

FAIR ISAAC & COMPANY INC

Form 10-K/A

January 10, 2003

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K/A**

**Amendment No. 1**

(Mark One)

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

For the fiscal year ended September 30, 2002

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

**[NO FEE REQUIRED]**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-16439

**Fair, Isaac and Company, Incorporated**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**200 Smith Ranch Road**

**San Rafael, California**

*(Address of principal executive offices)*

**94-1499887**

*(I.R.S. Employer  
Identification No.)*

**94903**

*(Zip Code)*

**Registrant's telephone number, including area code:**

**(415) 472-2211**

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

**(Title of Class)**  
Common Stock, \$0.01 par value per share  
Preferred Stock Purchase Rights

**(Name of each exchange on which registered)**  
New York Stock Exchange, Inc.  
New York Stock Exchange, Inc.

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

**None**

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

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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.

As of October 31, 2002, the aggregate market value of the Registrant's common stock held by nonaffiliates of the Registrant was \$1,451,217,274 based on the last transaction price as reported on the New York Stock Exchange. This calculation does not reflect a determination that certain persons are affiliates of the Registrant for any other purposes.

The number of shares of common stock outstanding on October 31, 2002 was 50,729,166 (excluding 4,949,724 shares held by the Company as treasury stock).

Items 10, 11, 12 and 13 of Part III incorporate information by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held on February 3, 2003.

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**EXPLANATORY NOTE**

This Form 10-K/A is being filed solely for the purpose of correcting a typographical error in the Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations of the Form 10-K originally filed with the Securities and Exchange Commission on November 21, 2002.

The Item 7 information below sets forth a corrected disclosure of the percentage of 2002 revenues generated from our alliances with Equifax, TransUnion, and Experian, which accounted for 12%, 8%, and 7% of our 2002 revenues, respectively.

Except for the correction of the typographical error described above, all information in this Form 10-K/A is stated as of the date of filing of the original Form 10-K. This amendment does not otherwise update information in the original filing to reflect facts or events occurring subsequent to the date of the original filing.

**PART II**

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

**RESULTS OF OPERATIONS**

**Overview**

We provide analytic, software and data management products and services that enable businesses to automate and improve decisions. On a combined basis including HNC, our predictive modeling, decision analysis, intelligence management, decision management systems and consulting services power more than 25 billion customer decisions a year. We help companies acquire customers more efficiently, increase customer value, reduce fraud and credit losses, lower operating expenses and enter new markets more profitably. Most leading banks and credit card issuers rely on our solutions, as do insurers, retailers, telecommunications providers, healthcare organizations and government agencies. We also serve consumers through online services that enable people to purchase and understand their FICO® scores, the standard measure of credit risk, to manage their financial health.

On August 5, 2002, we completed our acquisition of HNC, a provider of analytic and decision management software. Results of operations of HNC are included prospectively from the date of acquisition. Accordingly, our financial results in fiscal 2002 are not directly comparable to those in fiscal 2001.

Following our acquisition of HNC, we changed our reportable business segments to reflect the new primary method in which management organizes and evaluates internal financial information to make operating decisions and assess performance. Our current reportable segments include: Scoring Solutions, Strategy Machine Solutions, Professional Services and Analytic Software Tools. Information for fiscal 2001 and 2000 has been restated to conform to the fiscal 2002 presentation for comparability. Comparative segment revenues, operating income, and related financial information for fiscal 2002, 2001 and 2000 are set forth in Note 16 to the Consolidated Financial Statements.

A certification with respect to this report on Form 10-K/A by our Chief Executive Officer and Chief Financial Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002, has been submitted to the Securities and Exchange Commission (SEC) as additional correspondence accompanying this report.

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The following table displays (a) the percentage of revenues by segment and (b) the percentage change in revenues from the prior fiscal year for the fiscal periods indicated.

| Segment                    | Percentage of Revenues |      |      | Period-to-Period Percentage Change |         |
|----------------------------|------------------------|------|------|------------------------------------|---------|
|                            | Fiscal Year            |      |      | 2002                               | 2001    |
|                            | 2002                   | 2001 | 2000 | to 2001                            | to 2000 |
| Scoring Solutions          | 32%                    | 37%  | 37%  | 4%                                 | 9%      |
| Strategy Machine Solutions | 49%                    | 49%  | 49%  | 17%                                | 11%     |
| Professional Services      | 16%                    | 12%  | 13%  | 65%                                | (2)%    |
| Analytic Software Tools    | 3%                     | 2%   | 1%   | 87%                                | 286%    |
| Total Revenues             | 100%                   | 100% | 100% | 19%                                | 10%     |

The growth in Scoring Solutions segment revenues in fiscal 2002 over fiscal 2001 was due primarily to an increase in revenues derived from risk and insurance scoring services at the credit reporting agencies, offset by a decrease in PreScore and ScoreNet services. The growth in risk scoring services resulted primarily from increased sales of scores for account review and increased online scores for auto financing, as well as a continued strong market for mortgage originations and refinancing. The increase in Scoring Solutions revenues in fiscal 2001 as compared to fiscal 2000 resulted primarily from an increase in revenues derived from risk scoring services at the credit reporting agencies, driven predominantly by increased marketing efforts of credit card issuers, and in part by a stronger market for mortgage refinancing in fiscal 2001 as compared to fiscal 2000.

While we have been successful in extending or renewing our agreements with credit reporting agencies and credit card processors in the past, and believe we will likely be able to do so in the future, the loss of one or more such alliances or an adverse change in terms could have a material adverse effect on revenues and operating margins. In fiscal 2002, revenues generated from our alliances with Equifax, TransUnion and Experian accounted for approximately 12%, 8%, and 7% of our revenues, respectively. In fiscal 2001, Equifax, TransUnion and Experian accounted for approximately 11%, 9% and 7% of total revenues, respectively, and in fiscal 2000, TransUnion, Equifax and Experian accounted for approximately 12%, 10% and 7% of total revenues, respectively.

The increase in Strategy Machine Solutions segment revenues in fiscal 2002 over fiscal 2001 was due primarily to increased revenues derived from MarketSmart, consumer score service revenues through myFICO.com and strategic alliance partners Web sites, our Strategy Science offering, Netsourced and Processor TRIAD products, and the addition of products previously offered by HNC, offset by a decrease in revenues from List Processing, maintenance on retired products, CreditDesk and StrategyWare. Revenues derived from the Strategy Machine Solutions segment increased in fiscal 2001 as compared to fiscal 2000, due primarily to the addition of consumer score service revenues through myFICO.com and increased revenues from Liquid Credit, StrategyWare and Processor TRIAD.

The increase in Professional Services revenues in fiscal 2002 over fiscal 2001 was due primarily to increased revenues resulting from the acquisitions of the Nykamp and HNC businesses as well as increased revenues derived from consulting services related to TRIAD, MarketSmart, Strategy Science, Blaze Decision System, and StrategyWare. Revenues derived from the Professional Services segment in fiscal 2001 decreased slightly as compared to fiscal 2000, due mainly to a decrease in consulting related to Strategy Machines Solutions products, offset by an increase in analytic consulting.

The increase in Analytic Software Tools segment revenues in fiscal 2002 over fiscal 2001 was due primarily to the addition of Blaze Advisor revenues previously offered by HNC and to additional revenues from Blaze Decision System (formerly Fair, Isaac Decision System), offset by a decrease in the sale of Model Builder for Decision Trees. Tools revenues increased in fiscal 2001 compared to fiscal 2000 due principally to increased revenues from Blaze Decision System and Strategy Designer products.



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Revenues derived from clients outside the United States totaled \$76.2 million, \$60.0 million and \$57.1 million in fiscal 2002, 2001 and 2000, respectively, representing 19%, 18% and 19% of total consolidated revenues in these years, respectively. The increase in international revenues in fiscal 2002 resulted primarily from increased sales of our TRIAD and Decision System products and Strategy Science services, offset by a decrease in international credit bureau scoring revenue. In fiscal 2001, the increase in international revenues resulted primarily from increased sales of our Strategy Machines Solutions products, including StrategyWare and the increased usage of our Processor TRIAD product. Fluctuations in currency exchange rates have not had a significant effect on revenues to date. In October 2001, we initiated a hedging program to reduce our exposure to fluctuations in certain foreign currency translation rates resulting from holding receivables and cash denominated in foreign currencies within our U.S. reporting entities.

**Operating Expenses and Other Income (Expense)**

The following table sets forth for the fiscal periods indicated (a) the percentage of revenues represented by certain line items in our Consolidated Statements of Income and (b) the percentage change in the amount of each such line item from the prior fiscal year.

|  | Percentage of Revenues |      |      | Period-to-Period<br>Percentage<br>Change |                    |
|--|------------------------|------|------|--|--------------------|
|  | Fiscal Year            |      |      | 2002<br>to<br>2001                       | 2001<br>to<br>2000 |
|  | 2002                   | 2001 | 2000 |  |                    |
| Revenues   | 100%                   | 100% | 100% | 19%                                      | 10%                |
| Operating expenses:                                |                        |      |      |  |                    |
| Cost of revenues                                   | 45%                    | 44%  | 43%  | 18%                                      | 15%                |
| Research and development                           | 9%                     | 9%   | 10%  | 19%                                      | (5)%               |
| Sales, general and administrative                  | 21%                    | 24%  | 30%  | 7%                                       | (13)%              |
| Amortization of intangibles                        | 1%                     | 1%   | 1%   | 109%                                     |                    |
| In-process research and development                | 10%                    |      |      | 100%                                     |                    |
| Restructuring and merger-related                   | 2%                     |      | 1%   | 100%                                     | (100)%             |
| Total operating expenses                           | 88%                    | 78%  | 85%  | 34%                                      | 1%                 |
| Operating income                                   | 12%                    | 22%  | 15%  | (35)%                                    | 62%                |
| Interest income                                    | 2%                     | 2%   | 1%   | 10%                                      | 41%                |
| Interest expense on convertible subordinated notes |                        |      |      | (100)%                                   |                    |
| Other income (expense), net                        |                        |      | (1)% | (204)%                                   | (37)%              |
| Income before income taxes                         | 14%                    | 23%  | 16%  | (31)%                                    | 63%                |
| Provision for income taxes                         | 9%                     | 9%   | 7%   | 15%                                      | 58%                |
| Net income   | 5%                     | 14%  | 9%   | (61)%                                    | 67%                |

**Cost of Revenues**

Cost of revenues consists primarily of employee salaries and benefits for personnel directly involved in creating, installing and supporting revenue products; travel and related overhead costs; costs of computer service bureaus; and our payments made to credit reporting agencies for scores, related outside support in connection with the ScoreNet Service and expenses related to our consumer score services through myFICO.com.

Cost of revenues, as a percentage of revenues, increased in each of fiscal 2002 and 2001 over the prior fiscal year. In fiscal 2002, the increase was primarily due to the acquisition of the Nykamp and HNC businesses and to an increase in direct materials expenses associated with

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our consumer score services through myFICO.com, offset by a reduction in the use of outside consultants and contractors that are relatively more expensive than internal resources. In fiscal 2001, the increase was primarily due to higher operating costs

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incurred for telecommunications services, planning and compliance functions and software and consulting services related to the North American market.

### ***Research and Development***

Research and development expenses include the personnel and related overhead costs incurred in development of new products and services, including research of mathematical and statistical models, and the development of other Strategy Machines Solutions and Analytic Software tools.

Research and development expenses as a percentage of revenues were consistent between fiscal 2002 and fiscal 2001. As a percentage of revenues, the decrease in fiscal 2001 as compared to the prior year was due primarily to the redeployment of research and development personnel to support roles for our new products, particularly within our Strategy Machine Solutions segment.

### ***Sales, General and Administrative***

Sales, general and administrative expenses consist principally of employee salaries and benefits, travel, overhead, advertising and other promotional expenses, corporate facilities expenses, legal expenses, business development expenses, and the cost of operating computer systems.

As a percentage of revenues, sales, general and administrative expenses in fiscal 2002 were lower than in fiscal 2001, due primarily to a reduction in personnel, consulting, sales commission, conference and trade show expenses, offset in part by increased personnel and other expenses resulting from the HNC acquisition. As a percentage of revenues, sales, general and administrative expenses in fiscal 2001 were lower than in fiscal 2000, due primarily to reductions in personnel, consulting and travel expenses as a result of our cost containment efforts.

### ***Amortization of Intangibles***

Amortization of intangibles consists of amortization expense that we have recorded on intangible assets recorded in connection with acquisitions accounted for by the purchase method of accounting. Amortization expense in fiscal 2002 totaled \$4.4 million as compared to amortization expense of \$2.1 million in each of fiscal 2001 and 2000. The increase in fiscal 2002 is attributable primarily to the incremental amortization of intangible assets recorded in connection with the HNC acquisition on August 5, 2002, and to a lesser degree the amortization of intangible assets resulting from our acquisition of assets from Nykamp Consulting Group, Inc. (Nykamp) in December 2001. Our intangible assets are being amortized using the straight-line method over periods ranging from three to fifteen years. See Notes 1 and 2 to the Consolidated Financial Statements for additional information.

### ***In-process Research and Development***

During fiscal 2002, we recorded in-process research and development (IPR&D) expense of \$40.2 million in connection with our acquisition of HNC. IPR&D represents the present value of the estimated after-tax cash flows expected to be generated by purchased technologies that, as of the acquisition dates, had not yet reached technological feasibility. The classification of the technology as complete or under development was made in accordance with the guidelines of Statement of Financial Accounting Standards No. 86: *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, and Financial Accounting Standards Board Interpretation No. 4: *Applicability of SFAS No. 2 to Business Combinations Accounted for by the Purchase Method*. In addition, the Fair Value, as defined below, of the IPR&D projects was determined in accordance with Statement of Financial Accounting Standards No. 141: *Business Combinations*, and SFAS No. 142: *Goodwill and Other Intangible Assets*.

We used an independent appraisal firm to assist us with our valuation of the fair value of the assets purchased from HNC. Fair value is defined as the price at which property would expect to be exchanged between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.

HNC's IPR&D projects consisted of projects within HNC's three legacy suites of software, consisting of the Efficiency, Risk and Opportunity suites, as well as its development of a new software platform technology.

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The current Efficiency Suite products under development as of the acquisition date were Roamex 5.0, which replaces 60% of the existing Roamex code and adds additional capabilities, and Blaze Advisor 4.5, a business rules product that adds additional rules management features to this product line. The current Risk Suite products under development were Falcon 5.0, which will be the first project in a series to replace the legacy Falcon product code base with new Java and platform technology, and Payment Optimizer, a payment optimizer tool that incorporates new platform modeling and profiling components. The current Opportunity Suite product under development was Opportunity Suite Development ( OSD ). OSD was the core engine for this suite, and was a build out of the Optimization and Simulation Environment ( OSE ) application version 2.0 UNIX based running on a web browser. At the time of acquisition, HNC was also in the process of developing a new software platform technology that enables efficient deployment and installation of multiple products while significantly reducing implementation and development costs.

The IPR&D projects were valued through the application of discounted cash flow analyses, taking into account many key characteristics of HNC as well as its future prospects, the rate of technological change in the industry, product life cycles, risks specific to each project, and various projects stage of completion. Stage of completion was estimated by considering the time, cost, and complexity of tasks completed prior to the acquisition, versus the project s overall expected cost, effort and risks required for achieving technological feasibility. In the application of the discounted cash flow analyses, HNC s management provided distinct revenue forecasts for each IPR&D project. The projections were based on the expected date of market introduction, an assessment of customer needs, the expected pricing and cost structure of the related product(s), product life cycles, and the importance of the existing technology relative to the in-process technology. In addition, the costs expected to complete each project were added to the operating expenses to calculate the operating income for each IPR&D project. As certain other assets contribute to the cash flow attributable to the assets being valued, returns to these other assets were calculated and deducted from the pre-tax operating income to isolate the economic benefit solely attributable to each of the in-process technologies. The present value of IPR&D was calculated based on discount rates recommended by the American Institute of Certified Public Accountants IPR&D Practice Aid, which depend on the stage of completion and the additional risk associated with the completion of each of the IPR&D projects. As a recommended basis for the valuation of technology under development, we considered venture capital rates of return as an appropriate measure of the discount rates associated with each IPR&D project. As a result, the earnings associated with the incomplete technology were discounted at a rate ranging from 25% to 60%.

### ***Restructuring and Merger-related***

During fiscal 2002, in connection with our acquisition of HNC, we incurred charges totaling \$7.2 million, consisting of the following: (i) \$5.0 million in restructuring charges, including \$3.2 million in charges associated with our abandonment of a Fair, Isaac facility lease concurrent with the merger, representing future cash obligations under the lease net of estimated sublease income, and \$1.8 million in severance costs associated with a reduction in Fair, Isaac staff in connection with the merger, and (ii) \$2.2 million in other non-recurring merger related costs, consisting primarily of retention bonuses earned through September 30, 2002 by employees with future severance dates and employee outplacement costs.

In October 1999, we announced the discontinuance of our Healthcare Receivables Management System product line, and in connection therewith recorded a restructuring charge totaling \$1.9 million during fiscal 2000. We also recorded a restructuring charge totaling \$1.0 million related to a reduction in staff during fiscal 2000. These restructuring actions were completed during fiscal 2000 and resulted in a combined restructuring charge of \$2.9 million in fiscal 2000, \$0.3 million of which related to the write-down of operating assets. At September 30, 2000, we had an outstanding restructuring liability of \$0.4 million related to these charges, which was included in other accrued liabilities. During fiscal 2001, we made cash payments of \$0.2 million and wrote off \$0.2 million in remaining operating assets such that no remaining restructuring liability existed at September 30, 2001.

### ***Interest Income***

Interest income increased to \$6.4 million in fiscal 2002, as compared to \$5.8 million in fiscal 2001 and \$4.1 million in fiscal 2000. Interest income is derived primarily from the investment of funds in excess of our

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immediate operating requirements. Interest income increased in both fiscal 2002 and 2001, due primarily to higher average cash and investment balances, partially offset by lower interest and investment income yields due to market conditions. Also contributing to the increase in interest income in fiscal 2002 was the contribution of HNC's cash and investment balances as a result of our acquisition of HNC on August 5, 2002.

### ***Interest Expense on Convertible Subordinated Notes***

As a result of the HNC acquisition and subsequent liquidation of the HNC entity, we are the issuer of \$150.0 million in 5.25% convertible subordinated notes due in September 2008. The notes were recorded at their fair value of \$139.7 million on the acquisition date, as determined based on their quoted market price, which resulted in our recognition of a \$10.3 million note discount. The carrying amount of the notes is being accreted to \$150.0 million over their remaining term using the effective interest method, resulting in an effective interest rate of approximately 6.64% per annum. Interest expense on the notes recorded by us totaled \$1.5 million during fiscal 2002.

### ***Other Income (Expense), Net***

Other income (expense), net consists primarily of realized investment gains/ losses, exchange rate gains/ losses resulting from re-measurement of foreign-denominated receivable and cash balances held by our U.S. reporting entities into the U.S. dollar functional currency at period-end market rates, net of the impact of offsetting forward exchange contracts, and other non-operating items. Other income (expense), net was \$1.1 million in fiscal 2002 as compared to \$(1.0) million in fiscal 2001 and \$(1.7) million in fiscal 2000. Other income (expense), net in fiscal 2002 includes \$2.7 million in realized gains on the sale of investments, whereas investment gains/losses were insignificant in fiscal 2001 and 2000. In fiscal 2002 and 2001, we also recorded our share of losses in an early-stage development company accounted for using the equity method, as well as net foreign currency losses.

In fiscal 1998, we entered into a lease arrangement to construct an office complex in San Rafael, California to accommodate future growth. During fiscal 2000, we decided not to build out the site as planned following a five-month study of our options. Under an agreement with the San Rafael City Government, we were released from our obligation to occupy buildings on the site. As a result of the transaction, we recorded a loss of approximately \$1.4 million, which is reflected in other income (expense), net in fiscal 2000.

### ***Provision for Income Taxes***

Our effective tax rate was 66.3%, 40.0%, and 41.3% in fiscal 2002, 2001 and 2000, respectively. The increase in fiscal 2002 compared to fiscal 2001 was due primarily to a \$40.2 million non-deductible IPR&D charge, offset by the reduction of valuation allowance on capital loss carryovers and an increased level of research and development tax credits. The effective tax rate net of the IPR&D adjustment would have been 37.7%. The decrease in fiscal 2001 compared to fiscal 2000 was due to the implementation of an extraterritorial income exclusion tax structure and relatively more income generating activities in states with lower tax rates.

### ***Operating Income***

Operating income in fiscal 2002 decreased as compared to fiscal 2001, primarily as a result of the IPR&D charge and other merger-related costs recorded in connection with the HNC acquisition. Excluding these charges, operating income in fiscal 2002 increased, due principally to increased segment operating income derived from our Strategy Machines Solutions, Scoring Solutions and Analytic Software Tools segments, offset by a decrease in Professional Services segment operating income.

The fiscal 2002 increase in Strategy Machines Solutions segment operating income was due primarily to the increase in revenues from consumer score services through myFICO.com and strategic alliance partners' Web sites. The increase in Scoring Solutions segment operating income was due primarily to the growth in risk and insurance scoring revenues from the credit reporting agencies. The increase in Analytic Software Tools segment operating income was due primarily to an increase in Blaze Decision System and Blaze Advisor revenues in fiscal 2002, the latter of which resulted from the HNC acquisition. The decrease in the Professional Services segment operating income resulted primarily from the acquisitions of Nykamp and

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HNC, which contributed to lower professional services margins, offset by the increase in professional service revenue contributions from these acquisitions.

Operating income in fiscal 2001 increased as compared to fiscal 2000, primarily as a result of increased segment operating income within our Strategy Machines Solutions and Scoring Solutions segments, and to a decline in the Analytic Software Tools segment operating loss. The increased Strategy Machines Solutions segment operating income was attributable primarily to the introduction in fiscal 2001 of consumer score services through myFICO.com and to the elimination of lower operating margins associated with our former Healthcare Receivables Management System line of business, which was discontinued in fiscal 2000. The increase in the Scoring Solutions segment operating income was due primarily to increased revenues related to risk scores from the credit reporting agencies. The decline in the Analytic Software Tools segment operating loss was due principally to increased revenues from Blaze Decision System products and to a lower percentage increase of segment operating expenses.

## **Capital Resources and Liquidity**

Our working capital at September 30, 2002 and 2001 totaled \$338.0 million and \$94.6 million, respectively. The increase in working capital year over year is attributable mainly to an increase in cash and cash equivalents, short-term marketable securities and accounts receivable, primarily resulting from our acquisition of HNC.

Our primary method for funding operations and growth has been through cash flows generated from operations. Net operating cash flows increased from \$70.5 million in fiscal 2001 to \$103.1 million in fiscal 2002, reflecting primarily an increase in net earnings before merger-related IPR&D and other non-cash charges, partially offset by the effect of net working capital changes excluding the impact of the HNC and Nykamp acquisitions. Net operating cash flows increased from \$36.7 million in fiscal 2000 to \$70.5 million in fiscal 2001, reflecting primarily an increase in net earnings before non-cash charges, partially offset by net working capital changes.

Net cash provided by investing activities totaled \$92.5 million in fiscal 2002, compared to net cash used in investing activities of \$98.1 million in fiscal 2001 and \$27.6 million in fiscal 2000. The increase in cash flows from investing activities in fiscal 2002 as compared to fiscal 2001 is attributable primarily to the acquisition of \$143.1 million of HNC cash and cash equivalents and a reduction in purchases of marketable securities, net of sales and maturities year over year, partly offset by cash paid to effect the Nykamp acquisition in fiscal 2002. The increase in cash used in investing activities in fiscal 2001 as compared to fiscal 2000 was attributable primarily to an increase in purchases of marketable securities, net of sales and maturities, partially offset by a decline in purchases of property and equipment year over year.

Net cash used in financing activities totaled \$123.4 million in fiscal 2002, compared to net cash provided by financing activities of \$12.7 million in fiscal 2001 and \$9.7 million in fiscal 2000. The increase in net cash used in financing activities in fiscal 2002, as compared to fiscal 2001, is attributable primarily to a increase in stock repurchases, a decrease in proceeds from issuances of common stock and an increase in cash dividends paid year over year. The increase in net cash provided by financing activities in fiscal 2001 as compared to fiscal 2000 was attributable primarily to an increase in proceeds from issuances of common stock, partially offset by an increase in stock repurchases year over year.

From time to time, we repurchase our common stock in the open market pursuant to programs approved by our Board of Directors. During fiscal 2002, 2001 and 2000, we expended \$144.4 million, \$19.9 million and \$0.1 million, respectively, in connection with our repurchase of common stock under such programs. In August 2002, we announced a 6.0 million share repurchase program. When the current program was announced, we stated an expectation that the volume of repurchases would be made in amounts consistent with the previous quarter's free cash flow and that the program would have a term of up to three years. In November 2002, our board of Directors determined that it is in the Company's best interest to have the discretion to accelerate the rate of repurchase activity and that the Company should not be subject to restrictions on the rate of repurchases or the duration of the program. As of September 30, 2002, approximately 1.1 million shares of our common stock had been repurchased under the current program. We anticipate that we will continue to repurchase shares in accordance with this program.

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We paid quarterly dividends of two cents per share, or eight cents per year, during each of fiscal 2002, 2001 and 2000. Our dividend rate is set by the Board of Directors on a quarterly basis taking into account a variety of factors, including among others, our operating results and cash flows, general economic and industry conditions, our obligations and other factors deemed relevant by the Board. Although we expect to continue to pay dividends at the current rate, our dividend rate is subject to change from time to time based on the Board's business judgment with respect to these and other relevant factors.

In connection with our merger with HNC and the subsequent liquidation of the HNC entity, we are the issuer of \$150,000 of 5.25% Convertible Subordinated Notes that mature on September 1, 2008. The notes are convertible into shares of Fair, Isaac common stock at a conversion rate of approximately 18.02 shares of Fair, Isaac common stock per \$1,000 principal amount of the notes, subject to anti-dilution adjustment. The notes are general unsecured obligations of Fair, Isaac and are subordinated in right of payment to all existing and future senior indebtedness of Fair, Isaac. Interest on the notes is payable on March 1 and September 1 of each year until maturity. We may redeem the notes on or after September 5, 2004, or earlier if the price of Fair, Isaac common stock reaches certain levels. If we redeem the notes prior to September 1, 2007, we will also be required to pay a redemption premium as prescribed by the indenture.

As of September 30, 2002, we had \$421.6 million in cash, cash equivalents and marketable security investments. We believe that these balances, including interest to be earned thereon, and anticipated cash flows from operating activities will be sufficient to fund our working and other capital requirements over the course of the next twelve months and for the foreseeable future. In the normal course of business, we evaluate the merits of acquiring technology or businesses, or establishing strategic relationships with or investing in these businesses. We may elect to use available cash and cash equivalents and marketable security investments to fund such activities in the future. In the event additional needs for cash arise, we may raise additional funds from a combination of sources including the potential issuance of debt or equity securities. Additional financing might not be available on terms favorable to us, or at all, particularly in light of the current decline in the capital markets. If adequate funds were not available or were not available on acceptable terms, our ability to take advantage of unanticipated opportunities or respond to competitive pressures could be limited.

We are party to a credit agreement with a financial institution that provides for a \$15.0 million revolving line of credit through February 2004. Under the agreement we are required to comply with various financial covenants which include but are not limited to, minimum levels of domestic liquidity, parameters for treasury stock repurchases, dividend payments, and merger and acquisition requirements. At our option, borrowings under this agreement bear interest at the rate of LIBOR plus 1.25% or at the financial institution's Prime Rate, payable monthly. This agreement, executed in November 2002, replaces a former \$15.0 million revolving credit facility that was held by HNC. As of September 30, 2002, the former HNC credit facility served to collateralize certain letters of credit aggregating \$0.7 million, made by us in the normal course of business. These letters of credit are now collateralized by the new facility. Our available borrowings under this facility are reduced by the principal amount of letters of credit collateralized by this credit agreement.

We are a limited partner in Azure Capital Partners L.P., a venture capital investment management fund. We are committed to invest an additional \$2.2 million into this fund, and we expect to make this additional investment in fiscal 2003.

## **Critical Accounting Policies and Estimates**

We prepare our financial statements in conformity with U.S. generally accepted accounting principles. These accounting principles require management to make certain judgments and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. We periodically evaluate our estimates including those relating to revenue recognition, the allowance for doubtful accounts, goodwill and other intangible assets, capitalized software development costs, income taxes and contingencies and litigation. We base our estimates on historical experience and various other assumptions that we believe to be reasonable based on the specific circumstances, the results of which form the basis for

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making judgments about the carrying value of certain assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe the following critical accounting policies impact the most significant judgments and estimates used in the preparation of our consolidated financial statements:

### ***Revenue Recognition***

We recognize software license revenue upon delivery, provided all significant obligations have been met, persuasive evidence of an arrangement exists, fees are fixed and determinable, collections are probable, and we are not involved in significant production, customization, or modification of the software or services that are essential to the functionality of the software.

If the arrangement involves (1) development of custom scoring systems or (2) significant production, customization, or modification of software or service essential to the functionality of the software, the revenue is generally recognized under the percentage-of-completion method of contract accounting. Progress toward completion is generally measured by achieving certain standards and objectively verifiable milestones present in each project. In order to apply the percentage of completion of method, management is required to estimate the number of hours needed to complete a particular project. As a result, recognized revenues and profits are subject to revisions as the contract progresses to completion.

Revenues from multiple element arrangements are allocated to each element based on the relative fair values of the elements. The determination of fair value is based on objective evidence that is specific to our business. If such evidence of fair value for each element of the arrangement does not exist, all revenue from the arrangement is deferred until such time that evidence of fair value for each element does exist or until all elements of the arrangement are delivered. If in a multiple element arrangement, fair value does not exist for one or more of the delivered elements in the arrangement, but fair value does exist for all of the undelivered elements, then the residual method of accounting is applied. Under the residual method, the fair value of the undelivered elements is deferred, and the remaining portion of the arrangement fee is recognized as revenue.

Revenue determined by the percentage-of-completion method in excess of contract billings is recorded as unbilled work in progress. Such amounts are generally billable upon reaching certain performance milestones as defined by individual contracts. Billings received in advance of performance under contracts are recorded as billings in excess of earned revenues.

Revenues recognized from our credit scoring, data processing, data management, internet delivery services and consulting are generally recognized as these services are performed, provided all significant obligations have been met, persuasive evidence of an arrangement exists, fees are fixed and determinable, and collections are probable.

Transactional-based license fees under software license arrangements, network service and internally-hosted software agreements are recognized as revenue based on system usage or when fees based on system usage exceed monthly minimum license fees.

Revenues from post-contract customer support, such as maintenance, are recognized on a straight-line basis over the term of the contract.

### ***Allowance for Doubtful Accounts***

We make estimates regarding the collectibility of our accounts receivables. When we evaluate the adequacy of our allowance for doubtful accounts, we closely analyze specific accounts receivable balances, historical bad debts, customer creditworthiness, current economic trends and changes in our customer payment cycles. Material differences may result in the amount and timing of expense for any period if we were to make different judgments or utilize different estimates. If the financial condition of our customers deteriorates resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowances might be required.

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### ***Business Acquisitions; Valuation of Goodwill and Other Intangible Assets***

Our business acquisitions typically result in the recognition of goodwill and other intangible assets, and in certain cases one-time charges associated with the write-off of in-process research and development, which affect the amount of current and future period charges and amortization expense. The determination of value of these components of a business combination, as well as associated asset useful lives, requires management to make various estimates and assumptions. Estimates using different, but each reasonable, assumptions could produce significantly different results.

We continually review the events and circumstances related to our financial performance and economic environment for factors that would provide evidence of the impairment of enterprise-level goodwill. If factors suggesting impairment exist, we use the market value method to determine the extent of the impairment. We will adopt the provisions of Statement of Financial Accounting Standards No. 142 in the first quarter of fiscal 2003, and as a result we will cease to amortize all goodwill. In lieu of amortization, we will be required to perform an initial impairment review based on the estimated fair value of our goodwill and intangible assets as of October 1, 2002 and on a periodic basis thereafter. There are many management assumptions and estimates underlying the determination of an impairment loss, and estimates using different, but each reasonable, assumptions could produce significantly different results. Therefore, the timing and recognition of impairment losses by us in the future, if any, may be highly dependent upon our estimates and assumptions. We have not yet determined whether any impairment loss will result from our initial impairment review in fiscal 2003.

### ***Capitalized Software Development Costs***

We capitalize certain software development costs after establishment of a product's technological feasibility. Such costs are then amortized over the estimated life of the related product. Periodically, we compare a product's unamortized capitalized cost to the product's estimated net realizable value. To the extent unamortized capitalized costs exceed net realizable value based on the product's estimated future gross revenues, reduced by the estimated future costs of completing and disposing of the product, the excess is written off. This analysis requires us to estimate future gross revenues associated with certain products, and the future costs of completing and disposing of certain products. If these estimates change, write-offs of capitalized software costs could result.

### ***Internal-use Software***

Costs incurred to develop internal-use software during the application development stage are capitalized and reported at the lower of cost or net realizable value. Application development stage costs generally include costs associated with internal-use software configuration, coding, installation and testing. Costs of significant upgrades and enhancements that result in additional functionality are also capitalized whereas costs incurred for maintenance and minor upgrades and enhancements are expensed as incurred. We assess potential impairment to capitalized internal-use software whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future net cash flows that are expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

### ***Income Taxes***

We use the asset and liability approach to account for income taxes. This methodology recognizes deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax base of assets and liabilities. We then record a valuation allowance to reduce deferred tax assets to an amount that likely will be realized. We consider future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. If we determine during any period that we could realize a larger net deferred tax asset than the recorded amount, we would adjust the deferred tax asset to increase income for the period. Conversely, if we determine that we would be unable to realize a portion of our recorded deferred tax asset, we would adjust the deferred tax asset to record a charge to income for the period.

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### ***Contingencies and Litigation***

We are subject to various proceedings, lawsuits and claims relating to product, technology, labor, shareholder and other matters. We are required to assess the likelihood of any adverse outcomes and the potential range of probable losses in these matters. The amount of loss accrual, if any, is determined after careful analysis of each matter, and is subject to adjustment if warranted by new developments or revised strategies.

### **New Accounting Pronouncements**

In July 2001, the FASB issued SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires that goodwill and certain intangibles with indefinite lives are no longer amortized, but instead are tested for impairment at least annually or more frequently if impairment circumstances arise. SFAS No. 142 is required to be applied starting with fiscal years beginning after December 15, 2001; therefore, the Company will adopt SFAS 142 beginning October 1, 2002. We are currently evaluating the impact that the adoption of SFAS No. 142 will have on our financial position and results of its operations. Annual goodwill amortization was approximately \$2.1 million for each of the fiscal years 2002, 2001 and 2000.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 revises the accounting for specified employee and contract terminations that are part of restructuring activities and allows recognition of a liability for the cost associated with an exit or disposal activity only when the liability is incurred and can be measured at fair value. This Statement only applies to termination benefits offered for a specific termination event or a specified period. We are required to adopt this statement for exit or disposal activities initiated after December 31, 2002. We do not expect the adoption of this statement to have a significant impact on our financial position and results of operations.

## **RISK FACTORS**

**Although we expect that the recently completed merger between Fair, Isaac and HNC will benefit us, we may not realize those benefits because of integration and other challenges.**

On August 5, 2002, we completed the acquisition of HNC, previously announced on April 29, 2002. Our failure to meet the challenges involved in successfully integrating the operations of Fair, Isaac and HNC or otherwise to realize any of the anticipated benefits of the recently completed merger, including anticipated cost savings, could seriously harm our results of operations. Realizing the benefits of the recently completed merger will depend in part on the continued integration of products, technologies, operations, and personnel. Although we have made progress since the merger was completed, the continued integration is a complex, time-consuming and expensive process that, even with proper planning and implementation, could significantly disrupt our business. In many recent mergers, especially mergers involving technology companies, merger partners have experienced difficulties integrating the combined businesses, and we have not previously faced an integration challenge as substantial as the one presented by the recently completed merger. The challenges involved in this integration include the following:

continuing to persuade employees that the business cultures of Fair, Isaac and HNC are compatible, maintaining employee morale and retaining key employees;

managing a workforce over expanded geographic locations;

demonstrating to our customers that the merger will not lower client service standards, interfere with business focus, adversely affect product quality or alter current product development plans;

consolidating and rationalizing corporate IT and administrative infrastructures;

combining product offerings;

coordinating sales and marketing efforts to effectively communicate our capabilities to current and prospective customers;

coordinating and rationalizing research and development activities to enhance introduction of well designed new products and technologies;



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preserving our marketing or other important relationships and resolving potential conflicts that may arise;

minimizing the diversion of management attention from other ongoing business concerns; and

coordinating and combining overseas operations, relationships and facilities, which may be subject to additional constraints imposed by local laws and regulations.

We may not successfully integrate the operations of Fair, Isaac and HNC in a timely manner, or at all. Moreover, we may not realize the anticipated benefits or synergies of the merger to the extent, or in the time frame, anticipated. The anticipated benefits and synergies relate to cost savings associated with anticipated restructurings and other operational efficiencies, greater economies of scale and revenue growth opportunities through expanded markets and cross-sell opportunities. However, these anticipated benefits and synergies are based on projections and assumptions, not actual experience, and assume a successful integration.

### **Charges to earnings resulting from the application of the purchase method of accounting may cause the market value of our common stock to decline.**

In accordance with United States generally accepted accounting principles, we are accounting for the merger using the purchase method of accounting. Under the purchase method of accounting, we have allocated the total estimated purchase price to HNC's net tangible assets, amortizable intangible assets, intangible assets with indefinite lives and in-process research and development, based on their fair values as of the date of completion of the merger on August 5, 2002. We have recorded the excess of the purchase price over those fair values as goodwill. We have expensed approximately \$40.2 million of the estimated purchase price allocated to in-process research and development in the fourth quarter. We will incur additional depreciation and amortization expense over the useful lives of certain of the net tangible and intangible assets acquired in connection with the merger. Annual amortization of intangible assets is currently estimated at \$13.3 million, as compared to our amortization expense for such items during our most recent completed fiscal year of \$2.1 million. In addition, to the extent the value of goodwill or intangible assets with indefinite lives becomes impaired in the future, we may be required to incur material charges relating to the impairment of those assets. These depreciation, amortization, in-process research and development and potential impairment charges could seriously harm our results of operations.

### **We may incur significant liabilities and merger-related charges resulting from integration of the two companies following the recently completed restructuring.**

We recognized approximately \$7.2 million of merger-related and restructuring costs in the fourth quarter of our fiscal year 2002. However, additional liabilities ultimately will be recorded for severance, retention or relocation costs, costs of vacating some facilities, or other costs associated with ceasing certain activities. These liabilities and charges may be significant and could seriously harm our operating results in future periods.

### **Customer uncertainties related to the recently completed merger could harm our businesses and results of operations.**

Since the merger we have been communicating our future plans to our customers. Despite these efforts there may be customer uncertainty, causing our customers to delay or defer purchasing decisions or elect to switch to other suppliers. In particular, prospective customers could be reluctant to purchase our products due to uncertainty about the direction of our product offerings and our willingness to support and service existing products. Prospective and current clients may worry about how integration of the two companies' technologies may affect current and future products. To the extent that the recently completed merger creates uncertainty among those persons and organizations contemplating product purchases such that one large customer, or a significant group of smaller customers, delays, defers or changes purchases, our results of operations would be seriously harmed. Further, we may have to make additional customer assurances and assume additional obligations to address our customers' uncertainty about the direction of our products and related support offerings. Accordingly, our quarterly results of operations could be substantially below expectations of market analysts, potentially decreasing our stock price.

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**Our effective tax rate after the recently completed merger is uncertain, and any increase in tax liability would harm our operating results.**

The impact of the recently completed merger on our overall effective tax rate is uncertain. Although we will attempt to optimize our overall effective tax rate, it is difficult to predict our effective tax rate following the recently completed merger. The combination of the operations of Fair, Isaac and HNC may result in an overall effective tax rate that is higher than our currently reported tax rate, and it is possible that our combined effective tax rate on a consolidated basis may exceed the average of the pre-merger separate tax rates of Fair, Isaac and HNC.

**We may not be able to sustain the revenue growth rates previously experienced by HNC and Fair, Isaac individually.**

We cannot assure you that we will experience the same rate of revenue growth following the recently completed merger as HNC and Fair, Isaac experienced individually because of the difficulty of maintaining high percentage increases as the base of revenue increases. If our revenue does not increase at or above the rate analysts expect, the trading price for our common stock may decline.

**Any failure to recruit and retain additional qualified personnel, more challenging in light of uncertainty following the recent acquisition, could hinder our ability to successfully manage our business.**

Our future success will likely depend in large part on our ability to attract and retain experienced sales, research and development, marketing, technical support and management personnel. Employee retention may be particularly challenging in connection with the recently completed acquisition as a result of employee uncertainty about their future roles, the distractions of integration, and morale challenges posed by workforce reductions that occurred after completion of the acquisition. Moreover, the complexity of our products requires highly trained customer service and technical support personnel to assist customers with product installation and deployment. The labor market for these persons is very competitive due to the limited number of people available with the necessary technical skills and understanding. We have experienced difficulty in recruiting qualified personnel, especially technical and sales personnel, and we may need additional staff to support new customers and/or increased customer needs. We may also recruit and employ skilled technical professionals from other countries to work in the United States. Limitations imposed by federal immigration laws and the availability of visas could hinder our ability to attract necessary qualified personnel and harm our business and future operating results. There is a risk that even if we invest significant resources in attempting to attract, train and retain qualified personnel, we will not succeed in our efforts, and our business could be harmed.

**Since our revenues depend, to a great extent upon conditions in the consumer credit, financial services and insurance industries, and to some extent on general economic conditions, an industry specific or general downturn may harm our results of operations.**

During fiscal 2002, approximately 90% of our revenues were derived from sales of products and services to the consumer credit, financial services and insurance industries. A downturn in the consumer credit, the financial services or the insurance industry, including a downturn caused by increases in interest rates or a tightening of credit, among other factors, could harm our results of operations. Since 1990, while the rate of account growth in the U.S. bankcard industry has been slowing and many of our large institutional clients have merged and consolidated, we have generated most of our revenue growth from our bankcard-related scoring and account management businesses by selling and cross-selling our products and services to large banks and other credit issuers. As this industry continues to consolidate, we may have fewer opportunities for revenue growth due to changing demand for our products and services that support clients' customer acquisition programs. In addition, industry consolidation could affect the base of recurring revenues derived from contracts in which we are paid on a per-transaction basis if consolidated customers combine their operations under one contract. We cannot assure you that we will be able effectively to promote future revenue growth in our businesses.

In addition, a softening of demand for our decisioning solutions or other products and services caused by a weakening of the economy generally may result in decreased revenues or lower growth rates. Due to the

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current slowdown in the economy generally, we believe that many of our existing and potential customers are reassessing or reducing their planned technology investments and deferring purchasing decisions. As a result, there is increased uncertainty with respect to our expected revenues. Further delays or reductions in business spending for business analytics could seriously harm our revenues and operating results.

**Quarterly revenues and operating results have varied in the past and this unpredictability may continue in the future and could lead to substantial declines in the market price for our common stock.**

Our revenues and operating results varied in the past and future fluctuations in our operating results are possible. Consequently, we believe that you should not rely on period-to-period comparisons of financial results as an indication of future performance. Our future operating results may fall below the expectations of market analysts and investors, and in this event the market price of our common stock would likely fall. In addition, most of our operating expenses will not be affected by short-term fluctuations in revenues; thus, short-term fluctuations in revenues may significantly impact operating results. Factors that will affect our revenues and operating results include the following:

- variability in demand from our existing customers;
- the lengthy and variable sales cycle of many products;
- consumer dissatisfaction with, or problems caused by, the performance of our products;
- the relatively large size of orders for our products and our inability to compensate for unanticipated revenue shortfalls;
- the timing of new product announcements and introductions in comparison with our competitors;
- the level of our operating expenses;
- changes in competitive conditions in the consumer credit, financial services and insurance industries;
- fluctuations in domestic and international economic conditions;
- our ability to complete large installations on schedule and within budget;
- acquisition-related expenses and charges; and
- timing of orders for and deliveries of software systems.

**We may not be able to forecast our revenues accurately because our products have a long and variable sales cycle.**

We cannot predict the timing of the recognition of our revenues accurately because the length of our sales cycles makes it difficult for us to predict the quarter in which sales to expected customers will occur. The long sales cycle for our products may cause license revenue and operating results to vary significantly from period to period. The sales cycle to license our products can typically range from 60 days to 18 months. Customers are often cautious in making decisions to acquire our products, because purchasing our products typically involves a significant commitment of capital, and may involve shifts by the customer to a new software and/or hardware platform or changes in the customer's operational procedures. Delays in completing sales can arise while customers complete their internal procedures to approve large capital expenditures and test and accept our applications. Consequently, we face difficulty predicting the quarter in which sales to expected customers will occur. This has contributed, and we expect it to continue to contribute, to fluctuations in our operating results.

**We derive a substantial portion of our revenues from a small number of products and services, and our revenue will decline if the market does not continue to accept these products and services.**

We expect that revenues from some or all of our Falcon Fraud Manager, Decision Manager for Medical Bill Review and Outsourced Bill Review products and services, and agreements with TransUnion, Equifax and Experian, will account for a substantial portion of our total revenues for the foreseeable future. Our revenue



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will decline if the market does not continue to accept these products and services. Factors that might affect the market acceptance of these products and services include the following:

changes in the business analytics industry;

technological change;

our inability to obtain or use state fee schedule or claims data in our insurance products;

saturation of market demand;

loss of key customers;

industry consolidation;

factors that reduce the effectiveness of or need for fraud detection capabilities; and

reduction of the use of credit and other payment cards as payment methods.

**We will continue to depend upon major contracts with credit reporting agencies, and our future revenue could decline if the terms of these relationships change.**

We will continue to derive a substantial portion of our revenues from contracts with the three major credit reporting agencies. These contracts, which normally have a term of five years or less, accounted for approximately 27% of our revenues in fiscal 2002. If we are unable to renew any of these contracts on the same or similar terms, our revenues and results of operations would be harmed.

**Our revenue growth could decline if any major customer cancels, reduces or delays a purchase of our products.**

Most of our customers are relatively large enterprises, such as banks, insurance companies, healthcare firms, retailers and telecommunications carriers. Our future success will depend upon the timing and size of future licenses, if any, from these customers and new customers. Many of our customers and potential customers are significantly larger than we are and may have sufficient bargaining power to demand reduced prices and favorable nonstandard terms. The loss of any major customer, or the delay of significant revenue from these customers, could reduce or delay our recognition of revenue.

**Our ability to increase our revenues will depend to some extent upon introducing new products and services, and if the marketplace does not accept these new products and services, our revenues may decline.**

We will have a significant share of the available market in our Scoring segment and for certain services in our Strategy Machine Solutions segment (specifically, account management services at credit card processors and in the market for credit card fraud detection software through our Falcon products). To increase our revenues, we must enhance and improve existing products and continue to introduce new products and new versions of existing products that keep pace with technological developments, satisfy increasingly sophisticated customer requirements and achieve market acceptance. We believe much of our future growth prospects will rest on our ability to continue to expand into newer markets for our products and services, such as direct marketing, insurance, small business lending, retail, telecommunications, personal credit management, the design of business strategies using Strategy Science technology and internet services. These areas are relatively new to our product development and sales and marketing personnel, and completely new to some personnel integrated as a result of the merger. Products that we plan to market in the future are in various stages of development. We cannot assure you that the marketplace will accept these products. If our current or potential customers are not willing to switch to or adopt our new products and services, our revenues will decrease.

**Defects, failures and delays associated with our introduction of new products could seriously harm our business.**

Significant undetected errors or delays in new products or new versions of products, especially in the area of customer relationship management, may affect market acceptance of our products and could harm our business, results of operations or financial position. If we were to experience delays in commercializing and



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introducing new or enhanced products, if our customers were to experience significant problems with implementing and installing our products, or if our customers were dissatisfied with our products' functionality or performance, our business, results of operations or financial position could be harmed. In the past, we have experienced delays while developing and introducing new products and product enhancements, primarily due to difficulties developing models, acquiring data and adapting to particular operating environments. Errors or defects in our products that are significant, or are perceived to be significant, could result in the rejection of our products, damage to our reputation, lost revenues, diverted development resources, potential product liability claims and increased service and support costs and warranty claims.

### **If we fail to keep up with rapidly changing technologies, our products could become less competitive or obsolete.**

In our markets, technology changes rapidly, and there are continuous improvements in computer hardware, network operating systems, programming tools, programming languages, operating systems, database technology and the use of the Internet. If we fail to enhance our current products and develop new products in response to changes in technology or industry standards, our products could rapidly become less competitive or obsolete. For example, the rapid growth of the Internet environment creates new opportunities, risks and uncertainties for businesses, such as ours, which develop software that must also be designed to operate in Internet, intranet and other online environments. Our future success will depend, in part, upon our ability to:

internally develop new and competitive technologies;

use leading third-party technologies effectively;

continue to develop our technical expertise;

anticipate and effectively respond to changing customer needs;

initiate new product introductions in a way that minimizes the impact of customers delaying purchases of existing products in anticipation of new product releases; and

influence and respond to emerging industry standards and other technological changes.

### **New product introductions and pricing strategies by our competitors could decrease our product sales and market share, or could pressure us to reduce our product prices in a manner that reduces our margins.**

We may not be able to compete successfully against our competitors, and this inability could impair our capacity to sell our products. The market for business analytics is new, rapidly evolving and highly competitive, and we expect competition in this market to persist and intensify. Our competitors vary in size and in the scope of the products and services they offer, and include:

in-house analytics departments; credit reporting agencies;

computer service providers;

regional risk management, marketing, systems integration and data warehousing competitors;

application software companies, including enterprise software vendors;

management information system departments of our customers and potential customers, including financial institutions, insurance companies and telecommunications carriers;

third-party professional services and consulting organizations;

internet companies;

hardware suppliers that bundle or develop complementary software;

network and telecommunications switch manufacturers, and service providers that seek to enhance their value-added services;

neural network tool suppliers; and

managed care organizations.

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We expect to experience additional competition from other established and emerging companies, as well as from other technologies. For example, our Falcon Fraud Manager and Falcon Fraud Manager for Merchants products compete against other methods of preventing credit card fraud, such as credit cards that contain the cardholder's photograph, smart cards, cardholder verification and authentication solutions and other card authorization techniques. Many of our anticipated competitors have greater financial, technical, marketing, professional services and other resources than we do. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements. They may also be able to devote greater resources than we can to develop, promote and sell their products. Many of these companies have extensive customer relationships, including relationships with many of our current and potential customers. Furthermore, new competitors or alliances among competitors may emerge and rapidly gain significant market share. If we are unable to respond as quickly or effectively to changes in customer requirements as our competition, our ability to expand our business and sell our products will be negatively affected.

Our competitors may be able to sell products competitive to ours at lower prices individually or as part of integrated suites of several related products. This ability may cause our customers to purchase products of our competitors that directly compete with our products. Price reductions by our competitors could negatively impact our margins and results of operations, and could also harm our ability to obtain new long-term contracts and renewals of existing long-term contracts on favorable terms.

### **We will continue to rely upon proprietary technology rights, and if we are unable to protect them, our business could be harmed.**

Our success will depend, in part, upon our proprietary technology and other intellectual property rights. To date, we have relied primarily on a combination of copyright, patent, trade secret, and trademark laws, and nondisclosure and other contractual restrictions on copying and distribution to protect our proprietary technology. Because the protection of our proprietary technology is limited, our proprietary technology could be used by others without our consent. In addition, patents may not be issued with respect to our pending or future patent applications, and our patents may not be upheld as valid or may not prevent the development of competitive products. Any disclosure, loss, invalidity of, or failure to protect our intellectual property could negatively impact our competitive position, and ultimately, our business. We cannot assure you that our means of protecting our intellectual property rights in the United States or abroad will be adequate or that others, including our competitors, will not use our proprietary technology without our consent. Furthermore, litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition.

In addition, some of our technologies were developed under research projects conducted under agreements with various United States government agencies or subcontractors. Although we have commercial rights to these technologies, the United States government typically retains ownership of intellectual property rights and licenses in the technologies developed by us under these contracts, and in some cases can terminate our rights in these technologies if we fail to commercialize them on a timely basis. Under these contracts with the United States government, the results of research may be made public by the government, limiting our competitive advantage with respect to future products based on our research.

### **We may be subject to possible infringement claims that could harm our business.**

With recent developments in the law that permit patenting of business methods, we expect that products in the industry segments in which we will compete, including software products, will increasingly be subject to claims of patent infringement as the number of products and competitors in our industry segments grow and the functionality of products overlaps. We will have to defend claims made against our products, and such claims may require us to:

incur significant defense costs or substantial damages;

cease the use or sale of infringing products;

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expend significant resources to develop or license a substitute non-infringing technology;

discontinue the use of some technology; or

obtain a license under the intellectual property rights of the third party claiming infringement, which license may not be available or might require substantial royalties or license fees that would reduce our margins.

**Security is important to our business, and breaches of security, or the perception that e-commerce is not secure, could harm our business.**

Internet-based, business-to-business electronic commerce requires the secure transmission of confidential information over public networks. Several of our products are accessed through the Internet, including our new consumer services accessible through the www.myfico.com website. Consumers using the Internet to access their personal information will demand the secure transmission of such data. Security breaches in connection with the delivery of our products and services, including our netsourced products and consumer services, or well-publicized security breaches affecting the Internet in general, could significantly harm our business, operating results and financial condition. We cannot be certain that advances in computer capabilities, new discoveries in the field of cryptography, or other developments will not compromise or breach the technology protecting the networks that access our netsourced products, consumer services and proprietary database information.

**We may incur risks related to acquisitions or significant investment in businesses.**

We have made in the past, and may make in the future, acquisitions of, or significant investments in, businesses that offer complementary products, services and technologies. Any acquisitions or investments will be accompanied by the risks commonly encountered in acquisitions of businesses. Such risks include:

the possibility that we will pay more than the acquired companies or assets are worth;

the difficulty of assimilating the operations and personnel of the acquired businesses;

the potential product liability associated with the sale of the acquired companies' products;

the potential disruption of our ongoing business;

the potential dilution of our existing stockholders and earnings per share;

unanticipated liabilities, legal risks and costs;

the distraction of management from our ongoing business; and

the impairment of relationships with employees and clients as a result of any integration of new management personnel.

These factors could harm our business, results of operations or financial position, particularly in the event of a significant acquisition.

**If our products do not comply with government regulations that apply to us or to our customers, we could be exposed to liability or our products could become obsolete.**

Legislation and governmental regulation inform how our business is conducted. Both our core businesses and our newer consumer initiatives are affected by regulation. Significant regulatory areas include:

federal and state regulation of consumer report data and consumer reporting agencies, such as the Fair Credit Reporting Act, or FCRA;

regulation designed to insure that lending practices are fair and non-discriminatory, such as the Equal Credit Opportunity Act;

privacy law, such as provisions of the Financial Services Modernization Act of 1999 and the Health Insurance Portability and Accountability Act of 1996;

regulations governing the extension of credit to consumers and by Regulation E under the Electronic Fund Transfers Act, as well as non-governmental VISA and MasterCard electronic payment standards;

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Fannie Mae and Freddie Mac regulations, among others, for our mortgage services products;

insurance regulations related to our insurance products; and

consumer protection laws, such as federal and state statutes governing the use of the Internet and telemarketing.

In connection with our core activities, these statutes will continue, to some degree, to directly govern our operations. For example, the Financial Services Modernization Act restricts our use and transmittal of nonpublic personal information, grants consumers opt out rights, requires us to make disclosures to consumers about our collection and use of personal information and governs when and how we may deliver credit score explanation services to consumers. Many foreign jurisdictions relevant to our business will also regulate our operations. For example, the European Union's Privacy Directive creates minimum standards for the protection of personal data. In addition, some EU member states have enacted protections which go beyond the requirements of the Privacy Directive. We will be subject to the risk of possible regulatory enforcement actions if we fail to comply with any of the statutes governing our operations.

Additionally, existing regulation and legislation is subject to change or more restrictive interpretation by enforcement agencies, and new restrictive legislation might pass. For example, new legislation might restrict the sharing of information by affiliated entities, mandate providing credit scores to consumers, or narrow the permitted uses of consumer report data. Currently, the permitted uses of consumer report data in connection with customer acquisition efforts are governed primarily by the FCRA, whose federal preemption provisions effectively expire in 2004. Unless extended, this expiration could lead to greater state regulation, increasing the cost of customer acquisition activity. State regulation could cause financial institutions to pursue new strategies, reducing the demand for our products. In addition, in many states, including California, there have been periodic legislative efforts to reform workers' compensation laws in order to reduce workers' compensation insurance costs and to curb abuses of the workers' compensation system. Simplifying state workers' compensation laws, regulations or fee schedules could diminish the need for, and the benefits provided by our Decision Manager for Medical Bill Review products and Outsourced Bill Review services. Any changes to existing regulation or legislation, new regulation or legislation, or more restrictive interpretation of existing regulation could harm our business, results of operations and financial condition.

Finally, governmental regulation influences our current and prospective clients' activities, as well as their expectations and needs in relation to our products and services. For example, our clients include credit reporting agencies, credit card processors, telecommunications companies, state and federally chartered banks, savings and loan associations, credit unions, consumer finance companies, insurance companies and other consumer lenders, all of which are subject to extensive and complex federal and state regulations, and often international regulations. Moreover, industries of our future clients may also be subject to extensive regulations. We must appropriately design products and services to function in regulated industries or risk liability to our customers for our products' non-compliance.

**Failure to obtain data from our clients to update and re-develop or to create new models could harm our business.**

To develop, install and support our products, including consumer credit, financial services, predictive modeling, decision analysis, intelligence management, credit card fraud control and profitability management, loan underwriting and insurance products, we will require periodic updates of our technologies and models. We must develop or obtain a reliable source of sufficient amounts of current and statistically relevant data to analyze transactions and update our models. In most cases, these data must be periodically updated and refreshed to enable our products to continue to work effectively in a changing environment. We do not own or control much of the data that we require, most of which are collected privately and maintained in proprietary databases. Generally, our customers agree to provide us the data we require to analyze transactions, report results and build new models. If we fail to maintain good relationships with our customers, or if they decline to provide such data due to legal privacy concerns or a lack of permission from their own customers, we could lose access to required data and our products might become less effective. In addition, our Decision Manager for Medical Bill Review products use data from state workers' compensation fee schedules adopted by state regulatory agencies. Third parties have previously asserted copyright interests in these data. These assertions,

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if successful, could prevent us from using these data. Any interruption of our supply of data could seriously harm our business, financial condition or results of operations.

**Our operations outside the United States subject us to unique risks that may harm our results of operations.**

A growing portion of our revenues is derived from international sales. During fiscal 2002, approximately 19% of our revenues were derived from business outside the United States. As part of our growth strategy, we plan to continue to pursue opportunities outside the United States. Accordingly, our future operating results could be negatively affected by a variety of factors arising out of international commerce, some of which are beyond our control. These factors include:

the general economic and political conditions in countries where we sell our products and services;

incongruent tax structures;

difficulty in staffing our operations in various countries;

the effects of a variety of foreign laws and regulations;

import and export licensing requirements;

longer payment cycles;

potentially reduced protection for intellectual property rights;

currency fluctuations;

changes in tariffs and other trade barriers; and

difficulties and delays in translating products and related documentation into foreign languages.

We cannot assure you that we will be able to successfully address each of these challenges in the near term.

Additionally, some of our business will be conducted in currencies other than the U.S. dollar. Foreign currency transaction gains and losses are not currently material to our financial position, results of operations or cash flows. However, an increase in our foreign revenues could subject us to increased foreign currency transaction risks in the future.



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/s/ DAVID S. P. HOPKINS\*

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Director

January 10, 2003

David S. P. Hopkins

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/s/ MARGARET L. TAYLOR\*

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Director

January 10, 2003

Margaret L. Taylor

\*By /s/ KENNETH J. SAUNDERS

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Kenneth J. Saunders  
Attorney-in-Fact

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**CERTIFICATIONS**

I, Thomas G. Grudnowski, certify that:

1. I have reviewed the Report on Form 10-K/A of Fair, Isaac and Company, Incorporated;
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the Report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the Report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of the Report (the "Evaluation Date"); and
  - c) presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in the Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: January 10, 2003

/s/ THOMAS G. GRUDNOWSKI

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Thomas G. Grudnowski  
*Chief Executive Officer*

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**CERTIFICATIONS (Continued)**

I, Kenneth J. Saunders, certify that:

1. I have reviewed the Report on Form 10-K/A of Fair, Isaac and Company, Incorporated;
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the Report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the Report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of the Report (the "Evaluation Date"); and
  - c) presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in the Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: January 10, 2003

/s/ KENNETH J. SAUNDERS

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Kenneth J. Saunders  
*Chief Financial Officer*