

DIGITAL INSIGHT CORP  
Form 10-Q  
August 09, 2006

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

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2006

Commission file number 000-27459

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**Digital Insight Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State of incorporation)

**77-0493142**  
(IRS Employer  
Identification Number)

**26025 Mureau Road, Calabasas, CA 91302**

(Address of principal executive offices, including zip code)

**(818) 871-0000**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

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

As of July 31, 2006, there were 33,859,273 shares of the registrant's \$0.001 par value common stock outstanding.

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**DIGITAL INSIGHT CORPORATION**

**FORM 10-Q**

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## PART I FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

## DIGITAL INSIGHT CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share information)

	June 30, 2006 (Unaudited)	December 31, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 23,668	\$ 50,734
Short-term investments	76,322	65,421
Accounts receivable, net of allowance for doubtful accounts of \$2,155 and \$1,025	31,514	32,583
Accumulated implementation costs	2,286	2,125
Deferred tax asset, net	18,111	18,987
Prepaid and other current assets	4,640	3,932
Total current assets	156,541	173,782
Property and equipment, net of accumulated depreciation of \$74,047 and \$69,705	30,657	29,609
Goodwill	134,390	136,382
Intangible assets, net of accumulated amortization of \$40,816 and \$38,782	7,354	9,388
Accumulated implementation costs	5,100	3,883
Long-term investments	6,769	8,802
Deferred tax asset, net	19,573	17,440
Other assets	5,592	6,116
Total assets	\$ 365,976	\$ 385,402
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 9,649	\$ 8,144
Accrued compensation and related benefits	5,813	6,504
Customer deposits and deferred revenue	14,436	16,250
Accrued expenses and other liabilities	11,919	8,931
Current portion of capital lease obligation	303	262
Tax contingency reserve	5,332	5,158
Total current liabilities	47,452	45,249
Customer deposits and deferred revenue	9,193	7,843
Capital lease obligations	1,098	1,241
Total liabilities	57,743	54,333
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Common stock, \$.001 par value; 100,000,000 shares authorized; 38,971,122 shares issued and 33,646,767 shares outstanding at June 30, 2006 and 37,221,490 shares issued and 34,488,234 shares outstanding at	39	37

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December 31, 2005

Additional paid-in capital	512,461	472,729
Treasury stock, at cost; 5,018,604 shares at June 30, 2006 and 2,544,509 shares at December 31, 2005	(129,677)	(50,091)
Deferred stock-based compensation		(4,466)
Accumulated deficit	(74,590)	(87,140)

Total stockholders' equity	308,233	331,069
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Total liabilities and stockholders' equity	\$ 365,976	\$ 385,402
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The accompanying notes are an integral part of these condensed consolidated financial statements.

## DIGITAL INSIGHT CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited, in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	\$ 61,622	\$ 52,324	\$ 119,512	\$ 104,071
Cost of revenues (including stock-based compensation of \$454 and \$807 for the three and six months ended June 30, 2006, respectively)	27,216	22,197	52,519	44,536
Gross profit	34,406	30,127	66,993	59,535
Operating expenses:				
Sales, general and administrative (including stock-based compensation of \$2,035 and \$3,357, \$39 and \$78 for the three and six months ended June 30, 2006 and 2005, respectively)	15,960	13,076	29,263	26,182
Research and development (including stock-based compensation of \$617 and \$1,075 for the three and six months ended June 30, 2006, respectively)	7,499	5,688	14,465	11,042
Amortization of intangible assets	957	2,025	2,034	4,050
Restructuring charge	352		1,595	
Total operating expenses	24,768	20,789	47,357	41,274
Income from operations	9,638	9,338	19,636	18,261
Interest and other income, net	1,238	777	2,391	1,314
Income before provision for income taxes	10,876	10,115	22,027	19,575
Provision for income taxes	4,527	3,720	9,477	7,457
Net income	\$ 6,349	\$ 6,395	\$ 12,550	\$ 12,118
Basic net income per share	\$ 0.18	\$ 0.18	\$ 0.36	\$ 0.34
Diluted net income per share	\$ 0.18	\$ 0.18	\$ 0.35	\$ 0.34
Shares used to compute basic net income per share	34,340	34,811	34,416	35,183
Shares used to compute diluted net income per share	35,225	35,765	35,390	35,835

The accompanying notes are an integral part of these condensed consolidated financial statements.

## DIGITAL INSIGHT CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	Six Months Ended June 30,	
	2006	2005
<b>Cash flows from operating activities:</b>		
Net income	\$ 12,550	\$ 12,118
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	6,444	6,857
Amortization of intangible assets	2,034	4,050
Stock-based compensation	5,239	78
Deferred income taxes	(2,034)	5,636
Loss on disposition of property and equipment	24	47
Restructuring, net of cash paid	1,213	
Income tax benefit on stock options exercised	10,357	1,033
Excess tax benefits from stock-based compensation	(5,878)	
Changes in operating assets and liabilities:		
Accounts receivable	1,069	2,756
Accumulated implementation costs	(1,378)	170
Prepaid and other current assets	(708)	(1,597)
Other assets	1,302	(5,723)
Accounts payable	1,828	3,718
Accrued compensation and related benefits	(1,209)	1,746
Customer deposits and deferred revenue	(464)	(476)
Other liabilities and tax contingency reserve	1,279	475
Net cash provided by operating activities	31,668	30,888
<b>Cash flows from investing activities:</b>		
Purchases of investments:		
Held-to-maturity	(61,941)	(60,911)
Available-for sale	(800)	(15,073)
Other instruments		(500)
Proceeds from maturity of investments:		
Held-to-maturity	52,270	44,814
Available for sale	1,603	3,615
Purchase of property and equipment	(8,543)	(8,077)
Net cash used in investing activities	(17,411)	(36,132)
<b>Cash flows from financing activities:</b>		
Principal payments on capital leases	(102)	
Acquisition of treasury stock	(75,381)	(46,184)
Proceeds from issuance of common stock	28,282	7,157
Excess tax benefits from stock-based compensation	5,878	
Net cash used in financing activities	(41,323)	(39,027)
Net decrease in cash and cash equivalents	(27,066)	(44,271)
Cash and cash equivalents, beginning of period	50,734	64,682
Cash and cash equivalents, end of period	\$ 23,668	\$ 20,411

**Supplementary disclosures of cash flow information:**

Cash paid during the period for interest	\$	42	\$	
Cash paid during the period for income taxes	\$	789	\$	861

**Non-cash items:**

Accrued property and equipment	\$	290	\$	(909)
Accrued treasury stock purchase	\$	1,848	\$	
Settlement of Escrow Claim (see notes 2 and 5)				
Reduction of goodwill	\$	1,992	\$	
Increase in additional paid-in capital	\$	365	\$	
Return of common stock included in treasury stock	\$	2,357	\$	

The accompanying notes are an integral part of these condensed consolidated financial statements.



## DIGITAL INSIGHT CORPORATION

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited, in thousands, except share data)

	Common Stock		Additional	Treasury	Treasury	Deferred	Accumulated	Total
	Shares	Amount	Paid-In	Shares	Stock, at	Stock-Based	Deficit	Stockholders
			Capital		cost	Compensation		Equity
Balance at December 31, 2005	37,221,490	\$ 37	\$ 472,729	(2,544,509)	\$ (50,091)	\$ (4,466)	\$ (87,140)	\$ 331,069
Reclassification of deferred stock-based compensation upon adoption of SFAS 123(R) (Note 8)			(4,466)			4,466		
Stock options exercised	1,504,380	2	26,493					26,495
Issuance of restricted stock	121,381							
Tax benefit on stock options exercised			10,357					10,357
Proceeds from other issuance of common stock	124,497		1,787					1,787
Purchase of treasury stock, at cost				(2,352,965)	(77,229)			(77,229)
Settlement of escrow claim			365	(119,834)	(2,357)			(1,992)
Stock-based compensation			5,239					5,239
Restricted stock forfeitures and other	(626)		(43)	(1,296)				(43)
Net income							12,550	12,550
Balance at June 30, 2006	38,971,122	\$ 39	\$ 512,461	(5,018,604)	\$ (129,677)		\$ (74,590)	\$ 308,233

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**DIGITAL INSIGHT CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company and Summary of Significant Accounting Policies**  
**The Company**

Digital Insight Corporation (the "Company"), incorporated in March 1997 in Delaware, provides outsourced online banking applications and services to banks, credit unions and savings and loan associations. Its outsourcing operations include three operating segments: Internet banking, business banking and lending. The Internet banking segment includes online banking for consumers, including bill payment and bill presentment, and the business banking segment includes online banking for business organizations ranging from small businesses to large corporations. The lending operation provides tools for financial institutions to streamline underwriting decisioning and processing of consumer loans originated through the Internet, branch and call center channels. Substantially all of the Company's revenues are derived from these products and services. The Company's consolidated financial statements include the accounts of its subsidiaries, and there were no inter-company transactions requiring elimination in consolidation.

**Method of presentation**

The accompanying condensed consolidated financial statements as of June 30, 2006 and for the three and six months ended June 30, 2006 and 2005 have been prepared in accordance with generally accepted accounting principles ("GAAP") and the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements in accordance with GAAP have been omitted or condensed in accordance with quarterly reporting requirements of the Securities and Exchange Commission (the "SEC"). Independent auditors have not audited these condensed consolidated financial statements. The condensed consolidated financial statements include all adjustments (consisting of normal recurring adjustments), which are, in the opinion of management, necessary for a fair statement of the consolidated financial condition, results of operations and cash flows for such periods. However, these results are not necessarily indicative of results for any other interim period or for the full year. The accompanying consolidated balance sheet as of December 31, 2005 has been derived from the audited consolidated financial statements, but does not include all disclosures required by GAAP.

Management believes that the disclosures included in the accompanying interim condensed consolidated financial statements and footnotes are adequate to make the information not misleading, but should be read together with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Adoption of Statement of Financial Accounting Standard 123(R)**

During the first quarter of fiscal 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards No. 123 revised 2004 ("SFAS 123(R)"), *Share-Based Payment*, which replaced Statement of Financial Accounting Standards No. 123 ("SFAS 123"), *Accounting for Stock-Based Compensation*, and superseded APB Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award. The Company elected to recognize the expense on a straight-line basis over the requisite service period, which is the vesting period. The Company also elected the modified-prospective method, under which prior periods are not revised for comparative purposes. The compensation expense recognition provisions of SFAS 123(R) apply to new grants and to the unvested portion of grants that were outstanding as of the effective date. Estimated compensation for the unvested portion of grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The application of SFAS 123(R) had a material impact on the Company's consolidated financial statements. See Note 8 for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense. The cumulative effect upon adoption of SFAS 123(R) was not material.

Shares of newly issued common stock will be issued upon exercise of stock options or vesting of restricted stock.

### New accounting standards

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle and to changes required by an accounting pronouncement in the instance that the pronouncement does not include specific transition provisions. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 defines *retrospective application* as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also redefines *restatement* as the revising of previously issued financial statements to reflect the correction of an error. SFAS No. 154 carries forward without change the guidance contained in APB Opinion No. 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 also carries forward the guidance in APB Opinion No. 20 requiring justification of a change in accounting principle on the basis of preferability. SFAS No. 154 is effective in fiscal years beginning after December 31, 2005. The adoption of SFAS No. 154 did not have a material effect on the Company's consolidated financial statements.

On November 3, 2005, the FASB issued FSP No. FAS 115-1 which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FSP No. 115-1 is effective in fiscal years beginning after December 15, 2005. The adoption of this FSP did not have a material effect on the Company's consolidated financial statements.

On November 10, 2005, the FASB issued FSP No. FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ( APIC pool ) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). The Company has up to one year from the date of the adoption of FAS 123(R) to elect to use the simplified method. The Company is in the process of evaluating this FSP and the effect the election would have on the Company's financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its condensed consolidated financial statements.

### Reclassification

Certain prior year reported amounts have been reclassified to conform to the 2006 presentation. Accounts payable and accrued expenses and other liabilities related to the acquisition of property and equipment have been excluded from the statement of cash flows balances at June 30, 2006 and 2005. In addition, the related amount in property and equipment purchased during those years has been excluded as well, with the activity being disclosed in the supplemental disclosure of non-cash activity. The amount has been reflected as a cash outflow under purchase of property and equipment in the period the liability was paid. The effect of this reclassification was a reduction of \$909,000 to previously reported cash used to purchase property and equipment for the six months ended June 30, 2005 and a corresponding decrease to operating cash flows for the same period.

## 2. Goodwill and Intangibles

In June 2006, the Company settled its escrow arbitration claims with the former stockholders of Magnet Communications following the purchase of Magnet in 2003 (see note 5). As part of this settlement, the Company recovered 119,834 shares of common stock that have been held in escrow since the acquisition closed. The former stockholders of Magnet received the remaining 25,000 shares and approximately \$3.5 million in cash held in escrow. All of the shares held in escrow were included in the initial purchase price allocation. Consequently, goodwill and stockholders' equity were reduced by approximately \$2.0 million.

Goodwill by operating segment as of June 30, 2006 and December 31, 2005 is set forth below (in thousands):

	Internet Banking	Business Banking	Lending	Total
Balance, December 31, 2005	\$ 70,110	\$ 34,290	\$ 31,982	\$ 136,382
Settlement of escrow		(1,992)		(1,992)
Balance, June 30, 2006	\$ 70,110	\$ 32,298	\$ 31,982	\$ 134,390

As of June 30, 2006 and December 31, 2005, all other intangible assets were subject to amortization. A summary of the other intangible assets as of June 30, 2006 and December 31, 2005 is set forth below (in thousands):

	Cost	Accumulated Amortization	Carrying Amount	Weighted Average Life
June 30, 2006:				
Customer relationships	\$ 33,330	\$ (27,270)	\$ 6,060	6 years
Acquired technology	12,840	(12,313)	527	4.1 years
Acquired backlog	1,800	(1,033)	767	4.5 years
Trade name	200	(200)		1 year
Total intangible assets	\$ 48,170	\$ (40,816)	\$ 7,354	

	Cost	Accumulated Amortization	Carrying Amount	Weighted Average Life
December 31, 2005:				
Customer relationships	\$ 33,330	\$ (26,310)	\$ 7,020	6 years
Acquired technology	12,840	(11,439)	1,401	4.1 years
Acquired backlog	1,800	(833)	967	4.5 years
Trade name	200	(200)		1 year
Total intangible assets	\$ 48,170	\$ (38,782)	\$ 9,388	

Amortization expense for all intangible assets was \$957,000 and \$2.0 million, and \$2.0 million and \$4.1 million for the three and six months ended June 30, 2006 and 2005, respectively. Estimated intangible asset amortization expense remaining for the next five years is as follows (in thousands):

2006 (Remaining six months)	\$ 1,688
2007	2,321
2008	954
2009	788
2010	788

**3. Restructuring**

In December 2005, the Company initiated restructuring activities involving the outsourcing of the call center associated with the lending division and realigning certain resources to enhance profitability in the lending division. As a result of these restructuring activities, the Company reduced space utilized at one of its facilities, disposed of certain related assets and eliminated approximately 90 employee positions. The call center migration and the work force reduction were generally completed by April 30, 2006. The Company recorded charges for severance related payments, asset disposals and other related costs for these activities as a restructuring charge on the statements of operations.

The charges related to the restructuring were as follows (in thousands):

	Total Restructuring Charges Expected to be Recognized	Restructuring Charges Recognized for the Three Months Ended June 30, 2006	Cumulative Restructuring Charges Recognized through June 30, 2006
One-time termination benefits	\$ 948	\$ 76	\$ 830
Contract termination costs	118	58	58
Other associated costs	1,222	218	1,137
Total	\$ 2,288	\$ 352	\$ 2,025

The restructuring activity has resulted in the following accrual as of June 30, 2006 (in thousands):

	Restructuring Costs Accrued, Net as of March 31, 2006	Restructuring Costs Accrued in the Three Months Ended June 30, 2006	Payments made during the Three Months Ended June 30, 2006	Balance at June 30, 2006
One-time termination benefits	\$ 499	\$ 76	\$ (511)	\$ 64
Other associated costs		72	(72)	
Total	\$ 499	\$ 148	\$ (583)	\$ 64

#### 4. Reportable Segments and Major Customers

The Company manages its business through three reportable segments: Internet banking, business banking and lending.

The results of operations from these reportable segments were as follows for the three and six month periods ended June 30, 2006 and 2005 (in thousands):

	Internet Banking	Business Banking	Lending	Unallocated <sup>(1)</sup>	Total
Three months ended June 30, 2006:					
Revenues	\$ 50,972	\$ 7,874	\$ 2,776	\$	\$ 61,622
Cost of revenues <sup>(4)</sup>	21,602	3,137	2,023	454	27,216
Gross profit	29,370	4,737	753	(454)	34,406
Operating expenses <sup>(2)</sup>	9,913	3,670	1,188	9,997	24,768
Income (loss) from operations	19,457	1,067	(435)	(10,451)	9,638
Three months ended June 30, 2005:					
Revenues	\$ 42,126	\$ 6,643	\$ 3,555	\$	\$ 52,324
Cost of revenues	17,233	2,809	2,155		22,197
Gross profit	24,893	3,834	1,400		30,127
Operating expenses <sup>(3)</sup>	8,394	3,203	1,177	8,015	20,789
Income (loss) from operations	16,499	631	223	(8,015)	9,338
Six months ended June 30, 2006:					
Revenues	\$ 98,674	\$ 15,397	\$ 5,441	\$	\$ 119,512
Cost of revenues <sup>(4)</sup>	41,268	6,188	4,256	807	52,519

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Gross profit	57,406	9,209	1,185	(807)	66,993
Operating expenses <sup>(2)</sup>	18,940	7,232	3,350	17,835	47,357
Income (loss) from operations	38,466	1,977	(2,165)	(18,642)	19,636
Six months ended June 30, 2005:					
Revenues	\$ 84,479	\$ 13,091	\$ 6,501	\$	\$ 104,071
Cost of revenues	34,685	5,500	4,351		44,536
Gross profit	49,794	7,591	2,150		59,535
Operating expenses <sup>(3)</sup>	16,703	6,367	2,213	15,991	41,274
Income (loss) from operations	33,091	1,224	(63)	(15,991)	18,261

<sup>(1)</sup> Unallocated amounts include intangible asset amortization, stock-based compensation, and general and administrative expenses that are not included in the measure of segment profit or loss used internally to evaluate the segment operating results.

<sup>(2)</sup> Unallocated operating expenses include \$957 and \$2,034 of intangible asset amortization, \$2,652 and \$4,432 of stock-based compensation under SFAS 123(R) and \$6,388 and \$11,369 of general and administrative expenses for the three and six months ended June 30, 2006.

- (3) Unallocated operating expenses include \$2,025 and \$4,050 of intangible asset amortization and \$5,990 and \$11,941 of general and administrative expenses for the three and six months ended June 30, 2005.
- (4) Unallocated cost of revenues includes \$454 and \$807 of stock-based compensation under SFAS 123(R) for the three and six months ended June 30, 2006.

The Company assesses the performance of its long-lived assets in the aggregate and accordingly assets are not presented on a segment basis.

For the three and six month periods ended June 30, 2006 and 2005, no customer comprised more than 10% of total revenues. The Company has no significant foreign operations.

## 5. Commitments and Contingencies

The Company accounts for contingent liabilities, including pending and threatened litigation and tax contingencies, in accordance with SFAS No. 5, *Accounting for Contingencies* and records liabilities when the outcome is deemed probable and the amount is reasonably estimable.

### *In Re Digital Insight Corporation Initial Public Offering Securities Litigation*

On December 6, 2001, the Company and two of its former officers and directors and one current director were named as defendants in a class-action lawsuit filed in the United States District Court for the Southern District of New York. The lawsuit is captioned *In Re Digital Insight Corp. Initial Public Offering Securities Litigation*, No. 01 CV 11231. The claims, which were also asserted against the managing underwriters of the Company's previous public offerings, are based on allegations that the underwriter defendants solicited and received from certain investors, in exchange for allocating Digital Insight shares to the investors in connection with the previous public offerings, additional, excessive and undisclosed commissions and undisclosed commitments to purchase additional Digital Insight shares in the aftermarket. Other actions have been filed in New York making similar allegations regarding the public offerings of more than 300 other companies. Along with these companies and the individual defendants, but not the underwriter defendants, the Company has entered into a settlement agreement with the plaintiffs to settle the claims. As part of the settlement, once the settlement documents become effective, the plaintiffs will dismiss with prejudice the settling companies and individual defendants. On August 31, 2005, the court issued an order preliminarily approving the proposed settlement. In April 2006, the court held a fairness hearing for final approval of the proposed settlement and listened to arguments from counsel. The Company is awaiting the court's final ruling on the settlement proposal. In the opinion of management, after consultation with legal counsel and based on currently available information, the ultimate disposition of these matters is not expected to have a material adverse effect on the Company's business, financial condition or results of operations. No amounts have been accrued for this lawsuit.

### *Magnet Claims*

Approximately \$3.5 million of cash and 144,834 shares of the Company's common stock issued in connection with its acquisition of Magnet were held in escrow. The Company notified the prior stockholders of Magnet that it had various claims against them in connection with the acquisition, and sought recovery of damages, including the amounts in escrow. The prior stockholders initiated arbitration proceedings in Los Angeles, California, seeking release of the escrowed amounts. In June 2006, the Company settled the arbitration claims and related legal proceedings. As part of this settlement, the Company recovered 119,834 shares of common stock held in escrow. The prior stockholders of Magnet will receive the remaining 25,000 shares and approximately \$3.5 million in cash held in escrow. The settlement agreement, which was also signed by certain former executives of Magnet in July 2006, provides the dismissal of all pending legal proceedings by all parties. All of the shares held in escrow were included in the purchase price allocation. Consequently, goodwill and stockholders' equity have been reduced by approximately \$2.0 million to reflect the shares returned to the Company.

In addition, the Company may be involved from time to time in litigation arising in the normal course of its business. Although the Company is currently not a party to such litigation that it believes would have a material adverse effect, individually or in the aggregate, on its business, financial condition or results of operations, it is possible that in the future the Company could become a party to such proceedings.



*Tax Contingencies*

The Company records a contingent income tax liability for differences between the as-filed basis and book basis of certain tax assets and liabilities. As of June 30, 2006 and December 31, 2005, the cumulative tax contingency reserve of \$5.3 million and \$5.2 million, respectively, is included in current liabilities on the accompanying condensed consolidated balance sheets.

**6. Treasury Stock**

On October 21, 2004, the Company announced that its Board of Directors had approved a share repurchase program for up to \$25.0 million of the Company's common stock for 12 months. The Company repurchased 1,503,244 shares for an aggregate cost of \$25.0 million.

In April 2005, the Company's Board of Directors approved another \$25.0 million stock repurchase program. The Company repurchased 1,038,100 shares for an aggregate cost of \$25.0 million.

In February 2006, the Company announced that its Board of Directors had approved a share repurchase program for up to \$50.0 million. The Company repurchased 1,492,744 shares for an aggregate cost of \$50.0 million.

In May 2006, the Company announced that its Board of Directors had approved a share repurchase program for up to \$50.0 million. As of June 30, 2006, the Company had repurchased 860,221 shares for an aggregate cost of \$27.2 million.

In August 2006, the Company announced that its Board of Directors had approved a share repurchase program for up to \$50.0 million.

There are no restrictions on the Company's treasury stock. The repurchased common stock is classified as Treasury stock, at cost in the accompanying condensed consolidated balance sheets.

**7. Earnings Per Share**

The following table sets forth the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Net income	\$ 6,349	\$ 6,395	\$ 12,550	\$ 12,118
Denominator for basic calculation	34,340	34,811	34,416	35,183
Dilutive effect of common stock equivalents outstanding	885	954	974	652
Denominator for diluted calculation	35,225	35,765	35,390	35,835
Basic net income per share	\$ 0.18	\$ 0.18	\$ 0.36	\$ 0.34
Diluted net income per share	\$ 0.18	\$ 0.18	\$ 0.35	\$ 0.34
Common stock equivalents that are not included in the diluted net income per share calculation above because to do so would be anti-dilutive for the periods indicated are as follows (in thousands):				

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Warrants				44
Stock options, restricted stock and employee stock purchase plan	1,090	1,168	1,068	1,981

1,090	1,168	1,068	2,025
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**8. Stock-Based Compensation****Stock options**

Our stock option program is a long-term retention program that is intended to attract, retain and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. Currently, the Company grants options from: 1) the 1997 Stock Plan (the 1997 Plan), under which options could be granted to all employees, non-employee board members and consultants; 2) the 1999 Stock Plan (the 1999 Plan), under which options could be granted to all employees, non-employee board members and consultants; and 3) the 2001 Non-Employee Director Stock Option Plan, which provides for the granting of stock options to outside directors who are not employees of the Company. The plans listed above are collectively referred to in the following discussion as the Plans. Option vesting periods are generally four years for all of the Plans. The maximum contractual term of our options is ten years. Our option plans, excluding acquired plans, permit the grant of shares for up to 11.7 million shares of common stock.

**Restricted stock grants**

The Company grants restricted shares to employees under the 1999 Plan. Restricted stock grants generally vest annually over four years but are considered issued at the time of grant, as the stockholders are entitled to dividends and voting rights.

**1999 Employee Stock Purchase Plan**

The Company's 1999 Employee Stock Purchase Plan (the Purchase Plan) allows eligible employees to have up to 15% of their earnings withheld, up to certain maximums, and to be used to purchase shares of the Company's common stock on every May 1 and November 1 of each year. The price of the common stock purchased under the Purchase Plan is equal to 85% of the lower of the fair market value of the common stock on the offering date of each two-year offering period or the specified purchase date. Our purchase plan permits the purchase of up to 2.1 million shares of common stock.

**Adoption of SFAS 123(R)**

The Company adopted SFAS 123(R) using the modified prospective transition method beginning January 1, 2006. The Company recognizes compensation expense based on the estimated grant date fair value method using the Black-Scholes valuation model using a straight-line amortization method. As SFAS 123(R) requires that stock-based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the three and six month periods ended June 30, 2006 has been reduced for estimated forfeitures. When estimating forfeitures, the Company considers voluntary termination behaviors as well as trends of historical option forfeitures. The impact on the Company's results of operations of recording stock-based compensation was as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of revenues	\$ 454	\$ 807
Sales, general and administrative	2,035	3,357
Research and development	617	1,075
	\$ 3,106	\$ 5,239

Prior to adopting SFAS 123(R), the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Condensed Consolidated Statement of Cash Flows. SFAS 123(R) requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting SFAS 123(R), \$5.9 million of excess tax benefits for the six months ended June 30, 2006 have been classified as a financing cash inflow. Cash received from option exercises and employee stock purchase plan purchases for the six month periods ended June 30, 2006 and 2005, was \$28.3 million and \$7.2 million, respectively. The actual tax benefits recognized in net income related to stock-based compensation for the three and six months ended June 30, 2006 were \$869,000 and \$1.5 million, respectively. The actual tax benefits recognized in net income related to stock-based compensation for the three and six months ended June 30, 2005 were \$16,000 and \$31,000, respectively. Also, in connection with the

adoption of SFAS 123(R), the Company reclassified \$4.5 million out of deferred stock-based compensation to additional paid-in capital.

### Valuation assumptions

The following assumptions were used for each respective period to value option grants:

	Three Months Ended			Six Months Ended		
	2006	June 30, 2005		2006	June 30, 2005	
Risk-free interest rates	4.78%	3.62%	-3.90%	4.31%	-4.78%	3.28%
Expected term (in years)	4.5	3.5		4.5		3.5
Dividend yield	0%	0%		0%		0%
Expected volatility	56%	63%		56%		63%

The Company's computation of expected volatility for 2006 is based on a combination of historical and market-based implied volatility from traded options on our stock. Prior to 2006, the Company's computation of expected volatility was based on historical volatility. The Company's computation of expected term in 2006 was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The interest rate is based on the U.S. Treasury yield curve in effect at the time of grant.

### Stock-based payment award activity

The following table summarizes activity under the Company's equity incentive plans for the six months ended June 30, 2006 (in thousands, except per share amounts):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2006	4,660,112	\$ 20.44		
Granted	534,050	33.43		
Exercised	(1,504,380)	17.61		
Forfeited/expired/cancelled	(105,073)	22.32		
Outstanding at June 30, 2006	3,584,709	\$ 23.51	7.25	\$ 43,585
Vested and expected to vest at June 30, 2006	3,326,486	\$ 23.36	7.11	\$ 41,252
Options exercisable at June 30, 2006	1,634,548	\$ 25.01	5.58	\$ 20,050

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the 3.0 million options that were in-the-money at June 30, 2006. During the three months ended June 30, 2006 and 2005, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$11.2 million and \$1.6 million, respectively, determined as of the date of option exercise. During the six months ended June 30, 2006 and 2005, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$24.9 million and \$2.3 million, respectively, determined as of the date of option exercise. As of June 30, 2006, there was approximately \$23.0 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under the Company's stock awards plans. That cost is expected to be recognized over a weighted-average period of 1.4 years. The total fair value of shares vested during the three months ended June 30, 2006 and 2005 was \$2.1 million and \$3.8 million, respectively. The total fair value of shares vested during the six months ended June 30, 2006 and 2005 was \$5.6 millions and \$7.4 million, respectively.

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As of June 30, 2006, there was approximately \$7.9 million of total unrecognized compensation cost related to unvested restricted stock. The cost is expected to be recognized over a weighted average period of 2.1 years.

For the three and six months ended June 30, 2006, the stock-based compensation expense related to the activity under the Purchase Plan was \$524,000 and \$1.0 million, respectively. As of June 30, 2006, there was \$1.3 million of unrecognized compensation cost related to the Purchase Plan which is expected to be recognized over a weighted average period of 0.8 years.

The weighted average grant-date fair value of options granted in the six month periods ended June 30, 2006 and 2005 was \$16.91 and \$8.33, respectively.

A summary of the status and changes of the Company's restricted stock related to the Company's stock plans as of and during the six months ended June 30, 2006 is presented below:

	Shares	Weighted Average Grant Date Fair Value
Restricted stock at January 1, 2006	188,746	\$ 25.67
Granted	121,381	34.03
Vested	(3,750)	16.79
Forfeited	(626)	29.48
Restricted stock at June 30, 2006	305,751	\$ 29.08

#### Pro forma information for periods prior to the adoption of SFAS 123(R)

Prior to the adoption of FAS No. 123(R), the Company provided the disclosures required under FAS No. 123, as amended by FAS No. 148, *Accounting for Stock-Based Compensation: Transition and Disclosures*. Employee stock-based compensation expense recognized under SFAS 123(R) was not reflected in the Company's results of operations for the three and six month periods ended June 30, 2005 for employee stock option awards as all options were granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Forfeitures of awards were estimated and applied to determine stock-based compensation. Previously reported amounts have not been restated.

The pro forma information for the three and six months ended June 30, 2005 was as follows (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	\$ 6,395	\$ 12,118
Add: Stock-based compensation expense included in reported income, net of tax	23	47
Deduct: Total stock-based compensation expense determined under fair value based method, net of tax	1,314	2,431
Pro forma net income	\$ 5,104	\$ 9,734
Earnings per share:		
Basic Reported	\$ 0.18	\$ 0.34
Pro forma	\$ 0.14	\$ 0.27
Diluted Reported	\$ 0.18	\$ 0.34
Pro forma	\$ 0.14	\$ 0.27

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

*The forward-looking statements included in this section involve risks and uncertainties, including anticipated financial performance, business prospects, anticipated capital expenditures and other similar matters. Such statements reflect management's best judgment based on factors currently known. Actual results and experience could differ materially from the anticipated results or other expectations expressed in our forward-looking statements as a result of a number of factors, including but not limited to those discussed under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005. We undertake no obligation to update publicly any forward-looking statements for any reason after the date of this Quarterly Report.*

*The following discussion should be read together with our condensed consolidated financial statements and related notes.*

**Overview**

We manage our business through three reportable segments: Internet banking, business banking and lending. Our Internet banking segment includes online banking for consumers, which includes bill payment and bill presentment. Our business banking segment includes online business banking for small to large financial institutions. Our lending operation offers online lending for consumer loans. In addition, general and administrative expenses and stock-based compensation expenses are managed on a company-wide basis across all of our operations and therefore, these expenses are not included in the operating results of the business segments.

**Critical accounting policies**

The following discussion and analysis of our financial condition and operating results are based on our unaudited condensed consolidated financial statements. Preparation of this Form 10-Q requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates and assumptions. In preparing our financial statements and accounting for the underlying transactions and balances, we apply our accounting policies as disclosed in our Notes to Condensed Consolidated Financial Statements. Critical accounting policies are described in our Annual Report on Form 10-K for the year ended December 31, 2005 and changes in our critical accounting policies from the Form 10-K are discussed below.

*Stock-based compensation*

Upon the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), we now record stock-based compensation for all of our share-based awards. The application of this standard had a material impact on our consolidated statements of operations and cash flows.

During the first quarter of 2006, we implemented the following new critical accounting policy related to our stock-based compensation. Beginning on January 1, 2006, we began accounting for stock options, restricted stock, and employee stock purchase program shares under the provisions of SFAS 123(R), which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions for SFAS 123(R), stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. We have used the Black-Scholes valuation model, or BSM, to estimate fair value of our stock-based awards which requires various judgmental assumptions including estimating stock price volatility, forfeiture rates, and expected term. Our computation of expected volatility is based on a combination of historical and market-based implied volatility. In addition, we consider many factors when estimating expected forfeitures and expected term, including types of awards, employee class, and historical experience. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

We adopted SFAS 123(R) using the modified prospective method which requires the application of the accounting standard as of January 1, 2006. Our consolidated financial statements as of and for the first and second quarter of 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). The cumulative effect upon adoption of SFAS 123(R) was not material.

**Known trends and uncertainties**

The following discussion identifies known trends and uncertainties currently impacting each of our business segments.

The growth in our Internet banking revenues during the first six months of 2006 was driven primarily by a 19% increase in Internet banking end users and a 37% increase in online bill payment users at June 30, 2006 when compared to June 30, 2005. Revenue from end user growth was partially offset by a slight decrease in the average revenue per end user, due primarily to price discounts experienced at the time of contract renewal (generally once every three to five years) and the effects of tiered pricing incentives in most of our contracts. We expect a continuing modest decline in average monthly revenue per Internet banking end user over the next several years as our base of end users continues to increase and as customers renew their contracts with us. Additionally, growth in Internet banking and bill payment end users can vary significantly from quarter to quarter due to the timing of client implementations, merger and acquisition activity among our client base that can lead to client deactivations, the effectiveness of our cooperative marketing initiatives, and other factors outside of our control.

The growth in our business banking revenues during the first six months of 2006 compared to 2005 was driven by an increase in the number of business banking hosted end users and an increase in professional services revenues. We continue to invest significant resources to further develop our business banking software for large financial institutions (a product line resulting from our acquisition of Magnet in November 2003), including an initiative to standardize the Magnet software code which should lead to greater efficiency in future product development. Although our financial results and outlook for the acquired business has continued to improve in recent quarters, professional service fees and license fees generated from large banks deploying our software in-house are less predictable, and fluctuate more significantly, than the recurring service fees generated within our outsourcing business. Recurring revenue contributions from our outsourced business banking products, including the Magnet products hosted in our data center, remained strong, and we expect that this performance will continue.

The decrease in our lending revenues during the six month period ended June 30, 2006 reflects the continuation of a shift in the percentage of applications processed from the call center to our Internet channel, client attrition and \$500,000 in license fees recognized in the second quarter of 2005. Internet-based applications result in lower revenue per application compared to applications received through the call center. We expect the Internet channel to continue to increase as a percentage of total loan applications processed in future quarters. During the first half of 2006, we outsourced our lending call center to a third party provider of call center services and eliminated 90 positions in a restructuring of the lending business. Although outsourcing the call center has reduced our cost structure, revenues and operating profitability for the lending business have continued to underperform relative to our prior expectations. We expect lending revenues for the balance of 2006 to remain below comparable levels in 2005 as we continue to pursue new sales channels for our lending products. In light of the continuing underperformance relative to our prior financial projections, we continue to monitor the carrying values of the lending segment's assets for potential impairment.

**Results of operations**

We manage our business through three reportable segments: Internet banking, business banking and lending.

Summarized results of operations for our reportable segments were as follows for the three and six months ended June 30, 2006 and 2005:

	Three Months Ended				Six Months Ended			
	June 30,		June 30,		June 30,		June 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
	(dollars in thousands)							
	Dollars	%	Dollars	%	Dollars	%	Dollars	%
<b>Revenues:</b>								
Internet banking	\$ 50,972	83	\$ 42,126	80	\$ 98,674	83	\$ 84,479	81
Business banking	7,874	13	6,643	13	15,397	13	13,091	13
Lending	2,776	4	3,555	7	5,441	4	6,501	6
<b>Total</b>	<b>\$ 61,622</b>	<b>100</b>	<b>\$ 52,324</b>	<b>100</b>	<b>\$ 119,512</b>	<b>100</b>	<b>\$ 104,071</b>	<b>100</b>
	Dollars	Margin <sup>(1)</sup>	Dollars	Margin <sup>(1)</sup>	Dollars	Margin <sup>(1)</sup>	Dollars	Margin <sup>(1)</sup>
<b>Gross profit:</b>								
Internet banking	\$ 29,370	58%	\$ 24,893	59%	\$ 57,406	58%	\$ 49,794	59%
Business banking	4,737	60	3,834	58	9,209	60	7,591	58



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Lending	753	27	1,400	39	1,185	22	2,150	33
Unallocated <sup>(5)</sup>	(454)	n/a			(807)	n/a		
Total	\$ 34,406	56%	\$ 30,127	58%	\$ 66,993	56%	\$ 59,535	57%

	Dollars	%	Dollars	%	Dollars	%	Dollars	%
Operating expenses:								
Internet banking	\$ 9,913	40	\$ 8,394	40	\$ 18,940	40	\$ 16,703	41
Business banking	3,670	15	3,203	15	7,232	15	6,367	15
Lending	1,188	5	1,177	6	3,350	7	2,213	5
Unallocated <sup>(2) (3) (4)</sup>	9,997	40	8,015	39	17,835	38	15,991	39
Total	\$ 24,768	100	\$ 20,789	100	\$ 47,357	100	\$ 41,274	100

Dollars    Margin<sup>(1)</sup>    Dollars    Margin<sup>(1)</sup>    Dollars