

NETZEE INC  
Form 10-K  
April 01, 2002

Table of Contents

---

---

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

---

**FORM 10-K**

(Mark One)

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

**For the fiscal year ended December 31, 2001**

**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: 0-27925**

**Netzee, Inc.**

(Exact name of registrant as specified in its charter)

---

**Georgia 58-2488883** (*State or other jurisdiction of incorporation or organization*) (*I.R.S. Employer*

*Identification No.*) **6190 Powers Ferry Road, Suite 400 30339 Atlanta,**

**Georgia** (*Zip Code*) (*Address of principal executive offices*)

Registrant's telephone number, including area code: **(770) 850-4000**

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

**None**

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

**Common Stock, no par value**

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

Edgar Filing: NETZEE INC - Form 10-K

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant as of March 25, 2002 is: \$919,668

The number of shares of Netzee, Inc. common stock outstanding as of March 25, 2002 was 3,377,911.

Documents incorporated by reference: The Registrant hereby incorporates by reference information required by Part III of this Form 10-K from its proxy statement to be filed with the Securities and Exchange Commission on or before April 30, 2002.

---

---

---

**TABLE OF CONTENTS**

INDEX

Part I

Item 1. Business

Item 2. Properties

Item 3. Legal Proceedings

Item 4. Submission of Matters to a Vote of Security Holders

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Item 6. Selected Financial Data

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 7A. Qualitative and Quantitative Disclosures Regarding Market Risk

Item 8. Financial Statements and Supplementary Data

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

PART III

Item 10. Directors and Executive Officers of the Registrant

Item 11. Executive Compensation

Item 12. Security Ownership Of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13. Certain Relationships and Related Transactions

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

SIGNATURES

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

CONSOLIDATED STATEMENTS OF OPERATIONS

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' (DEFICIT) EQUITY

CONSOLIDATED STATEMENTS OF CASH FLOWS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2nd Amendment to Registration Rights Agmt 3/29/02

Amendment No1 to Amended & Restated Credit Agmt

Severance Agreement

Subsidiaries of the Registrant

Consent of Arthur Andersen LLP

Letter Required by Temporary Note 3T

Schedule II to Consolidated Financial Statements

Report of Independent Public Accountants

---

**Table of Contents**

**INDEX**

	<b><u>Page</u></b>
<b>Part I:</b>	
Item 1.	
Business	1
Item 2.	
Properties	14
Item 3.	
Legal	
Proceedings	14
Item 4.	
Submission of	
Matters to a Vote of	
Security	
Holders	14
	<b>Part</b>
<b>II:</b>	
Item 5.	
Market for	
Registrant s	
Common Equity	
and Related	
Stockholder	
Matters	14
Item 6.	
Selected Financial	
Data	16
Item 7.	
Management s	
Discussion and	
Analysis of	
Financial Condition	
and Results of	
Operations	19
Item 7A	
Qualitative and	
Quantitative	
Disclosures	
Regarding Market	
Risk	41
Item 8.	
Financial	
Statements and	
Supplementary	
Data	41
Item 9.	
Changes in and	
Disagreements with	
Accountants on	
Accounting and	
Financial	
Disclosure	41
	<b>Part</b>
<b>III:</b>	

Item 10.

Directors and  
Executive Officers  
of the  
Registrant 41

Item 11.

Executive  
Compensation 41

Item 12.

Security  
Ownership of  
Certain Beneficial  
Owners and  
Management and  
Related Stockholder  
Matters 41

Item 13.

Certain  
Relationships and  
Related  
Transactions 42

**Part IV:**

Item 14.

Exhibits, Financial  
Statement Schedules  
and Reports on  
Form 8-K 42

**Table of Contents**

**Item 1. Business**

**Forward-Looking Statements**

This Form 10-K contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These statements include all statements that are not statements of historical fact regarding the intent, belief or expectations of Netzee, Inc. and our management. The words may, will, anticipate, believe, intend, expect, estimate, plan, strategy and similar expressions identify forward-looking statements. These statements are based upon a number of assumptions and estimates that are subject to significant uncertainties, many of which are beyond our control. These forward-looking statements are not guarantees of future performance, and actual results may differ materially from those projected in the forward-looking statements as a result of risks related to our brief operating history and our ability to achieve or maintain profitability; our ability to achieve, manage or maintain growth and execute our business strategy successfully; our ability to achieve our cash flow and cost-saving objectives; our dependence on developing, testing, implementing, and our ability to successfully market and sell, enhanced and new products and services; risks associated with possible system failures and rapid changes in technology; risks associated with previous and potential future security breaches; our ability to retain existing customers and execute agreements with new customers; our ability to sell our products and services to financial institution customers and their customers; our ability to respond to competition; the volatility associated with Internet-related companies; our ability to maintain our listing on the Nasdaq National Market; and various other factors discussed in detail in this Form 10-K, including the risks described in Management's Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Our Future Results of Operations and Financial Condition, and other periodic reports we file under the Exchange Act. We do not undertake any obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or future operating results.

**General**

We provide Internet-enabled software products to community financial institutions in the United States, generally with assets of less than \$10 billion. Our core Internet banking suite of products provides community financial institutions with additional channels to deliver services to their customers. As of December 31, 2001, we had 662 financial institution customers contracted for one of our core Internet banking products, of which 615 financial institution customers were implemented as of year-end 2001. These implemented financial institutions had more than 880,000 customers using our Internet banking products at December 31, 2001.

Our Internet banking products provide a cost-effective, secure and scalable solution that enables community financial institutions to offer their customers a wide array of financial products and services over the Internet, in either an in-house or fully outsourced environment. Among the services that can be offered with our suite of Internet banking products are commercial cash management, bill payment, brokerage, targeted marketing, portal and e-commerce marketplace services. These products and services are branded with the financial institution's own name and contain each institution's logo, colors and other distinctive branding characteristics. This branded solution enables community financial institutions to provide their customers with the convenience of Internet banking without losing the personal relationship and service associated with the local community financial institution. We also offer telephone banking products and services to allow community financial institutions an additional channel for communication with their customers. Our broad range of products and services are designed to enable a community financial institution to compete effectively with the services offered by both larger and Internet-based financial institutions.

We currently earn much of our revenues from recurring monthly service fees, flat monthly per user fees and per transaction charges. However, in November 2000, we began to offer an in-house Internet banking product, pursuant to which we earn up-front software license fees, implementation fees and recurring monthly fees based on active users and user-generated transactions. We also sell our in-house products under three- to five-year subscriptions that include annual subscription and maintenance fees.



## **Table of Contents**

We are focused on increasing our community financial institution customer base, expanding relationships with our existing community financial institution customers, and increasing the penetration of our products and services within the community financial institution customer base.

### **Formation of Netzee**

Netzee was formed as a Georgia corporation in August 1999 to be merged with Direct Access Interactive, Inc. ( Direct Access or the Predecessor ), a company that was formed in October 1996 to provide Internet and telephone banking products and services. InterCept, Inc. ( InterCept ) acquired Direct Access in March 1999 as a wholly-owned subsidiary. InterCept currently owns approximately 28% of our common stock.

In August 1999, Direct Access acquired SBS Corporation ( SBS ) in a merger. Immediately after the merger, Direct Access sold all of the assets of SBS, other than its Internet and telephone banking assets, to our former parent company, InterCept. Based in Birmingham, Alabama, SBS provided automated technology products and services, including Internet and telephone banking systems, to community financial institutions nationwide.

In September 1999, Direct Access was merged into Netzee, with Netzee being the surviving corporation. At the same time, Netzee acquired the Internet banking divisions of each of TIB-The Independent BankersBank ( TIB ), a Texas state chartered and Federal Reserve member bank, and The Bankers Bank, a Georgia state chartered and Federal Reserve member bank (collectively, the Divisions ). Each of these entities is a bankers bank, which is a bank that exclusively serves and is owned by community financial institutions. Certain of these acquired assets were written down in 2000.

In September 1999, Netzee also acquired all of the ownership interests in Call Me Bill, LLC ( Call Me Bill ). Based in Elizabethtown, Kentucky, Call Me Bill provided 24-hour electronic bill payment services to financial institutions customers. Subsequently, we integrated these services into our core Internet banking product. In May 2001, we sold a portion of these assets to iPay, LLC ( iPay ).

In September 1999, Netzee also acquired Dyad Corporation ( Dyad ). Based in Norcross, Georgia, Dyad developed, among other things, proprietary loan application, approval and fulfillment software. These acquired assets were written off during 2000.

In December 1999, a wholly-owned subsidiary of Netzee acquired certain of the assets and liabilities of DPSC Software, Inc. ( DPSC ). Located near Los Angeles, California, DPSC provided regulatory reporting and support applications designed to meet the special needs of community financial institutions. In February 2001, we sold substantially all of these assets to InterCept.

In March 2000, Netzee acquired certain assets and assumed certain liabilities of Digital Visions, Inc. ( DVI ). Based in Minneapolis, Minnesota, DVI provided Internet based financial information tools for community financial institutions. These assets were used to provide certain wholesale applications to community financial institutions. Certain of these acquired assets were written down and we subsequently sold substantially all of the assets we acquired from DVI to SS&C Technologies, Inc. ( SS&C ) in November 2001.

In July 2000, Netzee acquired certain assets and assumed certain liabilities of Card Plus, Inc. ( Card Plus ). Based in Norcross, Georgia, Card Plus provided outsourced software and systems development and related consulting services. These acquired assets were written off during 2001.

In November 2000, Netzee acquired certain assets and assumed certain liabilities from John H. Harland Company ( Harland ). The assets acquired were principally located in Trumbull, Connecticut and Portland, Oregon and are used

to provide Internet banking and bill payment services. This acquisition allows us to offer an in-house Internet banking product to our customers that already have established more extensive network infrastructures. As a result of this purchase, Harland currently owns approximately 16% of our common stock.

## **Table of Contents**

In March 2001, we purchased certain assets of HomeCom Communications, Inc. ( HomeCom ) Internet banking business and assumed certain of HomeCom's operating liabilities related to the business. The assets acquired were principally located in Atlanta, Georgia and are used to provide Internet banking services.

## **Nasdaq Delisting**

Because our common stock is currently listed on the Nasdaq National Market, we are subject to financial and market-related tests and other qualitative standards established by Nasdaq to maintain our listing. On February 14, 2002 we received notification from The Nasdaq Stock Market indicating that we were out of compliance with the \$5 million minimum market value requirement for our publicly held shares. We have been given 90 calendar days, or until May 15, 2002, to come into compliance with this requirement, which would require our publicly held shares to maintain a minimum market value of \$5 million for a minimum of 10 consecutive trading days during that period. If we fail to meet this requirement, we will become subject to delisting from The Nasdaq National Market, at which time we can appeal the delisting to the Nasdaq Listing Qualifications Panel. It is likely that we will be delisted from the Nasdaq National Market. In addition, we also have the option of applying to transfer our common stock to The Nasdaq SmallCap Market, where we also would have to satisfy continued inclusion requirements for that market. These requirements include maintaining certain levels of shareholders' equity, minimum bid price and market value, which we may not be able to achieve.

## **Industry Overview**

### *The Internet and E-Commerce*

The Internet has emerged as the fastest growing global communications and transactional medium in history, and continues to dramatically change the way people and businesses share information and conduct commerce. According to eMarketer, a leading provider of Internet and e-business statistics, Internet usage is expected to increase in the United States from 116.5 million users in 2000 to 167.0 million users in 2004. This continuing growth in Internet usage is being driven by a number of factors, including:

- an expanding base of personal computers in the home and workplace;
- an increasing general awareness of the Internet and e-commerce among consumer and business users;
- improvements in network and communications infrastructure and security;
- easier, faster and less expensive access to the Internet and commercial on-line services; and
- the introduction of alternative Internet-enabled devices, such as televisions, hand-held computers and Internet-enabled cellular phones.

Businesses have also embraced the Internet as an important means of communicating and conducting transactions. Many companies' web sites are interactive and transaction-based, enabling them to provide a wide range of e-commerce applications. eMarketer estimates that revenue from business to consumer e-commerce in the United States will increase from approximately \$27.3 billion in 2000 to more than \$109.4 billion in 2005, a compound annual growth rate of approximately 32%.

### *Internet Banking*

Consumers, businesses and financial institutions are recognizing that the Internet is a powerful and efficient medium for the delivery of banking services. These services include Internet banking, bill payment, bill presentment and other services for individuals, and cash management, payroll and other services for the commercial customers of financial institutions. Consumers and small businesses are increasing their demand for Internet banking as a convenient and cost-effective method to monitor financial accounts and transact business 24 hours a day, seven days a week. Additionally, unlike PC banking which requires the user to load software onto their computers, Internet banking provides the flexibility to perform a wide range of transactions from any personal computer or Internet-enabled device. According to Juniper Media Metrics, a leading provider of statistical Internet usage information, there were 14.6 million users of Internet banking services in

## **Table of Contents**

the United States at the end of 2000, and it is expected that the number of users will reach 43.5 million by 2005.

In addition to customer demand, financial institutions are motivated to provide Internet banking solutions to retain existing customers, attract new customers, provide additional non-interest sources of revenues and reduce costs. Financial institutions have been faced with the loss of their traditional customer base due in part to customer demand for comprehensive financial services from a single provider. The Internet provides the platform to market traditional banking products and services and the flexibility to expand into non-traditional banking services, such as brokerage, insurance and bill presentment services. Internet banking also allows a financial institution to collect and analyze customer data for use in targeted marketing programs.

### *Internet Banking for Community Financial Institutions*

The Office of the Comptroller of the Currency reported that every national bank with assets of more than \$10 billion offered Internet banking, as compared to only 7% of the smallest banks, those with assets less than \$100 million. According to the Federal Deposit Insurance Corporation and the National Credit Union Administration, there are approximately 8,000 banks, 1,500 thrifts and 10,000 credit unions in the United States with assets of less than \$10 billion each. As a result of the adoption of Internet banking services by their larger competitors and the growth of e-commerce, community financial institutions remain under increasing pressure to offer Internet-based individual and commercial banking services. Community financial institutions realize that if their product and service offerings are inadequate, they risk losing customers to larger institutions, Internet-only banks, investment and brokerage companies, retailers, insurance companies or locally competitive community financial institutions that offer these services.

Community financial institutions face many hurdles in providing a comprehensive Internet banking solution to their individual and commercial banking customers. In particular, competition from other banks and non-bank financial institutions has eroded profit margins and has forced community financial institutions to focus on reducing non-interest related costs. These institutions often lack the capital and human resources to develop and maintain the necessary technology and infrastructure to design the desired on-line banking services in-house and to provide integrated customer support for these services.

Because of these capital and human resources constraints, we believe that many community financial institutions require a low-cost, outsourced Internet-based banking solution. This solution must be implemented rapidly and cost-effectively and must interface with the institution's existing core processing systems. A community financial institution's Internet banking system must be secure, reliable and scalable. In addition, the Internet solution must provide the flexibility to add new products and services, such as e-commerce and other non-traditional banking service offerings.

## **The Netzee Solution**

We provide products and services that fulfill the Internet-based needs of community financial institutions. Our suite provides Internet banking and e-commerce solutions that enable community financial institutions to offer to their customers a wide array of financial products and services over the Internet.

Our Internet-based suite gives community financial institutions the ability to provide the convenience of on-line banking services while maintaining personal relationships and affording quality service to their customers. Netzee's suite of products and services consists of our core Internet banking solution, as well as commercial cash management, bill payment, brokerage, targeted marketing, portal and e-commerce functionality. Each community financial institution can choose the products and services that best fit its customers and internal requirements and can easily

customize our system to add new or different functions. These software products interface with a community financial institution's existing computer hardware and core processing systems. They can be installed and operated within our data center in a fully outsourced mode, or installed and operated in-house at a community financial institution. In connection with our suite, we offer web site design and hosting, product implementation and continuing service and support.

## **Table of Contents**

Each community financial institution can create a customized and branded Internet banking system, with its own trademarks, logo, colors and other distinctive features. Our web site design team creates fully interactive and customized web sites for our community financial institution customers. Working closely with the customer, the team designs a web site to incorporate the form and functionality required by the community financial institution, including the integration of the financial institution's proprietary and value-added financial services such as logos and other branding methods, application forms, financial calculators and links to other web sites. We offer basic web site development services without additional charge and provide additional enhancement, customization, web portal and design services for a fee.

We provide all of the proprietary software and the hardware necessary to operate our Internet-banking products in an outsourced, service bureau environment. Community financial institutions that use our outsourced products do not need to develop or purchase in-house software, purchase or maintain expensive equipment, or hire a technical staff. Our data centers contain the web servers, computers, data storage, retrieval and security systems, and support personnel necessary to operate our outsourced Internet-based products. Compared to in-house products, our outsourced product can significantly reduce the time and expense necessary for a financial institution to implement, upgrade and support Internet-based products.

We also provide an in-house version of our suite of products and services to allow financial institutions with more extensive levels of infrastructure to operate, maintain and support our products and services in the financial institution's own data center.

We are able to integrate our products and services with a community financial institution's core processing systems. Our Internet-banking systems are designed to work with different types of core processing software and data processing services. At present, we have successfully installed Internet banking products and services that interface with over 50 different core-processing environments. Further, we believe that we have the ability to interface our products with many other core processing systems with nominal effort and expense. For a typical Internet banking system installation, the implementation period currently averages approximately 60 to 90 days.

Security plays a key role in the successful installation and operation of both our outsourced and in-house products. Our data centers employ various data and session security measures, including data security detection systems, firewalls and advanced session termination technology. Additionally, access to our data centers is physically controlled and monitored with swipe-card door entry and 24-hour video surveillance systems. The data centers also undergo various penetration and vulnerability reviews by our full-time security staff, as well as by outside security consultants. Customers of our in-house products are responsible for maintaining the network and physical security of their Internet banking system, although we recommend that they adopt similar security measures as are used within our data centers.

## **Products and Services**

### *Internet Banking*

Our core Internet banking product is designed to provide our community financial institution customers an additional channel to offer products and services to their customers. Through our Internet banking product, a community financial institution can offer its customers access to the following services on-line 24 hours per day, seven days per week:

*Account Information.* Customers can view balance information for checking and savings accounts, certificates of deposit, lines of credit, and loans. Customers can also view year-to-date interest accrued or paid, interest rates and

deposit maturity dates.

*Funds Transfer.* Customers can transfer funds among accounts.

*Compatibility with Personal Financial Management Software.* Customers can download their account information into popular personal financial management software, such as Quicken® and Microsoft Money®.



**Table of Contents**

*U.S. Patriot Bonds (formerly known as U.S. Series EE Savings Bonds).* Customers can purchase U.S. Patriot Bonds.

*Secure Messaging.* Customers can communicate with a financial institution through secure, encrypted message systems.

*Additional Features.* Customers can reorder paper checks, view images of cleared checks, request an account statement or contact financial institution personnel by e-mail.

*Cash Management.* For the commercial customers of the financial institution, we also offer a commercial cash management product. This allows the financial institution to offer various treasury management functions via the Internet. Business customers can monitor their accounts, process payroll, make tax payments, stop payments, execute wire transfers and order coins and currency. We provide full automated clearing house, or ACH, capabilities including origination and importation of National Automated Clearing House Association, or NACHA, formatted files.

*Bill Payment.* Our bill payment product allows our financial institution customers to offer their customers an electronic bill payment service. Our bill payment products permit the payment of both recurring and non-recurring bills via the Internet 24 hours a day, seven days a week. Our bill payment product provides financial institutions with an additional mechanism for customer retention, as end users who initially set up their recurring payments through a financial institution are less apt to switch financial institutions.

*Online Brokerage Services.* Through our strategic relationship with STARfn, a provider of online financial services, we are able to offer our community financial institutions an online brokerage product. Community financial institutions are able to offer their customers brokerage services linked to their accounts at the community financial institution. The accounts do not require an initial funding, allowing the community financial institution to retain their customers' cash balances. Additionally, investment transactions are settled directly from and to the customer's account at the community financial institution.

*Targeted Marketing.* With our targeted marketing product, a financial institution customer can target products and services to its customers who would most likely buy them by dynamically classifying and profiling customer subsets in a real-time environment. This enables financial institutions to expand their traditional sales techniques in order to market and sell their products and services more effectively.

*Web Portal.* With our web portal product, a customer can make its home page look like a branded Internet portal by offering local news, weather, stock information and certain other content selections determined by the community financial institution. Additionally, the community financial institution's customers perceive that they are interacting with their community financial institution, rather than with a third party content provider. This allows the community financial institution to compete more effectively in its market, to improve its customer relations and to increase its customer base.

*E-commerce Marketplace.* Our e-commerce Marketplace product enables community financial institutions to create a branded virtual marketplace consisting of its commercial customers that agree to participate. Commercial customers are able to create a customized web page and list their goods and services for sale in a community environment centered around the community financial institution's Internet banking web site. This service provides an additional product offering for community financial institutions and an additional retention mechanism for a financial institution's commercial customers.

*Telephone Banking Product.* We offer a telephone banking product to provide a community financial institution's customers with convenient and safe access to information regarding their accounts from their homes or businesses at any time of day or night. Our telephone banking product provides functions similar to our core Internet banking

product. This product also allows the community financial institution to spend less time responding to routine account information requests.

Community financial institutions typically enter into three- to five-year contracts for our outsourced suite of products and services. Customers pay a monthly fee under these contracts, based upon the level of usage by their customers and the types of optional products and services utilized. We may charge additional fees for optional products and services that our customers elect to receive, such as consulting and marketing services.

**Table of Contents**

In-house installations are sold in the form of perpetual licenses that include an up-front software license fee, implementation fees and recurring monthly fees based on the number of active users and user generated transactions. In-house installations are also sold under three- to five-year subscriptions that include annual subscription fees and maintenance fees.

*Marketing Services*

We provide our financial institution customers with a marketing package designed to increase the number of their customers who use our Internet products and services. We generally charge fees for these services based upon the type and length of engagement. This marketing package includes the following services:

*Strategic Consulting Services.* We offer customized consulting services to community financial institutions to assist them in conducting effective in-branch and community-wide promotions of our Internet banking services.

*Advertising and Promotional Efforts.* We assist customers in advertising their on-line services. We also provide customers with in-branch marketing materials, such as brochures, banners, statement stuffers and other promotional items.

*Employee Training.* We assist our customers in educating their employees about the uses and benefits of Internet banking and Internet commerce. Our employee training guide also explains the financial and security features of on-line systems.

**The Netzee Strategy**

We provide an innovative gateway to the Internet by combining Internet banking products and services with e-commerce capabilities and other Internet based products. Community financial institutions can utilize these products and services to create new banking relationships and enhance relationships with their existing customers. Our goal is to become the leading provider of Internet banking and e-commerce products and services to community financial institutions. Our growth will be driven by both the adoption of our products by community financial institutions and the use of our suite by the customers of our community financial institution customers. Our strategy includes:

*Capitalizing on Strategic Marketing Alliances with InterCept, Harland and Other Partners.* We plan to increase our customer base through our strategic marketing alliances. Our existing strategic partners have business relationships with numerous financial institutions to which they assist us in marketing our Internet based products.

We have formed an exclusive strategic marketing alliance with InterCept, the owner of approximately 28% of our common stock and a provider of integrated electronic commerce products and services for community financial institutions. We also seek to leverage our relationship with Harland, the owner ofif; margin: 0pt 0; text-align: center">(underlying return =  
(130 – 100) / 100 = 30%)

120

(underlying return =  
(120 – 100) / 100 = 20%)

**No\$1,000Example 5**

75

(underlying return =  
 $(75 - 100) / 100 = -25\%$ )

80

(underlying return =  
 $(80 - 100) / 100 = -20\%$ )

**No\$1,000Example 6**

140

(underlying return =  
 $(140 - 100) / 100 = 40\%$ )

50

(underlying return =  
 $(50 - 100) / 100 = -50\%$ )

**Yes\$500Example 7**

20

(underlying return =  
 $(20 - 100) / 100 = -80\%$ )

60

(underlying return =  
 $(60 - 100) / 100 = -40\%$ )

**Yes\$200**

**Example 4:** On the final valuation date, the Russell 2000® Index has the lowest underlying return and, therefore, is the worst performing underlying on the final valuation date. In this scenario, the final underlying value of the worst performing underlying on the final valuation date is greater than its initial underlying value. Accordingly, at maturity, you would receive the stated principal amount of the securities, but you would not participate in the appreciation of any of the underlyings.

PS-4

Citigroup Global Markets Holdings Inc.

**Example 5:** On the final valuation date, the S&P 500® Index has the lowest underlying return and, therefore, is the worst performing underlying on the final valuation date. In this scenario, the final underlying value of the worst performing underlying on the final valuation date is less than its initial underlying value and a knock-in event has not occurred. Accordingly, at maturity, you would receive the stated principal amount of the securities.

**Example 6:** On the final valuation date, the Russell 2000® Index has the lowest underlying return and, therefore, is the worst performing underlying on the final valuation date. In this scenario, the final underlying value of the worst performing underlying on the final valuation date is less than its initial underlying value and a knock-in event has occurred. Accordingly, at maturity, you would receive a payment per security calculated as follows:

Payment at maturity = \$1,000 + (\$1,000 × the underlying return of the worst performing underlying on the final valuation date)

$$= \$1,000 + (\$1,000 \times -50\%)$$

$$= \$1,000 + -\$500$$

$$= \$500$$

In this scenario, because the final underlying value of the worst performing underlying on the final valuation date is less than its initial underlying value and a knock-in event has occurred, you would lose a significant portion of your investment in the securities. A knock-in event may occur on any scheduled trading day during the observation period. If a knock-in event occurs, you will have full downside exposure to the worst performing underlying on the final valuation date if its final underlying value is less than its initial underlying value.

**Example 7:** On the final valuation date, the S&P 500® Index has the lowest underlying return and, therefore, is the worst performing underlying on the final valuation date. In this scenario, the final underlying value of the worst performing underlying on the final valuation date is less than its initial underlying value and a knock-in event has occurred. Accordingly, at maturity, you would receive a payment per security calculated as follows:

Payment at maturity = \$1,000 + (\$1,000 × the underlying return of the worst performing underlying on the final valuation date)

$$= \$1,000 + (\$1,000 \times -80\%)$$

$$= \$1,000 + -\$800$$

$$= \$200$$

**It is possible that the closing value of the worst performing underlying will be less than its coupon barrier value on each valuation date and less than its initial underlying value on the final valuation date and a knock-in event occurs on any single scheduled trading day during the observation period, such that you will not receive any contingent coupon payments over the term of the securities and will receive less than the stated principal amount of your securities at maturity.**

PS-5

Citigroup Global Markets Holdings Inc.

## Summary Risk Factors

An investment in the securities is significantly riskier than an investment in conventional debt securities. The securities are subject to all of the risks associated with an investment in our conventional debt securities (guaranteed by Citigroup Inc.), including the risk that we and Citigroup Inc. may default on our obligations under the securities, and are also subject to risks associated with each underlying. Accordingly, the securities are suitable only for investors who are capable of understanding the complexities and risks of the securities. You should consult your own financial, tax and legal advisors as to the risks of an investment in the securities and the suitability of the securities in light of your particular circumstances.

The following is a summary of certain key risk factors for investors in the securities. You should read this summary together with the more detailed description of risks relating to an investment in the securities contained in the section “Risk Factors Relating to the Securities” beginning on page EA-7 in the accompanying product supplement. You should also carefully read the risk factors included in the accompanying prospectus supplement and in the documents incorporated by reference in the accompanying prospectus, including Citigroup Inc.’s most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q, which describe risks relating to the business of Citigroup Inc. more generally.

**You may lose some or all of your investment.** Unlike conventional debt securities, the securities do not provide for the repayment of the stated principal amount at maturity in all circumstances. If the securities are not automatically redeemed prior to maturity and a knock-in event has occurred, meaning the closing value of at least one of the underlyings was less than its knock-in value on at least one scheduled trading day during the period from but excluding the pricing date to and including the final valuation date, you will be fully exposed to any depreciation of the worst performing underlying on the final valuation date. If a knock-in event has occurred, you will lose 1% of the stated principal amount of the securities for every 1% by which the worst performing underlying has declined from its initial underlying value. There is no minimum payment at maturity on the securities, and you may lose up to all of your investment.

**You will not receive any contingent coupon on the contingent coupon payment date following any valuation date on which the closing value of the worst performing underlying on that valuation date is less than its coupon barrier value.** A contingent coupon payment will be made on a contingent coupon payment date if and only if the closing value of the worst performing underlying on the immediately preceding valuation date is greater than or equal to its coupon barrier value. If the closing value of the worst performing underlying on any valuation date is less than its coupon barrier value, you will not receive any contingent coupon payment on the immediately following contingent coupon payment date. If the closing value of the worst performing underlying on each valuation date is below its coupon barrier value, you will not receive any contingent coupon payments over the term of the securities.

**Higher contingent coupon rates are associated with greater risk.** The securities offer contingent coupon payments at an annualized rate that, if all are paid, would produce a yield that is generally higher than the yield on our conventional debt securities of the same maturity. This higher potential yield is associated with greater levels of

expected risk as of the pricing date for the securities, including the risk that you may not receive a contingent coupon payment on one or more, or any, contingent coupon payment dates and the risk that the value of what you receive at maturity may be significantly less than the stated principal amount of your securities and may be zero. The volatility of, and correlation between, the closing values of the underlyings are important factors affecting these risks. Greater expected volatility of, and lower expected correlation between, the closing values of the underlyings as of the pricing date may result in a higher contingent coupon rate, but would also represent a greater expected likelihood as of the pricing date that the closing value of the worst performing underlying on one or more valuation dates will be less than its coupon barrier value, such that you will not receive one or more, or any, contingent coupon payments during the term of the securities, and that the closing value of at least one underlying will be less than its knock-in value on any scheduled trading day during the observation period and less than its initial underlying value on the final valuation date, such that you will not be repaid the stated principal amount of your securities at maturity.

**The securities are subject to heightened risk because they have multiple underlyings.** The securities are more risky than similar investments that may be available with only one underlying. With multiple underlyings, there is a greater chance that any one underlying will perform poorly, adversely affecting your return on the securities.

**The securities are subject to the risks of each of the underlyings and will be negatively affected if any one underlying performs poorly.** You are subject to risks associated with each of the underlyings. If any one underlying performs poorly, you will be negatively affected. The securities are not linked to a basket composed of the underlyings, where the blended performance of the underlyings would be better than the performance of the worst performing underlying alone. Instead, you are subject to the full risks of whichever of the underlyings is the worst performing underlying.

**You will not benefit in any way from the performance of any better performing underlying.** The return on the securities depends solely on the performance of the worst performing underlying, and you will not benefit in any way from the performance of any better performing underlying.

**You will be subject to risks relating to the relationship between the underlyings.** It is preferable from your perspective for the underlyings to be correlated with each other, in the sense that their closing values tend to increase or decrease at similar times and by similar magnitudes. By investing in the securities, you assume the risk that the underlyings will not exhibit this relationship. The less correlated the underlyings, the more likely it is that any one of the underlyings will perform poorly over the term of the securities. All that is necessary for the securities to perform poorly is for one of the underlyings to perform poorly. It is impossible

PS-6



Citigroup Global Markets Holdings Inc.

to predict what the relationship between the underlyings will be over the term of the securities. The underlyings differ in significant ways and, therefore, may not be correlated with each other.

**You may not be adequately compensated for assuming the downside risk of the worst performing underlying.**

The potential contingent coupon payments on the securities are the compensation you receive for assuming the downside risk of the worst performing underlying, as well as all the other risks of the securities. That compensation is effectively “at risk” and may, therefore, be less than you currently anticipate. First, the actual yield you realize on the securities could be lower than you anticipate because the coupon is “contingent” and you may not receive a contingent coupon payment on one or more, or any, of the contingent coupon payment dates. Second, the contingent coupon payments are the compensation you receive not only for the downside risk of the worst performing underlying, but also for all of the other risks of the securities, including the risk that the securities may be automatically redeemed prior to maturity, interest rate risk and our and Citigroup Inc.’s credit risk. If those other risks increase or are otherwise greater than you currently anticipate, the contingent coupon payments may turn out to be inadequate to compensate you for all the risks of the securities, including the downside risk of the worst performing underlying.

**The securities may be automatically redeemed prior to maturity, limiting your opportunity to receive contingent coupon payments.**

On any potential autocall date, the securities will be automatically called for redemption if the closing value of the worst performing underlying on that potential autocall date is greater than or equal to its initial underlying value. As a result, if the worst performing underlying performs in a way that would otherwise be favorable, the securities are likely to be automatically redeemed, cutting short your opportunity to receive contingent coupon payments. If the securities are automatically redeemed prior to maturity, you may not be able to reinvest your funds in another investment that provides a similar yield with a similar level of risk.

**The securities offer downside exposure to the worst performing underlying, but no upside exposure to any underlying.**

You will not participate in any appreciation in the value of any underlying over the term of the securities. Consequently, your return on the securities will be limited to the contingent coupon payments you receive, if any, and may be significantly less than the return on any underlying over the term of the securities.

**You will not receive dividends or have any other rights with respect to the underlyings.**

You will not receive any dividends with respect to the underlyings. This lost dividend yield may be significant over the term of the securities. The payment scenarios described in this pricing supplement do not show any effect of such lost dividend yield over the term of the securities. In addition, you will not have voting rights or any other rights with respect to the underlyings.

**The securities are particularly sensitive to the volatility in the closing values of the underlyings on or near the valuation dates.**

Whether the contingent coupon will be paid on any given contingent coupon payment date and whether the securities will be automatically redeemed prior to maturity will depend on the closing values of the underlyings solely on the applicable valuation dates, regardless of the closing values of the underlyings on other days during the term of the securities. If the securities are not automatically redeemed prior to maturity and a knock-in event occurs on any single scheduled trading day during the observation period, what you receive at maturity will depend solely on the closing value of the worst performing underlying on the final valuation date, and not on any other day during the term of the securities. Because the performance of the securities depends on the closing values of

the underlyings on a limited number of dates, and because a knock-in event may occur on any single scheduled trading day during the observation period, the securities will be particularly sensitive to volatility in the closing values of the underlyings on or near the valuation dates. You should understand that the closing value of each underlying has historically been highly volatile.

**The securities are subject to the credit risk of Citigroup Global Markets Holdings Inc. and Citigroup Inc.** If we default on our obligations under the securities and Citigroup Inc. defaults on its guarantee obligations, you may not receive anything owed to you under the securities.

**The securities will not be listed on any securities exchange and you may not be able to sell them prior to maturity.** The securities will not be listed on any securities exchange. Therefore, there may be little or no secondary market for the securities. CGMI currently intends to make a secondary market in relation to the securities and to provide an indicative bid price for the securities on a daily basis. Any indicative bid price for the securities provided by CGMI will be determined in CGMI's sole discretion, taking into account prevailing market conditions and other relevant factors, and will not be a representation by CGMI that the securities can be sold at that price, or at all. CGMI may suspend or terminate making a market and providing indicative bid prices without notice, at any time and for any reason. If CGMI suspends or terminates making a market, there may be no secondary market at all for the securities because it is likely that CGMI will be the only broker-dealer that is willing to buy your securities prior to maturity. Accordingly, an investor must be prepared to hold the securities until maturity.

**The estimated value of the securities on the pricing date, based on CGMI's proprietary pricing models and our internal funding rate, is less than the issue price.** The difference is attributable to certain costs associated with selling, structuring and hedging the securities that are included in the issue price. These costs include (i) any selling concessions or other fees paid in connection with the offering of the securities, (ii) hedging and other costs incurred by us and our affiliates in connection with the offering of the securities and (iii) the expected profit (which may be more or less than actual profit) to CGMI or other of our affiliates in connection with hedging our obligations under the securities. These costs adversely affect the economic terms of the securities because, if they were lower, the economic terms of the securities would be more favorable to you. The economic terms of the securities are also likely to be adversely affected by the use of our internal funding rate, rather than our secondary market rate, to price the securities. See "The estimated value of the securities would be lower if it were calculated based on our secondary market rate" below.

PS-7

Citigroup Global Markets Holdings Inc.

**The estimated value of the securities was determined for us by our affiliate using proprietary pricing models.** CGMI derived the estimated value disclosed on the cover page of this pricing supplement from its proprietary pricing models. In doing so, it may have made discretionary judgments about the inputs to its models, such as the volatility of, and correlation between, the closing values of the underlyings, dividend yields on the underlyings and interest rates. CGMI's views on these inputs may differ from your or others' views, and as an underwriter in this offering, CGMI's interests may conflict with yours. Both the models and the inputs to the models may prove to be wrong and therefore not an accurate reflection of the value of the securities. Moreover, the estimated value of the securities set forth on the cover page of this pricing supplement may differ from the value that we or our affiliates may determine for the securities for other purposes, including for accounting purposes. You should not invest in the securities because of the estimated value of the securities. Instead, you should be willing to hold the securities to maturity irrespective of the initial estimated value.

**The estimated value of the securities would be lower if it were calculated based on our secondary market rate.** The estimated value of the securities included in this pricing supplement is calculated based on our internal funding rate, which is the rate at which we are willing to borrow funds through the issuance of the securities. Our internal funding rate is generally lower than our secondary market rate, which is the rate that CGMI will use in determining the value of the securities for purposes of any purchases of the securities from you in the secondary market. If the estimated value included in this pricing supplement were based on our secondary market rate, rather than our internal funding rate, it would likely be lower. We determine our internal funding rate based on factors such as the costs associated with the securities, which are generally higher than the costs associated with conventional debt securities, and our liquidity needs and preferences. Our internal funding rate is not an interest rate that is payable on the securities.

Because there is not an active market for traded instruments referencing our outstanding debt obligations, CGMI determines our secondary market rate based on the market price of traded instruments referencing the debt obligations of Citigroup Inc., our parent company and the guarantor of all payments due on the securities, but subject to adjustments that CGMI makes in its sole discretion. As a result, our secondary market rate is not a market-determined measure of our creditworthiness, but rather reflects the market's perception of our parent company's creditworthiness as adjusted for discretionary factors such as CGMI's preferences with respect to purchasing the securities prior to maturity.

**The estimated value of the securities is not an indication of the price, if any, at which CGMI or any other person may be willing to buy the securities from you in the secondary market.** Any such secondary market price will fluctuate over the term of the securities based on the market and other factors described in the next risk factor. Moreover, unlike the estimated value included in this pricing supplement, any value of the securities determined for purposes of a secondary market transaction will be based on our secondary market rate, which will likely result in a lower value for the securities than if our internal funding rate were used. In addition, any secondary market price for the securities will be reduced by a bid-ask spread, which may vary depending on the aggregate stated principal amount of the securities to be purchased in the secondary market transaction, and the expected cost of unwinding related hedging transactions. As a result, it is likely that any secondary market price for the securities will be less than the issue price.

**The value of the securities prior to maturity will fluctuate based on many unpredictable factors.** The value of your securities prior to maturity will fluctuate based on the closing values of the underlyings, the volatility of, and correlation between, the closing values of the underlyings, dividend yields on the underlyings, interest rates generally, the time remaining to maturity and our and Citigroup Inc.'s creditworthiness, as reflected in our secondary market rate, among other factors described under "Risk Factors Relating to the Securities—Risk Factors Relating to All Securities—The value of your securities prior to maturity will fluctuate based on many unpredictable factors" in the accompanying product supplement. Changes in the closing values of the underlyings may not result in a comparable change in the value of your securities. You should understand that the value of your securities at any time prior to maturity may be significantly less than the issue price.

**Immediately following issuance, any secondary market bid price provided by CGMI, and the value that will be indicated on any brokerage account statements prepared by CGMI or its affiliates, will reflect a temporary upward adjustment.** The amount of this temporary upward adjustment will steadily decline to zero over the temporary adjustment period. See "Valuation of the Securities" in this pricing supplement.

**The Russell 2000® Index is subject to risks associated with small capitalization stocks.** The stocks that constitute the Russell 2000® Index are issued by companies with relatively small market capitalization. The stock prices of smaller companies may be more volatile than stock prices of large capitalization companies. These companies tend to be less well-established than large market capitalization companies. Small capitalization companies may be less able to withstand adverse economic, market, trade and competitive conditions relative to larger companies. Small capitalization companies are less likely to pay dividends on their stocks, and the presence of a dividend payment could be a factor that limits downward stock price pressure under adverse market conditions.

**Our offering of the securities is not a recommendation of any underlying.** The fact that we are offering the securities does not mean that we believe that investing in an instrument linked to the underlyings is likely to achieve favorable returns. In fact, as we are part of a global financial institution, our affiliates may have positions (including short positions) in the underlyings or in instruments related to the underlyings, and may publish research or express opinions, that in each case are inconsistent with an investment linked to the underlyings. These and other activities of our affiliates may affect the closing values of the underlyings in a way that negatively affects the value of and your return on the securities.

PS-8

Citigroup Global Markets Holdings Inc.

**The closing value of an underlying may be adversely affected by our or our affiliates' hedging and other trading activities.** We expect to hedge our obligations under the securities through CGMI or other of our affiliates, who may take positions in the underlyings or in financial instruments related to the underlyings and may adjust such positions during the term of the securities. Our affiliates also take positions in the underlyings or in financial instruments related to the underlyings on a regular basis (taking long or short positions or both), for their accounts, for other accounts under their management or to facilitate transactions on behalf of customers. These activities could affect the closing value of the underlyings in a way that negatively affects the value of and your return on the securities. They could also result in substantial returns for us or our affiliates while the value of the securities declines.

**We and our affiliates may have economic interests that are adverse to yours as a result of our affiliates' business activities.** Our affiliates engage in business activities with a wide range of companies. These activities include extending loans, making and facilitating investments, underwriting securities offerings and providing advisory services. These activities could involve or affect the underlyings in a way that negatively affects the value of and your return on the securities. They could also result in substantial returns for us or our affiliates while the value of the securities declines. In addition, in the course of this business, we or our affiliates may acquire non-public information, which will not be disclosed to you.

**The calculation agent, which is an affiliate of ours, will make important determinations with respect to the securities.** If certain events occur during the term of the securities, such as market disruption events and other events with respect to an underlying, CGMI, as calculation agent, will be required to make discretionary judgments that could significantly affect your return on the securities. In making these judgments, the calculation agent's interests as an affiliate of ours could be adverse to your interests as a holder of the securities. See "Risks Relating to the Securities—Risks Relating to All Securities—The calculation agent, which is an affiliate of ours, will make important determinations with respect to the securities" in the accompanying product supplement.

**Changes that affect the underlyings may affect the value of your securities.** The sponsors of the underlyings may at any time make methodological changes or other changes in the manner in which they operate that could affect the values of the underlyings. We are not affiliated with any such underlying sponsor and, accordingly, we have no control over any changes any such sponsor may make. Such changes could adversely affect the performance of the underlyings and the value of and your return on the securities.

**The U.S. federal tax consequences of an investment in the securities are unclear.** There is no direct legal authority regarding the proper U.S. federal tax treatment of the securities, and we do not plan to request a ruling from the Internal Revenue Service (the "IRS"). Consequently, significant aspects of the tax treatment of the securities are uncertain, and the IRS or a court might not agree with the treatment of the securities as described in "United States Federal Tax Considerations" below. If the IRS were successful in asserting an alternative treatment, the tax consequences of ownership and disposition of the securities might be materially and adversely affected. Moreover, as described in the accompanying product supplement under "United States Federal Tax Considerations," in 2007 the U.S. Treasury Department and the IRS released a notice requesting comments on various issues regarding the U.S. federal income tax treatment of "prepaid forward contracts" and similar instruments. While it is not clear whether the securities would be viewed as similar to the typical prepaid forward contract described in the notice, it is possible that any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the securities, including the

character and timing of income or loss recognized by U.S. investors, possibly with retroactive effect. You should read carefully the discussion under “United States Federal Tax Considerations” and “Risk Factors Relating to the Securities” in the accompanying product supplement and “United States Federal Tax Considerations” in this pricing supplement. You should also consult your tax adviser regarding the U.S. federal tax consequences of an investment in the securities, as well as tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Non-U.S. investors should note that persons having withholding responsibility in respect of the securities may withhold on any coupon payment paid to a non-U.S. investor, generally at a rate of 30%. To the extent that we have withholding responsibility in respect of the securities, we intend to so withhold.

In addition, Section 871(m) of the Internal Revenue Code of 1986, as amended (the “Code”), imposes a withholding tax of up to 30% on “dividend equivalents” paid or deemed paid to non-U.S. investors in respect of certain financial instruments linked to U.S. equities. In light of Treasury regulations, as modified by an IRS notice, that provide a general exemption for financial instruments issued prior to January 1, 2021 that do not have a “delta” of one, the securities should not be subject to withholding under Section 871(m). However, the IRS could challenge this conclusion.

We will not be required to pay any additional amounts with respect to amounts withheld.

PS-9

Citigroup Global Markets Holdings Inc.

### Information About the S&P 500® Index

The S&P 500® Index consists of the common stocks of 500 issuers selected to provide a performance benchmark for the large capitalization segment of the U.S. equity markets. It is calculated and maintained by S&P Dow Jones Indices LLC.

Please refer to the section “Equity Index Descriptions— The S&P U.S. Indices—The S&P 500® Index” in the accompanying underlying supplement for additional information.

We have derived all information regarding the S&P 500® Index from publicly available information and have not independently verified any information regarding the S&P 500® Index. This pricing supplement relates only to the securities and not to the S&P 500® Index. We make no representation as to the performance of the S&P 500® Index over the term of the securities.

The securities represent obligations of Citigroup Global Markets Holdings Inc. (guaranteed by Citigroup Inc.) only. The sponsor of the S&P 500® Index is not involved in any way in this offering and has no obligation relating to the securities or to holders of the securities.

### Historical Information

The closing value of the S&P 500® Index on April 30, 2019 was 2,945.83.

The graph below shows the closing value of the S&P 500® Index for each day such value was available from January 2, 2008 to April 30, 2019. We obtained the closing values from Bloomberg L.P., without independent verification. You should not take historical closing values as an indication of future performance.

### **S&P 500® Index – Historical Closing Values**

**January 2, 2008 to April 30, 2019**

PS-10

Citigroup Global Markets Holdings Inc.

### Information About the Russell 2000® Index

The Russell 2000® Index is designed to track the performance of the small capitalization segment of the U.S. equity market. All stocks included in the Russell 2000® Index are traded on a major U.S. exchange. It is calculated and maintained by FTSE Russell.

Please refer to the section “Equity Index Descriptions—The Russell Indices—The Russell~~2000~~® Index” in the accompanying underlying supplement for additional information.

We have derived all information regarding the Russell 2000® Index from publicly available information and have not independently verified any information regarding the Russell 2000® Index. This pricing supplement relates only to the securities and not to the Russell 2000® Index. We make no representation as to the performance of the Russell 2000® Index over the term of the securities.

The securities represent obligations of Citigroup Global Markets Holdings Inc. (guaranteed by Citigroup Inc.) only. The sponsor of the Russell 2000® Index is not involved in any way in this offering and has no obligation relating to the securities or to holders of the securities.

### Historical Information

The closing value of the Russell 2000® Index on April 30, 2019 was 1,591.211.

The graph below shows the closing value of the Russell 2000® Index for each day such value was available from January 2, 2008 to April 30, 2019. We obtained the closing values from Bloomberg L.P., without independent verification. You should not take historical closing values as an indication of future performance.

### **Russell 2000® Index – Historical Closing Values**

**January 2, 2008 to April 30, 2019**

PS-11



Citigroup Global Markets Holdings Inc.

## United States Federal Tax Considerations

You should read carefully the discussion under “United States Federal Tax Considerations” and “Risk Factors Relating to the Securities” in the accompanying product supplement and “Summary Risk Factors” in this pricing supplement.

Due to the lack of any controlling legal authority, there is substantial uncertainty regarding the U.S. federal tax consequences of an investment in the securities. In connection with any information reporting requirements we may have in respect of the securities under applicable law, we intend (in the absence of an administrative determination or judicial ruling to the contrary) to treat the securities for U.S. federal income tax purposes as prepaid forward contracts with associated coupon payments that will be treated as gross income to you at the time received or accrued in accordance with your regular method of tax accounting. In the opinion of our counsel, Davis Polk & Wardwell LLP, which is based on current market conditions, this treatment of the securities is reasonable under current law; however, our counsel has advised us that it is unable to conclude affirmatively that this treatment is more likely than not to be upheld, and that alternative treatments are possible.

Assuming this treatment of the securities is respected and subject to the discussion in “United States Federal Tax Considerations” in the accompanying product supplement, the following U.S. federal income tax consequences should result under current law:

Any coupon payments on the securities should be taxable as ordinary income to you at the time received or accrued in accordance with your regular method of accounting for U.S. federal income tax purposes.

Upon a sale or exchange of a security (including retirement at maturity), you should recognize capital gain or loss equal to the difference between the amount realized and your tax basis in the security. For this purpose, the amount realized does not include any coupon paid on retirement and may not include sale proceeds attributable to an accrued coupon, which may be treated as a coupon payment. Such gain or loss should be long-term capital gain or loss if you held the security for more than one year.

We do not plan to request a ruling from the IRS regarding the treatment of the securities, and the IRS or a court might not agree with the treatment described herein. In addition, the U.S. Treasury Department and the IRS have released a notice requesting comments on the U.S. federal income tax treatment of “prepaid forward contracts.” While it is not clear whether the securities would be viewed as similar to the typical prepaid forward contract described in the notice, it is possible that any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the securities, including the character and timing of income or loss, possibly with retroactive effect. You should consult your tax adviser regarding possible alternative tax treatments of the securities and potential consequences of the IRS notice.

**Withholding Tax on Non-U.S. Holders.** Because significant aspects of the tax treatment of the securities are uncertain, persons having withholding responsibility in respect of the securities may withhold on any coupon payment paid to Non-U.S. Holders (as defined in the accompanying product supplement), generally at a rate of 30%. To the extent that we have (or an affiliate of ours has) withholding responsibility in respect of the securities, we intend to so withhold. In order to claim an exemption from, or a reduction in, the 30% withholding, you may need to comply with certification requirements to establish that you are not a U.S. person and are eligible for such an exemption or reduction under an applicable tax treaty. You should consult your tax adviser regarding the tax treatment of the securities, including the possibility of obtaining a refund of any amounts withheld and the certification requirement described above.

Moreover, as discussed under “United States Federal Tax Considerations – Tax Consequences to Non-U.S. Holders – Possible Withholding Under Section 871(m) of the Code” in the accompanying product supplement, Section 871(m) of the Code and Treasury regulations promulgated thereunder (“Section 871(m)”) generally impose a 30% withholding tax on dividend equivalents paid or deemed paid to Non-U.S. Holders with respect to certain financial instruments linked to U.S. equities (“U.S. Underlying Equities”) or indices that include U.S. Underlying Equities. Section 871(m) generally applies to instruments that substantially replicate the economic performance of one or more U.S. Underlying Equities, as determined based on tests set forth in the applicable Treasury regulations (a “Specified Security”). However, the regulations, as modified by an IRS notice, exempt financial instruments issued prior to January 1, 2021 that do not have a “delta” of one. Based on the terms of the securities and representations provided by us, our counsel is of the opinion that the securities should not be treated as transactions that have a “delta” of one within the meaning of the regulations with respect to any U.S. Underlying Equity and, therefore, should not be Specified Securities subject to withholding tax under Section 871(m).

A determination that the securities are not subject to Section 871(m) is not binding on the IRS, and the IRS may disagree with this treatment. Moreover, Section 871(m) is complex and its application may depend on your particular circumstances. For example, if you enter into other transactions relating to a U.S. Underlying Equity, you could be subject to withholding tax or income tax liability under Section 871(m) even if the securities are not Specified Securities subject to Section 871(m) as a general matter. You should consult your tax adviser regarding the potential application of Section 871(m) to the securities.

We will not be required to pay any additional amounts with respect to amounts withheld.

**You should read the section entitled “United States Federal Tax Considerations” in the accompanying product supplement. The preceding discussion, when read in combination with that section, constitutes the full opinion of Davis Polk & Wardwell LLP regarding the material U.S. federal tax consequences of owning and disposing of the securities.**

**You should also consult your tax adviser regarding all aspects of the U.S. federal income and estate tax consequences of an investment in the securities and any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.**

PS-12

Citigroup Global Markets Holdings Inc.

### Supplemental Plan of Distribution

CGMI, an affiliate of Citigroup Global Markets Holdings Inc. and the underwriter of the sale of the securities, is acting as principal and will receive an underwriting fee of \$8.75 for each security sold in this offering. From this underwriting fee, CGMI will pay selected dealers not affiliated with CGMI a fixed selling concession of \$8.75 for each security they sell. For the avoidance of doubt, the fees and selling concessions described in this pricing supplement will not be rebated if the securities are automatically redeemed prior to maturity.

See “Plan of Distribution; Conflicts of Interest” in the accompanying product supplement and “Plan of Distribution” in each of the accompanying prospectus supplement and prospectus for additional information.

### Valuation of the Securities

CGMI calculated the estimated value of the securities set forth on the cover page of this pricing supplement based on proprietary pricing models. CGMI’s proprietary pricing models generated an estimated value for the securities by estimating the value of a hypothetical package of financial instruments that would replicate the payout on the securities, which consists of a fixed-income bond (the “bond component”) and one or more derivative instruments underlying the economic terms of the securities (the “derivative component”). CGMI calculated the estimated value of the bond component using a discount rate based on our internal funding rate. CGMI calculated the estimated value of the derivative component based on a proprietary derivative-pricing model, which generated a theoretical price for the instruments that constitute the derivative component based on various inputs, including the factors described under “Summary Risk Factors—The value of the securities prior to maturity will fluctuate based on many unpredictable factors” in this pricing supplement, but not including our or Citigroup Inc.’s creditworthiness. These inputs may be market-observable or may be based on assumptions made by CGMI in its discretionary judgment.

For a period of approximately three months following issuance of the securities, the price, if any, at which CGMI would be willing to buy the securities from investors, and the value that will be indicated for the securities on any brokerage account statements prepared by CGMI or its affiliates (which value CGMI may also publish through one or more financial information vendors), will reflect a temporary upward adjustment from the price or value that would otherwise be determined. This temporary upward adjustment represents a portion of the hedging profit expected to be realized by CGMI or its affiliates over the term of the securities. The amount of this temporary upward adjustment will decline to zero on a straight-line basis over the three-month temporary adjustment period. However, CGMI is not obligated to buy the securities from investors at any time. See “Summary Risk Factors—The securities will not be listed on any securities exchange and you may not be able to sell them prior to maturity.”

### Certain Selling Restrictions

Hong Kong Special Administrative Region

The contents of this pricing supplement and the accompanying product supplement, underlying supplement, prospectus supplement and prospectus have not been reviewed by any regulatory authority in the Hong Kong Special Administrative Region of the People's Republic of China ("Hong Kong"). Investors are advised to exercise caution in relation to the offer. If investors are in any doubt about any of the contents of this pricing supplement and the accompanying product supplement, underlying supplement, prospectus supplement and prospectus, they should obtain independent professional advice.

The securities have not been offered or sold and will not be offered or sold in Hong Kong by means of any document, other than

- (i) to persons whose ordinary business is to buy or sell shares or debentures (whether as principal or agent); or
- (ii) to "professional investors" as defined in the Securities and Futures Ordinance (Cap. 571) of Hong Kong (the "Securities and Futures Ordinance") and any rules made under that Ordinance; or

in other circumstances which do not result in the document being a "prospectus" as defined in the Companies (iii) Ordinance (Cap. 32) of Hong Kong or which do not constitute an offer to the public within the meaning of that Ordinance; and

There is no advertisement, invitation or document relating to the securities which is directed at, or the contents of which are likely to be accessed or read by, the public of Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to securities which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance.

Non-insured Product: These securities are not insured by any governmental agency. These securities are not bank deposits and are not covered by the Hong Kong Deposit Protection Scheme.

Singapore

This pricing supplement and the accompanying product supplement, underlying supplement, prospectus supplement and prospectus have not been registered as a prospectus with the Monetary Authority of Singapore, and the securities

will be offered pursuant to exemptions under the Securities and Futures Act, Chapter 289 of Singapore (the “Securities and Futures Act”). Accordingly, the securities may not be offered or sold or made the subject of an invitation for subscription or purchase nor may this pricing supplement or any other document or material in connection with the offer or sale or invitation for subscription or purchase of any securities be circulated or distributed, whether directly or indirectly, to any person in Singapore other than (a) to an institutional investor pursuant to Section 274 of the Securities and Futures Act, (b) to a relevant person under Section 275(1) of the Securities and Futures Act or to any

PS-13

Citigroup Global Markets Holdings Inc.

person pursuant to Section 275(1A) of the Securities and Futures Act and in accordance with the conditions specified in Section 275 of the Securities and Futures Act, or (c) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the Securities and Futures Act. Where the securities are subscribed or purchased under Section 275 of the Securities and Futures Act by a relevant person which is:

a corporation (which is not an accredited investor (as defined in Section 4A of the Securities and Futures Act)) the (a) sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or

a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an individual who is an accredited investor, securities (as defined in Section 239(1) of the Securities (b) and Futures Act) of that corporation or the beneficiaries' rights and interests (howsoever described) in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the relevant securities pursuant to an offer under Section 275 of the Securities and Futures Act except:

to an institutional investor or to a relevant person defined in Section 275(2) of the Securities and Futures Act or to (i) any person arising from an offer referred to in Section 275(1A) or Section 276(4)(i)(B) of the Securities and Futures Act; or

(ii) where no consideration is or will be given for the transfer; or

(iii) where the transfer is by operation of law; or

(iv) pursuant to Section 276(7) of the Securities and Futures Act; or

(v) as specified in Regulation 32 of the Securities and Futures (Offers of Investments) (Shares and Debentures) Regulations 2005 of Singapore.

Any securities referred to herein may not be registered with any regulator, regulatory body or similar organization or institution in any jurisdiction.

The securities are Specified Investment Products (as defined in the Notice on Recommendations on Investment Products and Notice on the Sale of Investment Product issued by the Monetary Authority of Singapore on 28 July 2011) that is neither listed nor quoted on a securities market or a futures market.

Non-insured Product: These securities are not insured by any governmental agency. These securities are not bank deposits. These securities are not insured products subject to the provisions of the Deposit Insurance and Policy Owners' Protection Schemes Act 2011 of Singapore and are not eligible for deposit insurance coverage under the Deposit Insurance Scheme.

#### Validity of the Securities

In the opinion of Davis Polk & Wardwell LLP, as special products counsel to Citigroup Global Markets Holdings Inc., when the securities offered by this pricing supplement have been executed and issued by Citigroup Global Markets Holdings Inc. and authenticated by the trustee pursuant to the indenture, and delivered against payment therefor, such securities and the related guarantee of Citigroup Inc. will be valid and binding obligations of Citigroup Global Markets Holdings Inc. and Citigroup Inc., respectively, enforceable in accordance with their respective terms, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith), provided that such counsel expresses no opinion as to the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law on the conclusions expressed above. This opinion is given as of the date of this pricing supplement and is limited to the laws of the State of New York, except that such counsel expresses no opinion as to the application of state securities or Blue Sky laws to the securities.

In giving this opinion, Davis Polk & Wardwell LLP has assumed the legal conclusions expressed in the opinions set forth below of Scott L. Flood, General Counsel and Secretary of Citigroup Global Markets Holdings Inc., and Barbara Politi, Assistant General Counsel—Capital Markets of Citigroup Inc. In addition, this opinion is subject to the assumptions set forth in the letter of Davis Polk & Wardwell LLP dated May 17, 2018, which has been filed as an exhibit to a Current Report on Form 8-K filed by Citigroup Inc. on May 17, 2018, that the indenture has been duly authorized, executed and delivered by, and is a valid, binding and enforceable agreement of, the trustee and that none of the terms of the securities nor the issuance and delivery of the securities and the related guarantee, nor the compliance by Citigroup Global Markets Holdings Inc. and Citigroup Inc. with the terms of the securities and the related guarantee respectively, will result in a violation of any provision of any instrument or agreement then binding upon Citigroup Global Markets Holdings Inc. or Citigroup Inc., as applicable, or any restriction imposed by any court or governmental body having jurisdiction over Citigroup Global Markets Holdings Inc. or Citigroup Inc., as applicable.

In the opinion of Scott L. Flood, Secretary and General Counsel of Citigroup Global Markets Holdings Inc., (i) the terms of the securities offered by this pricing supplement have been duly established under the indenture and the Board of Directors (or a duly authorized committee thereof) of Citigroup Global Markets Holdings Inc. has duly authorized the issuance and sale of such securities and such authorization has not been modified or rescinded; (ii) Citigroup Global Markets Holdings Inc. is validly existing and in good standing under the laws of the State of New York; (iii) the indenture has been duly authorized, executed and delivered by Citigroup Global Markets Holdings Inc.; and (iv) the execution and delivery of such indenture and of the securities offered by this pricing supplement by Citigroup Global Markets Holdings Inc., and the performance by Citigroup Global Markets Holdings Inc. of its obligations thereunder, are within its corporate powers and do not contravene its certificate of incorporation or bylaws or other constitutive documents. This opinion is given as of the date of this pricing supplement and is limited to the laws of the State of New York.



PS-14

Citigroup Global Markets Holdings Inc.

Scott L. Flood, or other internal attorneys with whom he has consulted, has examined and is familiar with originals, or copies certified or otherwise identified to his satisfaction, of such corporate records of Citigroup Global Markets Holdings Inc., certificates or documents as he has deemed appropriate as a basis for the opinions expressed above. In such examination, he or such persons has assumed the legal capacity of all natural persons, the genuineness of all signatures (other than those of officers of Citigroup Global Markets Holdings Inc.), the authenticity of all documents submitted to him or such persons as originals, the conformity to original documents of all documents submitted to him or such persons as certified or photostatic copies and the authenticity of the originals of such copies.

In the opinion of Barbara Politi, Assistant General Counsel—Capital Markets of Citigroup Inc., (i) the Board of Directors (or a duly authorized committee thereof) of Citigroup Inc. has duly authorized the guarantee of such securities by Citigroup Inc. and such authorization has not been modified or rescinded; (ii) Citigroup Inc. is validly existing and in good standing under the laws of the State of Delaware; (iii) the indenture has been duly authorized, executed and delivered by Citigroup Inc.; and (iv) the execution and delivery of such indenture, and the performance by Citigroup Inc. of its obligations thereunder, are within its corporate powers and do not contravene its certificate of incorporation or bylaws or other constitutive documents. This opinion is given as of the date of this pricing supplement and is limited to the General Corporation Law of the State of Delaware.

Barbara Politi, or other internal attorneys with whom she has consulted, has examined and is familiar with originals, or copies certified or otherwise identified to her satisfaction, of such corporate records of Citigroup Inc., certificates or documents as she has deemed appropriate as a basis for the opinions expressed above. In such examination, she or such persons has assumed the legal capacity of all natural persons, the genuineness of all signatures (other than those of officers of Citigroup Inc.), the authenticity of all documents submitted to her or such persons as originals, the conformity to original documents of all documents submitted to her or such persons as certified or photostatic copies and the authenticity of the originals of such copies.

Contact

Clients may contact their local brokerage representative. Third-party distributors may contact Citi Structured Investment Sales at (212) 723-7005.

© 2019 Citigroup Global Markets Inc. All rights reserved. Citi and Citi and Arc Design are trademarks and service marks of Citigroup Inc. or its affiliates and are used and registered throughout the world.

PS-15

gn="right" valign="bottom" nowrap> (3.13)

---

---

---

---

---

Basic and diluted net loss per share before cumulative effect of change in accounting principle(4)(6)  
(0.10) (0.35) (18.67) (34.81) (17.89)

**Table of Contents**

	Predecessor			Netzee, Inc.		
	Year Ended December 31, 1997	Year Ended December 31, 1998	For the Period from January 1, 1999 to February 28, 1999	For the Period from March 1, 1999 to December 31, 1999(1)	Year Ended December 31, 2000(2)	Year Ended December 31, 2001(3)
Loss per share from cumulative effect of change in accounting principle(4)(6)	—	—			(0.13)	—
Basic and diluted net loss per share(4)(6)	\$ (0.10)	\$ (0.35)		\$ (18.67)	\$ (34.94)	\$ (17.89)
Weighted average common shares outstanding(4)(5)(6)	1,000	1,000		1,443	2,781	3,355

- (1) On August 6, 1999, we acquired SBS in a transaction accounted for as a purchase, and its results of operations have been included in our consolidated financial statements since the date of acquisition. On September 3, 1999, we acquired Call Me Bill, Dyad and the Divisions, in transactions accounted for as purchases, and the results of operations of these acquisitions have been included in our consolidated financial statements since the date of acquisition. On December 15, 1999, we acquired certain assets and assumed certain liabilities from DPSC in a transaction accounted for as a purchase, and the results of operations of this acquisition have been included in our consolidated financial statements from the date of acquisition until the sale of such assets. See Note 3 of the Notes to Consolidated Financial Statements.
- (2) On March 7, 2000, we acquired certain assets and assumed certain liabilities from DVI in a transaction accounted for as a purchase, and its results of operations have been included in our consolidated financial statements since the date of acquisition. Effective July 1, 2000, we acquired certain assets and assumed certain liabilities from Card Plus in a transaction accounted for as a purchase, and its results of operations have been included in our consolidated financial statements since the effective date of acquisition. Effective November 1, 2000, we acquired certain assets and assumed certain liabilities from Harland in a transaction accounted for as a purchase, and the results of operations of this acquisition have been included in our consolidated financial statements since the effective date of acquisition. See Note 3 of the Notes to Consolidated Financial Statements.
- (3) On February 2, 2001, we sold to InterCept certain of the regulatory reporting assets acquired from DPSC in 1999, and InterCept assumed certain of the related operating liabilities, resulting in a loss on sales of assets included in our consolidated financial statements. On March 15, 2001, we purchased certain assets of HomeCom's Internet banking business and assumed certain of HomeCom's operating liabilities related to the business in a transaction accounted for as a purchase, and its results of operations have been included in our consolidated financial statements since the date of acquisition. Effective May 1, 2001, we sold to iPay certain assets related to a portion of our bill payment operations, and iPay assumed certain of the operating liabilities related to those assets. The transaction resulted in a gain on sales of assets included in our consolidated statement of operations. Effective November 1, 2001, we sold substantially all the assets acquired from DVI to SS&C, and SS&C assumed

substantially all the operating liabilities related to those assets. Additionally, during 2001, we determined that a triggering event had occurred in connection with our decision to sell certain assets we acquired from DVI, as well as the termination of customer contracts we acquired in our Card Plus acquisition. Consequently, the original cost bases of these assets were reduced to reflect their fair market value during 2001. The resulting losses were included in our consolidated financial statements. See Notes 3 and 4 of the Notes to Consolidated Financial Statements.

- (4) The number of weighted average common shares shown for the period from March 1, 1999 to December 31, 1999 is calculated by assuming a calculation period from January 1, 1999 to December 31, 1999. Basic and diluted net loss per share for the period from March 1, 1999 to December 31, 1999 is

18

---

**Table of Contents**

calculated from net loss for the period from January 1, 1999 to February 28, 1999 and the period from March 1, 1999 to December 31, 1999 divided by the number of weighted average common shares as noted.

- (5) The number of weighted average common shares outstanding for the years ended December 31, 1997 and 1998 reflects the initial investment of InterCept in the Predecessor. InterCept was the former parent company of the Predecessor and owned all of its capital stock prior to September 3, 1999.
- (6) All share and per share information has been adjusted to reflect the one-for-eight reverse stock split effected May 16, 2001.

Predecessor		Netzee, Inc.		
December 31,		December 31,		
1997	1998	1999	2000	2001

**Balance Sheet Data**  
(In thousands):

Cash and cash equivalents	\$28	\$14	\$11,255	\$960	\$465
Working (deficit) capital	(94)	(499)	4,798	(5,489)	(1,176)
Total assets	88	94	143,244	106,715	32,501
Redeemable preferred stock(1)	6,500	6,500	6,500		
Related party borrowings(2)	12,173	21,466	13,192		
Total shareholders (deficit) equity	(103)	(455)	113,880	63,090	5,232

- (1) Relates to our Series B preferred stock.
- (2) Related party borrowings related to our joint credit facility with InterCept and Harland.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Consolidated Financial Statements and the related notes and other financial information included elsewhere in this Annual Report. This discussion also contains certain forward-looking statements which are subject to, but not limited to, the risks and uncertainties included in Factors That May Affect Our Future Results of Operations or Financial Condition below and elsewhere in this Annual Report.

**Formation and Acquisitions**

We are a provider of integrated Internet banking products to financial institutions and their customers. We provide a suite of integrated Internet banking products and services and Internet commerce solutions to financial institutions. The suite provides cost-effective, outsourced, secure and scalable Internet banking and Internet commerce products that enable financial institutions to offer to their customers a wide array of financial products and services over the Internet. Included in the suite are full-service Internet banking, bill payment, cash management, targeted marketing, custom web site design and hosting, branded portal design, access to brokerage services as well as implementation and marketing services.

Netzee was formed as a Georgia corporation in August 1999 to be merged with Direct Access, a company that was formed in October 1996 to provide Internet and telephone banking products and services. InterCept acquired Direct Access as a wholly-owned subsidiary in March 1999.

In August 1999, Direct Access acquired SBS in a merger. Immediately after the merger, Direct Access sold all of the assets of SBS, other than its Internet and telephone banking assets, to our then parent company, InterCept. SBS provided automated technology products and services, including Internet and telephone banking systems, to community financial institutions nationwide.

In September 1999, Direct Access was merged into Netzee, with Netzee being the surviving corporation. At the same time, Netzee acquired the Divisions. In September 1999, Netzee also acquired all of the ownership interests in Call Me Bill, which provided 24-hour electronic and telephone bill payment services to

## **Table of Contents**

customers of financial institutions and property management companies. Subsequently, we integrated these services into our core Internet banking product. Effective May 1, 2001, we sold to iPay certain assets related to our bill payment operations.

In September 1999, Netzee also acquired Dyad, which developed proprietary loan application, approval and fulfillment software. Certain of the assets acquired from Dyad were written down in 2000.

In December 1999, a wholly-owned subsidiary of Netzee acquired certain of the assets and assumed certain liabilities of DPSC, which provided regulatory reporting and support applications designed to meet the needs of community financial institutions. In February 2001, we sold to InterCept substantially all of the regulatory reporting assets acquired from DPSC in 1999 and InterCept assumed substantially all of the related operating liabilities.

In March 2000, Netzee acquired certain of the assets and assumed certain liabilities of DVI, which provided Internet based financial information tools for community financial institutions. In November 2001, we sold substantially all DVI related assets to SS&C, and SS&C assumed substantially all of the related operating liabilities. Certain of these acquired assets were written down prior to the sale.

In July 2000, Netzee acquired certain of the assets and assumed certain of the liabilities of Card Plus, which provided outsourced software and systems development, and related consulting services. Certain of these acquired assets were written off during 2001.

In November 2000, Netzee acquired certain of the assets and assumed certain liabilities of Harland. These assets were used to provide Internet banking and bill payment services. This acquisition allowed us to offer an in-house Internet banking product to our customers that already have established more extensive network infrastructures. As a result of this purchase, Harland currently owns approximately 16% of our common stock.

During March 2001, Netzee acquired certain assets of HomeCom's Internet banking businesses and assumed certain of HomeCom's operating liabilities. These assets were used to provide Internet banking and related services.

We collectively refer to Call Me Bill, Card Plus, DPSC, DVI, Dyad, HomeCom, the Internet banking and bill payment assets of Harland, and the Internet and telephone banking operations of SBS and the Divisions as the Acquired Operations.

## **Overview**

For our outsourced suite of products and services, we charge a fixed monthly fee based on the number and type of products and services purchased by the financial institution. We also charge variable fees that are based on the number of end users and the number of transactions for certain products and services. We generally provide products and services under contracts with terms ranging from three to five years. Revenues from these types of arrangements are recognized over the term over which the related services are provided.

We charge fees for our in-house Internet banking product under either a perpetual license agreement which includes a software license fee, implementation fees and recurring monthly fees based on the number of active users and user generated transactions, or under a three to five-year subscription that includes annual subscription and maintenance fees. Revenues from the software and implementation component of those types of arrangements are recognized in accordance with Statement of Position ( SOP ) No. 97-2 Software Revenue Recognition and Staff Accounting Bulletin ( SAB ) No. 101, Revenue Recognition. Recurring fees represent post-contract customer support and are recognized over the period in which the support services are provided.



Our costs of services, license, hardware, implementation and maintenance are comprised of the initial equipment and personnel costs required to implement Internet and telephone banking products and services for our financial institution customers, ongoing personnel and system maintenance costs associated with our data and call centers, royalties paid to information providers, and personnel, production and shipping costs

**Table of Contents**

associated with our fulfillment business, but excludes non-cash stock-based compensation and restructuring costs.

Selling and marketing expenses include marketing expenses, sales commissions and related costs as well as sales employee compensation and benefits. Commissions are paid to sales personnel based on products and services sold. Selling and marketing expenses exclude non-cash stock based compensation and restructuring costs.

General and administrative expenses include employee compensation and benefits and general office expenses incurred in the ordinary course of business, but exclude non-cash stock based compensation and restructuring costs.

Restructuring costs include charges related to severance and other payroll-related items, as well as certain office lease and other contract termination costs resulting from our plan to reduce costs through the consolidation of our Internet and bill payment operations.

We use EBITDA as a metric to measure our on-going operating performance. EBITDA is defined as earnings before interest, taxes, depreciation and amortization. Even though we use EBITDA to measure our on-going operating performance, it is not an accepted measure of profitability under generally accepted accounting principles.

We use Adjusted EBITDA as a metric to measure our on-going operating performance. Adjusted EBITDA is defined as earnings before restructuring costs, interest, taxes, depreciation and amortization. Even though we use Adjusted EBITDA to measure our on-going operating performance, it is not an accepted measure of profitability under generally accepted accounting principles.

Depreciation consists of depreciation of property, equipment and capitalized software development costs.

Preferred stock dividends are related to our Series B preferred stock.

Net interest expense includes our borrowing costs related to our credit facility less amounts received related to our lease receivables, interest on shareholders' notes and cash sweep interest income.

We also use cash loss as a metric to measure our on-going operating performance. Cash loss is defined as net loss attributable to common shareholders, excluding the effects of amortization of intangible assets, amortization of stock-based compensation, net loss on sales of assets, long-lived asset impairment charges, extraordinary items and cumulative effect of change in accounting principle. Even though we use cash loss to measure our on-going operating performance, it is not an accepted measure of profitability under generally accepted accounting principles.

Amortization relates to goodwill, acquired technology and other intangible assets resulting from our acquisitions. Intangible assets are being amortized over lives ranging from two to five years.

Amortization of stock-based compensation consists of amortization of deferred compensation for certain stock options with an exercise price below the initial public offering price and compensation expense for stock sold or awarded to employees at prices below the initial public offering price.

The extraordinary item consists of deferred financing costs for the difference between the fair value of common stock and the exercise price of warrants related to a line of credit terminated in 1999.

Net loss on sales of assets consists of the disposal of certain assets offset by the gain on the sale of certain bill payment-related assets we acquired from Call Me Bill.

Long-lived asset impairment charges include non-cash charges related to the write down of certain acquisition-related intangible assets resulting from the change in capital markets and our revised strategic direction.

We have incurred operating losses through December 31, 2001. Due to the uncertainty of the realizability of the net operating losses, we have not reflected an income tax benefit in our statements of operations, and we have recorded a valuation allowance for the full amount of our net operating loss carry-forwards.

**Table of Contents**

Although we have experienced significant growth in customers and revenues, we have incurred substantial operating losses and negative cash flows from operations. We incurred net losses of approximately \$97 million and \$60 million for the twelve months ended December 31, 2000 and December 31, 2001, respectively. Non-cash expenses including depreciation, amortization, amortization of stock-based compensation, net loss on sales of assets and long-lived asset impairment charges accounted for approximately 87% and 89% of the net loss attributable to common shareholders for the twelve months ended December 31, 2000 and December 31, 2001, respectively. We incurred cash losses, excluding restructuring costs, of approximately \$14.3 million and \$6.9 million for the twelve months ended December 31, 2000 and December 31, 2001, respectively. Including restructuring costs, we incurred cash losses of approximately \$14.5 million and \$8.9 million for the twelve months ended December 31, 2000 and December 31, 2001, respectively.

**Results of Operations**

For comparative purposes, the cumulative effect of change in accounting principle of \$351,980 resulting from the implementation in 2000 of SAB No. 101 has been excluded from the results of operations summarized below. All share and per share amounts have been restated to reflect our 1-for-8 reverse stock split effected in May 2001.

	Years Ended December 31,					
	1999(1)		2000		2001	
		% of Revenues		% of Revenues		% of Revenues
Revenues	\$2,349,913	100%	\$19,911,544	100%	\$25,764,043	100%
Cost of services, license, hardware, implementation and maintenance	1,958,318	83	10,105,570	51	14,115,008	55
<hr/>						
<hr/>						
<hr/>						
<hr/>						
<hr/>						
<hr/>						
Gross profit	391,595	17	9,805,974	49	11,649,035	45
Operating expenses:						
Selling and marketing	2,587,607	110	9,422,085	47	3,559,257	14
General and administrative, excluding amortization of stock based compensation and restructuring costs	1,894,028	81	11,342,280	57	11,556,547	45
Restructuring costs	0		211,200	1	2,002,139	8
<hr/>						
<hr/>						

---



---



---



---

4,481,635 191 20,975,565 105 17,117,943 66

---



---



---



---



---



---



---

EBITDA loss(2)

(4,090,040) (174) (11,169,591) (56) (5,468,908) (21)

Other cash expenses:

Depreciation

193,000 8 1,773,436 9 2,065,577 8

Preferred stock dividends

24,200 1 520,000 3 520,000 2

Interest expense, net

673,972 29 1,050,664 5 878,824 3

---



---



---



---



---



---



---



---



---



---

891,172 38 3,344,100 17 3,464,401 13

---



---



---



---



---



---



---



---



---



---

Cash loss(3)

(4,981,212) (212) (14,513,691) (73) (8,933,309) (35)

Other non-cash expenses:

Amortization

12,863,016 52,802,042 32,969,808

Amortization of stock-based compensation

4,591,888 3,192,688 1,255,437

Extraordinary item

4,518,760

Loss on sales of assets

4,719,863

Long-lived asset impairment

26,300,278 12,142,146

---



---



---

21,973,664 82,295,008 51,087,254

---



---



---

Net loss attributable to common shareholders

\$(26,954,876) \$(96,808,699) \$(60,020,563)

---



---



---

**Table of Contents**

	Years Ended December 31,					
	1999(1)		2000		2001	
	% of Revenues		% of Revenues		% of Revenues	
Weighted average basic and diluted shares outstanding	1,442,754		2,781,141		3,354,909	
EBITDA loss per share(2)						
\$(2.83) \$(4.02) \$(1.63)						
Cash loss per share(3)						
\$(3.45) \$(5.22) \$(2.66)						
Net loss per share						
\$(18.68) \$(34.81) \$(17.89)						
Adjusted EBITDA loss(4)						
\$(4,090,040) \$(10,958,391) \$(3,466,769)						
Adjusted EBITDA loss per share(4)						
\$(2.83) \$(3.94) \$(1.03)						
Cash loss, excluding restructuring costs(3)						
\$(4,981,212) \$(14,302,491) \$(6,931,170)						
Cash loss per share excluding restructuring costs(3)						
\$(3.45) \$(5.14) \$(2.07)						
Net loss, excluding restructuring costs, long-lived asset impairment and net loss on sales of assets						
\$(26,954,876) \$(69,922,221)(5 ) \$(41,156,415)						
Net loss per share, excluding restructuring costs, long-lived asset impairment and net loss on sales of assets						
\$(18.68) \$(25.14) \$(12.27)						

- (1) The results of operations for the Predecessor from January 1, 1999 to February 28, 1999 and the results of operations for Netzee for the period from March 1, 1999 to December 31, 1999 have been combined for comparative purposes.
- (2) EBITDA is defined as earnings before interest, taxes, depreciation, amortization and amortization of stock-based compensation.
- (3) Cash loss is defined as net loss attributable to common shareholders plus amortization of intangible assets, amortization of stock-based compensation, net loss on sales of assets, long-lived asset impairment charges extraordinary items and cumulative effect of change in accounting principle.
- (4) Adjusted EBITDA is defined as EBITDA excluding restructuring costs.
- (5) Includes \$375,000 in accelerated stock-based compensation expenses related to our management restructuring.

**Year Ended December 31, 2001 Compared to Year Ended December 31, 2000***Revenues*

Total revenues increased approximately \$5.9 million, or 29%, from approximately \$19.9 million for the twelve months ended December 31, 2000 to approximately \$25.8 million for the twelve months ended December 31, 2001. This increase consisted primarily of an increase in monthly maintenance and service revenues due primarily to the increase in the number of financial institution customers, and an increase in the number of their customers utilizing our products. This increased customer base resulted from new customer implementations, additional product sales to existing customers and customers obtained from Harland in November 2000, and is partially offset by approximately

\$5 million in decreases resulting from the sale of our regulatory reporting assets to InterCept and bill payment assets to iPay.

*Cost of services, license, hardware, implementation and maintenance*

Cost of services, license, hardware, implementation and maintenance increased by approximately \$4.0 million, or 40%, from approximately \$10.1 million for the twelve months ended December 31, 2000 to approximately \$14.1 million for the twelve months ended December 31, 2001. The increase in the cost of services, license, hardware, implementation and maintenance was due primarily to an increase in the total



**Table of Contents**

number of institutional customers for which we have implemented our products and costs associated with certain of the Acquired Operations during the fourth quarter of 2000.

As a percentage of revenue, cost of services, license, hardware, implementation and maintenance increased to 55% from 51% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000. Correspondingly, our gross margin decreased to 45% from 49% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000. These changes were due primarily to the sale of our regulatory reporting business in February 2001, which generated higher margins relative to our remaining non-core businesses, partially offset by cost reductions from the consolidation of our data center operations.

*Selling and marketing expenses*

Selling and marketing expenses decreased by approximately \$5.9 million, or 63%, from approximately \$9.4 million for the twelve months ended December 31, 2000 to approximately \$ 3.6 million for the twelve months ended December 31, 2001. The decrease in selling and marketing expenses was primarily due to a decrease in sales personnel associated with our restructuring, lower new sales volume and sales commissions paid in 2001 as compared to 2000 as well as a decrease in our external advertising expenditures compared to levels in the prior year. As a percentage of revenue, selling and marketing expenses decreased to 14% from 47% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000.

*General and administrative expenses*

General and administrative expenses increased by approximately \$300,000, or 2%, from approximately \$11.3 million for the twelve months ended December 31, 2000 to approximately \$11.6 million for the twelve months ended December 31, 2001. The increase in general and administrative expenses was primarily due to increases in overall business and operating activities, an increase in the number of employees and facilities obtained during 2000 from certain of the Acquired Operations and an increase in management, support staff, and general operating expenses resulting from our growth over the prior year. Additionally, due to our growth over the prior year, we experienced increased product development costs and higher insurance costs as compared to the prior year. These increases were partially offset by reductions in personnel and facility costs resulting from our restructuring and office consolidation efforts. As a percentage of revenue, general and administrative expenses decreased to 45% from 57% for the twelve months ended December 31, 2001, as compared to the twelve months ended December 31, 2000.

*EBITDA loss*

EBITDA loss for the twelve months ended December 31, 2001, was approximately \$5.5 million, or \$1.63 per share on 3.4 million weighted average shares outstanding, compared to \$11.2 million, or \$4.02 per share on 2.8 million weighted average shares outstanding for the same period last year. As a percentage of revenue, EBITDA loss decreased to 21% from 56% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000.

Adjusted EBITDA loss, or EBITDA excluding restructuring costs, for the twelve months ended December 31, 2001 was approximately \$3.5 million, or \$1.03 per share, compared with \$11.0 million, or \$3.94 per share in the same period last year. The improvement is primarily due to increased revenues as well as cost reductions resulting from our restructuring efforts.

*Restructuring costs*

Restructuring costs increased by approximately \$1.8 million, from approximately \$211,000 for the twelve months ended December 31, 2000 to approximately \$2.0 million for the twelve months ended December 31, 2001. Restructuring costs consisted of severance and payroll related items, as well as certain office lease and contract termination costs. During the first quarter of 2001, we finalized and announced a plan to reduce our operating expenses through the consolidation of our Internet banking and bill payment operations. This plan

**Table of Contents**

has resulted in the closure of our offices in Alabama, Kentucky, Tennessee, and Texas, as well as a reduction in our operations in Connecticut. During the fourth quarter of 2001, we finalized these efforts with further staff reductions in our sales force, as well as at our Atlanta and Portland offices.

*Depreciation*

Depreciation increased by approximately \$300,000, or 16%, from approximately \$1.8 million for the twelve months ended December 31, 2000 to approximately \$2.1 million for the twelve months ended December 31, 2001. This increase was primarily due to the depreciation of acquired assets and from depreciation associated with capital acquisitions used to support our growth during the prior year. This was partially offset by the elimination of depreciation costs associated with assets that were sold during 2001. As a percentage of revenue, depreciation expenses decreased to 8% from 9% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000.

*Preferred stock dividends*

Preferred stock dividends related to accrued dividends on our Series B 8% preferred stock. No dividends were paid related to fiscal 2000 and 2001.

*Interest expense, net*

Net interest expense decreased by approximately \$200,000, or 16%, from approximately \$1.1 million for the twelve months ended December 31, 2000 to approximately \$900,000 for the twelve months ended December 31, 2001. This decrease was due to a lower average effective interest rate on the average debt balances for the twelve months ended December 31, 2001, as compared to the twelve months ended December 31, 2000, partially offset by a higher weighted average debt balance in fiscal 2001 as compared to fiscal 2000. As a percentage of revenue, net interest expense decreased to 3% from 5% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000.

*Cash loss*

For the twelve months ended December 31, 2001, cash loss decreased to \$8.9 million, or \$2.66 per share on 3.4 million weighted average shares outstanding, compared with \$14.5 million, or \$5.22 per share on 2.8 million weighted average shares outstanding, for the twelve months ended December 31, 2000. As a percentage of revenue, cash loss decreased to 35% from 73% for the twelve months ended December 31, 2001 as compared to the twelve months ended December 31, 2000.

Excluding restructuring costs, cash loss decreased to \$6.9 million, or \$2.07 per share, for the twelve months ended December 31, 2001 compared to approximately \$14.3 million, or \$5.14 per share, for the twelve months ended December 31, 2000. This decrease was due primarily to increases in revenues as well as decreases in other operating expenses resulting from our restructuring efforts.

*Amortization expense*

Amortization expense decreased by approximately \$19.8 million, or 38%, from approximately \$52.8 million for the twelve months ended December 31, 2000 to approximately \$33.0 million for the twelve months ended December 31, 2001. Amortization expense decreased primarily due to the write-down of certain intangible assets during 2000 and the write down of DVI-related assets during 2001, combined with the elimination of the amortization

related to the regulatory reporting assets that were sold in February 2001. These decreases were partially offset by the additional amortization expense resulting from the Harland assets purchased in November 2000.

*Amortization of stock-based compensation*

Amortization of stock-based compensation decreased by approximately \$1.9 million, or 38%, from approximately \$3.2 million for the twelve months ended December 31, 2000 to approximately \$1.3 million for

## **Table of Contents**

the twelve months ended December 31, 2001. Stock-based compensation expense declined due to the forfeiture of certain unvested stock options by terminated employees and the partial accelerated vesting of a restricted stock award during the fourth quarter of 2000. Each of these items related to our restructuring efforts.

### *Net loss on sales of assets*

Net loss on sales of assets was approximately \$4.7 million for the twelve months ended December 31, 2001 and resulted primarily from the sale of our regulatory reporting and DVI-related assets in February 2001 and November 2001, respectively, partially offset by the gain on certain bill payment assets sold in May 2001.

### *Long-lived asset impairment*

Long-lived asset impairment was approximately \$12.1 million for the twelve months ended December 31, 2001, compared to approximately \$26.3 million for the twelve months ended December 31, 2000. Long-lived asset impairment charges resulted primarily from the write down of certain intangible assets related to certain acquisitions in 2000, and the closure of certain operations during 2001.

### *Net loss*

Net loss for the twelve months ended December 31, 2001 was \$60.0 million, or \$17.89 per share, compared with \$96.8 million, or \$34.81 per share, for the twelve months ended December 31, 2000. Excluding long-lived asset impairment charges, restructuring costs and net loss on sales of assets, net loss for the twelve months ended December 31, 2001 totaled \$41.2 million, or \$12.27 per share, compared with \$69.9 million, or \$25.14 per share, for the twelve months ended December 31, 2000.

## **Year Ended December 31, 2000 Compared to Year Ended December 31, 1999**

### *Revenues*

Total revenues increased by approximately \$17.6 million, or 747%, from approximately \$2.3 million for the twelve months ended December 31, 1999 to approximately \$19.9 million for the twelve months ended December 31, 2000. This increase consisted primarily of an increase in monthly maintenance and service revenues due primarily to the increase in the number of financial institution customers, and an increase in the number of financial institution customers utilizing our products. This increased customer base is a result of new sales, additional product sales to existing customers and customers obtained from the Acquired Operations.

### *Cost of services, license, hardware, implementation and maintenance*

Cost of services, license, hardware, implementation and maintenance increased by approximately \$8.1 million, or 416%, from approximately \$2.0 million for the twelve months ended December 31, 1999 to approximately \$10.1 million for the twelve months ended December 31, 2000. The increase in the cost of services, license, hardware, implementation and maintenance was due primarily to an increase in the number of new institutional customers for which we have implemented our products. Additionally, we experienced increased data center costs required to support the increase in the total number of institutions to which we provided services.

As a percentage of revenue, cost of service, license, hardware, implementation and maintenance decreased to 51% from 83% for fiscal year 2000 as compared to fiscal 1999. Correspondingly, our gross margin improved from 17% for fiscal year 1999 to 49% for fiscal year 2000. This increase in gross margin was due to our ability to continue to add

additional customers at a pace that exceeded the incremental costs required to support those new customers.

**Table of Contents**

*Selling and marketing expenses*

Selling and marketing expenses increased by approximately \$6.8 million, or 264%, from approximately \$2.6 million for the twelve months ended December 31, 1999 to approximately \$9.4 million for the twelve months ended December 31, 2000. The increase in selling and marketing expenses was primarily due to an increase in sales personnel and an increase in sales commissions paid on new sales. We also increased our advertising expenditures in order to increase our brand recognition and our end-user penetration. As a percentage of revenue, selling and marketing expenses decreased to 47% for fiscal year 2000 from 110% for fiscal year 1999.

*General and administrative expenses*

General and administrative expenses increased by approximately \$9.4 million, or 499%, from approximately \$1.9 million for the twelve months ended December 31, 1999 to approximately \$11.3 million for the twelve months ended December 31, 2000. The increase in general and administrative expenses was primarily due to increases in overall business and operating activities, an increase in the number of employees and facilities obtained primarily from the Acquired Operations and an increase in management, support staff and general operating expenses resulting from our growth. As a percentage of revenue, general and administrative expenses decreased to 57% for fiscal year 2000 from 81% for fiscal year 1999.

*Restructuring costs*

Restructuring costs, consisting primarily of employee severance and payroll related costs, were \$211,000 for the twelve months ended December 31, 2000 compared to zero for the twelve months ended December 31, 1999. Restructuring costs were a result of the restructuring of our management initiated during the fourth quarter of fiscal 2000.

*EBITDA loss*

EBITDA loss for the twelve months ended December 31, 2000 was approximately \$11.2 million, or \$4.02 per share on 2.8 million weighted average shares outstanding, compared to \$4.1 million, or \$2.83 per share on 1.4 million weighted average shares outstanding, for the twelve months ended December 31, 1999. As a percentage of revenue, EBITDA loss decreased to 56% from 174% for the twelve months ended December 31, 2000 as compared to the twelve months ended December 31, 1999.

Adjusted EBITDA loss for the twelve months ended December 31, 2000 was approximately \$10.9 million, or \$3.94 per share, compared with \$4.1 million, or \$2.83 per share, in the same period in 1999.

*Depreciation*

Depreciation increased by approximately \$1.6 million, or 819%, from approximately \$200,000 for the twelve months ended December 31, 1999 to approximately \$1.8 million for the twelve months ended December 31, 2000. This increase was due primarily to the depreciation of assets from the Acquired Operations and from depreciation associated with capital acquisitions necessary to support our growth.

As a percentage of revenue, depreciation expenses increased slightly to 9% for fiscal year 2000 from 8% for fiscal year 1999. This slight increase was due to our continued data center expansion in early 2000, along with additional depreciation expense associated with assets obtained from our acquisitions in fiscal 2000.

*Preferred stock dividends*

Preferred stock dividends increased from approximately \$24,000 for the twelve months ended December 31, 1999 to \$520,000 for the twelve months ended December 31, 2000. This increase was a result of preferred stock dividends accruing for a partial month in fiscal 1999 as compared to the entire year in 2000.



**Table of Contents***Interest expense, net*

Net interest expense increased by approximately \$400,000, or 56%, from approximately \$700,000 for the twelve months ended December 31, 1999 to approximately \$1.1 million for the twelve months ended December 31, 2000. The increase was due primarily to a higher average debt balance for debt incurred to fund our operations and acquisitions for the twelve months ended December 31, 2000, as compared to a lower average debt balance incurred during 1999. As a percentage of revenue, net interest expense decreased to 5% for fiscal year 2000 from 29% for fiscal year 1999.

*Cash loss*

Cash loss increased by approximately \$9.5 million, or 191%, from approximately \$5.0 million, or \$3.45 per share on 1.4 million weighted average shares outstanding for the twelve months ended December 31, 1999 compared to \$14.5 million, or \$5.22 per share on 2.8 million weighted average shares outstanding for the twelve months ended December 31, 2000. The increase was due to increases in operating expenses, including selling and marketing, general and administrative, depreciation, interest and preferred dividends. Operating expenses increased in fiscal year 2000 as we experienced an increase in our number of employees and facilities, primarily obtained from the Acquired Operations. We also increased our sales staff over staffing levels in fiscal 1999, expanded our data center operations and experienced an increase in the staff necessary to support our increased customer base. The increase in cash loss as a result of increased operating expenses was partially offset by increases in our revenues.

Excluding restructuring costs, cash loss increased to \$14.3 million, or \$5.14 per share for the twelve months ended December 31, 2000 compared to approximately \$5.0 million, or \$3.45 per share for the comparable period in 1999.

*Amortization expense*

Amortization expense increased by approximately \$39.9 million, or 310%, from approximately \$12.9 million for the twelve months ended December 31, 1999 to \$52.8 million for the twelve months ended December 31, 2000. Amortization expense increased due to an increase in intangible assets recorded as a result of purchase accounting associated with our acquisitions during fiscal year 2000, combined with a full year of amortization of intangible assets related to our acquisitions in August, September and December 1999.

*Amortization of stock-based compensation*

Amortization of stock-based compensation decreased by approximately \$1.4 million, or 30%, from approximately \$4.6 million for the twelve months ended December 31, 1999 to \$3.2 million for the twelve months ended December 31, 2000. Amortization of stock-based compensation expense for the twelve months ended December 31, 2000 included twelve months of amortization for certain stock options issued during fiscal year 1999 with an exercise price below the initial public offering price and \$375,000 due to the accelerated vesting of restricted stock resulting from our management restructuring in the fourth quarter of 2000. Amortization of stock-based compensation for the twelve months ended December 31, 1999 was due to the expenses associated with the vesting of options upon our initial public offering and the issuance of stock in August and September 1999 at a price below the initial public offering price.

*Long-lived asset impairment*

Long-lived asset impairment was approximately \$26.3 million for the twelve months ended December 31, 2000 as compared to zero for the twelve months ended December 31, 1999. Long-lived asset impairment charges resulted primarily from the write down of certain acquired intangible assets.

*Net loss*

Net loss for the twelve months ended December 31, 2000 was \$96.8 million, or \$34.81 per share, compared with \$27.0 million, or \$18.68 per share, for the twelve months ended December 31, 1999. Excluding

**Table of Contents**

extraordinary item, long-lived asset impairment charges and restructuring costs, net loss for the twelve months ended December 31, 2000 totaled \$69.9 million, or \$25.14 per share, compared with \$27.0 million, or \$18.68 per share, for the twelve months ended December 31, 1999.

**Liquidity and Capital Resources**

Our operating activities used cash of approximately \$8.4 million and \$15.6 million for the twelve months ended December 31, 2001 and 2000, respectively. Cash used in operating activities for the twelve months ended December 31, 2001 resulted primarily from our net operating losses, the payment of restructuring related costs and the recognition of previously collected deferred revenue. This was partially offset by the collection of receivables during the twelve months ended December 31, 2001. Cash used in operating activities for the twelve months ended December 31, 2000 resulted primarily from our operating losses and the payment of accounts payable and accrued liabilities. This was partially offset by the advance collection of deferred revenue.

Our investing activities provided cash of approximately \$14.0 million and used cash of approximately \$4.3 million for the twelve months ended December 31, 2001 and 2000, respectively. Cash provided by investing activities for the twelve months ended December 31, 2001 resulted primarily from the disposition of our regulatory reporting assets in February 2001, certain bill payment assets in May 2001 and the DVI-related assets in November 2001. This was partially offset by the purchase of property, equipment and costs associated with capitalized software development and the purchase of other property required to support our business, as well as our acquisition of assets from HomeCom in March 2001. Cash used in investing activities for the twelve months ended December 31, 2000 resulted primarily from our investment in property, equipment and capitalized software for our data centers.

Our financing activities used cash of approximately \$6.0 million and provided cash of approximately \$9.5 million for the twelve months ended December 31, 2001 and 2000, respectively. Cash used in financing activities for the twelve months ended December 31, 2001 resulted primarily from repayments on our credit facility with proceeds from the sale of our regulatory reporting assets, certain bill payment and DVI-related assets, as well as proceeds from the repayment of shareholder notes, offset by additional borrowings from our credit facility. Cash provided by financing activities for the twelve months ending December 31, 2000 resulted from additional borrowings from our credit facility, borrowings from a note payable, the repayment of shareholder notes and proceeds from the exercise of warrants. This was partially offset by the payments of notes payable assumed in the acquisition of DVI and repayments on our credit facility.

Our working capital deficit as of December 31, 2001 was approximately \$1.2 million compared to a working capital deficit of \$5.5 million at December 31, 2000. This increase in working capital is primarily due to changes in working capital associated with certain dispositions of assets, partially offset by accrued dividends during 2001. As of December 31, 2001, we had \$6.4 million in available borrowings under our credit facility, which we may use to remedy our working capital deficit.

In February 2001, we completed the sale of certain of our regulatory reporting assets acquired from DPSC in 1999. As a result, we received cash proceeds of approximately \$14.1 million. We used approximately \$11.8 million of the proceeds to pay down principal balances on the joint credit facility. The balance of the proceeds was used to fund operations as well as to pay certain closing costs and certain liabilities related to the sale. In connection with this sale, we converted our \$15 million line of credit with InterCept and our \$5 million promissory note with Harland into a \$20 million joint credit facility (\$15 million funded by InterCept and \$5 million funded by Harland). The terms of the credit facility remained consistent with the terms of the former line of credit and promissory note, except that both InterCept and Harland had the right (instead of just InterCept) to enforce the covenants contained in the line of credit agreement.

In May 2001, we sold certain bill payment assets which we considered to be a non-core component of our business. We received cash proceeds of \$1,275,000, which were primarily used to pay down our credit facility. In connection with this sale, Harland's portion of the joint credit facility was permanently reduced to \$4,775,000, reducing the total credit facility to \$19,775,000. InterCept's portion of the credit facility remained at \$15 million.

**Table of Contents**

In November 2001, we sold certain assets we acquired from DVI to SS&C for gross proceeds of approximately \$1.35 million, which were primarily used to pay down our credit facility. In connection with this sale, Harland's portion of the joint credit facility was permanently reduced to \$4,555,000, reducing the total credit facility to \$19,555,000. InterCept's portion of the credit facility remained at \$15 million. As of December 31, 2001, the facility was funded approximately 77% by InterCept and 23% by Harland. As of December 31, 2001, we were in compliance with all of the covenants of the credit facility.

In March 2002, we extended the maturity date of our joint credit facility from November 2, 2002 to April 10, 2003. We also reduced the total credit facility to \$18,000,000. The first \$17 million, to the extent borrowed, will be funded approximately 77% by InterCept and 23% by Harland. The remaining \$1 million, if borrowed, will be funded solely by InterCept. We paid extension fees of \$100,000 to InterCept and \$20,000 to Harland as a result of these changes to the credit facility. As of March 29, 2002, we had approximately \$4.3 million available under the line and we were in compliance with all of the covenants of the credit facility.

In December 1999, we issued 500,000 shares of preferred stock in connection with our acquisition of DPSC. These shares of preferred stock permit us to repurchase all such shares at a price of \$13.00 per share, plus accrued but unpaid dividends thereon, subject to certain conditions, none of which have currently been met. In addition, the holder of the preferred stock has the right, beginning on April 10, 2003, to require us to repurchase such stock at \$13.00 per share, plus accrued but unpaid dividends thereon, except that in the event that indebtedness under our joint credit facility is accelerated, the repurchase right shall become immediately exercisable. On March 29, 2002, this repurchase right was extended from June 15, 2002 for an extension fee of approximately \$500,000. Any repurchase of preferred shares will require the approval of our creditors pursuant to the terms of our credit facility and the banking regulators under the MOU. The preferred stock obligation is subordinate to our obligations to our creditors under the credit facility.

We have incurred net losses since our inception. As of December 31, 2001, we had an accumulated deficit of approximately \$184 million. These losses have resulted from the costs we have incurred to develop our products and services, and to increase our customer base and build our infrastructure as well as from the amortization of intangible assets associated with the Acquired Operations. We believe that our existing capital resources, together with cash provided by our operations and borrowings under our credit facility, will be sufficient to fund our working capital requirements for the next 12 months. If we are unable to achieve and maintain our cost savings goals, if our working capital requirements exceed our current expectations, if cash provided by our operations is less than anticipated, or if we make additional acquisitions, we may need to raise additional capital either through debt or equity sources before that time. We cannot be sure that we will be able to obtain the additional financing necessary to satisfy these additional capital requirements or to implement our strategy on acceptable terms or at all. Additionally, we may need to further extend the due dates of our line of credit as well as our preferred stock. If we cannot obtain this financing or these extensions on terms acceptable to us or at all, we may be forced to curtail some planned business expansion, we may be unable to fund our ongoing operations, or we may have to cease operations altogether. Alternatively, we may be required to reduce the level of spending on capital and operating expenses in order to utilize our existing financing and sources of liquidity to operate the business on a reduced scale.

**Selected Quarterly Data**

The following table sets forth our selected quarterly data for the years ending December 31, 2000 and 2001. All share and per share amounts have been restated to reflect our 1-for-8 reverse stock split effected in May 2001.

---

**Quarter Ended**

Edgar Filing: NETZEE INC - Form 10-K

	<u>March 31, 2001</u>	<u>June 30, 2001</u>	<u>September 30, 2001</u>	<u>December 31, 2001</u>
	(Unaudited)			
Revenues				
\$7,468,000	\$6,350,000	\$6,236,000	\$5,710,000	
Gross profit				
3,085,000	2,602,000	2,921,000	3,041,000	
Operating loss				
(19,974,000)	(9,591,000)	(21,781,000)	(7,276,000)	
Net loss attributable to common shareholders				
(20,400,000)	(9,904,000)	(22,129,000)	(7,587,000)	
Basic and diluted loss per share				
(6.08)	(2.96)	(6.60)	(2.25)	

**Table of Contents**

	Quarter Ended			
	March 31, 2000	June 30, 2000	September 30, 2000	December 31, 2000
	(Unaudited)			
Revenues	\$2,815,349	\$4,303,000	\$5,235,000	\$7,558,000
Gross profit	1,224,000	2,181,000	2,640,000	3,760,000
Operating loss	(15,606,000)	(17,544,000)	(17,191,000)	(44,897,000)
Net loss before extraordinary item and change in accounting principle	(15,847,000)	(17,913,000)	(17,846,000)	(45,202,000)
Net loss attributable to common shareholders	(16,156,000)	(17,902,000)	(17,703,000)	(45,752,000)
Loss per share before extraordinary item and change in accounting principle	(6.10)	(6.60)	(6.51)	(14.73)
Basic and diluted loss per share(1)(2)	(6.24)	(6.56)	(6.48)	(14.91)

- (1) The sum of the quarterly basic and diluted loss per share does not equal the year-to-date basic and diluted loss per share calculation for the respective fiscal periods presented, due to differences in rounding as well as differences in quarterly average shares outstanding versus year-to-date average shares outstanding.
- (2) The data for the quarters ended March 31, June 30 and September 30, 2000 have been restated as a result of our adoption of SAB No. 101 in the fourth quarter of 2000. SAB No. 101 established guidelines for revenue recognition and enhanced revenue recognition disclosure requirements. See Note 12 in Notes to Consolidated Financial Statements.

**Factors that May Affect Our Future Results of Operations or Financial Condition**

*To execute our strategy, we may require additional funding that may not be available on favorable terms or at all, and a lack of funds could substantially impair our ability to operate, grow and be profitable*

We do not have sustained earnings or positive cash flow, and our business strategy currently requires us to incur significant expenses to operate competitively and to grow our business. We do not currently have adequate cash flow from operations to fund these expenses, although we expect to achieve positive cash flow from operations in fiscal 2002. Until that time, we will be funding our operations from borrowings under our credit facility. If we are unable to borrow money under that facility for whatever reason, our business and operations would be greatly impaired and we would be required to seek new or additional sources of funds. If we should need additional financing, it may not be available on favorable terms or at all. If we cannot raise adequate funds to satisfy our operating and capital requirements, we may have to limit our operations significantly or cease operations altogether. Our future operating and capital requirements depend upon many factors, including:

- our ability to maintain and achieve our cost levels and targets;
- the response of customers to our product and service offerings;
- the extent to which we expand our products and services; and

the extent to which we develop and upgrade our technology and data network infrastructure.



**Table of Contents**

*Because we have a limited operating history in a rapidly evolving industry, it is difficult to evaluate our business and prospects*

We were incorporated in August 1999 as the successor to a company which had operated only since October 1996. Therefore, it is difficult for an investor to evaluate us and our prospects. An investor in our common stock must consider the risks we face as a company operating in the relatively new and rapidly evolving Internet banking and e-commerce markets. These risks include our inability to:

operate profitably;

comply with regulatory guidelines;

develop, test, market and sell our products and services;

expand successfully our sales and marketing efforts;

maintain our current, and develop new, strategic marketing alliances;

promote acceptance of our Internet based services by our community financial institution customers and their customers;

protect our Internet-based products and services and our data stored on our servers from unauthorized access or use;

respond effectively to competitive pressures; and

continue to develop and upgrade our technology.

We may not succeed in achieving any or all of these goals. We may never achieve or sustain profitability.

*We have a history of losses and anticipate losses in the future, and we may never become profitable*

We incurred net losses of approximately \$60 million for the year ended December 31, 2001. We expect to incur significant operating losses in the foreseeable future. We will need to generate significant revenues to achieve and maintain profitability, and we cannot give assurances that we will be able to do so. Our revenues for the year ended December 31, 2001 were approximately \$26 million, and our cash operating expenses for the year were approximately \$35 million. If our revenues are less than we anticipate or if we cannot reduce our operating expenses as expected, our financial performance will be adversely affected. See Selected Financial Information and Management's Discussion and Analysis of Financial Condition and Results of Operations.

*Our continued inability to comply with the maintenance listing criteria of the Nasdaq National Market may cause our common stock to be delisted*

Our common stock is currently listed on the Nasdaq National Market. Thus, we are subject to financial and market-related requirements and other qualitative standards established by Nasdaq to maintain our listing. On February 14, 2002, we were notified by Nasdaq that we failed to meet the \$5 million minimum market value requirement for our publicly held shares. We have been given until May 15, 2002 to come into compliance with this rule. If we fail to meet this requirement, Nasdaq could delist our common stock. If this were to happen, it may be more difficult for a shareholder to buy or sell our stock at competitive market prices, or at all, and we may lose

support from institutional investors, brokerage firms and market makers, if any, that currently buy and sell our stock and provide information to investors about us. Such an event could also cause the price of our stock to decrease further. It is likely that we will be delisted from the Nasdaq National Market.

*Our business and prospects will suffer if end users do not accept and use our products and services*

We derive substantially all of our revenues from products and services provided to community financial institutions, their customers and other participants in the financial services industry. Our future success depends significantly upon the willingness of community financial institutions to offer technological innovations such as Internet and telephone banking and upon their customers' demand for and acceptance of these

**Table of Contents**

technological innovations. If community financial institutions and their customers do not readily accept these technological innovations as reflected in our products and services, we will experience reduced demand for our products and services.

We may not be able to be successful in marketing these products and services or other integrated products and services. In addition, changes in economic conditions and unforeseen events, including recession, inflation or other adverse occurrences, may result in a significant decline in the utilization of community financial institution services or demand for our products and services. Any event that results in decreased consumer or corporate use of community financial institution services, or increased pressures on community financial institutions toward the in-house development of Internet based systems, could have a material adverse effect on our business, financial condition and results of operations.

Because we offer Internet-based products and services, our business would be adversely affected if Internet use does not continue to grow or grows more slowly than expected. Internet usage may be inhibited for a number of reasons, including inadequate network infrastructure, security concerns, inconsistent quality of service, and unavailability of cost effective, high-speed access to the Internet. If the market for Internet-based financial services fails to grow, grows more slowly than anticipated, or becomes saturated with competitors, our business, financial condition and results of operations likely would be materially adversely affected.

*We have recently experienced a period of significant operational reductions that may place a strain on our ability to achieve revenue growth and profitability*

We previously experienced significant growth in our operations through acquisitions in 1999 and 2000. Our recent reorganization and the resulting reduction in personnel and facilities is placing and will continue to place additional demands on our management and operational ability. Our current management, sales, technical and accounting resources may not be adequate to support our anticipated revenue growth. Our future operating results will substantially depend on the ability of our management to handle changing business conditions and to implement and improve our systems. To manage these changes effectively, we must:

predict accurately the growth in the demand for our products and related services and our capacity to address that demand;

respond adequately to the needs of our financial institution customers and their customers;

motivate, manage and retain key employees; and

respond effectively to changes in the industry.

*Our relationships with InterCept and Harland may present potential conflicts of interest, which may result in decisions that favor InterCept and Harland over our other shareholders*

Because Netzee, InterCept and Harland are engaged in the sale of electronic commerce products and services to community financial institutions, numerous potential conflicts of interest exist between these companies or their affiliates. We compete with each other when offering some products and services to potential customers. Our bylaws contain provisions addressing potential conflicts of interest between us and InterCept and the allocation of transactions that, absent such allocation, could constitute corporate opportunities of both companies. Under these provisions, InterCept may take advantage of a corporate opportunity rather than presenting that opportunity to us, absent a clear indication that the opportunity was directed to us rather than to InterCept.

Our existing and future agreements and relationships with InterCept have not resulted and will not necessarily result from arms-length negotiations. InterCept currently owns approximately 28% of our common stock. Our Chairman, our former Vice Chairman, our Chief Executive Officer and another of our former directors are directors or significant shareholders of InterCept. In addition, John W. Collins, our Chairman, serves as Chief Executive Officer of InterCept. When the interests of InterCept diverge from our interests, InterCept's officers and directors may exercise their influence in InterCept's best interests. Therefore, our agreements and relationships with InterCept may be less favorable to us than those that we could obtain from unaffiliated third parties. Moreover, many of the transactions between us and InterCept do not lend

**Table of Contents**

themselves to precise allocations of costs and benefits. Thus, the value of these transactions will be left to the discretion of the parties, who are subject to potentially conflicting interests.

Other than the provisions of our bylaws relating to corporate opportunities, there is no mechanism in place to resolve these conflicts of interest, except that it is our policy that transactions with affiliated parties be approved by a majority of our disinterested directors. Nevertheless, due to the extensive relationships between InterCept and us, we may make decisions that potentially favor InterCept or its affiliates at the expense of our shareholders. Furthermore, Georgia law may prohibit a shareholder from successfully challenging these decisions, if the decision received the affirmative vote of a majority, but not less than two, of our disinterested directors who received full disclosure of the existence and nature of the conflict.

Our existing agreements and relationships with Harland have resulted, but future agreements will not necessarily result, from arms-length negotiations. Harland currently owns approximately 16% of our common stock.

*We may experience delays in product development, and these delays may adversely affect us*

The electronic banking and financial services industry is characterized by rapidly changing technology, evolving industry standards, emerging competition and frequent new product and service introductions. Our future success will depend on our ability to develop, test, sell and support new and integrated products and services that will keep pace with technological advances and industry standards and satisfy the evolving needs of both financial institutions and their customers. Our inability to develop and introduce new and integrated products and services in a timely manner could limit the marketability of our products and services and could render them obsolete, which would adversely affect us. Further, we cannot predict the time required and costs involved in developing new and integrated products and services. Actual development costs could substantially exceed budgeted amounts, and estimated product development schedules could require extensions. In these cases, our business, financial condition and results of operations may be materially adversely affected.

*The unpredictability of our future financial results and events beyond our control may adversely affect the trading price of our common stock*

The price of our common stock has fluctuated substantially and our financial results and stock price may fluctuate substantially in the future. These fluctuations may be caused by numerous factors, including pricing competition for our products and services and our ability to generate revenues and operate profitably. Other factors which may cause our common stock to be adversely affected and which may cause significant fluctuations in our stock price include:

our actual or anticipated operating results;

our actual or anticipated growth rates, as they may change from time to time;

our ability to remain listed on the Nasdaq National Market;

changes in analysts' estimates;

competitors' announcements;

regulatory actions;

industry conditions;

general economic conditions; and

a variety of other factors that we have discussed elsewhere in Factors That May Affect Our Future Results of Operations or Financial Condition.

Further, the market for Internet and technology companies has experienced extreme price and volume volatility that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may materially and adversely affect our stock price, regardless of our operating performance. The trading prices of the stock of many Internet and technology companies remain at or near historical lows and reflect relative valuation levels substantially lower than historical levels. Because our stock price is currently very low and the number of shares outstanding is relatively small, small trades and changes in our stock price can produce significant percentage changes in the value of our common stock.

**Table of Contents**

*Our sales efforts may be delayed because community financial institutions are generally slow to adopt new technology, and our financial condition may make sales of our products and services to such financial institutions more difficult*

Community financial institutions tend to be cautious in making purchase decisions regarding new technologies. This requires us to provide a significant level of education to prospective customers regarding the use and benefits of our products and services prior to the purchase of our products and services. Further, community financial institutions are frequently slow to approve capital expenditures and to review new technologies that affect key operations. In addition, our low stock price, operating losses, recent security issues and level of financial resources have made some financial institutions reluctant to purchase our products and services. All of this could have the effect of significantly lengthening our sales cycle or reducing sales, thereby delaying revenue growth and adversely affecting our business, operating results and financial condition.

*Our operating results may be adversely affected because implementation of our Internet banking products and services by our community financial institution customers may take longer than we anticipate*

During the course of an initial implementation of our Internet banking products and services, we must integrate our Internet banking software with a community financial institution's core processing systems. This involves the installation of an interface to permit communication between our Internet banking products and services and the community financial institution's core processing systems. We may, from time to time, experience some delays in the integration process, particularly if we do not already have an established interface for a particular core processing system. It takes us an average of 60 to 90 days to implement our service bureau Internet banking services. A longer integration period will increase our costs associated with the implementation and delay the recognition of revenues. Changes to existing core software systems by existing customers and custom implementations for future client financial institutions may also cause integration delays in future implementations that could have a material adverse effect on our business, operating results and financial condition for subsequent periods. The implementation of our in-house Internet banking product depends on the size and complexity of the financial institution's infrastructure of systems, network structure and software.

*Damage to our data centers would result in failures or interruptions in providing our products and services to our customers, which could jeopardize our business and customer relationships*

Although we have backup facilities to provide Internet services if either or both of our data centers fail to function, a natural disaster, such as a fire, tornado or flood, or other unanticipated problem at one or more of our data centers, including an extended power loss, telecommunications failure, break-in or other security breach, computer virus, hacker attack or other events beyond our control, could nevertheless result in failures or interruptions in providing our products and services to our customers. The occurrence of any of these events could have a material adverse effect on our business, financial condition and results of operations. See Network security problems could hinder the growth of the Internet and cause us to lose customers.

*Our business could suffer if our community financial institution customers terminate their contracts with us*

Significant consolidation is occurring in the financial services industry, and our community financial institution customers that are involved in mergers and acquisitions may terminate their agreements with us or fail to renew them when they expire. An existing community financial institution customer may be acquired by or merged with another financial institution that utilizes a different Internet banking system or does not desire to continue the relationship with us for some other reason. This could result in the new entity terminating the relationship with us. This risk is particularly relevant to us because we target small to mid-sized community financial institutions as customers, which

are more likely to be potential acquisition candidates.

Customers of financial institutions that continue to use our products and services may ultimately decide to discontinue using the Internet banking and related product offerings of that financial institution because of



**Table of Contents**

concerns regarding our financial condition or inability to offer a secure and stable Internet banking system. A decrease in the use of our Internet banking system by customers of community financial institutions could have a material adverse effect on our business, financial condition, results of operations and future prospects. Our business, financial condition and results of operations would suffer if community financial institution customers terminate their relationships with us for any reason. See Our business and prospects will suffer if end users do not accept and use our products and services.

*If we cannot hire and retain qualified personnel, we will not be able to conduct our operations successfully or at all*

There is significant competition for qualified employees, and high employee turnover exists among Internet and other technology companies today. As a result, we may experience difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Our operating results may be adversely affected if we experience increased expenses related to attracting, training and retaining qualified employees. Our failure to succeed in attracting new personnel or retaining and motivating our current personnel could adversely affect our business, financial condition and results of operations.

*Network security problems could hinder the growth of the Internet and cause us to lose customers*

To the extent that our activities involve the storage and transmission of proprietary information, security breaches could expose us to possible liability and damage our reputation. Any compromise of our security could harm our business and could deter people from using the Internet to conduct transactions that involve transmitting confidential information. We rely on standard Internet security systems, all of which are licensed from third parties, to provide the security and authentication necessary to effect secure transmission of data. Nevertheless, compromises or breaches of our security measures have occurred and may occur in the future.

Our networks have been, and may continue to be, vulnerable to unauthorized access, computer viruses and other disruptive problems. Someone who is able to circumvent our security measures could misappropriate our proprietary information or cause interruptions in our Internet operations. We, as well as other Internet and on-line service providers have in the past experienced, and we and they may in the future experience, interruptions in service as a result of the accidental or intentional actions of Internet users, including current and former employees or others. Concerns regarding security risks may deter community financial institutions from purchasing our products and services and deter their customers from using our products and services. We may need to expend significant capital or other resources to protect against the threat of security breaches or to alleviate problems caused by breaches. These breaches may also require us to pay money damages to others who were harmed by them. Eliminating computer viruses and alleviating other security problems may result in interruptions, delays or termination of service to users accessing web sites that deliver our services, any of which could harm our business, financial condition and results of operations.

Security breaches may permit unauthorized persons to obtain private financial information of users of the services we provide to our financial institution customers. If this private information is illegally obtained, it may be used to commit identity theft or commit other types of fraud. During 2001, we experienced the unauthorized access of private data due to a security breach at our former Birmingham, Alabama data center. As a result of this breach, unauthorized persons used the data to open online investment accounts and send extortion e-mails to financial institutions in an attempt to transfer funds using Internet-based person-to-person payment systems. To our knowledge, these incidents did not result in any material direct financial loss to any of our customers. However, we were required to invest considerable resources and management attention to investigate these incidents and properly notify our customers. Additionally, some of our customers terminated their contracts with us as a result of these incidents.

While we have continued to invest in additional resources to prevent security breaches and other similar incidents from recurring, future security breaches would cause us to incur significant costs to investigate, restore services, implement additional security measures and notify our customers. Furthermore, additional unauthorized intrusions would likely result in additional customer attrition, which would have a material adverse impact on our business, results of operations and financial condition.

**Table of Contents**

*Defects in software products that we use in our products and our inability to sustain a high volume of traffic may materially and adversely affect our business*

The software used by our systems and products and services may contain errors, defects or bugs. Although we have not suffered significant harm from any errors or defects to date, we may discover significant errors or defects in the future that we may or may not be able to correct. We have recently introduced and will be continually introducing new products in the market and have not experienced any product liability claims to date, but the sale and support of our products and services may entail the risk of these claims. A product liability claim brought against us could have a material adverse effect on our business, financial condition and results of operations.

Furthermore, as the volume of traffic and transactions on our system increases substantially, we could experience periodic temporary capacity constraints, which may cause unanticipated system disruptions, slower response times and lower levels of customer service. We may be unable to project accurately the rate or timing of increases, if any, in the use of our services or expand and upgrade our systems and infrastructure in a timely manner to accommodate these increases. Any inability to do so could harm our business.

*Increased competition may increase pricing pressures, reduce margins and create a loss of market share*

The market for our products and services is highly competitive. We compete with a variety of third parties, including other providers of Internet banking systems, as well as systems developed internally by financial institutions. We also expect competition in our markets to increase significantly as new companies enter our market and current competitors expand their product lines and services. These new competitors may include non-bank financial institutions, such as brokerage firms, on-line service providers and data processing vendors, among others. In many instances, these entities are dominant competitors and may enjoy substantial competitive advantages, including:

greater name recognition;

better financial condition;

greater financial, technical and marketing resources to devote to the development, promotion and sale of their services;

longer operating histories; and

a larger base of client financial institutions.

Any pricing pressures, reduced margins or loss of market share resulting from our failure to compete effectively would materially and adversely affect our business, financial condition and operating results.

*Infringement by others upon our proprietary technology could harm our ability to establish and protect our proprietary rights, which could adversely affect our business*

Our inability to protect our proprietary rights adequately could have a material adverse effect on the acceptance of our brand names and on our business, financial condition and operating results. We rely on a combination of copyright, trademark and trade secret laws and contractual provisions to establish and protect our proprietary rights.

There can be no assurance that the steps we have taken, and will take in the future, to protect our proprietary rights will be adequate or that third parties will not infringe upon or misappropriate our copyrights, trademarks, service

marks, domain names and similar proprietary rights. In addition, effective copyright and trademark protection may be unenforceable or limited in foreign countries, and the global nature of the Internet makes it impossible to control the ultimate destination of our services. Our competitors or others may adopt product or service names similar to ours, thereby impeding our ability to build brand identity and possibly leading to customer confusion. Moreover, because Internet domain names derive value from the individual's ability to remember these names, we cannot guarantee that our Internet domain names will

**Table of Contents**

maintain their value if, for example, users begin to rely on mechanisms other than Internet domain names to access on-line resources.

Furthermore, we may become involved in litigation or other proceedings regarding our trade secrets, copyrights and other intellectual property rights. An adverse determination in intellectual property litigation could result in the loss of proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from selling our products and services. There can be no assurance that we would be able to obtain licenses, if necessary, on commercially reasonable terms, if at all. In addition, litigation would divert management resources and be expensive. Any of these results could have a material adverse effect on the acceptance of our brand names and on our business, financial condition and operating results.

*Our growth may be adversely affected by government regulation and legal uncertainties that could add additional costs to doing business on the Internet*

Other than the Gramm-Leach-Bliley Act discussed below, there are currently few laws or regulations that specifically regulate communications or commerce on the Internet. However, laws and regulations may be adopted in the future that address issues, including user privacy, pricing, and the characteristics and quality of products and services. For example, the Telecommunications Act sought to prohibit transmitting various types of information and content over the Internet. Several telecommunications companies have petitioned the Federal Communications Commission to regulate Internet service providers and on-line service providers in a manner similar to long distance telephone carriers and to impose access fees on those companies. This could increase the cost of transmitting data over the Internet. Moreover, it may take years to determine the extent to which existing laws relating to issues such as property ownership, libel and personal privacy issues apply to the Internet. Any new laws or regulations relating to the Internet or the manner in which existing laws are applied to the Internet could adversely affect our business.

Our primary customers are community financial institutions, which are heavily regulated. In addition, financial institution regulators can effectively control and mandate the standards for the required security systems, communication technologies and other features of our products and services. There can be no assurance that federal, state or foreign governmental authorities will not adopt new regulations addressing electronic financial institution operations that could require us to modify our current or future products and services.

For example, the U.S. Congress enacted the Gramm-Leach-Bliley Act in November 1999. This law may restrict or prohibit our ability to offer third parties access to non-public personal information generated by our Internet banking products and services. Further, with respect to the information of each particular individual that does business with a community financial institution, we will be required to comply with the privacy policies that are adopted by each financial institution. Pursuant to this law, the federal banking authorities, the Securities and Exchange Commission and the Federal Trade Commission have adopted rules and regulations implementing this law. Finally, this law specifically permits states to adopt financial privacy laws that are more restrictive than federal law. Some states have interpreted laws that were in effect when the Gramm-Leach-Bliley Act was enacted to be more restrictive than the new federal laws, and those states have continued to enforce those laws. Several other states have adopted or are considering the adoption of consumer privacy legislation that would be more restrictive than this federal law, and it is possible that every state in which we provide our products and services could adopt laws that are more restrictive than the Gramm-Leach-Bliley Act and its complementary rules. This law or the adoption of other laws or regulations affecting our business or our community financial institution customers' businesses could reduce our growth rate or could otherwise have a material adverse effect on our business, financial condition and operating results. See Business Government Regulation.



**Table of Contents**

*Taxation of our Internet products and services could affect our pricing policies and reduce demand for our products and services*

Any legislation that substantially impairs the growth of e-commerce could have a material adverse effect on our business, financial condition and operating results. The tax treatment of the Internet and e-commerce is currently unsettled. A number of proposals at the federal, state and local levels in the United States and before foreign governments would, if enacted, impose taxes on the sale of goods and services provided over the Internet. The Internet Tax Nondiscrimination Act extends a moratorium on new state and local taxes on Internet commerce until November 1, 2003. However, future laws may impose taxes or other regulations on such commerce. We cannot predict the effect of any such future laws or current attempts to tax or regulate commerce over the Internet.

*Our stock value may be adversely affected because our management and affiliates beneficially own approximately 53% of our common stock, and thus no corporate actions requiring shareholder approval can be taken without their approval*

Our officers, directors and affiliated persons beneficially own approximately 53% of our common stock. As a result, our officers, directors and affiliated persons effectively are able to:

elect, or defeat the election of, our directors;

amend or prevent amendment of our articles of incorporation or bylaws;

effect or prevent a merger, sale of assets or other corporate transaction; and

control the outcome of any other matter submitted to the shareholders for vote.

Our public shareholders, for so long as they hold less than a majority of the outstanding shares of our common stock, are unable to control the outcome of any shareholder vote. Management's stock ownership may discourage a potential acquirer from offering to purchase or otherwise attempting to obtain control of Netzee, which in turn could reduce our stock price or prevent our shareholders from realizing a premium over our stock price.

*Future sales of our common stock will dilute current shareholder ownership and may further depress our stock price*

We may seek to raise funds to support or expand our operations by selling shares of our common or preferred stock. In the future, we may acquire other businesses and products using our stock or a combination of our stock and cash. Such issuances would dilute current shareholder ownership interest in Netzee.

Our stock price is currently very low. If our shareholders sell substantial amounts of our common stock, including shares issuable upon the conversion of shares of preferred stock and the exercise of outstanding options, the market price of our common stock could fall further. These sales also might make it more difficult for us to sell equity securities in the future at a time and price that we deem appropriate. As of March 25, 2002, we had 3,377,911 shares of common stock outstanding, 51,384 shares of common stock reserved for issuance upon the conversion of our Series B preferred stock and outstanding options to acquire 202,973 shares of common stock.

In addition, we may be required to register up to 550,000 shares of common stock that we issued to Harland in connection with our acquisitions of assets from Harland, subject to the terms and conditions of a registration rights agreement we entered into with Harland.

Further, we have reserved a total of 790,404 shares of our common stock for issuance under our stock option plan. The plan provides that this amount will be automatically increased on January 1 of each year to an amount equal to 20% of the fully diluted shares of our common stock on the preceding December 31, provided, however, that the number of shares available for issuance shall not be less than 437,500. As of March 25, 2002, we have outstanding options to purchase a total of 202,973 shares of common stock under this plan. We have registered all of the shares presently issuable under this plan for sale in the public market.



## **Table of Contents**

### *Our future earnings will be reduced because we have a significant amount of intangible assets*

As of December 31, 2001, approximately \$22 million, or 68%, of our total assets were intangible assets. These intangible assets primarily represent amounts attributable to the issuance of stock in acquisitions accounted for as purchases. We will likely record additional intangible assets in the future if we acquire additional businesses. Additionally, we currently amortize intangible assets over a useful life that management believes is reasonable and is allowable under generally accepted accounting principles, or GAAP. GAAP can change in the future and affect the amortization period and therefore our future results. Additionally, any additional impairment in the value of these intangible assets could have a material adverse effect on our business, financial condition and operating results.

### *Our articles of incorporation and bylaws, as well as Georgia corporate law, may prevent or delay third parties from buying your stock and result in a decrease in the stock price*

Our articles of incorporation, bylaws and Georgia law could make it more difficult for a third party to acquire us, even if a change in control would be beneficial to our shareholders. For example, our articles of incorporation and bylaws provide, among other things, that:

the board of directors, without shareholder approval, has the authority to issue preferred stock with rights superior to the rights of the holders of common stock, and we have already issued a series of preferred stock in connection with one of our acquisitions;

our directors may only be removed for cause, and only upon the vote of the holders of at least 66 2/3% of our voting stock;

the board of directors is divided into three classes and directors have staggered terms; and

the shareholders may call a special meeting only upon request of 75% of votes entitled to be cast on an issue.

Georgia law also contains business combination and fair price provisions. Our board of directors may adopt these provisions and other anti-takeover measures without shareholder approval, the effect of which may be to delay, deter or prevent a change in control of Netzee.

## **Recent Accounting Pronouncements**

In June 2001, the Financial Accounting Standards Board ( FASB ) approved Statement of Financial Accounting Standards ( SFAS ) No. 141, Business Combinations. SFAS No. 141 prospectively prohibits the pooling of interest method of accounting for business combinations initiated after June 30, 2001. Additionally, SFAS No. 141 requires additional disclosure regarding the reasons for a business combination and the allocation of the purchase price for business combinations accounted for as a purchase subsequent to June 30, 2001.

In June 2001, the FASB also approved SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires companies to cease the amortization of goodwill that existed at June 30, 2001. SFAS No. 142 established a new method of testing goodwill for impairment on an annual basis or on an interim basis if an event occurs or circumstances change that would change the fair value of goodwill from its carrying value. SFAS No. 142 becomes effective for our fiscal year beginning January 1, 2002. We are currently assessing the impact of adopting SFAS No. 142 to determine the effect, if any, it may have on the consolidated results of operations and financial position as amortization of goodwill will cease for our fiscal year beginning January 1, 2002 and periodic impairment losses may be recognized. The cumulative impact of adopting SFAS No. 142 will be reported as a change in accounting principle in our fiscal 2002 consolidated financial statements.

In October 2001, the FASB approved SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. SFAS No. 144 supersedes SFAS No. 121 and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. In contrast to SFAS No. 121, this statement requires the exclusion of goodwill from its scope and, therefore, eliminates the requirement of SFAS No. 121 to allocate

**Table of Contents**

goodwill to long-lived assets to be tested for impairment. SFAS No. 144 also requires that the depreciable life of a long-lived asset to be abandoned be revised in accordance with the Accounting Principles Board Opinion ( APB ) No. 20, Accounting Changes. APB No. 20 requires that a change in estimate be accounted for in the period of change if the change only affects that period or the period of change and future periods if the change affects both. APB No. 20 does not require restatement or pro forma information for prior periods. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We are required to adopt SFAS No. 144 on January 1, 2002. We believe that the adoption of SFAS No. 144 will not have a material impact on our financial position or results of operations.

**Item 7A. *Qualitative and Quantitative Disclosures Regarding Market Risk***

We do not use derivative financial instruments in our operations or investments, and we do not have significant operations subject to fluctuations in foreign currency exchange rates. We have a joint credit facility with InterCept and Harland that has an interest rate based upon the prime rate as published in the Wall Street Journal, plus a 2% margin. Any increases in such rates may dramatically increase the interest rate under such facility and would make it more costly for us to borrow funds thereunder. These increased borrowing costs may impede our acquisition and growth strategies if management determines that such costs are too high to implement these strategies. These increased costs may also hinder our ability to fund our working capital requirements.

**Item 8. *Financial Statements and Supplementary Data***

The Consolidated Financial Statements of Netzee, including Netzee's Consolidated Balance Sheets as of December 31, 2000 and 2001 and Consolidated Statements of Operations, Consolidated Statements of Cash Flows and Consolidated Statements of Changes in Shareholders' Equity for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001, together with the report thereto of Arthur Andersen LLP dated February 15, 2002 (except with respect to related party borrowings and preferred stock discussed in Note 21, as to which the date is March 29, 2002), are attached hereto as pages F-1 through F-29.

**Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

Since January 1, 2000, we have not had any disagreements on accounting or financial disclosures with our accountants and we have not changed such accountants.

**PART III**

**Item 10. *Directors and Executive Officers of the Registrant***

In accordance with General Instruction G(3) to the Form 10-K, the information required by this item is hereby incorporated by reference from our definitive proxy statement, to be filed with the Securities and Exchange Commission on or before April 30, 2002.

**Item 11. *Executive Compensation***

In accordance with General Instruction G(3) to the Form 10-K, the information required by this item is hereby incorporated by reference from our definitive proxy statement, to be filed with the Securities and Exchange Commission on or before April 30, 2002.

**Item 12. *Security Ownership Of Certain Beneficial Owners and Management and Related Stockholder Matters***

In accordance with General Instruction G(3) to the Form 10-K, the information required by this item is hereby incorporated by reference from our definitive proxy statement, to be filed with the Securities and Exchange Commission on or before April 30, 2002.

**Table of Contents****Item 13. *Certain Relationships and Related Transactions***

In accordance with General Instruction G(3) to the Form 10-K, the information required by this item is hereby incorporated by reference from our definitive proxy statement, to be filed with the Securities and Exchange Commission on or before April 30, 2002.

**PART IV****Item 14. *Exhibits, Financial Statement Schedules and Reports on Form 8-K*****(a) *Exhibits and Financial Statements.***

## Financial Statements

The following consolidated financial statements of Netzee, Inc. and Subsidiaries are filed as part of this Report and are attached hereto as pages F-1 through F-29:

- (i) Report of Independent Public Accountants
- (ii) Consolidated Balance Sheets at December 31, 2000 and 2001
- (iii) Consolidated Statements of Operations for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001
- (iv) Consolidated Statements of Cash Flows for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001
- (v) Consolidated Statements of Shareholders' Equity for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001
- (vi) Notes to Consolidated Financial Statements

## Financial Statement Schedule

Schedule II - Valuation and Qualifying Accounts, is incorporated by reference herein from Exhibit 99.2 filed herewith. The Report of Independent Public Accountants on Financial Statement Schedule with respect thereto is incorporated by reference herein from Exhibit 99.3 filed herewith.

**(3) Exhibits**

<b>Exhibit No.</b>	<b>Description of Exhibits</b>
2.1*	Agreement and Plan of Merger, dated August 6, 1999, by and among Direct Access Interactive, Inc., SBS Corporation and the shareholders of SBS Corporation.(1)
2.2*	Agreement and Plan of Merger, dated September 3, 1999, by and among Netzee, Inc., Dyad Corporation and certain of the shareholders of Dyad Corporation.(1)

## Edgar Filing: NETZEE INC - Form 10-K

- 2.3\* Asset Contribution Agreement, dated September 3, 1999, by and among The InterCept Group, Inc., Netzee, Inc. and The Bankers Bank.(1)
- 2.4\* Asset Contribution Agreement, dated September 3, 1999, by and among The InterCept Group, Inc., Netzee, Inc. and TIB The Independent BankersBank.(1)
- 2.5\* Acquisition Agreement, dated September 3, 1999, by and among Netzee, Inc., Call Me Bill, LLC and each of the members of Call Me Bill, LLC.(1)
- 2.6\* Asset Transfer Agreement, dated August 6, 1999, by and between The InterCept Group, Inc. and Direct Access Interactive, Inc.(1)
- 2.7\* Agreement and Plan of Merger, dated September 3, 1999, by and between Netzee, Inc. and Direct Access Interactive, Inc.(1)

**Table of Contents**

Exhibit No.	Description of Exhibits
2.8*	Asset Purchase Agreement, dated December 15, 1999, by and among Netzee, Inc., Netcal, Inc. and DPSC Software, Inc.(2)
2.9*	Asset Purchase Agreement, dated February 28, 2000, by and among Netzee, Inc., Digital Visions, Inc. and certain shareholders of Digital Visions, Inc.(3)
2.10*	Asset Purchase Agreement, dated July 28, 2000, by and among Netzee, Inc., NetzeePlus, Inc., Card Plus, Inc. and the shareholders of Card Plus, Inc.(7)
2.11*	Asset Purchase Agreement, dated September 29, 2000, by and among Netzee, Inc., John H. Harland Company, Concentrex Incorporated, Meca Software, L.L.C. and MoneyScape Holdings, Inc.(8)
2.11.1*	Amendment No. 1 to the Asset Purchase Agreement, dated November 10, 2000, by and among Netzee, Inc., John H. Harland Company, Concentrex Incorporated, Meca Software, L.L.C. and MoneyScape Holdings, Inc.(8)
2.12*	Asset Purchase Agreement, dated February 2, 2001, by and among Netzee, Inc., Netcal, Inc. and The InterCept Group, Inc.(9)
2.13*	Asset Purchase Agreement, dated March 15, 2001, by and between Netzee, Inc., and HomeCom Communications, Inc.(11)
2.14*	Asset Purchase Agreement, dated May 8, 2001, by and among Netzee, Inc., Call Me Bill, LLC, and iPay, LLC.(11)
2.15*	Asset Purchase Agreement, dated November 15, 2001, by and between Netzee, Inc. and SS&C Technologies, Inc.(12)
3.1	Amended Articles of Incorporation of Netzee, Inc., as amended to date.(11)
3.2	Amended and Restated Bylaws of Netzee, Inc., as amended.(4)
4.1	Form of Netzee, Inc. common stock certificate.(11)
4.2	Form of Netzee, Inc. Series B 8% Convertible Preferred Stock certificate.(7)
4.3	Registration Rights Agreement, dated December 15, 1999, by and between Netzee, Inc. and each of the former shareholders of DPSC Software, Inc.(2)
4.3.1	First Amendment to Registration Rights Agreement, dated September 29, 2000, by and between Netzee, Inc. and Bruce R. Gall & Associates, Inc., on behalf of each of the former shareholders of DPSC Software, Inc.(7)
4.3.2	Second Amendment to Registration Rights Agreement, dated March 29, 2002, by and among Netzee, Inc. and each of the former shareholders of DPSC Software, Inc.
4.4	Registration Rights Agreement, dated July 28, 2000, by and between Netzee, Inc. and Card Plus, Inc.(7)
4.5	Registration Rights Agreement, dated November 10, 2000, by and between Netzee, Inc. and John H. Harland Company.(8)
10.1	Netzee, Inc. 1999 Stock Option and Incentive Plan.(1)
10.2	Option Agreement, dated July 1, 1999, by and between Netzee, Inc. (as successor to Direct Access Interactive, Inc.) and Glenn W. Sturm.(1)
10.3	Option Agreement, dated July 1, 1999, by and between Netzee, Inc. (as successor to Direct Access Interactive, Inc.) and John W. Collins.(1)
10.4	Option Agreement, dated August 5, 1999, by and between Netzee, Inc. (as successor to Direct Access Interactive, Inc.) and Richard S. Eiswirth.(1)
10.5	Employment Agreement, dated September 1, 1999, by and between Netzee, Inc. and Glenn W. Sturm.(1)
10.6	Employment Agreement, dated March 1, 2000, by and between Netzee, Inc. and Richard S. Eiswirth.(4)
10.6.1	Amendment to Employment Agreement, dated May 1, 2001, by and between Netzee, Inc. and Richard S. Eiswirth.(11)

**Table of Contents**

Exhibit No.	Description of Exhibits
10.7	Form of Indemnification Agreement entered into between Netzee, Inc. and each of its executive officers and directors.(1)
10.8	Promissory Note, dated September 1, 1999, from Richard S. Eiswirth as maker to Netzee, Inc. (as successor to Direct Access Interactive, Inc.)(1)
10.9	General Marketing Agent Agreement, dated September 3, 1999, as amended, by and between Netzee, Inc. and TIB The Independent Bankers Bank.(1)(5)
10.10	General Marketing Agent Agreement, dated September 3, 1999, as amended, by and between Netzee, Inc. and The Bankers Bank.(1)(5)
10.11	Commercial Lease, dated January 9, 1998, by and between DMB, LLC and Netzee, Inc. (as successor to Direct Access Interactive, Inc. (as successor to SBS Corporation)).(1)
10.12	Credit Agreement, dated May 31, 2000, by and between Netzee, Inc. and The InterCept Group, Inc.(6)
10.12.1	Amendment No. 1 to Credit Agreement, dated September 29, 2000, by and between Netzee, Inc. and The InterCept Group, Inc.(7)
10.12.2	Amended and Restated Credit Agreement, dated February 2, 2001, by and among Netzee, Inc., The InterCept Group, Inc. and John H. Harland Company.(9)
10.12.3	Consent and Release, dated May 1, 2001, by and among Netzee, Inc., Call Me Bill, LLC, The InterCept Group, Inc., and John H. Harland Company.(11)
10.12.4	Amendment No. 1 to Amended and Restated Credit Agreement, dated March 29, 2002, by and among Netzee, Inc., InterCept, Inc. and John H. Harland Company.
10.13	Employment Agreement, dated July 26, 2000, by and between Netzee, Inc. and Catherine G. Silver.(7)
10.14	Warranty Bill of Sale, dated March 1, 2001, from Netzee, Inc. in favor of W-II Investments, Inc.(10)
10.15	Assignment and Assumption Agreement (Business Loan Agreement), dated March 1, 2001, by and between Netzee, Inc. and W-II Investments, Inc.(10)
10.16	Assignment and Assumption Agreement (Mortgage, Security Agreement and Assignment), dated March 1, 2001, by and between Netzee, Inc. and W-II Investments, Inc.(10)
10.17	Employment Agreement, dated October 9, 2000, by and between Netzee, Inc. and Dan Anderson.(10)
10.18	Severance Agreement, dated November 1, 2000, by and between Netzee, Inc. and Catherine G. Silver.(10)
10.19	Employment Agreement, dated October 10, 2000, by and between Netzee, Inc. and Donny R. Jackson.(10)
10.20	Severance Agreement, dated May 5, 2001, by and between Netzee, Inc. and Dan Anderson.(11)
10.21	Employment Agreement, dated May 7, 2001, by and between Netzee, Inc. and William Todd Shiver.(11)
10.22	Severance Agreement, dated November 30, 2001, by and between Netzee, Inc. and C. Michael Bowers
21.1	Subsidiaries of the Registrant.
23.1	Consent of Arthur Andersen LLP.
99.1	Letter Required by Temporary Note 3T to Article 3 of Regulation S-X.
99.2	Schedule II to Consolidated Financial Statements Valuation and Qualifying Accounts.
99.3	Report of Independent Public Accountants on Financial Statement Schedule.



\* Certain schedules and exhibits to this exhibit have been omitted in accordance with the rules of the Securities and Exchange Commission. Netzee, Inc. agrees to furnish supplementally a copy of any such omitted schedule or exhibit to the Securities and Exchange Commission upon request.

**Table of Contents**

- (1) Previously filed as an exhibit to Netzee, Inc. s Registration Statement on Form S-1 (File No. 333-87089), and hereby incorporated by reference herein.
  - (2) Previously filed as an exhibit to Netzee, Inc. s Form 10-Q for the quarter ended September 30, 1999, as filed with the Securities and Exchange Commission on December 22, 1999, and hereby incorporated by reference herein.
  - (3) Previously filed as an exhibit to Netzee, Inc. s Form 8-K, dated March 7, 2000, as filed with the Securities and Exchange Commission on March 22, 2000, and hereby incorporated by reference herein.
  - (4) Previously filed as an exhibit to Netzee, Inc. s Form 10-K for the fiscal year ended December 31, 1999, as filed with the Securities and Exchange Commission on March 29, 2000, and as amended May 1, 2000, and hereby incorporated by reference herein.
  - (5) Portions of this exhibit were previously omitted pursuant to a confidential treatment request granted by the Securities and Exchange Commission on November 8, 1999 and renewed on November 15, 2000 and October 18, 2001.
  - (6) Previously filed as an exhibit to Netzee, Inc. s Form 8-K, dated May 31, 2000, as filed with the Securities and Exchange Commission on June 20, 2000, and hereby incorporated by reference herein.
  - (7) Previously filed as an exhibit to Netzee, Inc. s Form 10-Q for the quarter ended September 30, 2000, as filed with the Securities and Exchange Commission on November 14, 2000, and hereby incorporated by reference herein.
  - (8) Previously filed as an exhibit to Netzee, Inc. s Form 8-K, dated November 10, 2000, as filed with the Securities and Exchange Commission on November 22, 2000, and hereby incorporated by reference herein.
  - (9) Previously filed as an exhibit to Netzee, Inc. s Form 8-K, dated February 2, 2001, as filed with the Securities and Exchange Commission on February 16, 2001, and hereby incorporated by reference herein.
  - (10) Previously filed as an exhibit to Netzee, Inc. s Form 10-K for the fiscal year ended December 31, 2000, as filed with the Securities and Exchange Commission on April 2, 2001, and hereby incorporated by reference herein.
  - (11) Previously filed as an exhibit to Netzee, Inc. s Form 10-Q for the quarter ended June 30, 2001, as filed with the Securities and Exchange Commission on August 14, 2001, and hereby incorporated by reference herein.
  - (12) Previously filed as an exhibit to SS&C Technologies, Inc. s Form 8-K, dated November 15, 2001 (File No. 0-28430), as filed with the Securities and Exchange Commission on November 27, 2001, and hereby incorporated by reference herein.
- (b) Reports on Form 8-K.*

During the last quarter of our 2001 fiscal year, we did not file any reports on Form 8-K.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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:

NETZEE, INC.

By: /s/ DONNY R. JACKSON

---

Donny R. Jackson  
*Chief Executive Officer*

Date: April 1, 2002

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ DONNY R. JACKSON _____ Donny R. Jackson	Chief Executive Officer and Director (Principal Executive Officer)	April 1, 2002
/s/ RICHARD S. EISWIRTH _____ Richard S. Eiswirth	Senior Executive Vice President, Chief Financial Officer and Secretary (Principal Financial Officer)	April 1, 2002
/s/ JARETT J. JANIK _____ Jarett J. Janik	Vice President and Controller (Principal Accounting Officer)	April 1, 2002
/s/ JOHN W. COLLINS _____ John W. Collins	Chairman of the Board of Directors	April 1, 2002
/s/ STILES A. KELLETT, JR. _____ Stiles A. Kellett, Jr.	Director	April 1, 2002
/s/ JEFFERSON B. A. KNOX, SR. _____ Jefferson B. A. Knox, Sr.	Director	April 1, 2002
/s/ BRUCE P. LEONARD _____ Bruce P. Leonard	Director	April 1, 2002
/s/ A. JAY WAITE _____ A. Jay Waite	Director	April 1, 2002

**Table of Contents**

**NETZEE, INC.**  
**AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 1999, 2000 AND 2001**  
**TABLE OF CONTENTS**

	<b>Page</b>
<b>Report of Independent Public Accountants</b>	F-2
<b>Consolidated Financial Statements</b>	
Consolidated Balance Sheets as of December 31, 2000 and 2001 F-3	
Consolidated Statements of Operations for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999 and for the years ended December 31, 2000 and 2001 F-4	
Consolidated Statements of Changes in Shareholders (Deficit) Equity for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999 and for the years ended December 31, 2000 and 2001 F-5	
Consolidated Statements of Cash Flows for the period from	

Edgar Filing: NETZEE INC - Form 10-K

January 1, 1999 to  
February 28, 1999,  
for the period from  
March 1, 1999 to  
December 31,  
1999 and for the  
years ended  
December 31,  
2000 and 2001

F-6

**Notes to  
Consolidated  
Financial  
Statements**

F-7

F-1

---

**Table of Contents**

**REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS**

To Netzee, Inc.:

We have audited the accompanying consolidated balance sheets of **NETZEE, INC.** (a Georgia corporation, formerly Direct Access Interactive, Inc.) **AND SUBSIDIARIES** as of December 31, 2000 and 2001 and the related consolidated statements of operations, shareholders' equity, and cash flows for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001 and the consolidated statements of operations, shareholders' deficit, and cash flows of its predecessor (Direct Access Interactive, Inc.) for the period from January 1, 1999 to February 28, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Netzee, Inc. and subsidiaries as of December 31, 2000 and 2001, the results of their operations and their cash flows for the years ended December 31, 2000 and 2001 and the period from March 1, 1999 to December 31, 1999, and the results of operations and cash flows of its predecessor (Direct Access Interactive, Inc.) for the period from January 1, 1999 to February 28, 1999 in conformity with accounting principles generally accepted in the United States.

ARTHUR ANDERSEN LLP

Atlanta, Georgia

February 15, 2002 (except with respect to related party borrowings and preferred stock discussed in Note 21, as to which the date is March 29, 2002)

**Table of Contents**

**NETZEE, INC.**  
**AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	<b>December 31, 2000</b>	<b>December 31, 2001</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$960,231	\$464,889
Restricted cash	135,000	325,000
Accounts receivable, net of allowance for doubtful accounts of \$641,447 and \$375,202, at December 31, 2000 and 2001, respectively	5,836,904	2,708,227
Leases receivable, current	671,580	630,083
Prepaid and other current assets	1,130,294	1,091,442
Total current assets	8,734,009	5,219,641
Property and equipment, net of accumulated depreciation of \$3,552,971 and \$3,007,404 at December 31, 2000 and 2001, respectively	6,616,804	4,315,900
Intangible assets, net of accumulated amortization of \$47,824,555 and \$50,028,727 at December 31, 2000 and 2001, respectively	89,950,659	22,261,157
Leases receivable, net of current portion	1,202,606	638,267
Other non-current assets	210,942	65,607
Total assets	\$106,715,020	\$32,500,572

**LIABILITIES AND SHAREHOLDERS****EQUITY**

## Current liabilities:

Accounts payable  
\$1,784,480 \$1,303,835

Accrued liabilities  
4,372,821 1,354,045

Deferred revenue  
7,263,099 2,697,894

Note payable, current portion  
134,231

Other current liabilities  
668,151 1,039,996

---

Total current liabilities  
14,222,782 6,395,770

Related-party borrowings  
20,000,000 13,191,715

Note payable, net of current portion  
1,465,590

Deferred revenue, net of current portion  
1,436,576 1,180,780

---

Total liabilities  
37,124,948 19,587,485

Commitments and contingencies (Note 20)

Redeemable preferred stock, no par value;  
5,000,000 shares authorized: 8% convertible  
preferred stock, \$13 stated value; 500,000  
shares authorized and outstanding at  
December 31, 2000 and 2001

6,500,000 6,500,000

Shareholders' equity:

Common stock, no par value; 70,000,000  
shares authorized at December 31, 2000 and  
2001; 3,358,642 and 3,377,911 shares  
issued and outstanding at December 31,  
2000 and 2001, respectively

192,304,886 190,555,255

Notes receivable from shareholders  
(1,525,467) (579,486)

Deferred stock compensation  
(3,595,682) (629,234)

Accumulated deficit  
(124,093,665) (184,114,228)

---

Total shareholders' equity



63,090,072 5,232,307

---

---

Total liabilities and shareholders' equity  
\$106,715,020 \$32,500,572

---

---

The accompanying notes are an integral part of these consolidated balance sheets.

F-3

---

**Table of Contents**

The year ended December 31, 1999 is presented in two columns below due to the acquisition of the predecessor on March 9, 1999, which established a new basis of accounting for certain assets and liabilities of Netzee, Inc. The purchase method of accounting was used to record assets acquired and liabilities assumed by Netzee, Inc. Such accounting generally results in increased amortization reported in future periods. Accordingly, the accompanying consolidated financial statements of the Predecessor and Netzee, Inc. are not comparable in all material respects, since those financial statements report financial position, results of operations, and cash flows on a different basis of accounting.

**NETZEE, INC.**

**(Formerly Direct Access Interactive, Inc. ( Predecessor ))**  
**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

	<u>Predecessor</u>		<u>Netzee, Inc.</u>	
	<u>For the</u>	<u>For the</u>		
	<u>Period</u>	<u>Period</u>		
	<u>from</u>	<u>from</u>		
	<u>January</u>	<u>March</u>	<u>Year</u>	<u>Year</u>
	<u>1, 1999 to</u>	<u>1, 1999</u>	<u>Ended</u>	<u>Ended</u>
	<u>February</u>	<u>to</u>	<u>December</u>	<u>December</u>
	<u>28,</u>	<u>December</u>	<u>31,</u>	<u>31,</u>
	<u>1999</u>	<u>31,</u>	<u>2000</u>	<u>2001</u>
Revenues:				
Monthly maintenance and service	\$33,082	\$1,737,592	\$17,760,838	\$23,467,947
License, hardware, implementation and other	57,080	522,159	2,150,706	2,296,096
Total revenues	90,162	2,259,751	19,911,544	25,764,043
Operating expenses:				
Cost of services, license, hardware, implementation and maintenance	44,358	1,913,960	10,105,570	14,115,008
Selling and marketing	12,350	2,575,257	9,422,085	3,559,257
General and administrative, excluding amortization of stock-based compensation and restructuring costs	49,399	1,844,629	11,342,280	11,556,547
Amortization of stock-based compensation	4,591,888	3,192,688	1,255,437	
Depreciation				

Edgar Filing: NETZEE INC - Form 10-K

2,476	190,524	1,773,436	2,065,577
Amortization			
12,863,016	52,802,042	32,969,808	
Restructuring costs			
211,200	2,002,139		
Long-lived asset impairment charges			
26,300,278	12,142,146		
Net loss on sales of assets			
4,719,863			

---



---



---



---

Total operating expenses			
108,583	23,979,274	115,149,579	84,385,782

---



---



---



---

Operating loss			
(18,421)	(21,719,523)	(95,238,035)	(58,621,739)
Interest expense, net			
(3,469)	(670,503)	(1,050,664)	(878,824)

---



---



---



---

Loss before extraordinary item			
(21,890)	(22,390,026)	(96,288,699)	(59,500,563)
Extraordinary loss			
(4,518,760)			

---



---



---



---

Net loss before preferred dividends and cumulative effect of change in accounting principle			
(21,890)	(26,908,786)	(96,288,699)	(59,500,563)
Preferred stock dividends			
(24,200)	(520,000)	(520,000)	

---

---



---



---

Net loss attributable to common shareholders before cumulative effect of change in accounting principle  
 (21,890) (26,932,986) (96,808,699) (60,020,563)  
 Cumulative effect of change in accounting principle  
 (351,980)

---



---



---



---

Net loss attributable to common shareholders  
 \$(21,890) \$(26,932,986) \$(97,160,679) \$(60,020,563)

---



---



---



---

Basic and diluted loss per share before extraordinary item  
 \$(15.54) \$(34.81) \$(17.89)  
 Extraordinary loss per share  
 (3.13)

---



---



---

Basic and diluted net loss per share before cumulative effect of change in accounting principle  
 \$(18.67) \$(34.81) \$(17.89)  
 Loss per share from cumulative effect of change in accounting principle  
 (0.13)

---



---



---

Basic and diluted loss per share  
 \$(18.67) \$(34.94) \$(17.89)

---

---

---

Weighted average common shares outstanding  
1,442,754 2,781,141 3,354,909

---

---

---

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

F-4

---

**Table of Contents**

The purchase method of accounting was used to record assets acquired and liabilities assumed by Netzee, Inc. Such accounting generally results in increased amortization reported in future periods. Accordingly, the accompanying consolidated financial statements of the Predecessor and Netzee, Inc. are not comparable in all material respects, since those financial statements report financial position, results of operations, and cash flows on a different basis of accounting.

**NETZEE, INC.**

**(Formerly Direct Access Interactive, Inc. ( Predecessor ))  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS (DEFICIT) EQUITY**

	Common Stock	Shareholder Advances	Deferred Compensation	Notes Receivable	Accumulated Deficit
	Shares	Amount	Warrants	Receivable	Deficit
Predecessor:					
Balance, December 31, 1998	2,000,000	\$50,871	\$	\$	\$(505,689)
Net loss		(21,890)			
<hr/>					
<hr/>					
<hr/>					
<hr/>					
<hr/>					
<hr/>					
<hr/>					
Balance, February 28, 1999	2,000,000	\$50,871	\$	\$	\$(527,579)
<hr/>					
<hr/>					
<hr/>					
<hr/>					
<hr/>					

Netzee, Inc.:

Initial InterCept investment, March 9, 1999	1,000,147	\$1,379,965	\$	\$	\$	\$
Issuance of common stock for notes receivable	194,375	3,110,000	(3,110,000)			
Capital contributions	1,990,556					
Issuance of common stock in connection with acquisitions	765,280	71,884,011				
Issuance of common stock in connection with marketing agreements	16,077	1,479,096				
Deferred stock-based compensation	20,000	13,224,100	(85,000)	(13,139,100)		
Amortization of deferred stock-based compensation		4,591,888				
Stock options exercised for note receivable	3,750	93,300	(93,300)			
Payment of shareholder notes		85,000				
Interest on shareholder notes		(111,499)				
Issuance of warrants to purchase common stock		4,618,760				
Initial public offering proceeds, net of expenses	550,000	54,895,583				
Net loss attributable to common shareholders		(26,932,986)				

Balance, December 31, 1999	2,549,629	148,056,611	4,618,760	(3,314,799)	(8,547,212)	(26,932,986)
----------------------------	-----------	-------------	-----------	-------------	-------------	--------------

Exercise of warrants to purchase common stock	57,735	6,119,857	(4,618,760)			
---	--------	-----------	-------------	--	--	--

Edgar Filing: NETZEE INC - Form 10-K

Issuance of common stock and options to purchase common stock in connection with acquisitions

705,232 39,834,929

Issuance of common stock in connection with employer 401k match

47,401 142,204

Forfeiture of restricted shares

(3,125) (375,000) 375,000

Initial public offering expenses

(107,480)

Exercise of stock options

1,771 17,607

Interest on shareholder notes

(214,241)

Repayment of shareholders notes

2,003,573

Amortization of deferred stock-based compensation

3,192,688

Forfeiture of stock options

(1,383,842) 1,383,842

Net loss attributable to common shareholders

(97,160,679)

---



---



---



---



---



---



---



---

Balance, December 31, 2000

3,358,642 192,304,886 (1,525,467) (3,595,682) (124,093,665)

---



---



---



---



---



---



---



---

Return of common stock in connection with acquisitions

(23,824) (115,885)

Forfeitures of stock options

(1,711,011) 1,711,011

Repayment of shareholders notes

981,659

Exercise of stock options

2,223 177

Issuance of common stock in connection with acquisitions

28,572 56,573

Interest on shareholder notes

(35,678)



Edgar Filing: NETZEE INC - Form 10-K

Amortization of deferred stock-based compensation	1,255,437
Issuance of common stock in connection with employer 401(k) match	12,298 20,516
Net loss attributable to common shareholders	(60,020,563)

---



---



---



---



---



---



---

Balance, December 31, 2001	3,377,911	\$190,555,255	\$	\$(579,486)	\$(629,234)	\$(184,114,228)
----------------------------	-----------	---------------	----	-------------	-------------	-----------------

---



---



---



---



---



---



---

[Additional columns below]

[Continued from above table, first column(s) repeated]

**Total  
Shareholders  
(Deficit)  
Equity**

---

Predecessor:

Balance, December 31, 1998	\$(454,818)
Net loss	(21,890)

---

Balance, February 28, 1999	\$(476,708)
----------------------------	-------------

---

Netzee, Inc.:

Initial InterCept investment,  
 March 9, 1999  
 \$1,379,965  
 Issuance of common stock for  
 notes receivable

Capital contributions  
 1,990,556  
 Issuance of common stock in  
 connection with acquisitions  
 71,884,011  
 Issuance of common stock in  
 connection with marketing  
 agreements  
 1,479,096  
 Deferred stock-based  
 compensation

Amortization of deferred  
 stock-based compensation  
 4,591,888  
 Stock options exercised for  
 note receivable

Payment of shareholder notes  
 85,000  
 Interest on shareholder notes  
 (111,499)  
 Issuance of warrants to  
 purchase common stock  
 4,618,760  
 Initial public offering  
 proceeds, net of expenses  
 54,895,583  
 Net loss attributable to  
 common shareholders  
 (26,932,986)

---

Balance, December 31, 1999  
 113,880,373

---

Exercise of warrants to  
 purchase common stock  
 1,501,097  
 Issuance of common stock and  
 options to purchase common  
 stock in connection with  
 acquisitions  
 39,834,929  
 Issuance of common stock in  
 connection with employer  
 401k match  
 142,204  
 Forfeiture of restricted shares

Initial public offering expenses  
 (107,480)  
 Exercise of stock options  
 17,607

Interest on shareholder notes  
 (214,241)  
 Repayment of shareholders  
 notes  
 2,003,573  
 Amortization of deferred  
 stock-based compensation  
 3,192,688  
 Forfeiture of stock options

Net loss attributable to  
 common shareholders  
 (97,160,679)

---

Balance, December 31, 2000  
 63,090,072

---

Return of common stock in  
 connection with acquisitions  
 (115,885)  
 Forfeitures of stock options

Repayment of shareholders  
 notes  
 981,659  
 Exercise of stock options  
 177

Issuance of common stock in  
 connection with acquisitions  
 56,573

Interest on shareholder notes  
 (35,678)

Amortization of deferred  
 stock-based compensation  
 1,255,437

Issuance of common stock in  
 connection with employer  
 401(k) match  
 20,516

Net loss attributable to  
 common shareholders  
 (60,020,563)

---

Balance, December 31, 2001  
 \$5,232,307

---

(1) All shares have been adjusted to reflect the one-for-eight reverse stock split effected May 16, 2001.  
 The accompanying notes are an integral part of these consolidated statements.

**Table of Contents**

The year ended December 31, 1999 is presented in two columns below due to the acquisition of the predecessor on March 9, 1999, which established a new basis of accounting for certain assets and liabilities of Netzee, Inc. The purchase method of accounting was used to record assets acquired and liabilities assumed by Netzee, Inc. Such accounting generally results in increased amortization reported in future periods. Accordingly, the accompanying consolidated financial statements of the Predecessor and Netzee, Inc. are not comparable in all material respects, since those financial statements report financial position, results of operations, and cash flows on a different basis of accounting.

**NETZEE, INC.**

**(Formerly Direct Access Interactive, Inc. ( Predecessor ))**  
**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Predecessor</b>	<b>Netzee, Inc.</b>		
	<b>For the Period from January 1, 1999 to February 28, 1999</b>	<b>For the Period from March 1, 1999 to December 31, 1999</b>	<b>Year Ended December 31, 2000</b>	<b>Year Ended December 31, 2001</b>
Cash flows from operating activities:				
Net loss attributable to common shareholders	\$(21,890)	\$(26,932,986)	\$(97,160,679)	\$(60,020,563)
Adjustments to reconcile net loss to net cash used in operating activities:				
Cumulative effect of change in accounting principle		351,980		
Depreciation and amortization	2,476	13,053,540	54,575,478	35,035,385
Stock-based compensation expense	4,591,888	3,192,688	1,255,437	
Asset impairment charges		26,300,278	12,142,146	
Provision for bad debt		579,590	10,572	
Net loss on sales of assets		4,719,858		
Extraordinary loss		4,518,760		
Interest income on shareholder notes		(111,499)	(214,241)	(35,678)
Changes in assets and liabilities, net of effect of acquisitions and dispositions:				
Accounts receivable	12,606	(2,008,746)	(2,946,615)	2,255,972
Leases receivable		(198,873)	(621,207)	605,836
Prepaid and other current assets		(303,528)	(387,938)	(175,409)

Accounts payable and accrued liabilities  
 (42,889) 3,238,796 (956,124) (3,205,903)  
 Accrued restructuring costs  
 98,300 (61,292)  
 Deferred revenue  
 41,222 1,602,925 990,444 (1,530,326)  
 Other current liabilities  
 24,200 639,085 586,795

---



---



---



---

Net cash used in operating activities  
 (8,475) (2,525,523) (15,558,961) (8,417,170)

Cash flows from investing activities:

Acquisitions, net of cash acquired  
 (48,938,638) (420,954)  
 Purchase of property, equipment and capitalized software  
 (4,233,946) (4,138,335) (2,238,777)  
 Purchase of short-term investments related to restricted cash  
 (135,000) (575,000)  
 Proceeds from sale of short-term investments related to restricted cash  
 380,000  
 Proceeds from the sale of assets  
 16,863,801

---



---



---



---

Net cash (used in) provided by investing activities  
 (53,172,584) (4,273,335) 14,009,070

Cash flows from financing activities:

Contributions from shareholder				
1,240,556				
Related party borrowings				
41,830,132	27,046,095	10,450,000		
Payments on related party borrowings				
(31,524,798)	(18,003,025)	(17,496,706)		
Decrease in line of credit				
(277,473)				
Payments on notes payable				
(25,865)	(3,403,911)	(22,372)		
Net proceeds from refinancing of note payable				
400,192				
Repayment of shareholder notes				
2,003,573	981,659			
Payments of preferred stock dividends				
(24,200)				
Proceeds from exercise of warrants				
1,501,097				
Proceeds from exercise of options for common stock				
17,607	177			
Sale of common stock				
55,707,144				
Decrease in related party loans from shareholder of predecessor entity				
(2,000)				

---



---



---



---

Net cash (used in) provided by financing activities

(2,000)	66,949,696	9,537,428	(6,087,242)	
---------	------------	-----------	-------------	--

---



---



---



---

Net (decrease) increase in cash and cash equivalents

(10,475)	11,251,589	(10,294,868)	(495,342)	
----------	------------	--------------	-----------	--

Cash and cash equivalents beginning of period

13,985	3,510	11,255,099	960,231	
--------	-------	------------	---------	--

---



---



---



---

Cash and cash equivalents end of period

\$3,510	\$11,255,099	\$960,231	\$464,889	
---------	--------------	-----------	-----------	--



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

F-6



**Table of Contents**

**NETZEE, INC.**

**AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 1999, 2000, and 2001**

**1. ORGANIZATION AND NATURE OF BUSINESS**

**Organization, Formation, Certain Acquisitions and Certain Dispositions**

Netzee, Inc. ( we, Netzee or the Company ) is a provider of Internet banking products and services and Internet commerce solutions to small and mid-sized banks, thrifts and credit unions, typically with assets of less than \$10 billion. We provide solutions that enable financial institutions to offer their customers a wide array of financial products and services over the Internet. We also offer financial institutions custom web site design, implementation and marketing services, telephone banking products and other support applications.

Netzee was formed as a Georgia corporation in August 1999 to be merged with Direct Access Interactive, Inc. ( Direct Access or the Predecessor ), a company that was formed in October 1996 to provide Internet and telephone banking products and services. In March 1999, InterCept, Inc. ( InterCept ) acquired Direct Access as a wholly owned subsidiary. InterCept currently owns approximately 28% of our common stock.

In August 1999, Direct Access acquired SBS Corporation ( SBS ) in a merger. Immediately after the merger, Direct Access sold all of the assets of SBS, other than its Internet and telephone banking assets, to our former parent company, InterCept. Based in Birmingham, Alabama, SBS provided automated technology products and services, including Internet and telephone banking systems, to community financial institutions nationwide.

In September 1999, Direct Access was merged into Netzee, with Netzee being the surviving corporation. On that same day, Netzee acquired the Internet banking divisions (the Divisions ) of each of TIB The Independent BankersBank ( TIB ), a Texas state chartered and Federal Reserve member bank, and The Bankers Bank, a Georgia state chartered and Federal Reserve member bank. Each of these entities is a bankers bank, which is a bank that exclusively serves and is owned by other financial institutions.

In September 1999, we also acquired all of the ownership interests in Call Me Bill, LLC ( Call Me Bill ) based in Elizabethtown, Kentucky. Call Me Bill provided 24-hour electronic bill payment services to financial institutions customers. Subsequently, we integrated these services into our core Internet banking product. In May 2001, we sold a portion of these assets which we considered a non-core component of our business to iPay, LLC ( iPay ), a related party, which also assumed certain of the liabilities associated with the assets (see Note 4).

In September 1999, we also acquired Dyad Corporation ( Dyad ). Based in Norcross, Georgia, Dyad developed, among other things, proprietary loan application, approval and fulfillment software.

In November 1999, we completed our initial public offering. We issued 550,000 shares of common stock (including the exercise of a portion of the underwriter s over-allotment option) at an offering price of \$112 per share. Net proceeds from the offering were approximately \$55 million after deducting underwriters discounts, commissions and expenses of the offering. We used the proceeds to repay principal and accrued interest owed to InterCept pursuant to outstanding promissory notes and previous working capital advances and to acquire DPSC Software, Inc. ( DPSC ) in December 1999.



Edgar Filing: NETZEE INC - Form 10-K

Located near Los Angeles, California, DPSC provided regulatory reporting and support applications designed to meet the special needs of community financial institutions. In February 2001, we sold substantially all of these assets to InterCept, which also assumed substantially all of the liabilities associated with the assets (see Note 4).

In March 2000, we acquired certain of the assets and assumed certain liabilities of Digital Visions, Inc. ( DVI ) based in Minneapolis, Minnesota. DVI provided Internet-based financial information tools for

F-7

---

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

community financial institutions. In November 2001, we sold substantially all of these assets to SS&C Technologies, Inc. ( SS&C ), which also assumed certain of the liabilities associated with the assets (see Note 4).

In July 2000, we acquired certain assets and assumed certain liabilities of Card Plus, Inc. ( Card Plus ). Located in Norcross, Georgia, Card Plus provided software and outsourced consultants for systems development.

In November 2000, we acquired certain assets and assumed certain liabilities of John H. Harland Company ( Harland ). The assets acquired were principally located in Trumbull, Connecticut and Portland, Oregon and are used to provide Internet banking and bill payment services. As a result of our purchase of these assets, Harland now has beneficial ownership of approximately 16% of our common stock.

In March 2001, we purchased certain assets of HomeCom s Internet banking business and assumed certain of HomeCom s operating liabilities related to the business. The assets acquired were principally located in Atlanta, Georgia and are used to provide Internet banking services (see Note 3).

We collectively refer to Call Me Bill, Card Plus, DPSC, DVI, Dyad, HomeCom, the Internet banking and bill payment assets of Harland, the Internet and telephone banking operations of SBS and the Divisions as the Acquired Operations.

We have incurred net losses since our inception. As of December 31, 2001, we had an accumulated deficit of approximately \$184 million. These losses have resulted from the costs we have incurred to develop our products and services, and to increase our customer base and build our infrastructure as well as from the amortization of intangible assets associated with the Acquired Operations. We believe that our existing capital resources, together with cash provided by our operations and borrowings under our credit facility, will be sufficient to fund our working capital requirements for the next 12 months. If we are unable to achieve and maintain our cost savings goals, if our working capital requirements exceed our current expectations, if cash provided by our operations is less than anticipated, or if we make additional acquisitions, we may need to raise additional capital either through debt or equity sources before that time. We cannot be sure that we will be able to obtain the additional financing necessary to satisfy these additional capital requirements or to implement our strategy on acceptable terms or at all. Additionally, we may need to further extend the due dates of our line of credit as well as our preferred stock. If we cannot obtain this financing or these extensions on terms acceptable to us or at all, we may be forced to curtail some planned business expansion, we may be unable to fund our ongoing operations, or we may have to cease operations altogether. Alternatively, we may be required to reduce the level of spending on capital and operating expenses in order to utilize our existing financing and sources of liquidity to operate the business on a reduced scale.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The financial statements of the Predecessor for the period from January 1, 1999 through February 28, 1999, include only the accounts of Direct Access. The consolidated financial statements for the period from March 1, 1999 to December 31, 1999 and for the years ended December 31, 2000 and 2001 include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial statements of the Predecessor and the Company are not comparable in all material respects, since those financial statements report the financial position, results of operations, and cash flows on a different basis of accounting. Although Direct Access was acquired on March 9, 1999, the accompanying financial statements for the year ended December 31, 1999 are presented as if the acquisition

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

occurred on the close of business on February 28, 1999 instead of March 9, 1999. The operations between March 1, 1999 and March 9, 1999 were not material. The accompanying financial statements prior to February 28, 1999 present the financial position and the results of operations and cash flows of Direct Access, the predecessor to Netzee.

The Acquired Operations noted above were accounted for using the purchase method of accounting. Accordingly, the results of operations of the Acquired Operations have been included in the consolidated financial statements from their respective dates of acquisition forward.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash and Cash Equivalents**

We consider all short-term, highly liquid investments with an original maturity date of three months or less to be cash equivalents.

**Restricted Cash**

Restricted cash at December 31, 2001 is comprised of certificates of deposit and are related to certain operating stand-by letters of credit, as well as \$125,000 held in escrow related to certain divestitures in 2001 (see Note 4). Restricted cash at December 31, 2000 related to certain operating stand-by letters of credit.

**Property and Equipment**

Property and equipment are recorded at cost and are depreciated using the straight-line method over the estimated useful lives of the assets for financial reporting purposes. Effective March 9, 1999, the property and equipment of the Predecessor were restated to the fair value at the date of acquisition. Major additions and improvements are charged to the property accounts while maintenance and repairs, which do not improve or extend the lives of assets, are expensed in the current period. Estimated useful lives for our assets are as follows:

Leasehold improvements
Lesser of useful life or term of lease
Computer equipment
3 to 5 years
Furniture and fixtures
10 years
Machinery and other equipment
3 to 15 years
Software
3 to 5 years

## **Intangible Assets**

Intangible assets consist of the intangibles recorded as a result of the acquisitions discussed in Note 1 and include acquired technology, workforce, contracts in progress, marketing agreements and goodwill. The carrying amounts of the intangible assets are reviewed for impairment when events and circumstances indicate that the recorded costs may not be recoverable in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of. If the review indicates that the undiscounted cash flows from operations of the related intangible assets over the remaining amortization period are expected to be less than the recorded amount of

F-9

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the intangible, our carrying value of the intangible asset would be reduced to its estimated fair value determined based on discounted future cash flows. We recorded impairment charges related to certain intangible assets during 2000 and 2001 (see Note 11).

We have allocated the value of acquired intangible assets to acquired technology, workforce, contracts in progress, marketing agreements and goodwill. The value of workforce was determined by reference to the cost of the workforce retained. Contracts in progress represent existing customer contracts acquired. The value of contracts in progress was determined by reference to the recurring revenue generated from existing customers. Marketing agreements represent agreements with several bankers banks to use their best efforts to promote and market our products and services to community financial institutions on an exclusive basis.

Excluding intangible assets acquired from Card Plus, we determined that the remaining value of intangible assets was related to acquired technology. Acquired technology also represents internally developed software acquired. Intangible assets obtained in the Card Plus acquisition in excess of amounts allocated to workforce were allocated to goodwill. Each of these intangible assets is amortized on a straight-line basis over the following periods:

Workforce	
3 years	
Contracts in progress	
3 to 4 years	
Marketing agreements	
2 years	
Acquired technology	
3 years	
Goodwill	
3 years	

**Software Development Costs**

For certain of our service bureau software applications, we account for costs incurred to develop software applications in accordance with the American Institute of Certified Public Accountants ( AICPA ) Statement of Position ( SOP ) No. 98-1, Accounting for the Cost of Computer Software Developed or Obtained for Internal Use. SOP No. 98-1 requires that entities capitalize certain internal use software costs, which includes software design, coding, installation, configuration and testing, once technical feasibility of the developed software is attained. Costs incurred in the process of attaining technological feasibility, which includes the conceptual formulation and evaluation of the software alternatives, and costs to upgrade and enhance software once developed are expensed as incurred. Under SOP 98-1, overhead, general and administration costs, support costs and training costs are not capitalized. Capitalized software costs are depreciated on a straight-line basis over the estimated useful life of the application. Depreciation commences when the application is put into production. We perform an on-going assessment of the carrying value of our capitalized software cost in accordance with SFAS No. 121.

For certain of our in-house software applications that we sell or lease to customers, we account for costs to develop software applications in accordance with SFAS No. 86, Accounting for Computer Software to be Sold, Leased, or Otherwise Marketed. Research and development costs are expensed as incurred. Computer software

development costs are charged to research and development expense until technological feasibility or a detail design document of the software is established, after which remaining significant software production costs are capitalized. These costs are amortized on a straight-line basis over the estimated economic life of the software. Amortization of capitalized software costs begins when products are made available for sale or when the related product is put into use. We make an ongoing assessment of recoverability of our capitalized software projects by comparing the amount capitalized for each product to the estimated net realizable value ( NRV ) of the product. If the NRV is less than the amount capitalized, a write-down of the amount capitalized is recorded.

F-10

---

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

We capitalized approximately \$1.6 million, \$2.2 million and \$1.1 million in software development costs, respectively, for the years ended December 31, 1999, 2000 and 2001 with an estimated useful of approximately five years. These costs are classified in property and equipment in the accompanying consolidated balance sheets.

**Revenue Recognition**

For our outsourced suite of products and services, we generally charge a fixed monthly fee based on the number and type of products and services purchased by the financial institution. We also charge variable fees that are based on the number of end users and the number of transactions for certain products and services. We generally provide products and services under contracts with terms ranging from three to five years. Revenues from these types of arrangements are recognized over the term over which the related services are provided.

We generally charge fees for our in-house products under either a perpetual license agreement which includes an up-front software fee, implementation fees and recurring monthly fees based on the number of active users and user generated transactions, or under a three to five-year subscription that includes annual subscription and maintenance fees. Revenues from the software and implementation component of those types of arrangements are recognized in accordance with SOP No. 97-2, Software Revenue Recognition and Staff Accounting Bulletin ( SAB ) No. 101, Revenue Recognition. SOP No. 97-2 software revenue is recognized when delivery has occurred, contract is signed, the price is fixed and determinable, and collectibility is assured. The related implementation revenue is recognized as the implementation is performed. Recurring fees represent post-contract customer support and are recognized over the period in which the support services are provided. Subscription contracts result in fees being recognized over the term of the agreement.

**Deferred Revenue and Unbilled Receivables**

Deferred revenue represents amounts receivable and collected prior to revenue recognition. The balance primarily consists of quarterly and annual billings collected in advance and recognized ratably over the subsequent three or twelve months, as applicable. Deferred revenues will be recognized as revenue as the related services are provided.

Unbilled receivables were approximately \$1.4 million and \$700,000 at December 31, 2000 and 2001, respectively. These receivables relate to end user fees and transaction fees that are billed in arrears.

**Income Taxes**

We account for our income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In the event the future tax consequences of differences between the financial reporting bases and the tax bases of our assets and liabilities results in deferred tax assets, an evaluation of the probability of our ability to realize the future benefits indicated by such asset is required. A valuation allowance is provided for a portion of the deferred tax



asset when it is more likely than not that some portion or all of the deferred tax asset will not

F-11

---

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

be realized. In assessing the realizability of the deferred tax assets, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income and tax-planning strategies.

**Fair Value of Financial Instruments**

The fair value of financial instruments classified as current assets or liabilities, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable and preferred stock, approximate carrying value due to the short-term maturity of the instruments. The fair values of short-term and long-term debt amounts approximate carrying value and are based on their effective interest rates compared to current market rates.

**Comprehensive Loss**

Comprehensive loss for the period from January 1, 1999 to February 28, 1999, for the period from March 1, 1999 to December 31, 1999 and for the years ended December 31, 2000 and 2001 is the same as the net loss as presented in the accompanying statements of operations.

**Segment Reporting**

We currently operate in only one segment, and as such, no additional disclosure is required. Additionally, we did not have any operations, net assets or liabilities in foreign locations.

**Stock Split**

All share, per share calculations, and references to historical share prices have been adjusted to reflect the one-for-eight reverse stock split effected May 16, 2001.

**Reclassifications**

Certain amounts in prior period financial statements have been reclassified to conform to the current year presentation. These reclassifications had no impact on previously reported results of operations.

**Concentration of Risk**

During 2001, Bank of America accounted for approximately 15% of our total revenue related to certain of our non-core operating contracts that will terminate during the first half of fiscal 2002. No other individual customer accounted for more than 10% of our total revenues. There is no material impact from the termination of these operating contracts on our continuing operations.

**New Accounting Pronouncements**

In June 2001, the Financial Accounting Standards Board ( FASB ) approved SFAS No. 141, Business Combinations. SFAS No. 141 prospectively prohibits the pooling of interest method of accounting for business

combinations initiated after June 30, 2001. Additionally, SFAS No. 141 requires additional disclosure regarding the reasons for a business combination and the allocation of the purchase price for business combinations accounted for as a purchase subsequent to June 30, 2001.

In June 2001, the FASB also approved SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires companies to cease the amortization of goodwill that existed at June 30, 2001. SFAS No. 142 established a new method of testing goodwill for impairment on an annual basis or on an interim basis if an event occurs or circumstances change that would change the fair value of goodwill from its carrying value. SFAS No. 142 becomes effective for our fiscal year beginning January 1, 2002. We are currently

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

assessing the impact of adopting SFAS No. 142 to determine the effect, if any, it may have on the consolidated results of operations and financial position as amortization of goodwill will cease for our fiscal year beginning January 1, 2002 and periodic impairment losses may be recognized. The cumulative impact of adopting SFAS No. 142 will be reported as a change in accounting principle in our fiscal 2002 consolidated financial statements.

In October 2001, the FASB issued SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. SFAS No. 144 supersedes SFAS No. 121, and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. In contrast to SFAS No. 121, this statement requires the exclusion of goodwill from its scope and, therefore, eliminates the requirement of SFAS No. 121 to allocate goodwill to long-lived assets to be tested for impairment. SFAS No. 144 also requires that the depreciable life of a long-lived asset to be abandoned be revised in accordance with the Accounting Principles Board Opinion ( APB ) No. 20, Accounting Changes. APB No. 20 requires that a change in estimate be accounted for in the period of change if the change only affects that period or the period of change and future periods if the change affects both. APB No. 20 does not require restatement or pro forma information for prior periods. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We are required to adopt SFAS No. 144 on January 1, 2002. We believe that the adoption of SFAS No. 144 will not have a material impact on our financial position or results of operations.

**3. ACQUISITIONS****Acquisition of the remote Internet and telephone banking division of SBS Corporation**

On August 6, 1999, Direct Access purchased the remote banking operations of SBS. The purchase price for these operations included 325,000 shares of Direct Access common stock at the estimated fair market value of \$92.00 per share and \$21,534,625 in cash. Only the remote Internet and telephone banking operations of SBS were retained by the Company and the remaining operations were sold to InterCept in exchange for 56,250 shares of Direct Access common stock valued at \$92.00 per share, for a total sales price of \$5,175,000. The Company recorded no gain or loss on the sale of assets to InterCept, as the sale was a related party transaction. The acquisition of SBS was accounted for as a purchase. The results of operations of SBS have been included in the consolidated financial statements from the date of acquisition. The excess of the purchase price over the net tangible assets acquired was allocated to the following intangible assets with the following amortization lives:

Acquired technology	
\$45,041,300	3 years
Contracts in progress	
1,340,000	4 years
Workforce	
440,000	3 years

**Acquisitions of the Divisions**

On September 3, 1999, we purchased the Divisions. The acquisitions of the Divisions were accounted for as purchases. The purchase price of the Divisions included a total of 340,250 shares of our common stock valued at \$92.00 per share. The results of operations of the Divisions have been included in the consolidated financial statements from the date of acquisition. The excess of the purchase price over the tangible net assets was allocated to

acquired technology, marketing agreements, workforce and contracts in progress were amortized over 2 to 3 years. Certain of these intangible assets were written down in 2000 (see Note 11).

**Acquisition of Dyad Corporation**

On September 3, 1999, we purchased Dyad. The purchase price of Dyad included 77,268 shares of our common stock valued at \$92.00 per share and approximately \$900,000 in cash. We also assumed debt owed by

F-13

---

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Dyad of approximately \$3,500,000. The acquisition of Dyad was accounted for as a purchase. The results of operations of Dyad have been included in the consolidated financial statements from the date of acquisition. The excess of the purchase price over the net tangible assets acquired totaled \$12,314,000 and was allocated to acquired technology with a three-year amortization life. The unamortized balances of these intangible assets were written off during 2000 (see Note 11).

**Acquisition of Call Me Bill, LLC**

On September 3, 1999, we purchased Call Me Bill. The purchase price of Call Me Bill included cash of approximately \$3,288,000. The acquisition of Call Me Bill was accounted for as a purchase. The results of operations of Call Me Bill have been included in the consolidated financial statements from the date of acquisition. The excess of the purchase price over the net tangible assets acquired totaled approximately \$3,635,000 and was allocated to acquired technology with a three-year amortization life. Certain of these assets were sold in 2001 (see Note 4).

**Acquisition of DPSC Software, Inc.**

On December 15, 1999, we purchased DPSC. The purchase price of DPSC included 52,282 shares of Netzee common stock, as adjusted to reflect shares of common stock that were returned to us to satisfy certain indemnification claims, valued at \$115.00 per share, 500,000 shares of preferred stock valued at \$13.00 per share, \$18,500,000 in cash and the payment of other acquisition costs of approximately \$1,000,000. The acquisition of DPSC was accounted for as a purchase. The results of operations of DPSC have been included in the consolidated financial statements from the date of acquisition until the assets were sold in 2001. The excess of the purchase price over the net tangible assets acquired totaled \$35,760,000 and was allocated to acquired technology with a three-year amortization life. Certain of these assets were sold in 2001 (see Note 4).

**Acquisition of DVI**

On March 7, 2000, we purchased DVI. The purchase price of DVI included 94,329 shares of our common stock, as adjusted to reflect shares of common stock that were returned to us to satisfy certain indemnification claims, valued at \$177.00 per share and options to purchase 8,803 shares of common stock in exchange for the cancellation of options to purchase DVI common stock. In addition, we assumed approximately \$3,300,000 in outstanding debt of DVI and \$1,200,000 in operating liabilities and other acquisition costs. We also granted DVI the right to receive up to 78,534 additional shares of our common stock upon the attainment of certain revenue targets in fiscal years 2000 and 2001. None of these shares were issued based on fiscal 2000 and 2001 performance. The acquisition was accounted for as a purchase. The results of operations of DVI have been included in the consolidated financial statements from the date of the acquisition until the assets were sold in 2001. The excess of purchase price over the net tangible assets acquired was allocated to acquired technology and workforce with a three-year life. Certain of these assets were written down and subsequently sold in 2001 (see Notes 4 and 11).

**Acquisition of Card Plus**

Effective July 1, 2000, we purchased Card Plus. The purchase price included 40,000 shares of our common stock valued at \$56.00 per share and options to purchase 4,445 shares of common stock in exchange for the cancellation of Card Plus phantom stock units. Additionally, we granted Card Plus the right to receive up to 28,572 shares of common

stock upon the attainment of certain revenue and employee retention goals for the period from July 1, 2000 to June 30, 2001. However, we were required to issue all of these shares if the closing price of a share of our common stock was less than \$36.00 on June 29, 2001. Because our closing stock

F-14

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

price on June 29, 2001 was \$4.20, we issued all of these shares and recorded the amount within equity. The acquisition was accounted for as a purchase. The results of operations of Card Plus have been included in the Consolidated Financial Statements since the effective date of the acquisition. The excess of purchase price over the net tangible assets acquired was allocated to goodwill and workforce with a three-year life. The unamortized balances of these intangible assets were written off during 2001 (see Note 11).

**Acquisition of Assets from Harland**

Effective November 1, 2000, we purchased Harland's Internet banking and bill payment businesses and assumed certain liabilities related to those businesses. The purchase price included 550,000 shares of our common stock valued at \$32.00 per share. As a result of this issuance, Harland owns approximately 16% of our common stock. The acquisition was accounted for as a purchase. The results of operations of Harland have been included in the consolidated financial statements from the effective date of the acquisition. The excess of the purchase price over the net tangible assets acquired was allocated to the following intangible assets with a three-year life:

Acquired technology	
\$17,747,000	
Workforce	
950,000	

**Acquisition of HomeCom**

On March 15, 2001, we purchased certain assets of HomeCom's Internet banking business and assumed certain of HomeCom's operating liabilities related to the business. The purchase price was approximately \$420,000 in cash and related acquisition expenses. The transaction was accounted for as a purchase. The excess of purchase price over the net tangible assets acquired was allocated to acquired technology and is being amortized over three years. The results of operations of HomeCom have been included in the consolidated financial statements from the effective date of the acquisition and are not material to the results of our operations.

We will continue to evaluate the carrying amounts of these assets and liabilities for 12 months following the date of their acquisition and may adjust the allocations to intangible assets based on this evaluation. See Note 4 for pro forma consolidated financial information related to these acquisitions.

**4. DISPOSITIONS****Disposition of DPSC Assets**

On February 2, 2001, we sold to InterCept certain of the regulatory reporting assets acquired from DPSC in 1999, and InterCept assumed certain of the related operating liabilities, for total consideration of approximately \$16.5 million, including liabilities assumed of approximately \$2.4 million. We received cash proceeds of approximately \$14.1 million. In connection with the sale of these assets, we recorded a non-cash loss of approximately \$5.7 million. This non-cash loss is included in the net loss on sales of assets in our Consolidated Statement of Operations.



**Disposition of Certain Bill Payment Assets**

Effective May 1, 2001, we sold to iPay certain assets related to a portion of our bill payment operations including contracts for bill payment only services that were not considered to be a part of our core business, and iPay assumed certain of the related operating liabilities. Gross proceeds from the sale were approximately \$1.3 million in cash, of which \$50,000 was placed in escrow for indemnification and other purposes. In connection with the sale of these assets, we recorded a gain of approximately \$1.2 million. This gain is included in the net loss on sales of assets in our Consolidated Statement of Operations.

F-15

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Disposition of DVI Assets**

On November 15, 2001, we sold substantially all the assets acquired from DVI to SS&C and SS&C assumed substantially all the related operating liabilities. Gross proceeds from the sale were approximately \$1.35 million in cash, of which \$75,000 was placed in escrow for indemnification and other purposes. Prior to the sale, certain of the intangible assets were written down in 2001 (see Note 11). In connection with the sale of these assets, we recorded a non-cash loss on sale assets of approximately \$206,000. This loss is included in the net loss on sales of assets in our Consolidated Statements of Operations.

**Pro Forma Consolidated Financial Information**

The following unaudited pro forma consolidated financial information for the years ended December 31, 2000 and 2001 assume that the acquisitions or dispositions occurred as of January 1, 2000.

	<b>For the year ended</b>	
	<b>December 31, 2000</b>	<b>December 31, 2001</b>
Total revenue	\$26,936,942	\$22,303,390
Net loss attributable to common shareholders		
\$(68,863,292) \$(35,730,498)		
Basic and diluted loss per share		
\$(33.24) \$(11.22)		

The unaudited pro forma consolidated financial information does not purport to represent what our results of operations would have been had the acquisitions or dispositions occurred as of such date, nor what results will be for any future period.

**5. LEASES RECEIVABLE**

We have sold certain of our telephone banking products under sales-type leases. At December 31, 2001, future minimum lease payments under non-cancelable leases are as follows:

Total minimum lease payments receivable:

2002	\$630,083
2003	415,876
2004	307,984
2005	69,798
	<hr/>

1,423,741  
Less amount representing  
interest  
(155,392)

---

Present value of net  
minimum lease payments  
receivable  
1,268,350  
Less current maturities of  
lease payments  
receivable  
(630,083)

---

Leases receivable, net of  
current portion  
\$638,267

---

F-16

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. PROPERTY AND EQUIPMENT**

Property and equipment at December 31, 2000 and 2001 consisted of the following:

	<u>2000</u>	<u>2001</u>
Leasehold improvements	\$ 1,138,369	\$ 1,163,964
Computer equipment		
4,132,127	3,108,391	
Furniture and fixtures		
424,339	254,232	
Machinery and other equipment		
2,614,118	446,425	
Software		
1,860,822	2,350,292	
<hr/>		
	10,169,775	7,323,304
Less accumulated depreciation		
(3,552,971)	(3,007,404)	
<hr/>		
<hr/>		
Property and equipment, net		
\$6,616,804	\$4,315,900	
<hr/>		
<hr/>		

**7. INTANGIBLE ASSETS**

Intangible assets at December 31, 2000 and 2001 consisted of the following:

	<u>2000</u>	<u>2001</u>
Goodwill	\$ 1,903,393	\$
Workforce		
4,427,000	1,780,000	
Contracts in progress		
1,880,000	1,880,000	
Marketing agreements		
4,135,104		
Acquired technology		
125,429,717	68,629,884	

---



---

137,775,214	72,289,884
Less accumulated amortization	
(47,824,555)	(50,028,727)

---



---

Intangible assets, net	
\$89,950,659	\$22,261,157

---



---

## 8. NOTE PAYABLE

On October 18, 1999, we entered into a \$1,345,000 term loan with a bank to secure the purchase of equipment. The loan bore interest at LIBOR plus 2% per year and outstanding principal under the loan was due in 60 monthly installments starting November 1, 1999. On August 22, 2000 the loan was revalued and refinanced due to equipment upgrades. The loan amount was thereby increased to \$1,650,000 resulting in net proceeds of \$400,192. The loan was secured by equipment and a personal guaranty by two directors of Netzee. On March 1, 2001, the note payable was assumed by the directors providing the guarantee, in exchange for the equipment that was purchased with the proceeds of the loan. We no longer have any liability under the loan.

## 9. RELATED-PARTY TRANSACTIONS

As discussed in Note 3 and Note 4, we completed several acquisitions and dispositions during 2000 and 2001. In some of these transactions, persons who were previously officers, directors or shareholders of the acquired companies became executive officers or directors of Netzee, or beneficial owners of more than 5% of our common stock.

### *Related Party Borrowings*

Prior to our initial public offering, InterCept loaned us money to fund the cash portions of the acquisitions of Dyad and Call Me Bill discussed in Note 3 and to fund our operations. All pre-offering borrowings were

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

paid off with proceeds from the initial public offering. On December 15, 1999, we received a commitment for a \$15 million line of credit from InterCept in connection with the acquisition of DPSC. During 1999, we incurred approximately \$677,000 of interest expense associated with these borrowings. In May 2000, the \$15 million line of credit agreement with InterCept was finalized. At that time, the outstanding principal balance due on the borrowings was transferred to the line of credit. The line of credit bore interest at a yearly rate of prime plus 2% and was secured by substantially all of our assets. Accrued interest under the line of credit was payable quarterly beginning July 1, 2000. The principal balance was payable at maturity on May 31, 2003. The line of credit agreement provided for earnings, tangible net worth and other affirmative and negative covenants with which we were required to comply, and provided for various other conditions and restrictions. These borrowings were used to fund working capital requirements. As of December 31, 2000, we were out of compliance with certain of these covenants. However, InterCept waived such non-compliance as of December 31, 2000. As of December 31, 2000, the outstanding balance on the credit facility was \$15 million. We incurred approximately \$1.1 million of interest expense associated with our borrowings from InterCept for the year ended December 31, 2000.

On September 29, 2000, we entered into an acquisition agreement with Harland to acquire Harland's Internet banking and bill payment businesses. Simultaneously with the signing of the acquisition agreement, we borrowed \$5.0 million from Harland pursuant to a promissory note. The note bore interest at a rate of prime plus 2% per year and was secured by substantially all of our assets. Such security was *pari passu* in priority to the security given to InterCept with respect to the line of credit. The principal balance was payable at maturity on September 29, 2005, or upon demand with 30 days notice after September 29, 2002. We incurred approximately \$148,000 in interest associated with this borrowing in 2000. In conjunction with the sale of the DPSC assets to InterCept in February 2001, we converted the \$15 million line of credit with InterCept and our \$5 million promissory note to Harland into a joint \$20 million credit facility that matured on November 2, 2002 (\$15 million to be funded by InterCept and \$5 million to be funded by Harland). The terms of the credit facility remained consistent with the terms of the former InterCept line of credit and Harland promissory note except that both InterCept and Harland had the right (instead of just InterCept) to enforce the covenants contained in the line of credit agreement. On February 2, 2001, we sold to InterCept certain of the regulatory reporting assets acquired from DPSC in 1999 and InterCept assumed certain of the related operating liabilities, for total consideration of approximately \$16.5 million, including liabilities assumed of approximately \$2.4 million. The proceeds from the sale of the DPSC assets were used to pay down this credit facility by approximately \$11.8 million.

On May 8, 2001, we sold certain assets related to a portion of our bill payment operations. Gross proceeds from the sale were approximately \$1.3 million in cash and the majority of these proceeds were used to pay down our joint credit facility. As a result of this sale, Harland's portion of the joint credit facility was permanently reduced by \$225,000. The total credit facility was reduced to \$19,775,000 and the ratio of available borrowings was adjusted to approximately 76% from InterCept and approximately 24% from Harland.

On November 15, 2001, we sold certain assets acquired from DVI. Gross proceeds from the sale were approximately \$1.35 million in cash and the majority of these proceeds were used to pay down our joint credit facility. As a result of this sale, Harland's portion of the joint credit facility was permanently reduced by \$220,000. The total credit facility was reduced to \$19,555,000 and the ratio of available borrowings was adjusted to approximately 77% from InterCept and approximately 23% from Harland.

As of December 31, 2001, the balance on this joint credit facility was \$13,192,000 with InterCept's and Harland's portion totaling \$10,118,000 and \$3,074,000, respectively. We incurred interest expense associated with our borrowings from InterCept and Harland of approximately \$824,000 and \$265,000, respectively, during 2001, and we were in compliance with all the covenants of the credit agreement. These loans require us

F-18

---

Table of Contents

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

to maintain certain levels of EBITDA (as defined). We were in compliance with this covenant at December 31, 2001. Subsequent to December 31, 2001, we extended the maturity date of the credit facility to April 10, 2003 and reduced the total credit facility to \$18 million (see Note 21).

On October 18, 1999, we entered into a \$3,000,000 line of credit facility with a company, and in connection therewith, an affiliate of that company was appointed as one of our directors. In connection with this line of credit, we issued to that company a warrant to purchase 57,735 shares of our common stock. The line of credit was terminated in December 1999 (see Note 13). This warrant was exercised in full in March 2000.

Related-party loans from shareholders at December 31, 2000 and 2001 consisted of the following:

	2000	2001
Line of credit from InterCept, interest payable quarterly at prime plus 2% per year; principal payable in full on May 31, 2003; the line of credit was secured by substantially all our assets, pari passu with the promissory note below	\$ 15,000,000	\$
Promissory note from Harland, interest payable quarterly at prime plus 2% per year; payable in full upon maturity on September 29, 2005 or upon demand with 30 days notice after September 29, 2002; the note was secured by substantially all our assets, pari passu with the line of credit above		
Joint line of credit from InterCept and Harland (InterCept funds 76.7%, Harland funds 23.3%), interest payable quarterly at prime plus 2% per year; payable in full on November 2, 2002 (subsequently extended to April 10, 2003, see Note 21); the facility is secured by substantially all our assets	13,191,715	
<hr/>		
	20,000,000	13,191,715
Less current maturities		
<hr/>		
	\$20,000,000	\$13,191,715
<hr/>		
<hr/>		

*Other Relationships with InterCept*

Our Chairman of the Board of Directors is the Chairman and Chief Executive Officer of InterCept. Our Chief Executive Officer is a director of InterCept. Our former Chief Executive Officer and former Vice Chairman of the



Board of Directors is a director of InterCept. A former non-employee director of Netzee is also a director of InterCept.

In September 1999, we entered into a marketing agreement with InterCept under which InterCept sells our products and services. Under this agreement, we pay a commission to InterCept for each sale of our products and services made by InterCept and for each referral to our sales force that results in a sale. We paid InterCept approximately \$357,000 and \$141,000 in 2000 and 2001, respectively, as a result of this agreement.

During 2000 and 2001, we shared some of our facilities with InterCept. We paid approximately \$163,000 and \$112,000 related to those shared costs during 2000 and 2001, respectively.

During 2000 and 2001, we used InterCept's vendor relationships to purchase certain hardware and software used to implement our Internet and telephone banking products. By utilizing these vendor relationships, we were able to take advantage of discounts that we would have been unable to obtain on our

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

own. In addition, InterCept assisted us in managing the ordering and inventory process related to this equipment. During 2000 and 2001, we paid approximately \$435,000 and \$123,000, respectively, in costs to purchase the equipment, which included a fee to InterCept for its services.

InterCept also licenses certain of our telephone banking products for sales to their customers. Under this agreement, InterCept pays us an initial license fee along with an annual maintenance fee. We received approximately \$286,000 and \$248,000 in payments from InterCept related to this agreement during 2000 and 2001, respectively.

*Other Relationships with Harland*

In connection with the acquisition of assets from Harland, beginning in November 2000, we subleased certain of our Connecticut and Oregon facilities from Harland. We paid approximately \$135,000 and \$356,000 in expenses during 2000 and 2001, respectively, associated with these subleases. Additionally, we incurred costs totaling approximately \$322,000 and \$122,000 during 2000 and 2001, respectively, related to the usage of certain of their employees and certain administrative support and equipment lease costs during the post-acquisition transition.

In May 2001, we entered into a marketing agreement with Harland under which Harland sells certain of our Internet-based products and services. Under this agreement we pay a commission for sales of our products and services made by Harland and for each referral to our sales force that results in a sale. We incurred expenses of approximately \$76,000 in 2001 as a result of this agreement.

*Our Other Relationships*

Our former Chief Executive Officer and former Vice Chairman of the Board of Directors is a partner at Nelson Mullins Riley & Scarborough, L.L.P., a law firm that provided legal services to us. We paid approximately \$425,000 and \$62,000 during fiscal 2000 and 2001, respectively, to this firm for these legal services.

On July 1, 1999, certain officers and directors of Netzee and InterCept entered into full-recourse promissory notes with Direct Access as lender. These notes totaled \$3,110,000 and were given as consideration for the issuance of shares of Direct Access common stock to these individuals. Each of the notes bears interest at 7% per year and matures on June 30, 2002. During fiscal 2000 and 2001, principal payments on the notes were made in the amount of \$1,766,500 and \$952,745, respectively, and interest payments were made in the amount of \$237,073 and \$28,914, respectively. The outstanding principal balances totaled \$1,343,500 and \$400,000 as of December 31, 2000 and 2001, respectively. Accrued interest on the notes as of December 31, 2000 and 2001 totaled approximately \$79,000 and \$70,000, respectively.

On August 5, 1999, an officer of Netzee entered into a full-recourse promissory note with Netzee as lender. The note totaled \$93,300 and the proceeds were used to exercise options to purchase shares of our common stock. Accrued interest on this note as of December 31, 2000 and 2001 was approximately \$10,000 and \$16,000, respectively. The loan bears interest at a rate of 7% and matures on August 4, 2002. The interest on these promissory notes has been included in the principal amount and is, therefore, classified as a component of stockholders' equity.

In May 2001, we sold a portion of our non-core business to iPay, which also assumed certain of the liabilities associated with the assets (see Note 4). Certain of the owners of iPay were former officers of Netzee.

Management believes that these transactions were made on terms no less favorable to us than could have been obtained with unaffiliated third parties.

F-20

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. RESTRUCTURING COSTS**

In the fourth quarter of 2000, we initiated a restructuring of management with the termination of certain management employees. Consequently, a restructuring charge of \$586,200 was recorded in accordance with Emerging Issues Task Force ( EITF ) 94-3, Liability Recognition for Cost to Exit an Activity (Including Certain Costs Incurred in a Restructuring). This amount was comprised of \$375,000 in non-cash stock-based compensation associated with the accelerated vesting of restricted stock, which is included in amortization of stock-based compensation in the Consolidated Statements of Operations, and \$211,200 in severance and payroll-related items.

During fiscal 2001, we finalized and announced restructuring plans to reduce expenses through the consolidation of our Internet and bill payment operations. This restructuring has resulted in the closure of our offices in Alabama, Kentucky, Texas and Tennessee, as well as the downsizing of offices in Connecticut. Total staff reductions were approximately 195 employees. Consequently, a restructuring charge of approximately \$2,002,000 was recorded for the year ended December 31, 2001 in accordance with EITF 94-3. This amount was comprised of approximately \$1,350,000 in severance and payroll-related items and approximately \$652,000 in lease and other contract termination costs.

In connection with this restructuring, we have accrued approximately \$1,109,000 as additional purchase price for the acquisition of assets from Harland as a result of the termination of employees and the closing of offices obtained in that acquisition in accordance with EITF 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination. This amount is comprised of approximately \$1,060,000 for severance and payroll-related items and approximately \$50,000 for office lease and other contract termination costs.

As of December 31, 2001, we had paid approximately \$3,535,000 in restructuring costs consisting of approximately \$2,858,000 in severance and payroll related costs and approximately \$677,000 in contract and lease termination costs. As of December 31, 2001, we had terminated approximately 190 employees out of an anticipated total of 195 employees to be terminated as the result of the restructuring plan. At December 31, 2001, approximately \$162,000 in restructuring costs remained as an accrued liability, consisting of approximately \$137,000 in future severance benefits and other payroll-related costs and \$25,000 in additional contract and lease termination costs.

The following table summarizes our restructuring charges accrued and paid in 2000 and 2001:

	<b>Severance and Payroll Related Items</b>	<b>Lease and Other Contract Termination Costs</b>	<b>Total</b>
	<hr/>	<hr/>	<hr/>
Restructuring charges accrued in 2000	\$586,000	\$	\$586,000
Restructuring charges recorded in connection with the acquisition of assets from Harland			
773,000 200,000 973,000			
Paid in 2000			
(487,000) (487,000)			
	<hr/>		

---

---

Balance at December 31, 2000  
872,000 200,000 1,072,000  
Restructuring charges accrued in 2001  
1,350,000 652,000 2,002,000  
Restructuring charges recorded in connection with the  
acquisition of assets from Harland  
286,000 (150,000) 136,000  
Paid in 2001  
(2,371,000) (677,000) (3,048,000)

---

---

---

Balance at December 31, 2001  
\$137,000 \$25,000 \$162,000

---

---

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. ASSET IMPAIRMENT CHARGES**

In accordance with the provisions of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets, we perform an impairment test with regards to a long-lived asset when a triggering event occurs which may indicate that the carrying value of the asset is unrealizable. Our policy for the completion of such analysis is to compare the undiscounted cash flows expected to be generated from the long-lived asset over its useful life to the carrying value of the asset. SFAS No. 121 also requires that when a group of assets being tested for impairment was acquired as part of a business combination using the purchase method of accounting, any cost in excess of net assets acquired that arose as part of the transaction must be included as part of the asset group. During fiscal 2000, management determined that a triggering event had occurred with respect to certain acquired software applications as a result of our management restructuring and realigned strategic focus.

Additionally, during 2001 we determined that a triggering event had occurred related to our decision to sell certain assets related to the DVI acquisition, as well as the termination of a customer associated with our Card Plus acquisition. An analysis of the estimated future cash flows expected to be generated by these acquired assets was determined to be less than the carrying amount, and allocated cost was determined to be in excess of net assets acquired. Therefore, these acquired assets were determined to be impaired in accordance with SFAS No. 121. Consequently, the original cost bases of these assets were reduced to reflect the fair market value of such assets at the date of the analysis.

These triggering events resulted in a \$26.3 million and \$12.1 million asset impairment loss for the years ended December 31, 2000 and 2001, respectively. In determining the fair market value of these assets, we considered recent transactions and market trends involving similar assets.

**12. CHANGE IN ACCOUNTING PRINCIPLE**

In the fourth quarter of fiscal 2000, we adopted SAB No. 101, which establishes guidelines for revenue recognition and enhances revenue recognition disclosure requirements. Pursuant to this guideline, up-front fees associated with certain product implementations are now being recognized over the term of the underlying agreement, rather than upon the completion of product implementation. The cumulative impact of adopting SAB No. 101 was recorded as of January 1, 2000 and is reported as a change in accounting principle for our year ended December 31, 2000.

The following unaudited pro forma consolidated financial information for the years ended December 31, 1999, 2000 and 2001 assumes that the change in accounting principle occurred as of January 1, 1999.

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Loss attributable to common shareholders before cumulative effect of change in accounting principle	\$(26,954,876)	\$(96,808,699)	\$(60,020,563)
Cumulative effect of change in accounting principle (351,980)			

---

---

Pro forma net loss attributable to common shareholders  
\$(27,306,856) \$(96,808,699) \$(60,020,563)

---

---

---

Basic and diluted loss per share before change in accounting  
principle  
\$(18.67) \$(34.81) \$(17.89)  
Cumulative effect of change in accounting principle per share  
(0.24)

---

---

---

Basic and diluted net loss per share  
\$(18.92) \$(34.81) \$(17.89)

---

---

---

Basic and diluted weighted average shares outstanding  
1,442,754 2,781,141 3,354,909

---

---

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

All of the pro forma effects of SAB No. 101 have been allocated to 1999 as we did not charge any up front fees for services in prior periods.

**13. EXTRAORDINARY ITEM**

On October 18, 1999, we entered into a \$3,000,000 line of credit facility with a company, and in connection therewith, an affiliate of that company was appointed as one of our directors. The line of credit facility bore interest at the prime rate. In conjunction with the line of credit facility, we issued warrants to purchase 57,735 shares of common stock at an exercise price of \$26.00 per share. We recorded deferred financing costs for the difference between the fair value of common stock, valued at \$106.00 per share, and the exercise price of the warrants. The deferred financing costs were to be recognized over the three-year term of the line of credit. The line of credit facility was terminated in December 1999 in connection with the receipt of the commitment from InterCept discussed in Note 9 above. The termination resulted in the recognition of an extraordinary non-cash loss of \$4,518,760 for the period from March 1, 1999 to December 31, 1999 related to the write off of the unamortized deferred financing fees.

**14. INCOME TAXES**

We have incurred net operating losses ( NOL ) since inception. As of December 31, 2000 and 2001, we had NOL carryforwards of approximately \$25.8 million and \$47.2 million, respectively, available to offset our future income tax liability. The NOL carryforwards will begin to expire in 2014. Due to the uncertainty of the realizability of the net operating losses, we have not reflected an income tax benefit in the accompanying statements of operations for any period presented and have recorded a valuation allowance equal to the net deferred tax assets at December 31, 2000 and 2001.

The components of the deferred tax assets and liabilities are as follows as of December 31, 2000 and 2001:

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
Deferred tax assets:		
Net operating loss carryforwards		
\$12,231,914	\$18,029,840	
Deferred revenue		
3,305,877	1,172,699	
Accounts receivable reserve		
243,750	142,577	
Stock-based compensation		
2,958,139	3,292,705	
Intangible assets		
418,000	505,963	
Other		
427,872	213,057	



---

Total deferred tax assets  
19,585,552 23,356,841  
Deferred tax liabilities

Property and equipment  
(283,322) (283,322)  
Unbilled accounts receivable  
(712,191) 0

---

---

Total deferred tax liabilities  
(995,513) (283,322)

---

---

Net deferred tax assets  
18,590,039 23,073,519  
Valuation allowance  
(18,590,039) (23,073,519)

---

---

Net  
\$ \$

---

---

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of the income tax benefit for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001 are as follows:

	<u>December 31, 1999</u>	<u>December 31, 2000</u>	<u>December 31, 2001</u>
Current benefit			
Federal			
\$ \$ \$			
State			
_____			
_____			
_____			
Deferred benefit			
Federal			
(5,134,862) (11,503,613) (3,374,311)			
State			
(598,198) (1,353,366) (396,978)			
_____			
_____			
_____			
(5,733,060) (12,856,979) (3,771,289)			
Total benefit			
(5,733,060) (12,856,979) (3,771,289)			
Valuation allowance			
5,733,060 12,856,979 3,771,289			
_____			
_____			
_____			
Total			
\$ \$ \$			
_____			
_____			
_____			

Edgar Filing: NETZEE INC - Form 10-K

The following is a summary of the items, which resulted in recorded income taxes that differ from taxes, computed using the statutory income tax rates for the period from March 1, 1999 to December 31, 1999, and for the years ended December 31, 2000 and 2001, respectively:

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Tax benefit at federal statutory rates	34%	34%	34%
Tax benefit at state statutory rate			
4 4 4			
Permanent tax differences			
(59) (51) (44)			
Effect of valuation allowance			
21 13 6			
<hr/>			
<hr/>			
<hr/>			
Effective tax rate			
% % %			
<hr/>			
<hr/>			
<hr/>			

The income tax benefit for the period from January 1, 1999 to February 28, 1999 was not material.

**15. PREFERRED STOCK**

In December 1999, we issued 500,000 shares of Series A 8% Convertible Preferred Stock, no par value, with a \$13.00 per share stated value. The Series A Preferred Stock was convertible at the option of the shareholder, in whole or in part, into 51,384 split-adjusted shares of common stock. In addition, if the average closing price of our common stock had equaled or exceeded a split-adjusted price of \$208.00 per share for any four-week period, we would have been permitted to redeem all of the Series A Preferred Stock for cash or 51,384 split-adjusted shares of common stock. If we had elected to redeem the Series A Preferred Stock for cash, the holder had the option to receive payment in common stock. Series A Preferred Stock dividends were cumulative and were payable when declared by the Board of Directors, at the rate of \$1.04 per share per year. We accrued \$24,200 in dividends on the shares of Series A Preferred Stock for the period from December 15, 1999 to December 31, 1999. During 2000, we paid \$24,200 in accrued dividends on these shares.

In September 2000, we exchanged all 500,000 shares of Series A 8% Convertible Preferred Stock for 500,000 shares of Series B 8% Convertible Preferred Stock, no par value. The rights, preferences and limitations of the Series B Preferred Stock are substantially identical to those of the Series A Preferred Stock, except that upon conversion of the Series B Preferred Stock or upon the liquidation of Netzee, a holder of the Series B Preferred Stock is entitled to receive all accrued but unpaid dividends thereupon.

In connection with a registration rights agreement entered into with the former shareholders of DPSC, the shares were subject to the right, as of June 15, 2002, of the holders of the Series B Preferred Stock to



**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

require us to repurchase all of such shares at a price of \$13.00 per share, plus all accrued and unpaid dividends thereupon. Subsequent to December 31, 2001, we extended the repurchase requirement date to April 10, 2003 (see Note 21).

We have accrued \$1,040,000 in dividends on the shares of Series B Preferred Stock for the year ended December 31, 2001 and have included that amount in the other current liabilities in the accompanying balance sheets. Additionally, we have included the preferred dividends for each year in the calculation of net income attributable to common shareholders.

**16. STOCK OPTION PLAN**

During 1999, we adopted, and our shareholders approved, the 1999 Stock Option and Incentive Plan (the Plan). Awards under the Plan are granted to eligible officers, directors, employees and other persons by the Board of Directors or by our Compensation Committee, which is composed of the entire Board of Directors. Awards issued under the Plan may include incentive stock options (ISOs), nonqualified stock options (NQSOs), restricted stock or stock appreciation rights. The Compensation Committee administers the Plan and generally has the discretion to determine the terms of an option grant, including the number of option shares, option price, term, vesting schedule, the post-termination exercise period, and whether the grant will be an ISO or NQSO, except that the Board of Directors must approve all awards to our executive officers and directors.

The maximum number of shares of common stock that may be issued under the Plan as of January 1, 2002 is 790,404. The Plan provides that the number of shares of common stock available for issuance shall be automatically increased on January 1 of each year to an amount equal to 20% of the fully diluted shares of stock outstanding on December 31 of the previous year, provided that the shares available for issuance shall not be less than 437,500, and no more than 437,500 shares shall be issuable with respect to ISOs.

The Plan will remain in effect until terminated by the Board of Directors. The Board of Directors may generally amend the Plan without the consent of our shareholders.

During 1999, we issued options with exercise prices below the initial public offering price. Accordingly, we recorded approximately \$13.1 million in deferred compensation and included such amount in common stock. This amount is being amortized over the respective vesting periods of the options. We recorded \$3.2 million and \$1.3 million in compensation expense for these options during 2000 and 2001, respectively.

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of stock options granted and related information for the years ended December 31, 1999, 2000 and 2001 is presented below:

	<u>Shares</u>	<u>Price Range</u>
Outstanding at December 31, 1998		\$
Granted		
351,938		\$16.00 - \$118.00
Exercised		
\$		
Outstanding at December 31, 1999		
351,938		\$16.00 - \$118.00
<hr/>		
<hr/>		
Granted		
297,802		\$ 0.08 - \$177.04
Exercised		
(1,771)		\$ 0.08 - \$ 40.00
Forfeited		
(111,347)		\$40.00 - \$177.04
<hr/>		
Outstanding at December 31, 2000		
536,622		\$ 0.08 - \$136.64
Granted		
48,700		\$ 3.84 - \$ 4.00
Exercised		
(2,223)		\$0.08
Forfeited		
(380,126)		\$ 0.08 - \$177.04
Outstanding at December 31, 2001		
202,973		\$ 3.84 - \$122.00
<hr/>		
Exercisable at December 31, 2001		
119,871		\$10.00 - \$122.00
<hr/>		

The following summarizes information about the stock options outstanding as of December 31, 2001:

**Options Outstanding****Options Exercisable**

Range of Exercise Prices	Number Outstanding at		Weighted-Average Remaining Contractual Life		Weighted-Average Exercise Price		Number Exercisable at		Weighted-Average Exercise Price	
	December 31, 2001		Life	Price	December 31, 2001		December 31, 2001	Price		
\$ 3.84 - \$ 10	.00	40,212	9.34	\$ 5.04	2,820			\$ 10.00		
\$16.00 - \$ 38.	75	80,750	7.58	\$20.68	60,996			\$20.57		
\$40.00 - \$ 62.	24	35,344	7.71	\$40.31	25,358			\$40.14		
\$78.00 - \$122.0	0	46,667	8.01	\$98.04	30,697			\$102.91		
	202,973	8.05	\$38.79	119,871	\$45.55					

During 1999, we issued 9,375 shares of restricted stock under the Plan. In conjunction with our management restructuring (see discussion in Note 10), we accelerated the vesting period of 3,125 of these shares in exchange for the forfeiture of 3,125 shares. As of December 31, 2001, there were 6,250 shares issued and outstanding related to this grant, all of which are vested. The weighted average fair value of these shares at grant date was \$120.00 per share.

During 1995, the FASB issued SFAS No. 123, Accounting for Stock-Based Compensation, which defines a fair value-based method of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the method of accounting prescribed by Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees. Entities electing to use the accounting methodology required by APB Opinion No. 25 must make pro forma disclosures of net income, and, if presented, earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied.

We have elected to account for our stock-based compensation plan under APB Opinion No. 25. We have computed, for pro forma disclosure purposes, the value of all options to purchase shares of our common stock granted in 1999, 2000 and 2001 to our employees using the Black-Scholes option pricing model prescribed in

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

SFAS No. 123 and the following weighted-average assumptions: for 1999, risk-free interest rates of 5.80% to 6.17%, expected dividend yield of 0%, expected lives of four years, and expected volatility of 69%; for 2000, risk-free interest rates of 6.03% to 6.21%, expected dividend yield of 0%, expected lives of four years, and expected volatility of 132%; and for 2001, risk-free interest rates of 3.49% to 5.02%, expected dividend yield of 0%, expected lives of four years, and expected volatility of 185%.

The weighted average fair value of options granted to employees of Netzee in 1999, 2000 and 2001 was \$90.64, \$52.08 and \$3.79 per share, respectively. The total value of the options granted to these employees during 1999, 2000 and 2001 was computed as approximately \$21.0 million, \$15.9 million and \$185,000, respectively, which would be amortized on a pro forma basis over the three-year vesting period of the options. If we had accounted for the Plan in accordance with SFAS No. 123, our net loss for the years ended December 31, 1999, 2000 and 2001 would have been as follows:

	<b>Year Ended December 31, 1999</b>	<b>Year Ended December 31, 2000</b>	<b>Year Ended December 31, 2001</b>
Net loss attributable to common shareholders as reported	\$(26,954,876)	\$(97,160,679)	\$(60,020,563)
Pro forma net loss			
\$(28,212,750) \$(107,169,281) \$(58,581,010)			
Loss per share (basic and diluted) as reported			
\$(18.72) \$(34.94) \$(17.89)			
Loss per share (basic and diluted) pro forma			
\$(19.52) \$(38.53) \$(17.46)			

**17. BASIC AND DILUTED NET LOSS PER SHARE**

Basic and diluted net loss per share have been computed in accordance with SFAS No. 128, Earnings per Share, using net loss divided by the weighted average number of shares of common stock outstanding for the period presented. Potentially dilutive options to purchase 351,938, 536,622, and 202,973 shares of common stock with a weighted average exercise price of \$59.76, \$51.92 and \$38.79 per share were outstanding at December 31, 1999, 2000 and 2001, respectively, approximately 51,384 common shares issuable upon conversion of the preferred stock for the years ended December 31, 1999, 2000, and 2001, 57,735 outstanding warrants to purchase common stock for the year ended December 31, 1999, and 107,106 common shares issuable upon the achievement of certain performance targets associated with the DVI and Card Plus acquisitions for the year ended December 31, 2000 were excluded from the presentation of diluted net loss per share, as they are antidilutive due to the net loss.

**18. EMPLOYEE BENEFITS**

In 1999, we established a defined contribution 401(k) savings plan, which covers substantially all employees, subject to certain minimum age and service requirements. Contributions to this plan are voluntary; however, for 1999 we matched in cash 100% of the first 6% of an employee's compensation contributed. For the year ended December 31, 2000, we matched in cash 100% of the first 4% of compensation contributed, and in our common stock 100% of the next 2% of compensation contributed. For the year ended December 31, 2001, we matched in cash 50%



of the first 4% of compensation contributed and in our common stock, 50% of the next 2% contributed. The stock will be issued to those employees who contributed in excess of 4% and were still employed by us as of December 31, 2000 and 2001, respectively. The number of shares was determined by taking the total dollar value of the matching contribution divided by the share closing price on the last trading day of the year. We contributed approximately 47,400 and 12,300 shares valued at approximately \$142,000 and \$21,000 at December 31, 2000 and 2001, respectively. Our cash contributions were approximately \$577,000 and \$187,000 for the years ended December 31, 2000 and 2001, respectively.

F-27

---

**Table of Contents****NETZEE, INC.  
AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****19. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

	Predecessor	Netzee, Inc.		
	For the Period from January 1, 1999 to February 28, 1999	For the Period from March 1, 1999 to December 31, 1999	Year Ended December 31, 2000	Year Ended December 31, 2001
Cash paid for interest	\$2,971	\$740,638	\$908,132	\$1,379,936
Supplemental disclosure of non-cash investing and financing activities:				
Stock issued for acquisitions				
71,884,011 39,834,929				
Warrants issued for the purchase of common stock				
4,618,760				
Stock issued for notes receivable				
3,110,000				
Purchase of property and equipment with note payable				
1,345,000				
Stock issued as deferred compensation				
1,125,000				
Stock issued in connection with marketing agreements, net of cash paid				
1,079,096				
Capital contribution for property and equipment from shareholder				
750,000				
Exercise of stock options for note receivable				
93,300				
Stock issued for employer 401(k) match				
142,204 20,516				
Stock reclaimed from escrow				
(68,713)				

**20. COMMITMENTS AND CONTINGENCIES****Property Leases**

We lease various facilities under non-cancelable property lease agreements. Future minimum annual obligations under these leases as of December 31, 2001 are as follows:

\$571,210
2003
325,962
2004
362,781
2005
378,056
2006
189,024
<hr/>
Total
\$1,827,034
<hr/>

Rent expense for the period from January 1, 1999 to February 28, 1999, the period from March 1, 1999 to December 31, 1999, and the years ended December 31, 2000 and 2001 was \$8,934, \$138,874, \$1,111,384, and \$1,373,932, respectively.

### **Litigation**

We are party to various claims and legal proceedings that arise in the normal course of business (see Note 21). Management, on the advice of legal counsel, does not believe that a negative outcome of any known pending litigation would have a material adverse effect on us or our financial condition or results of operations.

**Table of Contents**

**NETZEE, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**21. SUBSEQUENT EVENTS**

**Nasdaq Notification**

On February 14, 2002, we received notification from The Nasdaq Stock Market indicating that we were out of compliance with the \$5 million minimum market value requirement for our publicly held shares, as stated in Marketplace Rule 4450(a)(2). This rule provides us with 90 calendar days, or until May 15, 2002, to come into compliance with this rule, which would require our publicly held shares to maintain a minimum market value of \$5 million for a minimum of 10 consecutive trading days during that period. If we fail to meet this requirement, we will become subject to delisting from the Nasdaq National Market, at which time we can appeal the delisting to the Nasdaq Listing Qualifications Panel. It is likely that we will be delisted from the Nasdaq National Market. In addition, we also have the option of applying to transfer our common stock to the Nasdaq SmallCap Market, where we also would have to satisfy continued inclusion requirements for that market. These requirements include maintaining certain levels of shareholders equity and market value, which we may be unable to achieve.

**Litigation**

As reported in our Form 10-Q for the quarter ended June 30, 2001, on November 1, 1999, Independent Banker's Bank of Florida (IBBF) filed a lawsuit against Netzee in the U.S. District Court for the Middle District of Florida. In this lawsuit, IBBF claimed that we violated the terms of a marketing agreement between IBBF and SBS, a company acquired by our predecessor. We terminated this marketing agreement after the acquisition of SBS in August 1999. In the lawsuit, IBBF claimed that the marketing agreement did not permit Netzee to terminate the agreement and that Netzee breached certain exclusivity provisions of the agreement. In March 2002, we settled this litigation for \$750,000. This amount was recorded in the first quarter of 2002 upon settlement of the litigation, as the amount was not reasonably estimable at December 31, 2001.

**Related Party Borrowings**

On March 29, 2002, our joint credit facility with InterCept and Harland was amended. The maturity date of the credit facility was extended to April 10, 2003 and the total credit facility was reduced from approximately \$19.6 million to \$18 million. The first \$17 million, to the extent borrowed, will be funded approximately 76.7% by InterCept and 23.3% by Harland. The remaining \$1 million, if borrowed, will be funded solely by InterCept. In connection with this amendment, InterCept was paid an extension fee of \$100,000 and Harland was paid an extension fee of \$20,000.

**Preferred Stock**

On March 29, 2002, the Registration Rights Agreement with the former shareholders of DPSC was amended to defer, until April 10, 2003, the right of the holders of the Series B Preferred Stock to require Netzee to repurchase the preferred stock. In connection with this amendment, Netzee paid an extension fee of approximately \$500,000.

**Memorandum of Understanding**

In the first quarter of 2002, we entered into a Memorandum of Understanding (the MOU ) with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Georgia State Banking Department. The MOU addresses several operational tasks which we believe we have now substantially completed, imposes continuing reporting requirements and prohibits us from declaring or paying cash or stock dividends on any shares of our capital stock without the approval of the banking regulators. No civil or monetary penalties have been imposed on us as a result of the MOU.

F-29