. Check-related operating income was \$1,141,000 for the quarter ended December 31, 2005 as compared to \$641,000 in the same period last year. The improvement in this business segment was primarily attributable to the 21.5% increase in revenue.

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2005, we had available cash and cash equivalents of \$6,902,000, restricted cash of \$2,007,000 in reserve with our primary processing bank and a working capital of \$9,374,000.

Accounts receivable net of allowance for doubtful accounts increased from \$2,421,000 at September 30, 2005 to \$2,716,000 at December 31, 2005. Allowance for doubtful accounts mainly reserved for chargeback losses increased to \$232,000 at December 31, 2005 from \$92,000 at September 30, 2005. The higher allowance was primarily related to a \$120,000 provision for doubtful accounts related to three bankcard merchants' chargeback receivables.

Net cash provided by operating activities for the three months ended December 31, 2005 was \$1,022,000, as compared to net cash provided by operating activities of \$898,000 for the three months ended December 31, 2004.

Cash amounts classified as settlement receivable/payable are amounts due to/from merchants and result from timing differences in our settlement process with those merchants. These timing differences account for the difference between the time that funds are received in our bank accounts and the time that settlement payments are made to

merchants. Therefore, at any given time, settlement receivable/payable may vary and ultimately depends on the volume of transactions processed and the timing of the cut-off date. Settlement deposits are cash deposited in our bank accounts from the merchant settlement transactions.

In the three months ended December 31, 2005, we used \$227,000 for the purchase of equipment and \$802,000 for the acquisition and capitalization of software costs. During the three months ended December 31, 2005, we paid off \$115,000 of notes payable and capitalized lease obligations. We had proceeds of \$291,000 from stock option exercises.

During fiscal year 2005, we negotiated a secured \$3,000,000 line of credit and a \$2,000,000 equipment lease line with Bank of the West. As of December 31, 2005, we have drawn down \$1,000,000 against the \$2 million equipment lease line. We have not drawn down against the \$3,000,000 line of credit.

Index

At December 31, 2005, we had the following cash commitments:

Payment Due By Period

<u>Contractual Obligations</u>	Total	Less than 1 year	2-3 years	4-5 years	After 5 years
Long-term debt including interest	\$ 971,000	\$ 313,000	\$ 544,000	\$ 114,000	\$ -0-