

DIGITAL INSIGHT CORP

Form 10-K

March 16, 2005

[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

Commission File Number 0-27459

DIGITAL INSIGHT CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0493142
(I.R.S. Employer
Identification Number)

26025 Mureau Road, Calabasas, California 91302

(Address of principal executive offices, including zip code)

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

(818) 871-0000

(Registrant's telephone number, including area code)

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

None

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

Common Stock, \$0.001 par value per share

(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 ☒ 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 Exchange Act Rule 12b-2). YES ☐ NO ☒

Based on the closing sale price of \$20.56 as reported by the Nasdaq National Market System on June 30, 2004, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the registrant's common stock held by non-affiliates was \$622.6 million. The shares of common stock held by each officer and director and by each person known to the registrant who owns 5% or more of the outstanding common stock 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 February 28, 2005, registrant had 36,173,520 shares of its common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for the 2005 annual meeting of stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K to the extent stated herein. The proxy statement will be filed within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Table of Contents

INDEX

	<u>Page</u>
<u>PART I</u>	
Item 1. <u>Business</u>	1
Item 2. <u>Properties</u>	16
Item 3. <u>Legal Proceedings</u>	16
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	16
<u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	17
Item 6. <u>Selected Financial Data</u>	18
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 7A. <u>Quantitative and Qualitative Disclosure about Market Risk</u>	32
Item 8. <u>Financial Statements and Supplementary Data</u>	33
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	33
Item 9A. <u>Controls and Procedures</u>	33
<u>PART III</u>	
Item 10. <u>Directors and Executive Officers of the Registrant</u>	37
Item 11. <u>Executive Compensation</u>	37
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	37
Item 13. <u>Certain Relationships and Related Transactions</u>	38
Item 14. <u>Principal Accountant Fees and Services</u>	38
<u>PART IV</u>	
Item 15. <u>Exhibits, Financial Statement Schedules and Reports on Form 8-K</u>	39
<u>Signatures</u>	42
<u>Index to Consolidated Financial Statements</u>	F-1

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information, this Annual Report on Form 10-K as well as other statements made or to be made by Digital Insight in periodic press releases and other public communications contain forward-looking statements that involve risks and uncertainties. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, anticipate, intend, plan, believe, estimate, potential, continue, the negative or comparable terminology. These statements are only predictions. Actual events or results may differ materially from any forward-looking statement. In evaluating these statements, you should specifically consider various factors, including the risks outlined under Risk Factors in Item 1 of Part I.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. We undertake no obligation to update publicly any forward-looking statements for any reason after the date of this Annual Report on Form 10-K.

INFORMATION ABOUT DIGITAL INSIGHT

We file annual, quarterly and current reports, proxy statements, and other documents with the Securities and Exchange Commission, or the SEC, under the Securities Exchange Act of 1934, or the Exchange Act. You may read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Our reports, proxy statements, and other documents filed electronically with the SEC are available at the website maintained by the SEC at <http://www.sec.gov>.

We also make available free of charge on or through our Internet website at <http://www.digitalinsight.com> our annual, quarterly, and current reports, and, if applicable, amendments to those reports, filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such reports with, or furnish them to, the SEC.

Table of Contents

PART I

ITEM 1. BUSINESS

Overview

We are a leading provider of outsourced online banking applications and services to banks, credit unions and savings and loan associations, serving more than 1,700 client financial institutions. We offer outsourced software products, generally hosted in our data centers, and related services primarily to financial institutions with under \$20 billion in assets. Our products are highly configurable to provide a look and feel that preserves the financial institution's unique brand identity. Our contracts with financial institutions are long-term in nature, generally ranging from three to five years. Our clients pay monthly fees that are generally variable with growth in active end users and the number of transactions. More than 90% of our revenues was derived from recurring service fees during 2004.

Our outsourcing operations include three main product lines: online banking for consumers, which also includes bill payment and bill presentment; online banking for businesses, now referred to as online corporate banking (also referred to as online cash management); and online lending for consumer loans. We also offer online corporate banking products to large financial institutions that are available either as a licensed software implementation or hosted in our data centers. Our broad capabilities within online corporate banking allow us to serve all tiers of financial institutions and their business customers of all sizes. Our clients benefit from an extensive portfolio of complementary products and services that add value to our core products and services, including online check imaging, online statements, target marketing, multi-language support, web portal technology, web site development and maintenance, and professional services.

In contrast to in-house software deployments that require significant development resources, we provide comprehensive Internet applications that can be implemented rapidly and cost-effectively. By using our applications, financial institutions can keep pace with rapid advancements in Internet technology and large development expenditures by large banks without placing demands on in-house technical resources. We also help our clients generate a higher return on investment with our cooperative marketing and support programs, which promote end user adoption and cross-selling. Our comprehensive suite of products enables our clients to generate higher revenues from increased loan and account balances, to increase customer retention, and to lower their costs to serve customers by promoting self-service functions available on the Internet.

Since our inception in 1996, we have established a growing range of strategic relationships with the industry's leading data processing vendors to ensure that financial institutions can leverage their investments in existing data processing systems by fully integrating them with our Internet applications. In recent years, we have also established a growing network of partnerships with more than 100 developers of third party products that complement our core offerings with full interoperability and integration. Our scale and large client base typically allow us to negotiate more favorable pricing terms with these vendors and preferential support for new product releases relative to other online banking vendors that have less purchasing influence.

Our applications also offer high levels of security, up-time availability and system redundancy, and are designed to be readily expandable, or scalable, as the number of end users grows.

As of December 31, 2004, 5.3 million consumer end users were actively using our Internet banking applications representing 15.1% penetration of the 35.0 million potential end users among our live Internet banking clients. Of the 5.3 million active Internet banking end users, 1.0 million end users were signed up for our online bill payment service, representing 19.0% of active Internet banking users. As of December 31, 2004, 83,500 business end users were actively using our outsourced corporate banking solutions.

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

We were formed as a Minnesota limited liability company in 1996 and converted to a Delaware corporation in 1997.

Table of Contents

Industry Background

Consumers, businesses and financial institutions increasingly recognize that the Internet is a powerful and efficient medium for the delivery of financial services, including Internet banking, bill payment and bill presentment, online lending, and a host of other services for retail and business customers of financial institutions. Consumers and businesses increasingly bank online because of the convenience of remote access to account information 24 hours a day, 7 days a week, the rapid growth of broadband technologies that encourage higher Internet use, and generally increasing product awareness and comfort with conducting financial transactions online. JupiterResearch, a financial services research and advisory firm, estimates that 35.3 million U.S. households were banking online in 2004, and that the number of U.S. households banking online will increase to 51.3 million by 2007.

For financial institutions, the Internet offers a cost-effective service delivery channel from which to market a broad portfolio of products and services in an effort to strengthen and secure customer relationships and generate higher revenues. The Internet channel also enables financial institutions to expand their addressable markets and maintain service availability 24 hours a day, 7 days a week. In addition, a growing body of industry research and case studies, including recent analysis from Forrester Research, Celent Communications, Bank of America and Citibank, has demonstrated that Internet banking and online bill payment end users are more profitable to serve because online users:

generate significantly higher revenues than offline customers, primarily because online customers use more banking products and services, and maintain higher account balances than offline customers;

cost less to serve because online users tend to utilize more self-service functions and therefore interact with the more costly retail branch and call center service channels less frequently than offline customers; and

are retained by financial institutions at significantly higher rates than offline customers.

Research published by Bank of America demonstrated that end users of the bank's online bill payment service experienced attrition that was 80% lower than offline customers, and were 31% more profitable than offline customers within 31 months. Citibank also reported that its online customers are 40% more profitable than customers who do not bank online. Consequently, Bank of America, Citibank, US Bank, Wachovia and most other large financial institutions have eliminated their monthly customer fees for online bill payment and launched aggressive marketing campaigns to promote adoption of the online channel. In response, a fast-growing segment of smaller financial institutions have initiated similar campaigns, increasing the adoption of bill payment throughout the industry, particularly among the two-thirds of U.S. consumers who will not pay for bill payment services, according to Forrester estimates.

The largest U.S. financial institutions generally develop and maintain an internally hosted solution for the delivery of online financial services such as Internet banking. By contrast, we believe that the majority of the approximately 19,000 credit unions, banks, and savings and loans in the U.S. with assets of less than \$20 billion prefer to outsource the development and maintenance of their online banking initiatives to a technology services provider. These community and regional financial institutions increasingly seek to provide advanced Internet-based services to remain competitive, but frequently lack the capital, expertise, or information technology resources to offer such services in-house.

Our Business

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

We provide a comprehensive portfolio of outsourced online banking software products, generally hosted in our data centers, and related services primarily to financial institutions with assets of less than \$20 billion. We generate recurring revenues that generally correlate to the growth in active Internet banking end users and user transaction volume. Our contracts with financial institutions are long-term in nature, generally ranging between three to five years. More than 90% of our revenues were derived from recurring service fees in 2004.

Table of Contents

Our three core product offerings are Internet banking, corporate banking and lending. Our Internet banking applications for consumers include: account management, account transfers and interfaces to personal financial management software, bill payment and bill presentment, check imaging, online statements, multi-language support, inter-institutional funds transfer, and other expanded services. Our corporate banking software products serve the online banking needs of our clients' business customers and include features similar to those of our consumer product, as well as payroll direct deposits, wire and inter-account fund transfers, account reconciliation and other services. Our corporate banking software products can be deployed as a licensed software implementation or hosted in our data centers. A licensed implementation allows financial institutions to host our software using their own equipment and facilities. We have a versatile corporate banking product line that allows us to serve all tiers of financial institutions and their business customers of all sizes. Supporting products and services for consumer and business online banking include web portal technology, wireless capability, target marketing, professional services, and web site development and maintenance.

Our lending software products and related services streamline our clients' lending operations for non-mortgage consumer loans across multiple customer service channels, including back office administrative functions such as document preparation. Lending products include a loan origination system for automating workflow throughout the loan approval process, an Internet-based, real-time loan decisioning product, multi-channel automated underwriting services, and a call center staffed with qualified loan officers, 24 hours a day, 7 days a week.

We offer the following benefits to financial institutions:

Comprehensive and Customizable Solutions. We offer turnkey, subscription-based products and services with all critical applications hosted in our data centers. Our online banking applications can be configured to offer financial institutions and end users the industry's broadest portfolio of standard and optional features, including applications developed internally and in cooperation with our extensive network of product partners. Our web site design and implementation services also enable financial institutions to establish Internet banking services with a look and feel that preserves their unique brand identity.

Rapid and Affordable Implementation. Our applications can be rapidly implemented, and represent an affordable alternative to internally developed Internet banking applications for financial institutions. Average implementation times for our Internet banking applications range from four to six months, depending on the availability of an existing interface with a financial institution's data processing vendor and the financial institution's schedule.

Reliable, Secure, and Scalable Service. Our service is highly reliable. Our systems incorporate sophisticated data encryption techniques, a series of firewalls between the Internet and financial institutions, and several layers of security technology in order to guard against unauthorized access to our network. In addition, our systems can scale rapidly to accommodate an increased number of end users.

Extensive Data Processing Vendor Relationships. We provide direct connections, or interfaces, to multiple vendors of core banking software and data processing services to financial institutions. As of December 31, 2004, we have developed interfaces to a majority of the major data processing vendors serving our addressable market of financial institutions. By working directly with these vendors, we can quickly and cost-effectively connect our systems allowing relatively more rapid implementation of new customers to the same core processing system. Our interfaces also allow for tight integration with other functions supported by the data processing vendor, such as loan origination, online statements and check imaging. We believe that the number of data processing vendor interfaces we have developed provides us with a unique and significant competitive advantage.

Uniquely Broad Set of Value-Added Products. We enable financial institutions to expand their Internet presence beyond their core banking functions by providing additional value-added products and services to their customers. We believe our product suite offers the broadest capabilities in the industry, including: online bill payment and bill presentment, online lending, online corporate banking, check imaging,

Table of Contents

account aggregation, inter-institutional payments, online statements, check reordering, target marketing software, multi-language support, professional services, and training seminars. We maintain an extensive network of vendors that have cooperatively developed many of our value-added products and services.

Cooperative Marketing Programs. Our cooperative marketing programs encourage higher end user adoption of the online channel through a series of direct marketing and promotional tools including direct mail, in-branch displays, training programs, online banner advertisements, statement stuffers, and email campaigns.

Our Strategy

Our objective is to further enhance our position as a leading provider of online banking solutions to financial institutions for their retail and business customers. We intend to provide these institutions with a competitive platform that will permit them to achieve additional revenue-producing opportunities, enhance long-term cost-efficiencies, and improve customer service and client retention. To achieve this objective, we intend to:

Increase End User Penetration. As of December 31, 2004, our financial institutions with live Internet banking sites had an average penetration of 15.1% for consumer online banking, and 19.0% of these online banking users were also registered for online bill payment. Although our penetration has grown rapidly, these averages are well below levels achieved by industry-leading financial institutions that have reported online banking penetration in excess of 50%. We believe our base of 35.0 million potential consumer end users among our live Internet banking clients provides a large opportunity to increase our revenues as end user adoption increases in the future. We help clients expand the number of active end users of our Internet banking and bill payment applications through marketing assistance programs and by sharing best practices. These cooperative marketing programs enable clients to increase their returns from the online channel through increased revenue opportunities, lower customer attrition, and reduced service costs.

Pursue Cross-Selling Opportunities Within Our Existing Customer Base. We currently enable financial institutions to offer Internet banking applications and automated lending capabilities to their retail and business banking end users. We believe that we have a significant opportunity to sell our comprehensive suite of products and services to existing customers as their needs evolve and their customer base grows.

Increase the Number of Our Financial Institution Customers. We intend to further penetrate the substantial market for online banking applications. As of December 31, 2004, we had contracts with 1,720 financial institutions throughout the U.S. Our addressable market for new customers is comprised of two segments: financial institutions that have yet to offer online banking or lending services but plan to do so, and those that currently offer online services and want to either change from an in-house system or change their outsource providers.

Retain Existing Customers. Approximately 20-25% of our client base is subject to contract renewals each year. We intend to maximize client retention through a dedicated account management team, aggressive utilization of sales resources, a strategic approach to managing of key accounts, and other initiatives.

Increase Our Relationships with Core Data Processing Vendors. We intend to increase the number of our relationships with core data processing vendors to allow our applications to interface with more financial institutions and to expand our sales and distribution channel relationships. We currently interface with most of the major vendors that provide data processing services to the financial institutions in our addressable market. We intend to continually increase this coverage and to expand our existing relationships. We believe our uniquely broad portfolio of available products, financial strength, large client base and highly reliable data center make us an attractive partner for core data processors.

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

Broaden Product and Service Offerings. We plan to continue to offer new and enhanced products and services to provide our customers with a comprehensive range of product and service capabilities. We intend to enhance the capabilities or functionality of our applications to further drive end user adoption

Table of Contents

and enable our customers to offer a broad portfolio of products to better compete against larger financial institutions. Our product plans include internal development efforts and developing products in cooperation with product partners. We believe our large client base allows us to negotiate the best available pricing terms with product partners and receive preferential support for new product releases relative to smaller Internet banking providers with less purchasing influence.

Pursue Strategic Merger and Acquisition Opportunities. We intend to continue to pursue opportunities to acquire businesses that will add financial institution customers, complementary technologies or services, or provide other benefits.

Products and Services

Internet Banking

We offer a broad range of outsourced Internet banking products and services for the retail customers of our financial institution clients that include the following features:

View online transaction history, account balances, check images, and statements.

Online bill payment capability to pay anyone through the financial institution's web site.

Online bill presentment capability to receive, view, pay and store electronic bills online.

Two-way data transfer with Microsoft Money® and Intuit Quicken® financial software.

Secure online applications to open new accounts, apply for credit cards, insurance, loans or other products.

Inter-institutional and person-to-person payments outside the financial institution.

Wireless banking and alerts through mobile devices.

Promotion and marketing tools to allow financial institutions to market to online users.

E-commerce web portal for marketing third-party financial products.

Web site development, maintenance, and implementation services.

Funds transfer between accounts, current or scheduled.

Re-ordering of checks online.

Corporate Banking

Our corporate banking products, also referred to as cash management products, serve the business customers of our financial institution clients. We generally provide our corporate banking products on an outsourced basis; however, we also offer a licensed software option for large financial institutions. Primary features include:

Online administration platform to control access among business users.

View online transaction history and balance information.

Funds transfer between accounts, current or scheduled.

Stop payments for previously issued checks.

File export to business financial management software.

Bill payment and bill presentment.

Automated clearing house (ACH) services for payroll and other payments.

Table of Contents

Wire transfers with other financial institutions or vendors.

Foreign exchange rates and trading.

Check reconciliation services.

Lockbox reporting and viewing of lockbox deposit detail.

Through December 31, 2003 we managed the corporate banking business within Internet banking. With the acquisition of Magnet Communications, Inc., or Magnet, on November 25, 2003, we expanded our corporate banking products and services and consequently we established corporate banking as a separate reportable business segment on January 1, 2004.

Lending

Our lending products provide loan origination capabilities and rules-based underwriting on behalf of our financial institution clients, applying client-specific and client-defined rules to reach a credit decision. We support a wide range of consumer loans including home equity, auto loans and personal loans, but we do not support mortgage lending. We do not bear any of the underwriting or financial risk of these loans. We charge our clients a predetermined fee per loan application regardless of whether the loan is approved and a fixed monthly maintenance fee for clients utilizing our loan origination system. Lending products are configured to support multiple service channels to match consumer preferences and include:

A loan origination system that manages workflow throughout the lending process, document preparation, and related back-office and administrative functions.

Real-time loan evaluation over the Internet for consumer loans, including the retrieval of an electronic credit report and a credit decision response to the applicant, generally in less than a minute.

Loan evaluation through our 24 hours a day, 7 days a week call center staffed with trained loan officers.

Loan evaluation by the financial institution client's loan officer, using our Internet-based product for desktop decisioning within the retail branch.

Our lending underwriting products feature interfaces to our loan origination system as well as other major loan origination vendors, online credit bureau verification, and pre-qualification capabilities for home equity and consumer loans. We are in the process of migrating our clients to a new lending platform, which has taken longer than expected.

Data Centers

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

We currently provide our Internet banking services out of a data center located in Westlake Village, California. In addition, we operate a smaller data center in Sacramento in connection with our lending division and a data center in Atlanta for our large corporate banking clients. All of our data centers currently have disaster recovery capabilities. Our disaster recovery data center in Norcross, Georgia allows for emergency backup and disaster recovery functions in the event of system interruption or shutdown involving the Westlake Village data center.

Each of our data centers maintains a controlled access environment with security measures ranging from alarms, video cameras, security guards, biometric access controls and a centrally monitored key card access system. Our data centers are also equipped with a self-contained power system that includes a high capacity battery backup system, providing continuous power to all production systems. In addition, diesel power generators provide backup power to each of our facilities in the event of an extended power outage. We maintain and test our Norcross disaster recovery data center to provide system redundancy, fail-over and emergency backup capabilities.

Table of Contents

Customers

As of December 31, 2004, we had contracts with 1,720 financial institutions, including 1,467 for Internet banking services, 605 for corporate banking services and 224 for lending services. We had approximately 5.3 million active Internet banking end users representing a 15.1% penetration of the 35.0 million potential end users among 1,350 live client sites at December 31, 2004.

For the year ended December 31, 2004, no individual financial institution accounted for over 10% of our total revenues.

Third Party Relationships

We have relationships and have developed interfaces with most of the major vendors of core data processing software and outsourced data processing services to financial institutions. These system interfaces enable us to access a financial institution's host system to provide end users access to their account data. In addition to developing new interfaces, we continue to significantly enhance our numerous existing interfaces in order to deliver more robust connectivity and increase operating efficiencies. We have developed interfaces to the majority of the core data processing systems that provide services to financial institutions, most of which are supported within joint marketing arrangements that we have in place with data processing vendors. More than 50% of our revenue is derived from these referral and reseller agreements with core processing partners, including Fiserv, BISYS, Fidelity Information Services, Inc., Metavante, Computer Services Inc., Data Center Inc., Financial Solutions, Inc., re:Member Data, John Harland, Bradford Scott, COCC, and BMA.

To deliver bill payment and bill presentment services, we maintain value-added reseller relationships with major providers such as Metavante Corporation and CheckFree Services Corporation, and have fully integrated these products into our offerings. We market bill payment and bill presentment services as an integral part of our product suite, enabling financial institutions to offer bill payment within their online banking site with the convenience of a single password. Our agreement with Metavante is renewable in February of each year for successive one-year terms. Our agreement with CheckFree is renewable for additional one-year terms following the expiration of the initial term in September 2007. Our agreements require us to pay variable fees based on factors such as the number of customers, end users, and bill payment transactions and generally provide improved pricing terms as transaction volumes increase.

Sales and Marketing

We sell to our customers and potential customers primarily utilizing a direct sales model, and to a lesser extent, in cooperation with core processing partners. As of December 31, 2004, our sales, marketing and client relations staff consisted of 95 people, who are responsible for prospecting and acquiring new accounts, managing existing client relationships and renewals, and cross-selling additional products to those accounts. Our sales team is generally organized by geographic regions. We also have a dedicated national account sales team that targets larger institutions throughout the U.S. to complement our sales force and an account management team that pursues cross-selling opportunities with existing clients.

Our target market for outsourced online banking, corporate banking and lending services is comprised of financial institutions that have yet to offer online services and may wish to do so and those that currently offer online banking services and wish to change their outsource provider or switch from an in-house system. We target both markets through our direct sales force and in cooperation with core processing partners.

Our typical sales cycle is approximately four to six months for new financial institution customers and approximately two months for add-on sales to existing financial institution customers. We also have a dedicated account management and sales staff to manage the client renewal process and a sales compensation plan that rewards client retention. Our account managers identify customers whose contracts are subject to renewal with sufficient lead-time to allow the customer, our sales people, and executive sponsors to manage the renewal process and maximize client retention.

Table of Contents

Our primary marketing efforts are focused on identifying potential customers and marketing our services to consumer end users in cooperation with our financial institution clients. Our marketing efforts include: press relations, advertising, direct mail, trade shows and meetings with Internet banking user groups, and client conferences hosted by us and our core processing partners. We also offer cooperative marketing programs for existing customers, under which financial institutions partner with us to promote higher adoption and retention of the online channel, and cross-selling of additional products to online end users.

In addition, we receive marketing benefits from endorsements and promotional arrangements. We are exclusively endorsed by the American Bankers Association, or ABA, for our Internet banking product. The ABA endorsement, issued by the Corporation for American Banking, or CAB, an ABA subsidiary, was granted to us after an extensive due diligence process which included an analysis of our management, financial soundness, solution functionality, marketing capabilities and customer service standards, as well as a review of other national providers of Internet banking solutions. Our endorsement agreement requires CAB to promote our Internet banking services to all ABA members in the United States and permits us to display the American Bankers Association-Sponsored logo in all of our marketing materials related to Internet banking services. We provide CAB with a small percentage share of the revenues received from ABA members who have become our customers since the effective date of the endorsement agreement, subject to annual minimum payments. In addition, we have promotional arrangements with several state banking associations that promote our products to their constituents in exchange for referral fees.

Product Development

As of December 31, 2004, our product development staff consisted of 248 software developers and engineers, as well as product and project managers. Their development efforts are focused on:

Enhancements to Existing Products. We are continuously developing new features and functions for our consumer and business banking and lending products in order to provide a broader range of capabilities. Additional product enhancements will provide enhanced usability for our financial institution clients and their end users.

Introduction of New Product Lines. We are continuously seeking to expand our product offerings. For example, we recently introduced a loan origination system to complement our lending underwriting products, and to allow our customers to streamline workflow and administrative functions throughout the lending process.

Interfaces with Data Processing Vendors and Other Third Parties. We are continuing to enhance and expand our interfaces to financial institutions' core data processing systems and other third-party systems, such as vendors of online check imaging systems.

Our research and development expenses were \$23.4 million in 2004, \$15.6 million in 2003, and \$16.2 million in 2002. These expenses relate to product development and are charged to operations as incurred.

Competition

The market for Internet banking services is highly fragmented with many providers. In the area of retail Internet banking, we primarily compete with other companies that provide outsourced online banking services to financial institutions, including Online Resources, S1 Corporation, FundsXpress and Certegy. Also, vendors such as Corillian and Financial Fusion (a subsidiary of Sybase) that primarily target the largest financial institutions occasionally compete with us in our market segment. In addition, Fiserv, Open Solutions, Jack Henry, Metavante and

Edgar Filing: DIGITAL INSIGHT CORP - Form 10-K

several other vendors of data processing services to financial institutions offer their own online banking products, although many of these firms also offer our products through a referral or reseller arrangement with us. Local competition for Internet banking services is provided by more than a dozen smaller online service outsourcing companies located throughout the U.S.

Table of Contents

Our primary competitors in the business banking services segment are vendors of corporate banking systems for large corporations such as P&H Solutions, Fundtech, and S1 Corporation. Our primary competitors for providing lending products to financial institutions are APPRO, IA Systems, and Lending Solutions, Inc.

We also face potential indirect competition from Internet portals such as Quicken.com, MSN.com, and Yahoo! which might serve as an alternative to financial institutions' web sites, particularly for bill payment and bill presentment services. In addition, we could experience competition from our financial institution customers and potential customers who develop their own online banking products and services.

Government Regulation

The financial services industry is subject to extensive and complex federal and state regulation. Our current and prospective customers, which consist of financial institutions such as commercial banks, savings and loans associations, credit unions and savings banks, operate in markets that are also subject to rigorous regulatory oversight and supervision. The compliance of our products and services with these requirements depends on a variety of factors including the particular functionality, the interactive design, and the charter or license of the financial institution. Our financial services customers must independently assess and determine what is required of them under these regulations and are responsible for ensuring that our system and the design of their web sites conform to their regulatory obligations.

We are not licensed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration or other federal or state agencies that regulate or supervise depository institutions or other providers of financial services. We are examined by the Federal Financial Institution Examination Council under the Information Technology examination guidelines. Although we believe we are not subject to direct supervision by federal and state banking agencies relating to other regulations, we have from time to time agreed to examinations of our business and operations by these agencies. We are also subject to encryption and security export laws and regulations, which depending on future developments, could render our business or operations more costly, less efficient or impossible.

Proprietary Rights

Our proprietary rights are important to our products and services, and we continually seek to expand the technology that we use in our business through internal development, licensing and acquisitions. We generally rely on copyright, trademark and trade secret laws, and contractual rights to establish and maintain our proprietary rights in our technology and products. In 2002, the Digital Insight mark was approved as a registered trademark by the U.S. Patent and Trademark Office. Due to the nature of the technology associated with our products and services, we believe that our ability to compete does not depend to any significant extent on whether or not our technology is patented, and none of our technology is currently patented. In order to protect our proprietary information we limit access to and distribution of our source code and other intellectual property and we also enter into confidentiality agreements with our employees, consultants, resellers and customers.

Employees

As of December 31, 2004, we had a total of 761 employees, including 25 part-time employees. None of our work force is unionized. We have not experienced any work stoppages and consider our relations with our employees to be good.

Risk Factors

You should carefully consider the following risk factors in your evaluation of us. Our business and results of operations could be seriously harmed by any of the following risks. The trading price of our common stock could decline due to any of these risks, and you may lose part or all of your investment.

Table of Contents

Fluctuations of our operating results could cause our stock price to fluctuate.

Our operating results may fluctuate significantly in the future based upon a number of factors, many of which are not within our control. We base our operating expenses on anticipated revenue growth and many of our operating expenses are relatively fixed in the short-term. Our revenue model is based largely on recurring revenues predominately derived from actual end users and transaction volume. The number of total end users is affected by many factors, many of which are beyond our control, including the number of new user registrations, end user turnover, loss of customers, and general consumer trends. We may expend funds and management resources to increase end user penetration and still fail to achieve the targeted end user growth. Accordingly, our results of operations for a particular period may be adversely affected if the revenues based on the number of end users forecasted for that period are less than expected. As a result, if our revenues are lower than we expect in some future period, our operating results may be below the expectations of market analysts or investors. If this occurs, the price of our common stock would likely decrease.

Our operating results may also fluctuate in the future due to a variety of other factors, including:

the overall level of demand for Internet banking services by consumers and businesses and the demand for our products, product enhancements and services in particular;

loss of significant customers due to non-renewals of the service contracts, acquisition of customers by non-customer financial institutions, customer insolvencies and other reasons;

actions taken by our competitors, including the introduction of new products or changes in their pricing models;

spending patterns and budgetary resources of financial institutions and their end user customers;

the timing of upgrades to our computer hardware infrastructure;

the timing of customer product implementations or our failure to timely complete scheduled product implementations;

delays in the product development schedule of one or more of our new products or services;

a negative outcome in any significant legal proceeding or prolonged litigation;

governmental actions affecting Internet operations or content; and

general economic trends and the impact of external factor or events, such as war or acts of terrorism.

Any failure in our disaster recovery or emergency fail-over procedures could cause interruption in our system and loss of customers.

Most of our communications and network equipment related to our Internet banking operation is currently located in our main data center in Westlake Village, California out of which we provide our Internet banking services. We also maintain a back-up data center in Norcross, Georgia for the Westlake Village data center. We maintain these two data centers in a manner that will continue to provide system redundancy, fail-over from the Westlake facility to the Norcross facility and emergency backup capabilities. While the architecture of the two systems was largely integrated by early 2001, the process of failing over to a recovery site currently involves some manual intervention, and there is some attendant delay and loss of use of non-key features and functionality. In addition, we maintain similar, but less integrated back-up capabilities for our data centers in Sacramento and Atlanta. We cannot assure you that these data centers will provide full system redundancy, fail-over and disaster recovery capabilities as expected. In addition, we may experience problems during the recovery or fail-over process that could cause system failures and decreased levels of service. Although we perform testing on a periodic basis to ensure that recovery mechanisms perform as planned, unexpected failure of any of these mechanisms may prevent a successful recovery.

Table of Contents

A natural disaster, such as a fire, an earthquake or a flood, at any of our data centers could result in failures or interruptions in providing our products and services to our customers. Although we maintain and regularly test an uninterruptible power supply system for our critical systems in all of our data centers, there is no assurance that this system, consisting of a back-up battery and a diesel generator, will function properly, or at all, in case of a power loss. In addition to a potential loss of power, our systems are vulnerable to operational failures, telecommunications failures and similar events. We have contracted to provide a certain level of service to our customers and, consequently, a failure or interruption of our system has in the past caused, and in the future could cause, us to refund fees to some of our customers to compensate for decreased levels of service. Even with our disaster recovery plan and the integration of our two main facilities, we could experience a failure or interruption in our systems that could lead to loss of data or the inability to provide services to our customers.

If we do not retain our customers or they do not successfully market our products, we will not be able to increase our revenues.

We also depend on our financial institution clients to market and promote our products to their end user customers. Neither we nor our financial institution customers may be successful in marketing our current or future Internet banking products and services.

Moreover, financial institutions generally agree to use our products and services pursuant to contracts with durations that range from three to five years. Upon expiration, these contracts may be discontinued and we may lose customers as a result. We lose customers every quarter for a variety of reasons, and continually seek to replace these and add new customers. Unless our Internet banking products and services are successfully deployed and marketed by a significant number of financial institutions and achieve widespread market acceptance by their end user customers for a significant period of time, we will not be able to achieve our business objectives and increase our revenues.

We depend on the efficient operation of the Internet, other networks and systems of third parties; if they do not operate efficiently, we will not be able to effectively provide our products and services.

We depend on the efficient operation of network connections from our financial institution clients, their data processing vendors and other third-party vendors such as bill payment providers. Further, portions of our revenue are dependent on continued usage by end users of Internet banking services and their connections to the Internet. Each of these connections, in turn, depends on the secure and efficient operation of web browsers, Internet service providers and Internet backbone service providers, all of which have had periodic operational problems or have experienced outages. In addition, the majority of our services depend on real-time connections to the systems of financial institutions, data processing vendors and bill payment providers. Any operational problems or outages in these systems would cause us to be unable to provide a real-time connection to these systems and we would be unable to process transactions for end users, resulting in decreased revenues. In addition, any system delays, failures or loss of data, whatever the cause, could reduce customer and end user satisfaction with our products and services and harm our revenues.

Our past and potential future acquisitions involve risks to our business and financial results.

We may acquire complementary technologies or businesses in the future. Due to consolidation trends within the Internet banking services industry, our failure to successfully implement a long-term acquisition strategy could damage our competitive position. We closed our acquisitions of nFront Inc. on February 10, 2000; IView Network Corporation, or IView, on June 21, 2000; AnyTime Access, Inc., or ATA, on July 31, 2000; Virtual Financial Services, Inc., or ViFi, on January 28, 2002; and Magnet on November 25, 2003. Acquisitions may not perform as we expect and may involve large one-time write-offs, including goodwill impairment charges, and amortization expenses related to intangible assets. In this regard, any of these factors could adversely affect our operating results or stock price. Acquisitions involve numerous risks, including, but not limited to:

difficulties in assimilating the operations, products, technology, information systems and personnel of the acquired company with our operations;

Table of Contents

diverting our management's attention from other business concerns;

impairing relationships with our employees, affiliates, strategic marketing alliances and third-party vendors;

the inability to maintain uniform standards, controls, procedures and policies;

loss of acquired customers and strategic partners beyond projected thresholds;

entering markets and adopting business models in which we have no direct prior experience; and

losing key employees of the acquired company.

Some or all of these risks could result in a material adverse effect on our business, financial condition and operating results. In addition, we cannot assure you that we will be able to identify suitable acquisition candidates that are available for sale at reasonable prices. We may elect to finance future acquisitions with debt financing, which would create debt service requirements, or through the issuance of additional common or preferred stock, which could result in dilution to our stockholders. We cannot assure you that we will be able to arrange adequate financing, if required, for any acquisitions on acceptable terms.

We depend on cooperation from data processing vendors for financial institutions, some of whom have resisted efforts in the past to allow the integration of our products and services with their systems.

Our products involve integration with products and systems developed by data processing vendors that serve financial institutions. If any of our products fail to be supported by financial institutions' data processing vendors, we would have to redesign our products to suit these financial institutions. We cannot assure that any redesign could be accomplished in a cost-effective or timely manner. We rely on these vendors to jointly develop technology with us and to disclose source code specifications to enable our products to integrate effectively with their products and systems. In the past, some vendors have resisted integrating our products or have caused delays or other disruptions in the implementation process. Several of these data processing vendors offer or are planning to offer Internet banking products and services that are directly competitive with our products and services. In addition, financial institutions' data processing vendors may develop new products and systems that are incompatible with our products. Our failure to integrate our products effectively with financial institutions' data processing vendors could result in higher implementation costs or the loss of current and potential customers.

Competition could reduce or eliminate demand or result in lower prices for our products and services.

The market for Internet banking services is highly competitive and fragmented with many providers. We face competition from three main areas: other companies similar to us with outsourced Internet banking offerings, vendors of data processing services to financial institutions, and smaller, local online service outsourcing companies. Also, vendors who primarily target the largest financial institutions occasionally compete in our target market. Many of our current and potential competitors have longer operating histories and may be in a better position to produce and market their services due to their greater financial, technical, marketing and other resources, as well as their significantly greater name recognition and larger installed bases of customers. In addition, many of our competitors have well-established relationships with our current and potential financial institution customers and data processing vendors and have extensive knowledge of our industry.

We may not be able to compete successfully against our current or future competitors and, accordingly, we cannot be certain that we will be able to expand the number of our customers and end users, retain our current customers or third-party service providers, or maintain our current pricing levels for our products and services. In particular, as we negotiate the renewal of long-term service contracts with current customers, we may be subject to competitive pressures and other factors that may require concessions on pricing and other material contract terms to induce the customer to remain with us.

Table of Contents

Security breaches could damage our reputation and business.

Our products and networks may be vulnerable to unauthorized access, computer viruses and other disruptive problems. We transmit confidential financial information in providing our services. Users of Internet banking and other electronic commerce services are concerned about the security of transmissions over public networks. Therefore, it is critical that our facilities and infrastructure remain secure and be perceived by the marketplace as secure. A material security breach affecting us could damage our reputation, deter financial institutions from purchasing our products, deter their end user customers from using our products, or result in liability to us. Further, any material security breach affecting our competitors could affect the marketplace's perception of Internet banking in general and have the same adverse effects.

Concerns over security and the privacy of end users have intensified both within and outside of the U.S., and may inhibit the growth of the Internet and other online services generally, especially as a means of conducting commercial transactions. Any well-publicized compromise of security or a widespread epidemic involving identity theft could deter people from using the Internet or using it to conduct transactions that involve transmitting confidential information. We may need to expend significant capital or other resources to protect against the threat of security breaches or to alleviate problems caused by breaches. Although we intend to continue to implement state-of-the-art security measures and upgrade our product to address these issues, persons may be able to circumvent the measures that we implement in the future. Eliminating computer viruses and alleviating other security problems may result in interruptions, delays or cessation of service to