

ONLINE RESOURCES CORP

Form 10-Q

November 09, 2005

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(MARK ONE)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**COMMISSION FILE NUMBER 0-26123**

**ONLINE RESOURCES CORPORATION**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE

52-1623052

(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

4795 MEADOW WOOD LANE, SUITE 300,  
CHANTILLY, VIRGINIA

20151

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(ZIP CODE)

(703) 653-3100

(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  NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

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 November 2, 2005 there were 25,095,094 shares of the issuer's common stock outstanding.

**ONLINE RESOURCES CORPORATION  
FORM 10-Q  
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**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS.**  
**ONLINE RESOURCES CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	<b>SEPTEMBER 30, 2005</b>	<b>DECEMBER 31, 2004</b>
	(unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 51,528,949	\$ 3,341,678
Restricted cash	2,219,674	1,650,723
Investments		1,298,909
Accounts receivable (net of allowance of approximately \$154,000 and \$152,000 at September 30, 2005 and December 31, 2004, respectively)	7,290,758	8,433,113
Deferred implementation costs	562,544	460,600
Prepaid expenses and other current assets	1,205,235	2,634,961
Total current assets	62,807,160	17,819,984
Property and equipment, net	14,657,172	13,099,829
Deferred implementation costs, less current portion	524,700	420,035
Goodwill	16,368,602	11,272,463
Intangible assets	2,468,003	1,569,800
Other assets	587,007	351,157
Total assets	\$ 97,412,644	\$ 44,533,268
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 824,152	\$ 1,654,650
Accrued expenses and other current liabilities	3,906,246	3,159,743
Accrued compensation	2,023,209	1,808,233
Deferred revenues	2,419,058	972,890
Deferred rent obligations	158,237	158,237
Capital lease obligations	15,867	10,573
Total current liabilities	9,346,769	7,764,326
Deferred revenues, less current portion	1,035,136	379,036
Deferred rent obligations, less current portion	1,780,040	1,524,828
Other long term liabilities		94,422
Total liabilities	12,161,945	9,762,612
Commitments and contingencies		
Stockholders equity		
Series B junior participating preferred stock, \$0.01 par value; 297,500 shares authorized; none issued at September 30, 2005 and December 31, 2004		

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Common stock, \$0.0001 par value; 70,000,000 shares authorized; 25,127,737 issued and 25,052,212 outstanding at September 30, 2005; and 19,340,222 issued and 19,264,697 outstanding at December 31, 2004	2,505	1,926
Additional paid-in capital	158,992,432	114,647,954
Accumulated deficit	(73,516,438)	(79,651,309)
Treasury stock, 75,525 shares at September 30, 2005 and December 31, 2004, respectively	(227,800)	(227,800)
Accumulated other comprehensive loss		(115)
Total stockholders' equity	85,250,699	34,770,656
Total liabilities and stockholders' equity	\$ 97,412,644	\$ 44,533,268

See accompanying notes to consolidated unaudited financial statements.

**ONLINE RESOURCES CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>THREE MONTHS ENDED</b>		<b>NINE MONTHS ENDED</b>	
	<b>SEPTEMBER 30,</b>		<b>SEPTEMBER 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Revenues:				
Account presentation services	\$ 1,898,573	\$ 727,518	\$ 6,923,501	\$ 2,289,032
Payment services	8,972,203	7,349,478	26,110,389	20,476,526
Relationship management services	1,850,528	2,017,012	5,807,734	5,881,358
Professional services and other	2,571,188	952,646	5,891,855	2,235,563
<b>Total revenues</b>	<b>15,292,492</b>	<b>11,046,654</b>	<b>44,733,479</b>	<b>30,882,479</b>
Costs and expenses:				
Service costs	4,823,006	4,120,557	14,840,668	12,449,031
Implementation and other costs	1,249,710	275,731	3,235,802	943,875
<b>Costs of revenues</b>	<b>6,072,716</b>	<b>4,396,288</b>	<b>18,076,470</b>	<b>13,392,906</b>
<b>Gross profit</b>	<b>9,219,776</b>	<b>6,650,366</b>	<b>26,657,009</b>	<b>17,489,573</b>
General and administrative	3,412,671	2,083,215	9,960,199	6,280,917
Sales and marketing	2,599,896	1,748,500	7,566,778	5,399,069
Systems and development	1,195,556	1,024,816	3,493,657	2,838,962
<b>Total expenses</b>	<b>7,208,123</b>	<b>4,856,531</b>	<b>21,020,634</b>	<b>14,518,948</b>
<b>Income from operations</b>	<b>2,011,653</b>	<b>1,793,835</b>	<b>5,636,375</b>	<b>2,970,625</b>
Other income (expense):				
Interest income	429,932	30,635	780,896	83,426
Interest expense	(2,158)	6,069	(10,901)	2,029
Other income	1,576	33,118	1,382	33,118
<b>Total other income</b>	<b>429,350</b>	<b>69,822</b>	<b>771,377</b>	<b>118,573</b>
<b>Income before income tax provision</b>	<b>2,441,003</b>	<b>1,863,657</b>	<b>6,407,752</b>	<b>3,089,198</b>
Income tax provision	77,600	53,000	272,881	71,000
<b>Net income</b>	<b>\$ 2,363,403</b>	<b>\$ 1,810,657</b>	<b>\$ 6,134,871</b>	<b>\$ 3,018,198</b>
Net income per share:				
Basic net income per share	\$ 0.09	\$ 0.10	\$ 0.27	\$ 0.17
Diluted net income per share	\$ 0.09	\$ 0.09	\$ 0.24	\$ 0.15
Shares used in calculation of net income per share:				
Basic	25,017,690	18,128,023	22,864,363	18,006,793
Diluted	27,321,956	20,031,531	25,208,877	20,057,026

**See accompanying notes to consolidated unaudited financial statements.**



**ONLINE RESOURCES CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>NINE MONTHS ENDED</b>	
	<b>SEPTEMBER 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Operating activities</b>		
Net income	\$ 6,134,871	\$ 3,018,198
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,211,949	2,744,719
Loss on impairment of assets	103,967	38,014
Provision for losses on accounts receivable	2,091	14,275
Net realized gain on investments		(205)
Amortization of discount premium	(976)	(28,051)
Changes in assets and liabilities, net of acquisitions:		
Restricted cash	(568,951)	(763,189)
Accounts receivable	1,298,869	(650,037)
Prepaid expenses and other current assets	1,431,893	(725,911)
Deferred implementation costs	(206,609)	(3,682)
Other assets	(210,116)	8,230
Accounts payable	(874,861)	1,324,099
Accrued expenses	600,148	982,284
Deferred revenues	1,186,450	(38,491)
Deferred rent obligation	255,212	
Other long term liabilities	(94,422)	
Net cash provided by operating activities	13,269,515	5,920,253
<b>Investing activities</b>		
Purchases of property and equipment	(5,391,624)	(4,911,452)
Purchases of available-for-sale securities	(3,100,000)	(9,814,405)
Sales of available-for-sale securities	4,400,000	8,779,164
Acquisition of Integrated Data Systems, Inc., net of cash acquired	(3,316,653)	
Net cash used in investing activities	(7,408,277)	(5,946,693)
<b>Financing activities</b>		
Net proceeds from issuance of common stock (non-secondary related)	2,123,411	892,940
Net proceeds from issuance of common stock in secondary offering	40,221,834	
Repayment of capital lease obligations	(19,212)	(93,209)
Net cash provided by financing activities	42,326,033	799,731
Net increase in cash and cash equivalents	48,187,271	773,291
Cash and cash equivalents at beginning of period	3,341,678	7,054,537
Cash and cash equivalents at end of period	\$ 51,528,949	\$ 7,827,828

**Supplemental information to statement of cash flows:**



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Cash paid for interest	\$	10,744	\$	4,902
Income taxes paid		178,600		25,275
Net unrealized gain (loss) on investments		115		(10,521)
Common stock issued in connection with Integrated Data Systems, Inc. acquisition		1,999,791		

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**ONLINE RESOURCES CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION**

Online Resources Corporation (the Company) provides Internet technology services consisting of account presentation, payment, relationship management and professional services to financial services providers nationwide. The Company offers services, branded in the clients name, that integrate seamlessly into a single-vendor, end-to-end solution, supported by 24x7 customer care, targeted consumer marketing, training and other network and technical professional products and services. The Company currently operates in two business segments Banking and eCommerce ( banking ) and Card and Credit Services ( card ). The card segment is the result of the acquisition of Incurrent Solutions, Inc. ( Incurrent ) on December 22, 2004.

**INTERIM FINANCIAL INFORMATION**

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the consolidated financial statements include all adjustments necessary (which are of a normal and recurring nature) for the fair presentation of the results of the interim periods presented. These consolidated financial statements should be read in conjunction with our consolidated audited financial statements for the year ended December 31, 2004 included in the Annual Report on Form 10-K/A filed by the Company with the Securities and Exchange Commission on August 19, 2005. The results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

**2. RESTATEMENT**

On August 15, 2005, the Company concluded that the its financial statements for fiscal periods ending December 31, 2004 and 2003 and the first interim period of 2005 should be restated to reflect a change in its policy regarding unclaimed bill payment checks and correct its accounting treatment with regard to its prior policy.

In the third quarter of 2003, the Company adopted a policy to recognize stale bill payment checks as assets and began withdrawing funds related to certain stale unclaimed bill payment checks from an escrow account held for bill payments. The Company believed that there was a basis for making a claim of ownership of these funds for unclaimed bill payment checks after reviewing an appropriate legal analysis. Based on the length of time that the unclaimed checks were outstanding, the Company would withdraw the cash from the escrow accounts and record an asset with a corresponding liability. The Company then reduced the liability in accordance with FASB Statement No. 5, *Accounting for Contingencies*, based on an analysis of its payment history related to stale unclaimed bill payments with a corresponding reduction to payment processing costs. The amount by which payment processing costs were reduced from July 1, 2003 through March 31, 2005 totaled \$1.9 million. The Company has determined that under this policy, the liability for the unclaimed bill payments should not have been reduced as the liability was not legally extinguished under paragraph 16 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Under its revised policy, the Company will either return unclaimed funds to its financial institution clients or surrender the funds to the appropriate state escheat funds. The policy was revised to derive consistency with that of other bill payment providers, to take cognizance of changes occurring in the adoption of unclaimed property laws and to resolve issues regarding the manner in which the Company accounted for unclaimed bill payment funds following the adoption of its initial policy. As a result of this revised policy, the Company restated its financial statements, which resulted in a reduction to net income of \$1.0, \$0.7 and \$0.2 million and reduced earnings per share by \$0.05, \$0.04 and \$0.01 for the years ended December 31, 2004 and 2003 and the quarter ended March 31, 2005, respectively.

Unclaimed bill payment funds are now no longer reflected in the Company s statements of operations, nor do they contribute to its financial performance. Unclaimed bill payment funds no longer are used to reduce the Company s service costs, thereby resulting in a corresponding decrease in the Company s gross profits and net income. In addition,

the Company has accrued a liability equal to the cash it obtained subsequent to the adoption of its initial policy to reflect its obligation to either return funds to its clients or to surrender the funds in accordance with unclaimed property laws. This cash and the corresponding liability will remain on the Company's balance sheet until such funds have been disposed of in accordance with the new policy.

The following table sets forth the effects of the restatement on certain line items within the Company's consolidated statements of operations and comprehensive income for the three and nine months ended September 30, 2004:

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	<b>THREE MONTHS ENDED SEPTEMBER 30, 2004</b>		<b>NINE MONTHS ENDED SEPTEMBER 30, 2004</b>	
	<b>PREVIOUSLY</b>		<b>PREVIOUSLY</b>	
	<b>REPORTED</b>	<b>RESTATED</b>	<b>REPORTED</b>	<b>RESTATED</b>
Service costs	\$ 3,781,504	\$ 4,120,557	\$ 11,697,390	\$ 12,449,031
Gross profit	6,989,419	6,650,366	18,241,214	17,489,573
Income from operations	2,132,888	1,793,835	3,722,266	2,970,625
Net income	2,149,710	1,810,657	3,769,839	3,018,198
Net income per share:				
Basic	\$ 0.12	\$ 0.10	\$ 0.21	\$ 0.17
Diluted	\$ 0.11	\$ 0.09	\$ 0.19	\$ 0.15

### 3. RECLASSIFICATION

Certain amounts reported in prior periods have been reclassified to conform to the 2005 presentation.

### 4. ACQUISITIONS

#### *Incurrent*

On December 22, 2004, the Company completed the acquisition of Incurrent, a New Jersey corporation, pursuant to which Incurrent merged with and into the Company's wholly-owned subsidiary, Incurrent Acquisition LLC, a New Jersey limited liability company. The Company now operates the Incurrent business as its card division. Founded in 1997, Incurrent develops and operates advanced web-based products for financial institutions in the global payment card industry, including issuers of consumer, small business, purchasing, corporate and private label cards. Incurrent's products enhance the card issuers' relationship with their cardholders by allowing the issuers to achieve enhanced service and functionality on the Internet. Services provided by Incurrent include account, statement and transaction inquiry, account maintenance requests, payments, compliant statements and collections. The Company issued 1,000,014 shares of common stock to the Incurrent shareholders. The Company paid to, and for the benefit of, the Incurrent shareholders, approximately \$7.9 million in cash.

The Company's primary reasons for acquiring Incurrent were to allow the Company to enter a complementary vertical market, exploit potential product and customer synergies between the companies and acquire management for that business line. The value of this acquisition to the Company lay in what could be created by marketing new products to the card issuer community and through layering its technology onto the Incurrent platform.

The acquisition has been accounted for using the purchase method of accounting. The purchase price was allocated to the estimated fair value of the assets acquired and liabilities assumed. The estimated fair value of the tangible assets acquired and liabilities assumed approximated the historical basis. Incurrent lacked significant intangible assets other than its customer list, technology and employee base. Identified values were assigned for the customer list and technology and the identified value assigned to the employee base was included in goodwill. No other significant intangible assets were identified or included in goodwill. The Company engaged a qualified, independent valuation firm to identify and value any intangible assets acquired in the transaction.

The preliminary purchase price allocation to identifiable intangible assets was \$1.6 million and goodwill was \$11.6 million. The identifiable intangible assets will be amortized on a straight-line basis over the estimated useful life of five years.

**Integrated Data Systems, Inc. ( IDS )**

On June 27, 2005, the Company completed the acquisition of IDS, a California corporation, pursuant to which IDS merged with and into the Company's wholly-owned subsidiary, IDS LLC, a California limited liability company. The Company now operates the IDS business as part of its banking division. Founded in 1990, IDS is a privately held software development firm that develops and implements software applications for credit unions and other financial institutions. The acquisition adds approximately 30 employees and facilities in Woodland Hills, California and Pleasanton, California.

The Company's primary reasons for acquiring IDS were to acquire additional distribution and complimentary software products and to exploit the potential product synergies between the companies and to acquire management for that business line. The value of this acquisition to the Company lay in what could be created by exploiting the potential product synergies between the two companies.

The Company issued 181,108 shares of common stock to the IDS shareholders. The Company paid to, and for the benefit of, the IDS shareholders, approximately \$3.3 million in cash. The acquisition has been accounted for using the purchase method of accounting. The purchase price was allocated to the estimated fair value of the assets acquired and liabilities assumed. The estimated fair value of the tangible assets acquired and liabilities assumed approximated the historical basis. IDS lacked significant intangible assets other than its customer list, non-compete covenants, technology and employee base. Identified values were assigned for the customer list, non-compete covenants and technology, and the identified value assigned to the employee base was included in goodwill. No other significant intangible assets were identified or included in goodwill. The Company engaged a qualified, independent valuation firm to identify and value any intangible assets acquired in the transaction.

The preliminary purchase price allocation to identifiable intangible assets was \$1.2 million and goodwill was \$4.7 million. The identifiable assets will be amortized on a straight-line basis over the estimated useful life of five years.

The results of operations for IDS are included in the unaudited consolidated statements of operations beginning July 1, 2005. The financial information in the table below summarizes the results of operations of the Company and IDS on a pro forma basis, as though the companies had been combined as of the beginning of the periods being presented. This pro forma information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved had the acquisition actually taken place as of the beginning of the period being presented.

	<b>Three Months Ended</b>	<b>Nine Months Ended September</b>	
	<b>September 30,</b>	<b>30,</b>	
	<b>2004</b>	<b>2005</b>	<b>2004</b>
Revenues	\$ 11,950,329	\$ 46,138,226	\$ 33,048,353
Net income	\$ 1,774,132	\$ 4,451,083	\$ 2,314,242
Net income per share:			
Basic	\$ 0.10	\$ 0.19	\$ 0.13
Diluted	\$ 0.09	\$ 0.18	\$ 0.11

**5. REPORTABLE SEGMENTS**

The Company manages its business through two reportable segments: banking and card. On January 1, 2005 the Company established the card segment with the acquisition of Incurrent. The operating results of the business segments exclude the allocation of intangible asset amortization.

The results of operations from these reportable segments were as follows for the three and nine months ended September 30, 2005 and 2004:



	<b>UNALLOCATED EXPENSES</b>			
	<b>BANKING</b>	<b>CARD</b>	<b>(1)</b>	<b>TOTAL</b>
Three months ended September 30, 2005:				
Revenues	\$ 13,540,790	\$ 1,751,702	\$	\$ 15,292,492
Costs of revenues	4,952,544	1,029,032	91,140	6,072,716
Gross profit	8,588,246	722,670	(91,140)	9,219,776
Operating expenses	6,514,441	646,665	47,017	7,208,123
Income from operations	\$ 2,073,805	\$ 76,005	\$ (138,157)	\$ 2,011,653
Three months ended September 30, 2004:				
Revenues	\$ 11,046,654	\$	\$	\$ 11,046,654
Costs of revenues	4,396,288			4,396,288
Gross profit	6,650,366			6,650,366
Operating expenses	4,856,531			4,856,531
Income from operations	\$ 1,793,835	\$	\$	\$ 1,793,835
Nine months ended September 30, 2005:				
Revenues	\$ 38,511,276	\$ 6,222,203	\$	\$ 44,733,479
Costs of revenues	14,719,281	3,166,049	191,140	18,076,470
Gross profit	23,791,995	3,056,154	(191,140)	26,657,009
Operating expenses	18,754,048	2,162,589	103,997	21,020,634
Income from operations	\$ 5,037,947	\$ 893,565	\$ (295,137)	\$ 5,636,375
Nine months ended September 30, 2004:				
Revenues	\$ 30,882,479	\$	\$	\$ 30,882,479
Costs of revenues	13,392,906			13,392,906
Gross profit	17,489,573			17,489,573
Operating expenses	14,518,948			14,518,948
Income from operations	\$ 2,970,625	\$	\$	\$ 2,970,625

(1) Unallocated expenses are comprised of intangible asset amortization that is not included in the measure of

segment profit  
or loss used  
internally to  
evaluate the  
segments.

#### **6. SECONDARY OFFERING**

The Company completed the placement of 4,400,000 shares of its common stock on April 4, 2005 at a public offering price of \$8.50. The underwriters subsequently exercised their option to purchase an aggregate of 720,734 additional shares on April 29,2005. The Company generated net proceeds from the offering of approximately \$40 million, which it intends to use for acquisitions and accelerating development of products and services.

#### **7. STOCK BASED COMPENSATION**

The Company has accounted for stock option grants using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB No. 25 ), for stock-based compensation and to furnish the pro forma disclosures required under Statement of Financial Accounting Standards ( SFAS ) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* ( SFAS No. 148 ). In electing to continue to follow APB No. 25 for expense recognition purposes, the Company has provided below the expanded disclosures required under SFAS No. 148 for stock-based compensation granted, including, if materially different from reported results, disclosure of pro forma net earnings or losses and earnings or losses per share had compensation expense relating to grants been measured under the fair value recognition provisions of SFAS No. 123, *Accounting*