

BOTTOMLINE TECHNOLOGIES INC /DE/

Form 10-K

September 12, 2006

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**FORM 10-K**

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(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended June 30, 2006

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 0-25259

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**BOTTOMLINE TECHNOLOGIES (de), INC.**

(Exact Name of Registrant as Specified in Its Charter)

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**Delaware**  
(State or Other Jurisdiction)

of Incorporation or Organization)

325 Corporate Drive

**Portsmouth, New Hampshire**  
(Address of Principal Executive Offices)

Registrant's telephone number, including area code: (603) 436-0700

**02-0433294**  
(I.R.S. Employer

Identification No.)

**03801**  
(Zip Code)

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

|   |  |
|---|--|
| Title of each class:  | Name of each exchange on which registered: |
| <b>Common Stock, \$.001 par value per share</b>                         | <b>The NASDAQ Global Market</b>            |
| <b>Securities registered pursuant to Section 12(g) of the Act: None</b> |  |

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

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

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

|  |   |  |
|--|---|--|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> |
|--|---|--|

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the last sale price of the registrant's common stock at the close of business on December 31, 2005 was \$246,627,236 (reference is made to Part II, Item 5 herein for a statement of assumptions upon which this calculation is based). The registrant has no non-voting stock.

There were 23,933,906 shares of common stock, \$.001 par value per share, of the registrant outstanding as of August 31, 2006.

**DOCUMENTS INCORPORATED BY REFERENCE**

Items 10, 11, 12, 13 and 14 of Part III (except for information required with respect to our executive officers, which is set forth under Part I Executive Officers and Other Key Employees of the Registrant) have been omitted from this report, as we expect to file with the Securities and Exchange Commission, not later than 120 days after the close of our fiscal year ended June 30, 2006, a definitive proxy statement for our 2006 annual meeting of stockholders. The information required by Items 10, 11, 12, 13 and 14 of Part III of this report, which will appear in our definitive proxy statement, is incorporated by reference into this report.

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### **PART I**

*This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Any statements (including statements to the effect that we believe, expect, anticipate, plan and similar expressions) that are not statements relating to historical matters should be considered forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements as a result of numerous important factors, including those discussed in Item 1A. Risk Factors .*

#### **Item 1. Business. Our Company**

We provide electronic payment and invoice solutions to corporations, financial institutions and banks around the world. Bottomline's solutions are used to streamline, automate and manage processes and transactions involving global payments, invoice approval, collections, cash management, risk mitigation, reporting and document archive. We offer software designed to run on-site at the customer's location as well as hosted solutions. Historically, our software has been sold predominantly on a perpetual license basis. Today, however, we are transitioning our model and a large part of our focus is on selling subscription and transaction-based product offerings.

Our offerings include products and services that automate the Purchase-to-Pay process for corporations allowing them to achieve better control and efficiency with the documents, transactions and payments involved. We also provide a service that receives, manages and controls legal invoices and the related spend management for insurance companies and other large consumers of outside legal services. In addition to these, we offer banks software and services that they use to provide cash management services to their corporate customers.

Our solutions complement and leverage our customers' existing information systems, accounting applications and banking relationships. As a result, our solutions can be deployed quickly and efficiently. To help our customers receive the maximum value from our products and meet their own particular needs, we also provide professional services for installation, training, consulting and product enhancement. Additionally, we offer our customers a broad range of equipment and supplies products that complement our software products.

Bottomline was originally organized as a New Hampshire corporation in 1989 and was reincorporated as a Delaware corporation in August 1997. We maintain our corporate headquarters in Portsmouth, New Hampshire and our international headquarters in Reading, England. We maintain a website with the address [www.bottomline.com](http://www.bottomline.com). Our website includes links to our Code of Business Conduct and Ethics, and our Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee charters. We are not including the information contained in our website as part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available free of charge, through our website, our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practical after such material is electronically filed with, or furnished to, the Securities and Exchange Commission (SEC).

#### **Our Strategy**

Our objective is to be the leading global provider of business payment and invoice management software solutions and services. Key elements of our strategy include the following:

Continuing to add customers and functionality to our growing Legal eXchange network and looking for opportunities to leverage the technology by expanding into new spend management verticals;

Leveraging recent increased investment in electronic banking products, as well as our current customer references to win new customers and increase our market share in the electronic banking market;

Leveraging our software functionality and product suite to offer a solution addressing the full Purchase-to-Pay cycle;



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Increasing our deployment of hosted solutions, as well as subscription and transaction based pricing, in order to increase our recurring revenue contribution;

Continuing to expand our presence outside of North America and the United Kingdom by leveraging our experience with changing global payment standards;

Broadening our relationships with our existing customer base by selling existing applications, as well as new product offerings; and

Pursuing strategic acquisitions that expand our geographical footprint or complement our product functionality.

## **Our Products and Services**

### ***Purchase-to-Pay***

Our comprehensive Purchase-to-Pay offerings allow businesses to automate the almost entirely paper-based processes central to purchasing requisition and invoice management, as well as to facilitate the ultimate payment. Traditionally only available to customers under a software license model, we have recently adopted a subscription and transaction-based pricing model for our Purchase-to-Pay offerings.

We offer a modular solution, that streamlines purchasing and invoice management through a combination of integrated invoice data capture services and highly configurable software. This solution is a flexible and cost-effective alternative to inefficient paper-based invoice management processes. The inclusion of services for invoice receipt and line-item data capture enables businesses to transform paper invoices into clean, electronic data files that can be fed directly into Bottomline's system, an installed ERP or other host financial system within 24 hours, along with invoices received in electronic format.

The payments automation capabilities inherent in our WebSeries® and PayBase® solutions can produce a wide variety of domestic and international payment instructions along with consolidated bank reporting of cash activity, including ACH, EDI, Fedwire transfer, BACSTEL-IP, as well as SWIFT messaging and paper checks in most currencies. Through our payments automation capabilities, customers can reduce administrative expenses, and strengthen compliance and anti-fraud controls. Users are able to gather and access data via the Internet on payment and bank account information, including account totals and detailed transaction data, providing improved workflow, financial reporting and bank communications.

To help augment the financial document composition and delivery components of the Purchase-to-Pay cycle, we offer Create!form, a document process automation suite. Our Create!form products offer advanced design, output formatting and delivery capabilities that enable customers to replace paper-based forms (such as invoices, purchase orders and shipping notices) with more efficient and cost-effective electronic documents. With the capabilities of this product suite, users can centrally manage, distribute and archive important documents and then distribute them via email, print, fax or the Web.

### ***Spend Management***

Our hosted spend management solution, Legal eXchange, integrates with claims management and time and billing systems to automate legal invoice management processes and provide insight into all areas of a company's outside legal spend. Legal eXchange's combination of automated invoice routing and a sophisticated rules engine allows corporate legal and insurance claims departments to create more efficient processes for managing invoices generated by outside law firms, while offering access to important legal spend factors including budgeting, expense monitoring and outside counsel performance. Our Legal eXchange product capability and customer base was significantly enhanced during 2006 with our acquisition of Visibillity, Inc. in December of 2005 and our acquisition of a patent related to certain of the Legal eXchange intellectual property in January of 2006.

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### ***Electronic Banking***

Our WebSeries Electronic Banking Platform allows banks and financial institutions to deploy Internet-based cash management services for their corporate clients. Based on patented technology and complementing existing systems, our banking platform enables users to leverage a single Web-based interface for the origination and processing of all types of inbound and outbound domestic and international payments. The software architecture of our banking platform allows banks and financial institutions to configure highly specialized solution sets for Enterprise Cash Management, Wholesale Banking and Retail Branch Payments using modules for ACH, International Payments, Check Management, Information Reporting, Unattended Payment and File Transmission, and Distributed Document Printing.

### ***Professional Services***

Our teams of service professionals draw on extensive experience to provide consulting, project implementation and training services to our clients. By easing the implementation of our products, these services help our customers accelerate the time to value. By improving the overall customer experience, these services help us retain customers and drive future revenue generating arrangements from existing customers.

### ***Equipment and Supplies***

We offer consumable products for laser check printing, including magnetic ink character recognition toner and blank-paper check stock. We also provide printers and printer-related equipment, primarily through arrangements with our hardware vendors, to complement our software product offerings.

### ***Our Customers***

We support more than 9,000 customers, including 3,000 that access our payment and invoice automation capabilities through convenient subscription and transaction-based services. Our customers are in industries such as financial services, insurance, health care, technology, communications, education, media, manufacturing and government. We provide our products and services to approximately 60 of the Fortune 100 companies and 90 of the FTSE (Financial Times) 100 companies. Our customers include leading organizations such as Bank of America, British Airways, Cisco Systems, Citibank, GMAC, British Petroleum, National City Corporation, UMB Bank, American International Group, Liberty Mutual, and Safeco Insurance.

### ***Our Competition***

The markets in which we participate are highly competitive. We believe our ability to compete depends on factors within and beyond our control, including:

the performance, reliability, features, price and ease of use of our offerings as compared to competitor alternatives;

our industry knowledge and expertise;

the execution of our sales organizations;

our ability to secure and maintain strategic relationships;

our ability to support our customers; and

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the timing and market acceptance of new products and enhancements to existing products by us and by our current and future competitors.

Our invoice management and payments automation products compete primarily with companies that provide a diverse array of Accounts Payable automation and workflow capabilities, such as Xign, BasWare and 170 Systems; companies that provide solutions to create, publish, manage and archive electronic documents, such as Adobe, Optio Software and Xerox and companies that offer electronic payment and laser check printing software and services, such as Payformance, MHC Associates, and ACOM Solutions in the US and Microgen, Albany Software Ltd., Access Europe and Eiger Systems Limited in the UK. To a lesser extent, we compete with



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providers of enterprise resource planning solutions and providers of traditional payment products, including check stock and check printing software and services. In addition, some financial institutions compete with us as outsourced check printing and electronic payment services for their customers.

For Electronic Banking, we primarily compete with companies such as S1 Corporation and Digital Insight that offer a wide range of financial services including electronic banking applications. We also encounter competition to a lesser degree from Metavante, SunGard, Fundtech and Transaction Systems Architects, as well as companies that provide traditional treasury workstation solutions.

With our Legal eXchange solution, we compete with a number of companies, including DataCert, CT TyMetrix, LexisNexis Examen and Allegient Systems.

Although we believe that we compete favorably in each of the markets in which we participate, the markets for our products and services are intensely competitive and characterized by rapid technological change and a number of factors could adversely affect our ability to compete in the future, including those discussed in Item 1A, Risk Factors .

## **Our Operating Segments**

We organize our business by segments in order to maximize market opportunities. Our operating segments are organized principally by the type of products or services offered. As of July 1, 2005, we consolidated the structure of our internal operating segments and aggregated similar operating segments into two reportable segments, Licensed Technology and Outsourced Solutions. The change in segment composition on July 1, 2005 resulted in the consolidation of our Licensed Technology and Tailored Solutions segments into a single segment, Licensed Technology, and that change is reflected for all financial periods presented. A brief overview of our reportable operating segments follows:

*Licensed Technology.* Our Licensed Technology segment includes licensed software products that provide a range of financial process solutions including making and collecting payments and generating and storing business documents. With the consolidation of the Tailored Solutions segment, the Licensed Technology segment also includes solutions specifically designed for banking and financial institution customers, which typically involve longer implementation periods and generally require a significant level of professional services. Due to the customized nature of our banking and financial institution products, revenue is normally recognized on a percentage of completion basis. The Licensed Technology segment also includes an array of standard professional services and equipment and supplies that complement and enhance our core product offerings.

*Outsourced Solutions.* Our Outsourced Solutions segment provides customers with outsourced or hosted solution offerings that facilitate payment processing and the receipt, review and approval of invoices. Also included within our Outsourced Solutions segment is our fully outsourced invoice data capture service, which is a component of our Purchase-to-Pay offering. Revenue for this segment is generally recognized on a per transaction basis or proportionately over the estimated life of the customer relationship.

Each of our operating segments has a dedicated sales force and, periodically, a sales person in one operating segment will sell products or services that are typically sold within a different operating segment. In such cases, the transaction can be recorded by the operating segment to which the sales person is assigned. Accordingly, segment results can include the results of transactions that have been allocated to a specific segment based on the contributing sales resource, rather than the nature of the product or service. Conversely, a transaction can be recorded by the operating segment primarily responsible for delivery to the customer, even if the sales person is assigned to a different operating segment. Such decisions are made by our chief operating decision makers.

Our chief operating decision makers assess segment performance based on segment revenue and a segment measure of profit or loss. Each segment's measure of profit or loss is on a pre-tax basis, and excludes acquisition-related expenses such as amortization of intangible assets, charges related to acquired in-process research and development or acquisition related technology write-offs and stock compensation expense. There are no inter-

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segment sales; accordingly the measure of segment revenue and profit or loss reflects only revenues from our external customers. The costs of certain corporate level expenses, primarily general and administrative expenses, are allocated to our operating segments at predetermined rates that approximate cost.

The Company does not track or assign its assets by operating segment.

The following represents a summary of our reportable segments for the years ended June 30, 2004, 2005 and 2006.

|                                   | Fiscal Year Ended June 30 |           |            |
|-----------------------------------|---------------------------|-----------|------------|
|                                   | 2004                      | 2005      | 2006       |
|                                   | (in thousands)            |           |            |
| Revenues:                         |                           |           |            |
| Licensed Technology               | \$ 68,033                 | \$ 80,349 | \$ 75,694  |
| Outsourced Solutions              | 14,099                    | 16,156    | 25,971     |
| Total revenues                    | \$ 82,132                 | \$ 96,505 | \$ 101,665 |
| Segment measure of profit (loss): |                           |           |            |
| Licensed Technology               | \$ 3,262                  | \$ 6,930  | \$ 3,294   |
| Outsourced Solutions              | (639)                     | 2,102     | 3,944      |
| Total measure of segment profit   | \$ 2,623                  | \$ 9,032  | \$ 7,238   |

A reconciliation of the measure of segment profit to our GAAP income (loss) for 2004, 2005 and 2006, before the provision for income taxes, is as follows:

|   | Fiscal Year Ended June 30 |          |            |
|---|---------------------------|----------|------------|
|   | 2004                      | 2005     | 2006       |
|   | (in thousands)            |          |            |
| Segment measure of profit                       | \$ 2,623                  | \$ 9,032 | \$ 7,238   |
| Less:   |                           |          |            |
| Amortization of intangible assets               | (4,277)                   | (3,217)  | (4,491)    |
| Stock compensation expense                      | (41)                      | (14)     | (6,984)    |
| Acquisition related technology write-offs       |                           |          | (189)      |
| In-process research and development             | (842)                     |          |            |
| Other income, net                               | 288                       | 444      | 3,252      |
| Income (loss) before provision for income taxes | \$ (2,249)                | \$ 6,245 | \$ (1,174) |

**Financial Information About Geographic Areas**

Revenues, based on the point of sales, not the location of the customer, are as follows:

|                | Fiscal Year Ended June 30, |       |           |       |           |       |
|----------------|----------------------------|-------|-----------|-------|-----------|-------|
|                | 2004                       |       | 2005      |       | 2006      |       |
|                | (in thousands)             |       |           |       |           |       |
| United States  | \$ 45,942                  | 55.9% | \$ 46,527 | 48.2% | \$ 54,331 | 53.5% |
| United Kingdom | 34,883                     | 42.5% | 48,300    | 50.1% | 45,471    | 44.7% |
| Australia      | 1,307                      | 1.6%  | 1,678     | 1.7%  | 1,863     | 1.8%  |

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|       |           |        |           |        |            |        |
|-------|-----------|--------|-----------|--------|------------|--------|
| Total | \$ 82,132 | 100.0% | \$ 96,505 | 100.0% | \$ 101,665 | 100.0% |
|-------|-----------|--------|-----------|--------|------------|--------|

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Long-lived assets, which are based on geographical designation, were as follows:

|                         | Fiscal Year Ended<br>June 30 |          |
|-------------------------|------------------------------|----------|
|                         | 2005                         | 2006     |
|                         | (in thousands)               |          |
| Long-lived assets:      |                              |          |
| United States           | \$ 4,173                     | \$ 4,169 |
| United Kingdom          | 3,675                        | 3,970    |
| Australia               | 133                          | 214      |
| Total long-lived assets | \$ 7,981                     | \$ 8,353 |

A significant percentage of our revenues have been generated by our international operations, and our future growth rates and success are in part dependent on continued growth and success in international markets. As is the case with most international operations, the success and profitability of these operations is subject to numerous risks and uncertainties including exchange rate fluctuations that are not hedged currently. A number of other factors could also have a negative effect on our business and results from operations outside the US, including different regulatory and industry standards and certification requirements; reduced protection for intellectual property rights in some countries; import or export licensing requirements; the complexities of foreign tax jurisdictions; and difficulties and costs of staffing and managing our foreign operations.

**Sales and Marketing**

As of June 30, 2006, we employed 123 sales and marketing employees worldwide, of whom 59 were focused on the Americas markets, 61 were focused on European markets and 3 were focused on Asia Pacific markets. We market and sell our products directly through our sales forces and indirectly through a variety of channel partners and reseller relationships. We market and sell our products domestically and internationally with a focus on the UK and, to a lesser degree, Australia. We also maintain an inside sales group, which provides a lower-cost channel into maintaining existing customers and expanding our customer base.

**Product Development and Engineering**

Our product development and engineering organization included 79 employees as of June 30, 2006. We have three primary development groups: software engineering, quality assurance and technical writing. We spent \$9.3 million, \$9.4 million, and \$12.4 million on product development and engineering costs in fiscal years 2004, 2005 and 2006. With respect to our 2006 expenditures, the \$12.4 million is inclusive of the impact of stock compensation expense based on accounting rules that we adopted on July 1, 2005.

Our software engineers have substantial experience in advanced software development techniques as well as extensive knowledge of the complex processes involved in business payment and invoicing systems. Our engineers participate in the Microsoft Developer Network, IBM Partner World for Developers, and the Oracle Partner Developer Program. They maintain extensive knowledge of software development trends and best practices. Our technology focuses on providing business solutions utilizing industry standards, providing a path for extensibility and scalability of our products. Security, control and fraud prevention, as well as data management and information reporting, are priorities in the technology we develop and deploy.

Our quality assurance engineers have extensive knowledge of our products and expertise in software quality assurance techniques. Members of the quality assurance group make use of automated software testing tools to facilitate comprehensive and timely testing of products. The quality assurance group members participate in beta releases, including tests of new products or enhancements, and provide initial training materials for customer support and service.

Our technical support group provides all product documentation as well as technical support for released products. The technical writers are versed in current document technology and work closely with the software

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engineers to create and maintain documentation that is clear, current and complete. The technical support engineers are responsible for the analysis of reported software problems and work closely with customers and customer support staff. The group's broad knowledge of our products, our technology, and our customers' infrastructure allows them to rapidly respond to customer support needs.

### **Backlog**

At the end of fiscal year 2006, our backlog was \$43.5 million, including deferred revenues of \$21.1 million. At the end of fiscal year 2005, our backlog was \$45.1 million, including deferred revenues of \$22.2 million. We do not believe that backlog is a meaningful indicator of sales that can be expected for any period, and there can be no assurance that backlog at any point in time will translate into revenue in any specific subsequent period.

### **Proprietary Rights**

We rely upon a combination of patents, copyrights, trademarks and trade-secret laws to establish and maintain proprietary rights in our technology and products. We had 31 active patent applications relating to our products as of June 30, 2006. We have been awarded six patents and expect to receive others. The earliest year of expiration for our awarded patents is 2015. We intend to continue to file patent applications as we develop new technologies.

There can be no assurance, however, that our existing patent applications, or any others that may be filed in the future, will issue or will be of sufficient scope and strength to provide meaningful protection of our technology or any commercial advantage to us, or that the issued patents will not be challenged, invalidated or circumvented. In addition, we rely upon a combination of copyright and trademark laws and non-disclosure and other intellectual property contractual arrangements to protect our proprietary rights. Given the rapidly changing nature of the industry's technology, the creative abilities of our development, marketing and service personnel may be as or more important to our competitive position as the legal protections and rights afforded by patents. We also enter into agreements with our employees and clients that seek to limit and protect our intellectual property and the distribution of proprietary information. However, there can be no assurance that the steps we have taken to protect our intellectual property will be adequate to deter misappropriation of proprietary information, and we may not be able to detect unauthorized use and take appropriate steps to enforce our proprietary rights.

### **Government Regulation**

Although our operations have not been subject to any material industry-specific governmental regulation, some of our existing and potential customers are subject to extensive federal and state governmental regulations. In addition, governmental regulation in the financial services industry is evolving, particularly with respect to payment technology, and our customers may become subject to increased regulation in the future. Accordingly, our products and services must be designed to work within the regulatory constraints under which our customers operate.

### **Employees**

As of June 30, 2006, we had 481 full-time employees, 123 of whom were in sales and marketing, 197 of whom were in customer support, 79 of whom were in development and 82 of whom were in administration and finance. None of our employees are represented by a labor union. We have not experienced any work stoppages and we believe that employee relationships are good. Our future success will depend in part on our ability to attract, retain and motivate highly qualified technical and managerial personnel in a highly competitive market.

### **Item 1A. Risk Factors.**

*Investing in our common stock involves a high degree of risk. You should carefully consider the risks and uncertainties described below before making an investment decision involving our common stock. The risks and*

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*uncertainties described below are not the only ones facing our company. Additional risks and uncertainties may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer. In that case, the trading price of our common stock could fall, and you may lose all or part of the money you paid to buy our common stock.*

### **Our common stock has experienced and may continue to undergo extreme market price and volume fluctuations**

Stock markets in general, and The NASDAQ Global Market in particular, have experienced extreme price and volume fluctuations, particularly in recent years. Broad market fluctuations of this type may adversely affect the market price of our common stock. The stock prices for many companies in the technology sector have experienced wide fluctuations that often have been unrelated to their operating performance. The market price of our common stock has experienced and may continue to undergo extreme fluctuations due to a variety of factors, including:

changes in or our failure to meet analysts' or investors' estimates or expectations;

general and industry-specific business, economic and market conditions;

actual or anticipated fluctuations in operating results, including those arising as a result of any impairment of goodwill or other intangible assets related to past or future acquisitions;

the impact on operating results of the significant expense associated with share based payments (stock compensation expense) under SFAS 123R, the provisions of which we adopted on July 1, 2005;

public announcements concerning us, including announcements of litigation, our competitors or our industry;

introductions of new products or services or announcements of significant contracts by us or our competitors;

acquisitions, strategic partnerships, joint ventures, or capital commitments by us or our competitors;

adverse developments in patent or other proprietary rights; and

announcements of technological innovations by our competitors.

### **Our future financial results will be impacted by our success in moving components of our business to a subscription-based revenue model**

A substantial portion of our historic revenues and profitability are generated from software license revenues. We are currently transforming some, and may in the future transform other, portions of our business to a subscription-based revenue model which we believe has certain advantages over a perpetual license model, including better predictability of revenue. Our recent acquisitions of Visibillity and Transmit are aligned toward, and will be operated principally under, a subscription-based revenue model. Over time, we expect that more of our licensed software products that were historically sold only on a perpetual license basis will be offered for sale on a subscription basis.

A subscription-based revenue model results in substantially less up-front revenue than a perpetual license model. Additionally, there can be no assurance that our customers, or the markets in which we compete, will respond favorably to our approach. To the extent that our software license revenues were to decline significantly in any period, or if we did not receive general marketplace acceptance of a subscription-based approach, our financial results could be materially and adversely affected.

**The demand for our BACSTEL-IP product in the UK, which during 2005 generated significant software license revenue growth, has declined as the technology adoption date has passed**

In 2005, we experienced strong market demand in the UK for our software products that address the new standard for electronic payments in the UK called BACSTEL-IP. Under the existing regulatory requirements, UK businesses had until the end of December 2005 to be in compliance with this standard.

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We have introduced new products to the UK market which are intended to capitalize on the customer relationships we established during the BACSTEL-IP initiative. In addition, we offer the BACSTEL-IP solution on a subscription basis to a portion of our customers, which we expect will generate ongoing recurring revenues. The payment market in Europe is continuing to evolve with new payment regulations and payment types, both currently proposed and expected in the future, for which we have introduced and anticipate continuing to introduce new products. However, the combination of new product sales, recurring subscription revenues, sales of new products targeting new payment regulations and standards or growth in our other revenue streams may not be sufficient to offset the revenue from our BACSTEL-IP software products, in which case our operating results and stock price could be materially and adversely affected.

### **Integration of acquisitions could interrupt our business and our financial condition could be harmed**

We have made several recent acquisitions of companies, including our acquisition of HMSL during fiscal 2005 and our acquisitions of Visiblility and Transmit during fiscal 2006. We may in the future continue to acquire, or make investments in, other businesses, products or technologies. Any acquisition or strategic investment we have made in the past or may make in the future may entail numerous risks, including the following:

difficulties integrating acquired operations, personnel, technologies or products;

inadequacy of existing operating, financial and management information systems to support the combined organization or new operations;

write-offs related to impairment of goodwill and other intangible assets;

entrance into markets in which we have no or limited prior experience or knowledge;

diversion of management's focus from our core business concerns;

dilution to existing stockholders and earnings per share;

incurrence of substantial debt; and

exposure to litigation from third parties, including claims related to intellectual property or other assets acquired or liabilities assumed. Any such difficulties encountered as a result of any merger, acquisition or strategic investment could have a material adverse effect on our business, operating results and financial condition.

### **As a result of our acquisitions, we could be subject to significant future write-offs with respect to intangible assets, which may adversely affect our future operating results**

We review our intangible assets, including goodwill, periodically for impairment. At June 30, 2006, the carrying value of our goodwill and our other intangible assets was \$41.2 million and \$19.9 million, respectively. While we reviewed our goodwill and intangible assets during our fourth quarter of fiscal year 2006 and concluded that there was no impairment, we could be subject to future impairment charges with respect to these intangible assets, or intangible assets arising as a result of additional acquisitions in future periods. Such charges, to the extent occurring, would likely have a material adverse effect on our operating results.



**Our fixed costs may lead to operating results below analyst or investor expectations if our revenues are below anticipated levels, which could adversely affect the market price of our common stock**

A significant percentage of our expenses, particularly personnel and facilities costs, are relatively fixed and based in part on anticipated revenue levels. In recent years we have experienced slowing growth rates with certain of our licensed software products, and in 2006 we experienced a decrease in software license revenues as a result of the BACSTEL-IP initiative having ended in the UK. A decline in revenues without a corresponding

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and timely slowdown in expense growth could negatively affect our business. Significant revenue shortfalls in any quarter may cause significant declines in operating results since we may be unable to reduce spending in a timely manner.

Quarterly or annual operating results that are below the expectations of public market analysts could adversely affect the market price of our common stock. Factors that could cause fluctuations in our operating results include the following:

economic conditions, which may affect our customers' and potential customers' budgets for information technology expenditures;

the timing of orders and longer sales cycles;

the timing of product implementations, which are highly dependent on customers' resources and discretion;

the incurrence of costs relating to the integration of software products and operations in connection with acquisitions of technologies or businesses; and

the timing and market acceptance of new products or product enhancements by either us or our competitors.

Because of these factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful.

### **Our mix of products and services could have a significant effect on our financial condition, results of operations and the market price of our common stock**

The gross margins for our products and services vary considerably. Our software revenues generally yield significantly higher gross margins than do our service, maintenance, and equipment and supplies revenue streams. In recent fiscal years we experienced a decrease in our software license fees, particularly in the US, and during 2006 we experienced a decrease in software license revenues as the BACSTEL-IP initiative in the UK had ended. If software license fees continue to decline, or if the mix of our products and services in any given period does not match our expectations, our results of operations and the market price of our common stock could be significantly affected.

### **We face risks associated with our international operations that could harm our financial condition and results of operations**

A significant percentage of our revenues have been generated by our international operations, and our future growth rates and success are in part dependent on our continued growth and success in international markets. We currently have operations in the US, UK and Australia. As is the case with most international operations, the success and profitability of these operations are subject to numerous risks and uncertainties that include, in addition to the risks our business as a whole faces, the following:

difficulties and costs of staffing and managing foreign operations;

differing regulatory and industry standards and certification requirements;

the complexities of foreign tax jurisdictions;

reduced protection for intellectual property rights in some countries;

currency exchange rate fluctuations; and

import or export licensing requirements.

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### **A significant percentage of our revenues to date have come from our payment management offerings and our performance will depend on continued market acceptance of these solutions**

A significant percentage of our revenues to date have come from the license and maintenance of our payment management offerings and sales of associated products and services. Any significant reduction in demand for our payment management offerings could have a material adverse effect on our business, operating results and financial condition. Our future performance could depend on the following factors:

continued market acceptance of our payment management offerings as part of our overall purchase to pay solution;

prospective customers dependence upon enterprises seeking to enhance their payment functions to integrate electronic payment capabilities;

our ability to introduce enhancements to meet the market's evolving needs for secure payments and cash management solutions; and

continued acceptance of desktop and enterprise software, and laser check printing solutions.

### **Our future financial results will depend on our ability to manage growth effectively**

In the past, rapid growth has strained our managerial and other resources. If rapid growth resumes, our ability to manage that growth will depend in part on our ability to continue to enhance our operating, financial and management information systems. We cannot assure you that our personnel, systems and controls will be adequate to support future growth. If we are unable to manage growth effectively, the quality of our services, our ability to retain key personnel and our business, operating results and financial condition could be materially adversely affected.

### **We face significant competition in our targeted markets, including competition from companies with significantly greater resources**

In recent years we have encountered increasing competition in our targeted markets. We compete with a wide range of companies, ranging from small start-up enterprises with limited resources, which compete principally on the basis of technology features or specific customer relationships, to large companies, which can leverage significant customer bases and financial resources. Given the size and nature of the markets we target, the implementation of our growth strategy and our success in competing for market share is dependent on our ability to grow our sales and marketing capabilities and maintain an appropriate level of financial resources.

### **An increasing number of large and more complex customer contracts, or contracts that involve the delivery of services over contractually committed periods, generally delay the timing of our revenue recognition and in the short-term may adversely affect our operating results, financial condition and the market price of our stock**

Due to an increasing number of large and more complex customer contracts, we have experienced, and will likely continue to experience, delays in the timing of our revenue recognition. These large and complex customer contracts generally require significant implementation work, product customization and modification resulting in the recognition of revenue over the period of project completion, which normally spans several quarters. Additionally, a growing number of our products and services are sold on a hosted basis, which can involve contractually defined service periods. In such cases, revenue is typically recorded over the expected life of the customer relationship period, rather than at the outset of the arrangement, thus lengthening the period of revenue recognition. Delays in revenue recognition on these contracts could affect our operating results, financial condition and the market price of our common stock.

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### **We depend on key employees who are skilled in e-commerce, payment, cash and document management and invoice presentment methodology and Internet and other technologies**

Our success depends upon the efforts and abilities of our executive officers and key technical employees who are skilled in e-commerce, payment methodology and regulation, and Internet, database and network technologies. The loss of one or more of these individuals could have a material adverse effect on our business. We currently do not maintain key man life insurance policies on any of our employees. While some of our executive officers have employment or retention agreements with us, the loss of the services of any of our executive officers or other key employees could have a material adverse effect on our business, operating results and financial condition.

### **We must attract and retain highly skilled personnel with knowledge in e-commerce, payment, cash and document management and invoice presentment methodology and Internet and other technologies**

We believe that our success is in part dependent upon our ability to attract, hire, train and retain highly skilled technical, sales and marketing, and support personnel, particularly with expertise in e-commerce, payment, cash management and invoice methodology and Internet and other technologies. Competition for qualified personnel is intense. As a result, we may experience increased compensation costs that may not be offset through either improved productivity or higher sales prices. There can be no assurance that we will be successful in attracting, recruiting or retaining existing personnel. Based on our experience, it takes an average of nine months for a salesperson to become fully productive. We cannot assure you that we will be successful in increasing the productivity of our sales personnel, and the failure to do so could have a material adverse effect on our business, operating results and financial condition.

### **Increased competition may result in price reductions and decreased demand for our product solutions**

The markets in which we compete are intensely competitive and characterized by rapid technological change. Some competitors in our targeted markets have longer operating histories, significantly greater financial, technical, and marketing resources, greater brand recognition and a larger installed customer base than we do. We expect to face additional competition as other established and emerging companies enter the markets we address. In addition, current and potential competitors may make strategic acquisitions or establish cooperative relationships to expand their product offerings and to offer more comprehensive solutions. This growing competition may result in price reductions of our products and services, reduced revenues and gross margins and loss of market share, any one of which could have a material adverse effect on our business, operating results and financial condition.

### **Our success depends on our ability to develop new and enhanced products, services and strategic partner relationships**

The markets in which we compete are subject to rapid technological change and our success is dependent on our ability to develop new and enhanced products, services and strategic partner relationships that meet evolving market needs. Trends that could have a critical impact on us include:

evolving industry standards, mandates and laws, such as those mandated by the National Automated Clearing House Association and the Association for Payment Clearing Services;

rapidly changing technology, which could cause our software to become suddenly outdated or could require us to make our products compatible with new database or network systems;

developments and changes relating to the Internet that we must address as we maintain existing products and introduce any new products; and

the loss of any of our key strategic partners who serve as a valuable network from which we can leverage industry expertise and respond to changing marketplace demands.

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There can be no assurance that technological advances will not cause our technology to become obsolete or uneconomical. If we are unable to develop and introduce new products, or enhancements to existing products, in a timely and successful manner, our business, operating results and financial condition could be materially adversely affected. Similarly, if our new products did not receive general marketplace acceptance, or if the sales cycle of any of our new products significantly delayed the timing of revenue recognition, our results could be negatively affected.

### **Our products could be subject to future legal or regulatory actions, which could have a material adverse effect on our operating results**

Our software products and hosted services offerings facilitate the transmission of business documents and information including, in some cases, confidential financial data related to payments, invoices and cash management. Our web-based software products, and certain of our hosted services offerings, transmit this data electronically. While we believe that all of our product and service offerings comply with current regulatory and security requirements, there can be no assurance that future legal or regulatory actions will not impact our product and service offerings. To the extent that regulatory or legal developments mandate a change in any of our products or services, or alter the demand for or the competitive environment of our products and services, we might not be able to respond to such requirements in a timely or successful manner. If this were to occur, our business, operating results and financial condition could be materially adversely affected.

### **Any unanticipated performance problems or bugs in our product offerings could have a material adverse effect on our future financial results**

If the products that we offer and continue to introduce do not sustain marketplace acceptance, our future financial results will be adversely affected. Since many of our software solutions are still in early stages of adoption and since most of our software products are continually being enhanced or further developed in response to general marketplace demands, any unanticipated performance problems or bugs that we have not been able to detect could result in additional development costs, diversion of technical and other resources from our other development efforts, negative publicity regarding us and our products, harm to our customer relationships and exposure to potential liability claims. In addition, if our products do not enjoy wide commercial success, our long-term business strategy will be adversely affected, which could have a material adverse effect on our business, operating results and financial condition.

### **We could incur substantial costs resulting from warranty claims or product liability claims**

Our software license agreements typically contain provisions that afford customers a degree of warranty protection in the event that our software fails to conform to its written specifications. These agreements typically contain provisions intended to limit the nature and extent of our risk of warranty and product liability claims. There is a risk, however, that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Furthermore, some of our licenses with our customers are governed by non-U.S. law, and there is a risk that foreign law might provide us less or different protection. While we maintain general liability insurance, including coverage for errors and omissions, we cannot be sure that our existing coverage will continue to be available on reasonable terms or will be available in amounts sufficient to cover one or more large claims. Although we have not experienced any material warranty or product liability claims to date, a warranty or product liability claim, whether or not meritorious, could result in substantial costs and a diversion of management's attention and our resources, which could have an adverse effect on our business, operating results and financial condition.

### **We could be adversely affected if we are unable to protect our proprietary technology and could be subject to litigation regarding our intellectual property rights, causing serious harm to our business**

We rely upon a combination of patent, copyright and trademark laws and non-disclosure and other intellectual property contractual arrangements to protect our proprietary rights. However, we cannot assure you

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that our patents, pending applications for patents that may issue in the future, or other intellectual property will be of sufficient scope and strength to provide meaningful protection to our technology or any commercial advantage to us, or that the patents will not be challenged, invalidated or circumvented. We enter into agreements with our employees and customers that seek to limit and protect the distribution of proprietary information. Despite our efforts to safeguard and maintain our proprietary rights, there can be no assurance that such rights will remain protected or that we will be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We may be a party to litigation in the future to protect our intellectual property rights or as a result of an alleged infringement of the intellectual property rights of others. Any such claims, whether or not meritorious, could require us to spend significant sums in litigation, pay damages, delay product implementations, develop non-infringing intellectual property or acquire licenses to intellectual property that is the subject of the infringement claim. These claims could have a material adverse effect on our business, operating results and financial condition.

### **We engage off-shore development resources which may not be successful and which may put our intellectual property at risk**

In order to optimize our research and development capabilities and to meet development timeframes, we contract with off-shore third party vendors in India and elsewhere for certain development activities. While our experience to date with these activities has been positive, there are a number of risks associated with off-shore development activities that include but are not limited to the following:

less efficient and less accurate communication and information flow as a consequence of time, distance and language barriers between our primary development organization and the off-shore resources, resulting in delays or deficiencies in development efforts;

disruption due to political or military conflicts around the world;

misappropriation of intellectual property from departing personnel, which we may not readily detect;

currency exchange rate fluctuations that could adversely impact the cost advantages intended from these agreements.

To the extent that these or unforeseen risks occur, our operating results and financial condition could be adversely impacted.

### **We may incur significant costs from class action litigation as a result of expected volatility in our common stock**

In the past, companies that have experienced market price volatility of their stock have been the targets of securities class action litigation. In August 2001, we were named as a party in one of the so-called "laddering" securities class action suits relating to the underwriting of our initial public offering. We could incur substantial costs and experience a diversion of our management's attention and resources in connection with such litigation, which could have a material adverse effect on our business, financial condition and results of operations.

### **Item 1B. *Unresolved Staff Comments.***

There are no material unresolved written comments from the staff of the SEC regarding our periodic or current reports received not less than 180 days before the end of our fiscal year to which this Form 10-K relates.

### **Item 2. *Properties.***

We currently lease approximately 65,000 square feet of office space at our corporate headquarters in Portsmouth, New Hampshire under a lease that expires in 2012. We also occupy approximately 24,000 square feet of leased domestic offices in Great Neck, New York and Chicago, Illinois.





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We own approximately 16,000 square feet of office space in Reading, England and lease approximately 21,000 square feet of office space in Andover and Hertford, England and Melbourne, Australia.

Our Portsmouth, New Hampshire and Reading, England properties are used by personnel associated with both our Licensed Technology and Outsourced Solutions segments. Our Great Neck, New York and Melbourne, Australia properties are used by personnel associated with our Licensed Technology segment. Our Chicago, Illinois and Andover and Hertford, England properties are used by personnel associated with our Outsourced Solutions segment.

### **Item 3. Legal Proceedings.**

On August 10, 2001, a class action complaint was filed against us in the United States District Court for the Southern District of New York: Paul Cyrek v. Bottomline Technologies, Inc.; Daniel M. McGurl; Robert A. Eberle; FleetBoston Robertson Stephens, Inc.; Deutsche Banc Alex Brown Inc.; CIBC World Markets; and J.P. Morgan Chase & Co. A consolidated amended class action complaint, *In re Bottomline Technologies Inc. Initial Public Offering Securities Litigation*, was filed on April 20, 2002. The amended complaint supersedes the class action complaint filed against us in the United States District Court for the Southern District of New York on August 10, 2001.

The amended complaint filed in the action asserts claims under Sections 11, 12(2) and 15 of the Securities Act of 1933, as amended, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (Exchange Act). The amended complaint asserts, among other things, that the description in our prospectus for our initial public offering was materially false and misleading in describing the compensation to be earned by the underwriters of our offering, and in not describing certain alleged arrangements among underwriters and initial purchasers of our common stock from the underwriters. The amended complaint seeks damages (or, in the alternative, tender of the plaintiffs' and the class's Bottomline common stock and rescission of their purchases of our common stock purchased in the initial public offering), costs, attorneys' fees, experts' fees and other expenses.

In July 2002, Bottomline, Daniel M. McGurl and Robert A. Eberle joined in an omnibus motion to dismiss, which challenged the legal sufficiency of plaintiffs' claims. The motion was filed on behalf of hundreds of issuer and individual defendants named in similar lawsuits. Plaintiffs opposed the motion, and the court heard oral argument on the motion in early November 2002. On February 19, 2003, the court issued an order denying the motion to dismiss as to Bottomline. In addition, in early October 2002, Daniel M. McGurl and Robert A. Eberle were dismissed from this case without prejudice. A special litigation committee of the board of directors of Bottomline authorized Bottomline to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding negotiated among class plaintiffs, all issuer defendants and their insurers. The parties have negotiated a settlement, which is subject to approval by the court. On February 15, 2005, the court issued an Opinion and Order preliminarily approving the settlement, provided that the defendants and plaintiffs agree to a modification narrowing the scope of the bar order set forth in the original settlement agreement. If the settlement is not approved, we intend to vigorously defend ourselves against this amended complaint. We do not currently believe that the outcome of this proceeding will have a material adverse impact on our financial condition, results of operations or cash flows.

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

No matter was submitted to a vote of our stockholders, through the solicitation of proxies or otherwise, during the fourth quarter of fiscal year 2006.

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### **Executive Officers and Other Key Employees of the Registrant**

Our executive officers and other key employees and their respective ages as of August 31, 2006, are as follows:

| <b>Name</b>        | <b>Age</b> | <b>Positions</b>  |
|--------------------|------------|---|
| Joseph L. Mullen   | 54         | Chief Executive Officer and Director  |
| Robert A. Eberle   | 45         | President, Chief Operating Officer and Director                               |
| Peter S. Fortune   | 47         | Chief Marketing Officer and President of Bottomline Europe                    |
| Kevin M. Donovan   | 36         | Chief Financial Officer and Treasurer   |
| Paul J. Fannon     | 38         | Managing Director, Transaction Services Europe                                |
| Richard A. Bell    | 41         | Vice President and General Manager, Financial Process Solutions North America |
| Thomas D. Gaillard | 43         | Vice President and General Manager, Transaction Services North America        |
| Craig A. Jones     | 49         | Vice President and General Manager, Financial Process Solutions North America |
| Michael J. Kosek   | 46         | Vice President and General Manager, Financial Process Solutions North America |
| Chris W. Peck      | 41         | Managing Director, Group Sales Europe   |
| Nigel K. Savory    | 39         | Managing Director, Europe   |

*Joseph L. Mullen* has served as a director since July 1996 and Chief Executive Officer since August 2002. Mr. Mullen also served as President from September 2000 to August 2004. From September 2000 to April 2001, Mr. Mullen also served as Chief Operating Officer. From July 1996 to September 2000, Mr. Mullen served as Executive Vice President of Operations.

*Robert A. Eberle* has served as a director since September 2000. Mr. Eberle has served as President since August 2004 and as Chief Operating Officer since April 2001. Mr. Eberle served as Chief Financial Officer from September 1998 to August 2004. From September 1998 to May 2001, Mr. Eberle also served as Treasurer.

*Peter S. Fortune* has served as Chief Marketing Officer since November 2005, and as President of Bottomline Europe since we acquired the predecessor company in August 2000. From May 1993 to August 2000, Mr. Fortune served as Executive Director of Checkpoint Security Services Limited, an electronic payment software company in the UK and from March 1999 to August 2000, Mr. Fortune served as Chief Executive Officer of Checkpoint Holdings.

*Kevin M. Donovan* has served as Chief Financial Officer since August 2004 and as Treasurer since May 2001. Mr. Donovan served as Vice President, Finance from January 2000 to August 2004. From February 1999 through December 1999, Mr. Donovan served as Corporate Controller.

*Paul J. Fannon* has served as Managing Director, Transaction Services Europe since December 2003. From December 2001 through December 2003, Mr. Fannon served as Managing Director, Payment Solutions Europe. From August 2000, the date we acquired the predecessor company, to December 2001, Mr. Fannon served as Client Services Director of Bottomline Europe. From November 1999 through August 2000, Mr. Fannon served as Client Services Director of Checkpoint Security Services Limited.

*Richard A. Bell* has served as Vice President and General Manager, Financial Process Solutions North America since September 2005 and Vice President of Create!form, acquired by the Company in September 2003, since January 2001. Prior to joining the Company, Mr. Bell served as President and Co-Founder of Resolutions, an electronic forms software company.

*Thomas D. Gaillard* has served as Vice President and General Manager, Transaction Services North America since July 2003. From May 2002 to June 2003, Mr. Gaillard served as Vice President, Corporate

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Development. From December 2001 to May 2002, Mr. Gaillard served as Chief Operating Officer of eVelocity Corporation, a provider of legal electronic invoicing solutions. From November 1999 to June 2001, Mr. Gaillard served as Chief Financial Officer for Newmarket International, a software company.

*Craig A. Jones* has served as Vice President and General Manager, Financial Process Solutions North America since July 2003. From July 2002 to June 2003, Mr. Jones served as Vice President of Product Management. From September 1999 to July 2002, Mr. Jones served as Vice President of Marketing.

*Michael J. Kosek* has served as Vice President and General Manager, Financial Process Solutions North America since July 2005. Prior to joining the Company, Mr. Kosek served as General Manager, New England operations of Microsoft Corporation from April 1998 through November 2004.

*Christopher W. Peck* has served as Managing Director, Group Sales Europe since July 2003. From August 2000, the date we acquired the predecessor company, through June 2003, Mr. Peck served as Group Sales Director of Bottomline Europe. From March 1994 to August 2000, Mr. Peck served as Group Sales Director of Checkpoint Security Services Limited and from March 1999 to August 2000, Mr. Peck served in the same capacity for Checkpoint Holdings.

*Nigel K. Savory* has served as Managing Director, Europe since December 2003. From December 2001 through December 2003, Mr. Savory served as the Managing Director Transaction Services Europe. From August 2000, the date we acquired the predecessor company, through December 2001, Mr. Savory served as the European Business Development Director of Bottomline Europe. From January 1998 through August 2000, Mr. Savory served as the European Business Development Director of Checkpoint Security Services Limited.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock is traded on The NASDAQ Global Market under the symbol EPAY. The following table sets forth, for the periods indicated, the high and low sale prices of our common stock, as quoted on The NASDAQ Global Market (previously the NASDAQ National Market).

| Period         | High     | Low      |
|----------------|----------|----------|
| Fiscal 2005    |          |          |
| First quarter  | \$ 10.61 | \$ 7.50  |
| Second quarter | \$ 17.35 | \$ 8.90  |
| Third quarter  | \$ 16.23 | \$ 10.63 |
| Fourth quarter | \$ 16.02 | \$ 11.31 |
| Fiscal 2006    |          |          |
| First quarter  | \$ 18.62 | \$ 14.57 |
| Second quarter | \$ 15.67 | \$ 10.01 |
| Third quarter  | \$ 13.75 | \$ 10.33 |
| Fourth quarter | \$ 14.00 | \$ 8.05  |

As of August 31, 2006, there were approximately 205 holders of record of our common stock. Because many of the shares are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of individual stockholders represented by these holders of record.

The closing price for our common stock on August 31, 2006 was \$10.09. For purposes of calculating the aggregate market value of the shares of our common stock held by non-affiliates, as shown on the cover page of this report, it has been assumed that all the outstanding shares were held by non-affiliates except for the shares beneficially held by our directors and executive officers. However, there may be other persons who may be deemed to be affiliates of ours.

We have never paid dividends on our common stock. We intend to retain our earnings for use in our business and, therefore, do not anticipate paying any cash dividends on our common stock for the foreseeable future. Additionally, pursuant to the terms of our existing Loan and Security Agreement with Silicon Valley Bank, any decision to pay dividends on our common stock would be subject to the bank's approval.

The following table provides information about purchases by us of our common stock during the quarter ended June 30, 2006:

| Period                         | Total Number of<br>Shares Purchased | Average Price Paid<br>Per Share | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plans<br>or Programs | Approximate<br>Dollar Value of<br>Shares That May<br>Yet be Purchased<br>Under The<br>Plans<br>or Programs<br>(1) |
|--------------------------------|-------------------------------------|---------------------------------|--|---|
| April 1, 2006 - April 30, 2006 |                                     |                                 |  | \$ 1,600,000  |
| May 1, 2006 - May 31, 2006     |                                     |                                 |  | \$ 1,600,000  |
| June 1, 2006 - June 30, 2006   | 7,500                               | \$ 8.20                         | 7,500  | \$ 9,900,000  |
| Total                          | 7,500                               | \$ 8.20                         | 7,500  | \$ 9,900,000  |

(1) In July 2002, our board of directors announced that it had authorized a repurchase program for the repurchase of up to \$3.0 million of our common stock. At June 30, 2006, we had repurchased 242,650



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shares at an average repurchase price of \$5.79 per share. The approximate remaining dollar value of shares available for repurchase under this program is \$1.6 million. During the year ended June 30, 2006, we did not repurchase any shares under this program and this repurchase program was closed by our board of directors in June, 2006.

In June 2006, our board of directors announced that it had authorized a repurchase program for the repurchase of up to \$10.0 million of our common stock. At June 30, 2006, we had repurchased 7,500 shares at an average repurchase price of \$8.20 per share. The approximate remaining dollar value of shares available for repurchase under this program is \$9.9 million.

**Item 6. Selected Financial Data.**

You should read the following consolidated financial data in conjunction with the Financial Statements, including the related notes, and Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations. The results shown herein are not necessarily indicative of the results to be expected for any future periods.

**SELECTED CONSOLIDATED FINANCIAL DATA**

|  | 2002      | Fiscal Year Ended June 30, |           |           |           | 2006 |
|--|-----------|----------------------------|-----------|-----------|-----------|------|
|  |           | 2003                       | 2004      | 2005      |           |      |
| (in thousands, except per share data)  |           |                            |           |           |           |      |
| Statements of Operations Data:   |           |                            |           |           |           |      |
| Revenues:  |           |                            |           |           |           |      |
| Software licenses  | \$ 16,023 | \$ 13,021                  | \$ 14,366 | \$ 18,789 | \$ 12,236 |      |
| Service and maintenance  | 38,169    | 40,865                     | 51,364    | 62,233    | 74,801    |      |
| Equipment and supplies   | 19,794    | 17,379                     | 16,402    | 15,483    | 14,628    |      |
| Total revenues   | 73,986    | 71,265                     | 82,132    | 96,505    | 101,665   |      |
| Cost of revenues:  |           |                            |           |           |           |      |
| Software licenses  | 1,455     | 1,936                      | 1,678     | 2,295     | 1,419     |      |
| Service and maintenance  | 19,125    | 21,056                     | 22,363    | 26,656    | 32,250    |      |
| Stock compensation expense   |           |                            |           |           | 474       |      |
| Equipment and supplies   | 14,457    | 13,615                     | 13,312    | 11,980    | 11,639    |      |
| Total cost of revenues   | 35,037    | 36,607                     | 37,353    | 40,931    | 45,782    |      |
| Gross profit   | 38,949    | 34,658                     | 44,779    | 55,574    | 55,883    |      |
| Operating expenses:  |           |                            |           |           |           |      |
| Sales and marketing  | 19,504    | 18,372                     | 21,062    | 24,323    | 23,023    |      |
| Stock compensation expense   |           |                            |           |           | 2,489     |      |
| Product development and engineering:   |           |                            |           |           |           |      |
| Product development and engineering  | 13,176    | 10,138                     | 9,264     | 9,419     | 11,576    |      |
| In-process research and development  |           |                            | 842       |           |           |      |
| Stock compensation expense   | 411       | 71                         | 41        | 14        | 841       |      |
| General and administrative   | 11,016    | 11,088                     | 11,830    | 12,800    | 14,709    |      |
| Stock compensation expense   |           |                            |           |           | 3,180     |      |
| Amortization of intangible assets  | 33,634    | 8,830                      | 4,277     | 3,217     | 4,491     |      |
| Total operating expenses   | 77,741    | 48,499                     | 47,316    | 49,773    | 60,309    |      |
| Income (loss) from operations  | (38,792)  | (13,841)                   | (2,537)   | 5,801     | (4,426)   |      |
| Other income (expense), net  | 63        | (189)                      | 288       | 444       | 3,252     |      |
| Income (loss) before provision for income taxes and cumulative effect of accounting change |           |                            |           |           |           |      |
|  | (38,729)  | (14,030)                   | (2,249)   | 6,245     | (1,174)   |      |

|                            |    |    |     |     |     |
|----------------------------|----|----|-----|-----|-----|
| Provision for income taxes | 60 | 60 | 169 | 357 | 660 |
|----------------------------|----|----|-----|-----|-----|

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|  | 2002        | Fiscal Year Ended June 30,<br>(in thousands, except per share data) |            |          |            | 2006 |
|--|-------------|---|------------|----------|------------|------|
| Income (loss) before cumulative effect of accounting change                                | (38,789)    | (14,090)  | (2,418)    | 5,888    | (1,834)    |      |
| Cumulative effect of accounting change   |             | (13,764)  |            |          |            |      |
| Net income (loss)  | \$ (38,789) | \$ (27,854)   | \$ (2,418) | \$ 5,888 | \$ (1,834) |      |
| Basic income (loss) per common share before cumulative effect of accounting change         | \$ (2.63)   | \$ (0.90)   | \$ (0.15)  | \$ 0.33  | \$ (0.08)  |      |
| Diluted income (loss) per common share before cumulative effect of accounting change       | \$ (2.63)   | \$ (0.90)   | \$ (0.15)  | \$ 0.31  | \$ (0.08)  |      |
| Cumulative effect of accounting change   |             | (0.88)  |            |          |            |      |
| Basic net income (loss) per common share   | \$ (2.63)   | \$ (1.78)   | \$ (0.15)  | \$ 0.33  | \$ (0.08)  |      |
| Diluted net income (loss) per common share   | \$ (2.63)   | \$ (1.78)   | \$ (0.15)  | \$ 0.31  | \$ (0.08)  |      |
| Shares used in computing basic income (loss) per share                                     | 14,725      | 15,667  | 16,514     | 18,030   | 22,838     |      |
| Shares used in computing diluted income (loss) per share                                   | 14,725      | 15,667  | 16,514     | 19,119   | 22,838     |      |
| Non-GAAP presentation:   |             |   |            |          |            |      |
| Income (loss) before provision for income taxes and cumulative effect of accounting change | \$ (38,729) | \$ (14,030)   | \$ (2,249) | \$ 6,245 | \$ (1,174) |      |
| Amortization of intangible assets  | 33,634      | 8,830   | 4,277      | 3,217    | 4,491      |      |
| Stock compensation expense   | 411         | 71  | 41         | 14       | 6,984      |      |
| Acquisition-related technology write-offs  |             |   |            |          | 189        |      |
| In-process research and development  |             |   | 842        |          |            |      |
| Provision for income taxes   | (60)        | (60)  | (169)      | (357)    | (660)      |      |
| Non-GAAP net income (loss)   | \$ (4,744)  | \$ (5,189)  | \$ 2,742   | \$ 9,119 | \$ 9,830   |      |

The non-GAAP presentation above consists of a reconciliation of our net income or loss before the cumulative effect of accounting changes and income taxes to a measure of non-GAAP net income or loss. We present this supplemental information in the form of non-GAAP financial measures, which excludes certain non-cash items specifically in-process research and development charges, acquisition related technology write-offs, amortization of intangible assets and stock compensation expense. We believe that this supplemental, non-GAAP presentation is useful to investors because it allows for an evaluation of Bottomline with a focus on the performance of its core operations. Our executive management team, including our chief operating decision makers, use this same non-GAAP measure internally to assess the on-going performance of Bottomline.

Since the presentation above is not a GAAP measurement of financial performance, there are material limitations to its usefulness on a stand alone basis, including the lack of comparability of this presentation to the GAAP financial results of other companies. Accordingly the non-GAAP information should not be used in isolation to, or as a substitute for, our GAAP results.

Certain prior period amounts have been reclassified to comply with recent accounting pronouncements and for comparative purposes. To ensure comparability, these reclassifications also reflect changes in where certain classes of employees are now reported within our operating expense categories.



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|                            |           | Fiscal Year Ended June 30, |                |           |           |
|----------------------------|-----------|----------------------------|----------------|-----------|-----------|
|                            | 2002      | 2003                       | 2004           | 2005      | 2006      |
|                            |           |                            | (in thousands) |           |           |
| Balance Sheet Data:        |           |                            |                |           |           |
| Cash and cash equivalents  | \$ 25,931 | \$ 25,802                  | \$ 20,724      | \$ 20,789 | \$ 38,752 |
| Marketable securities      |           |                            | 4,291          | 15,127    | 41,745    |
| Working capital            | 20,700    | 17,564                     | 17,991         | 27,552    | 71,874    |
| Total assets               | 98,710    | 74,535                     | 91,243         | 110,441   | 175,834   |
| Long-term debt             | 253       |                            |                |           |           |
| Total stockholders' equity | 72,631    | 47,695                     | 59,253         | 72,793    | 136,608   |

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Selected Consolidated Financial Data and the financial statements and notes thereto appearing elsewhere in this Annual Report on Form 10-K. This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. The statements contained in this Annual Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Without limiting the foregoing, the words may, will, should, could, expects, plans, anticipates, believes, estimates, predicts, potential and similar expressions are intended to identify forward-looking statements. All forward-looking statements included in this Annual Report on Form 10-K are based on information available to us up to and including the date of this document, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors and elsewhere in this Form 10-K. You should carefully review those factors and also carefully review the risks outlined in other documents that we file from time to time with the Securities and Exchange Commission.

**Overview**

We provide software products and services for business payments and invoice management. Our solutions enable organizations to automate, manage, standardize and control transaction based processes across the enterprise, particularly those that involve making payments, sending and receiving invoices, receiving payments, generating business documents and conducting electronic banking. We offer software designed to run on-site at the customer's location as well as hosted solutions. Historically, our software has been sold predominantly on a perpetual license basis. We expect that a large part of our focus going forward will be on selling subscription and transaction based product offerings.

Our software applications address the global payment and related process requirements of business enterprises, permitting them to achieve greater operating efficiency, increase visibility of the cash cycle and better comply with applicable regulations and standards. We support a broad range of global networks and payment standards, including Automated Clearing House (ACH), Financial Electronic Data Interchange (EDI), Fed Wire transfer, BACS (ACH for the UK), BACSTEL-IP and SWIFT, as well as new and evolving standards.

During fiscal 2006, our revenue increased to \$101.7 million from \$96.5 million in 2005. This increase was primarily attributable to growth in our subscription and transaction revenues, driven by the contribution of revenue from HMSL, a company we acquired in April 2005, increases in revenue from our Legal eXchange product in North America complemented by the revenue contribution from Visibillity which we acquired in December 2005, and the contribution of revenue from Transmit which we acquired in January 2006. The increase in revenue was offset in part by a decrease in BACSTEL-IP software license revenues in the UK, as the technology adoption date of December 2005 passed. During fiscal 2006, we derived approximately 47% of our revenue through our international operations, the majority of which was attributable to our Bottomline Europe

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subsidiary. We expect future revenue growth to be driven from increased purchases by both new and existing financial institution customers in both North America and international markets, the continued market adoption of our Legal eXchange product in the US, the contribution of a full year of revenue from our recent acquisitions and the contribution of revenue from our subscription and transaction based products.

We incurred a net loss of \$1.8 million in the fiscal year ended June 30, 2006 compared to net income of \$5.9 million in fiscal year 2005. For the fiscal year ended June 30, 2006, our operating results were significantly impacted, in the form of additional expense, by the adoption of SFAS 123R, Share Based Payment. As a result of our adoption of SFAS 123R, the fair value of all stock-based compensation is now recorded as expense in our financial statements, rather than as a footnote disclosure. Accordingly, we recorded approximately \$7.0 million in stock compensation expense for the fiscal year ended June 30, 2006. Additionally, the decrease in software license revenues for the fiscal year ended June 30, 2006 compared to fiscal year 2005 significantly impacted our operating results in the form of reduced gross profit.

## **Revenue Sources**

Our revenues are derived from multiple sources, and are reported under the following classifications:

*Software License Fees.* Software license revenues, which we derive from our software applications, are generally based on the number of software applications and user licenses purchased. Fees from the sale of software licenses are generally recognized upon delivery of the software to the customer. However, certain of our software arrangements, particularly those related to banking and financial institution customers, are recognized on a percentage of completion basis over the life of the project because they require significant customization and modification and involve extended implementation periods.

*Service and Maintenance Fees.* Our service and maintenance revenues consist of subscription and transaction fees, professional services fees and customer support and maintenance fees. Transaction revenues relating to our Legal eXchange product and our other transactional-based product offerings are typically recognized at the time transactions are processed. Subscription revenues are typically recognized on a ratable basis over the subscription period. Revenues relating to professional services not associated with customized software solutions are normally recognized at the time services are rendered. Professional services revenues associated with software license arrangements that include significant customization and modification are generally recognized on a percentage of completion basis over the life of the project. Software maintenance fees which are established as a percentage (typically 15%-20%) of the list price for the software license are recognized as revenue ratably over the maintenance period. Certain of our offerings, particularly our outsourced and transactional service offerings, often require customers to pay a non-refundable set up or installation fee. In such cases, since the up-front payment does not reflect a separate earnings process by Bottomline, these fees are deferred and are recognized as revenue over the estimated life of the customer relationship, which is generally four years. Going forward, we expect that a large part of our focus will be on growing the revenue contribution from our subscription and transaction based product offerings, which are currently reported as a component of service and maintenance revenues.

*Equipment and Supplies Revenues.* We derive equipment and supplies revenues from the sale of printers, check paper and magnetic ink character recognition toners. These revenues are normally recognized at the time of delivery. Equipment and supplies revenue also includes postage and shipping related charges billed to customers.

## **Reclassifications**

Certain prior year amounts have been reclassified to conform to the current year presentation in our consolidated financial statements.

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### **Critical Accounting Policies and Significant Judgments and Estimates**

We believe that several accounting policies are important to understanding our historical and future performance. We refer to such policies as critical because these specific areas generally require us to make judgments and estimates about matters that are uncertain at the time we make the estimate, and different estimates which also would have been reasonable could have been used. These critical accounting policies and estimates relate to stock-based compensation, revenue recognition and goodwill and intangible assets. These critical policies, and our procedures related to these policies, are discussed below. In addition, refer to Note 2 to the accompanying consolidated financial statements for a discussion of all of our significant accounting policies.

#### *Share Based Payments*

Effective July 1, 2005, we adopted accounting rules (SFAS 123R, *Share-Based Payment*) requiring the expense recognition of the estimated fair value of all share-based payments issued to employees. Prior to this, the estimated fair value associated with such awards was not recorded as an expense, but rather was disclosed in a footnote to our financial statements. For the fiscal year ended June 30, 2006, we recorded approximately \$7.0 million of expense associated with share-based payments, with the majority of this expense, approximately \$5.5 million, attributable to employee stock options.

The valuation of employee stock options is an inherently subjective process, since market values are generally not available for long-term, non-transferable employee stock options. Accordingly, an option pricing model is utilized to derive an estimated fair value. In calculating the estimated fair value of our stock options, we used a Black-Scholes pricing model which requires the consideration of the following variables for purposes of estimating fair value:

the stock option exercise price,

the expected term of the option,

the grant date price of our common stock,

the expected volatility of our common stock,

expected dividends on our common stock (we do not anticipate paying dividends for the foreseeable future), and

the risk free interest rate for the expected option term.

Of the variables above, the selection of an expected term and expected stock price volatility are the most subjective. For purposes of calculating an estimated expected term, we reviewed our historic option activity, considered the underlying option holding period (including the holding period inherent in currently vested but unexercised options) and, for stock options granted during 2006, estimated an expected term of 4.9 - 5.1 years. In estimating our stock price volatility, we analyzed our historical volatility for a period equal to the expected term of our stock option awards, and, by reference to actual stock prices during this period, calculated an estimated volatility for options granted during 2006 ranging from 59% to 87%. We believe that each of these estimates, both expected term and volatility, is reasonable in light of the historic data we analyzed. However, as with any estimate, the ultimate accuracy of these estimates is only verifiable over time.

The specific valuation assumptions noted above were applied to stock options that were granted subsequent to our adoption of SFAS 123R, however a significant amount of the stock option expense recorded during fiscal year 2006 relates to the continued vesting of stock options that were granted prior to July 1, 2005. In accordance with the transition provisions of SFAS 123R, the grant date estimates of fair value associated with prior awards, which were also calculated using a Black-Scholes option pricing model, have not been changed. The specific valuation assumptions that were utilized for purposes of deriving an estimate of fair value at the time that prior awards were issued are as disclosed in Note 9 to the accompanying consolidated financial statements.

Upon our adoption of SFAS 123R, we were also required to estimate the level of award forfeitures expected to occur and record compensation cost only for those awards that are ultimately expected to vest. This

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requirement applies to all awards that are not yet vested, including awards granted prior to July 1, 2005. Accordingly, we performed a historical analysis of option awards that were forfeited (such as by employee separation) prior to vesting, and ultimately recorded total stock option expense that reflected this estimated forfeiture rate. Our annual forfeiture estimate was calculated at 3.6%. From a sensitivity perspective, had we estimated our forfeiture rate at 0%, stock compensation expense for 2006 would have increased by \$871,000.

### *Revenue Recognition*

We derive our revenues from the sale of both perpetual and subscription based software licenses, transactional based outsourced offerings, professional services, software maintenance and equipment and supplies. We recognize revenue when persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed and determinable and collectibility is probable. We consider a non-cancelable fully executed agreement or customer purchase order to be persuasive evidence of an arrangement. We consider delivery to have occurred upon transfer of product title to the customer, or completion of services rendered. We consider the fee to be fixed or determinable if the fee is not subject to adjustment, or if we have not granted extended payment terms to the customer. Excluding our long-term contract arrangements for which revenue is recorded on a percentage of completion basis, our normal customer payment terms do not exceed 90 days. We consider collection to be probable if our internal credit analysis indicates that the customer will be able to pay amounts as they become due under the arrangement.

Our sales arrangements can contain multiple revenue elements, such as perpetual or subscription based software licenses, transaction fees, professional services, and software maintenance. Revenue earned on software arrangements involving multiple elements which qualify for separate element treatment is allocated to each element based on the relative fair values of those elements. Revenue allocated to the software element is based on the residual method, under which revenue equal to the fair value of professional services and software support is allocated to those items and recognized as revenue as those items are delivered. Any residual or remaining portion of the total arrangement fee is then allocated to the software license. Revenue is recognized for each element when each of the aforementioned revenue recognition criteria have been met.

Certain of our software arrangements require significant customization and modification and involve extended implementation periods. These arrangements do not qualify for separate element revenue recognition treatment as described above, and instead must be accounted for under contract accounting. Under contract accounting, companies must select from two generally accepted methods of accounting: the completed contract method and the percentage of completion method. The completed contract method recognizes revenue only upon contract completion, and all project costs and revenues are reported as deferred items in the balance sheet until that time. The percentage of completion method recognizes revenue and costs on a contract as the work progresses.

We have historically used the percentage of completion method of accounting for our long-term and custom contracts, since we believe that we can make reasonably reliable estimates of progress toward completion. Progress is measured based on labor hours, as measured at the end of each reporting period, as a percentage of total expected labor hours. Accordingly, the revenue we record in any reporting period for arrangements accounted for on a percentage of completion basis is dependent upon our estimates of the remaining labor hours that will be incurred in fulfilling our contractual obligations. Our estimates at the end of any reporting period could prove to be materially different from final project results, as determined only at subsequent stages of project completion. To mitigate this risk, we solicit the input of our project professional staff on a monthly basis, as well as at the end of each reporting period, for purposes of evaluating cumulative labor hours incurred and verifying the estimated remaining effort to completion, so that our estimates are always based on the most current projections available.

### *Goodwill and Intangible Assets*

Effective July 1, 2002, we adopted the provisions of Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (SFAS 142) relating to goodwill and intangible assets. We were required

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to perform a transitional impairment test upon adoption to determine the amount of goodwill impairment, if any. Based on the results of this impairment test, we recorded an impairment charge of \$13.8 million associated with goodwill in Bottomline Europe.

We were required to calculate the fair value of our reporting units in connection with this impairment review. The principal component of each fair value calculation was the determination of discounted future cash flows, and there were a number of variables that we considered for purposes of projecting these future cash flows. There is inherent uncertainty involved with this estimation process, however our estimates were consistent with our internal planning assumptions. The particularly sensitive components of these estimates included, but were not limited to:

the selection of an appropriate discount rate;

the required return on all assets employed by the valued asset to generate future income streams;

our projected overall revenue growth and mix of revenue;

our gross margin estimates (which are highly dependent on our mix of revenue);

the level of Bottomline US products that will be sold by Bottomline Europe;

our software product life cycles;

the attrition rate of our customers, particularly those who contribute to our recurring revenue streams (such as software maintenance);

our planned level of operating expenses; and

our effective tax rate.

The use of different assumptions or projections, in some or all of the areas noted above, would likely have resulted in different fair value results, thus affecting our determination of the overall goodwill impairment.

Since our adoption of SFAS 142, we have tested our goodwill annually for impairment and for fiscal 2006 we performed this review during our fourth quarter (which is the historic timing of our annual goodwill impairment review). Based on this review, we concluded that there was no goodwill impairment. Our analysis was performed at the reporting unit level. Our analysis of goodwill impairment required an estimate of the fair value of each reporting unit, which is an inherently subjective process. Based on the results of our impairment review we concluded that none of our reporting units were impaired. However, there can be no assurance that there will not be impairment charges in subsequent periods as a result of future periodic impairment reviews. To the extent that future impairment charges occurred, it would likely have a material impact on our financial results. At June 30, 2006, the carrying value of goodwill for all of our reporting units was approximately \$41.2 million.

In addition to our annual goodwill impairment review, we also perform periodic reviews of the carrying value of our other intangible assets. These intangible assets consist primarily of acquired core technology and customer related intangibles such as acquired customer lists and customer contracts. In evaluating potential impairment of these assets, we specifically consider whether any indicators of impairment are present, including:

whether there has been a significant decrease in the market price of an asset;

whether there has been a significant adverse change in the extent or manner in which an asset is used; and

whether there is an expectation that the asset will be sold or disposed of before the end of its originally estimated useful life.

If indicators of impairment are present, an estimate of the undiscounted cash flows that the specific asset is expected to generate must be made, to ensure that the carrying value of the asset can be recovered. These

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estimates involve significant subjectivity. At June 30, 2006, the carrying value of our intangible assets, excluding goodwill, was \$19.9 million. As a result of our fiscal 2006 impairment review, none of these assets were deemed to be impaired.

### *Valuation of Acquired Intangible Assets*

In connection with our recent acquisitions we recorded several intangible assets relating principally to acquired technology and customer related intangible assets. The valuation process used to calculate the values assigned to these acquired intangible assets is complex and involves significant estimation relative to our financial projections. The principal component of the valuation process is the determination of discounted future cash flows, and there are a number of variables that we considered for purposes of projecting these future cash flows. There is inherent uncertainty involved with this estimation process, and, while our estimates are consistent with our internal planning assumptions, the ultimate accuracy of these estimates is only verifiable over time. Further, the projections required for the valuation process normally utilize a ten-year forecast, which exceeds our normal internal planning and forecasting timeline. The particularly sensitive components of these estimates include, but are not limited to:

the selection of an appropriate discount rate;

the required return on all assets employed by the valued asset to generate future income streams;

our projected overall revenue growth and mix of revenue;

our gross margin estimates (which are highly dependent on our mix of revenue);

our technology and product life cycles;

the attrition rate of our customers, particularly those who contribute to our recurring revenue streams (such as software maintenance);

our planned level of operating expenses; and

our effective tax rate.

### **Recent Accounting Pronouncements**

#### *Stock Based Compensation*

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS 123R). Under SFAS 123R, companies are required to recognize as expense the estimated fair value of all share-based payments to employees, including the fair value of employee stock options. Pro forma disclosure of the estimated expense impact of such awards is no longer an alternative to expense recognition within the financial statements. SFAS 123R became effective for public companies in the first annual reporting period beginning after June 15, 2005. Accordingly, we adopted the provisions of SFAS 123R effective July 1, 2005, the first quarter of our 2006 fiscal year. The adoption of SFAS 123R during fiscal 2006 had a material impact on our consolidated financial statements in the form of additional expense.

#### *Income Tax Uncertainties*



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In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 creates a single accounting and disclosure model for uncertain tax positions, provides guidance on the minimum threshold that a tax uncertainty is required to meet before it can be recognized in the financial statements and applies to all tax positions taken by a company; both those deemed to be routine as well as those for which there may be a high degree of uncertainty.

FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the tax matter) that a tax position is more likely than not to be sustained on examination by a taxing authority. The second step, measurement, is only considered

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after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with the taxing authority or upon the expiration of the statute of limitations. Derecognition of a tax position previously recognized would occur when a company subsequently concludes that a tax position no longer meets the more likely than not threshold of being sustained. FIN 48 also significantly expands the financial statement disclosure requirements relating to uncertain tax positions.

FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, we will adopt the pronouncement effective July 1, 2007. Differences between the amounts recognized in the balance sheet prior to adoption and the amounts recognized in the balance sheet after adoption will be accounted for as a cumulative effect adjustment to the beginning balance of retained earnings. We are currently evaluating the impact of FIN 48 on our financial statements.

**Results of Operations**

The following table sets forth, for the fiscal years indicated, the percentage relationships that selected items in the Consolidated Statements of Operations bear to total revenues.

|   | Percentages of Total Revenues<br>Fiscal Year Ended June 30, |       |       |
|---|---|-------|-------|
|   | 2004  | 2005  | 2006  |
| Revenues:                                       |   |       |       |
| Software licenses                               | 17.5%   | 19.5% | 12.0% |
| Service and maintenance                         | 62.5  | 64.5  | 73.6  |
| Equipment and supplies                          | 20.0  | 16.0  | 14.4  |
| Total revenues                                  | 100.0   | 100.0 | 100.0 |
| Cost of revenues:                               |   |       |       |
| Software licenses                               | 2.0   | 2.4   | 1.4   |
| Service and maintenance                         | 27.3  | 27.6  | 31.7  |
| Stock compensation expense                      |   |       | 0.5   |
| Equipment and supplies                          | 16.2  | 12.4  | 11.4  |
| Total cost of revenues                          | 45.5  | 42.4  | 45.0  |
| Gross profit                                    | 54.5  | 57.6  | 55.0  |
| Operating expenses:                             |   |       |       |
| Sales and marketing                             | 25.7  | 25.2  | 22.7  |
| Stock compensation expense                      |   |       | 2.4   |
| Product development and engineering:            |   |       |       |
| Product development and engineering             | 11.3  | 9.8   | 11.4  |
| In-process research and development             | 1.0   |       |       |
| Stock compensation expense                      |   |       | 0.8   |
| General and administrative                      | 14.4  | 13.3  | 14.5  |
| Stock compensation expense                      |   |       | 3.1   |
| Amortization of intangible assets               | 5.2   | 3.3   | 4.5   |
| Total operating expenses                        | 57.6  | 51.6  | 59.4  |
| Income (loss) from operations                   | (3.1)   | 6.0   | (4.4) |
| Other income, net                               | 0.4   | 0.5   | 3.2   |
| Income (loss) before provision for income taxes | (2.7)   | 6.5   | (1.2) |
| Provision for income taxes                      | 0.2   | 0.4   | 0.6   |

|                   |        |      |        |
|-------------------|--------|------|--------|
| Net income (loss) | (2.9)% | 6.1% | (1.8)% |
|-------------------|--------|------|--------|

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As of July 1, 2005, we consolidated the structure of our internal operating segments and changed the nature of the financial information that is provided to and used by our chief operating decision makers. We have aggregated similar operating segments into two reportable segments, Licensed Technology and Outsourced Solutions. The change in segment composition on July 1, 2005 resulted in the consolidation of our Licensed Technology and Tailored Solutions segments into a single segment, Licensed Technology, and that change is reflected for all financial periods presented. The following table represents our revenues by segment:

|                      | For the Year Ended June 30,<br>(in thousands) |               |            |               |  |          |
|----------------------|---|---------------|------------|---------------|--|----------|
|                      | 2005  |               | 2006       |               | Increase (Decrease)<br>Between Periods |          |
|                      | Revenues                                      | As % of total | Revenues   | As % of total | Revenues                               | % Change |
| Licensed Technology  | \$ 80,349                                     | 83.3          | \$ 75,694  | 74.5          | \$ (4,655)                             | (5.8)    |
| Outsourced Solutions | 16,156  | 16.7          | 25,971     | 25.5          | 9,815                                  | 60.8     |
|                      | \$ 96,505                                     | 100.0         | \$ 101,665 | 100.0         | \$ 5,160                               | 5.3      |

*Licensed Technology.* The revenue decrease for the fiscal year ended June 30, 2006 was primarily attributable to a decrease in software license revenue as a result of the conclusion of the BACSTEL-IP conversion in the UK and due to a decrease in the foreign currency exchange rate in the UK. The decrease was offset in part by an increase in professional services revenues in the US as a result of the revenue contribution from several large projects with financial institution customers. We expect that revenues will decrease in fiscal 2007 as compared to revenues reported in fiscal 2006, as a result of our on-going transition to subscription and transaction based pricing for our Purchase-to-Pay offerings, offset in part by revenue growth from our banking product offerings.

*Outsourced Solutions.* The revenue increase for the fiscal year ended June 30, 2006 was primarily due to a full year of revenue contribution from HMSL, which we acquired in April 2005, and increases in revenue from our Legal eXchange product in the US, in part as a result of the revenue contribution from Visibillity which we acquired in December 2005 and the revenue contribution from Tranmit, which we acquired in January 2006. We expect that revenues will increase in fiscal 2007 compared to revenues reported in fiscal 2006.

**Revenues by Category**

|                         | Fiscal Year Ended<br>June 30, |            | Increase (Decrease)<br>Between Periods<br>2006<br>Compared to |        |
|-------------------------|-------------------------------|------------|---|--------|
|                         | 2005                          | 2006       | 2005  | %      |
|                         | (in thousands)                |            |   |        |
| Revenues:               |                               |            |   |        |
| Software licenses       | \$ 18,789                     | \$ 12,236  | \$ (6,553)  | (34.9) |
| Service and maintenance | 62,233                        | 74,801     | 12,568  | 20.2   |
| Equipment and supplies  | 15,483                        | 14,628     | (855)   | (5.5)  |
| Total revenues          | \$ 96,505                     | \$ 101,665 | \$ 5,160  | 5.3    |

The overall revenue increase in 2006 was due primarily to increases in Legal eXchange revenues and the revenue contribution from our acquisitions in fiscal 2005 and 2006, offset in part by a decrease in software license revenues in the UK as the BACSTEL-IP initiative ended. Revenues, based on the point of sale rather than the location of the customer, were \$54.3 million in the US, \$45.5 million in the UK and \$1.9

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million in Australia for the fiscal year ended June 30, 2006. Revenues based on the point of sale for the fiscal year ended June 30, 2005 were \$46.5 million in the US, \$48.3 million in the UK and \$1.7 million in Australia.

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*Software Licenses.* The decrease in software license revenues was due principally to a decrease in software license revenues in the UK as the BACSTEL-IP initiative ended and due to a decrease in the foreign currency exchange rate in the UK. Based on current plans, we anticipate that software license revenues will decline slightly during 2007 as a result of our on-going transition to a subscription and transaction based pricing model.

*Service and Maintenance.* The increase in service and maintenance revenues occurred primarily as a result of a full year of revenue contribution from HMSL, which we acquired in April 2005, increases in Legal eXchange revenues and the revenue contribution from our acquisitions of Visibillity and Transmit which were completed during fiscal 2006, offset in part by a decrease in the foreign currency exchange rate in the UK. Based on current plans, we anticipate that service and maintenance revenues will increase in fiscal year 2007.

*Equipment and Supplies.* The decrease in equipment and supplies revenues was primarily due to decreases in order flow in the UK, due in part to our continued de-emphasis of this revenue stream and by a decrease in the foreign currency exchange rate in the UK, offset in part by several large equipment orders with financial institution customers in the US. We anticipate that equipment and supplies revenues will decline slightly during 2007 as a result of our continued de-emphasis of this revenue stream.

**Cost of Revenues**

|                            | Fiscal Year Ended<br>June 30, |                        | Increase (Decrease)<br>Between Periods<br>2006 |        |
|----------------------------|-------------------------------|------------------------|--|--------|
|                            | 2005                          | 2006<br>(in thousands) | 2005   | %      |
| Cost of revenues:          |                               |                        |  |        |
| Software licenses          | \$ 2,295                      | \$ 1,419               | \$ (876)                                       | (38.2) |
| Service and maintenance    | 26,656                        | 32,250                 | 5,594  | 21.0   |
| Stock compensation expense |                               | 474                    | 474  |        |
| Equipment and supplies     | 11,980                        | 11,639                 | (341)  | (2.8)  |
| Total cost of revenues     | \$ 40,931                     | \$ 45,782              | \$ 4,851                                       | 11.9   |
| Gross profit               | \$ 55,574                     | \$ 55,883              | \$ 309   | 0.6    |

*Software Licenses.* Software license costs consist of expenses incurred by us to manufacture, package and distribute our software products and related documentation and costs of licensing third party software that is incorporated into or sold with certain of our products. Software license costs remained consistent at 12% of software license revenues in the fiscal years ended June 30, 2006 and 2005. The decrease in software license costs in dollar terms was due to the overall decrease in software license revenues. Based on current product plans, we anticipate that fiscal year 2007 software license costs, as a percentage of software license revenues, will approximate fiscal year 2006 levels.

*Service and Maintenance.* Service and maintenance costs include salaries and other related costs for our customer service, maintenance and help desk support staffs, as well as expenses associated with third party contractors used to complement our professional services team. Service and maintenance costs (excluding the impact of stock based compensation expense) remained consistent at 43% of service and maintenance revenues in the fiscal years ended June 30, 2006 and 2005. The increase in service and maintenance costs in dollar terms was consistent with the overall increases in service and maintenance revenues and due primarily to higher third party costs associated with BACSTEL-IP product implementations in the UK and increased operating costs associated with our acquisitions of HMSL, Visibillity and Transmit.

*Equipment and Supplies.* Equipment and supplies costs include the costs associated with equipment and supplies that we resell, as well as freight, shipping and postage costs associated with the delivery of our products. Equipment and supplies costs increased to 80% of equipment and supplies revenues in the fiscal year ended June 30, 2006 compared to 77% of equipment and supplies revenues in the fiscal year ended June 30, 2005. The



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increase in equipment and supplies costs as a percentage of equipment and supplies revenues was attributable to several lower margin equipment transactions in the US and an increase in third party costs in the UK. Based on current product plans, we anticipate that fiscal year 2007 equipment and supplies costs, as a percentage of revenues, will approximate fiscal year 2006 levels.

**Operating Expenses**

|                                      | Fiscal Year Ended<br>June 30, |                        | Increase (Decrease)<br>Between Periods<br>2006 |         |
|--------------------------------------|-------------------------------|------------------------|--|---------|
|                                      |                               |                        | Compared to                                    |         |
|                                      | 2005                          | 2006<br>(in thousands) | 2005   | %       |
| Operating expenses:                  |                               |                        |  |         |
| Sales and marketing                  | \$ 24,323                     | \$ 23,023              | \$ (1,300)                                     | (5.3)   |
| Stock compensation expense           |                               | 2,489                  | 2,489  |         |
| Product development and engineering: |                               |                        |  |         |
| Product development and engineering  | 9,419                         | 11,576                 | 2,157  | 22.9    |
| Stock compensation expense           | 14                            | 841                    | 827  | 5,907.1 |
| General and administrative           | 12,800                        | 14,709                 | 1,909  | 14.9    |
| Stock compensation expense           |                               | 3,180                  | 3,180  |         |
| Amortization of intangible assets    | 3,217                         | 4,491                  | 1,274  | 39.6    |
| Total operating expenses             | \$ 49,773                     | \$ 60,309              | \$ 10,536                                      | 21.2    |

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations and marketing materials and trade show participation. The decrease in sales and marketing expenses was attributable to decreased commissions and other employee compensation costs and a decrease in the foreign currency exchange rate in the UK, offset by increases in expenses associated with the operations of HMSL, Visibillity and Transmit. We anticipate that sales and marketing expenses will remain relatively consistent, as a percentage of revenues, in fiscal year 2007.

*Product Development and Engineering.* Product development and engineering expenses consist primarily of personnel costs to support product development, which continues to be focused on enhancements and revisions to our products based on customer feedback and general marketplace demands. Product development and engineering expenses increased in the US principally as a result of contract employee costs associated with development efforts on certain of our banking products. This increase was offset in part by a decrease in employee related expenses in Australia due to a decrease in headcount. We anticipate that product development and engineering expenses will remain relatively consistent, as a percentage of revenues, in fiscal year 2007.

*General and Administrative.* General and administrative expenses consist primarily of salaries and other related costs for operations and finance employees and legal and accounting services. The increase in general and administrative expenses was attributable to the operations of HMSL, Visibillity and Transmit, and an increase in employee and contract labor costs in the US and the UK. We anticipate that general and administrative expenses will decrease, as a percentage of revenues, in fiscal year 2007.



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**Stock Compensation Expense.** During the fiscal year ended June 30, 2006, we recorded approximately \$7.0 million of expense associated with share-based payments in connection with our July 1, 2005 adoption of SFAS 123R. The expense associated with these awards is recorded as expense within the same functional expense category as cash compensation for the respective employee is recorded. For the fiscal year ended June 30, 2006, stock compensation expense was allocated as follows:

|   | In Thousands |
|---|--------------|
| Cost of revenues: service and maintenance | \$ 474       |
| Sales and marketing                       | 2,489        |
| Product development and engineering       | 841          |
| General and administrative                | 3,180        |
|   | \$ 6,984     |

**Amortization of Intangible Assets.** Amortization expense increased for the fiscal year ended June 30, 2006 compared to the fiscal year ended June 30, 2005. The increase in amortization expense was due to the amortization of intangible assets arising from our acquisitions of HMSL, Visibillity, Transmit and a patent. We anticipate that amortization expense will approximate \$5.7 million for fiscal year 2007.

**Other Income (Expense), Net**

|                             | Fiscal Year Ended<br>June 30, |                        | Increase (Decrease)<br>Between Periods<br>2006<br>Compared to<br>2005 |        |
|-----------------------------|-------------------------------|------------------------|---|--------|
|                             | 2005                          | 2006<br>(in thousands) |   | %      |
| Interest income             | \$ 591                        | \$ 3,138               | \$ 2,547  | 431.0  |
| Interest expense            | (10)                          | (15)                   | (5)   | (50.0) |
| Other income (expense), net | (137)                         | 129                    | 266   | 194.2  |
| Other income, net           | \$ 444                        | \$ 3,252               | \$ 2,808  | 632.4  |

**Interest Income.** The increase in interest income in fiscal 2006 was attributable to an increase in rates of return during the year and, as a result of proceeds raised in our follow-on offering of common stock in July 2005, an increase in our average investment balances throughout the year.

**Interest Expense.** Interest expense remained minimal in fiscal 2006 as compared to fiscal 2005.

**Other Income (Expense), Net.** Other income (expense), net consists primarily of foreign currency transaction gains and losses. The change from a net expense in 2005 to income in 2006 was due to the strengthening of the US Dollar versus the British Pound during fiscal 2006.

**Provision for Income Taxes**

Our provision for income taxes was \$660,000 for the fiscal year ended June 30, 2006 compared to \$357,000 for the fiscal year ended June 30, 2005. The increase in income tax expense was due principally to an increase in the income tax expense associated with our Australian operations, an increase in deferred income tax expense in the US as a result of an increase in the valuation allowance associated with specific US deferred tax assets and the absence of an income tax benefit that was recorded in fiscal 2005 as a result of an income tax refund received in that year.

**Net Loss.** The net loss for 2006 was primarily due to a decrease in software license revenues which carry a very high gross margin, the expense impact associated with stock-based compensation as a result of accounting rules that we adopted on July 1, 2005, and an increase in expenses associated with the amortization of intangible assets.



**Table of Contents****Fiscal Year Ended June 30, 2005 Compared to Fiscal Year Ended June 30, 2004****Revenues by Segment**

The following table sets forth our revenue by segment, for the years ended June 30, 2004 and 2005.

|                      | For the Year Ended June 30,<br>(in thousands) |                       |           |                       | Increase (Decrease)<br>Between Periods |          |
|----------------------|---|-----------------------|-----------|-----------------------|--|----------|
|                      | Revenues                                      | 2004<br>As % of total | Revenues  | 2005<br>As % of total | Revenues                               | % Change |
| Licensed Technology  | \$ 68,033                                     | 82.8                  | \$ 80,349 | 83.3                  | \$ 12,316                              | 18.1     |
| Outsourced Solutions | 14,099  | 17.2                  | 16,156    | 16.7                  | 2,057                                  | 14.6     |
|                      | \$ 82,132                                     | 100.0                 | \$ 96,505 | 100.0                 | \$ 14,373                              | 17.5     |

During 2005, we experienced revenue increases in our Licensed Technology and Outsourced Solutions segments. The increase in Licensed Technology segment revenues were driven principally by the revenue contribution from the UK as a result of the BACSTEL IP initiative, a full year's revenue contribution from Createform and increases in foreign exchange rates. The increase in Outsourced Solutions revenues was primarily the result of increased revenue from our Legal eXchange product in the US and from the revenue contribution of HMSL which we acquired in April 2005.

**Revenues by Category**

|                         | Fiscal Year Ended<br>June 30, |                        | Increase (Decrease)<br>Between Periods<br>2005 |       |
|-------------------------|-------------------------------|------------------------|--|-------|
|                         | 2004                          | 2005<br>(in thousands) | Compared to<br>2004                            | %     |
| Revenues:               |                               |                        |  |       |
| Software licenses       | \$ 14,366                     | \$ 18,789              | \$ 4,423                                       | 30.8  |
| Service and maintenance | 51,364                        | 62,233                 | 10,869   | 21.2  |
| Equipment and supplies  | 16,402                        | 15,483                 | (919)  | (5.6) |
| Total revenues          | \$ 82,132                     | \$ 96,505              | \$ 14,373                                      | 17.5  |

The overall revenue increase in 2005 was due primarily to growth being driven by the BACSTEL IP opportunity in the UK, a full year's revenue contribution from Createform, increases in the foreign exchange rate in the UK and the revenue contribution from our April 2005 acquisition of HMSL, offset in part by a decrease in sales of certain of our legacy payment offerings. Revenues, based on the point of sale rather than the location of the customer, were \$46.5 million in the US, \$48.3 million in the UK and \$1.7 million in Australia for the fiscal year ended June 30, 2005. Revenues based on the point of sale for the fiscal year ended June 30, 2004 were \$45.9 million in the US, \$34.9 million in the UK and \$1.3 million in Australia.

*Software Licenses.* The increase in software license revenues was due principally to the increased contribution of revenue from the UK as a result of the BACSTEL IP initiative and, to a lesser extent, a full year's revenue contribution from Createform and an increase in the foreign currency exchange rate in the UK. This increase was partially offset by a decrease in our WebSeries licenses in the US and, to a lesser extent a decrease in license fees from certain of our legacy payment products.

*Service and Maintenance.* The increase in service and maintenance revenues was due to an increase in professional services revenues in the UK related to BACSTEL IP deployments, an increase in revenues from our Legal eXchange product in the US, a full year's revenue contribution

from Createform and from the revenue contribution of HMSL, partially offset by a decrease in the professional services associated with certain of our legacy products in the US.

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*Equipment and Supplies.* The decrease in equipment and supplies revenues was due principally to our continued de-emphasis of sales efforts for lower margin products and the continued migration of US and UK customers to our web-based products and solutions, which are not equipment and supplies intensive, offset in part by an increase in the foreign currency exchange rate in the UK.

**Cost of Revenues**

|                         | Fiscal Year Ended<br>June 30, |           | Increase (Decrease)<br>Between Periods<br>2005 |        |
|-------------------------|-------------------------------|-----------|--|--------|
|                         | 2004                          | 2005      | 2004   | %      |
|                         | (in thousands)                |           | Compared to                                    |        |
| Cost of revenues:       |                               |           |  |        |
| Software licenses       | \$ 1,678                      | \$ 2,295  | \$ 617   | 36.8   |
| Service and maintenance | 22,363                        | 26,656    | 4,293  | 19.2   |
| Equipment and supplies  | 13,312                        | 11,980    | (1,332)  | (10.0) |
| Total cost of revenues  | \$ 37,353                     | \$ 40,931 | \$ 3,578                                       | 9.6    |
| Gross profit            | \$ 44,779                     | \$ 55,574 | \$ 10,795                                      | 24.1   |

*Software Licenses.* Software license costs consist of expenses incurred by us to manufacture, package and distribute our software products and related documentation and costs of licensing third party software that is incorporated into or sold with certain of our legacy products. Software license costs remained comparable at 12% of software license revenues for the fiscal years ended June 30, 2005 and 2004. The increase in software license cost of revenues in dollar terms was proportional to the increase in software license revenues.

*Service and Maintenance.* Service and maintenance costs include salaries and other related costs for our customer service, maintenance and help desk support staffs, as well as third party contractor expenses used to complement our professional services teams. Service and maintenance costs remained comparable at 43% of service and maintenance revenues in the fiscal year ended June 30, 2005 compared to 44% of service and maintenance revenues in the fiscal year ended June 30, 2004. The dollar increase in service and maintenance costs over the prior year was primarily the result of higher implementation costs in the UK as a result of the BACSTEL IP initiative, a full year's expense contribution of Createform, expenses of HMSL and an increase in the foreign currency exchange rate in the UK.

*Equipment and Supplies.* Equipment and supplies costs include the costs associated with equipment and supplies that we resell, as well as freight, shipping and postage costs associated with the delivery of our products. Equipment and supplies costs decreased to 77% of equipment and supplies revenues in the fiscal year ended June 30, 2005 compared to 81% of equipment and supplies revenues in the fiscal year ended June 30, 2004. The decrease in equipment and supplies costs as a percentage of equipment and supplies revenues was due primarily to decreases in delivery related costs in the UK, which typically carry no gross margin, and an improvement on the gross margin yield of certain US products.

**Table of Contents****Operating Expenses**

|                                      | Fiscal Year Ended<br>June 30, |                        | Increase (Decrease)<br>Between Periods<br>2005 |         |
|--------------------------------------|-------------------------------|------------------------|--|---------|
|                                      |                               |                        | Compared to                                    |         |
|                                      | 2004                          | 2005<br>(in thousands) | 2004   | %       |
| Operating expenses:                  |                               |                        |  |         |
| Sales and marketing                  | \$ 21,062                     | \$ 24,323              | \$ 3,261                                       | 15.5    |
| Product development and engineering: |                               |                        |  |         |
| Product development and engineering  | 9,264                         | 9,419                  | 155  | 1.7     |
| In-process research and development  | 842                           |                        | (842)  | (100.0) |
| Stock compensation expense           | 41                            | 14                     | (27)   | (65.9)  |
| General and administrative           | 11,830                        | 12,800                 | 970  | 8.2     |
| Amortization of intangible assets    | 4,277                         | 3,217                  | (1,060)  | (24.8)  |
| Total operating expenses             | \$ 47,316                     | \$ 49,773              | \$ 2,457                                       | 5.2     |

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations, marketing materials and trade shows. The increase in sales and marketing expenses was primarily attributable to increased commission costs as a result of higher revenues, a full year's expense contribution of Createform, two months of expense contribution from HMSL, increases in customer conferences and trade show events and increases in the foreign currency exchange rate in the UK.

*Product Development and Engineering.* Product development and engineering expenses consist primarily of personnel costs to support product development, which continues to be focused on enhancements and revisions to our products based on customer feedback and general marketplace demands, and expenditure levels remained relatively comparable on a year over year basis.

*In-Process Research and Development.* In-process research and development of \$842,000 in the fiscal year ended June 30, 2004 represents the expense associated with acquired in-process research and development of Createform of \$789,000 and ABM of \$53,000. There was no comparable expense in the fiscal year ended June 30, 2005.

*Stock Compensation Expense.* In connection with our acquisition of Flashpoint in August 2000, we assumed all of the outstanding common stock options of Flashpoint, which were exchanged for our common stock options, and recorded deferred compensation of \$1.3 million at the date of acquisition relating to the intrinsic value of the unvested options. The deferred compensation was amortized to expense over the remaining vesting period of the options. The decrease in stock compensation expense was due principally to the forfeiture of unvested stock options as a result of employee separations. At June 30, 2005 the expense associated with these options had been fully amortized.

*General and Administrative.* General and administrative expenses consist primarily of salaries and other related costs for operations and finance employees and legal and accounting services. The increase in general and administrative expenses was primarily attributable to compensation cost increases, increased costs associated with Sarbanes-Oxley Act compliance and an increase in the foreign currency exchange rate in the UK. To a lesser extent, the increase was driven by a full year's expense contribution from Createform and two months of expense associated with HMSL.

*Amortization of Intangible Assets.* The decrease in amortization expense was due principally to certain intangible assets that became fully amortized during 2005.

**Table of Contents*****Other Income (Expense), Net***

|                             | Fiscal Year Ended |        | Increase (Decrease) |         |
|-----------------------------|-------------------|--------|---------------------|---------|
|                             | June 30,          |        | Between Periods     |         |
|                             |                   |        | 2005                |         |
|                             |                   |        | Compared to         |         |
|                             | 2004              | 2005   | 2004                | %       |
|                             | (in thousands)    |        |                     |         |
| Interest income             | \$ 199            | \$ 591 | \$ 392              | 196.9   |
| Interest expense            | (14)              | (10)   | 4                   | 28.6    |
| Other income (expense), net | 103               | (137)  | (240)               | (233.0) |
| Other income, net           | \$ 288            | \$ 444 | \$ 156              | 54.2    |

*Interest Income.* The increase in interest income in 2005 was attributable to an increase in rates of return during the year and an increase in our average investment balances throughout the year.

*Interest Expense.* Interest expense of 2004 relates predominantly to interest associated with a promissory note that we assumed in connection with our acquisition of certain assets of eVelocity, in May 2002. Interest expense remained minimal in 2005 as compared to 2004.

*Other Income (Expense), Net.* Other income (expense), net consists of foreign currency transaction gains and losses and, for 2004, losses on our equity investments. The other income (expense), net included impairment losses on our equity investments, which we judged to be other than temporary, in the amount of \$31,000 for the fiscal year ended June 30, 2004. There were no such impairment charges recorded during 2005. The investments are in non-public entities accounted for under the cost method. The carrying value of all of our equity investments was approximately \$36,000 at June 30, 2005.

***Provision for Income Taxes***

The provision for income taxes for fiscal 2005 consists of a net US tax benefit of \$333,000 and tax expense associated with our foreign operations of \$690,000 for a consolidated tax expense of \$357,000. The net tax benefit recorded in the US is due to a tax refund that we recorded during 2005. For fiscal 2004, our tax expense consisted of a small amount of state tax expense in the US, which we incurred irrespective of our net operating loss position, and a provision for income taxes in Australia.

*Net Income.* The achievement of net income for 2005 was primarily due to our revenue growth and our ability to manage expenses, decreases in amortization expenses of intangible assets and the absence of charges associated with in-process research and development.

***Liquidity and Capital Resources***

We have financed our operations primarily from cash provided by operating activities and the sale of our common stock. We had net working capital of \$71.9 million at June 30, 2006, including cash and cash equivalents and marketable securities totaling \$80.5 million. In July 2005 we completed a follow-on offering of our common stock which generated proceeds, after underwriting discounts, of approximately \$47 million. This significantly increased our cash, cash equivalents and marketable securities holdings and significantly improved our overall liquidity position.

We have generated positive operating cash flows in each of our last five fiscal years. We believe that the cash generated from our operations and the cash, cash equivalents and marketable securities on hand, particularly given that we have no long-term debt obligations, will be sufficient to meet our working capital and capital expenditure requirements for the foreseeable future. We also may receive additional investments from, and make





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investments in, customers or other companies. However, any such transactions would be subject to the approval of our board of directors and potentially stockholder, bank or regulatory approval. We also may undertake additional business or asset acquisitions.

In January 2006, we paid approximately \$18.2 million (net of cash acquired) from our cash balances in connection with our acquisitions of Visibillity, Transmit and a patent. We do not believe that these disbursements adversely affected our overall liquidity position, and we continue to believe that our existing cash and investment balances, as well as cash generated from operations, will be sufficient to meet our operating requirements for the foreseeable future.

*Operating Activities*

|  | Fiscal Year Ended June 30, |           |            |
|--|----------------------------|-----------|------------|
|  | 2004                       | 2005      | 2006       |
|  | (in thousands)             |           |            |
| Net income (loss)                          | \$ (2,418)                 | \$ 5,888  | \$ (1,834) |
| Non-cash adjustments                       | 7,391                      | 6,434     | 13,489     |
| Decrease (increase) in accounts receivable | (3,101)                    | (2,661)   | 3,358      |
| All other, net                             | (89)                       | 3,556     | (3,158)    |
| Net cash provided by operating activities  | \$ 1,783                   | \$ 13,217 | \$ 11,855  |

Net cash provided by operating activities for the fiscal year ended June 30, 2006 was primarily due to our net loss, affected by favorable non-cash adjustments. Net cash provided by operating activities for the fiscal year ended June 30, 2005 was primarily due our net income position, favorable non-cash adjustments and increases in deferred revenue. Net cash provided by operating activities for the fiscal year ended June 30, 2004 was primarily due to our net loss affected by favorable non-cash adjustments partially offset by an increase in accounts receivable.

As of June 30, 2006, the deferred tax assets associated with our US operations and a portion of our deferred tax assets associated with our UK operations have been reserved since, given the available evidence, it was deemed more likely than not that these deferred tax assets would not be realized.

At June 30, 2006, we have available US net operating loss carry-forwards of \$32,669,000, which expire at various times through the year 2026. We also have \$2,081,000 of research and development tax credits available, which expire at various points through year 2026. The operating losses and tax credit carry forwards may be subject to limitations under provisions of the Internal Revenue Code.

*Investing Activities*

|  | Fiscal Year Ended June 30, |             |             |
|--|----------------------------|-------------|-------------|
|  | 2004                       | 2005        | 2006        |
|  | (in thousands)             |             |             |
| Purchases of marketable securities, net                    | \$ (4,288)                 | \$ (10,765) | \$ (26,612) |
| Purchases of property and equipment                        | (1,752)                    | (2,169)     | (2,612)     |
| Acquisition of businesses and assets, net of cash acquired | (3,201)                    | (5,802)     | (18,195)    |
| Net cash used in investing activities                      | \$ (9,241)                 | \$ (18,736) | \$ (47,419) |

In the fiscal year ended June 30, 2006 cash was primarily used to acquire high quality marketable securities and to fund our acquisitions of Visibillity, Transmit and a patent. The significant increase in purchases of marketable securities in the fiscal year ended June 30, 2006 was due to our investment of proceeds received from our follow-on offering of common stock completed in July 2005. Cash was primarily used in the fiscal year ended June 30, 2005 to acquire short-term investments, to acquire HMSL and to acquire property and equipment. During the fiscal year ended June 30, 2004 cash was used primarily to acquire Createform and ABM and, to a lesser extent, to acquire property and equipment.



**Table of Contents***Financing Activities*

|  | Fiscal Year Ended June 30, |          |           |
|--|----------------------------|----------|-----------|
|  | 2004                       | 2005     | 2006      |
|  | (in thousands)             |          |           |
| Proceeds from exercise of stock options, stock warrants and employee stock purchase plan | \$ 3,010                   | \$ 5,705 | \$ 6,288  |
| Proceeds from the sale of common stock, net  |                            |          | 46,772    |
| Repurchase of common stock   | (367)                      |          | (61)      |
| Excess tax benefit from stock based compensation   |                            |          | 282       |
| Payment of long-term debt and liabilities assumed upon acquisition                       | (584)                      |          |           |
| Payment of bank financing fees   | (25)                       | (16)     | (33)      |
| Net cash provided by financing activities  | \$ 2,034                   | \$ 5,689 | \$ 53,248 |

Net cash provided by financing activities for the fiscal year ended June 30, 2006 was primarily the result of \$46.8 million in net proceeds received from our follow-on offering of common stock in July 2005 and proceeds of \$6.3 million from the exercise of stock options and purchases under our employee stock purchase plan. Net cash provided by financing activities for the fiscal year ended June 30, 2005 was the result of proceeds received from the exercise of employee stock options, stock warrants and the employee stock purchase plan. Net cash provided by financing activities for the fiscal year ended June 30, 2004 was the result of proceeds received from the exercise of employee stock options and the employee stock purchase plan, partially offset by the repurchase of our common stock.

*Common Stock*

In July 2005, we sold an aggregate of 3,560,000 shares of common stock in an underwritten public offering, generating approximately \$47 million in proceeds, after underwriting discounts.

*Note Payable and Credit Facilities*

In May 2005, we extended, through March 26, 2007, our Loan and Security Agreement (Credit Facility), which provides for aggregate borrowings of up to \$3 million and requires us to maintain certain financial covenants. Borrowings under the Credit Facility are secured by substantially all of our US owned assets, bear interest at the bank's prime rate (8.25% at June 30, 2006) and are due on the expiration date of the Credit Facility. The Credit Facility also provides for the issuance of up to \$2 million in letters of credit for, and on behalf of, us. The borrowing capacity under the Credit Facility is reduced by any outstanding letters of credit. At June 30, 2006, a \$2 million letter of credit had been issued to our landlord as part of the lease arrangement for our corporate headquarters. There were no borrowings under the Credit Facility as of June 30, 2006.

In December 2005, our subsidiary, Bottomline Europe, renewed through December 31, 2006 its Committed Overdraft Facility (Overdraft Facility), which provides for borrowings of up to 500,000 British Pound Sterling, any borrowings of which are guaranteed by us. Borrowings under this Overdraft Facility are secured by substantially all assets of Bottomline Europe, bear interest at the bank's base rate (4.5% at June 30, 2006) plus 2% and are due on the expiration date of the Overdraft Facility. There were no outstanding borrowings under this Overdraft Facility at June 30, 2006.

*Business Acquisitions*

In April 2005, Bottomline Europe acquired all of the outstanding stock of HMSL Group, Ltd. (HMSL). The purchase consideration for HMSL was approximately \$10.1 million consisting of approximately \$7.6 million of cash (based on exchange rates in effect at the date of the acquisition), \$2.1 million of our common stock (184,956 shares) and acquisition related costs. Of the shares issued, 80,148 shares were placed in escrow for a

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two year period to cover potential liability claims that might be made against HMSL. As of June 30, 2006 there have not been any claims made against HMSL. From the date of acquisition forward, transactions associated with the HMSL acquisition are included in our Outsourced Solutions segment.

On December 31, 2005, the Company acquired all of the outstanding stock of Visibillity, Inc. (Visibillity). The initial purchase consideration for Visibillity was \$11,500,000 in cash plus acquisition related costs. Subsequent to the payment of the initial purchase consideration, the Company recovered \$500,000 from the Visibillity selling stockholders pursuant to the terms of the acquisition, and this recovery was recorded as a reduction to the amount of goodwill recorded as part of the acquisition. Visibillity operating results are included in the Company's operating results from the acquisition date forward, as a component of the Outsourced Solutions segment.

On January 24, 2006, the Company acquired all of the outstanding stock of Transmit Plc (Transmit). The purchase consideration for Transmit was approximately \$6.0 million of cash, \$4.2 million (316,970 shares) of the Company's common stock, as valued on the date of acquisition, and acquisition related costs. Transmit operating results are included in the Company's operating results from the acquisition date forward, as a component of the Outsourced Solutions segment.

**Repurchase of Common Stock**

In July 2002, our board of directors announced that it had authorized a repurchase program for the repurchase of up to \$3.0 million of our common stock. At June 30, 2006, we had repurchased 242,650 shares at an average repurchase price of \$5.79 per share. The approximate remaining dollar value of shares available for repurchase under this program is \$1.6 million. During the year ended June 30, 2006, we did not repurchase any shares under this program and this program was closed by our board of directors in June, 2006.

In June 2006, our board of directors announced that it had authorized a repurchase program for the repurchase of up to \$10.0 million of our common stock. At June 30, 2006, we had repurchased 7,500 shares at an average repurchase price of \$8.20 per share. The approximate remaining dollar value of shares available for repurchase under this program is \$9.9 million.

**Contractual Obligations**

Following is a summary of future payments that we are required to make under existing contractual obligations as of June 30, 2006:

|                               | Payments Due by Period |                  |                             |           | More Than |
|-------------------------------|------------------------|------------------|-----------------------------|-----------|-----------|
|                               | Total                  | Less Than 1 Year | 1-3 Years<br>(in thousands) | 4-5 Years | 5 Years   |
| Operating lease obligations   | \$ 11,494              | \$ 2,472         | \$ 4,606                    | \$ 3,222  | \$ 1,194  |
| Other contractual obligations |                        |                  |                             |           |           |
| Total                         | \$ 11,494              | \$ 2,472         | \$ 4,606                    | \$ 3,222  | \$ 1,194  |

Purchase orders are not included in the table above. Our purchase orders represent authorizations to purchase rather than binding agreements. The contractual obligation amounts in the table above are associated with agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum services to be used; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Obligations under contract that we can cancel without a significant penalty are not included in the table above.

**Off-Balance Sheet Arrangements**

During the twelve months ended June 30, 2006, we did not have any off-balance sheet arrangements.

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### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

#### *Interest rate risk*

Our exposure to financial risk, including changes in interest rates, relates primarily to cash and cash equivalents and our short-term investments. These investments bear interest at variable interest rates, which are subject to market changes. We have not entered into any interest rate swap agreements, or other instruments to minimize our exposure to interest rate fluctuations. We have not had any derivative instruments in the past and do not presently plan to in the future. Our investment portfolio consists of demand deposit accounts, money market mutual funds, U.S. Treasury securities, corporate debt securities and debt securities issued by U.S. state agencies and institutions. Our follow-on offering of common stock completed in July 2005 resulted in a significant increase to our cash, cash equivalents and marketable securities balances. As a result of this increase, a significant change in interest rates could have a material effect on our operating results. Based on our average investment portfolio and average actual interest rates during 2006, a 100 basis point increase or decrease in interest rates would result in an increase or decrease of approximately \$250,000, \$281,000 and \$812,000 for the fiscal years ended 2004, 2005 and 2006, respectively, in our results of operations and cash flows.

#### *Foreign currency exchange rate risk*

We have operations located in the United Kingdom, where the functional currency is British Pound Sterling (the Pound). Also, since our acquisition of Createform on September 18, 2003, we have had operations located in Australia where the functional currency is the Australian Dollar. We have not entered into any foreign currency hedging transactions or other instruments to minimize our exposure to foreign currency exchange rate fluctuations nor do we presently plan to in the future.

#### *Foreign currency translation risk*

Based on the current level of our Australian operations, our financial results would not be significantly impacted if the Australian Dollar experienced significant fluctuations over a short period of time. However, our operations could be significantly impacted if the Pound experienced significant fluctuations over a short period of time. A 10% increase or decrease in the average exchange rate between the Pound and the US dollar would result in an increase or decrease to revenue of approximately \$3,488,000 for fiscal 2004, \$4,798,000 for fiscal 2005 and \$4,555,000 for fiscal 2006. A 10% increase or decrease in the average exchange rate between the Pound and the US dollar would result in an increase or decrease to net income (loss) of approximately \$109,000 for fiscal 2004, \$118,000 for fiscal 2005 and \$140,000 for fiscal 2006.

#### *Foreign currency transaction risk*

Foreign currency transaction gains and losses are generally not significant and our financial results would not be significantly impacted in the event of a 10% increase or decrease in the average exchange rates between the US dollar, the Pound, or the Australian dollar.

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

Index to Financial Statements, Financial Statements and Supplementary Data appear on pages 44 to 75 of this Annual Report on Form 10-K.

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

None.

### **Item 9A. Controls and Procedures.**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other

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procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2006, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management's report on internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) and the independent registered public accounting firm's related audit report are included in Item 8 of this Form 10-K and are incorporated herein by reference.

No change in our internal control over financial reporting occurred during the fiscal quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **Item 9B. *Other Information.***

Not applicable.

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**PART III**

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

See Executive Officers and Other Key Employees of the Registrant in Part I of this Annual Report on Form 10-K. We will furnish to the Securities and Exchange Commission a definitive Proxy Statement (the Proxy Statement) not later than 120 days after the close of the fiscal year ended June 30, 2006. The information required by this item is incorporated herein by reference to the information contained under the captions Proposal I Election of Class II Directors , Section 16(a) Beneficial Ownership Reporting Compliance , Board and Committee Meetings and Corporate Governance Board Committees Audit Committee of the Proxy Statement.

We have adopted a Code of Business Conduct and Ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The text of our Code of Business Conduct and Ethics is posted in the Corporate Governance section of our website, [www.bottomline.com](http://www.bottomline.com). We intend to disclose on our website any amendments to, or waivers from, our Code of Business Conduct and Ethics that are required to be disclosed pursuant to the disclosure requirements of Item 5.05 of Form 8-K.

**Item 11. *Executive Compensation.***

The information required by this item is incorporated herein by reference to the information contained under the captions Executive Compensation, Director Compensation, Compensation Committee Interlocks and Insider Participation and Employment and Other Agreements of the Proxy Statement.

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

The information required by this item is incorporated herein by reference to the information contained under the captions Security Ownership of Certain Beneficial Owners and Management and Equity Compensation Plan Information of the Proxy Statement.

**Item 13. *Certain Relationships and Related Transactions.***

The information required by this item is incorporated herein by reference to the information contained under the captions Employment and Other Agreements and Certain Relationships and Related Transactions of the Proxy Statement.

**Item 14. *Principal Accountant Fees and Services.***

The information required to be disclosed by this item is incorporated herein by reference to the information contained under the caption Principal Accountant Fees and Services and Pre-Approval Policies and Procedures of the Proxy Statement.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a) *Financial Statements, Financial Statement Schedule and Exhibits*

|   |             |
|---|-------------|
|   | <b>Page</b> |
| (1) <u>Financial Statements see Index to Financial Statements</u>   | 46          |
| (2) <u>Financial Statement Schedule for the Years Ended June 30, 2004, 2005 and 2006: Schedule II Valuation and Qualifying Accounts</u>   | 45          |
| Financial statement schedules not included have been omitted because of the absence of conditions under which they are required or because the required information, where material, is shown in the financial statements or notes. |             |
| (3) Exhibits:   |             |
| <u>Exhibits filed as part of this Annual Report on Form 10-K are listed on the Exhibit Index immediately preceding such exhibits, which is incorporated herein by reference</u>   | 77          |



**Table of Contents****SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS****ALLOWANCE FOR DOUBTFUL ACCOUNTS AND RETURNS****Years Ended June 30, 2004, 2005 and 2006**

| <b>Year Ended</b> | <b>Balance at</b> | <b>(Charged to</b> | <b>Activity</b>       |                   |                      | <b>Balance at</b> |
|-------------------|-------------------|--------------------|-----------------------|-------------------|----------------------|-------------------|
|                   | <b>Beginning</b>  | <b>Costs and</b>   | <b>Additions(1)</b>   | <b>Recoveries</b> | <b>Deductions(2)</b> | <b>End of</b>     |
|                   | <b>of Year</b>    | <b>Expenses)</b>   | <b>(in thousands)</b> |                   |                      | <b>Year</b>       |
| June 30, 2004     | \$ 1,682          | 106                | 86                    | 1                 | 110                  | \$ 1,765          |
| June 30, 2005     | \$ 1,765          | 131                | 56                    | 31                | 153                  | \$ 1,830          |
| June 30, 2006     | \$ 1,830          | 128                | 228                   | 1                 | 354                  | \$ 1,833          |

(1) Additions represent increases to the allowance for doubtful accounts balances as a result of reserves recorded in connection with purchase business combinations and the impact of foreign currency exchange rate changes.

(2) Deductions are principally write-offs and reductions to reserves.

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**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

|   | <b>Page</b> |
|---|-------------|
| <u>Management's Annual Report on Internal Control Over Financial Reporting</u>  | 47          |
| <u>Report of Independent Registered Public Accounting Firm</u>  | 48          |
| <u>Consolidated Balance Sheets as of June 30, 2005 and 2006</u>   | 50          |
| <u>Consolidated Statements of Operations for the years ended June 30, 2004, 2005 and 2006</u>   | 51          |
| <u>Consolidated Statements of Stockholders' Equity and Comprehensive Income and Loss for the years ended June 30, 2004, 2005 and 2006</u> | 52          |
| <u>Consolidated Statements of Cash Flows for the years ended June 30, 2004, 2005 and 2006</u>   | 54          |
| <u>Notes to Consolidated Financial Statements</u>   | 55          |

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### **Management's Annual Report on Internal Control Over Financial Reporting**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of June 30, 2006. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment, management concluded that, as of June 30, 2006, the Company's internal control over financial reporting is effective based on those criteria.

The Company's independent registered public accounting firm has issued an audit report on our assessment of the Company's internal control over financial reporting. This report appears on page 48.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Bottomline Technologies (de), Inc.

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting that Bottomline Technologies (de), Inc. maintained effective internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Bottomline Technologies (de), Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Bottomline Technologies (de), Inc. maintained effective internal control over financial reporting as of June 30, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Bottomline Technologies (de), Inc. maintained, in all material respects, effective internal control over financial reporting as of June 30, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Bottomline Technologies (de), Inc. as of June 30, 2006 and 2005 and the related consolidated statements of operations, stockholders' equity and comprehensive income and loss and cash flows for each of the three years in the period ended June 30, 2006 of Bottomline Technologies (de), Inc. and our report dated September 6, 2006 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Boston, Massachusetts

September 6, 2006

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Bottomline Technologies (de), Inc.

We have audited the accompanying consolidated balance sheets of Bottomline Technologies (de), Inc. as of June 30, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and comprehensive income and loss, and cash flows for each of the three years in the period ended June 30, 2006. Our audits also included the consolidated financial statement schedule listed in the index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit 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 consolidated financial position of Bottomline Technologies (de), Inc. at June 30, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Bottomline Technologies (de), Inc.'s internal control over financial reporting as of June 30, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated September 6, 2006 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Boston, Massachusetts

September 6, 2006

**Table of Contents****CONSOLIDATED BALANCE SHEETS**

|   | June 30,       |            |
|---|----------------|------------|
|   | 2005           | 2006       |
|   | (in thousands) |            |
| ASSETS  |                |            |
| Current assets:   |                |            |
| Cash and cash equivalents   | \$ 20,789      | \$ 38,752  |
| Marketable securities   | 15,127         | 41,745     |
| Accounts receivable, net of allowances for doubtful accounts and returns of \$1,830 at June 30, 2005 and \$1,833 at June 30, 2006                                     | 22,956         | 21,043     |
| Inventory, net  | 954            | 700        |
| Prepaid expenses and other current assets   | 3,939          | 4,164      |
| Total current assets  | 63,765         | 106,404    |
| Property, plant and equipment, net  | 6,940          | 7,106      |
| Customer related intangible assets, net   | 8,053          | 14,885     |
| Core technology intangible assets, net  | 2,126          | 4,010      |
| Other intangible assets, net  |                | 992        |
| Goodwill  | 28,516         | 41,190     |
| Other assets  | 1,041          | 1,247      |
| Total assets  | \$ 110,441     | \$ 175,834 |
| LIABILITIES AND STOCKHOLDERS' EQUITY  |                |            |
| Current liabilities:  |                |            |
| Accounts payable  | \$ 6,094       | \$ 5,990   |
| Accrued expenses  | 9,096          | 8,660      |
| Deferred revenue and deposits   | 20,738         | 19,880     |
| Total current liabilities   | 35,928         | 34,530     |
| Deferred revenue and deposits, non current  | 1,435          | 1,249      |
| Deferred income taxes   |                | 2,985      |
| Other liabilities   | 285            | 462        |
| Total liabilities   | 37,648         | 39,226     |
| Stockholders' equity:   |                |            |
| Preferred Stock, \$.001 par value:  |                |            |
| Authorized shares 4,000; issued and outstanding shares none   |                |            |
| Common Stock, \$.001 par value:   |                |            |
| Authorized shares 50,000; issued shares 18,930 at June 30, 2005, and 23,647 at June 30, 2006; outstanding shares 18,787 at June 30, 2005, and 23,554 at June 30, 2006 | 19             | 23         |
| Additional paid-in-capital  | 182,534        | 246,543    |
| Accumulated other comprehensive income  | 2,350          | 3,585      |
| Treasury stock: 143 shares at June 30, 2005, and 93 shares at June 30, 2006, at cost  | (1,149)        | (748)      |
| Accumulated deficit   | (110,961)      | (112,795)  |
| Total stockholders' equity  | 72,793         | 136,608    |
| Total liabilities and stockholders' equity  | \$ 110,441     | \$ 175,834 |

See accompanying notes.



**Table of Contents****CONSOLIDATED STATEMENTS OF OPERATIONS**

|  | Year ended June 30,                   |           |            |
|--|---------------------------------------|-----------|------------|
|  | 2004                                  | 2005      | 2006       |
|  | (in thousands, except per share data) |           |            |
| Revenues:  |                                       |           |            |
| Software licenses  | \$ 14,366                             | \$ 18,789 | \$ 12,236  |
| Service and maintenance                                    | 51,364                                | 62,233    | 74,801     |
| Equipment and supplies                                     | 16,402                                | 15,483    | 14,628     |
| Total revenues   | 82,132                                | 96,505    | 101,665    |
| Cost of revenues:  |                                       |           |            |
| Software licenses  | 1,678                                 | 2,295     | 1,419      |
| Service and maintenance(1)                                 | 22,363                                | 26,656    | 32,724     |
| Equipment and supplies                                     | 13,312                                | 11,980    | 11,639     |
| Total cost of revenues                                     | 37,353                                | 40,931    | 45,782     |
| Gross profit   | 44,779                                | 55,574    | 55,883     |
| Operating expenses:  |                                       |           |            |
| Sales and marketing(1)                                     | 21,062                                | 24,323    | 25,512     |
| Product development and engineering:(1)                    |                                       |           |            |
| Product development and engineering                        | 9,305                                 | 9,433     | 12,417     |
| In-process research and development                        | 842                                   |           |            |
| General and administrative(1)                              | 11,830                                | 12,800    | 17,889     |
| Amortization of intangible assets                          | 4,277                                 | 3,217     | 4,491      |
| Total operating expenses                                   | 47,316                                | 49,773    | 60,309     |
| Income (loss) from operations                              | (2,537)                               | 5,801     | (4,426)    |
| Interest income  | 199                                   | 591       | 3,138      |
| Interest expense   | (14)                                  | (10)      | (15)       |
| Other, net   | 103                                   | (137)     | 129        |
| Other income, net  | 288                                   | 444       | 3,252      |
| Income (loss) before provision for income taxes            | (2,249)                               | 6,245     | (1,174)    |
| Provision for income taxes                                 | 169                                   | 357       | 660        |
| Net income (loss)  | \$ (2,418)                            | \$ 5,888  | \$ (1,834) |
| Basic net income (loss) per common share                   | \$ (0.15)                             | \$ 0.33   | \$ (0.08)  |
| Diluted net income (loss) per common share                 | \$ (0.15)                             | \$ 0.31   | \$ (0.08)  |
| Shares used in computing basic net income loss per share   | 16,514                                | 18,030    | 22,838     |
| Shares used in computing diluted net income loss per share | 16,514                                | 19,119    | 22,838     |

(1) Stock based compensation is allocated as follows:



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|   | Fiscal Year Ended June 30 |       |          |
|---|---------------------------|-------|----------|
|   | 2004                      | 2005  | 2006     |
|   | (in thousands)            |       |          |
| Cost of revenues: service and maintenance | \$                        | \$    | \$ 474   |
| Sales and marketing                       |                           |       | 2,489    |
| Product development and engineering       | 41                        | 14    | 841      |
| General and administrative                |                           |       | 3,180    |
|   | \$ 41                     | \$ 14 | \$ 6,984 |

See accompanying notes.

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**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**  
**AND COMPREHENSIVE INCOME AND LOSS**

|  | Year ended June 30, 2004, 2005 and 2006 |        |                |            |                                      |              |                                  |              |                        |
|--|---|--------|----------------|------------|--------------------------------------|--------------|----------------------------------|--------------|------------------------|
|  | Common Stock                            |        | Treasury Stock |            | Additional                           | Deferred     | Accumulated                      | Accumulated  | Total                  |
|  | Shares                                  | Amount | Shares         | Amount     | Paid-in<br>Capital<br>(in thousands) | Compensation | Other<br>Comprehensive<br>Income | Deficit      | Stockholders<br>Equity |
| Balances at June 30, 2003  | 16,501                                  | \$ 17  | 540            | \$ (4,250) | \$ 164,809                           | \$ (78)      | \$ 1,628                         | \$ (114,431) | \$ 47,695              |
| Repurchase of common stock to be held in treasury  |   |        | 49             | (367)      |                                      |              |                                  |              | (367)                  |
| Issuance of common stock for employee stock purchase plan and upon exercise of stock options | 510                                     |        | (110)          | 864        | 2,146                                |              |                                  |              | 3,010                  |
| Issuance of common stock in connection with acquisitions                                     | 1,162                                   | 1      | 38             | (380)      | 10,273                               |              |                                  |              | 9,894                  |
| Amortization of deferred stock compensation  |   |        |                |            | (23)                                 | 64           |                                  |              | 41                     |
| Net loss   |   |        |                |            |                                      |              |                                  | (2,418)      | (2,418)                |
| Foreign currency translation adjustment  |   |        |                |            |                                      |              | 1,398                            |              | 1,398                  |
| Comprehensive loss   |   |        |                |            |                                      |              |                                  |              | (1,020)                |
| Balances at June 30, 2004  | 18,173                                  | \$ 18  | 517            | \$ (4,133) | \$ 177,205                           | \$ (14)      | \$ 3,026                         | \$ (116,849) | \$ 59,253              |
| Issuance of common stock for employee stock purchase plan and upon exercise of stock options | 771                                     | 1      | (75)           | 596        | 4,682                                |              |                                  |              | 5,279                  |
| Issuance of common stock in connection with warrants exercised                               | 100                                     |        |                |            | 425                                  |              |                                  |              | 425                    |
| Issuance of common stock from treasury in connection with Createform acquisition             | (299)                                   |        | (299)          | 2,388      | (2,388)                              |              |                                  |              |                        |
| Issuance of common stock in connection with HMSL acquisition                                 | 185                                     |        |                |            | 2,127                                |              |                                  |              | 2,127                  |
| Amortization of deferred stock compensation  |   |        |                |            |                                      | 14           |                                  |              | 14                     |
| Tax benefit associated with non-qualified stock option exercises                             |   |        |                |            | 483                                  |              |                                  |              | 483                    |
| Net income   |   |        |                |            |                                      |              |                                  | 5,888        | 5,888                  |
| Foreign currency translation adjustment  |   |        |                |            |                                      |              | (676)                            |              | (676)                  |
| Comprehensive income   |   |        |                |            |                                      |              |                                  |              | 5,212                  |
| Balances at June 30, 2005  | 18,930                                  | \$ 19  | 143            | \$ (1,149) | \$ 182,534                           | \$           | \$ 2,350                         | \$ (110,961) | \$ 72,793              |
| Issuance of common stock for employee stock purchase plan and upon exercise of stock options | 840                                     | 1      | (58)           | 462        | 5,825                                |              |                                  |              | 6,288                  |

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|   | Year ended June 30, 2004, 2005 and 2006 |        |                |          |  |                          |   |                        |                                 |
|---|---|--------|----------------|----------|--|--------------------------|---|------------------------|---------------------------------|
|   | Common Stock                            |        | Treasury Stock |          | Additional<br>Paid-in<br>Capital<br>(in thousands) | Deferred<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>Income | Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |
|   | Shares                                  | Amount | Shares         | Amount   |  |                          |   |                        |                                 |
| Issuance of common stock in connection with follow-on offering                            | 3,560                                   | 3      |                |          | 46,769   |                          |   |                        | 46,772                          |
| Stock compensation expense  |   |        |                |          | 6,984  |                          |   |                        | 6,984                           |
| Issuance of common stock in connection with acquisitions, net of share registration costs | 317                                     |        |                |          | 4,149  |                          |   |                        | 4,149                           |
| Repurchase of common stock to be held in treasury   |   |        | 8              | (61)     |  |                          |   |                        | (61)                            |
| Tax benefit associated with non qualified stock option exercises                          |   |        |                |          | 282  |                          |   |                        | 282                             |
| Net loss  |   |        |                |          |  |                          |   | (1,834)                | (1,834)                         |
| Foreign currency translation adjustment   |   |        |                |          |  |                          | 1,235   |                        | 1,235                           |
| Comprehensive loss  |   |        |                |          |  |                          |   |                        | (599)                           |
| Balances at June 30, 2006   | 23,647                                  | \$ 23  | 93             | \$ (748) | \$ 246,543   | \$                       | \$ 3,585  | \$ (112,795)           | \$ 136,608                      |

See accompanying notes.

**Table of Contents****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | 2004       | Year ended June 30,<br>2005<br>(in thousands) | 2006       |
|---|------------|---|------------|
| Operating activities  |            |   |            |
| Net income (loss)   | \$ (2,418) | \$ 5,888                                      | \$ (1,834) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:          |            |   |            |
| Amortization of intangible assets   | 4,277      | 3,217   | 4,491      |
| Amortization of investment income   |            | (66)  | (7)        |
| Depreciation and amortization of property, plant and equipment                                    | 2,253      | 2,511   | 2,674      |
| Acquisition related technology write-offs   |            |   | 189        |
| In-process research and development   | 842        |   |            |
| Deferred income tax (benefit) expense   | 31         | 22  | (498)      |
| Provision for allowances on accounts receivable   | 106        | 131   | (77)       |
| Provision for allowances for obsolescence of inventory  | 15         | (8)   | 117        |
| Stock compensation expense  | 41         | 14  | 6,984      |
| Income tax benefit from exercise of non-qualified stock options                                   |            | 477   | (282)      |
| Gain on foreign exchange  | (174)      | 136   | (102)      |
| Changes in operating assets and liabilities:  |            |   |            |
| Accounts receivable   | (3,101)    | (2,661)                                       | 3,358      |
| Inventory, prepaid expenses and other current assets and other assets                             | 268        | (545)   | 869        |
| Accounts payable, accrued expenses, deferred revenue and deposits and other long-term liabilities | (357)      | 4,101   | (4,027)    |
| Net cash provided by operating activities   | 1,783      | 13,217  | 11,855     |
| Investing activities  |            |   |            |
| Purchases of available-for-sale securities  |            | (17,600)                                      | (41,750)   |
| Proceeds from sales of available-for-sale securities  |            | 4,550   | 13,100     |
| Purchases of held-to-maturity securities  | (6,298)    | (6,770)                                       | (46)       |
| Proceeds from sales of held-to-maturity securities  | 2,010      | 9,055   | 2,084      |
| Purchases of property and equipment, net  | (1,752)    | (2,169)                                       | (2,612)    |
| Acquisition of businesses and assets, net of cash acquired  | (3,201)    | (5,802)                                       | (18,195)   |
| Net cash used in investing activities   | (9,241)    | (18,736)                                      | (47,419)   |
| Financing activities  |            |   |            |
| Proceeds from exercise of stock options, warrants and employee stock purchase plan                | 3,010      | 5,705   | 6,288      |
| Income tax benefit from exercise of non-qualified stock options                                   |            |   | 282        |
| Payment of certain liabilities assumed upon acquisition   | (331)      |   |            |
| Payment of principal on long term debt  | (253)      |   |            |
| Payment of bank financing fees  | (25)       | (16)  | (33)       |
| Repurchase of common stock  | (367)      |   | (61)       |
| Proceeds from sale of common stock, net   |            |   | 46,772     |
| Net cash provided by financing activities   | 2,034      | 5,689   | 53,248     |
| Effect of exchange rate changes on cash   | 346        | (105)   | 279        |
| Increase (decrease) in cash and cash equivalents  | (5,078)    | 65  | 17,963     |
| Cash and cash equivalents at beginning of year  | 25,802     | 20,724  | 20,789     |
| Cash and cash equivalents at end of year  | \$ 20,724  | \$ 20,789                                     | \$ 38,752  |
| Supplemental disclosure of cash flow information:   |            |   |            |
| Cash paid during the year for:  |            |   |            |
| Interest  | \$ 17      | \$ 12   | \$ 15      |
| Income taxes  | \$ 135     | \$ 385  | \$ 508     |

Non-cash investing and financing activities:

|  |           |          |          |
|--|-----------|----------|----------|
| Issuance of common stock in connection with acquisitions | \$ 10,284 | \$ 2,127 | \$ 4,152 |
| See accompanying notes.                                  |           |          |          |

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### **BOTTOMLINE TECHNOLOGIES (de), INC.**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Year ended June 30, 2004, 2005 and 2006**

#### **1. Organization and Nature of Business**

Bottomline Technologies (de), Inc. (the Company) is a Delaware corporation that markets and provides a comprehensive set of products and services for financial process solutions. The Company's products and services enable businesses and financial institutions to more effectively make and collect payments, send and receive invoices and conduct electronic banking. The Company's products also allow customers to leverage the Internet in automating existing systems, accounting applications and banking functions. The Company's products and services are sold to customers operating in many different industries throughout the world, but principally in the US, UK and Australia.

#### **2. Significant Accounting Policies**

##### *Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned. All intercompany balances and transactions have been eliminated in consolidation.

##### *Use of Estimates in the Preparation of Consolidated Financial Statements*

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 amounts reported in the financial statements and accompanying notes. Estimates include, but are not limited to, revenue recognition (particularly revenue recognition associated with contracts accounted for on a percentage of completion basis), allowances for doubtful accounts and returns, determining the fair value associated with acquired intangible assets, asset impairment and certain of the Company's accrued liabilities. Actual results could differ from those estimates.

##### *Foreign Currency Translation*

The Company has various non-U.S. subsidiaries in the UK (Bottomline Europe) and in Australia (Bottomline Australia), whose functional currency is the British Pound Sterling and the Australian Dollar, respectively. Accordingly, assets and liabilities of Bottomline Europe and Bottomline Australia are translated into U.S. dollars at year-end exchange rates, and results of operations and cash flows are translated at the average exchange rates during the year. Gains or losses resulting from foreign currency translation are included as a component of accumulated other comprehensive income or loss. Realized foreign currency transaction gains and losses are included in results of operations as incurred, and are not significant to the Company's operating results.

##### *Cash and Cash Equivalents*

The Company considers all highly liquid instruments with an original maturity of ninety days or less to be cash equivalents. The carrying value of these instruments approximates their fair value. At June 30, 2006 the Company's cash equivalents consisted of demand deposit accounts and money market funds.

##### *Marketable Securities*

The Company accounts for marketable securities in accordance with Statement of Financial Accounting Standards No. 115 Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). SFAS 115 establishes the accounting and reporting requirements for all debt securities and for investments in equity securities that have determinable fair values. All marketable securities must be classified as one of the following: held-to-maturity, available-for-sale, or trading.

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The Company's marketable securities consist of auction rate securities which are invested in agencies and institutions affiliated with U.S. states. Marketable securities also consist of corporate bonds and term deposits at banking institutions. The Company's auction rate investments are classified as available-for-sale and are recorded at fair value. All other marketable securities are classified as held-to-maturity and are recorded at amortized cost, which approximates fair value. Interest income on the Company's marketable securities is recognized in earnings when earned. The cost of securities sold is determined based on the specific identification method.

The Company's available-for-sale investments may be offered for sale at auction every 28 or 35 days, depending on the individual security. The auction rate securities have stated contractual maturities, which represents the date they will be redeemed by the issuer, ranging from 10 to 40 years and may, at the option of the issuer, be redeemed prior to the stated maturity date.

The table below presents information regarding the Company's marketable securities by major security type as of June 30, 2005 and 2006.

|  | Held to<br>Maturity | June 30, 2005<br>Available<br>for Sale | Total<br>(in thousands) | Held to<br>Maturity | June 30, 2006<br>Available<br>for Sale | Total     |
|--|---------------------|--|-------------------------|---------------------|--|-----------|
| <b>Marketable securities:</b>                                  |                     |  |                         |                     |  |           |
| Debt securities issued by U.S. state agencies and institutions |                     | \$ 13,050                              | \$ 13,050               |                     | \$ 41,700                              | \$ 41,700 |
| Corporate and other debt securities                            | \$ 2,077            |  | 2,077                   |                     | 45                                     | 45        |
| Total marketable securities                                    | \$ 2,077            | \$ 13,050                              | \$ 15,127               |                     | \$ 41,745                              | \$ 41,745 |

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist of cash and cash equivalents, marketable securities and accounts receivable. The Company had approximately \$80.5 million of cash, cash equivalents and marketable securities invested primarily with four financial institutions at June 30, 2006. Concentration of credit risk with respect to non-auction rate marketable securities is generally limited as the Company's marketable securities are primarily state and municipal debt securities and investment-grade corporate bonds with high-quality credit financial institutions.

A large component of the Company's marketable securities at June 30, 2006 were invested in auction rate instruments. Auction rate securities are variable rate debt instruments whose interest rates are reset periodically in an auction process. The Company believes the risk associated with the auction process is low. However, in the event that the demand or competitive bids within a specific auction were less than the shares being offered for sale, the Company might be unable to sell its securities until a successful auction were to occur. The Company limits its risk within the auction rate market by diversifying its holdings and by transacting with large, highly reputable brokers who have significant experience with the auction rate process.

The Company's accounts receivable are reported in its consolidated balance sheet net of allowances for uncollectible accounts and customer returns. Concentration of credit risk with respect to accounts receivable is limited due to the large number of companies and diverse industries comprising the Company's customer base. At June 30, 2005 and 2006, there were no individual customers that accounted for greater than 10% of the Company's accounts receivable. On-going credit evaluations are performed and collateral is generally not required. The Company maintains reserves for potential credit losses based on customer specific situations as well as historic experience and such losses, in the aggregate, have not exceeded management's expectations.

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### *Financial Instruments*

The fair value of the Company's financial instruments, which include cash and cash equivalents, marketable securities, accounts receivable and accounts payable, are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates reflecting varying degrees of perceived risk. The carrying value of these financial instruments approximated their fair value at June 30, 2005 and 2006, respectively, due to the short-term nature of these instruments.

### *Inventory*

Inventory is stated at the lower of cost (first-in, first-out method) or market.

### *Property, Plant and Equipment*

Property, plant and equipment are stated at cost, net of accumulated amortization and depreciation. Property and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets (generally three to six years). Software is depreciated on a straight-line basis over the estimated useful lives of the assets (generally one to three years). The building is depreciated on a straight-line basis over the estimated useful life of the asset (fifty years). Leasehold improvements are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the respective remaining lease term.

### *Goodwill and Other Intangible Assets*

The Company accounts for goodwill and other intangible assets at their estimated fair values in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. In connection with prior business and asset acquisitions, the Company recorded goodwill based on the excess of the purchase price over the identifiable tangible and intangible assets acquired and liabilities assumed. Upon adoption of SFAS 142, the Company ceased recording recurring amortization of goodwill, and goodwill is now tested at least annually for impairment.

The Company's specifically identifiable intangible assets, which consist principally of acquired core technology and customer related intangible assets, are reported at cost, net of accumulated amortization. These intangible assets are being amortized over their estimated useful lives, which range from one to ten years, at amortization rates that are proportional to each asset's estimated economic benefit to the Company. The carrying value of these intangible assets is reviewed annually by the Company, or more frequently when indicators of impairment are present, in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

In performing its review of the recoverability of goodwill and other intangible assets, the Company considers several factors, including whether there have been significant changes in legal factors or the overall business climate that could affect the underlying value of an asset or whether there is an expectation that the asset will be sold or disposed of before the end of its originally estimated useful life. In the case of goodwill, the Company must also consider, and estimate, the fair value of the reporting unit to which the goodwill is assigned. If, as a result of examining any of these factors, the Company concludes that the carrying value of its goodwill or other intangible assets exceeds its estimated fair value, the Company will record an impairment charge and reduce the carrying value of the asset to its estimated fair value.

### *Advertising Costs*

The Company expenses advertising costs as incurred. Advertising costs were \$1,055,000, \$963,000 and \$1,294,000 for the years ended June 30, 2004, 2005 and 2006, respectively.

### *Shipping and Handling Costs*

The Company expenses all shipping, handling and delivery costs in the period incurred as a component of equipment and supplies cost of revenues.



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### *Research and Development Expenditures*

The Company expenses research and development costs in the period incurred.

### *Income Taxes*

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Under SFAS 109, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax basis of assets and liabilities, and are measured by applying tax rates that are expected to be in effect when the differences reverse. SFAS 109 requires a valuation allowance to reduce the amount of deferred tax assets recorded if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company has concluded that it is more likely than not that the deferred tax assets associated with its US operations and a component of the deferred tax assets associated with its UK operations will not be realized and, accordingly, a valuation allowance has been recorded against those assets. Deferred tax assets of Australia have been fully valued, as those amounts are expected to be realized by the Company's Australian subsidiaries.

### *Share Based Compensation*

Effective July 1, 2005, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS 123R). Under SFAS 123R, the Company is required to recognize, as expense, the estimated fair value of all share based payments to employees. The Company records expense associated with its share based payment awards on a straight-line basis over the respective award vesting period.

The Company adopted SFAS 123R under the modified prospective method. Under this method, the Company recognized compensation cost for all share-based payments to employees based on the grant date estimate of fair value for those awards, beginning on July 1, 2005. Prior period financial information has not been restated.

For periods prior to the adoption of SFAS 123R, the Company followed Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees*, (APB 25) and related Interpretations in accounting for its share based payment awards. Under APB 25, since the exercise price of the Company's employee stock options equaled the market price of the underlying stock on the date of the grant and, in the case of the Company's stock purchase plans, since the plans were non-compensatory, no compensation expense was recorded in the financial statements.

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The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock Based Compensation, to its stock-based employee compensation for the fiscal years ended June 30, 2004 and June 30, 2005.

|   | Fiscal Year<br>Ended<br>June 30, 2004 | Fiscal Year<br>Ended<br>June 30, 2005 |
|---|---------------------------------------|---------------------------------------|
|   | (in thousands,                        |                                       |
|   | except per share amounts)             |                                       |
| Net income (loss), as reported  | \$ (2,418)                            | \$ 5,888                              |
| Add: Stock-based employee compensation expense included in reported net income  | 41                                    | 14                                    |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (7,163)                               | (6,150)                               |
| Pro forma loss  | \$ (9,540)                            | \$ (248)                              |
| Net income (loss) per share, as reported:   |                                       |                                       |
| Basic   | \$ (0.15)                             | \$ 0.33                               |
| Diluted   | \$ (0.15)                             | \$ 0.31                               |
| Pro forma net loss per share  |                                       |                                       |
| Basic and diluted   | \$ (0.58)                             | \$ (0.01)                             |

The Company's assumptions made for purposes of estimating the fair value of its share based payments, as well as a summary of the activity under the Company's stock incentive plans, is included in Note 9.

*Capitalized Software Costs*

Capitalization of software development costs under SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed begins upon the establishment of technological feasibility. In the development of the Company's products and enhancements to existing products, the technological feasibility of the software is not established until substantially all product development is complete, including the development of a working model. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized software development costs requires considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenues, estimated economic life, and changes in software and hardware technologies. For the years ended June 30, 2004, 2005 and 2006, there were no costs capitalized since costs were incurred prior to attaining technological feasibility.

*Revenue Recognition*

The Company recognizes revenue on its software license arrangements in accordance with Statement of Position (SOP) 97-2 Software Revenue Recognition and related pronouncements. Consistent with SOP 97-2, revenue is recognized when four basic criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed and determinable and collectibility is deemed probable. The Company's software arrangements may contain multiple revenue elements, such as software licenses, professional services, hardware and post-contract customer support (PCS).

For multiple element arrangements which qualify for separate element accounting treatment, revenue is recognized for each element when each of the four basic criteria is met. Revenue for PCS under software maintenance agreements is recognized ratably over the term of the agreement, which is generally one year. For software arrangements involving multiple elements which qualify for separate element treatment, revenue is allocated to each element based on vendor specific objective evidence of fair value. Vendor specific objective



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evidence of fair value is limited to the price charged when the element is sold separately or, for an element not yet being sold separately, the price established by management having the relevant authority. For multiple element revenue arrangements for which the Company does not have vendor specific evidence of fair value for the software license but does have vendor specific evidence of fair value for all of the other elements in the arrangement, revenues are allocated to each element according to the residual method. Under the residual method, revenue equal to the fair value of each undelivered element is deferred, and recognized upon delivery of that element. Any residual arrangement fee is allocated to the software license.

Certain of the Company's software license arrangements require significant customization and modification and involve extended implementation periods. Such arrangements are accounted for using percentage of completion contract accounting as defined by Statement of Position No. 81-1 (SOP 81-1), Accounting for Performance of Construction-Type and Certain Production-Type Contracts. In such arrangements, since the Company is able to make reasonably reliable estimates of progress toward completion, revenue is recognized over the life of the project as work is performed. Revenue earned in each reporting period is determined based on the percentage of labor hours incurred on the project as a percentage of the estimated total labor hours.

For arrangements not involving a software license fee, such as with the Company's transactional and subscription based offerings, or equipment and supplies only sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104 (SAB 104), Revision of Topic 13-Revenue Recognition. SAB 104 summarizes certain of the SEC's views in applying generally accepted accounting principles to revenue recognition in financial statements. Under SAB 104, revenue is recognized when four basic criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the arrangement fee is fixed or determinable and collectibility is reasonably assured. SAB 104 also requires that up-front fees, even if non-refundable, that do not represent the completion of a separate earnings process be deferred and recognized as revenue over the period of performance. The Company does charge up-front fees, generally related to installation and integration services, in connection with many of its hosted services offerings. Accordingly, these fees are deferred and recognized as revenue ratably over the estimated customer relationship period, which is generally four years. The revenue recognition period associated with such fees normally commences upon customer implementation. The Company expenses any contract origination costs as incurred.

### *Customer Returns*

The sales value of customer returns are estimated and accrued for based upon return authorizations issued and past history. Actual returns, in the aggregate, have been consistent with management's expectations.

### *Earnings per Share*

The Company computes earnings per share in accordance with Statement of Financial Accounting Standards No. 128 Earnings per Share (SFAS 128). SFAS 128 requires the calculation and presentation of basic and diluted earnings per share. Basic earnings per share is calculated based on the weighted average number of shares of common stock outstanding and excludes any dilutive effects of warrants, stock options or other type of convertible securities. Diluted earnings per share is calculated based on the weighted average number of shares of common stock outstanding and the dilutive effect of stock options, warrants and other types of convertible securities calculated using the treasury stock method. Dilutive securities are excluded from the diluted earnings per share calculation if their effect is anti-dilutive.

### *401(k) and Pension Plans*

The Company has a 401(k) Profit Sharing Plan (the Plan), whereby eligible US employees may contribute up to 60% of their compensation, subject to limitations established by the Internal Revenue Code. The Company may contribute a discretionary matching contribution annually equal to 50% of each such participant's deferred

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compensation up to 5% of their annual compensation. The Company charged \$323,000, \$353,000 and \$382,000 to expense in the fiscal years ended 2004, 2005 and 2006, respectively, under the Plan.

The Company has a Group Personal Pension Plan (GPPP) for employees in the UK, whereby eligible employees may contribute a portion of their compensation, subject to their age and other limitations established by the Inland Revenue. The Company contributes 1.5% of the employee's annual compensation for those employees who make personal contributions of at least 1% of their annual earnings. The Company charged \$404,000, \$470,000 and \$365,000 to expense in the fiscal years ended 2004, 2005 and 2006, respectively, under the GPPP.

The Company is required by Australian government regulation to pay a certain percentage, currently 9%, of gross payroll to a compliant Superannuation Fund for the benefit of its Australian employees. The Company charged \$115,000, \$168,000 and 96,000 to expense for the fiscal years ended June 30, 2004, 2005 and 2006, reflecting the contribution to the Superannuation Fund.

### *Comprehensive Income (Loss)*

The Company records comprehensive income or loss in accordance with Statement of Financial Accounting Standard No. 130, Reporting Comprehensive Income (SFAS 130). SFAS 130 establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Comprehensive income, as defined, includes all changes in equity during a period from non-owner sources, such as foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities.

### *Recent Accounting Pronouncements:*

#### *Stock Based Compensation*

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 123 (revised 2004), Share Based Payment (SFAS 123R). Under SFAS 123R, companies are now required to recognize as expense the estimated fair value of all share-based payments to employees, including the fair value of employee stock options. Pro forma disclosure of the estimated expense impact of such awards is no longer an alternative to expense recognition within the financial statements. SFAS 123R was effective for public companies in the first annual reporting period beginning after June 15, 2005. Accordingly, the Company adopted the provisions of SFAS 123R effective July 1, 2005, the first quarter of the 2006 fiscal year.

There were two transition alternatives for public companies adopting the statement: the modified prospective method and the modified retrospective method. Under the modified prospective method, companies were required to recognize compensation cost for share-based payments to employees, based on the grant date estimate of fair value, from the beginning of the fiscal period in which the recognition provisions of SFAS 123R were first applied. Prior period financial information is not restated under this method. Under the modified retrospective method, companies are required to restate prior periods to include the recognition of compensation cost based on amounts previously reported in the pro forma disclosures relating to stock based compensation under the existing requirements of SFAS 123, Accounting for Stock-Based Compensation. The Company adopted the provisions of SFAS 123R using the modified prospective method and, accordingly, prior period financial information has not been restated.

### *Income Tax Uncertainties*

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 creates a single accounting and disclosure model for uncertain tax positions, provides guidance on the minimum threshold that a tax uncertainty is required to meet before it can be recognized in the financial statements and applies to all tax positions taken by a company; both those deemed to be routine as well as those for which there may be a high degree of uncertainty.

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FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the tax matter) that a tax position is more likely than not to be sustained on examination by a taxing authority. The second step, measurement, is only considered after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with the taxing authority or upon the expiration of the statute of limitations. Derecognition of a tax position previously recognized would occur when a company subsequently concludes that a tax position no longer meets the more likely than not threshold of being sustained. FIN 48 also significantly expands the financial statement disclosure requirements relating to uncertain tax positions.

FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company will adopt the pronouncement effective July 1, 2007. Differences between the amounts recognized in the balance sheet prior to adoption and the amounts recognized in the balance sheet after adoption will be accounted for as a cumulative effect adjustment to the beginning balance of retained earnings. The Company is currently evaluating the impact of FIN 48 on its financial statements.

### *Reclassifications*

Certain prior year amounts have been reclassified to conform to the current year presentation.

## **3. Product and Business Acquisitions**

### *HMSL Group, Ltd. (HMSL)*

On April 27, 2005 the Company acquired all of the outstanding stock of HMSL Group, Ltd. ( HMSL ). HMSL is a services company that provides organizations with the ability to streamline financial processes by outsourcing the front-end of their accounts payable function. The purchase consideration for HMSL was approximately \$10.1 million consisting of approximately \$7.6 million of cash, \$2.1 million (184,956 shares) of the Company's common stock, as measured on the transaction consummation date, and acquisition related costs (based on exchange rates in effect at the time of acquisition). Of the shares issued, 80,148 shares were placed in escrow for a two year period to cover potential liability claims that might be made against HMSL. As a result of the acquisition and the purchase price allocation, the Company recorded intangible assets of approximately \$7.6 million consisting of \$846,000 of core technology, \$4.4 million of customer related assets and \$2.4 million of goodwill. The finite lived intangibles, core technology and customer related assets are being amortized over their estimated useful lives of three and five years, respectively. HMSL results are included in the Company's results from the acquisition date forward, as a component of the Outsourced Solutions segment.

### *Visibillity, Inc.*

On December 31, 2005, the Company acquired all of the outstanding stock of Visibillity, Inc. (Visibillity), a provider of legal e-billing solutions specializing in the insurance industry. The initial purchase consideration for Visibillity was \$11,500,000 in cash plus acquisition related costs. Subsequent to the payment of the initial purchase consideration, the Company recovered \$500,000 from the Visibillity selling stockholders pursuant to the terms of the acquisition, and this recovery was recorded as a reduction to the amount of goodwill recorded.

Visibillity complements the Company's existing Legal eXchange product and the Company believes that the acquisition will strengthen its position as a leading provider of Web-based legal spend management services. Visibillity operating results are included in the Company's operating results from the acquisition date forward, as a component of the Outsourced Solutions segment.

As a result of the purchase price allocation, the Company recorded intangible assets of approximately \$11.2 million. The intangible assets consist of acquired customer related assets of \$6.4 million, acquired technology of

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\$1.6 million and goodwill of \$3.2 million. The customer related assets and acquired technology are being amortized to expense over a period of five and three years, respectively.

### *Tranmit Plc.*

On January 24, 2006, the Company acquired all of the outstanding stock of Tranmit Plc (Tranmit). Tranmit is a UK-based company that provides Web-based purchase-to-pay automation solutions. The purchase consideration for Tranmit was approximately \$6.0 million of cash, \$4.2 million (316,970 shares) of the Company's common stock, as valued on the date of acquisition, and acquisition related costs. The Company believes the addition of Tranmit's invoice management capabilities further enhance the Company's ability to provide global organizations with comprehensive hosted, licensed and outsourced solutions for improving the overall efficiency and productivity of the accounts payable function. Tranmit operating results are included in the Company's operating results from the acquisition date forward, as a component of the Outsourced Solutions segment.

As a result of the purchase price allocation and the exchange rates in effect at the time of the acquisition, the Company has recorded intangible assets of approximately \$12.6 million. The intangible assets consist of acquired customer related assets of \$3.4 million, acquired technology of \$1.5 million, a below market lease arrangement of \$84,000, and goodwill of \$7.6 million. The customer related assets, acquired technology and the below market lease are being amortized to expense over periods of five, three and two years, respectively.

### *Legal e-billing Patent*

On January 25, 2006, the Company acquired a patent that addresses the process of online budgeting and evaluation of legal invoices. The purchase price for the patent was \$935,000 in cash plus acquisition related costs. Per the terms of the patent purchase, the Company is obligated to make certain earn-out payments should the Company recover royalty payments from third parties or, beginning in fiscal 2009, should specific legal billing product revenues of the Company exceed \$12.5 million on a per annum basis. The patent costs are being amortized over the remaining legal life of the patent, which expires in June 2019.

### *Pro-forma Information*

The following unaudited pro-forma financial information presents the combined results of operations of the Company, Visibillity and Tranmit as if the acquisitions had occurred as of July 1, 2004 and July 1, 2005, and in respect of HMSL as if the acquisition had occurred in July 1, 2004, after giving effect to certain adjustments such as increased amortization expense of acquired intangible assets, a decrease in interest income as a result of cash paid for the acquisitions and the dilutive effect of common stock issued by the Company. This pro-forma financial information does not necessarily reflect the results of operations that would have actually occurred had the Company and the acquired entities been a single entity during these periods.

|                                     | Pro Forma<br>June 30, |            |
|-------------------------------------|-----------------------|------------|
|                                     | 2005                  | 2006       |
|                                     | (unaudited)           |            |
|                                     | (in thousands)        |            |
| Revenues                            | \$ 108,519            | \$ 105,957 |
| Net income (loss)                   | \$ 1,963              | \$ (3,650) |
| Net income (loss) per basic share   | \$ 0.11               | \$ (0.16)  |
| Net income (loss) per diluted share | \$ 0.10               | \$ (0.16)  |

**Table of Contents****4. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

|   | June 30,<br>2005 | 2006<br>(in thousands) |
|---|------------------|------------------------|
| Land  | \$ 359           | \$ 370                 |
| Buildings and improvements                      | 3,665            | 4,202                  |
| Furniture and fixtures                          | 1,294            | 1,423                  |
| Technical equipment                             | 12,999           | 13,705                 |
| Software  | 4,078            | 4,754                  |
|   | 22,395           | 24,454                 |
| Less: Accumulated depreciation and amortization | 15,455           | 17,348                 |
|   | \$ 6,940         | \$ 7,106               |

**5. Goodwill and Other Intangible Assets**

At June 30, 2006, the carrying value of the Company's goodwill was approximately \$41.2 million and consisted of approximately \$28.5 million and \$12.7 million allocated to the Company's Licensed Technology and Outsourced Solutions segments, respectively. The increase in goodwill in 2006 was due to the acquisition of Visibillity and Transmit.

The following tables set forth the information for intangible assets subject to amortization and for intangible assets not subject to amortization under SFAS 142:

|                                | Gross Carrying<br>Amount | As of June 30, 2006<br>Accumulated<br>Amortization<br>(in thousands) | Net Carrying<br>Value |
|--------------------------------|--------------------------|--|-----------------------|
| Amortized intangible assets:   |                          |  |                       |
| Core technology                | \$ 19,082                | \$ (15,072)  | \$ 4,010              |
| Customer related               | 21,633                   | (6,748)  | 14,885                |
| Patent                         | 953                      | (30)   | 923                   |
| Below market lease             | 87                       | (18)   | 69                    |
| Total                          | \$ 41,755                | \$ (21,868)  | \$ 19,887             |
| Unamortized intangible assets: |                          |  |                       |
| Goodwill                       |                          |  | 41,190                |
| Total intangible assets        |                          |  | \$ 61,077             |

|                              | Gross Carrying<br>Amount | As of June 30, 2005<br>Accumulated<br>Amortization<br>(in thousands) | Net Carrying<br>Value |
|------------------------------|--------------------------|--|-----------------------|
| Amortized intangible assets: |                          |  |                       |



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|                                |           |             |           |
|--------------------------------|-----------|-------------|-----------|
| Core technology                | \$ 15,685 | \$ (13,559) | \$ 2,126  |
| Customer related               | 11,606    | (3,553)     | 8,053     |
| Total                          | \$ 27,291 | \$ (17,112) | \$ 10,179 |
| Unamortized intangible assets: |           |             |           |
| Goodwill                       |           |             | 28,516    |
| Total intangible assets        |           |             | \$ 38,695 |

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Estimated amortization expense for each of the five subsequent fiscal years and thereafter, is as follows:

|                     | (in thousands) |
|---------------------|----------------|
| 2007                | \$ 5,699       |
| 2008                | 5,197          |
| 2009                | 4,018          |
| 2010                | 2,912          |
| 2011                | 1,275          |
| 2012 and thereafter | 786            |

**6. Accrued Expenses**

Accrued expenses consist of the following:

|                                    | June 30,<br>(in thousands) |          |
|------------------------------------|----------------------------|----------|
|                                    | 2005                       | 2006     |
| Employee compensation and benefits | \$ 3,493                   | \$ 4,146 |
| Sales and value added taxes        | 2,046                      | 693      |
| Professional fees                  | 707                        | 754      |
| Other                              | 2,850                      | 3,067    |
|                                    | \$ 9,096                   | \$ 8,660 |

**7. Commitments and Contingencies**

The Company leases its principal office facility in Portsmouth, New Hampshire under a non-cancelable operating lease expiring in fiscal year 2012. In addition to the base term, the Company has two five-year options to extend the term of the lease. Rent payments are fixed for the term of the lease, subject to increases each year based on fluctuations in the consumer price index. The Company is additionally obligated to pay certain incremental operating expenses over the base rent.

The Company also leases office space in certain other cities worldwide. All such leases expire by fiscal year 2012.

Future minimum annual rental commitments under the Company's facilities, equipment, and vehicle leases at June 30, 2006 are as follows:

|      | (in thousands) |
|------|----------------|
| 2007 | \$ 2,472       |
| 2008 | 2,410          |
| 2009 | 2,196          |
| 2010 | 1,733          |
| 2011 | 1,489          |
| 2012 | 1,194          |
|      | \$ 11,494      |

Rent expense charged to operations for the fiscal years ended June 30, 2004, 2005 and 2006 was \$2,947,000, \$2,761,000, and \$3,059,000 respectively. The Company subleases space in several of its offices. Sublease income recorded for the fiscal years ended June 30, 2004, 2005 and 2006 was \$204,000, \$165,000 and \$172,000, respectively.

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On August 10, 2001, a class action complaint was filed against us in the United States District Court for the Southern District of New York: Paul Cyrek v. Bottomline Technologies, Inc.; Daniel M. McGurl; Robert A.

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Eberle; FleetBoston Robertson Stephens, Inc.; Deutsche Banc Alex Brown Inc.; CIBC World Markets; and J.P. Morgan Chase & Co. A consolidated amended class action complaint, *In re Bottomline Technologies Inc. Initial Public Offering Securities Litigation*, was filed on April 20, 2002. The amended complaint supersedes the class action complaint filed against us in the United States District Court for the Southern District of New York on August 10, 2001.

The amended complaint filed in the action asserts claims under Sections 11, 12(2) and 15 of the Securities Act of 1933, as amended, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (Exchange Act). The amended complaint asserts, among other things, that the description in our prospectus for our initial public offering was materially false and misleading in describing the compensation to be earned by the underwriters of our offering, and in not describing certain alleged arrangements among underwriters and initial purchasers of our common stock from the underwriters. The amended complaint seeks damages (or, in the alternative, tender of the plaintiffs' and the class's Bottomline common stock and rescission of their purchases of our common stock purchased in the initial public offering), costs, attorneys' fees, experts' fees and other expenses.

In July 2002, Bottomline, Daniel M. McGurl and Robert A. Eberle joined in an omnibus motion to dismiss, which challenged the legal sufficiency of plaintiffs' claims. The motion was filed on behalf of hundreds of issuer and individual defendants named in similar lawsuits. Plaintiffs opposed the motion, and the court heard oral argument on the motion in early November 2002. On February 19, 2003, the court issued an order denying the motion to dismiss as to Bottomline. In addition, in early October 2002, Daniel M. McGurl and Robert A. Eberle were dismissed from this case without prejudice. A special litigation committee of the board of directors of Bottomline authorized Bottomline to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding negotiated among class plaintiffs, all issuer defendants and their insurers. The parties have negotiated a settlement, which is subject to approval by the court. On February 15, 2005, the court issued an Opinion and Order preliminarily approving the settlement, provided that the defendants and plaintiffs agree to a modification narrowing the scope of the bar order set forth in the original settlement agreement. If the settlement is not approved, we intend to vigorously defend ourselves against this amended complaint. We do not currently believe that the outcome of this proceeding will have a material adverse impact on our financial condition, results of operations or cash flows.

## **8. Notes Payable and Credit Facilities**

In May 2005, the Company extended, through March 26, 2007, its Loan and Security Agreement (Credit Facility), which provides for aggregate borrowings of up to \$3 million and requires the Company to maintain certain financial covenants. Borrowings under the Credit Facility are secured by substantially all US owned assets of the Company, bear interest at the bank's prime rate (8.25% at June 30, 2006) and are due on the expiration date of the Credit Facility. The Credit Facility also provides for the issuance of up to \$2 million in letters of credit for, and on behalf of, the Company. The borrowing capacity under the Credit Facility is reduced by any outstanding letters of credit. At June 30, 2006, a \$2 million letter of credit had been issued to the Company's landlord as part of the lease arrangement for its corporate headquarters. There were no borrowings under the Credit Facility as of June 30, 2006.

In December 2005, the Company's subsidiary, Bottomline Europe, renewed through December 31, 2006 its Committed Overdraft Facility (Overdraft Facility), which provides for borrowings of up to 500,000 British Pound Sterling. Borrowings under this Overdraft Facility are secured by substantially all assets of Bottomline Europe, bear interest at the bank's base rate (4.5% at June 30, 2006) plus 2% and are due on the expiration date of the Overdraft Facility. There were no outstanding borrowings under this Overdraft Facility at June 30, 2006.

## **9. Share Based Payments**

Effective July 1, 2005, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), Share Based Payment (SFAS 123R). Under SFAS 123R, the Company is required to recognize, as

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expense, the estimated fair value of all share based payments to employees. The Company records expense associated with its share based payment awards on a straight-line basis over the award vesting period. For the fiscal year ended June 30, 2006, the Company recorded expense of approximately \$7.0 million in connection with its share-based payment awards. As the Company adopted SFAS 123R under the modified prospective method, prior period financial information has not been restated.

### ***Share Based Compensation Plans***

#### ***Employee Stock Purchase Plan***

On November 16, 2000, the Company adopted the 2000 Employee Stock Purchase Plan, which was amended on November 18, 2004 (2000 Stock Purchase Plan), and which provides for the issuance of up to a total of 1,500,000 shares of common stock to participating employees. Eligible employees may contribute between 1% and 10% of their base pay to the 2000 Stock Purchase Plan. At the end of a designated purchase period, which occurs every six months on March 31 and September 30, employees purchase shares of the Company's common stock with contributions accumulated via payroll deductions, at an amount equal to 85% of the lower of the fair market value of the common stock on the first day of each 24-month offering period or the last day of the applicable six-month purchase period.

The Company's employee stock purchase plan has several complex features that make determining fair value on the grant date impracticable. Accordingly, and as permitted by SFAS 123R, the Company measures the fair value of its awards under the employee stock purchase plan at intrinsic value (the value of the Company's common stock less the employee stock purchase plan exercise price) at the end of each reporting period. For fiscal 2006, as a result of the Company's adoption of SFAS 123R, the Company recorded compensation cost of approximately \$215,000 associated with its employee stock purchase plan. As a result of the employee stock purchases in fiscal years 2004, 2005 and 2006, the Company issued 110,000, 75,000 and 58,000 shares of its common stock, respectively. The aggregate intrinsic value of shares issued under the employee stock plan during fiscal years 2004, 2005 and 2006 was \$436,000, \$328,000 and \$333,000, respectively. At June 30, 2006, based on employee withholdings and the Company's common stock price at that date, approximately 20,000 shares of common stock, with an approximate intrinsic value of \$25,000, would have been eligible for issuance were June 30, 2006 to have been a designated stock purchase date.

### ***Stock Incentive Plans***

#### ***1998 Non-Employee Director Stock Option Plan***

On November 12, 1998, the Company adopted the 1998 Non-Employee Director Stock Option Plan (the Director Plan), which provides for the issuance of non-statutory stock options with a 10-year contractual term. The Company has reserved up to 300,000 shares of its common stock for issuance under the Director Plan. Under the terms of the Director Plan, each non-employee director was granted an option to purchase 15,000 shares of common stock upon his or her initial election to the Board of Directors. Such options vest over four years from the date of the grant, with 25% of the award vesting at the end of each year.

Effective February 16, 2006, the Company determined that, in lieu of stock option awards, it will now grant restricted stock awards for 8,000 shares of the Company's common stock to each non-employee director upon his or her initial election to the Board of Directors, with such awards vesting over a four year period. These awards will be granted under the Company's 2000 Stock Incentive Plan.

Additionally, until November 17, 2005, each non-employee director was granted an option to purchase 7,500 shares of common stock at each annual meeting of stockholders following the annual meeting of the initial year of their election. Such options vested one year from the date of the grant. Effective November 17, 2005, the Company determined that, in lieu of the annual stock option grants, it will now grant restricted stock awards for 3,000 shares of the Company's common stock to each non-employee director on the date of each annual meeting of stockholders, with such awards vesting over a one year period. Accordingly, 18,000 shares of restricted stock

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were issued by the Company under the Company's 2000 Stock Incentive Plan in November 2005 to its non-employee directors, as compensation for their service as directors.

### 2000 Employee Stock Incentive Plan

On November 16, 2000, the Company adopted the 2000 Stock Incentive Plan (the 2000 Plan), which provides for the issuance of stock options, non-statutory stock options and restricted stock. Stock option awards under this plan have a 10-year contractual term. The 2000 Plan is administered by the Board of Directors, which has the authority to determine to whom options may be granted, the period of exercise and what other restrictions, if any, should apply. Vesting for awards granted under the 2000 Plan is principally over four years from the date of the grant, with 25% of the award vesting after one year and 6.25% of the award vesting each quarter thereafter. The Company initially reserved 1,350,000 shares of its common stock for issuance under the 2000 Plan.

On the first day of each fiscal year, beginning in fiscal year 2001 and ending in fiscal year 2010, the number of shares of common stock authorized for issuance under the 2000 Plan will automatically increase, without additional Board or stockholder approval. The number of shares authorized for issuance will increase, when added to the remaining available shares, to total an amount equal to 12% of the number of shares of common stock outstanding on the first day of the fiscal year, or such lesser number as the Board of Directors may determine prior to such increase. The annual increase can never exceed 5,000,000 shares. Stock options issued under the 2000 Plan must be issued at an exercise price not less than 100% of the fair market value of the common stock at the date of grant.

Compensation cost associated with stock options represented approximately \$5.5 million of the total share based payment expense recorded for the fiscal year ended June 30, 2006. The stock options were valued using a Black Scholes method of valuation, and the resulting fair value is recorded as compensation cost on a straight line basis over the option vesting period. The assumptions made for purposes of estimating fair value under the Black Scholes model for options granted during the fiscal years ended June 30, 2004, 2005 and 2006 were as follows:

|                                  | 2004       | 2005       | 2006       |
|----------------------------------|------------|------------|------------|
| Dividend yield                   | 0%         | 0%         | 0%         |
| Expected term of options (years) | 4          | 4          | 4.9 5.1    |
| Risk-free interest rate          | 2.38-3.54% | 3.48-3.81% | 4.11-5.25% |
| Volatility                       | 109-111%   | 102-107%   | 59%-87%    |

The Company's estimate of an expected option term was derived based on a review of its historic option holding periods, including a consideration of the holding period inherent in currently vested but unexercised options. The estimated stock price volatility was derived based on a review of the Company's actual historic stock prices over the past five years.

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A summary of stock option and restricted stock activity for 2006 is as follows (in respect of shares available for grant, the shares are available for issuance by the Company as either a stock option or as a restricted stock award):

|  | Shares<br>Available<br>for<br>Grant | Non-vested Stock<br>Weighted                                    |   | Stock Options<br>Weighted |  |   |                                 |
|--|-------------------------------------|---|---|---------------------------|--|---|---------------------------------|
|  |                                     | Number<br>of<br>Shares<br>(in thousands, except per share data) | Average<br>Grant<br>Date<br>Fair<br>Value | Number<br>of<br>Shares    | Weighted<br>Average<br>Exercise<br>Price | Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|  |                                     |   |   |                           |  |   |                                 |
| Awards outstanding at June 30, 2005        | 1,777                               |   |   | 5,284                     | \$ 11.41                                 |   |                                 |
| Additional shares reserved                 | 1,062                               |   |   |                           |  |   |                                 |
| Awards granted                             | (718)                               | 431   | \$ 14.11                                  | 287                       | 13.07                                    |   |                                 |
| Shares vested                              |                                     |   |   |                           |  |   |                                 |
| Stock options exercised                    |                                     |   |   | (840)                     | 6.88                                     |   |                                 |
| Awards forfeited or expired                | 315                                 |   |   | (315)                     | 13.84                                    |   |                                 |
| Awards outstanding at June 30, 2006        | 2,436                               | 431   | \$ 14.11                                  | 4,416                     | \$ 12.21                                 | 6.31  | \$ 2,125                        |
| Stock options exercisable at June 30, 2006 |                                     |   |   | 3,000                     | \$ 12.80                                 | 5.34  | \$ 1,753                        |

The weighted average grant date fair value of stock options granted during 2004, 2005 and 2006 was \$6.81, \$8.35 and \$8.44, respectively. The total intrinsic value of options exercised during the fiscal years ended June 30, 2004, 2005 and 2006 was approximately \$2.3 million, \$5.2 million and \$5.7 million, respectively. The total fair value of stock options that vested during the fiscal years ended June 30, 2004, 2005 and 2006 was approximately \$7.6 million, \$5.6 million and \$7.0 million, respectively. As of June 30, 2006, there was approximately \$9.7 million of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over a weighted average period of 2.4 years.

The following table presents weighted average price and life information about significant stock option groups outstanding at June 30, 2006:

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | Number Outstanding  | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
|                          |                     | (in thousands, except per share data)       |                                 |                     |                                 |
| \$3.30-\$8.08            | 1,045               | 5.81 years                                  | \$ 6.11                         | 790                 | \$ 5.92                         |
| \$8.09-\$9.54            | 988                 | 6.98 years                                  | 8.98                            | 711                 | 8.79                            |
| \$9.55-\$12.18           | 895                 | 7.87 years                                  | 11.54                           | 363                 | 11.13                           |
| \$12.19-\$14.00          | 902                 | 5.99 years                                  | 13.23                           | 611                 | 13.17                           |
| \$14.01-\$17.54          | 222                 | 4.99 years                                  | 15.21                           | 161                 | 14.76                           |
| \$17.55-\$27.25          | 33                  | 3.73 years                                  | 27.06                           | 33                  | 27.06                           |
| \$27.26-\$39.81          | 307                 | 3.65 years                                  | 35.80                           | 307                 | 35.80                           |
| \$39.82-\$59.00          | 24                  | 3.55 years                                  | 47.57                           | 24                  | 47.57                           |
|                          | 4,416               |   |                                 | 3,000               |                                 |

Prior to July 1, 2005, the Company had not granted awards of restricted stock. The majority of the restricted stock awards vest over a four year period on a vesting schedule similar to the Company's employee stock options, however, restricted stock awards granted annually to the Company's non-employee directors vest over a





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one year period. The restricted stock awards were valued based on the closing price of the Company's common stock on the date of grant, and compensation cost is recorded on a straight line basis over the share vesting period. The Company recorded expense of approximately \$1.3 million associated with its restricted stock awards for the fiscal year ended June 30, 2006. As of June 30, 2006, there was approximately \$4.8 million of unrecognized compensation cost related to restricted stock awards that will be recognized as expense over a weighted average period of 3.14 years. None of the restricted stock awards were vested at June 30, 2006.

**10. Earnings per Share**

The following table sets forth the computation of basic and diluted loss per share:

|   | Year Ended June 30,                   |          |            |
|---|---------------------------------------|----------|------------|
|   | 2004                                  | 2005     | 2006       |
|   | (in thousands, except per share data) |          |            |
| <b>Numerator:</b>   |                                       |          |            |
| Net income (loss)   | \$ (2,418)                            | \$ 5,888 | \$ (1,834) |
| <b>Denominator:</b>   |                                       |          |            |
| Denominator for basic income (loss) per share weighted-average shares outstanding   | 16,514                                | 18,030   | 22,838     |
| Denominator for diluted income (loss) per share weighted-average shares outstanding | 16,514                                | 19,119   | 22,838     |
| Net income (loss) per share:  |                                       |          |            |
| Basic net income (loss) per share   | \$ (0.15)                             | \$ 0.33  | \$ (0.08)  |
| Diluted net income (loss) per share   | \$ (0.15)                             | \$ 0.31  | \$ (0.08)  |

Options to purchase 5,063,000, 1,276,000 and 4,416,000 shares of the Company's common stock for the years ended June 30, 2004, 2005 and 2006, respectively, were excluded from the calculation of diluted earnings per share as the effect would have been anti-dilutive. Warrants for 200,000 shares for fiscal year ended June 30, 2004 and warrants for 100,000 shares for the fiscal year ended June 30, 2005 were excluded from the calculation of diluted earnings per share as the effect would have been anti-dilutive.

**11. Operations by Industry Segments and Geographic Area***Segment Information*

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information", establishes standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company's operating segments are organized principally by the type of products or services offered, and to a lesser degree, by geography. As of July 1, 2005, the Company consolidated the structure of its internal operating segments and changed the nature of the financial information that is provided to and used by the Company's chief operating decision makers. The change in segment composition on July 1, 2005 resulted in the consolidation of the Licensed Technology and Tailored Solutions segments into a single segment, Licensed Technology, and this change is reflected for all periods presented.

*Licensed Technology.* The Company's Licensed Technology segment is a supplier of licensed software products that provide a range of financial business process management solutions including making and collecting payments, sending and receiving invoices, and generating and storing business documents. The Licensed Technology segment also provides solutions designed for banking and financial institution customers,

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which typically involve longer implementation periods and a significant level of professional resources. This segment also provides an array of standard professional services and equipment and supplies that complement and enhance the Company's core software products. Revenue associated with this segment is generally recorded upon delivery, except in situations where a customized software solution is being delivered, in which case revenue is normally recorded on a percentage of completion basis.

*Outsourced Solutions.* The Outsourced Solutions segment provides customers with outsourced or hosted solution offerings that facilitate payment processing and invoice receipt and presentment. Revenue for this segment is generally recognized on a per transaction basis or proportionately over the estimated life of the contract.

Each operating segment has separate sales forces and periodically a sales person in one operating segment will sell products and services that are typically sold within a different operating segment. In such cases, the transaction is generally recorded by the operating segment to which the sales person is assigned. Accordingly, segment results can include the results of transactions that have been allocated to a specific segment based on the contributing sales resources, rather than the nature of the product or service. Conversely, a transaction can be recorded by the operating segment primarily responsible for delivery to the customer, even if the sales person is assigned to a different operating segment. Such decisions are made by the Company's chief operating decision makers.

The Company's chief operating decision makers assess performance based on segment revenue and a segment measure of profit or loss. Each segment's measure of profit or loss is on a pre-tax basis, and excludes stock compensation expense, acquisition-related expenses such as amortization of intangible assets, acquisition related technology write-offs and charges related to acquired in-process research and development. There are no inter-segment sales; accordingly the measure of segment revenue and profit or loss reflects only revenues from external customers. The costs of certain corporate level expenses, primarily general and administrative expenses, are allocated to the Company's operating segments at predetermined rates that approximate cost.

The Company does not track or assign its assets by operating segment.

The Company is presenting segment information for the years ended June 30, 2004, 2005 and 2006 according to the segment descriptions above.

|                                   | Year Ended June 30, |           |            |
|-----------------------------------|---------------------|-----------|------------|
|                                   | 2004                | 2005      | 2006       |
|                                   | (in thousands)      |           |            |
| Revenues:                         |                     |           |            |
| Licensed Technology               | \$ 68,033           | \$ 80,349 | \$ 75,694  |
| Outsourced Solutions              | 14,099              | 16,156    | 25,971     |
| Total revenues                    | \$ 82,132           | \$ 96,505 | \$ 101,665 |
| Segment measure of profit (loss): |                     |           |            |
| Licensed Technology               | \$ 3,262            | \$ 6,930  | \$ 3,294   |
| Outsourced Solutions              | (639)               | 2,102     | 3,944      |
| Total measure of segment profit   | \$ 2,623            | \$ 9,032  | \$ 7,238   |

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A reconciliation of the measure of segment profit to the Company's GAAP operating loss for 2004, 2005 and 2006, before the provision for income taxes, is as follows:

|   | Fiscal Year Ended June 30 |          |            |
|---|---------------------------|----------|------------|
|   | 2004                      | 2005     | 2006       |
|   | (in thousands)            |          |            |
| Segment measure of profit                       | \$ 2,623                  | \$ 9,032 | \$ 7,238   |
| Less:   |                           |          |            |
| Amortization of intangible assets               | (4,277)                   | (3,217)  | (4,491)    |
| Stock compensation expense                      | (41)                      | (14)     | (6,984)    |
| Acquisition related technology write-offs       |                           |          | (189)      |
| In-process research and development             | (842)                     |          |            |
| Other income, net                               | 288                       | 444      | 3,252      |
| Income (loss) before provision for income taxes | \$ (2,249)                | \$ 6,245 | \$ (1,174) |

The following depreciation expense amounts are included in the segment measure of profit (loss):

|                            | Fiscal Year Ended June 30 |          |          |
|----------------------------|---------------------------|----------|----------|
|                            | 2004                      | 2005     | 2006     |
|                            | (in thousands)            |          |          |
| Depreciation expense:      |                           |          |          |
| Licensed Technology        | \$ 1,491                  | \$ 1,662 | \$ 1,584 |
| Outsourced Solutions       | 762                       | 849      | 1,090    |
| Total depreciation expense | \$ 2,253                  | \$ 2,511 | \$ 2,674 |

Net sales, based on the point of sales, not the location of the customer are as follows:

|                                       | Year Ended June 30, |           |            |
|---------------------------------------|---------------------|-----------|------------|
|                                       | 2004                | 2005      | 2006       |
|                                       | (in thousands)      |           |            |
| Sales to unaffiliated customers:      |                     |           |            |
| United States                         | \$ 45,942           | \$ 46,527 | \$ 54,331  |
| United Kingdom                        | 34,883              | 48,300    | 45,471     |
| Australia                             | 1,307               | 1,678     | 1,863      |
| Total sales to unaffiliated customers | \$ 82,132           | \$ 96,505 | \$ 101,665 |

Long-lived assets, which are based on geographical designation, were as follows:

|                    | Fiscal Year Ended June 30 |          |
|--------------------|---------------------------|----------|
|                    | 2005                      | 2006     |
|                    | (in thousands)            |          |
| Long-lived assets: |                           |          |
| United States      | \$ 4,173                  | \$ 4,169 |
| United Kingdom     | 3,675                     | 3,970    |

|                         |          |          |
|-------------------------|----------|----------|
| Australia               | 133      | 214      |
| Total long-lived assets | \$ 7,981 | \$ 8,353 |

## 12. Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109. Under SFAS 109, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax basis of

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assets and liabilities, and are measured by applying tax rates that are expected to be in effect when the differences reverse. Significant components of the Company's deferred income taxes are as follows:

|  | 2005           | June 30,<br>2006 |
|--|----------------|------------------|
|  | (in thousands) |                  |
| Deferred tax assets:                                     |                |                  |
| Allowances and reserves                                  | \$ 870         | \$ 798           |
| Various accrued expenses                                 | 1,131          | 421              |
| Inventory  | 110            | 132              |
| Deferred revenue   | 325            | 711              |
| Intangible assets  | 14,844         | 13,499           |
| Property, plant and equipment                            | 358            | 910              |
| Capital loss and impairment losses on equity investments | 562            | 558              |
| Stock compensation                                       |                | 2,021            |
| Net operating loss carry forward                         | 10,645         | 13,650           |
| Research and development credits                         | 1,666          | 2,081            |
| Other  |                | 314              |
|  | 30,511         | 35,095           |
| Valuation allowance against deferred tax assets          | (30,461)       | (34,295)         |
| Deferred tax liabilities:                                |                |                  |
| Intangible assets  |                | (2,985)          |
| Net deferred tax assets (liabilities)                    | \$ 50          | \$ (2,185)       |

SFAS 109 requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. After consideration of all the evidence, both positive and negative, management has determined that a \$34,295,000 valuation allowance at June 30, 2006 is necessary. The majority (approximately \$33.4 million) of the valuation allowance at June 30, 2006 relates to deferred tax assets associated with the Company's US operations. Additionally, there is a valuation allowance of approximately \$945,000 recorded against certain of the Company's UK deferred tax assets due to specific concerns over the ability to realize these amounts. The change in the valuation allowance for 2006 was \$3,834,000. Upon liquidation of the valuation allowance, approximately \$1,400,000 will be reversed through goodwill as this amount relates to valuation allowances established in the purchase price allocation of the Company's prior business acquisitions.

At June 30, 2006, the Company has available US net operating loss carry-forwards of \$32,669,000, which expire at various times through the year 2026. Included within this loss carry-forward amount is approximately \$13,875,000 of loss carry-forward associated with non-qualified stock options that have been exercised. When realized against future period taxable income, the tax benefit of the stock option deduction will be recorded as an increase to additional paid in capital. The Company also has \$2,081,000 of research and development tax credits available, which expire at various points through year 2026. The operating losses and tax credit carry forwards may be subject to limitations under provisions of the Internal Revenue Code.

The Company has permanently reinvested the earnings of its Australian subsidiaries in the cumulative amount of approximately \$766,000 as of June 30, 2006, and therefore has not provided for U.S. income taxes that could result from the distribution of such earnings to the US parent. If these earnings were ultimately distributed to the US in the form of dividends or otherwise, or if the shares of the Australian subsidiaries were sold or transferred, the Company would likely be subject to additional US income taxes, net of the impact of any available foreign tax credits. It is not practicable to estimate the amount of unrecognized deferred US taxes on these undistributed earnings.

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The provision for income taxes consists of the following:

|           | Year Ended June 30, |          |        |
|-----------|---------------------|----------|--------|
|           | 2004                | 2005     | 2006   |
|           | (in thousands)      |          |        |
| Current:  |                     |          |        |
| Federal   |                     | \$ (378) | \$ 49  |
| State     | \$ 60               | 45       | 7      |
| Foreign   | 78                  | 668      | 1,102  |
|           | 138                 | 335      | 1,158  |
| Deferred: |                     |          |        |
| Federal   |                     |          | 355    |
| State     |                     |          | 62     |
| Foreign   | 31                  | 22       | (915)  |
|           | 31                  | 22       | (498)  |
|           | \$ 169              | \$ 357   | \$ 660 |

Net income (loss) before income taxes by geographic area is as follows:

|                | Year Ended June 30, |          |            |
|----------------|---------------------|----------|------------|
|                | 2004                | 2005     | 2006       |
|                | (in thousands)      |          |            |
| United States  | \$ (1,389)          | \$ 4,079 | \$ (1,491) |
| United Kingdom | (1,087)             | 1,778    | (205)      |
| Australia      | 227                 | 388      | 522        |
|                | \$ (2,249)          | \$ 6,245 | \$ (1,174) |

A reconciliation of the federal statutory rate to the effective income tax rate is as follows:

|   | Year Ended June 30, |        |         |
|---|---------------------|--------|---------|
|   | 2004                | 2005   | 2006    |
| Tax provision (benefit) at federal statutory rate | (34.0)%             | 34.0%  | (34.0)% |
| State taxes, net of federal benefit               | 2.7                 | 4.6    | (7.5)   |
| Non-deductible share-based payments               |                     |        | 72.7    |
| Unbenefited losses/valuation allowance            | 31.0                |        | 35.4    |
| Use of previously reserved deferred tax assets    |                     | (27.1) | (21.0)  |
| Foreign income taxes                              | 4.8                 | (0.2)  | (1.2)   |
| Non-deductible other expenses                     | 4.0                 | (0.4)  | 8.9     |
| US federal tax refund                             |                     | (6.1)  |         |
| Other   | (1.0)               | 0.9    | 2.9     |
|   | 7.5%                | 5.7%   | 56.2%   |

**13. Severance and Exit Costs**

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In connection with the acquisition of Visibillity in December 2005, the Company incurred approximately \$105,000 and \$174,000 related to involuntary termination costs of Visibillity employees and facility exit costs, respectively. As of June 30, 2006 all severance costs related to the Visibillity acquisition had been paid. The accrual for facility exit costs relates to rental costs of a Visibillity leased facility that the Company exited prior to lease expiration and the remaining rental obligation at June 30, 2006 of \$145,000 is being paid ratably over the remainder of the lease, which expires in November 2006.

**Table of Contents****14. Guarantees**

The Company generally offers a standard warranty on its products and services, specifying that its software products will perform in accordance with published product specifications and that any professional services will conform with applicable specifications and industry standards. Further, the Company offers, as an element of its standard licensing arrangements, an indemnification clause that protects the licensee against liability and damages, including legal defense costs, arising from claims of patent, copyright, trademark or other similar infringements by the Company's software products. To date, the Company has not had any significant warranty or indemnification claims against its software products. Warranty accruals were \$0 and \$23,000 at June 30, 2005 and 2006, respectively.

As disclosed in Note 8, Bottomline Europe is a party to an Overdraft Facility, which provides for aggregate borrowings of up to 500,000 British Pound Sterling. Bottomline US has guaranteed repayment of any amounts borrowed under the Overdraft Facility and at June 30, 2006, there were no outstanding borrowings.

**15. Stock Offering**

In July 2005, the Company completed a follow on offering of its common stock. In connection with this offering, the Company issued 3,560,000 shares of stock and generated proceeds, after underwriting discounts, of approximately \$47 million. General Atlantic, a significant stockholder at that time, sold 1,500,000 shares of the Company's common stock in connection with this offering. The Company did not receive any proceeds for the shares sold by General Atlantic.

The Company expects to use the offering proceeds for general corporate purposes, including working capital, product development and capital expenditures. The Company may also use a portion of the proceeds to acquire other complimentary products, technologies or businesses, however there are current commitments or agreements to any such transactions.

**16. Quarterly Financial Data (unaudited)**

|  | For the quarters ended                |                      |                   |                  |                       |                      |                   |                  |
|--|---------------------------------------|----------------------|-------------------|------------------|-----------------------|----------------------|-------------------|------------------|
|  | September 30,<br>2004                 | December 31,<br>2004 | March 31,<br>2005 | June 30,<br>2005 | September 30,<br>2005 | December 31,<br>2005 | March 31,<br>2006 | June 30,<br>2006 |
|  | (in thousands, except per share data) |                      |                   |                  |                       |                      |                   |                  |
| Revenues   | \$ 21,747                             | \$ 23,952            | \$ 24,488         | \$ 26,318        | \$ 24,678             | \$ 26,118            | \$ 24,892         | \$ 25,977        |
| Gross profit                                     | 12,577                                | 13,944               | 13,800            | 15,253           | 13,777                | 14,813               | 12,994            | 14,299           |
| Net income (loss)                                | \$ 679                                | \$ 1,240             | \$ 1,765          | \$ 2,204         | \$ 147                | \$ 1,069             | \$ (2,172)        | \$ (877)         |
| Basic income (loss) per share                    | \$ 0.04                               | \$ 0.07              | \$ 0.10           | \$ 0.12          | \$ 0.01               | \$ 0.05              | \$ (0.09)         | \$ (0.04)        |
| Diluted income (loss) per share                  | \$ 0.04                               | \$ 0.07              | \$ 0.09           | \$ 0.11          | \$ 0.01               | \$ 0.05              | \$ (0.09)         | \$ (0.04)        |
| Shares used in computing income (loss) per share |                                       |                      |                   |                  |                       |                      |                   |                  |
| Basic  | 17,540                                | 17,914               | 18,180            | 18,488           | 22,160                | 22,687               | 23,083            | 23,421           |
| Diluted  | 18,314                                | 18,953               | 19,464            | 19,744           | 23,242                | 22,988               | 23,083            | 23,421           |



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**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.

BOTTOMLINE TECHNOLOGIES (DE), INC.

By: /s/ KEVIN M. DONOVAN  
Kevin M. Donovan

**Chief Financial Officer and Treasurer**

Date: September 12, 2006

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:

| Name  | Title  | Date               |
|---|--|--------------------|
| /s/ DANIEL M. MCGURL<br><b>Daniel M. McGurl</b>       | Chairman of the Board  | September 12, 2006 |
| /s/ JOSEPH L. MULLEN<br><b>Joseph L. Mullen</b>       | Chief Executive Officer and Director (Principal Executive Officer)                 | September 12, 2006 |
| /s/ KEVIN M. DONOVAN<br><b>Kevin M. Donovan</b>       | Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer) | September 12, 2006 |
| /s/ JOSEPH L. BARRY JR.<br><b>Joseph L. Barry Jr.</b> | Director   | September 12, 2006 |
| /s/ JOHN W. BARTER<br><b>John W. Barter</b>           | Director   | September 12, 2006 |
| /s/ ROBERT A. EBERLE<br><b>Robert A. Eberle</b>       | Director   | September 12, 2006 |
| /s/ WILLIAM O. GRABE<br><b>William O. Grabe</b>       | Director   | September 12, 2006 |
| /s/ JEFFREY C. LEATHE<br><b>Jeffrey C. Leathe</b>     | Director   | September 12, 2006 |
| /s/ JAMES L. LOOMIS<br><b>James L. Loomis</b>         | Director   | September 12, 2006 |
| /s/ JAMES W. ZILINSKI<br><b>James W. Zilinski</b>     | Director   | September 12, 2006 |

**James W. Zilinski**

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 3.1(1)             | Amended and Restated Certificate of Incorporation of the Registrant.   |
| 3.2(1)             | Amended and Restated By-Laws of the Registrant.  |
| 4.1(1)             | Specimen Certificate for Shares of Common Stock.   |
| 10.1(1)#           | 1989 Stock Option Plan, as amended, including form of stock option agreement for incentive and non-statutory stock options.  |
| 10.2(1)#           | Amended and Restated 1997 Stock Incentive Plan, including form of stock option agreement for incentive and non-statutory stock options.  |
| 10.3(1)#           | 1998 Director Stock Option Plan, including form of non-statutory stock option agreement.   |
| 10.4(1)#           | 1998 Employee Stock Purchase Plan.   |
| 10.5(1)            | First Amendment and Restatement of Stock Rights and Voting Agreement, as amended.  |
| 10.6(1)            | Second Stock Rights Agreement, as amended.   |
| 10.7(2)            | Lease dated July 20, 1999, between the Registrant and 60 Cutter Mill Road Property Corp.   |
| 10.8(2)            | Lease dated May 22, 2000, between the Registrant and 55 Broad Street L.P.  |
| 10.9(2)            | Lease dated August 31, 2000, between the Registrant and 325 Corporate Drive II, LLC.   |
| 10.10(3)#          | 2000 Stock Incentive Plan, including form of stock option agreement for incentive and non-statutory stock options and form of stock option agreement for United Kingdom personnel. |
| 10.11(4)           | Form of Indemnification Letter dated as of September 21, 2000.   |
| 10.12(5)           | Second Amendment to Sublease, effective as of October 1, 2001, between the Registrant and 325 Corporate Drive II, LLC.   |
| 10.13(6)*          | Loan and Security Agreement dated as of December 28, 2001 between the Registrant and Silicon Valley Bank.  |
| 10.14(6)           | Negative Pledge Agreement dated as of December 28, 2001 between the Registrant and Silicon Valley Bank.  |
| 10.15(6)           | Committed Business Overdraft Facility dated as of December 18, 2001 between Bottomline Technologies Europe Ltd and National Westminster Bank Plc.                                  |
| 10.16(6)           | Legal Charge dated as of December 17, 2001 between Bottomline Technologies Europe Ltd and National Westminster Bank Plc.   |
| 10.17(6)           | Debenture dated as of December 17, 2001 between Bottomline Technologies Europe Ltd and National Westminster Bank Plc.  |
| 10.18(7)           | First Amendment to Sublease between the Registrant and 325 Corporate Drive II, LLC.  |
| 10.19(7)#          | Service Agreement of Mr. Fortune dated as of March 11, 1999.   |
| 10.20(8)#          | Amended and Restated Employment Agreement dated as of November 21, 2002 between the Registrant and Mr. Mullen.   |
| 10.21(8)#          | Amended and Restated Employment Agreement dated as of November 21, 2002 between the Registrant and Mr. Eberle.   |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.22(8)           | First Loan Modification Agreement dated as of December 31, 2002 between the Registrant and Silicon Valley Bank.  |
| 10.23(8)           | Confirmation of Committed Business Overdraft Facility as of January 31, 2003 between Bottomline Technologies Europe Limited and National Westminster Bank Plc.   |
| 10.24(9)           | Second Loan Modification Agreement dated as of January 19, 2004 between the Registrant and Silicon Valley Bank.  |
| 10.25(9)           | Confirmation of Committed Business Overdraft Facility as of January 9, 2004 between Bottomline Technologies Europe Limited and The Royal Bank of Scotland.   |
| 10.26(10)#         | Form of Officer Executive Bonus Plan for 2005 with respect to Joseph Mullen, Robert Eberle and Peter Fortune.  |
| 10.27(11)#         | 2000 Employee Stock Purchase Plan, as amended.   |
| 10.28(11)          | Third Loan Modification Agreement dated as of February 4, 2005 between the Registrant and Silicon Valley Bank.   |
| 10.29(11)          | Confirmation of Committed Business Overdraft Facility as of February 7, 2005 between Bottomline Technologies Europe Limited and Royal Bank of Scotland.  |
| 10.30(12)          | Fourth Loan Modification Agreement dated as of May 4, 2005 between the Registrant and Silicon Valley Bank.   |
| 10.31(13)#         | Letter Agreement dated as of September 30, 2005 between the Registrant and Joseph L. Mullen amending the Amendment and Restated Employment Agreement of Mr. Mullen dated as of November 21, 2002.        |
| 10.32(13)#         | Letter Agreement dated as of September 30, 2005 between the Registrant and Robert A. Eberle amending the Amendment and Restated Employment Agreement of Mr. Eberle dated as of November 21, 2002.        |
| 10.33(13)#         | Executive Retention Agreement dated as of October 10, 2005 between the Registrant and Peter Fortune.   |
| 10.34(13)#         | Restricted Stock Agreement dated as of August 25, 2005 between the Registrant and Joseph L. Mullen.  |
| 10.35(13)#         | Restricted Stock Agreement dated as of August 25, 2005 between the Registrant and Robert A. Eberle.  |
| 10.36(13)#         | Executive Retention Agreement dated as of February 5, 2004 between the Registrant and Kevin M. Donovan.  |
| 10.37(14)#         | Form of Restricted Stock Agreement, dated November 17, 2005, between the Registrant and each Joseph L. Barry, John W. Barter, William O. Grabe, James L. Loomis, Daniel M. McGurl and James W. Zilinski. |
| 10.38(14)#         | Restricted Stock Agreement, dated December 2, 2005, between the Registrant and Kevin M. Donovan.   |
| 10.39(14)#         | Restricted Stock Agreement, dated December 2, 2005, between the Registrant and Peter S. Fortune.   |
| 10.40(14)#         | Forms of Restricted Stock Agreement under 2000 Stock Incentive Plan.   |
| 21.1               | List of Subsidiaries (filed herewith).   |

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 23.1               | Consent of Ernst & Young LLP (filed herewith).   |
| 31.1               | Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer (filed herewith).  |
| 31.2               | Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer (filed herewith).  |
| 32.1               | Section 1350 Certification of Principal Executive Officer (filed herewith).  |
| 32.2               | Section 1350 Certification of Principal Financial Officer (filed herewith).  |
| <hr/>              |  |
| *                  | Certain schedules to this agreement were omitted by the Registrant. The Registrant agrees to furnish any schedule to this agreement supplementally to the Securities and Exchange Commission upon written request. |
| #                  | Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 15(a) of Form 10-K.  |
| (1)                | Incorporated herein by reference to the Registrant's Registration Statement on Form S-1 (File No. 333-67309).  |
| (2)                | Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the Fiscal Year Ended June 30, 2000 (File No. 000-25259), filed on September 28, 2000.   |
| (3)                | Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the Fiscal Year ended June 30, 2004 (File No. 000-25259), filed on September 14, 2004.   |
| (4)                | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended September 30, 2000 (File No. 000-25259), filed on November 14, 2000.                               |
| (5)                | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended September 30, 2001 (File No. 000-25259), filed on November 13, 2001.                               |
| (6)                | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended December 31, 2001 (File No. 000-25259), filed on February 14, 2002.                                |
| (7)                | Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the Fiscal Year Ended June 30, 2002 (File No. 000-25259), filed on September 30, 2002.   |
| (8)                | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended December 31, 2002 (File No. 000-25259), filed on February 12, 2003.                                |
| (9)                | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended December 31, 2003 (File No. 000-25259), filed on February 13, 2004.                                |
| (10)               | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended September 30, 2004 (File No. 000-25259), filed on November 9, 2004.                                |
| (11)               | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended December 31, 2004 (File No. 000-25259), filed on February 8, 2005.                                 |
| (12)               | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended March 31, 2005 (File No. 000-25259), filed on May 6, 2005.   |
| (13)               | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended December 31, 2005 (File No. 000-25259), filed on February 9, 2006.                                 |
| (14)               | Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the Fiscal Quarter Ended March 31, 2006 (File No. 000-25259), filed on May 9, 2006.   |