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DIGITAL INSIGHT CORP
Form 10-Q
November 09, 2001

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2001

Commission file number 0-27459

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)

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

Indicate the number of shares outstanding of each of the issuer's classes
of common stock, as of the latest practicable date:

Common Stock, \$0.001 par value
29,497,670 shares outstanding as of October 31, 2001

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DIGITAL INSIGHT CORPORATION
FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM 1. Consolidated Financial Statements (Unaudited)

DIGITAL INSIGHT CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands, except share information)

| | September 30, 2001 | December 31, 2000 |
|--|-----------------------|----------------------|
| ----- | | |
| Assets | | |
| ----- | | |
| Current assets: | | |
| Cash and cash equivalents..... | \$ 21,516 | \$ 71,523 |
| Short-term investments..... | 39,044 | 10,187 |
| Accounts receivable, net of allowances for doubtful accounts of \$120 and \$221 at September 30, 2001 and December 31, 2000, respectively..... | 18,622 | 14,403 |

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| | | |
|--|------------|-----------|
| Accumulated implementation costs..... | 5,032 | 4,551 |
| Other current assets..... | 2,966 | 3,907 |
| | ----- | ----- |
| Total current assets..... | 87,180 | 104,571 |
| Property and equipment, net of accumulated depreciation of \$20,853 and \$12,835 at September 30, 2001 and December 31, 2000, respectively..... | 38,469 | 34,702 |
| Goodwill and intangible assets, net of amortization of \$42,450 and \$16,125 at September 30, 2001 and December 31, 2000, respectively..... | 107,777 | 135,067 |
| Accumulated implementation costs..... | 6,488 | 5,173 |
| Long-term investments..... | 4,599 | - |
| Other assets..... | 685 | 2,713 |
| | ----- | ----- |
| Total assets..... | \$ 245,198 | \$282,226 |
| | ===== | ===== |
| Liabilities and Stockholders' Equity | | |
| ----- | | |
| Current liabilities: | | |
| Accounts payable..... | \$ 3,620 | \$ 5,308 |
| Accrued compensation and related benefits..... | 3,799 | 3,237 |
| Customer deposits and deferred revenue..... | 8,144 | 12,442 |
| Other accrued liabilities..... | 7,782 | 6,477 |
| Line of credit..... | - | 1,000 |
| Capital lease obligations..... | 1,567 | 2,265 |
| Current portion of long-term debt..... | 2,979 | 278 |
| | ----- | ----- |
| Total current liabilities..... | 27,891 | 31,007 |
| Capital lease obligations..... | 620 | 1,706 |
| Long-term debt..... | 4,821 | 2,222 |
| Customer deposits and deferred revenue..... | 7,810 | 7,456 |
| | ----- | ----- |
| Total liabilities..... | 41,142 | 42,391 |
| | ----- | ----- |
| Stockholders' equity: | | |
| Common stock, \$.001 par value; 100,000,000 shares authorized; 29,469,179 and 28,902,998 shares issued and outstanding at September 30, 2001 and December 31, 2000, respectively..... | 29 | 29 |
| Additional paid-in capital..... | 336,393 | 333,845 |
| Stockholder note receivable..... | (121) | (115) |
| Deferred stock-based compensation..... | (1,879) | (6,805) |
| Accumulated deficit..... | (130,366) | (87,119) |
| | ----- | ----- |
| Total stockholders' equity..... | 204,056 | 239,835 |
| | ----- | ----- |
| Total liabilities and stockholders' equity..... | \$ 245,198 | \$282,226 |
| | ===== | ===== |

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

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| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|-------------|------------------------------------|-------------|
| | 2001 | 2000 | 2001 | 2000 |
| | ----- | ----- | ----- | ----- |
| Revenue..... | \$ 24,524 | \$ 16,395 | \$ 67,626 | \$ 36,252 |
| Cost of revenue (including amortization of deferred stock-based compensation of \$187 and \$163 for the three months ended September 30, 2001 and 2000, respectively, and \$577 and \$225 for the nine months ended September 30, 2001 and 2000, respectively)..... | 13,827 | 9,849 | 40,682 | 21,037 |
| | ----- | ----- | ----- | ----- |
| Gross profit..... | 10,697 | 6,546 | 26,944 | 15,215 |
| | ----- | ----- | ----- | ----- |
| Operating expenses: | | | | |
| Sales, general and administrative (including amortization of deferred stock-based compensation of \$278 and \$493 for the three months ended September 30, 2001 and 2000, respectively, and \$901 and \$681 for the nine months ended September 30, 2001 and 2000, respectively)..... | 7,232 | 7,674 | 23,441 | 23,799 |
| Research and development (including amortization of deferred stock-based compensation of \$59 and \$1,496 for the three months ended September 30, 2001 and 2000, respectively, and \$2,870 and \$2,066 for the nine months ended September 30, 2001 and 2000, respectively)..... | 4,958 | 7,212 | 18,888 | 15,134 |
| Amortization of goodwill and intangible assets..... | 8,800 | 6,958 | 26,325 | 7,258 |
| Restructuring charge (including amortization of deferred stock-based compensation of \$940 for the nine months ended September 30, 2001)..... | - | - | 3,276 | - |
| Merger-related expenses..... | - | - | - | 12,658 |
| | ----- | ----- | ----- | ----- |
| Total operating expenses..... | 20,990 | 21,844 | 71,930 | 58,849 |
| | ----- | ----- | ----- | ----- |
| Loss from operations..... | (10,293) | (15,298) | (44,986) | (43,634) |
| Interest and other income, net..... | 355 | 1,045 | 1,739 | 2,692 |
| | ----- | ----- | ----- | ----- |
| Net loss before cumulative effect of change in accounting method..... | (9,938) | (14,253) | (43,247) | (40,942) |
| Cumulative effect of change in accounting method..... | - | - | - | (2,515) |
| | ----- | ----- | ----- | ----- |
| Net loss..... | \$ (9,938) | \$ (14,253) | \$ (43,247) | \$ (43,457) |
| | ===== | ===== | ===== | ===== |
| Basic and diluted net loss per share before cumulative effect of change in accounting method..... | \$ (0.34) | \$ (0.53) | \$ (1.48) | \$ (1.67) |
| Per share cumulative effect of change | | | | |

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| | | | | |
|---|-----------|-----------|-----------|-----------|
| in accounting method..... | - | - | - | (0.11) |
| | ----- | ----- | ----- | ----- |
| Basic and diluted net loss per share... | \$ (0.34) | \$ (0.53) | \$ (1.48) | \$ (1.78) |
| | ===== | ===== | ===== | ===== |
| Weighted average shares used in computing basic and diluted net loss per share..... | 29,429 | 27,079 | 29,211 | 24,449 |
| | ===== | ===== | ===== | ===== |

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

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DIGITAL INSIGHT CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

| | Nine months ended September 30, | |
|--|------------------------------------|-------------|
| | 2001 | 2000 |
| | ----- | ----- |
| Cash flows from operating activities: | | |
| Net loss..... | \$ (43,247) | \$ (43,457) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Cumulative effect of change in accounting method..... | - | 2,515 |
| Depreciation and amortization..... | 8,018 | 3,745 |
| Amortization of goodwill and intangible assets..... | 26,325 | 7,258 |
| Amortization of deferred stock-based compensation..... | 5,288 | 2,972 |
| Interest income on stockholder note receivable..... | (6) | (10) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable..... | (4,219) | (2,900) |
| Accumulated implementation costs..... | (1,796) | (2,934) |
| Other current assets..... | 941 | 906 |
| Other assets..... | 378 | (150) |
| Accounts payable..... | (1,688) | (3,721) |
| Accrued compensation and related benefits..... | 562 | 98 |
| Customer deposits and deferred revenue..... | (3,944) | 5,529 |
| Other accruals..... | 2,270 | (5,460) |
| | ----- | ----- |
| Net cash used in operating activities..... | (11,118) | (35,609) |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchase of investments..... | (43,456) | (49,707) |
| Proceeds from sale of investments..... | 10,000 | 44,752 |
| Cash used in acquisition of subsidiary..... | - | (5,000) |
| Acquisition of property and equipment..... | (10,135) | (14,495) |
| | ----- | ----- |
| Net cash used in investing activities..... | (43,591) | (24,450) |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Principal payments on debt..... | (7,784) | (3,842) |
| Proceeds from debt..... | 10,300 | 3,000 |
| Net proceeds from issuance of common stock..... | 2,186 | 64,738 |
| | ----- | ----- |

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| | | |
|---|-----------|-----------|
| Net cash provided by financing activities..... | 4,702 | 63,896 |
| | ----- | ----- |
| Net decrease in cash and cash equivalents..... | (50,007) | 3,837 |
| Cash and cash equivalents at beginning of the period..... | 71,523 | 51,274 |
| | ----- | ----- |
| Cash and cash equivalents at end of the period..... | \$ 21,516 | \$ 55,111 |
| | ===== | ===== |
| Supplementary disclosures of cash flow information: | | |
| Cash paid during the year for interest..... | \$ 95 | \$ 201 |
| Supplemental non-cash investing and financing activities: | | |
| Acquisition of property and equipment..... | - | (3,143) |
| Capital lease obligation incurred..... | - | 3,143 |
| Warrants issued..... | - | 473 |
| Effect of Acquisition: | | |
| Accounts receivable and other assets..... | - | (6,135) |
| Property and equipment..... | - | (3,861) |
| Goodwill and intangible assets..... | - | (150,464) |
| Accounts payable and accrued compensation and benefits and other accruals..... | - | 11,697 |
| Capital lease obligations..... | - | 695 |
| Customer deposits and deferred revenue..... | - | 392 |
| Deferred stock based compensation..... | - | (8,741) |
| Common stock issued in acquisition..... | - | 151,417 |

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

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DIGITAL INSIGHT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. The Company and Summary of Significant Accounting Policies

The Company

Digital Insight Corporation (the "Company") provides Internet banking services to credit unions, banks and savings and loans. The Company offers financial institutions cost-effective outsourced applications, branded in their name, which include Internet banking for their retail customers and Internet cash management for their commercial customers, a target marketing program to enable them to effectively sell additional financial services to end users, a 24 by 7 loan decisioning and member services center, a customized e-commerce portal and web site design and implementation services. Substantially all of the Company's revenue is derived from these services.

On February 10, 2000, the Company merged with nFront, Inc. ("nFront"). The merger was accounted for as a pooling of interests and was effectuated by a stock-for-stock exchange. The financial results for the Company and nFront have been combined for the historical periods presented in accordance with the pooling of interests method. In addition, the Company acquired 1View Network ("1View") on June 21, 2000 and AnyTime Access Inc. ("ATA") on July 31, 2000. Both acquisitions were accounted for using the purchase method of accounting.

The accompanying consolidated financial statements for the three and nine months ended September 30, 2001 and 2000 have been prepared in accordance with generally accepted accounting principles ("GAAP") and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote

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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 accountants have not audited these consolidated financial statements. The consolidated financial statements, however, 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, 2000 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 consolidated financial statements and footnotes are adequate to make the information not misleading, but should be read in conjunction 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, 2000.

Revenue recognition

During the fourth quarter of 2000, the Company adopted Staff Accounting Bulletin No. 101 ("SAB 101") "Revenue Recognition in Financial Statements," issued by the SEC in December 1999. The Company's historical method of revenue recognition for implementation services was upon completion of the implementation process, which is typically 90 to 120 days after contract initiation. The Company also deferred the implementation costs and recognized them upon completion of the implementation. Under SAB 101, the Company now defers recognition of certain implementation fees and related direct incremental costs and recognizes them over the life of the service relationship, generally three to five years. The change in accounting principle caused by SAB 101 resulted in a cumulative effect adjustment of approximately \$2.5 million at January 1, 2000. The consolidated financial statements previously reported as of September 30, 2000 and for the three and nine months then ended have been adjusted to reflect this change in accounting method.

Long-lived assets

The Company identifies and records impairment losses on long-lived assets whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of these assets is determined by comparing the forecasted undiscounted cash flows attributable to such assets to their carrying value. If the carrying value of the assets exceeds the forecasted undiscounted cash flows, then the assets are written down to their fair value. Fair value is determined based on discounted cash flows or appraised values, depending upon the nature of the assets. To date, there have been no such impairments.

DIGITAL INSIGHT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -(Continued)

New accounting standards

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." The new standard requires companies to record derivatives on their balance sheets as assets or liabilities, measured at fair value. Under SFAS No. 133, gains or losses

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resulting from changes in the values of derivatives are to be reported in the statement of operations or as a deferred item, depending on the use of the derivatives and whether they qualify for hedge accounting. The Company adopted SFAS No. 133 in the first quarter of 2001. To date, the Company has not engaged in any hedging activity. Application of SFAS No. 133 did not have an impact on the Company's financial reporting.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 establishes new standards for accounting and reporting requirements for business combinations initiated after June 30, 2001 and prohibits the use of the pooling-of-interests method for combinations initiated after June 30, 2001. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment only approach. Upon adoption of SFAS No. 142, goodwill will be tested at the reporting unit annually and whenever events or circumstances occur indicating that goodwill might be impaired. Amortization of goodwill, including goodwill from past business combinations will cease. The adoption date for SFAS No. 141 and 142 will be January 1, 2002. The Company is still assessing what the impact of SFAS No. 141 and 142 will be on its results of operations and financial position.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of. This Statement supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. This Statement also supersedes the accounting and reporting provisions of APB Opinion No. 30 ("APB 30"), Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for segments of a business to be disposed of. This Statement also amends ARB No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a temporarily controlled subsidiary. The adoption date for SFAS No. 144 will be January 1, 2002.

Reclassifications

Certain reclassifications have been made to the consolidated financial statements as of September 30, 2000 and for the three and nine months then ended in order to conform to the 2001 presentation.

2. Revolving line of credit

In May 2001, the Company renewed its \$10 million secured revolving credit commitment (the "Revolver") from a bank, which matures in July 2002. Interest on the outstanding borrowings is payable monthly. The interest rate on the Revolver is equal to the bank's prime rate. The Revolver is collateralized by all of the Company's assets. As of December 31, 2000, the Company had outstanding advances under the Revolver of \$1 million. As of September 30, 2001, the Company had no outstanding advances under the Revolver.

3. Long-term debt

In August 2000, the Company obtained a \$10 million equipment leasing line of credit evidenced by a Multiple Disbursement Note from a bank, collateralized by the participating equipment and a \$10 million certificate of deposit. The terms of the note were revised in August 2001 to allow principal to be borrowed from time to time prior to October 31, 2001. Interest will accrue at either (i) the bank's prime rate less 1% or (ii) 1.5% above the rate stated on the certificate of deposit pledged as collateral for the note. Under the revised terms, interest is paid monthly; principal will be paid in 34 monthly installments, commencing November 30, 2001. As of September 30, 2001 and December 31, 2000,

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the Company had \$7.8 million and \$2.5 million, respectively, in borrowings outstanding under this note. At September 30, 2001, the interest rate on the note was 5.5% per annum.

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DIGITAL INSIGHT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -(Continued)

4. Restructuring charge

In February 2001, the Company announced a plan to strategically restructure its business and reduce operating expenses. The process included a review of potentially redundant functions and facilities. The majority of these redundancies resulted from the three acquisitions completed by the Company in 2000. As a result of this process, the Company notified 58 employees that their positions would be eliminated. The Company also anticipated the closure of its facility in San Francisco, California. The Company has reached an agreement, effective October 1, 2001, to terminate the lease on the San Francisco facility. During the first quarter of 2001, the Company recorded a restructuring charge of approximately \$1,629,000 for severance payments and related benefits for employees whose positions were eliminated, approximately \$940,000 in deferred stock-based compensation expense for the acceleration of stock options and approximately \$707,000 for exit costs to be incurred as a result of the closure of the San Francisco facility. The following table sets forth the 2001 restructuring reserve activity:

| | Employee related ----- | Exit costs ----- | Deferred stock-based compensation ----- | Total ----- |
|--------------------------------------|------------------------------|------------------------|--|----------------|
| Restructuring reserve (in thousands) | | | | |
| Restructuring reserve..... | \$ 1,629 | \$ 707 | \$ 940 | \$ 3,276 |
| Cash payments..... | (1,376) | (150) | - | (1,526) |
| Non-cash disposals..... | - | - | (940) | (940) |
| | ----- | ----- | ----- | ----- |
| Reserve at September 30, 2001.... | \$ 253 | \$ 557 | \$ - | \$ 810 |
| | ===== | ===== | ===== | ===== |

5. Reportable segments

The Company manages its business in two reportable segments: the Internet banking division and the lending division. The results of operations from these reportable segments were as follows for the three and nine months ended September 30, 2001 and 2000:

| | Internet banking division (1) ----- | Lending division (2) ----- | Unallocated expenses (3) ----- | Total ----- |
|--|--|----------------------------------|--------------------------------------|----------------|
| | (In thousands) | | | |
| Three months ended September 30, 2001: | | | | |
| Revenue..... | \$ 20,427 | \$ 4,097 | - | \$ 24,524 |
| Gross profit..... | \$ 9,285 | \$ 1,412 | - | \$ 10,697 |

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| | | | | |
|--|-------------|------------|-------------|-------------|
| Loss from operations..... | \$ (1,410) | \$ (83) | \$ (8,800) | \$ (10,293) |
| Three months ended September 30, 2000: | | | | |
| Revenue..... | \$ 13,541 | \$ 2,854 | - | \$ 16,395 |
| Gross profit..... | \$ 5,842 | \$ 704 | - | \$ 6,546 |
| Loss from operations..... | \$ (8,063) | \$ (277) | \$ (6,958) | \$ (15,298) |
| Nine months ended September 30, 2001: | | | | |
| Revenue..... | \$ 56,137 | \$11,489 | - | \$ 67,626 |
| Gross profit..... | \$ 24,022 | \$ 2,922 | - | \$ 26,944 |
| Loss from operations..... | \$ (13,755) | \$ (1,630) | \$ (29,601) | \$ (44,986) |
| Nine months ended September 30, 2000: | | | | |
| Revenue..... | \$ 33,398 | \$ 2,854 | | \$ 36,252 |
| Gross profit..... | \$ 14,511 | \$ 704 | | \$ 15,215 |
| Loss from operations..... | \$ (23,441) | \$ (277) | \$ (19,916) | \$ (43,634) |

-
- (1) Loss from operations includes amortization of deferred stock-based compensation of \$276 and \$1,971 for the three months ended September 30, 2001 and 2000, respectively, and \$3,580 and \$2,791 for the nine months ended September 30, 2001 and 2000, respectively.
 - (2) Loss from operations includes amortization of deferred stock-based compensation of \$248 and \$181 for the three months ended September 30, 2001 and 2000, respectively, and \$768 and \$181 for the nine months ended September 30, 2001 and 2000, respectively.
 - (3) Represents amortization of goodwill and intangible assets, restructuring charge and merger-related expenses. The restructuring charge includes amortization of deferred stock-based compensation of \$940 for the nine months ended September 30, 2001.

For the nine-month period ended September 30, 2001, no customer comprised more than 10% of revenue. The Company has no foreign operations.

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

The following discussion should be read in conjunction with the accompanying Consolidated Financial Statements and Notes thereto. The forward-looking statements included in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") involve certain risks and uncertainties. These forward looking statements include statements regarding anticipated financial performance, business prospects, anticipated capital expenditures and other similar matters, which 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 in the MD&A and under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2000.

As of September 30, 2001, we had contracts with 1,385 financial institutions, 1,148 of which had contracted for Internet banking services, 477 of which had contracted for cash management services and 162 of which had contracted for on-line lending services. There were approximately 2.2 million active Internet banking end users at the end of the quarter, up 69% from a year earlier and 10% from the prior quarter. We had a total of 960 Internet banking clients with live sites at September 30, 2001, which represented approximately 25.0 million potential end users and an overall penetration rate of 8.8%. The total number of potential end users of the 1,148 contracted Internet banking institutions was approximately 27.6 million.

We manage our business in two reportable segments: the Internet banking

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division and the lending division. The results of operations from these reportable segments were as follows for the three and nine months ended September 30, 2001 and 2000:

| | Internet banking division (1) | Lending division (2) | Unallocated expenses (3) | Total |
|--|-------------------------------------|-------------------------|-----------------------------|-------------|
| | ----- | | | |
| | (In thousands) | | | |
| Three months ended September 30, 2001: | | | | |
| Revenue..... | \$ 20,427 | \$ 4,097 | - | \$ 24,524 |
| Gross profit..... | \$ 9,285 | \$ 1,412 | - | \$ 10,697 |
| Loss from operations..... | \$ (1,410) | \$ (83) | \$ (8,800) | \$ (10,293) |
| Three months ended September 30, 2000: | | | | |
| Revenue..... | \$ 13,541 | \$ 2,854 | - | \$ 16,395 |
| Gross profit..... | \$ 5,842 | \$ 704 | - | \$ 6,546 |
| Loss from operations..... | \$ (8,063) | \$ (277) | \$ (6,958) | \$ (15,298) |
| Nine months ended September 30, 2001: | | | | |
| Revenue..... | \$ 56,137 | \$11,489 | - | \$ 67,626 |
| Gross profit..... | \$ 24,022 | \$ 2,922 | - | \$ 26,944 |
| Loss from operations..... | \$ (13,755) | \$ (1,630) | \$ (29,601) | \$ (44,986) |
| Nine months ended September 30, 2000: | | | | |
| Revenue..... | \$ 33,398 | \$ 2,854 | | \$ 36,252 |
| Gross profit..... | \$ 14,511 | \$ 704 | | \$ 15,215 |
| Loss from operations..... | \$ (23,441) | \$ (277) | \$ (19,916) | \$ (43,634) |

-
- (1) Loss from operations includes amortization of deferred stock-based compensation of \$276 and \$1,971 for the three months ended September 30, 2001 and 2000, respectively, and \$3,580 and \$2,791 for the nine months ended September 30, 2001 and 2000, respectively.
 - (2) Loss from operations includes amortization of deferred stock-based compensation of \$248 and \$181 for the three months ended September 30, 2001 and 2000, respectively, and \$768 and \$181 for the nine months ended September 30, 2001 and 2000, respectively.
 - (3) Represents amortization of goodwill and intangible assets, restructuring charge and merger-related expenses. The restructuring charge includes amortization of deferred stock-based compensation of \$940 for the nine months ended September 30, 2001.

For the nine-month period ended September 30, 2001, no customer comprised more than 10% of revenue. We have no foreign operations.

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Results of Operations

The discussion of the results of operations compares the three and nine months ended September 30, 2001 with the three and nine months ended September 30, 2000. In February 2000, we merged with nFront in a pooling of interests transaction. Accordingly, our financial results have been combined with the financial results of nFront for the historical periods presented.

Comparison of Three Months Ended September 30, 2001 and September 30, 2000

Results of Operations: Net loss for the three months ended September 30, 2001 was approximately \$9.9 million, compared to approximately \$14.3 million for the corresponding period in 2000.

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Revenue: Revenue consists primarily of recurring monthly service fees and to a lesser extent, one-time implementation fees, which are recognized over the term of the service relationship. Our recurring revenue consists of services fees based on the number of end users or end user transactions and fees for hosting and maintaining customer websites and other monthly services. In addition, we receive fixed fees for other services such as training, web development and professional services. Revenue for the three months ended September 30, 2001 was approximately \$24.5 million, an increase of 49%, from approximately \$16.4 million for the same period last year.

Revenue for the three months ended September 30, 2001 included approximately \$20.4 million relating to the Internet banking division compared to approximately \$13.5 million for the same period last year. This increase of approximately \$6.9 million resulted from an increased number of end users combined with sales of additional services to our existing client customer base. The number of active Internet banking end users increased 69% to approximately 2.2 million at September 30, 2001 from approximately 1.3 million at September 30, 2000.

Revenue for the three months ended September 30, 2001 included approximately \$4.1 million relating to the lending division compared to approximately \$2.9 million for the same period last year. This increase of approximately \$1.2 million resulted from a full quarter of operations in 2001 compared to the partial quarter of operations subsequent to the date of acquisition in 2000. In addition, our lending division is experiencing a shift in the mix of our lending application volumes toward Internet applications and away from the historical emphasis on call center applications. The Internet applications produce a slightly lower revenue stream; however the costs associated with the Internet applications are relatively lower than the call center applications. Therefore, the shift in mix resulted in slightly lower revenues, but higher margins.

Consolidations in the banking and financial services industry could result in a smaller market for our products and services. Terminations of existing customers through industry consolidation or other occurrences may result in one-time termination fees and in some cases fees related to transition services, which could affect our revenue mix and have a negative impact on our future revenue.

Cost of Revenue: Cost of revenue is comprised primarily of salaries and related personnel expenses, network costs, expenses related to the operation of our data centers and fees paid to third parties, including bill payment vendors, data processing vendors and communication services providers. Cost of revenue for the three months ended September 30, 2001 was approximately \$13.8 million, an increase of 40%, from approximately \$9.8 million for the same period last year.

Cost of revenue for the three months ended September 30, 2001 included approximately \$11.1 million relating to the Internet banking division compared to approximately \$7.7 million for the same period last year. This increase of approximately \$3.4 million was primarily due to the cost of implementing and servicing additional financial institutions combined with continued investment in our data center infrastructure.

Cost of revenue for the three months ended September 30, 2001 included approximately \$2.7 million relating to the lending division compared to approximately \$2.1 million for the same period last year. This increase of approximately \$0.6 million resulted from a full quarter of operations in 2001, compared to the partial quarter of operations subsequent to the date of acquisition in 2000, partially offset by the effect of the shift in mix from the historical call center applications to the lower cost Internet applications.

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Gross Profit: Gross profit was approximately \$10.7 million for the three months ended September 30, 2001 compared to approximately \$6.5 million for the same period last year. Gross profit for the Internet banking division as a percentage of revenue was 45% for the third quarter of 2001 compared to 43% for the third quarter of 2000. Gross profit for the lending division as a percent of revenue was 34% for the third quarter of 2001 compared to 25% for the third quarter of 2000. The increase in gross profit for the lending division was the result of the shift in

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application mix, as discussed above, combined with the seasonal nature of the business. Typically, lending application volume is slightly higher in the second and third quarters as compared to the first and fourth quarters.

Sales, General and Administrative: Sales, general and administrative expenses consist primarily of salaries and related expenses for executive, sales, marketing, finance, human resources, administrative personnel and other general corporate expenses. In addition, these expenses include marketing expenses, such as trade shows and promotional costs.

Sales, general and administrative expenses were approximately \$7.2 million for the three months ended September 30, 2001 compared to approximately \$7.7 million for the three months ended September 30, 2000. As a percentage of revenue, sales, general and administrative expenses were 29% for the three months ended September 30, 2001 compared to 47% for the three months ended September 30, 2000.

Research and Development: Research and development expenses consist primarily of salaries, related personnel expenses and consultant fees related to the design, development, testing and enhancement of both our products and our data processing vendor interface software.

Research and development expenses were approximately \$5.0 million for the three months ended September 30, 2001 compared to approximately \$7.2 million for the three months ended September 30, 2000. This decrease was primarily due to a reduction in the use of outside consultants. Research and development expenses as a percentage of revenue were 20% for the three months ended September 30, 2001, compared to 44% for the three months ended September 30, 2000.

Amortization of Goodwill and Intangible Assets: The acquisitions of 1View and ATA generated goodwill and intangible assets of approximately \$150.2 million, which are being amortized on a straight-line basis over the estimated lives of three to five years. We are assessing the impact of SFAS No. 142 on the accounting of the goodwill generated from the acquisitions.

Interest and Other Income, Net: Interest and other income, net, was approximately \$355,000 for the three months ended September 30, 2001 and approximately \$1.0 million for the three months ended September 30, 2000. This decrease was primarily due to a lower rate of return on our investments combined with an increase in interest expense due to increased outstanding debt.

Comparison of Nine Months Ended September 30, 2001 and September 30, 2000

Results of Operations: Net loss for the nine months ended September 30, 2001 was approximately \$43.2 million, compared to approximately \$43.5 million for the corresponding period in 2000.

Revenue: Revenue for the nine months ended September 30, 2001 was approximately \$67.6 million, an increase of 86%, from approximately \$36.3 million for the same period last year.

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Revenue for the nine months ended September 30, 2001 included approximately \$56.1 million relating to the Internet banking division compared to approximately \$33.4 million for the same period last year. This increase of approximately \$22.7 million resulted from an increased number of end users combined with sales of additional services to our existing client customer base.

Revenue for the nine months ended September 30, 2001 included approximately \$11.5 million relating to the lending division compared to approximately \$2.9 million for the same period last year. This increase of approximately \$8.6 million resulted from a full nine months of operations in 2001 compared to approximately two months of operations subsequent to the date of acquisition in 2000.

Cost of Revenue: Cost of revenue for the nine months ended September 30, 2001 was approximately \$40.7 million, an increase of 93%, from approximately \$21.0 million for the same period last year.

Cost of revenue for the nine months ended September 30, 2001 included approximately \$32.1 million relating to the Internet banking division compared to approximately \$18.9 million for the same period last year. This increase of approximately \$13.2 million was primarily due to the cost of implementing and servicing additional financial institutions combined with continued investment in our data center infrastructure.

Cost of revenue for the nine months ended September 30, 2001 included approximately \$8.6 million relating to the lending division compared to approximately \$2.2 million for the same period last year. This increase of approximately \$6.4 million resulted from a full nine months of operations in 2001, compared to approximately two months of operations subsequent to the date of acquisition in 2000, partially offset by the effect of the shift in mix from the historical call center applications to the lower cost Internet applications.

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Gross Profit: Gross profit increased to approximately \$26.9 million for the nine months ended September 30, 2001 from approximately \$15.2 million for the nine months ended September 30, 2000. Gross profit for the Internet banking division as a percentage of revenue remained stable at 43% for both the first nine months of 2001 and 2000. Gross profit for the lending division as a percent of revenue remained stable at 25% for both the first nine months of 2001 and 2000.

Sales, General and Administrative: Sales, general and administrative expenses were approximately \$23.4 million for the nine months ended September 30, 2001 compared to approximately \$23.8 million for the nine months ended September 30, 2000. As a percentage of revenue, sales, general and administrative expenses were 35% for the nine months ended September 30, 2001 compared to 66% for the nine months ended September 30, 2000.

Research and Development: Research and development expenses were approximately \$18.9 million for the nine months ended September 30, 2001 compared to approximately \$15.1 million for the nine months ended September 30, 2000. Research and development expenses as a percentage of revenue were 28% for the nine months ended September 30, 2001, compared to 42% for the nine months ended September 30, 2000. We expect these expenses, as a percentage of revenue, to continue to decline in the fourth quarter as a result of the reduction in usage of outside consultants.

Amortization of Goodwill and Intangible Assets: The acquisitions of lView and ATA generated goodwill and intangible assets of approximately \$150.2 million,

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which are being amortized on a straight-line basis over the estimated lives of three to five years. We are assessing the impact of SFAS No. 142 on the accounting of the goodwill generated from the acquisitions.

Restructuring Charge: In February 2001, we announced a plan to strategically restructure our business and reduce operating expenses. The process included a review of potentially redundant functions and facilities. The majority of these redundancies resulted from the three acquisitions completed in 2000. As a result of this process, we notified 58 employees that their positions would be eliminated. We also anticipated the closure of our facility in San Francisco, California. We have reached an agreement, effective October 1, 2001, to terminate the lease on the San Francisco facility. During the first quarter of 2001, we recorded a restructuring charge of approximately \$1,629,000 for severance payments and related benefits for employees whose positions were eliminated, approximately \$940,000 in deferred stock-based compensation expense for the acceleration of stock options and approximately \$707,000 for exit costs to be incurred as a result of the closure of the San Francisco facility.

Interest and Other Income, Net: Interest and other income, net, was approximately \$1.7 million for the nine months ended September 30, 2001, and approximately \$2.7 million for the nine months ended September 30, 2000. This decrease was primarily due to a lower rate of return on our investments combined with an increase in interest expense due to increased outstanding debt.

Liquidity and Capital Resources

At September 30, 2001, we had cash, cash equivalents and short-term investments of \$60.6 million and \$4.6 million in long-term investments. In addition, we have access to our \$10 million Revolver and our \$10 million equipment leasing line of credit. As of September 30, 2001, we had no outstanding advances under the Revolver and \$7.8 million of outstanding advances under the equipment leasing line of credit.

Net cash used in operating activities was approximately \$11.1 million for the nine months ended September 30, 2001 and approximately \$35.6 million for the nine months ended September 30, 2000. The decrease in cash used in operating activities was primarily due to the decrease in non-recurring merger-related expenses combined with a reduction in the loss from operations excluding non-cash charges.

Net cash used in investing activities was approximately \$43.6 million for the nine months ended September 30, 2001 and approximately \$24.5 million for the nine months ended September 30, 2000. The increase in cash used in investing activities was primarily due to the decrease in proceeds from the sale of investments.

Net cash provided by financing activities was approximately \$4.7 million for the nine months ended September 30, 2001 and approximately \$63.9 million for the nine months ended September 30, 2000. The decrease in cash provided by financing activities was primarily due to the decrease in proceeds from issuances of common stock.

We have no material commitments other than the Revolver, equipment leasing line of credit and obligations under operating and capital leases. Future capital requirements will depend upon many factors, including the timing of research and product development efforts and the expansion of our marketing efforts. We expect to continue to

expend significant amounts on expansion of facility infrastructure, computer and

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related data center equipment, and personnel.

We believe that our cash, cash equivalents and short-term investment balances will be sufficient to satisfy our cash requirements for at least the next 12 months. We intend to invest our cash in excess of current operating requirements in interest bearing, investment grade securities.

Pro Forma Net Loss

The following pro forma net loss calculation, which is derived by excluding non-cash amortization of deferred stock-based compensation, amortization of goodwill and intangible assets, merger-related expenses and restructuring charge, is not a disclosure required by GAAP but is included for informational purposes only.

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|-------------|------------------------------------|----------|
| | 2001 | 2000 | 2001 | 2000 |
| (In thousands, except per share data) | | | | |
| Net loss | \$ (9,938) | \$ (14,253) | \$ (43,247) | \$ (43,4 |
| Amortization of goodwill and intangible assets..... | 8,800 | 6,958 | 26,325 | 7,2 |
| Amortization of deferred stock-based compensation... | 524 | 2,152 | 5,288 | 2,9 |
| Restructuring charge..... | - | - | 2,336 | |
| Merger-related expenses..... | - | - | - | 12,6 |
| Pro forma net loss before cumulative effect of change in accounting method..... | (614) | (5,143) | (9,298) | (20, |
| Cumulative effect of change in accounting method... | - | - | - | 2, |
| Pro forma net loss..... | \$ (614) | \$ (5,143) | \$ (9,298) | \$ (18,0 |
| Pro forma net loss per share before cumulative effect of change in accounting method..... | \$ (0.02) | \$ (0.19) | \$ (0.32) | \$ (0. |
| Per share cumulative effect of change in accounting method..... | - | - | - | 0. |
| Pro forma net loss per share..... | \$ (0.02) | \$ (0.19) | \$ (0.32) | \$ (0. |
| Weighted average shares used in computing pro forma net loss per share..... | 29,429 | 27,079 | 29,211 | 24,4 |

Pro Forma EBITDA

The following calculation of pro forma earnings before interest, taxes, depreciation and amortization, ("EBITDA") also excludes merger-related expenses, restructuring charge and the cumulative effect of change in accounting method. EBITDA is not a disclosure required by GAAP but is included for informational purposes only.

| Three months ended September 30, | Nine months ended September 30, |
|-------------------------------------|------------------------------------|
|-------------------------------------|------------------------------------|

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| | 2001 ----- | 2000 ----- | 2001 ----- | 2000 ----- |
|-----------------------------------|----------------|---------------|---------------|---------------|
| | (In thousands) | | | |
| Pro forma net loss..... | \$ (614) | \$ (5,143) | \$ (9,298) | \$ (18,054) |
| Interest and other income, net... | (355) | (1,045) | (1,739) | (2,692) |
| Depreciation..... | 2,822 | 1,658 | 8,018 | 3,745 |
| | ----- | ----- | ----- | ----- |
| Pro forma EBITDA..... | \$1,853 | \$ (4,530) | \$ (3,019) | \$ (17,001) |
| | ===== | ===== | ===== | ===== |

New Accounting Standards

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The new standard requires companies to record derivatives on their balance sheets as assets or liabilities, measured at fair value. Under SFAS No. 133, gains or losses resulting from changes in the values of derivatives are to be reported in the statement of operations or as a deferred item, depending on the use of the derivatives and whether they qualify for hedge accounting. We adopted SFAS No. 133 in the first quarter of 2001. To date, we have not engaged in any hedging activity. Application of SFAS No. 133 did not have an impact on our financial reporting.

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In July 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 establishes new standards for accounting and reporting requirements for business combinations initiated after June 30, 2001 and prohibits the use of the pooling-of-interests method for combinations initiated after June 30, 2001. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment only approach. Upon adoption of SFAS No. 142, goodwill will be tested at the reporting unit annually and whenever events or circumstances occur indicating that goodwill might be impaired. Amortization of goodwill, including goodwill from past business combinations will cease. The adoption date for SFAS No. 141 and 142 will be January 1, 2002. We are still assessing what the impact of SFAS No. 141 and 142 will be on our results of operations and financial position.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of. This Statement supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. This Statement also supersedes the accounting and reporting provisions of APB Opinion No. 30 ("APB 30"), Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for segments of a business to be disposed of. This Statement also amends ARB No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a temporarily controlled subsidiary. The adoption date for SFAS No. 144 will be January 1, 2002.

Other Matters

We are currently party to various legal proceedings. Although litigation is subject to inherent uncertainties, management, including internal counsel, does not believe that the ultimate outcome of these legal proceedings will have a material adverse effect on our financial position or overall trends in results of operations. However, if an unfavorable ruling were to occur in any specific period, there exists the possibility of a material adverse impact on the results

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of operations of that period. Management believes that, given our current liquidity and cash and investment balances, even an adverse judgment would not have a material impact on cash and investments or liquidity.

Our future results of operations and the other forward-looking statements contained in this MD&A section involve a number of risks and uncertainties -- in particular the statements regarding expectations regarding the shift in the mix of our lending division applications, plans to increase margins and lending application revenue, declining expenses as a percentage of revenue, interest income, future revenue, pricing, gross margin, anticipated earnings per share, and pending legal proceedings. Factors that could cause actual results to differ materially are the following: the possibility that we will fail to realize reduced expenses through the restructuring as expected; our inability to integrate ATA and its products into our operations on a cost-effective and timely basis; the possibility that we will fail to realize the increased margins from our lending application revenue through the shift from call center applications to Internet applications; the possibility that costs or difficulties related to the data center consolidation and product migration will be greater than expected; the termination of significant customer contracts; a general slowdown of the economy; changes in end user demand for Internet banking; and litigation involving antitrust, intellectual property, consumer and other issues.

We believe that we have the product offerings, facilities, personnel, and competitive and financial resources for continued business success, but future revenue, costs, margins and profits are all influenced by a number of factors, including those discussed above, all of which are inherently difficult to forecast.

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ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to the impact of interest rate changes and changes in the market values of our investments. Our interest income is sensitive to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on our cash equivalents. Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. We invest our excess cash in debt instruments of the U.S. government and its agencies, and in high-quality corporate issuers and, by policy, limit the amount of credit exposure to any one issuer. We protect and preserve our invested funds by limiting default, market and reinvestment risk. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates.

We are also exposed to the impact of interest rate changes as they affect our Revolver and equipment leasing line of credit. The interest rate charged on these credit facilities varies with the applicable lender's prime rate and, consequently, our interest expense will fluctuate with changes in the general level of U.S. interest rates. As of September 30, 2001, we had no outstanding advances under the Revolver and \$7.8 million outstanding under the equipment leasing line of credit.

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ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 10.1 Letter dated September 24, 2001, detailing employment and option agreement between Bruce Isaacson, Senior Vice President, Product Management, Marketing and Alliances and the Registrant.
- 10.2 Letter dated October 8, 2001, detailing employment and option agreement between Drew Hyatt, Senior Vice President, Internet Banking Client Services and the Registrant.
- 10.3 Amendment No. 2 to the 2001 Nonemployee Directors Option Plan.

(b) Reports on Form 8-K

None

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SIGNATURES

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

DIGITAL INSIGHT CORPORATION

Date: November 9, 2001

By: /s/ Kevin McDonnell

Kevin McDonnell
Senior Vice President, Finance and
Administration and Chief Financial Officer
(Principal Financial and Accounting Officer)

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