ELECTRONIC CLEARING HOUSE INC
Form 10-K
December 21, 2005

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

FORM 10-K

X Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended SEPTEMBER 30, 2005

--- 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)

[GRAPHIC OMITTED]

NEVADA	93-0946274
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
730 PASEO CAMARILLO, CAMARILLO, CALIFORNIA	93010
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code:(805) 419-8700,
fax number: (805) 419-8682

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

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
None	None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.01 par value
(Title of class)

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 X No ---

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ---

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ___ No X___

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Stock on March 31, 2005, as reported on the NASDAQ Capital Market, was approximately $51,246,840. Shares of Common Stock held by each officer and director have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of December 12, 2005, the Registrant had outstanding 6,661,701 shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE - NONE

ELECTRONIC CLEARING HOUSE, INC.
2005 FORM 10-K ANNUAL REPORT

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PART I

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This 2005 Annual Report on Form 10-K contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Those statements include statements regarding our intent, belief or current expectations. Examples of forward-looking statements include statements regarding our strategy, financial performance and revenue sources. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements as a result of various factors, including, but not limited to, those set forth elsewhere in this Annual Report. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Risk Factors."

ITEM 1. BUSINESS

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-presentment (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 annual report.

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HISTORY OF THE COMPANY

ECHO has been offering bankcard and check services for over 19 years. We were incorporated in Nevada in 1981 under the name Bio Recovery Technology, Inc. and changed our name to Electronic Clearing House, Inc. with the acquisition of a credit card processing company, Electronic Financial Systems, Inc. in January 1986. In 1986, ECHO developed the capability, utilizing the Federal Reserve System's Automated Clearing House ("ACH"), a network that serves as a nationwide, wholesale electronic payment and collection system by way of transferring funds between banks via the Federal Reserve System, to deposit funds into any U.S. bank of the merchant's choice. This development made it possible for remote banks and processors to provide the same processing services previously available only through the merchant's local bank.

In 1999, ECHO acquired Magic Software Development, Inc., a check processing company located in Albuquerque, New Mexico, that serviced National Check Network ("NCN"), an association of approximately 60 affiliated collection agencies across the nation. At the time, we provided a check guarantee service that only served California merchants, but with the addition of Magic's check processing capabilities, our check guarantee services have been offered on a national basis since 1999. In fiscal 2000, Magic's corporate name was changed to XPRESSCHEX.

In November 1999, we acquired Peak Collection Services, a collection agency in Albuquerque, New Mexico, and incorporated Peak into our XPRESSCHEX operations as our Collection Division in December of 1999. The XPRESSCHEX Collection Division conducts collections on a national basis. Having a fully integrated, nationally approved collection service allows XPRESSCHEX to operate as a central check clearing facility for NCN's collection agencies without each agency having to authorize such activity.

In January 2000, we acquired Rocky Mountain Retail Systems ("RMRS") located in Boulder, Colorado, which provided a national check verification service to over 200 collection agencies across the nation. RMRS maintained a national check database of negative and positive check writer records.

In December 2000, we signed an agreement with Visa U.S.A. to participate in a point-of-sale check processing pilot program as both an "Acquirer Processor" (a role that accepts transactions from a merchant's point-of-sale terminal and reformats them for submission to the Visa network) and as a "Third-Party Processor" (a role that approves or declines checks written on accounts of banks not yet participating in the Visa POS Check Service program and deposits approved funds utilizing the ACH). Under the program, any one of over 14,000 Visa member banks can offer various check processing services to their merchants and utilize Visa's dedicated communications network and banking relationships to clear check activity using direct debits from the check writer's account. In July 2001, several major financial institutions began participating in the pilot program. The program was released from pilot in December of 2002 and, as of September 2005, nine financial institutions were using ECHO as their Acquirer Processor and fifteen financial institutions were using ECHO as their Third-Party Processor.

In May 2001, we acquired the assets of National Check Network ("NCN") and combined the NCN positive and negative check writer records with the RMRS database, resulting in a combined database of over 120 million check writer records which identify the positive and negative check writing activities occurring with individual check writers (including information related to accepted checks, bounced checks, and the frequency of delinquent transactions). This database is ever-growing with additional contributions daily and as of September 30, 2005, contained over 160 million records.

In May 2001, ECHO launched MerchantAmerica.com, a web-based source of financial information whereby an ECHO merchant can access their transactional history, bank information, significant business and office-related services and build an online store and accept payment in the form of credit cards or checks. The site also contains a National Merchant Directory that is free to any merchant in the United States. Additionally, it provides any merchant in the United States with the ability to edit and enhance their directory listing. While we believe that MerchantAmerica.com is a valuable and cost-effective resource for merchants, it provides us with a low-cost method of keeping our merchants informed and involved with us.

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OUR SERVICES

BANKCARD AND TRANSACTION PROCESSING SERVICES

Services

With our bankcard and transaction processing services, we provide payment solutions to merchants and banks to allow them to accept credit and debit card payments from consumers. Our bankcard and transaction processing services include the following:

Debit and Credit Card Payment Processing
ECHO currently provides 24-hour daily payment processing, "800" number access to customer service personnel and, as needed, various field support services. Utilizing one of several methods of access to us, the merchants' systems dial our host computers that are connected to all the major card authorizing centers, and receive credit card and debit card authorizations. At the end of each day, electronic files of authorized transactions are transmitted to the major credit card organizations. They withdraw the funds from the card issuing banks and deposit a lump sum for the day's processing activity into our processing bank on the following morning. Using a distribution file that we provide to them daily, our processing bank then distributes and deposits the individual merchant's funds into the bank account of the merchant's choice. On average, ECHO deposits funds to over 600 banks across the nation on behalf of its merchants each day.

Other Payment Processing Services
We also provide various services related to our debit and credit card payment processing, including:

- Internet Processing - ECHO allows merchants to process payment transactions online with immediate processing, online reporting and security services that protect the cardholder, merchant and Internet Service Provider ("ISP") from fraud.
- Batch File Processing - ECHO allows mail order, telephone order or

direct marketing merchants to process and transmit payments by using Microsoft Excel(R), Access(R) or any other program that can create a "flat file" of data. In this process, the merchant can visit the ECHO Merchant Center, log on through a secure gateway, and upload the file to ECHO's processing center. The transactions are processed immediately, with reporting available almost immediately on each transaction.

Deriving Revenue

Bankcard and transaction processing services provide for the majority of our revenue. For the year ended September 30, 2005, bankcard and transaction processing accounted for approximately 74.0% of our revenue. Bankcard and transaction processing volume rose 12.7% in fiscal 2005, from $1,052,657,000 in fiscal 2004 to $1,186,397,000 in fiscal 2005, and revenue increased approximately 11.4%, from $36,897,000 in fiscal 2004 to $41,093,000 in fiscal 2005.

ECHO's revenue for debit/credit card processing is derived primarily from three sources: the merchant's discount rate, the merchant's transaction fee and set monthly fees.

The discount rate is expressed as a percentage of the amount being processed and is deducted from the amount of each transaction submitted by the merchant, while the net amount is deposited into the merchant's bank account. Discount rates range between 1.5% and 3.5%. Interchange, the fee charged by the card-issuing bank and paid each day when transactions are processed, normally constitutes 75% to 85% of the discount rate revenue. Other external costs, such as Visa and MasterCard dues and bank fees, increase external fees we pay to 85% to 90% of the total discount rate charged.

A transaction fee is charged for each transaction processed and ECHO's average transaction fee in fiscal 2005 was $0.20 per transaction, the same as in fiscal 2004. Both Visa and MasterCard have instituted a $0.10 transaction fee on each transaction processed that ECHO and all processors are required to pay. In addition, on average, ECHO pays approximately $0.01 per transaction for communication costs, depending upon the duration and method of transmission.

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The market size for credit card processing is approximately 19 billion transactions per year, and this number is growing annually. ECHO has a very small percentage of this market, but we are one of the top 50 credit card processors according to The Nilson Report, a monthly financial subscription-based newsletter. Our competitors include First Data Corporation, the biggest credit card processor in the United States, NPC/Bank of America, Total Systems, Global Payments, and a few other direct payment processors. The credit card processing market has undergone rapid consolidation, which has raised unique challenges, including supporting and integrating numerous processing methodologies, initiating quality customer support and field support services and maintaining merchant relationships. While merchant portfolios can be purchased by a processor or a credit card agent bank, merchants are generally under no contractual obligation to utilize the services of the new owner so many of the most active consolidators have been experiencing difficulty in maintaining their number of active merchants.

In an effort to enhance the bankcard transaction processing business segment's processing infrastructure and control processing costs, we have acquired three payment processing modules from Oasis Technologies/eFunds; Clearing, Merchant Accounting System (MAS) and Switch. Integration of the Clearing module is currently scheduled to be complete in the second quarter of 2006 followed by several months of testing. While we believe that the new processing modules will operate as represented and result in significant operating efficiencies, there is no assurance this will actually be the case.

Historically, ECHO has been effective in selling to merchants who operate in non-face-to-face, card not present environments, such as the internet, mail order and telephone order types of businesses. Approximately 70% of our monthly credit card volume comes from these types of merchants. Our Agent Bank program brings retail, face-to-face, card present types of merchants to us so we intend to continue to promote this channel going forward. Once the Clearing module is installed and operational, we also intend to broaden our marketing reach to actively pursue more retail types of business. Since there is more competition for this type of business, the price we charge to the merchant for our services will reflect lower margins than we have historically been accustomed to getting. While we intend to continue to pursue our historic higher margin merchant markets, the added scope of merchant we intend to pursue and the lower margins inherent in this market may compress our margins overall, depending upon how successful each channel is in bringing new merchant relationships.

In order to engage in Visa and MasterCard processing, a cooperative relationship is required with a Visa/MasterCard Primary Member Bank that sponsors the merchants to accept Visa and MasterCard transactions. ECHO's primary processing bank relationship is with First Regional Bank of Los Angeles, California. As a result of its relationship, ECHO is a registered Independent Sales Organization and Merchant Service Provider with Visa and MasterCard, respectively, which allows us to solicit and support merchants utilizing our services. We have an agreement with First Regional Bank, which continues our relationship through late 2005 and extension of the agreement is expected. Pursuant to the terms of the agreement, among other matters, we market and sell merchant services and the bank provides various support services in connection with individual transactions, in exchange for our payment to the bank, on a monthly basis, of a payment of $0.02 per transaction. The agreement does not allow either party to terminate other than for cause (as defined in the agreement) without incurring liability for breach of the agreement.

CHECK-RELATED PRODUCTS (OR "CHECK SERVICES")

Overview

ECHO has invested significant resources and management focus in its check services business. Check services revenue increased approximately 26.6% in fiscal 2005, from $11,423,000 in fiscal 2004 to $14,458,000 in fiscal 2005. 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.)

Services

With our check services, we provide various services to merchants and banks to allow them to accept and process check payments from consumers. Our check services include the following:

Check Verification

For a fee, we will search NCN, our proprietary database of negative and positive check writer accounts, attempting to match a specific piece of information, such as a driver's license number or Magnetic Ink Character Recognition ("MICR") number (the numeric data along the bottom of a check), provided by a merchant. A match may identify whether the check writer has a positive record or a negative record of check cashing activity in the past. Upon notification of this match (via a coded response from the provider), the merchant decides whether to accept or decline the check. Verification reduces the risk of accepting a bad check for the merchant, however, in providing this program alone, we typically offer no guarantee that the check will be honored by the check writer's bank and make no promise of reimbursement if the check is dishonored by the bank. Revenue from check verification is derived from fees collected from the merchants when a check is verified against our positive and negative check database. This revenue is recognized when the transaction is processed, since we have no further performance obligations.

Check Guarantee

With this service, if we approve a check transaction and the check is subsequently dishonored by the check writer's bank, the merchant is reimbursed by us and we must undertake any effort to collect the delinquent amount from the check writer.

The principal risk of providing this service is the risk of collecting the amount we guarantee from a delinquent check writer whose check transaction was dishonored by his or her own bank. If we are unable to collect the amount, we lose that amount. On average, we collect 50-60% of the amounts on those checks that become delinquent. Given the risks associated with check guarantee, especially for large volume merchants, we exercise strict risk parameters with the merchants to which this service is offered. We typically apply several risk management approaches with this service, which include searching NCN's database, and "scoring" each transaction. This includes several factors such as velocity (the number of times a check writer has been searched in a certain period of time), prior activity (historic negative or positive transactions with the check writer), check writer's presence in other databases (these national databases are selectively searched based upon the size of the check and the prior activity with the check writer), size of the check, and historic bad check activity by geographic and/or merchant specific locations, to name a few. If our scoring system concludes that the risk is too high, we issue a coded response instructing the merchant that we will not guarantee the check. If our scoring system results in a positive result, a coded response advises the merchant that we have guaranteed payment on that item.

Electronic Check Conversion ("ECC")
Check conversion is the ability to convert a paper check to an electronic item at the point of sale. ECC is a relatively new system of check settlement that is quickly gaining merchant acceptance. Under the program, the merchant slips a customer's completely filled-in check either through a check reader that reads the MICR line on the check or a check imager that records the total image of the face of the check and the merchant enters the amount of the check into the system. The merchant has the customer sign a receipt, much the same as in a credit card transaction, and gives a copy of the signed receipt along with the check to the customer. The electronic image, captured by the reader, is sent to our processing center and we settle the check transaction electronically. Merchants' customers like this new system because they get their check back immediately and still have a hard copy receipt of the transaction. Banks like ECC because no paper has to be handled by the bank to settle the transaction. While most national merchants already have MICR check-reading equipment, small merchants will adopt the system only if their check volume justifies the capital investment in equipment, ranging from $125 to $150 per MICR reader and $300 to $600 for an imager.

Check Re-Presentment
The Federal Reserve System's Automated Clearing House ("ACH") provides the tools to electronically present, re-present and settle funds between banks. Our check re-presentment program allows a merchant to advise its bank that a returned check should be sent to the XPRESSCHEX data processing center in Albuquerque, New Mexico, rather than returned to the merchant. Upon receipt, XPRESSCHEX converts the check to an electronic ACH transaction for resubmission through the ACH network and marks the check for possible collection activity, should it become necessary. One feature a merchant may choose is to time the re-presentment so as to coincide with a check writer's typical payday to better the odds of collection. Generally, the full face value of the check is returned to the merchant upon collection and a collection fee charged to the check writer, usually in the range of $15 to $25, is retained by XPRESSCHEX as payment for its services.

Internet Check, Batch Check and Virtual Terminal
A check can be presented as a form of payment over the Internet and we support the multiple types of ACH entry classes. XPRESSCHEX allows an e-commerce site to accept a check as payment, allows a batch of check data to be sent electronically for processing (this is commonly used by mail order or phone order businesses) and allows both verification-only and ACH transactions to be submitted by merchants via a secure logon and passcode connection over the Internet.

Visa POS Check Service Program ("Visa Program")

The Visa POS Check Program enables merchants to receive direct online authorization for checks written against consumer checking accounts, similar to the authorizations provided for credit and debit card transactions. The Visa Program was offered as a pilot program by Visa to its member banks from December of 2000 to December of 2002 over which time several banks electronically connected their check writer data to the Visa network, making verification of the check writer's bank account balance possible when checks drawn on these select banks were processed. In December of 2002, the program was officially released out of pilot and more banks have been added each year to the Visa network. As of September 2005, a national merchant could expect connection to around 20% of the nation's checking accounts from all locations and, within select metropolitan areas, 30% or higher connectivity. This number is expected to increase to 30% on average for a national merchant and, within select cities, 40% or higher over the coming year as more banks connect their check writer data to the Visa network. ECHO has invested significant resources and management focus in its check services business, particularly with respect to the Visa Program.

As described above, "check conversion" is the ability to convert a paper check to an electronic item at the point of sale. The Visa Program provides Visa member banks with a check conversion service that they can sell to their bank merchants. The Visa Program allows the merchant to get an immediate authorization or decline on a check while the check writer is at the checkout counter. If the check is approved, the service allows the merchant to immediately return the paper check to the check writer since the funds will be electronically withdrawn from the check writer's account and deposited into the merchant's account.

Being able to approve or decline a check in real time at the point of sale requires some method to verify the check writer has either an adequate balance in the bank to cover the check or, if that is not possible, to verify if the check written is in a negative check account database. In order to provide this check service on 100% of the checks received by a merchant, Visa needed a solution to approve or decline (and for those approved, electronically deposit) the checks that processed through the program on a bank that had not yet connected its check writer data

to the Visa network. We are currently one of two companies that provide this service to Visa as a Third-Party Processor. When a Visa member bank signs up to offer the Visa Program to its merchants, it chooses a Third-Party Processor from the certified providers and, to date, ECHO serves as a Third-Party Processor for fifteen financial institutions actively participating in the program.

When Visa receives electronic check data from a merchant and the bank upon which the check is drawn has not connected its check writer data to the Visa network, Visa routes that check to the Third-Party Processor that was chosen by the merchant's bank when they set up the program. The Third-Party Processor authorizes or declines a check based upon the negative and positive data contained in several national check account databases that are commercially available and, for those transactions that are approved, the Third-Party Processor will electronically move the funds from the check writer's account to either the merchant bank's master clearing account or directly to the merchant's banking account (depending on the bank's desired settlement method) utilizing the ACH.

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.

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 costs 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.

Deriving Revenue

For the past several years, we have invested significant resources and management focus in our check services business. This business segment comprised approximately 26.0% of our total revenue for the fiscal year ended September 30, 2005. As an individual segment, check-related revenue increased by 26.6% to $14,458,000 in fiscal 2005 from $11,423,000 in fiscal 2004.

ECHO's revenue in check services can come from several sources. Typically, the merchant pays either a fixed fee for each transaction (verification, conversion, etc.) or a fee based on the face amount of the check (check guarantee) or both (check guarantee). In the Visa model, ECHO can receive transaction fees for providing Third-Party services to Visa banks, whereby ECHO assists them in processing checks from banks not participating in the Visa Program. In addition, ECHO may serve a Visa bank as a collector of the transaction data for the merchant and submitting such data to VisaNet, a process referred to as an Acquirer Processor. ECHO can also participate in the mark-up over cost that is charged to those merchants ECHO sells directly through its own primary sales channels. Additional revenue is earned if the merchant utilizes ECHO's collection services and it is primarily derived from the collection fee associated with successful collection of an item. If ECHO refers a collection item to an NCN member, a small participation in the collection fee is returned to ECHO through agreement with the NCN member. Finally, when ECHO provides a guarantee service to a merchant directly or to a bank to offer to their merchants, it earns a percentage of every check processed from the merchant. ECHO's earnings in this case are directly tied to its success in collection and its risk management capability.

The NCN database includes over 30 million negative check account records and 130 million positive records. Approximately 300 affiliated collection agencies continually contribute to the database to enrich its depth and value. Through its network of NCN members, ECHO can offer regional collection services and distribute collection items to one or more of a select group of NCN's member agencies to maximize a merchant's or bank's ability to collect amounts on a local level. NCN provides an ongoing revenue stream for ECHO as collection agencies, major national merchants, banks, other transaction processors, and thousands of small merchants access the NCN database daily to verify the status of a check writer in real time. Check verification has been recognized as one of the lowest cost and most effective ways for retailers to lower the risks and losses experienced in accepting checks as a form of payment. Our NCN database is one of only four national databases that can serve this market need on a national scale, and we are currently the fifth largest check verification processor in the United States according to the September 2005 issue of The Nilson Report, a monthly financial subscription-based newsletter. In addition to operating NCN, we provide a common platform where a business can also access other major negative check writer databases that are currently available in the nation.

XPRESSCHEX collection revenue comes from two sources: service fees and percentage of the check collection agreements. When XPRESSCHEX is engaged by a merchant or a bank to immediately collect on returned checks that were converted from paper to an electronic item, XPRESSCHEX normally receives the service fee of $15 to $25 that is charged to the check writer, not the merchant. Some merchants also engage XPRESSCHEX in the active collection of paper checks that have bounced or in the active collection of secondary efforts after all initial attempts at collection have been exhausted by the merchant. In these cases, XPRESSCHEX negotiates a percentage of the check amount, ranging from 10% to 25%, depending on several factors.

STRATEGY

Overview

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.

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 representment 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

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.

EMPLOYEES

As of September 30, 2005, we employed 222 individuals, 203 of whom were full time employees.

REPORTABLE SEGMENTS

Refer to Note 14 "Segment Information" in the accompanying Notes to Consolidated Financial Statements for reportable segment information.

ITEM 2. PROPERTIES

In March 2004, we sold a building in Agoura Hills, California which was previously our corporate headquarters, for $2,382,000, and paid off the two notes collateralized by this building. As a result of this sale, we recognized a gain of $1,319,000 on a pre-tax basis.

In October 2003, we leased 21,566 square feet of a 40,000 square foot building in Camarillo, California. Our principal executive offices, including customer support, data center and other operational departments were moved to this

Camarillo location. We signed an addendum to the Camarillo lease in July 2004 and added 11,103 square feet to the lease. We currently occupy 32,669 square feet of the Camarillo building. The lease payment for this facility as of September 2005 was $35,936 per month.

We have additional real property leases in Albuquerque, New Mexico; Lakewood, Colorado; Provo, Utah; Lawrence, Kansas; and Glendale, California for sales, data center and other operations, under various agreements, which expire at various times over the next year. The total of these lease payments are approximately $18,000 per month.

ITEM 3. LEGAL PROCEEDINGS

We are involved in various lawsuits arising in the ordinary course of business. Based upon current information, management, after consultation with legal counsel, believes the ultimate disposition of these lawsuits will have no material effect upon either our 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 us, our subsidiary, XPRESSCHEX, Inc. and others, relating with respect to us and our subsidiary, to the alleged infringement by our 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. The discovery process and expert witness reports have been completed and claims construction briefs and summary judgment briefs have been filed with the court in anticipation of a December 19, 2005 hearing on these issues. LML seeks an undisclosed amount of damages in connection with the alleged infringement.

We were 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 we nor any of our 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 our original belief, and we will continue to vigorously defend our position against the remaining claims made.

Ultimately, we expect that we will not be held liable for any of the alleged infringement, including for any treble punitive damages. The case is scheduled to go to trial in April of 2006. Should we be held liable for any alleged infringement, which is not expected, the ultimate liability we 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 we actively began utilizing the check conversion processes alleged to infringe the LML patents. In view of the relatively short time period involved and the relatively small overall transaction volume arising from the alleged infringing check conversion services in comparison to our total transaction volume, we believe that any such alleged damages award should have a relatively minor impact on our results of operations, financial position, or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of ECHO's shareholders in the quarter ended September 30, 2005.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Since January 17, 1986, we have been trading on the over-the-counter market under the name Electronic Clearing House, Inc. On October 2, 1989, we were accepted for listing on the National Association of Securities Dealers Automated Quotation System ("NASDAQ") and trade under the symbol of "ECHO" on the NASDAQ Capital Market. The following table sets forth the range of high and low prices for our common stock during the fiscal periods indicated, as reported on the NASDAQ Capital Market.

FISCAL YEAR ENDED SEPTEMBER 30	High	Low
2005		
First Quarter	$ 9.65	$7.42
Second Quarter	$ 9.22	$7.99
Third Quarter	$10.35	$7.10
Fourth Quarter	$ 9.36	$8.00
2004		
First Quarter	$11.33	$6.15
Second Quarter	$13.06	$8.23
Third Quarter	$11.47	$8.75
Fourth Quarter	$ 9.99	$6.45

The prices set forth above are not necessarily indicative of liquidity of the trading market. Trading in our common stock is limited and sporadic, as indicated by the average monthly trading volume of 307,639 shares for the period from October 2004 to September 2005. On December 12, 2005, the closing representative price per share of our common stock, as reported on the NASDAQ Capital Market, was $9.90.

HOLDERS OF COMMON STOCK

As of December 12, 2005, there were 822 record holders and 2,591 beneficial holders of our common stock, with 6,661,701 shares outstanding. The number of holders of record is based on the actual number of holders registered on the books of our transfer agent and does not reflect holders of shares in "street name" or persons, partnerships, associations, corporations or other entities identified in security position listings maintained by depository trust companies.

DIVIDEND POLICY

We have not paid any dividends in the past and have no current plan to pay any dividends. We intend to devote all funds to the operation of our businesses.

EQUITY COMPENSATION PLAN INFORMATION

The Equity Compensation Plan Information identified in Item 11 of this Annual Report on Form 10-K is incorporated herein by this reference.

PURCHASES OF EQUITY SECURITIES

We have not repurchased, nor has any affiliated purchaser repurchased, shares of our common stock.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth certain selected consolidated financial data, which should be read in conjunction with the Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in Items 7 and 8 below. The following data, insofar as it relates to each of the five

years ended September 30, has been derived from our annual financial statements, including the consolidated balance sheets at September 30, 2005 and 2004, and the related consolidated statements of operations and of cash flows for the three years ended September 30, 2005, 2004 and 2003, and notes thereto appearing elsewhere herein.

	YEAR ENDED SEPTEMBER 30			
	2005	2004	2003	2
	(---- AMOUNTS IN THOUSANDS, EXCEPT PER			
STATEMENT OF OPERATIONS DATA:				
Revenue	$ 55,551	$ 48,320	$ 41,149	$
Costs and expenses	53,872	44,863	38,724	
Income (loss) from operations	1,679	3,457	2,425	
Interest income (expense), net	23	(104)	(172)	
Other income (expense), net	-0-	1,319	-0-	
Income (loss) before income tax (provision) benefit and cumulative effect of an accounting change	1,702	4,672	2,253	
(Provision) benefit for income taxes	(669)	(1,823)	(925)	
Income (loss) before cumulative effect of an accounting change	1,033	2,849	1,328	
Cumulative effect of an accounting change to adopt SFAS 142[1]	-0-	-0-	(4,707)	
Net income (loss)	$ 1,033	$ 2,849	$ (3,379)	$
Earnings (loss) per share-basic	$ 0.16	$ 0.45	$ (0.58)	$
Earnings (loss) per share-diluted	$ 0.15	$ 0.41	$ (0.56)	$
Weighted average number of common shares and equivalents outstanding-basic	6,485	6,312	5,812	
Weighted average number of common shares and equivalents outstanding-diluted	6,939	6,900	6,024	

BALANCE SHEET DATA:

Working capital	$ 8,037	$ 8,004	$ 3,201	$
Current assets	29,310	29,923	9,646	
Total assets	40,817	39,428	18,775	
Current liabilities	21,273	21,919	6,445	
Long-term debt, and payables to stockholders and related parties, less current portion	705	704	1,961	
Total stockholders' equity	$ 17,772	$ 16,240	$ 10,369	$

[1] The Company completed the transitional impairment testing required by SFAS 142 in the first quarter of fiscal 2003 and determined that its goodwill was fully impaired and a $4.7 million goodwill write-off was recognized.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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, 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 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, check verification, electronic check conversion, check re-presentment, and check collection.

We organize our service offerings under the following brand names:

- MerchantAmerica: ECHO's retail provider of payment processing services to both merchant and bank markets;
- National Check Network ("NCN"): 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.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, management evaluates its estimates, including those related to revenue recognition, deferred taxes, reserve for doubtful accounts, capitalization of software costs, contingencies and litigation. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

Management applies the following critical accounting policies in the preparation of our consolidated financial statements:

- REVENUE RECOGNITION POLICY. We earn revenue from services which include the following: debit and credit card processing, check verification, ACH services, check conversion, check re-presentment, check collection, check guarantee, and inventory tracking. All of these services are performed pursuant to a contract with customers which states the terms and fixed price for all contracted services. The price of a service may be a fixed fee for each transaction and/or a percentage of the transaction processed, depending on the service. We generally collect our fee at the time we process the transaction and accordingly, collectibility of the service fee is reasonably assured.

Revenue from debit and credit card (collectively called bankcards) and transaction processing revenue is based on a percentage of the transaction value, commonly referred to as a discount fee on a credit and debit card transaction processed by us. In addition, there is a per transaction fee associated with each bankcard transaction which is charged to the merchant. We recognize the processing and transaction revenue when the services are performed.

Revenue from check verification is derived from fees collected from the merchants when a check is verified against our own positive and negative check database and other check databases that we use. This revenue is recognized when the transaction is processed, since we have no further performance obligations.

Revenue from check conversion is derived from fees collected from merchants to convert the paper check received by merchants into an ACH transaction, which allows us to settle the transaction electronically for the merchant. We recognize the revenue related to check conversion fees when the services are performed.

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Revenue from check re-presentment is derived from fees charged to check writers. Check re-presentment is a service that allows merchants to collect a paper check through the ACH network after a check has previously been presented to the bank for collection unsuccessfully at least once. The fees earned from the check writer are recognized when collected, as collectibility is not reasonably assured until that point.

Revenue from check guarantee is derived from a percentage of the gross amount of the check and guarantees payment of the check to the merchant in the event the check is not honored by the check writer'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 us. We recognize revenue when the checks are processed at the point of sale. At the time the guarantee revenue is recognized, we provide a reserve for estimated guarantee losses based upon our historical loss experience. In the event the check is dishonored, we have the right to collect the full amount of the check from the check writer. We establish a receivable from the delinquent check writer for the full amount of the guaranteed check. The check guarantee service also earns revenue based on fees collected from delinquent check writers, which collection fee is recognized when collected, as collectibility is not reasonably assured until that point.

Revenue from check collection is derived from collection activities performed on behalf of a merchant on uncollected checks. The merchants usually keep the face amount of the uncollected checks if the collection effort is successful. Our revenue is derived from the collection fee collected from the check writer. If we refer the collection item to another collection agency, we will receive a fee from the collection agency upon its successful efforts. Collection fee revenue is recognized when collected, as collectibility is not reasonably assured until that point.

Revenue from inventory tracking is derived from transaction fees for processing and tracking U-Haul's daily inventory activities. This revenue is recognized when the transaction is processed, since we have no further performance obligations.

- DEFERRED TAXES. Deferred taxes are determined based on the differences between the financial statement and tax basis of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. In assessing the need for a valuation allowance, management considers estimates of future taxable income and ongoing prudent and feasible tax planning strategies.

- CHARGEBACK LOSSES. Chargeback losses occur when a credit card holder presents a valid claim against one of our merchants and the merchant has insufficient funds or is no longer in business resulting in the charge being absorbed by us. We record a receivable for those chargebacks for which the merchant is liable but has not made payment. We record a provision for estimated chargeback losses at the time bankcard transactions are processed. A reserve is estimated based upon a historically-determined percentage of gross credit card processing volume and actual losses experienced.

- RESEARCH AND DEVELOPMENT EXPENSE. Expenditures for activities relating to product development and improvement are charged to expense as incurred. Such expenditures amounted to $1,609,000 in fiscal year 2005 and $1,465,000 in fiscal year 2004.

- CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE. Effective October 1, 2002, we adopted Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets". SFAS 142 requires that goodwill no longer be amortized, but instead be tested for impairment at least annually using a fair value-based approach. SFAS No. 142 required us to perform an initial assessment of our reporting units to determine whether there was any indication that the goodwill carrying value was impaired. This transitional assessment was made by comparing the fair value of each reporting unit, as determined in accordance with the new standard, to its book value. In 2003, we determined that all of our goodwill was impaired under SFAS No. 142 and accordingly took a charge to write down the amount of that impairment.

- CAPITALIZATION OF SOFTWARE COSTS. The costs of purchased and internally developed software used to provide services to customers or for the process of internal administration are capitalized and amortized on a straight-line basis over the lesser of three years or estimated useful life. Under the provisions of Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," we capitalize software

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costs when both the preliminary project stage is completed and management has authorized further funding for the completion of the project. Capitalization of costs ceases when the project is substantially complete and the software is ready for its intended use. Software developed or obtained for internal use is tested for impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

RESULTS OF OPERATIONS

FISCAL YEARS 2005 AND 2004

Financial highlights for fiscal 2005 as compared to fiscal 2004 were as follows:

-- Total revenue increased 15.0% to $55.6 million

-- Gross margin from processing and transaction revenue decreased to 35.1% from 36.8%

-- Operating income decreased from $3.5 million to $1.7 million

-- Diluted earnings per share were $0.15 as compared to $0.41 per share.

-- Bankcard and transaction processing revenue increased by 11.4% to $41.1 Million

-- Bankcard processing volume increased 12.7% to $1.2 billion

-- Check-related revenue increased by 26.6% to $14.5 million

-- ACH processing volume increased 24.6% to 32.1 million transactions

REVENUE. Total revenue increased 15.0% to $55,551,000 for fiscal 2005, from $48,320,000 for fiscal 2004. The increase can be primarily attributable to 11.4% growth in bankcard and transaction processing revenue and 26.6% growth in check services revenue year-over-year. This growth has occurred organically from our existing merchants and from our marketing initiatives during the year.

The bankcard and transaction processing revenue increase was mainly attributable to a 12.7% increase in bankcard processing volume as compared to fiscal 2004. This increase was the result of our organic growth and the growth from our various marketing channels such as the Agent Bank Program and the MerchantAmerica marketing program.

The check-related processing revenue increase was attributable to a 41.8% increase in ACH services revenue and a 6.4% increase in check verification revenue. The high growth in ACH revenue was mainly due to wallet funding activities and increases in overall ACH activities.

COST OF SALES. Bankcard processing expenses are directly related to the changes in processing revenue. A majority of our bankcard processing expenses are fixed costs and are reflected as a percentage of the total face amount of each bankcard transaction, and the remaining costs are based on a fixed rate applied to the number of transactions processed. Processing-related expenses, consisting of bankcard processing expense and transaction and check processing expense, increased 18.1% for the year, from $30,370,000 in fiscal 2004 to $35,867,000 in fiscal 2005. The increase reflects the 15.0% increase in total revenue for the year, a $449,000 increase in amortization expense and a $1,020,000 increase in commission expense.

Total gross margin from processing and transaction services decreased from 36.8% in fiscal 2004 to 35.1% in fiscal 2005. Gross margin from bankcard and transaction processing decreased from 29.4% in fiscal 2004 to 27.2% in fiscal 2005. The decrease in gross margin was primarily attributable to several high volume merchants who negotiated lower than average discount rates due to the size of their accounts. Additionally, gross margin from check processing decreased from 61.1% in fiscal 2004 to 57.6% in fiscal 2005. The check services gross margin decrease was mainly attributable to an increase in commission expense and amortization expense.

EXPENSE. Other operating costs such as personnel costs, telephone, depreciation expenses and outside services increased 9.1%, from $5,182,000 in fiscal 2004 to $5,653,000 in fiscal 2005. This was primarily due to the 9% increase in salaries to support the 15% growth in fiscal 2005.

Research and development expenses increased 9.8%, from $1,465,000 in fiscal 2004 to $1,609,000 in fiscal 2005. Research and development initiatives are critical for us to remain competitive with our peers. Several major development projects were completed during fiscal year 2005. However, given the rapid change in technology in our industry, we plan to continue to invest in product development in both the bankcard processing business segment and the check-related products segment in order to stay ahead of our competitors.

Selling, general and administrative (SG&A) expenses increased 36.9% from $7,846,000 in fiscal 2004 to $10,743,000 in fiscal 2005. This increase was primarily attributable to: 1) greater personnel costs due to cost of living adjustments; 2) growth in sales and marketing expenses to implement our sales and marketing strategies; 3) a $1,141,000 increase in legal expenses to defend several lawsuits; and 4) $150,000 increase in legal settlement expenses. Even though we were expecting legal expenses related to the LMLP lawsuit to decrease in the second half of 2005, legal expense continues to be higher than expected.

As a percentage of total revenue, SG&A expenses increased from 16.2% in fiscal 2004 to 19.3% in fiscal 2005.

OPERATING INCOME. Operating income decreased from $3,457,000 in fiscal 2004 to $1,679,000 in fiscal 2005, a decrease of 51.4%. The decrease in operating income was primarily attributable to the 1.7% decrease in gross margin and the increased selling, general and administrative expenses described above.

INTEREST EXPENSE. Interest expense decreased to $113,000 for fiscal 2005, from $175,000 for fiscal 2004. The decrease was due to the full repayment of one note and some capital leases during fiscal 2005. Interest income increased from $71,000 in fiscal 2004 to $136,000 in fiscal 2005 due to higher than average cash balances on hand throughout fiscal year 2005.

GAIN ON SALE OF ASSETS. Fiscal 2004 results were favorably affected by a pre-tax gain of $1,319,000 resulting from the sale of the building that formerly held the Company's principal executive offices.

EFFECTIVE TAX RATE. The income tax provision was $669,000 for fiscal 2005 as compared to $1,823,000 for fiscal 2004. Our effective tax rate was 39.3% for fiscal 2005, as compared to 39.0% for fiscal 2004. See Notes to Consolidated Financial Statements included elsewhere herein for a further explanation of the income tax expense and a reconciliation of reported income taxes to the amount utilizing the statutory rate.

NET INCOME. Net income for fiscal 2005 was $1,033,000, as compared to $2,849,000 for fiscal 2004. This decrease was primarily attributable to the gain on the sale of assets in fiscal 2004 and the 36.9% increase in selling, general and administrative expenses in fiscal 2005.

SEGMENT RESULTS
Bankcard and Transaction Processing. For the year ended September 30, 2005, bankcard processing and transaction revenue accounted for approximately 74.0% of our revenue, compared to 76.4% in fiscal 2004. Bankcard processing and transaction revenue increased 11.4%, from $36,897,000 in fiscal 2004 to $41,093,000 in fiscal 2005. This increase was mainly attributable to a 12.7% increase in bankcard processing volume as compared to fiscal 2004. We continue to increase our bankcard processing business primarily through organic growth and various sales and marketing programs.

In fiscal 2005, the bankcard and transaction processing segment generated operating income of $5,829,000, or 14.2% of the related revenue, as compared to $5,977,000, or 16.2% of the related revenue in fiscal 2004. This decrease in operating income was primarily due to the lower gross margin combined with higher research and development expenses and selling G&A expense.

We purchased a fully integrated, multi-modular bankcard processing system from Oasis Technologies for approximately $1.6 million. We have incurred an additional $1.5 million of internal development costs thus far in implementing this system. The implementation of this system will give us greater flexibility to price our credit card processing services, allowing us to attract and retain larger merchants as well as the small and mid-market merchants that have been our target market. 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 portions of the Oasis system to begin live customer deployment in the second half of 2006.

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Check Related Products. Check-related revenue increased from $11,423,000 for fiscal 2004 to $14,458,000 for fiscal 2005, an increase of 26.6%. Check verification revenue increased 6.4% to $3,645,000 for fiscal 2005, from $3,425,000 for fiscal 2004. Check conversion, ACH services and check re-presentment revenue increased 41.8% to $8,251,000 for fiscal 2005, from $5,820,000 for fiscal 2004. Additionally, check collection revenue increased 15.4%, from $1,816,000 in fiscal 2004 to $2,096,000 in fiscal 2005. The high growth in ACH revenue was due to wallet funding activities and the overall increase in the ACH and conversion product. Total ACH transactions processed during fiscal 2005 were 32.1 million transactions, as compared to 25.8 million transactions processed in fiscal 2004, an increase of 24.6%.

Check services revenue made up 26.0% of the total processing and transaction revenue for fiscal 2005 as compared to 23.6% in fiscal 2004. Check-related operating income was $2,204,000 in fiscal 2005, as compared to operating income of $1,644,000 in fiscal 2004, an increase of 34.1%. The increase in operating income was mainly due to the 26.6% increase in check-related revenue.

The Visa Program has not grown as much as we had expected in the past year. Even though we are getting new merchants to sign up under the Visa Program, some of the larger merchants have shown a rather significant decline in the total transactions processed for fiscal 2005 as compared to fiscal 2004. We attribute this to the overall decline in check usage in the market. Additionally, certain store branded credit cards from one of our major Visa POS Check merchants shifted some of the payment transactions away from check. We are currently working with 16 Visa member banks that have signed up to participate in the Visa Program.

FISCAL YEARS 2004 AND 2003

Financial highlights for fiscal 2004 as compared to fiscal 2003 were as follows:

-- Total revenue increased 17.4% to $48.3 million

-- Gross margin from processing and transaction revenue improved to 36.8% from 33.5%

-- Operating income increased to $3.5 million from $2.4 million

-- Diluted earnings per share before cumulative effect of accounting change were $0.41 as compared to $0.22 per share.

-- Bankcard and transaction processing revenue increased by 12.0% to $36.9 million

-- Bankcard processing volume increased 9.5% to $1.1 billion

-- Check-related revenue increased by 39.4% to $11.4 million

-- ACH processing volume increased 128.4% to 25.8 million transactions

REVENUE. Total revenue increased 17.4% to $48,320,000 for fiscal 2004, from $41,149,000 for fiscal 2003. The increase was primarily attributable to 12.0% growth in bankcard and transaction processing revenue and 39.4% growth in check services revenue year-over-year. This growth occurred organically from our existing merchants and from our marketing initiatives during fiscal 2004, and as a result of increasing acceptance of our check services products and the continued growth in the Visa Program.

The bankcard and transaction processing revenue increase was mainly attributable to a 9.5% increase in bankcard processing volume as compared to fiscal 2003. This increase was the result of our organic growth and the growth from our various marketing channels such as the Agent Bank Program and the MerchantAmerica marketing program. The increase was partially offset by the departure of several high volume merchants during fiscal 2004.

The check-related processing revenue increase was attributable to a 10.6% increase in check verification revenue and a 101.3% increase in ACH services revenue. The high growth in ACH revenue was due to increasing market acceptance of this product and continued growth in the Visa Program.

COST OF SALES. Bankcard processing expenses are directly related to changes in processing revenue. A majority of our bankcard processing expenses are fixed costs and are reflected as a percentage of the total face

amount of each bankcard transaction, and the remaining costs are based on a fixed rate applied to the number of transactions processed. Processing-related expenses, consisting of bankcard processing expense and transaction and check processing expense, increased 11.8% for fiscal 2004, from $27,173,000 in fiscal 2003 to $30,370,000 in fiscal 2004. The increase reflected the 17.4% increase in processing and transaction revenue for fiscal 2004.

Gross margin from processing and transaction services improved from 33.5% in fiscal 2003 to 36.8% in fiscal 2004. This improvement in gross margin was mainly due to: 1) check-related revenue, which has a higher gross margin, which made up 23.6% of the total revenue in fiscal 2004 as compared to 19.9% of the total revenue in fiscal 2003; and 2) a rate adjustment was applied to a broad base of bankcard merchants during fiscal 2004 to offset increases in direct bankcard processing expenses.

EXPENSE. Other operating costs such as personnel costs, telephone, depreciation expenses and outside services increased 18.5%, from $4,373,000 in fiscal 2003 to $5,182,000 in fiscal 2004 primarily due to additional staff hired in fiscal 2004 to support our growth. Research and development expenses remained constant, from $1,464,000 in fiscal 2003 to $1,465,000 in fiscal 2004. Almost all of our major development projects were in the coding and testing phases in fiscal 2004.

Selling, general and administrative (SG&A) expenses increased 37.3% from

$5,714,000 in fiscal 2003 to $7,846,000 in fiscal 2004. This increase was primarily attributable to: 1) greater personnel costs due to cost of living adjustments and greater employee benefits costs, such as health insurance and worker's compensation insurance; 2) growth in sales and marketing expenses to implement our sales and marketing strategies; 3) increased legal and professional expenses to defend several lawsuits; 4) an increase in rent expense due to our corporate relocation in October 2003; and 5) a $300,000 litigation accrual related to an ordinary course contract dispute with one of our independent sales organizations. The accrual represented management's good faith evaluation of the dispute after consultation with its legal counsel. As a percentage of total revenue, SG&A expenses increased from 13.9% in fiscal 2003 to 16.2% in fiscal 2004.

OPERATING INCOME. Operating income increased from $2,425,000 in fiscal 2003 to $3,457,000 in fiscal 2004, an increase of 42.6%. The improvement in operating income was primarily attributable to the 17.4% increase in revenue and the 3.3% improvement in gross margin described above.

INTEREST EXPENSE. Interest expense decreased to $175,000 for fiscal 2004, from $200,000 for fiscal 2003. The decrease was due to the full repayment of two long-term notes. Interest income increased from $28,000 in fiscal 2003 to $71,000 in fiscal 2004 due to higher than average cash balances on hand throughout fiscal 2004.

GAIN ON SALE OF ASSETS. Fiscal 2004 results were favorably affected by a pre-tax gain of $1,319,000 resulting from the sale of the building that formerly held the Company's principal executive offices. After the sale, the Company used a portion of the proceeds to pay off two loans totaling $1,524,000, which were collateralized by the building.

EFFECTIVE TAX RATE. The income tax provision was $1,823,000 for fiscal 2004 as compared to $925,000 for fiscal 2003. Our effective tax rate was 39.0% for fiscal 2004, as compared to 37.7% for fiscal 2003. See Notes to Consolidated Financial Statements included elsewhere herein for a further explanation of the income tax expense and a reconciliation of reported income taxes to the amount utilizing the statutory rate.

NET INCOME. Net income for fiscal 2004 was $2,849,000, as compared to a net loss of $3,379,000 for fiscal 2003. Income before cumulative effect of an accounting change to adopt SFAS 142 was $1,328,000 in fiscal 2003 and $2,849,000 in fiscal 2004, an increase of 114.5%. This increase was primarily attributable to the 17.1% revenue growth year-over-year and the improvements in gross margin.

SEGMENT RESULTS

Bankcard and Transaction Processing. For the year ended September 30, 2004, bankcard processing and transaction revenue accounted for approximately 76.4% of our revenue, compared to 80.1% in fiscal 2003. Bankcard processing and transaction revenue increased 12.0%, from $32,957,000 in fiscal 2003 to $36,897,000 in fiscal 2004. This increase was mainly attributable to a 9.5% increase in bankcard processing volume as compared to fiscal 2003. This increase was partially offset by the departure of several high volume merchants. To a lesser extent, the increase was positively impacted by a rate adjustment to our bankcard merchant base during fiscal 2004. We continue to grow our bankcard processing business primarily through organic growth and various sales and marketing programs.

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In fiscal 2004, the bankcard and transaction processing segment generated operating income of $5,977,000, or 16.2% of the related revenue, as compared to $4,303,000, or 13.1% of the related revenue in fiscal 2003. This increase in operating income was reflective of the increase in revenue and higher gross margins resulting from the broad-base rate adjustment to merchants to offset higher operating costs.

In fiscal 2001, we purchased a fully integrated, multi-modular bankcard processing system from Oasis Technologies for approximately $1.3 million. We incurred an additional $700,000 of internal development costs in fiscal 2004 in implementing this system.

Check Related Products. Check-related revenue increased from $8,192,000 for fiscal 2003 to $11,423,000 for fiscal 2004, an increase of 39.4%. Check verification revenue increased 10.6% to $3,425,000 for fiscal 2004, from $3,097,000 for fiscal 2003. Check conversion, ACH services and check re-presentment revenue increased 101.2% to $5,820,000 for fiscal 2004, from $2,892,000 for fiscal 2003. Additionally, check collection revenue increased 1.4%, from $1,791,000 in fiscal 2003 to $1,816,000 in fiscal 2004. The high growth in the check conversion and ACH revenue was due to the increasing market acceptance of this product and to the transaction revenue generated by the Visa Program. Total ACH transactions processed during fiscal 2004 were 25.8 million transactions, as compared to 11.3 million transactions processed in fiscal 2003, an increase of 128.4%. ACH transactions, like ACH revenue, increased primarily from the increasing market acceptance of the ACH services and the Visa Program.

Check services revenue made up 23.6% of the total processing and transaction revenue for fiscal 2004 as compared to 19.9% in fiscal 2003. Check-related operating income was $1,644,000 in fiscal 2004, as compared to operating income of $591,000 in fiscal 2003, an increase of 178.2%. The increase in operating income was mainly due to the 39.4% increase in check-related revenue.

One of the Visa acquiring banks, using us as the Third-Party Processor, rolled out this Program to a national retailer in June 2003. This one merchant accounted for a significant percentage of revenue generated from the Visa Program in fiscal 2004 and an increased volume of transactions processed.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2005, we had available cash and cash equivalents of $6,732,000, restricted cash of $1,448,000 in reserve with our primary processing banks and working capital of $8,037,000.

Accounts receivable, net of allowance for doubtful accounts, increased to $2,421,000 at September 30, 2005 from $1,943,000 at the end of fiscal 2004. Allowance for doubtful accounts, which reflects chargeback losses decreased to $92,000 at the end of fiscal 2005 from $111,000 at September 30, 2004. The increase in accounts receivable was due to the higher processing revenue generated in fiscal 2005 and therefore higher month-end balances.

Net cash provided by operating activities for the year ended September 30, 2005 was $3,888,000 as compared to net cash provided by operating activities of $5,325,000 for fiscal 2004. The $1,437,000 decrease in cash from operations was primarily attributable to the $1,816,000 decrease in net income between fiscal 2005 and 2004.

Net cash used in investing activities was $4,636,000 for the fiscal 2005 as compared to $1,904,000 for fiscal year 2004. During fiscal 2005, we used $4,640,000 for purchases of equipment and capitalized software costs as compared to $4,278,000 for fiscal 2004.

Net cash used by financing activities was $96,000 for the current fiscal year as compared to net cash provided by financing activities of $1,247,000 for fiscal year 2004. We paid off $438,000 in notes payable, used $452,000 for the repayment of capitalized leases and received $394,000 from the exercise of employee stock options. During fiscal 2004, we received net proceeds of $2,693,000 from a private placement.

As of September 2005, we have a $2,000,000 equipment lease line and a $3,000,000 credit line with Bank of the West for working capital needs. As of September 30, 2005, we have drawn down $1,000,000 of the equipment lease line but have not used the $3,000,000 credit line.

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At September, 2005, we had the following cash commitments:

Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More Than 5 years
	Payments Due By Period				
Long-term debt including interest	$1,038,000	$ 339,000	$ 570,000	$ 129,000	$ -0-
Capital lease obligations	229,000	160,000	69,000	-0-	-0-
Operating leases	1,535,000	537,000	998,000	-0-	-0-
Total contractual cash obligations	$2,802,000	$1,036,000	$1,637,000	$ 129,000	$ -0-

Our primary source of liquidity is expected to be cash flow generated from operations and cash and cash equivalents currently on hand. Management believes that our cash flow from operations together with cash on hand, our equipment lease line, our established line of credit with Bank of the West, and cash previously received from our private placement financing will be sufficient to meet our working capital and other commitments.

OFF-BALANCE SHEET ARRANGEMENTS

At September 30, 2005, we did not have any off-balance sheet arrangements.

NEW ACCOUNTING PRONOUNCEMENT

In December 2004, the FASB issued SFAS 123R, "Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95," that addresses the accounting for share-based payment transactions in which a Company receives employee services in exchange for either equity instruments of the Company or liabilities that are based on the fair value of the Company's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R eliminates the ability to account for share-based compensation transactions using the intrinsic method that the Company currently uses and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expense in the consolidated statement of operations. SFAS 123R is effective for annual periods beginning after June 15, 2005. Management is currently evaluating the impact of SFAS 123R and it is expected that it will have a significant impact on the consolidated statement of operations as the Company will be required to expense the fair value of stock option awards.

RISK FACTORS

Our business, and accordingly, your investment in our common stock, is subject to a number of risks. These risks could affect our operating results and liquidity. You should consider the following risk factors, among others, before investing in our common stock:

RISKS RELATED TO OUR BUSINESS

WE RELY ON COOPERATIVE RELATIONSHIPS WITH, AND SPONSORSHIP BY, BANKS, THE ABSENCE OF WHICH MAY AFFECT OUR OPERATIONS.

We currently rely on cooperative relationships with, and sponsorship by, banks in order to process our Visa, MasterCard and other bankcard transactions. We also rely on several banks for access to the Automated Clearing House ("ACH") for submission of both credit card and check settlements. Our banking relationships are currently with smaller banks (with assets of less than $500,000,000). Even though smaller banks tend to be more susceptible to mergers or acquisitions and are therefore less stable, these banks find the programs we offer more attractive and we believe we cannot obtain similar relationships with larger banks at this time. A bank could at any time curtail or place restrictions on our processing volume because of its internal business policies or due to

other adverse circumstances. If a volume restriction is placed on us, it could materially adversely affect our business operations by restricting our ability to process credit card transactions and receive the related revenue. Our relationships with our customers and merchants would also be adversely affected by our inability to process these transactions.

We currently maintain one primary bankcard processing and sponsorship relationship with First Regional Bank in Agoura Hills, California. Our agreement with First Regional Bank continues through 2005. We are currently negotiating with First Regional Bank on an extension of the agreement. We also maintain several banking relationships for ACH processing. While we believe our current bank relationships are sound, we cannot assure that these banks will not restrict our increasing processing volume or that we will always be able to maintain these relationships or establish new banking relationships. Even if new banking relationships are available, they may not be on terms acceptable to us. With respect to First Regional Bank, while we believe their ability to terminate our relationship is cost-prohibitive, they may determine that the cost of terminating their agreement is less than the cost of continuing to perform in accordance with its terms, and may therefore determine to terminate their agreement prior to its expiration. Ultimately, our failure to maintain these banking relationships and sponsorships may have a material adverse effect on our business and results of operations.

MERCHANT FRAUD WITH RESPECT TO BANKCARD AND ACH TRANSACTIONS COULD CAUSE US TO INCUR SIGNIFICANT LOSSES.

We significantly rely on the processing revenue derived from bankcard and ACH transactions. If any merchants were to submit or process unauthorized or fraudulent bankcard or ACH transactions, depending on the dollar amount, ECHO could incur significant losses which could have a material adverse effect on our business and results of operations. ECHO assumes and compensates the sponsoring bank for bearing the risk of these types of transactions.

We have implemented systems and software for the electronic surveillance and monitoring of fraudulent bankcard and ACH use. As of September 30, 2005, we maintained a dedicated chargeback reserve of $776,000 at our primary bank specifically earmarked for such activity. Additionally, through our sponsoring bank, as of September 30, 2005, we had access to approximately $13.7 million in merchant deposits to cover any potential chargeback losses. Despite a long history of managing such risk, we cannot guarantee that these systems will prevent fraudulent transactions from being submitted and processed or that the funds set aside to address such activity will be adequate to cover all potential situations that might occur. We do not have insurance to protect us from these losses. There is no assurance that our chargeback reserve will be adequate to offset against any unauthorized or fraudulent processing losses that we may incur. Depending on the size of such losses, our results of operations could be immediately and materially adversely affected.

EXCESSIVE CHARGEBACK LOSSES COULD SIGNIFICANTLY AFFECT OUR RESULTS OF OPERATIONS AND LIQUIDITY.

Our agreements with our sponsoring bank require us 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 we are unable to collect this amount from the merchant's account, or if the merchant refuses or is unable to reimburse us for the chargeback due to merchant fraud, insolvency or other reasons, we will bear the loss for the amount of the refund paid to the cardholders.

A cardholder, through its issuing bank, 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 our 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 September 30, 2005, this potential exposure totaled approximately $443 million. At September 30, 2005, we, through our sponsoring banks, had approximately $106,000 of unresolved chargebacks that were in the process of resolution. At September 30, 2005, we, through our sponsoring banks, had access to $13.7 million belonging to our merchants. This money has been deposited at the sponsoring bank by the merchants to cover any potential chargeback losses.

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For the fiscal years 2005 and 2004, we processed approximately $1,186 million and $1,053 million, respectively, of Visa and MasterCard transactions, which resulted in $7.1 million in gross chargeback activities for the fiscal year ended 2005 and $7.6 million for the fiscal year ended 2004. Substantially all of these chargebacks were recovered from the merchants.

Nevertheless, if we are unable to recover these chargeback amounts from merchants, having to pay the aggregate of any such amounts would significantly affect our results of operations and liquidity.

FAILURE TO PARTICIPATE IN THE VISA POS CHECK SERVICE PROGRAM WOULD CAUSE US TO SIGNIFICANTLY SHIFT OUR OPERATING AND MARKETING STRATEGY.

We have significantly increased our infrastructure, personnel and marketing strategy to focus on the potential growth of our check services through the Visa POS Check Service program. We currently provide critical back-end infrastructure for the service, including our NCN database for verification and our access to the Federal Reserve System's Automated Clearing House for funds settlement and for checks written on bank accounts with banks not participating in the program.

Because we believe the market will continue to gain acceptance of the Visa POS Check Service program, we have expended significant resources to market our check conversion services and verification services to our merchant base, to solidify our strategic relationships with the various financial institutions that have chosen us as their Acquirer Processor and Third-Party processor under the program, and to sell our other check products such as electronic check re-presentments and check guarantee to the Visa member banks. We have also increased our personnel to handle the increased volume of transactions arising directly from our participation in the program.

Our failure to adequately market our services through this relationship could materially affect our marketing strategy going forward. Additionally, if we fail to adequately grow our infrastructure to address increases in the volume of transactions, cease providing services as a Third-Party processor or Acquirer Processor or are otherwise removed or terminated from the Visa Program, this would require us to dramatically shift our current operating strategy.

THE INABILITY OF THIRD-PARTY SOFTWARE VENDORS TO CONTINUE TO SUPPORT AND PROVIDE MAINTENANCE SERVICES WITH RESPECT TO THEIR PRODUCTS COULD SIGNIFICANTLY ADVERSELY AFFECT OUR RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

We utilize various third-party software applications and depend on the providers of such software applications to provide support and maintenance services to us. In the event that a third-party software vendor fails to continue to support and maintain its software application, or fails to do so in a timely manner, this could significantly affect our results of operations and financial condition.

Our inability to ultimately implement, or a determination to cease the implementation of various of our software technology initiatives will significantly adversely affect our results of operations and financial condition.

We have spent significant time and monetary resources implementing several software technologies, which resulted in significant cost being capitalized by us as non-current software assets. The implementation of these technologies will provide us with substantial operational advantages that would allow us to attract and retain larger merchants, as well as the small and mid-market merchants that have been our target market. Management believes that the implementation of these software technologies, and the technologies themselves, continues to be in the best interests of, and the most viable alternative for, the Company. However, the inability to ultimately implement, or a determination to cease the implementation of these software technologies would cause these assets to become impaired, and the corresponding impairment would significantly adversely affect our results of operations and financial condition.

THE BUSINESS IN WHICH WE COMPETE IS HIGHLY COMPETITIVE AND THERE IS NO ASSURANCE THAT OUR CURRENT PRODUCTS AND SERVICES WILL STAY COMPETITIVE OR THAT WE WILL BE ABLE TO INTRODUCE NEW PRODUCTS AND SERVICES TO COMPETE SUCCESSFULLY.

We are in the business of processing payment transactions and designing and implementing integrated systems for our customers so that they can better use our services. This business is highly competitive and is characterized by rapid technological change, rapid rates of product obsolescence, and rapid rates of new product introduction. Our market share is relatively small as compared to most of our competitors and most of these competitors have substantially more financial and marketing resources to run their businesses. While we believe our small size provides us the ability to move quickly in some areas, our competitors' greater resources enable them to investigate and embrace new and emerging technologies, to quickly respond to changes in customers needs, and to devote more resources to product and services development and marketing. We may face increased competition in the future and there is no assurance that current or new competition will allow us to keep our customers. If we lose customers, our business operations may be materially adversely affected, which could cause us to cease our business or curtail our business to a point where we are no longer able to generate sufficient revenue to fund operations. There is no assurance that our current products and services will stay competitive with those of our competitors or that we will be able to introduce new products and services to compete successfully in the future.

IF WE ARE UNABLE TO PROCESS SIGNIFICANTLY INCREASED VOLUME ACTIVITY, THIS COULD AFFECT OUR OPERATIONS AND WE COULD LOSE OUR COMPETITIVE POSITION.

We have built transaction processing systems for check verification, check conversion, ACH processing, and bankcard processing activities. While current estimates regarding increased volume are within the capabilities of each system, it is possible that a significant increase in volume in one of the markets would exceed a specific system's capabilities. To minimize this risk, ECHO has redesigned and upgraded its check related processing systems and has purchased a high end system to process bankcard activity. This system is not yet operational, and even when it becomes operational, no assurance can be given that it would be able to handle a significant increase in volume or that the operational enhancements and improvements will be completed in time to avoid such a situation. In the event we are unable to process increases in volume, this could significantly adversely affect our banking relationships, our merchant customers and our overall competitive position, and could potentially result in violations of service level agreements which would require us to pay penalty fees to the other parties to those agreements. Losses of such relationships, or the requirement to pay penalties, may severely impact our results of operations and financial condition.

WE INCUR FINANCIAL RISK FROM OUR CHECK GUARANTEE SERVICE.

The check guarantee business is essentially a risk management business. Any limitation of a risk management system could result in financial obligations being incurred by ECHO relative to our check guarantee activity. While ECHO has provided check guarantee services for several years, there can be no assurance that our current risk management systems are adequate to assure against any financial loss relating to check guarantee. ECHO is enhancing its current risk management systems and it is being conservative with reference to the type of merchants to which it offers guarantee services in order to minimize this risk but no assurance can be given that such measures will be adequate. During the year ended September 30, 2005, we incurred $258,000 in losses from uncollected guaranteed checks.

SECURITY BREACHES COULD IMPACT OUR CONTINUED OPERATIONS.

We process confidential financial information and maintain several levels of security to protect this data. Security includes hand and card-based identification systems at our data center locations that restrict access to the specific facilities, various employee monitoring and access restriction policies, and various firewall and network management methodologies that restrict unauthorized access through the Internet. While these systems have worked effectively in the past, there can be no assurance that they will continue to operate without a security breach in the future. Depending upon the nature of the breach, the consequences of security breaches could be significant and dramatic to ECHO's continued operations.

THE INDUSTRY IN WHICH WE OPERATE INVOLVES RAPIDLY CHANGING TECHNOLOGY AND OUR FAILURE TO IMPROVE OUR PRODUCTS AND SERVICES OR TO OFFER NEW PRODUCTS AND SERVICES COULD CAUSE US TO LOSE CUSTOMERS.

Our business industry involves rapidly changing technology. Recently, we have observed rapid changes in technology as evidenced by the Internet and Internet-related services and applications, new and better software, and faster computers and modems. As technology changes, ECHO's customers desire and expect better products and services. Our success depends on our ability to improve our existing products and services and to develop and market new products and services. The costs and expenses associated with such an effort could be

significant to us. There is no assurance that we will be able to find the funds necessary to keep up with new technology or that if such funds are available that we can successfully improve our existing products and services or successfully develop new products and services. Our failure to provide improved products and services to our customers or any delay in providing such products and services could cause us to lose customers to our competitors. Loss of customers could have a material adverse effect on ECHO.

OUR INABILITY TO PROTECT OR DEFEND OUR TRADE SECRETS AND OTHER INTELLECTUAL PROPERTY COULD HURT OUR BUSINESS.

We have expended a considerable amount of time and money to develop information systems for our merchants. We regard these information systems as trade secrets that are extremely important to our payment processing operations. We rely on trade secret protection and confidentiality and/or license agreements with employees, customers, partners and others to protect this intellectual property and have not otherwise taken steps to obtain additional intellectual property protection or other protection on these information systems. We cannot be certain that we have taken adequate steps to protect our intellectual property. In addition, our third-party confidentiality agreements can be breached and, if they are, there may not be an adequate remedy available to us. If our trade secrets become known, we may lose our competitive position, including the loss of our merchant and bank customers. Such a loss could severely impact our results of operations and financial condition.

Additionally, while we believe that the technology underlying our informa