

DST SYSTEMS INC  
Form 10-Q  
May 10, 2005

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2005**

**or**

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

**For the transition period from            to**

**Commission File Number 1-14036**

**DST SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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

**333 West 11th Street, Kansas City, Missouri**  
(Address of principal executive offices)

**43-1581814**  
(I.R.S. Employer  
Identification No.)

**64105**  
(Zip Code)

**(816) 435-1000**

(Registrant's telephone number, including area code)

**No Changes**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Number of shares outstanding of the Company's common stock as of April 29, 2005:

Common Stock \$0.01 par value 83,457,923

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DST Systems, Inc.

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March 31, 2005

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The brand, service or product names or marks referred to in this Report are trademarks or services marks, registered or otherwise, of DST Systems, Inc. or its subsidiaries or affiliates or of vendors to the Company.



**DST Systems, Inc.**

**Form 10-Q**

**March 31, 2005**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Introductory Comments**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto for the year ended December 31, 2004.

The results of operations for the three months ended March 31, 2005, are not necessarily indicative of the results to be expected for the full year 2005.

## DST Systems, Inc.

## Condensed Consolidated Balance Sheet

*(dollars in millions, except per share amounts)**(unaudited)*

|   | March 31,<br>2005 | December 31,<br>2004 |
|---|-------------------|----------------------|
| <b>ASSETS</b>   |                   |                      |
| Current assets  |                   |                      |
| Cash and cash equivalents   | \$ 97.3           | \$ 95.0              |
| Restricted cash   | 11.9              | 12.0                 |
| Transfer agency investments   | 70.3              | 75.2                 |
| Accounts receivable   | 417.9             | 462.0                |
| Other current assets  | 91.1              | 110.4                |
| Assets of business held for sale  | 272.1             | 41.4                 |
|   | 960.6             | 796.0                |
| Investments   | 1,351.1           | 1,473.7              |
| Properties  | 649.7             | 654.9                |
| Goodwill  | 117.0             | 117.1                |
| Intangibles   | 90.8              | 92.5                 |
| Other assets  | 70.9              | 36.3                 |
| Assets of business held for sale  | 212.1             | 212.9                |
| Total assets  | \$ 3,452.2        | \$ 3,383.4           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                   |                      |
| Current liabilities   |                   |                      |
| Debt due within one year  | \$ 214.7          | \$ 109.2             |
| Transfer agency deposits  | 70.3              | 75.2                 |
| Accounts payable  | 174.9             | 178.9                |
| Accrued compensation and benefits   | 71.3              | 96.9                 |
| Deferred revenues and gains   | 100.0             | 75.0                 |
| Other liabilities   | 100.9             | 107.6                |
| Liabilities of business held for sale   | 292.3             | 70.7                 |
|   | 1,024.4           | 713.5                |
| Long-term debt  | 1,298.7           | 1,373.7              |
| Deferred income taxes   | 422.0             | 466.2                |
| Other liabilities   | 83.0              | 84.2                 |
|   | 2,828.1           | 2,637.6              |
| Commitments and contingencies (Note 6)  |                   |                      |
| Stockholders' equity  |                   |                      |
| Common stock, \$0.01 par; 400 million shares authorized, 95.3 million shares issued | 1.0               | 1.0                  |
| Additional paid-in capital  | 220.1             | 226.3                |
| Retained earnings   | 786.6             | 737.4                |
| Unearned compensation   | (122.7)           | (132.6)              |
| Treasury stock (11.9 million and 12.3 million shares, respectively), at cost        | (509.4)           | (525.4)              |
| Stock under forward purchase agreement  | (105.8)           |                      |
| Accumulated other comprehensive income  | 354.3             | 439.1                |
| Total stockholders' equity  | 624.1             | 745.8                |
| Total liabilities and stockholders' equity  | \$ 3,452.2        | \$ 3,383.4           |

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



**DST Systems, Inc.****Condensed Consolidated Statement of Income***(in millions, except per share amounts)**(unaudited)*

|   | <b>For the Three Months<br/>Ended March 31,</b> |                |
|---|---|----------------|
|   | <b>2005</b>                                     | <b>2004</b>    |
| Operating revenues                              | \$ 437.1  | \$ 430.0       |
| Out-of-pocket reimbursements                    | 191.2   | 179.5          |
| <b>Total revenues</b>                           | <b>628.3</b>                                    | <b>609.5</b>   |
| Costs and expenses                              | 515.7   | 491.2          |
| Depreciation and amortization                   | 35.8  | 36.4           |
| <b>Income from operations</b>                   | <b>76.8</b>                                     | <b>81.9</b>    |
| Interest expense                                | (16.6)  | (13.5)         |
| Other income, net                               | 7.7   | 6.5            |
| Equity in earnings of unconsolidated affiliates | 7.9   | 5.1            |
| <b>Income before income taxes</b>               | <b>75.8</b>                                     | <b>80.0</b>    |
| Income taxes                                    | 26.6  | 28.4           |
| <b>Net income</b>                               | <b>\$ 49.2</b>                                  | <b>\$ 51.6</b> |
| Average common shares outstanding               | 78.4  | 84.1           |
| Diluted shares outstanding                      | 80.9  | 86.5           |
| <b>Basic earnings per share</b>                 | <b>\$ 0.63</b>                                  | <b>\$ 0.61</b> |
| <b>Diluted earnings per share</b>               | <b>\$ 0.61</b>                                  | <b>\$ 0.60</b> |

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



## DST Systems, Inc.

## Condensed Consolidated Statement of Cash Flows

*(in millions)**(unaudited)*

|   | For the Three Months<br>Ended March 31, |         |
|---|---|---------|
|   | 2005                                    | 2004    |
| <b>Cash flows operating activities:</b>                         |   |         |
| Net income  | \$ 49.2                                 | \$ 51.6 |
| Depreciation and amortization                                   | 35.8                                    | 36.4    |
| Equity in earnings of unconsolidated affiliates                 | (7.9)                                   | (5.1)   |
| Net realized gain on investments                                | (1.0)                                   | (3.6)   |
| Amortization of unearned compensation on restricted stock       | 6.4                                     |         |
| Deferred income taxes   | 9.6                                     | 7.6     |
| Increase (decrease) in restricted cash                          | 0.1                                     | (1.6)   |
| Decrease in accounts receivable                                 | 44.7                                    | 13.0    |
| Increase in inventories and other assets                        | (20.8)                                  | (12.9)  |
| Increase in transfer agency investments                         | (228.0)                                 | (342.8) |
| Increase in transfer agency deposits                            | 228.0                                   | 342.8   |
| Increase (decrease) in accounts payable and accrued liabilities | (9.7)                                   | 12.9    |
| Increase (decrease) in deferred revenues and gains              | 31.8                                    | (3.4)   |
| Decrease in accrued compensation and benefits                   | (30.0)                                  | (26.4)  |
| Other, net  | 3.9                                     | 2.1     |
| Total adjustments to net income                                 | 62.9                                    | 19.0    |
| Net   | 112.1                                   | 70.6    |
| <b>Cash flows investing activities:</b>                         |   |         |
| Capital expenditures  | (33.8)                                  | (39.9)  |
| Proceeds from sale of investments                               | 3.2                                     | 11.9    |
| Investments in securities                                       | (7.7)                                   | (9.7)   |
| Investments in and advances to unconsolidated affiliates        | (0.7)                                   | (13.9)  |
| Contingent payment for purchase of EquiServe                    |   | (25.6)  |
| Other, net  |   | 1.2     |
| Net   | (39.0)                                  | (76.0)  |
| <b>Cash flows financing activities:</b>                         |   |         |
| Proceeds from issuance of common stock                          | 7.0                                     | 15.8    |
| Principal payments on long-term debt                            | (27.5)                                  | (20.0)  |
| Net increase (decrease) in revolving credit facilities          | (47.8)                                  | 13.8    |
| Common stock repurchased  | (1.6)                                   | (13.2)  |
| Net   | (69.9)                                  | (3.6)   |
| Net increase (decrease) in cash and cash equivalents            | 3.2                                     | (9.0)   |
| Cash and cash equivalents at beginning of period                | 96.6                                    | 91.9    |
| Cash and cash equivalents at end of period                      | \$ 99.8                                 | \$ 82.9 |

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



**DST Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements**

*(unaudited)*

**1. Summary of Accounting Policies**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( *DST* or the *Company* ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto including the Company's Annual Report of Form 10-K for the year ended December 31, 2004.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of normal interim closing procedures) necessary to present fairly the financial position of the Company and its subsidiaries at March 31, 2005, and the results of operations and cash flows for the three months ended March 31, 2005 and 2004.

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

The results of operations for the three months ended March 31, 2005, are not necessarily indicative of the results to be expected for the full year 2005.

**2. Agreement to Sell EquiServe**

The Company announced on October 20, 2004 that it has signed a definitive agreement for Computershare Ltd. ( *CPU* ) to acquire, in a taxable transaction, the Company's wholly owned subsidiary, EquiServe, Inc. ( *EquiServe* ). Upon closing, the Company will receive U.S. \$216 million of cash plus 29.6 million shares of CPU common stock. The CPU stock is traded on the Australian Stock Exchange (ASX: CPU). The CPU common stock to be received represents slightly less than 5% of CPU's total issued capital, post-transaction, and had a value of approximately U.S. \$125 million on April 27, 2005.

Under terms of the agreement, the Company will continue to provide EquiServe various services, including data processing support, AWD products and services, Output Solutions services, E-Proxy services and lost instrument surety bond coverage. The disposition does not qualify to be reported as a discontinued operation due to ongoing cash flows from the aforementioned agreements. The Company recorded EquiServe operating revenues of \$52.7 million and \$54.3 million, and Out-of-Pocket ( *OOP* ) reimbursements of \$18.1 million and \$20.9 million, for the three months ended March 31, 2005 and 2004, respectively. EquiServe is included in the Financial Services Segment.

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The Company expects to record a one-time after-tax gain of approximately \$57 million associated with the transaction. The Company estimates that it will receive approximately \$147 million of after-tax cash proceeds associated with the transaction that may be used to reduce debt or repurchase shares of DST common stock. The estimated after-tax gain and after-tax cash proceeds will fluctuate based on changes in the value of the CPU common stock to be received at closing. The value of the CPU stock will fluctuate from changes in price and changes in the U.S. and Australian foreign currency exchange rates. The transaction is subject to approval from the Office of the Comptroller of Currency. The Company believes the transaction will close during the second quarter of 2005.

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The following table summarizes the assets and liabilities of EquiServe, categorized as held for sale in the consolidated balance sheet (in millions).

|                                   | March 31,<br>2005 |    | December 31,<br>2004 |
|-----------------------------------|-------------------|----|----------------------|
| Cash                              | \$ 2.5            | \$ | 1.6                  |
| Transfer agency investments       | 233.0             |    |                      |
| Accounts receivable               | 26.9              |    | 29.7                 |
| Other current assets              | 9.7               |    | 10.1                 |
| Investments                       | 0.8               |    | 0.9                  |
| Properties                        | 5.1               |    | 5.5                  |
| Goodwill                          | 170.9             |    | 170.9                |
| Intangible assets                 | 22.7              |    | 23.0                 |
| Other non-current assets          | 12.6              |    | 12.6                 |
| Total assets                      | 484.2             |    | 254.3                |
| Transfer agency deposits          | 233.0             |    |                      |
| Accounts payable                  | 4.4               |    | 9.4                  |
| Accrued compensation and benefits | 2.0               |    | 12.8                 |
| Deferred income taxes             | 19.3              |    | 17.7                 |
| Other liabilities                 | 33.6              |    | 30.8                 |
| Net assets held for sale          | \$ 191.9          | \$ | 183.6                |

### 3. Acquisition of Health Plan Solutions

The Company announced on April 8, 2005 that one of its subsidiaries had entered into a definitive agreement with Computer Sciences Corporation ( CSC ) under which the subsidiary would acquire CSC s Health Plan Solutions ( HPS ) business for 7.1 million shares of CSC common stock held by the DST subsidiary, and on April 29, 2005, DST s subsidiary completed the acquisition of HPS. The exchange value of the CSC shares at closing was \$45.53 per share and HPS held \$224.6 million of cash at the time of the exchange.

HPS is an enterprise software developer, software application services provider and business process outsourcer for the U.S. commercial healthcare industry and has been serving the healthcare industry since the 1960 s. HPS has 270 clients and its proprietary systems are used to provide claims administration services for approximately 24 million covered lives. HPS has approximately 700 employees and had revenues of \$110 million for the year ended April 2, 2004 and \$82 million for the nine months ended December 31, 2004.

The Company believes that the HPS business will expand its presence in the healthcare processing services industry, which currently uses DST s AWD and Output Solutions products. The Company expects to record net income of approximately \$50 million from the exchange of the CSC shares. The Company believes operations of HPS will be essentially neutral to DST s diluted earnings per share in 2005 and accretive in 2006. The actual impact on earnings per share will be dependent, among other factors, upon the finalization of the business combination accounting entries, which includes the allocation of approximately \$85 million of value in excess of the net tangible assets of the HPS business to be received.

The transaction has been structured to meet the requirements for treatment as a tax-free reorganization in accordance with Section 355 of the Internal Revenue Code. The Company has received two separate tax opinions at the more likely level of assurance that the transaction will comply with the provisions of Section 355. The tax opinions are not binding on the IRS. It is possible that the IRS could take a position contrary to the Company s. If the IRS were to take such a contrary position and ultimately prevail, then the Company could be required to

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recognize a gain on the exchange as if the Company sold the CSC shares at fair market value. The Company estimates, that under those circumstances, it would recognize a tax gain of approximately \$283 million and would incur federal and state tax liabilities of approximately \$111 million. Given the size and unique nature of the transaction, and the fact that the tax opinions of the Company's tax advisors have not reached the should level of assurance, the Company, for financial accounting purposes, has provided a tax reserve for the potential tax. The Company has provided an additional \$32 million of tax provision in April 2005, which, when added to previously recorded amounts results in a \$111 million accrual for the full amount of the potential tax. The Company will accrue interest related to the potential tax, until such tax treatment is finally determined.

**4. Investments**

Investments are as follows (in millions):

|   | 2005<br>Ownership<br>Percentage | March 31,<br>2005 | Carrying Value | December 31,<br>2004 |
|---|---------------------------------|-------------------|----------------|----------------------|
| <b>Available-for-sale securities:</b>         |                                 |                   |                |                      |
| State Street Corporation                      | 4%                              | \$ 559.3          | \$             | 628.3                |
| Computer Sciences Corporation                 | 4%                              | 326.9             |                | 401.9                |
| Euronet Worldwide, Inc.                       | 6%                              | 53.8              |                | 49.0                 |
| Other available-for-sale securities           |                                 | 129.0             |                | 120.8                |
|   |                                 | 1,069.0           |                | 1,200.0              |
| <b>Unconsolidated affiliates:</b>             |                                 |                   |                |                      |
| Boston Financial Data Services, Inc.          | 50%                             | 93.3              |                | 89.3                 |
| International Financial Data Services, U.K.   | 50%                             | 39.9              |                | 37.8                 |
| International Financial Data Services, Canada | 50%                             | 8.9               |                | 7.0                  |
| Unconsolidated Real Estate Affiliates         |                                 | 81.4              |                | 80.7                 |
| Other unconsolidated affiliates               |                                 | 22.0              |                | 22.3                 |
|   |                                 | 245.5             |                | 237.1                |
| <b>Other:</b>                                 |                                 |                   |                |                      |
| Trading securities                            |                                 |                   | 25.3           | 25.3                 |
| Held-to-maturity                              |                                 |                   | 12.1           | 12.2                 |
|   |                                 |                   | 37.4           | 37.5                 |
| Total investments                             |                                 | \$ 1,351.9        | \$             | 1,474.6              |

The table above includes \$0.8 million and \$0.9 million of investments classified as Assets of business held for sale in the Consolidated Balance Sheet as of March 31, 2005 and December 31, 2004, respectively.

Certain information related to the Company's available-for-sale securities is as follows (in millions):

|                         | March 31,<br>2005 | December 31,<br>2004 |
|-------------------------|-------------------|----------------------|
| Book cost basis         | \$ 524.3          | \$ 518.7             |
| Gross unrealized gains  | 546.1             | 681.7                |
| Gross unrealized losses | (1.4)             | (0.4)                |
| Market value            | \$ 1,069.0        | \$ 1,200.0           |

The Company has a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. All invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company has initiated a similar cash management service for a portion of its corporate securities processing transfer agency accounts. The Company had \$303.3 million and \$75.2 million of transfer agency investments and deposits at March 31, 2005 and December 31, 2004, respectively. These amounts include \$233.0 million and \$0 of transfer agency investments and deposits related to its corporate securities processing business as of March 31, 2005 and December 31, 2004, respectively, classified as Assets of business held for sale and Liabilities of business held for sale in the Consolidated Balance Sheet.





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The following table summarizes the fair value and gross unrealized losses of the Company's investments by the length of time that the securities have been in a continuous loss position, at March 31, 2005 (in millions):

|              | Less than 12 months |                   | Greater than 12 months |                   | Total      |                   |
|--------------|---------------------|-------------------|------------------------|-------------------|------------|-------------------|
|              | Fair Value          | Unrealized losses | Fair Value             | Unrealized losses | Fair Value | Unrealized losses |
| Common Stock | \$ 18.6             | \$ 1.3            | \$ 7.3                 | \$ 0.1            | \$ 25.9    | \$ 1.4            |

Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future. Such a charge could have a material effect on the Company's financial position.

The Company recognized \$0.4 million and \$1.2 million of investment impairments for the three months ended March 31, 2005 and 2004, respectively, which the Company believed were other than temporary. The impairments related primarily to investments available for sale in the Investments and Other Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted market value and is reflected in the Other income, net line in the statement of income.

The following table summarizes equity in earnings (losses) of unconsolidated affiliates net of income taxes (in millions):

|   | For the Three Months Ended March 31, |        |
|---|--------------------------------------|--------|
|   | 2005                                 | 2004   |
| Boston Financial Data Services, Inc.          | \$ 4.0                               | \$ 3.2 |
| International Financial Data Services, U.K.   | 2.4                                  | 1.5    |
| International Financial Data Services, Canada | 1.8                                  | 0.4    |
| Other   | (0.3)                                |        |
|   | \$ 7.9                               | \$ 5.1 |

### 5. Goodwill, Intangibles and Other Assets

The following table summarizes intangible assets (in millions):

|                                | March 31, 2005        |                          | December 31, 2004     |                          |
|--------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                                | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortizable intangible assets: |                       |                          |                       |                          |
| Customer relationships         | \$ 136.0              | \$ 22.5                  | \$ 136.0              | \$ 20.6                  |
| Other                          | 0.1                   | 0.1                      | 0.2                   | 0.1                      |
| Total                          | \$ 136.1              | \$ 22.6                  | \$ 136.2              | \$ 20.7                  |

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The table above includes \$22.7 million and \$23.0 million of intangible assets classified as Assets of business held for sale in the Consolidated Balance Sheet as of March 31, 2005 and December 31, 2004, respectively.

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Amortization of intangible assets for the quarter ended March 31, 2005 and 2004 was \$1.9 million and \$2.1 million, respectively. Annual amortization amounts for intangible assets recorded as of March 31, 2005 are estimated at \$7.7 million for each of the years 2005, 2006, and 2007, \$7.3 million for 2008 and \$7.0 million for 2009. Substantially all of the intangibles are tax-deductible.

The following table summarizes the changes in the carrying amount of goodwill for the three months ended March 31, 2005, by Segment (in millions):

|                       | December 31,<br>2004 | Acquisitions | Other        | March 31,<br>2005 |
|-----------------------|----------------------|--------------|--------------|-------------------|
| Financial Services    | \$ 273.4             | \$           | (0.1)        | \$ 273.3          |
| Output Solutions      | 9.2                  |              |              | 9.2               |
| Customer Management   | 5.4                  |              |              | 5.4               |
| Investments and Other |                      |              |              |                   |
| <b>Total</b>          | <b>\$ 288.0</b>      | <b>\$</b>    | <b>(0.1)</b> | <b>\$ 287.9</b>   |

The table above includes \$170.9 million of goodwill classified as Assets of business held for sale in the Consolidated Balance Sheet as of March 31, 2005 and December 31, 2004.

The August 2, 2002 acquisition of lockline was accounted for as a purchase. The minimum purchase price of \$190 million was paid in cash at closing and was financed by debt. There are provisions in the acquisition agreement that allow for additional consideration to be paid in cash if lockline's revenues, as defined in the acquisition agreement, exceed certain targeted levels for 2004. Goodwill will be increased by the amount of additional consideration paid.

### 6. Stockholders' Equity

**Earnings per share.** The computation of basic and diluted earnings per share is as follows (in millions, except per share amounts):

|  | For the Three Months<br>Ended March 31, |    |      |    |
|--|---|----|------|----|
|  | 2005                                    |    | 2004 |    |
| Net income   | \$ 49.2                                 | \$ | 51.6 | \$ |
| Average common shares outstanding                            | 78.4                                    |    | 84.1 |    |
| Incremental shares from assumed conversions of stock options | 2.5                                     |    | 2.4  |    |
| Diluted potential common shares                              | 80.9                                    |    | 86.5 |    |
| Basic earnings per share                                     | \$ 0.63                                 | \$ | 0.61 | \$ |
| Diluted earnings per share                                   | \$ 0.61                                 | \$ | 0.60 | \$ |

Shares from options to purchase shares of common stock that were excluded from the diluted earnings per share calculation because they were anti-dilutive totaled 2.4 million and 4.8 million for the three months ended March 31, 2005 and 2004, respectively. The Company issued convertible senior debentures that if converted in the future would have a potentially dilutive effect on the Company's stock. The Series A debentures are convertible into 11.0 million



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shares of common stock and the Series B debentures are convertible into 6.1 million shares of common stock, subject to adjustment. The Company intends to settle any conversions with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts. Related to the debentures, the calculation of diluted earnings per share would begin to include an incremental amount of shares assumed to be issued for the conversion spread if the Company's stock price exceeds \$49.08 per share. There was no impact during the first quarter of 2005 because the Company's average daily stock price for the quarter did not exceed \$49.08.

**Comprehensive income (loss).** Components of comprehensive income (loss) consist of the following (in millions):

|  | For the Three Months<br>Ended March 31, |         |
|--|---|---------|
|  | 2005                                    | 2004    |
| Net income   | \$ 49.2                                 | \$ 51.6 |
| Other comprehensive income (loss):                                     |   |         |
| Unrealized gains (losses) on investments:                              |   |         |
| Unrealized holding (losses) arising during the period                  | (135.5)                                 | (27.5)  |
| Proportional share of unconsolidated affiliate interest rate swap      | 1.7                                     |         |
| Less reclassification adjustments for net gains included in net income | (1.1)                                   | (3.6)   |
| Foreign currency translation adjustments                               | (2.6)                                   | 5.2     |
| Deferred income taxes  | 52.7                                    | 12.1    |
| Other comprehensive income (loss)                                      | (84.8)                                  | (13.8)  |
| Comprehensive income (loss)  | \$ (35.6)                               | \$ 37.8 |

**Stock repurchases.** On October 19, 2004, DST's Board of Directors authorized an additional 5.5 million share repurchase to the 6.0 million share repurchase plan authorized on February 26, 2004. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through February 28, 2007. In the first quarter of 2005, 2.1 million shares were repurchased under the forward stock purchase agreement as explained below. At March 31, 2005, the Company had purchased 7.8 million shares at an average price of \$49.08 per share since the program commenced. At March 31, 2005, the Company had approximately 3.7 million shares remaining to be purchased under this program.

During the fourth quarter 2004, the Company entered into a forward stock purchase agreement for the repurchase of its common stock as a means of securing potentially favorable prices for future purchases of its stock. During 2004, 0.7 million shares were purchased by the Company under this agreement. This agreement contained provisions which allowed the Company to elect a net cash or net share settlement in lieu of physical settlement of shares. On January 3, 2005, the Company entered into a new forward stock purchase agreement that requires physical settlement of shares. The shares held under the 2004 forward stock purchase agreement were assumed under the January 2005 forward stock purchase agreement. As of March 31, 2005, 2.1 million shares of common stock have been purchased under the January 2005 agreement at an average price of \$51.14 per share. In connection with this agreement, the Company increased debt due within one year and increased stock under forward purchase agreement by \$105.8 million.

**Restricted Stock Grant.** On October 29, 2004, the Compensation Committee of the Board of Directors of the Company voted to grant as of November 10, 2004, approximately 2.8 million shares of restricted common stock of the Company to officers and certain other participants in the DST Systems, Inc. 1995 Stock Option and Performance Award Plan. For ten senior executive officers, the restricted shares are subject to the earnings per share goal that must be met as an additional condition to the lapse of restrictions on January 31, 2010. Subject to early lapsing and forfeiture provisions, the restrictions on the shares granted to all other officers and participants lapse on November 10, 2009. The restricted stock grants cover the five-year period of 2005 through 2009 and are intended to be the only



restricted stock grants for such periods other than for new hires or promotions, for special employee recognition purposes, and, in accordance with past practice, for the portion of each annual incentive bonus the executive officers are required to take in the form of equity compensation. The Compensation Committee made the grant after evaluating the Company's equity compensation practices, particularly in light of changes pending at the time of the grant in the accounting rules applicable to stock options.

The Company recorded a total of \$137.1 million of unearned compensation in relation to the grant. The impact of amortized compensation expense for the quarter ended March 31, 2005 was \$6.4 million. The Company estimates that the impact of amortized compensation expense attributable to the grant for each subsequent year covered by the grant, based upon the average of the high and low trading prices for the Company's shares on November 10, 2004, will be approximately \$27 million for the years 2005 through 2008 and \$22.5 million in 2009. These estimates assume that all shares will be vested and all performance criteria will be met.

**Stock-based compensation.** The Company accounts for stock-based compensation in accordance with Accounting Principles Board Opinion ( APBO ) No. 25, Accounting for Stock Issued to Employees, and related interpretations and has presented the required Statement of Financial Accounting Standards ( SFAS ) No. 123 Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, pro forma disclosure in the table below.

At March 31, 2005, the Company maintained a stock option plan which provides for the availability of 30,000,000 shares of the Company's common stock for the grant of awards to officers, directors and other designated employees. The awards may take the form of an option, stock appreciation right, limited right, performance share or unit, dividend equivalent, or any other right, interest or option relating to shares of common stock granted under the plan. The option prices must be at least equal to the fair market value of the underlying shares on the date of grant. Options become exercisable and expire as determined by the Compensation Committee of the Board of Directors at the date of grant. The Company applies APBO No. 25 and related interpretations in accounting for its stock based compensation, and accordingly, no compensation cost has been recognized for the Company's stock option awards under the plan. Had compensation cost been determined consistent with SFAS No. 123, as amended by SFAS No. 148, the Company's net income would have been reduced to the following pro forma amounts:

|  |             | For the Three Months<br>Ended March 31, |       |      |       |
|--|-------------|---|-------|------|-------|
|  |             | 2005                                    |       | 2004 |       |
| Net income (millions):   | As reported | \$                                      | 49.2  | \$   | 51.6  |
| Stock-based employee compensation cost, net of related tax effects, included in the determination of net income as reported  |             | \$                                      | 4.1   |      |       |
| Stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards |             |   | (5.1) |      | (5.4) |
| Net Income   | Pro forma   | \$                                      | 48.2  | \$   | 46.2  |
| Basic earnings per share:  | As reported | \$                                      | 0.63  | \$   | 0.61  |
|  | Pro forma   | \$                                      | 0.62  | \$   | 0.55  |
| Diluted earnings per share:  | As reported | \$                                      | 0.61  | \$   | 0.60  |
|  | Pro forma   | \$                                      | 0.61  | \$   | 0.54  |





The Company uses the Black-Scholes option pricing model which requires the Company to make certain assumptions in order to estimate fair value.

## 7. Commitments and Contingencies

The Company has entered into an agreement to guarantee 50% of a construction loan of a 50% owned joint venture. The construction loan expires in June 2005. At March 31, 2005, there were no outstanding borrowings against the loan.

The Company has entered into an agreement to guarantee 49% of a \$2.2 million mortgage loan of a 50% owned real estate joint venture. The mortgage loan expires in August 2005.

The Company and DST Realty, Inc. have entered into an agreement to guarantee 50% of a \$10.0 million line of credit loan for a 50% owned real estate joint venture. The loan expires on June 17, 2006. At March 31, 2005, total borrowings against the line of credit were \$5.3 million.

The Company has entered into an agreement to guarantee, jointly and severally, and limited to \$10.0 million related to a \$60.0 million construction loan for a 50% owned real estate joint venture. The \$60.0 million loan expires on December 31, 2005. At March 31, 2005, total borrowings on the loan were \$33.6 million.

The Company is a 50% partner in a limited purpose real estate joint venture. The real estate joint venture is developing approximately 1.1 million square feet of office space to be leased to the U.S. government. The project is estimated to cost approximately \$362 million and has been financed with \$315 million of non-recourse insured bonds (issued June 2004) with the remainder in the form of equal equity contributions from the real estate joint venture partners. At March 31, 2005, each partner had contributed half of the aggregate equity of \$22.7 million. The real estate joint venture partners have committed aggregate additional equity investments of approximately \$23.9 million to complete the financing and up to \$33.3 million of equity investments in the aggregate in the event of delays in construction or lease commencement. The remaining equity contributions of \$23.9 million to \$57.1 million have been secured through \$57.1 million of letters of credit that will expire beginning in 2007 through 2008. The Company is responsible for \$28.6 million of the letters of credit. At March 31, 2005, there were no outstanding borrowings against the letters of credit.

The Company and State Street Corporation ( State Street ) have each guaranteed 50% of a lease obligation of International Financial Data Services, U.K. Limited ( IFDS U.K. ), which requires IFDS U.K. to make annual rent payments of approximately \$3.8 million through 2017, for its use of a commercial office building. The commercial office building is owned by a wholly owned affiliate of International Financial Data Services, (Canada) Limited ( IFDS Canada ) and was financed with a \$19.5 million mortgage loan from a bank. The loan has a floating interest rate based upon LIBOR and fully amortizes over the 15 year term. To fix the rate of borrowing costs, the IFDS Canada affiliate entered into a 15 year interest rate hedge agreement with the same bank. The interest rate hedge, which has an initial notional amount value of approximately \$19.5 million and scheduled reductions that coincide with the scheduled principal payments for the mortgage loan, was entered into for the purpose of fixing the borrowing costs of the mortgage at approximately 6.3%. The Company and State Street have each guaranteed 50% of the amounts of the interest rate hedge obligations. Upon default, the Company would be required to pay 50% of the total amount to close out of the hedge, which is approximately \$0.2 million at March 31, 2005.

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The Company's 50% owned joint ventures are generally governed by shareholder or partnership agreements. The agreements generally entitle the Company to elect one-half of the directors to the board in the case of corporations and to have 50% voting/managing interest in the case of partnerships.

The agreements generally provide that the Company or the other party has the option to establish a price payable in cash, or a promise to pay cash, for all of the other's ownership in the joint venture and to submit an offer, in writing, to the other party to sell to the other party all of its ownership interests in the joint venture or to purchase all ownership interests owned by the other party at such offering price. The party receiving the offer generally has a

specified period of time to either accept the offer to purchase, or to elect to purchase the offering party's stock at the offering price. The Company cannot estimate the potential aggregate offering price that it could be required to receive or elect to pay in the event this option becomes operable, however the amount could be material.

#### **FIN 45 Disclosures**

In addition to the guarantees entered into discussed in Unconsolidated Affiliates above, the Company has also guaranteed certain obligations of certain joint ventures under service agreements entered into by the joint ventures and their customers. The amount of such obligations is not stated in the agreements. Depending on the negotiated terms of the guaranty and/or on the underlying service agreement, the Company's liability under the guaranty may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

In certain instances in which the Company licenses proprietary systems to customers, the Company gives certain indemnities (including infringement indemnities) and warranties to the licensee, the terms of which vary depending on the negotiated terms of each respective license agreement. Such warranties generally warrant that such systems will perform in accordance with their specifications. The amount of such obligations is not stated in the license agreements. The Company's liability for breach of such obligations may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

From time to time, the Company enters into service agreements and other agreements with unaffiliated parties containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement. The amount of such obligations is not stated in the agreements. The Company's liability under such indemnification provisions may be subject to time and materiality limitations, monetary caps and other conditions and defenses. Such indemnity obligations include those described herein.

The Company has entered into purchase and service agreements with its vendors, and consulting agreements with providers of consulting services to the Company, pursuant to which the Company has agreed to indemnify certain of such vendors and consultants, respectively, against third party claims arising from the Company's use of the vendor's product or the services of the vendor or consultant.

In connection with the acquisition or disposition of subsidiaries, operating units and business assets by the Company, the Company has entered into agreements containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement, but which are generally described as follows: (i) in connection with acquisitions made by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller relating to the subject subsidiary, operating unit or asset and arising after the closing of the transaction, and (ii) in connection with dispositions made by the Company, the Company has agreed to indemnify the buyer against damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject subsidiary, operating unit or business assets in the disposition agreement if such representations or warranties were untrue when made, or due to any breach of the representations, warranties, agreements or covenants contained in the agreement.

The Company has entered into agreements with certain third parties, including banks and escrow agents, that provide software, escrow, fiduciary and other services to the Company or to its benefit plans or customers. Under such agreements, the Company has agreed to indemnify such service providers for third party claims relating to the carrying out of their respective duties under such agreements.

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The Company has entered into agreements with lenders providing financing to the Company pursuant to which the Company agrees to indemnify such lenders for third party claims arising from or relating to such financings. In connection with real estate mortgage financing, the Company has entered into environmental indemnity agreements in which the Company has agreed to indemnify the lenders for any damage sustained by the lenders relating to any environmental contamination on the subject properties.

In connection with the acquisition or disposition of real estate by the Company, the Company has entered into real estate contracts containing indemnification provisions, the terms of which vary depending on the negotiated terms of

each respective contract, but which are generally described as follows: (i) in connection with acquisitions by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller arising from the Company's on-site inspections, tests and investigations of the subject property made by the Company as part of its due diligence and against third party claims relating to the operations on the subject property after the closing of the transaction, and (ii) in connection with dispositions by the Company, the Company has agreed to indemnify the buyer for damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject property made by the Company in the real estate contract if such representations or warranties were untrue when made and against third party claims relating to operations on the subject property prior to the closing of the transaction.

In connection with the leasing of real estate by the Company, as landlord and as tenant, the Company has entered into occupancy leases containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective lease, but which are generally described as follows: (i) in connection with leases in which the Company is the tenant, the Company has agreed to indemnify the landlord against third party claims relating to the Company's occupancy of the subject property, including claims arising from loss of life, bodily injury and/or damage to property thereon, and (ii) in connection with leases in which the Company is the landlord, the Company has agreed to indemnify the tenant against third party claims to the extent occasioned wholly or in part by any negligent act or omission of the Company or arising from loss of life, bodily injury and/or damage to property in or upon any of the common areas or other areas under the Company's control.

At March 31, 2005, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect indebtedness of others in accordance with FIN 45.

#### **FIN 46 Disclosures**

In December 2003, the revised FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 was issued, which requires the consolidation of certain types of entities in which the Company absorbs a majority of another entity's expected losses, receives a majority of the other entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the other entity. These entities are called variable interest entities. The principal characteristics of variable interest entities are (1) an insufficient amount of equity to absorb the entity's expected losses, (2) equity owners as a group are not able to make decisions about the entity's activities, or (3) equity that does not absorb the entity's losses or receive the entity's residual returns. Variable interests are contractual, ownership or other monetary interests in an entity that change with fluctuations in the entity's net asset value. As a result, variable interest entities can arise from items such as joint ventures, lease agreements, loan arrangements, guarantees or service contracts.

If an entity is determined to be a variable interest entity, the primary beneficiary must consolidate the entity. The primary beneficiary is the holder of the variable interests that absorb a majority of the variable interest entity's expected losses or receive a majority of the entity's residual returns in the event no holder has a majority of the expected losses. There is no primary beneficiary in cases where no single holder absorbs the majority of the expected losses or receives a majority of the residual returns. The determination of the primary beneficiary is based on projected cash flows at the inception of the variable interests.

With regard to real estate, the Company is the lessee in a series of operating leases covering a large portion of its Kansas City based leased office facilities. The lessors are generally joint ventures (in which the Company has a 50% ownership) that have been established specifically to purchase, finance and engage in leasing activities with the joint venture partners and unrelated third parties. Two of the real estate joint ventures, which the Company entered into during 2001 and 2003, have entered into financing arrangements with the Company's wholly owned captive insurance company. In each case, the other joint venture partner has guaranteed at least 50% of the joint venture's borrowings (\$38.2 million at March 31, 2005) from the Company's captive insurance company. The Company is generally not the primary beneficiary of the joint ventures if the lease terms are consistent with market terms at the inception of the lease and do not include a residual value guarantee,

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fixed-price purchase options or similar features that disproportionately obligate it to absorb decreases in value or entitle it to participate in increases in the value of the real estate. The Company's analyses of its real estate joint ventures indicate that a large portion of the real estate joint ventures are variable interest

entities, however the real estate joint ventures do not need to be consolidated because the Company is not the primary beneficiary.

With regard to operating joint ventures, the Company has formed or entered into operating joint ventures to enter into or expand its presence in target markets. The Company has three significant operating joint ventures; BFDS; IFDS (includes IFDS U.K., IFDS Canada and International Financial Data Services, Luxembourg); and Argus. Each of these operating joint ventures was formed prior to February 1, 2003. The Company's FIN 46 analyses of these operating joint ventures indicate that none qualify as variable interest entities due to meeting the criteria for the operating joint venture exception in FIN 46. Accordingly, the Company does not consolidate the operating results of these operating joint ventures.

## 8. Recently Issued Accounting Standards

In December 2004, the FASB issued its final standard on accounting for share-based payments, Statement of Financial Accounting Standards No. 123R ( SFAS No. 123R ) (revised 2004). SFAS 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The cost will be measured based on the fair value of the instruments issued. SFAS No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R replaces SFAS No. 123 and supersedes APB Opinion No. 25. As originally issued in 1995, SFAS No. 123 established as preferable the fair value based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the fair value method been applied. The Company will apply SFAS No. 123R effective January 1, 2006 and expects to use the modified prospective method to adopt the standard. The Company is currently evaluating the impact of this new accounting standard.

There is a proposed accounting standard that involves an amendment to SFAS No. 128, Earnings per Share that would impact the way the Company treats the incremental shares to be issued from the assumed conversion of the \$840 million of convertible debentures issued in August 2003 in calculating diluted earnings per share. The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the if-converted method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle the conversions with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128. The proposed amendment to SFAS 128 is expected to be issued in the third quarter 2005, and would require retroactive restatement of a company's diluted earnings per share calculations. This would require the Company to restate its 2003, 2004 and 2005 diluted earnings per share calculations. Under the proposed amended SFAS 128 if converted method, in calculating diluted earnings per share the Company would need to increase net income for the interest expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion to 17.1 million shares, the amount of shares that would be issued if all \$840 million of convertible debentures would be converted to equity. Under this method, diluted earnings per share would have been \$0.56 for each of the quarters ended March 31, 2005 and 2004, as compared to the reported amounts of \$0.61 and \$0.60, respectively.

The proposed change in accounting principles does not affect the Company's ability to ultimately settle the convertible debentures in cash, shares or any combination thereof. They would affect the calculation of diluted earnings per share during the period the debentures are outstanding.

The estimated impact of this new accounting standard reflects the Company's current views. There may be material differences between these estimates and the actual impact of the standard.





**9. Segment Information**

The Company has several operating business units that offer sophisticated information processing and software services and products. The Company has elected to organize and report on these business units as three operating Segments (Financial Services, Output Solutions and Customer Management). In addition, investments in equity securities and certain financial interests and the Company's real estate subsidiaries and affiliates have been aggregated into an Investments and Other Segment.

Information concerning total assets by reporting Segment is as follows (in millions):

|                       | <b>March 31,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|-----------------------|---------------------------|------------------------------|
| Financial Services    | \$ 2,461.6                | \$ 2,295.1                   |
| Output Solutions      | 366.1                     | 361.2                        |
| Customer Management   | 146.0                     | 128.4                        |
| Investments and Other | 1,294.9                   | 1,400.5                      |
| Eliminations          | (816.4)                   | (801.8)                      |
|                       | \$ 3,452.2                | \$ 3,383.4                   |

The Company evaluates the performance of its Segments based on income before income taxes, non-recurring items and interest expense. Intersegment revenues are reflected at rates prescribed by the Company and may not be reflective of market rates.

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Summarized financial information concerning the Segments is shown in the following tables (in millions):

|  | Three Months Ended March 31, 2005 |                  |                     |                    |              |    | Consolidated Total |
|--|-----------------------------------|------------------|---------------------|--------------------|--------------|----|--------------------|
|  | Financial Services                | Output Solutions | Customer Management | Investments/ Other | Eliminations |    |                    |
| Operating revenues                                       | \$ 277.5                          | \$ 109.9         | \$ 46.3             | \$ 3.4             | \$           | \$ | \$ 437.1           |
| Intersegment operating revenues                          | 2.2                               | 18.5             |                     | 14.6               | (35.3)       |    |                    |
| Out-of-pocket reimbursements                             | 43.2                              | 152.3            | 13.2                | 0.1                | (17.6)       |    | 191.2              |
| Total revenues   | 322.9                             | 280.7            | 59.5                | 18.1               | (52.9)       |    | 628.3              |
| Costs and expenses                                       | 245.9                             | 262.1            | 50.4                | 10.2               | (52.9)       |    | 515.7              |
| Depreciation and amortization                            | 23.4                              | 6.7              | 1.5                 | 4.2                |              |    | 35.8               |
| Income from operations                                   | 53.6                              | 11.9             | 7.6                 | 3.7                |              |    | 76.8               |
| Other income, net  | 3.0                               | 0.2              |                     | 4.3                |              |    | 7.5                |
| Equity in earnings (losses) of unconsolidated affiliates | 8.4                               |                  |                     | (0.5)              |              |    | 7.9                |
| Earnings before interest and income taxes                | \$ 65.0                           | \$ 12.1          | \$ 7.6              | \$ 7.5             | \$           | \$ | \$ 92.2            |

|  | Three Months Ended March 31, 2004 |                  |                     |                    |              |    | Consolidated Total |
|--|-----------------------------------|------------------|---------------------|--------------------|--------------|----|--------------------|
|  | Financial Services                | Output Solutions | Customer Management | Investments/ Other | Eliminations |    |                    |
| Operating revenues                                       | \$ 268.9                          | \$ 107.8         | \$ 50.0             | \$ 3.3             | \$           | \$ | \$ 430.0           |
| Intersegment operating revenues                          | 2.7                               | 13.1             |                     | 12.1               | (27.9)       |    |                    |
| Out-of-pocket reimbursements                             | 37.8                              | 146.4            | 14.0                | 0.1                | (18.8)       |    | 179.5              |
| Total revenues   | 309.4                             | 267.3            | 64.0                | 15.5               | (46.7)       |    | 609.5              |
| Costs and expenses                                       | 226.6                             | 250.9            | 51.8                | 8.6                | (46.7)       |    | 491.2              |
| Depreciation and amortization                            | 24.8                              | 7.2              | 1.3                 | 3.1                |              |    | 36.4               |
| Income from operations                                   | 58.0                              | 9.2              | 10.9                | 3.8                |              |    | 81.9               |
| Other income, net  | 2.9                               |                  |                     | 3.6                |              |    | 6.5                |
| Equity in earnings (losses) of unconsolidated affiliates | 5.4                               |                  |                     | (0.3)              |              |    | 5.1                |
| Earnings before interest and income taxes                | \$ 66.3                           | \$ 9.2           | \$ 10.9             | \$ 7.1             | \$           | \$ | \$ 93.5            |

Earnings before interest and income taxes in the segment reporting information above less interest expense of \$16.6 million and \$13.5 million for the three months ended March 31, 2005 and 2004, respectively, is equal to the Company's income before income taxes on a consolidated basis for the corresponding periods.

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

*The discussions set forth in this Quarterly Report on Form 10-Q contain statements concerning potential future events. Such forward-looking statements are based upon assumptions by the Company's management, as of the date of this Quarterly Report, including assumptions about risks and uncertainties faced by the Company. In addition, management may make forward-looking statements orally or in other writings, including, but not limited to, in press releases, in the annual report to shareholders and in the Company's other filings with the Securities and Exchange Commission (SEC). Readers can identify these forward-looking statements by the use of such verbs as expects, anticipates, believes or similar verbs or conjugations of such verbs. If any of management's assumptions prove incorrect or should unanticipated circumstances arise, the Company's actual results could materially differ from those anticipated by such forward-looking statements. The differences could be caused by a number of factors or combination of factors including, but not limited to, those factors identified below in Company-Specific Trends and Risks. Readers are strongly encouraged to consider the factors listed in such section and any amendments or modifications thereof when evaluating any forward-looking statements concerning the Company. The Company's reports filed with or furnished to the SEC on Form 8-K, Form 10-K, Form 10-Q and other forms and any amendments to those reports, may be obtained by contacting the SEC's Public Reference Branch at 1-800-SEC-0330 or by accessing the forms electronically, free of charge, through the SEC's Internet website at <http://www.sec.gov> or through the Company's Internet website, as soon as reasonably practicable after filing with the SEC, at <http://www.dstsystems.com>. The Company will not update any forward-looking statements in this Quarterly Report to reflect future events or developments.*

*The information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto included in this Form 10-Q and the audited financial statements and notes thereto in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.*

**INTRODUCTION**

The Company has several operating business units that offer sophisticated information processing and software services and products. These business units are reported as three operating Segments (Financial Services, Output Solutions and Customer Management). In addition, investments in equity securities and certain financial interests and the Company's real estate subsidiaries and affiliates have been aggregated into an Investments and Other Segment.

**Financial Services**

The Company's Financial Services Segment provides sophisticated information processing and computer software services and products primarily to mutual funds, investment managers, corporations, insurance companies, banks, brokers and financial planners. The Segment also provides design, management and transaction processing services for customized consumer equipment maintenance and debt protection programs.

**Output Solutions**

The Company's Output Solutions Segment provides single source, integrated print and electronic statement and billing output solutions. The Segment also offers a variety of related professional services, including statement design and formatting, customer segmentation, and personalized messaging tools. The Segment also provides electronic bill payment and presentment solutions and computer output archival solutions.

**Customer Management**

The Company's Customer Management Segment provides customer management, billing and marketing solutions to the video/broadband, direct broadcast satellite, wire-line and Internet Protocol telephony, Internet and utility markets.

**Investments and Other**

The Company's Investments and Other Segment holds investments in equity securities and certain financial interests and the Company's real estate subsidiaries and affiliates.

**RESULTS OF OPERATIONS**

The following table summarizes the Company's operating results (dollars in millions, except per share amounts):

|  | <b>Three Months<br/>Ended March 31,</b> |             |
|--|---|-------------|
|  | <b>2005</b>                             | <b>2004</b> |
| <b>Revenues</b>  |   |             |
| <b>Operating revenues</b>  |   |             |
| Financial Services   | \$ 279.7                                | \$ 271.6    |
| Output Solutions   | 128.4                                   | 120.9       |
| Customer Management  | 46.3                                    | 50.0        |
| Investments and Other  | 18.0                                    | 15.4        |
| Eliminations   | (35.3)                                  | (27.9)      |
|  | \$ 437.1                                | \$ 430.0    |
| % change from prior year period                                      | 1.7%                                    |             |
| <b>Out-of-pocket reimbursements</b>                                  |   |             |
| Financial Services   | \$ 43.2                                 | \$ 37.8     |
| Output Solutions   | 152.3                                   | 146.4       |
| Customer Management  | 13.2                                    | 14.0        |
| Investments and Other  | 0.1                                     | 0.1         |
| Eliminations   | (17.6)                                  | (18.8)      |
|  | \$ 191.2                                | \$ 179.5    |
| % change from prior year period                                      | 6.5%                                    |             |
| <b>Total revenues</b>  | \$ 628.3                                | \$ 609.5    |
| % change from prior year period                                      | 3.1%                                    |             |
| <b>Income from operations</b>  |   |             |
| Financial Services   | \$ 53.6                                 | \$ 58.0     |
| Output Solutions   | 11.9                                    | 9.2         |
| Customer Management  | 7.6                                     | 10.9        |
| Investments and Other  | 3.7                                     | 3.8         |
|  | 76.8                                    | 81.9        |
| Interest expense   | (16.6)                                  | (13.5)      |
| Other income, net  | 7.7                                     | 6.5         |
| Equity in earnings of unconsolidated affiliates, net of income taxes | 7.9                                     | 5.1         |
| <b>Income before income taxes</b>                                    | 75.8                                    | 80.0        |
| Income taxes   | 26.6                                    | 28.4        |
| <b>Net income</b>  | \$ 49.2                                 | \$ 51.6     |
| Basic earnings per share   | \$ 0.63                                 | \$ 0.61     |
| Diluted earnings per share   | \$ 0.61                                 | \$ 0.60     |

## Consolidated revenues

Consolidated total revenues (including Out-of-Pocket ( OOP ) reimbursements) for the three months ended March 31, 2005, increased \$18.8 million or 3.1% over the same period in 2004. Consolidated operating revenues for the three months ended March 31, 2005 increased \$7.1 million or 1.7% over the prior year quarter. U.S. operating revenues for the three months ended March 31, 2005, were \$393.6 million, an increase of 3.3% over the same period in 2004. International operating revenues for the three months ended March 31, 2005 were \$43.5 million, a decrease of 11.4% over the same period in 2004.

Financial Services Segment total revenues for the three months ended March 31, 2005 increased \$13.5 million or 4.4% over the same period in 2004. Financial Services operating revenues for the three months ended March 31, 2005 increased \$8.1 million or 3.0% over the same period in 2004. U.S. Financial Services Segment operating revenues for the three months ended March 31, 2005 increased \$13.3 million or 5.5% over the same period in 2004. The increase in U.S. Financial Services Segment operating revenues for the three months ended March 31, 2005, resulted primarily from higher lock\line related revenues from increases in supported customers and expanded service offerings of \$13.3 million and higher U.S. mutual fund servicing revenues of \$3.4 million. U.S. mutual fund servicing revenues increased as U.S. mutual fund open shareowner accounts processed totaled 94.0 million at March 31, 2005, an increase of 1.8 million or 2.0% from the 92.2 million serviced at December 31, 2004, and an increase of 3.9 million or 4.3% from the 90.1 million serviced at March 31, 2004. Financial Services Segment international operating revenues for the three months ended March 31, 2005, were \$26.1 million, a decrease of \$5.2 million or 16.6% over the same period in 2004. The decrease for the three months ended March 31, 2005 compared to the same period in the prior year is primarily from lower software license revenues of \$4.8 million.

Output Solutions Segment total revenues for the three months ended March 31, 2005, increased \$13.4 million or 5.0% over the same period in 2004. Output Solutions Segment operating revenues for the three months ended March 31, 2005 increased \$7.5 million or 6.2% over the same period in 2004. The operating revenue increase resulted principally from increased revenues of \$3.9 million and \$2.5 million in the telecommunications and banking industries, respectively, for the three months ended March 31, 2005 compared to the same period last year. Output Solutions Segment images produced for the three months ended March 31, 2005, increased 18.2% to 2.6 billion and items mailed increased 1.9% to 437 million compared to the same period in 2004.

Customer Management Segment total revenues for the three months ended March 31, 2005 decreased \$4.5 million or 7.0% over the same period in 2004. Customer Management Segment operating revenues for the three months ended March 31, 2005 decreased \$3.7 million or 7.4% over the same period in 2004. The decrease for the quarter ended March 31, 2005 was a result of a decrease in processing and software service revenues of \$3.6 million primarily as a result of lower software development revenues, partially offset by higher professional services revenues. Total cable and satellite subscribers serviced were 36.2 million at March 31, 2005, a decrease of 3.2% compared to year end 2004 levels, resulting from a decrease in international cable subscribers serviced, partially offset by an increase in U.S. satellite subscribers.

Investments and Other Segment total revenues increased \$2.6 million or 16.8% for the three months ended March 31, 2005 as compared to the same period in 2004. Investments and Other Segment operating revenues increased \$2.6 million or 16.9% for the three months ended March 31, 2005 as compared to the same period in 2004. The increase was primarily from increased real estate leasing activity. Segment revenues are primarily rental income for facilities leased to the Company's operating segments.

**Income from operations**

Consolidated income from operations for the three months ended March 31, 2005 was \$76.8 million, a decrease of \$5.1 million or 6.2% over the same period in 2004.

Financial Services Segment income from operations for the three months ended March 31, 2005 was \$53.6 million, a decrease of \$4.4 million or 7.6% over the same period in 2004. Income from operations for the three months ended March 31, 2005 decreased due to an increase in costs and expenses of \$19.3 million or 8.5% compared to the prior

year quarter, primarily from higher OOP expenses of \$5.4 million associated with higher OOP revenues, additional compensation expense of \$4.4 million related to the restricted stock grant and increased lock\line costs to support revenue growth. Depreciation and amortization costs decreased \$1.4 million, primarily attributable to lower capital expenditures.

Output Solutions Segment income from operations for the three months ended March 31, 2005, was \$11.9 million, an increase of \$2.7 million or 29.3% over the same period in 2004. Costs and expenses increased \$11.2 million or 4.5% from the first quarter 2004, reflecting higher OOP costs associated with higher volumes and higher personnel costs, including additional compensation cost of \$1.2 million related to the restricted stock grant. Segment results include \$0.6 million of costs in 2004 associated with facility and other consolidations. Depreciation and amortization for the three months ended March 31, 2005 decreased \$0.5 million compared to the prior year period, primarily from lower capital expenditures.

Customer Management Segment income from operations totaled \$7.6 million for the three months ended March 31, 2005, a decrease of \$3.3 million or 30.3% over the same period in 2004, primarily from lower revenues and additional compensation expense related to the restricted stock grant. Costs and expenses decreased \$1.4 million for the three month period ending March 31, 2005 compared to the same period in 2004, primarily due to lower costs associated with lower revenues, partially offset by additional compensation expense of \$0.6 million related to the restricted stock grant. Depreciation and amortization increased \$0.2 million compared to the prior year quarter, primarily from the amortization of capitalized software for the first operational components of Collabrent, and increased capital expenditures.

Investments and Other Segment income from operations for the three months ended March 31, 2005, decreased \$0.1 million over the prior year quarter.

#### **Interest expense**

Interest expense was \$16.6 million for the quarter ended March 31, 2005 compared to \$13.5 million in the prior year quarter, principally from higher average interest rates and \$0.9 million of interest expense associated with the forward stock purchase agreement.

#### **Other income, net**

Other income was \$7.7 million for the quarter ended March 31, 2005 compared to \$6.5 million recorded in the prior year quarter. First quarter 2005 results include \$5.4 million primarily related to interest and dividend income and \$1.4 million primarily in net gains on securities. First quarter 2004 results include \$3.7 million primarily related to interest and dividend income and \$2.0 million primarily in net gains on securities.

#### **Equity in earnings of unconsolidated affiliates**

The following table summarizes the Company's equity in earnings (losses) of unconsolidated affiliates (in millions):

#### **Equity in earnings of unconsolidated affiliates**



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|             | Three months ended<br>March 31, |       |      |     |
|-------------|---------------------------------|-------|------|-----|
|             | 2005                            |       | 2004 |     |
| BFDS        | \$                              | 4.0   | \$   | 3.2 |
| IFDS U.K.   |                                 | 2.4   |      | 1.5 |
| IFDS Canada |                                 | 1.8   |      | 0.4 |
| Other       |                                 | (0.3) |      |     |
|             | \$                              | 7.9   | \$   | 5.1 |

Equity in earnings of unconsolidated affiliates totaled \$7.9 million for the three months ended March 31, 2005, as compared to \$5.1 million for the three months ended March 31, 2004. Boston Financial Data Services ( BFDS ) earnings increased \$0.8 million for the three months ended March 31, 2005, compared to the same period in 2004, primarily from higher revenues from an increase in accounts serviced and improved operational efficiencies. International Financial Data Services (U.K.) Limited ( IFDS U.K. ) results increased \$0.9 million for the three months ended March 31, 2005, compared to the same period in 2004, primarily due to the recognition of a deferred tax asset of \$1.4 million related to the entity's prior year loss carryforwards. Accounts serviced by IFDS U.K. were 5.3 million at March 31, 2005, unchanged from year end 2004 levels and an increase of 0.5 million or 10.4% over March 31, 2004 levels. An additional 57,000 accounts are scheduled to convert during the second quarter of 2005. International Financial Data Services (Canada) Limited ( IFDS Canada ) results increased \$1.4 million for the three months ended March 31, 2005, compared to the same period in 2004, primarily due to higher levels of accounts serviced. Accounts serviced by IFDS Canada were 6.2 million at March 31, 2005, unchanged from year end 2004 levels, and an increase of 3.4 million from March 31, 2004 levels, principally from the conversion of a client with 3.0 million accounts from a facility management arrangement to a remote processing arrangement.

### **Income taxes**

In general, the Company provides income taxes during interim periods based on its best estimate of the full year's effective tax rate. Certain items, however, are given discrete period treatment and, as a result, the tax effects of such items are reported in full in the relevant quarter. The Company's effective tax rate was 35.2% for the quarter, compared to 35.5% for the quarter ended March 31, 2004. The Company estimates its effective tax rate will be 35.2% for the year ending December 31, 2005, and, on this basis, has provided income taxes at this rate for the three months ended March 31, 2005. The reduction in the year to date tax rate from 35.5% to 35.2% is primarily the result of certain international operations. The 2005 and 2004 tax rates were affected by tax aspects of certain international operations and state tax income apportionment rules. The full year 2005 effective tax rate can be affected as a result of variances among the estimates and amounts of full year sources of taxable income (e.g. domestic consolidated, joint venture and/or international), the realization of tax credits (e.g. historic rehabilitation, research and experimental and state incentive) and adjustments which may arise from the resolution of tax matters under review.

### **Business Segment Comparisons**

#### **FINANCIAL SERVICES SEGMENT**

##### **Revenues**

Financial Services Segment total revenues for the three months ended March 31, 2005, increased 4.4% over the same period in 2004 to \$322.9 million. Financial Services Segment operating revenues for the three months ended March 31, 2005 were \$279.7 million, an increase of \$8.1 million or 3.0% over the same period in 2004. U.S. Financial Services Segment operating revenue increased 5.5% to \$253.6 million for the three months ended March 31, 2005. The increase in U.S. Financial Services Segment operating revenues for the three months ended March 31, 2005, resulted primarily from higher lock\line related revenues from increases in supported customers and expanded service offerings of \$13.3 million and higher U.S. mutual fund servicing revenues of \$3.4 million. U.S. mutual fund servicing revenues increased as U.S. mutual fund open shareowner accounts processed increased 4.3% from 90.1 million at March 31, 2004 to 94.0 million at March 31, 2005. Financial Services Segment operating revenues from international operations for the three months ended March 31, 2005 decreased 16.6% to \$26.1 million over the same period in 2004. The decrease for the three months ended March 31, 2005 compared to the same period in the prior year is primarily from lower software license fee revenues of \$4.8 million.

During the quarter, the Company obtained no new client commitments. The Company currently has commitments from a total of four complexes with a combined total of 6.2 million shareowner accounts and one insurance client with 200,000 401(k) participants. These new

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clients will be converted throughout the remainder of 2005. The Company is also pursuing a number of potential new clients for mutual fund processing services.

### **Costs and expenses**

Segment costs and expenses for the three months ended March 31, 2005 increased 8.5% to \$245.9 million over the same period in 2004. This increase was primarily from higher OOP expenses of \$5.4 million associated with higher

OOP revenues, additional compensation expense of \$4.4 million related to the restricted stock grant and increased lock\line costs to support revenue growth.

Segment costs and expenses continue to include costs associated with the development of Fairway, the Company's new securities transfer system, and Managed Asset Platform ( MAP ) and Open Platform for Advisors ( OpenPFA ), the Company's Wealth Management and Advisor products. Upon the closing of the pending EquiServe sale, the Fairway development costs will be reimbursable. Client accounts are currently being converted to the Fairway system from older systems and there are certain costs involved in these conversions. The Company will continue to incur development and conversion costs related to MAP and OpenPFA.

### **Depreciation and amortization**

Segment depreciation and amortization decreased 5.6% or \$1.4 million for the three months ended March 31, 2005 over the same period in 2004, primarily attributable to lower capital expenditures.

The Segment continues to incur amortization for capitalized costs related to the new Fairway system. As additional work is completed and more costs are capitalized, depreciation will increase as it relates to Fairway. The Company has assigned a 10 year life to Fairway for amortization purposes. The Fairway system is expected to be written off concurrent with the closing of the pending sale of EquiServe.

### **Income from operations**

Segment income from operations for the three months ended March 31, 2005 decreased 7.6% to \$53.6 million over the same period in 2004. The decrease resulted primarily from an increase in costs and expenses of \$19.3 million compared to the prior year quarter, primarily from higher OOP expenses of \$5.4 million associated with higher OOP revenues, additional compensation expense of \$4.4 million related to the restricted stock grant and increased lock\line costs to support revenue growth.

## **OUTPUT SOLUTIONS SEGMENT**

### **Revenues**

Output Solutions Segment total revenues for the three months ended March 31, 2005 increased 5.0% to \$280.7 million compared to the same period in 2004. Output Solutions Segment operating revenues for the three months ended March 31, 2005 increased 6.2% to \$128.4 million compared to the same period in 2004. The operating revenue increase resulted principally from increased revenues of \$3.9 million and \$2.5 million in the telecommunications and banking industries, respectively for the three months ended March 31, 2005 compared to the same period last year.

### **Costs and expenses**

Segment costs and expenses for the three months ended March 31, 2005 increased 4.5% to \$262.1 million over the same period in 2004. The increase is a result of higher OOP costs associated with higher volumes and higher personnel costs, including additional compensation cost of \$1.2 million related to the restricted stock grant. For the three months ended March 31, 2004, Segment results include \$0.6 million of costs associated with facility and other consolidations.

**Depreciation and amortization**

Segment depreciation and amortization decreased 6.9% to \$6.7 million for the three months ended March 31, 2005 compared to the same period in 2004, primarily from lower capital expenditures.

**Income from operations**

Segment income from operations for the three months ended March 31, 2005 increased 29.3% to \$11.9 million over the same period in 2004. The increase related primarily to increased revenues of \$3.9 million and \$2.5 million in the telecommunications and banking industries, respectively. Segment results for the three months ended March 31, 2004 include \$0.6 million of costs associated with facility and other consolidations.

## **CUSTOMER MANAGEMENT SEGMENT**

### **Revenues**

Customer Management Segment total revenues for the three months ended March 31, 2005 decreased 7.0% to \$59.5 million as compared to the same period in 2004. Customer Management Segment operating revenues for the three months ended March 31, 2005 were \$46.3 million, a decrease of \$3.7 million or 7.4% over the same period in 2004. Processing and software service revenues decreased \$3.6 million to \$45.7 million for the three months ended March 31, 2005 from \$49.3 million for the three months ended March 31, 2004. Total cable and satellite subscribers serviced were 36.2 million at March 31, 2005, a decrease of 3.2% compared to year end 2004 levels, resulting from a decrease in international cable subscribers serviced, partially offset by an increase in U.S. satellite subscribers.

### **Costs and expenses**

Segment costs and expenses for the three months ended March 31, 2005, decreased \$1.4 million or 2.7% compared to the same period in 2004, primarily due to lower variable operating costs partially offset by additional compensation expense of \$0.6 million related to the 2004 restricted stock grant and increased development costs for Collabrent.

Segment costs and expenses continue to include costs associated with the development of Collabrent, the Company's billing and customer care solution that has been designed as a fully integrated modular system to support the broadband, satellite, wire-line and voice over Internet Protocol telephony markets. Conversion of subscriber accounts to the Collabrent system has begun and the Company expects to incur additional costs on these conversions. Development and conversion costs are expected to continue at the current rate until the majority of subscriber accounts are converted onto Collabrent, however the amount that qualifies for capitalization of internally developed software costs will decrease.

### **Depreciation and amortization**

Segment depreciation and amortization for the three months ended March 31, 2005 increased \$0.2 million to \$1.5 million compared to the same period in 2004, primarily from the amortization of capitalized software for the first operational components of Collabrent, and increased capital expenditures.

The first components of Collabrent were placed into production in July 2004 and accordingly, amortization of the capitalized costs for those components commenced at that time. The Company has assigned a 7 year life to Collabrent for amortization purposes.

### **Income from operations**

Customer Management Segment income from operations for the three months ended March 31, 2005 decreased \$3.3 million to \$7.6 million compared to the same period in 2004. The decrease is primarily attributable to decreased operating revenues.

## **INVESTMENTS AND OTHER SEGMENT**

**Revenues**

Investments and Other Segment operating revenues were \$18.0 million for the three months ended March 31, 2005, an increase of \$2.6 million as compared to the same period in 2004. The increase is primarily attributable to increased real estate leasing activity.

**Costs and expenses**

Segment costs and expenses increased \$1.6 million to \$10.2 million for the three months ended March 31, 2005 compared to the prior year quarter.

**Depreciation and amortization**

Segment depreciation and amortization increased \$1.1 million to \$4.2 million for the three months ended March 31, 2005, as compared to the same period in 2004.

**Income from operations**

Segment income from operations totaled \$3.7 million for the three months ended March 31, 2005 as compared to \$3.8 million for the three months ended March 31, 2004.

## Segment Operating Data

The following table presents operating data for the Company's operating business Segments:

|   | March 31,<br>2005 | December 31,<br>2004 |
|---|-------------------|----------------------|
| <b>Financial Services Operating Data</b>                      |                   |                      |
| Mutual fund shareowner accounts processed (millions)          |                   |                      |
| U.S.  |                   |                      |
| Non-retirement accounts                                       | 56.6              | 55.9                 |
| IRA mutual fund accounts                                      | 22.1              | 21.7                 |
| Other retirement accounts                                     | 3.5               | 3.3                  |
| TRAC mutual fund accounts                                     | 6.3               | 6.3                  |
| Section 529 and Educational IRA's                             | 5.5               | 5.0                  |
|   | 94.0              | 92.2                 |
| International   |                   |                      |
| United Kingdom (1)  | 5.3               | 5.3                  |
| Canada (2)  | 6.2               | 6.2                  |
| TRAC participants (millions)                                  | 4.1               | 3.9                  |
| Security transfer accounts processed (millions)               | 18.4              | 18.8                 |
| Automated Work Distributor workstations (thousands)           | 97.8              | 96.4                 |
| lockline supported consumers (millions)                       | 26.8              | 25.3                 |
| <b>Customer Management Operating Data</b>                     |                   |                      |
| Video/broadband/satellite TV subscribers processed (millions) |                   |                      |
| U.S.  | 31.6              | 31.0                 |
| International   | 4.6               | 6.4                  |

(1) Processed by International Financial Data Services, (U.K.) Limited, an unconsolidated affiliate of the Company.

(2) Processed by International Financial Data Services, (Canada) Limited, an unconsolidated affiliate of the Company.

|  | For the Three Months<br>Ended March 31, |       |
|--|---|-------|
|  | 2005                                    | 2004  |
| <b>Output Solutions Operating Data</b> |   |       |
| Images produced (millions)             | 2,552                                   | 2,185 |
| Items mailed (millions)                | 437                                     | 429   |



## LIQUIDITY AND CAPITAL RESOURCES

### Sources and Uses of Cash

The Company's primary source of liquidity is cash provided by operations. Principal uses of cash are reinvestment in the Company's proprietary technologies, capital expenditures, stock repurchases, and payments on debt. Information on the Company's consolidated cash flows for the three months ended March 31, 2005 and 2004 is presented in the condensed consolidated statement of cash flows, categorized by operating activities, investing activities, and financing activities.

### Operating Activities

The Company's cash flow from operating activities totaled \$112.1 million for the three months ended March 31, 2005. Operating cash flows of \$112.1 million in 2005 resulted principally from net income of \$49.2 million plus net non-cash charges included in net income of \$42.9 million (principally \$35.8 million of depreciation and amortization), offset by an increase in working capital of \$20.0 million (principally a decrease in trade accounts receivable of \$44.7 million and an increase in deferred revenues and gains of \$31.8 million offset by a decrease in accrued compensation and benefits of \$30.0 million and an increase in inventories and other assets of \$20.8 million). The Company had \$99.8 million of cash and cash equivalents at March 31, 2005.

### *Cash Management Service*

The Company has a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. All invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company has initiated a similar cash management service for a portion of its corporate securities processing transfer agency accounts. The Company had \$70.3 million and \$75.2 million of mutual fund transfer agency investments and deposits at March 31, 2005 and December 31, 2004, respectively. The Company also had \$233.0 and \$0 of transfer agency investments and deposits related to its corporate securities processing business as of March 31, 2005 and December 31, 2004, respectively, classified as Assets of business held for sale and Liabilities of business held for sale in the Consolidated Balance Sheet.

### *Customer Deposits*

The Company collects from its clients and remits to the U.S. Postal Service a significant amount of postage. A significant number of contracts allow the Company to pre-bill and/or require deposits from its clients to mitigate the initial impact on cash flow.

### Investing Activities

Cash flows used in investing activities totaled \$39.0 million for the three months ended March 31, 2005. The Company continues to make significant investments in capital equipment, software, systems and facilities.

*Capital Expenditures*

During the three months ended March 31, 2005 the Company expended \$33.8 million in capital expenditures for equipment, software and systems and facilities, which includes amounts directly paid by third party lenders. Of this total, \$5.2 million related to the Investments and Other Segment, which consists primarily of acquisitions of buildings and building improvements. Future capital expenditures are expected to be funded primarily by cash flows from operating activities, secured term notes or draws from bank lines of credit, as required.

*Investments*

The Company made \$7.7 million of investments in available-for-sale securities for the three month period ending March 31, 2005, and made \$0.7 million of advances to unconsolidated affiliates and other investments. During the three months ended March 31, 2005, the Company received \$3.1 million from the sale of investments in available-for-sale securities and received \$0.1 million during the same period from the sale and maturities of other investments.

The Company expended approximately \$25.6 million during the first quarter of 2004 for a contingent payment for the purchase of EquiServe.

### **Financing Activities**

Cash flows used in financing activities totaled \$69.9 million for the three month period ending March 31, 2005.

#### *Common Stock Issuances and Repurchases*

The Company received proceeds of \$7.0 million from the issuance of common stock under the Company's Employee Stock Purchase Plan and from the exercise of employee stock options during the three month period ending March 31, 2005.

On October 19, 2004, the Company's Board of Directors authorized an additional 5.5 million share repurchase to the 6.0 million share repurchase plan authorized on February 26, 2004. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through February 28, 2007. In the first quarter of 2005, 2.1 million shares were repurchased under the forward stock purchase agreement as explained below. At March 31, 2005, the Company had purchased 7.8 million shares at an average price of \$49.08 per share since the program commenced. At March 31, 2005, the Company had approximately 3.7 million shares remaining to be purchased under this program.

Shares received in exchange for tax withholding obligations arising from exercise of options to purchase the Company's stock are included in common stock repurchased in the Condensed Consolidated Statement of Cash Flows. The amount of such share withholdings for option exercises were \$1.6 million in 2005.

During the fourth quarter 2004, the Company entered into a forward stock purchase agreement for the repurchase of its common stock as a means of securing potentially favorable prices for future purchases of its stock. This agreement contained provisions which allowed the Company to elect a net cash or net share settlement in lieu of physical settlement of shares. On January 3, 2005, the Company entered into a new forward stock purchase agreement that requires physical settlement of shares. The shares held under the 2004 forward stock purchase agreement were assumed under the January 2005 forward stock purchase agreement. As of March 31, 2005, 2.1 million shares of common stock have been purchased under the January 2005 agreement at an average price of \$51.14 per share. In connection with this agreement, the Company increased debt due within one year and increased stock under forward purchase agreement by \$105.8 million.

#### *Debt Activity*

The Company has used four primary sources of debt financing: 1) Parent Company Syndicated line of credit facility; 2) Parent Company convertible debentures; 3) Subsidiary line of credit facility; and 4) Real estate subsidiary secured promissory notes. The Company has also utilized bridge loans and forward stock purchase agreements to augment the above sources of debt financing. Net repayments from the Company's line of credit facilities totaled \$47.8 million for the three month period ending March 31, 2005. The Company had \$1,513.4 million of debt outstanding at March 31, 2005.

**Significant Transactions**

*Real Estate Joint Venture*

The Company is a 50% partner in a limited purpose real estate joint venture. The real estate joint venture plans to develop approximately 1.1 million square feet of office space intended to be leased to the U.S. government. The project is estimated to cost approximately \$362 million and has been financed with \$315 million of non-recourse insured bonds (issued June 2004) with the remainder in the form of equal equity contributions from the real estate joint venture partners. At March 31, 2005, each partner had contributed half of the aggregate equity of \$22.7 million.

The non-recourse bonds will bear interest on the unpaid principal amount thereof at a per annum rate equal to three-month LIBOR plus 40 basis points. The real estate joint venture entered into an interest rate swap agreement to fix the interest expense at 6.2% over the life of the bonds. The Company was not a party to this transaction. The

Company records its proportional share of any unrealized gain (loss) associated with the interest rate swap in Other Comprehensive Income.

The real estate joint venture partners have committed aggregate additional equity investments of approximately \$23.9 million to complete the financing and up to \$33.3 million of equity investments in the aggregate in the event of delays in construction or lease commencement. The remaining equity contributions of \$23.9 million to \$57.1 million have been secured through \$57.1 million of letters of credit that expire beginning in 2007 through 2008. The Company is responsible for \$28.6 million of the letters of credit. At March 31, 2005, there were no outstanding borrowings against the letters of credit.

#### *lockline*

The August 2, 2002 acquisition of lockline was accounted for as a purchase. The minimum purchase price of \$190 million was paid in cash at closing and was financed by debt. There are provisions in the acquisition agreement that allow for additional consideration to be paid in cash if lockline's revenues, as defined in the acquisition agreement, exceed certain targeted levels for 2004. Goodwill will be increased by the amount of additional consideration paid.

#### *EquiServe*

The Company announced on October 20, 2004 that it has signed a definitive agreement for Computershare Ltd. ( CPU ) to acquire, in a taxable transaction, the Company's wholly owned subsidiary, EquiServe, Inc. ( EquiServe ). Upon closing, the Company will receive U.S. \$216 million of cash plus 29.6 million shares of CPU common stock. The CPU stock is traded on the Australian Stock Exchange (ASX: CPU). The CPU common stock to be received represents slightly less than 5% of CPU's total issued capital, post-transaction, and had a value of approximately U.S. \$125 million on April 27, 2005. Under terms of the agreement, the Company will continue to provide EquiServe various services, including data processing support, AWD products and services, Output Solutions services, E-Proxy services and lost instrument surety bond coverage. The disposition does not qualify to be reported as a discontinued operation due to ongoing cash flows from the aforementioned agreements. The Company recorded EquiServe operating revenues of \$52.7 million and \$54.3 million, and Out-of-Pocket ( OOP ) reimbursements of \$18.1 million and \$20.9 million, for the three months ended March 31, 2005 and 2004, respectively. EquiServe is included in the Financial Services Segment.

The Company expects to record a one-time after-tax gain of approximately \$57 million associated with the transaction. The Company estimates that it will receive approximately \$147 million of after-tax cash proceeds associated with the transaction that may be used to reduce debt or repurchase shares of DST common stock. The Company believes that the transaction will be slightly dilutive to diluted earnings per share. The estimated after-tax gain and after-tax cash proceeds will fluctuate based on changes in the value of the CPU common stock to be received at closing. The value of the CPU stock will fluctuate from changes in price and changes in the U.S. and Australian foreign currency exchange rates. The transaction is subject to approval from the Office of the Comptroller of Currency. The Company believes the transaction will close during the second quarter of 2005.

#### **Acquisition of Health Plan Solutions**

The Company announced on April 8, 2005 that one of its subsidiaries had entered into a definitive agreement with Computer Sciences Corporation ( CSC ) under which the subsidiary would acquire CSC's Health Plan Solutions ( HPS ) business for 7.1 million shares of CSC common stock held by the DST subsidiary, and on April 29, 2005, DST's subsidiary completed the acquisition of HPS. The exchange value of the CSC shares at closing was \$45.53 per share and HPS held \$224.6 million of cash at the time of the exchange.

HPS is an enterprise software developer, software application services provider and business process outsourcer for the U.S. commercial healthcare industry and has been serving the healthcare industry since the 1960 s. HPS has 270 clients and its proprietary systems are used to provide claims administration services for approximately 24 million covered lives. HPS has approximately 700 employees and had revenues of \$110 million for the year ended April 2, 2004 and \$82 million for the nine months ended December 31, 2004.

The Company believes that the HPS business will expand its presence in the healthcare processing services industry, which currently uses DST's AWD and Output Solutions products. The Company expects to record net income of approximately \$50 million from the exchange of the CSC shares. The Company believes operations of HPS will be essentially neutral to DST's diluted earnings per share in 2005 and accretive in 2006. The actual impact on earnings per share will be dependent, among other factors, upon the finalization of the business combination accounting entries, which includes the allocation of approximately \$85 million of value in excess of the net tangible assets of the HPS business to be received.

The transaction has been structured to meet the requirements for treatment as a tax-free reorganization in accordance with Section 355 of the Internal Revenue Code. The Company has received two separate tax opinions at the more likely level of assurance that the transaction will comply with the provisions of Section 355. The tax opinions are not binding on the IRS. It is possible that the IRS could take a position contrary to the Company's. If the IRS were to take such a contrary position and ultimately prevail, then the Company could be required to recognize a gain on the exchange as if the Company sold the CSC shares at fair market value. The Company estimates, that under those circumstances, it would recognize a tax gain of approximately \$283 million and would incur federal and state tax liabilities of approximately \$111 million. Given the size and unique nature of the transaction, and the fact that the tax opinions of the Company's tax advisors have not reached the should level of assurance, the Company, for financial accounting purposes, has provided a tax reserve for the potential tax. The Company has provided an additional \$32 million of tax provision in April 2005, which, when added to previously recorded amounts results in a \$111 million accrual for the full amount of the potential tax. The Company will accrue interest related to the potential tax, until such tax treatment is finally determined.

#### **Restricted Stock Grant**

On October 29, 2004, the Compensation Committee of the Board of Directors of the Company voted to grant as of November 10, 2004, approximately 2.8 million shares of restricted common stock of the Company to officers and certain other participants in the DST Systems, Inc. 1995 Stock Option and Performance Award Plan. For ten senior executive officers, the restricted shares are subject to the earnings per share goal that must be met as an additional condition to the lapse of restrictions on January 31, 2010. Subject to early lapsing and forfeiture provisions, the restrictions on the shares granted to all other officers and participants lapse on November 10, 2009. The restricted stock grants cover the five-year period of 2005 through 2009 and are intended to be the only restricted stock grants for such periods other than for new hires or promotions, for special employee recognition purposes, and, in accordance with past practice, for the portion of each annual incentive bonus the executive officers are required to take in the form of equity compensation. The Compensation Committee made the grant after evaluating the Company's equity compensation practices, particularly in light of changes pending at the time of the grant in the accounting rules applicable to stock options.

The impact of amortized compensation expense for the quarter ended March 31, 2005 was \$6.4 million. The Company estimates that the impact of amortized compensation expense attributable to the grant for each subsequent year covered by the grant, based upon the average of the high and low trading prices for the Company's shares on November 10, 2004, will be approximately \$27 million for the years 2005 through 2008 and \$22.5 million in 2009. These estimates assume that all shares will be vested and all performance criteria will be met.

The Company believes that its existing cash balances and other current assets, together with cash provided by operating activities and, as necessary, the Company's bank and revolving credit facilities, will suffice to meet the Company's operating and debt service requirements and other current liabilities for at least the next 12 months. Further, the Company believes that its longer term liquidity and capital requirements will also be met through cash provided by operating activities and bank credit facilities.

#### **FIN 45 Disclosures**

In addition to the guarantees entered into discussed in Unconsolidated Affiliates above, the Company has also guaranteed certain obligations of certain joint ventures under service agreements entered into by the joint ventures and their customers. The amount of such obligations is not stated in the agreements. Depending on the negotiated terms of the guaranty and/or on the underlying service agreement, the Company's liability under the guaranty may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

In certain instances in which the Company licenses proprietary systems to customers, the Company gives certain indemnities (including infringement indemnities) and warranties to the licensee, the terms of which vary depending on the negotiated terms of each respective license agreement. Such warranties generally warrant that such systems will perform in accordance with their specifications. The amount of such obligations is not stated in the license agreements. The Company's liability for breach of such obligations may be subject to time and materiality limitations, monetary caps and other conditions and defenses.



From time to time, the Company enters into service agreements and other agreements with unaffiliated parties containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement. The amount of such obligations is not stated in the agreements. The Company's liability under such indemnification provisions may be subject to time and materiality limitations, monetary caps and other conditions and defenses. Such indemnity obligations include those described herein.

The Company has entered into purchase and service agreements with its vendors, and consulting agreements with providers of consulting services to the Company, pursuant to which the Company has agreed to indemnify certain of such vendors and consultants, respectively, against third party claims arising from the Company's use of the vendor's product or the services of the vendor or consultant.

In connection with the acquisition or disposition of subsidiaries, operating units and business assets by the Company, the Company has entered into agreements containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective agreement, but which are generally described as follows: (i) in connection with acquisitions made by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller relating to the subject subsidiary, operating unit or asset and arising after the closing of the transaction, and (ii) in connection with dispositions made by the Company, the Company has agreed to indemnify the buyer against damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject subsidiary, operating unit or business assets in the disposition agreement if such representations or warranties were untrue when made, or due to any breach of the representations, warranties, agreements or covenants contained in the agreement.

The Company has entered into agreements with certain third parties, including banks and escrow agents, that provide software, escrow, fiduciary and other services to the Company or to its benefit plans or customers. Under such agreements, the Company has agreed to indemnify such service providers for third party claims relating to the carrying out of their respective duties under such agreements.

The Company has entered into agreements with lenders providing financing to the Company pursuant to which the Company agrees to indemnify such lenders for third party claims arising from or relating to such financings. In connection with real estate mortgage financing, the Company has entered into environmental indemnity agreements in which the Company has agreed to indemnify the lenders for any damage sustained by the lenders relating to any environmental contamination on the subject properties.

In connection with the acquisition or disposition of real estate by the Company, the Company has entered into real estate contracts containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective contract, but which are generally described as follows: (i) in connection with acquisitions by the Company, the Company has agreed to indemnify the seller against third party claims made against the seller arising from the Company's on-site inspections, tests and investigations of the subject property made by the Company as part of its due diligence and against third party claims relating to the operations on the subject property after the closing of the transaction, and (ii) in connection with dispositions by the Company, the Company has agreed to indemnify the buyer for damages incurred by the buyer due to the buyer's reliance on representations and warranties relating to the subject property made by the Company in the real estate contract if such representations or warranties were untrue when made and against third party claims relating to operations on the subject property prior to the closing of the transaction.

In connection with the leasing of real estate by the Company, as landlord and as tenant, the Company has entered into occupancy leases containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective lease, but which are generally described as follows: (i) in connection with leases in which the Company is the tenant, the Company has agreed to indemnify the landlord against third party claims relating to the Company's occupancy of the subject property, including claims arising from loss of life, bodily injury and/or damage to property thereon, and (ii) in connection with leases in which the Company is the landlord, the Company has agreed to indemnify the tenant against third party claims to the extent occasioned wholly or in part by any negligent act or omission of the Company or arising from loss of life, bodily injury and/or damage to property in or upon any of the common areas or other areas under the Company's

control.

At March 31, 2005, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect indebtedness of others in accordance with FIN 45.

#### **FIN 46 Disclosures**

In December 2003, the revised FASB Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 was issued, which requires the consolidation of certain types of entities in which the Company absorbs a majority of another entity's expected losses, receives a majority of the other entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the other entity. These entities are called variable interest entities. The principal characteristics of variable interest entities are (1) an insufficient amount of equity to absorb the entity's expected losses, (2) equity owners as a group are not able to make decisions about the entity's activities, or (3) equity that does not absorb the entity's losses or receive the entity's residual returns. Variable interests are contractual, ownership or other monetary interests in an entity that change with fluctuations in the entity's net asset value. As a result, variable interest entities can arise from items such as joint ventures, lease agreements, loan arrangements, guarantees or service contracts.

If an entity is determined to be a variable interest entity, the primary beneficiary must consolidate the entity. The primary beneficiary is the holder of the variable interests that absorb a majority of the variable interest entity's expected losses or receive a majority of the entity's residual returns in the event no holder has a majority of the expected losses. There is no primary beneficiary in cases where no single holder absorbs the majority of the expected losses or receives a majority of the residual returns. The determination of the primary beneficiary is based on projected cash flows at the inception of the variable interests.

With regard to real estate, the Company is the lessee in a series of operating leases covering a large portion of its Kansas City based leased office facilities. The lessors are generally joint ventures (in which the Company has a 50% ownership) that have been established specifically to purchase, finance and engage in leasing activities with the joint venture partners and unrelated third parties. Two of the real estate joint ventures, which the Company entered into during 2001 and 2003, have entered into financing arrangements with the Company's wholly owned captive insurance company. In each case, the other joint venture partner has guaranteed at least 50% of the joint venture's borrowings (\$38.2 million at March 31, 2005) from the Company's captive insurance company. The Company is generally not the primary beneficiary of the joint ventures if the lease terms are consistent with market terms at the inception of the lease and do not include a residual value guarantee, fixed-price purchase options or similar features that disproportionately obligate it to absorb decreases in value or entitle it to participate in increases in the value of the real estate. The Company's analyses of its real estate joint ventures indicate that a large portion of the real estate joint ventures are variable interest entities, however the real estate joint ventures do not need to be consolidated because the Company is not the primary beneficiary. The Company entered into two real estate joint ventures during 2004. The Company has determined that these ventures are not variable interest entities.

With regard to operating joint ventures, the Company has formed or entered into operating joint ventures to enter into or expand its presence in target markets. The Company has three significant operating joint ventures; BFDS; IFDS (includes IFDS U.K., IFDS Canada and International Financial Data Services, Luxembourg); and Argus. Each of these operating joint ventures was formed prior to February 1, 2003. The Company's FIN 46 analyses of these operating joint ventures indicate that none qualify as variable interest entities due to meeting the criteria for the operating joint venture exception in FIN 46. Accordingly, the Company does not consolidate the operating results of these operating joint ventures.

#### **OTHER**

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**Comprehensive income (loss).** The Company's comprehensive income (loss) totaled \$(35.6) million for the three months ended March 31, 2005 compared to \$37.8 million for the comparable period in 2004. Comprehensive income (loss) consists of net income of \$49.2 million and other comprehensive loss of \$(84.8) million for the three months ended March 31, 2005, respectively, and net income of \$51.6 million and other comprehensive loss of \$(13.8) million for the three months ended March 31, 2004, respectively. Other comprehensive income consists of

unrealized gains (losses) on available-for-sale securities, net of deferred taxes, reclassifications for net gains included in net income, foreign currency translation adjustments, and the Company's share of an unconsolidated affiliate interest rate swap. The principal difference between net income and comprehensive income is the net change in unrealized gains (losses) on available-for-sale securities.

**Other than temporary impairments.** At March 31, 2005, the Company's available-for-sale securities had unrealized holding losses of \$1.4 million. If it is determined that a security's net realizable value is other than temporary, a realized loss will be recognized in the statement of operations and the cost basis of the security reduced to its estimated fair value. The Company does not believe that the unrealized losses at March 31, 2005 are other than temporary.

The Company recognized investment impairments of \$0.4 million and \$1.2 million for the three months ended March 31, 2005 and 2004, respectively, which the Company believed were other than temporary. The impairments related primarily to investments held by the Investment and Other Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted market value and is reflected in the Other income, net line in the statement of income.

**Seasonality.** Generally, the Company does not have significant seasonal fluctuations in its business operations. Processing and output solution volumes for mutual fund and corporate securities transfer processing customers are usually highest during the quarter ended March 31 due primarily to processing year-end transactions and printing and mailing of year-end statements and tax forms during January. The Company has historically added operating equipment in the last half of the year in preparation for processing year-end transactions which has the effect of increasing costs for the second half of the year. Revenues and operating results from individual license sales depend heavily on the timing and size of the contract.

#### **Recently Issued Accounting Standards**

In December 2004, the FASB issued its final standard on accounting for share-based payments, Statement of Financial Accounting Standards No. 123R (SFAS No. 123R) (revised 2004). SFAS 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The cost will be measured based on the fair value of the instruments issued. SFAS No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R replaces SFAS No. 123 and supersedes APB Opinion No. 25. As originally issued in 1995, SFAS No. 123 established as preferable the fair value based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the fair value method been applied. The Company will apply SFAS No. 123R effective January 1, 2006 and expects to use the modified prospective method to adopt the standard. The Company is currently evaluating the impact of this new accounting standard.

There is a proposed accounting standard that involves an amendment to SFAS No. 128, Earnings per Share that would impact the way the Company treats the incremental shares to be issued from the assumed conversion of the \$840 million of convertible debentures issued in August 2003 in calculating diluted earnings per share. The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the if-converted method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle the conversions with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128. The proposed amendment to SFAS 128 is expected to be issued in the third quarter 2005, and would require retroactive restatement of a company's diluted earnings per share calculations. This would require the Company to restate its 2003, 2004 and 2005 diluted earnings per share calculations. Under the proposed amended SFAS 128 if converted method, in calculating diluted earnings

per share the Company would need to increase net income for the interest

expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion to 17.1 million shares, the amount of shares that would be issued if all \$840 million of convertible debentures would be converted to equity. Under this method, diluted earnings per share would have been \$0.56 for each of the quarters ended March 31, 2005 and 2004, as compared to the reported amounts of \$0.61 and \$0.62, respectively.

The proposed change in accounting principles does not affect the Company's ability to ultimately settle the convertible debentures in cash, shares or any combination thereof. They would affect the calculation of diluted earnings per share during the period the debentures are outstanding.

The estimated impact of this new accounting standard reflects the Company's current views. There may be material differences between these estimates and the actual impact of the standard.

### **Company-Specific Trends and Risks**

The level of importance of each of the following trends and risks may vary from time to time and the trends and risks are not listed in any specific order of importance.

#### **Dependence on Certain Industries**

The Company derives a substantial proportion of its consolidated revenues from the delivery of services and products to clients that are publicly traded corporations, mutual funds, investment managers, insurance companies, banks, brokers, or financial planners or are in the video/broadband, direct broadcast satellite, wire-line, wireless and cellular, debt protection, Internet protocol telephony, Internet, utility and other businesses. Consolidations which would decrease the number of potential clients in such businesses, events which would reduce the rate of growth in or negatively impact such businesses, or significant declines in the number of accounts or subscribers serviced by clients in such businesses could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Development of Technology**

The Company is implementing and enhancing (a) a new stock transfer system ( Fairway ) that will replace the existing systems used by its wholly-owned subsidiary EquiServe, Inc. to maintain corporate stock transfer records, (b) a new subscriber management system, Collabrent, that will replace the existing systems used by its wholly-owned subsidiaries DST Interactive, Inc. and DST Innovis, Inc. to maintain cable and satellite TV subscriber records and (c) new proprietary systems for MAP and OpenPFA that are designed to facilitate the distribution, investment management, trading, reconciliation and reporting for managed accounts. Failure to successfully complete development and implementation of Fairway, Collabrent, MAP or OpenPFA, to successfully convert new or existing clients to such systems, or to successfully complete and implement various other current technology projects could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Impact of Technological and Market Changes**

#### **Recently Issued Accounting Standards**

The Company's clients use computer technology-based products and services in the complex and rapidly changing markets in which they operate. The technology available to the Company's clients, such as methods for the electronic dissemination of documents, is expanding. The Company's future success depends in part on its ability to continue to develop and adapt its technology, on a timely and cost effective basis, to meet clients' needs and demands for the latest technology. There can be no assurance that the Company will be able to respond adequately and in advance of its competitors to these technological demands or that more advanced technology, including technology for the electronic dissemination of documents, will not reduce or replace the need for certain of the Company's products and services.

Similarly, certain of the Company's clients provide services related to communications devices and/or the communications industry. The communications industry, and wireless communication devices in particular, are



rapidly evolving. The future success of the Company's business of providing administrative services to clients in the communications industry depends in part on the Company's ability to continue to develop and adapt its services, on a timely and cost effective basis, to meet clients' needs and demands for administrative services appropriate to the latest communications technology.

The Company has expended considerable funds to develop products to serve new and rapidly changing markets. If such markets grow or converge more slowly than anticipated or the Company's products and services fail to achieve market acceptance, there could be a material adverse effect on the financial condition, results of operations and cash flow of the Company.

The Company significantly invests in available-for-sale equity securities of other companies. The value of such securities depends on the market for such securities and on changes in the markets in which such other companies operate. Any significant decline in the value of the Company's equity investments could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Reliance on Facilities**

The Company's processing services are primarily dependent on facilities housing central computer operations or in which information, image or bill and statement processing occur. The Company's mutual fund full service, corporate stock transfer and warranty and debt protection administrative service businesses are dependent on call centers in various locations. The Company owns, leases and manages real estate. A natural disaster, terrorist act or other calamity that causes long-term damage to the Company's facilities, or economic or other events impacting the real estate markets in which the Company owns, leases or manages real estate, could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Reliance on Insurers**

Currently, the Company's business of providing administrative services in connection with the insurance, warranty, and debt protection services of its clients significantly depends upon its business relationships with one or more insurance companies that provide coverage necessary for the clients' products and services. Termination of the business relationships with these insurance companies could have a material adverse effect on the financial condition, results of operations and cash flow of the Company if the Company were unable to arrange alternative sources of coverage.

#### **Claims Experience Risk**

EquiServe is a transfer agent for public companies, and a Company subsidiary (Vermont Western) reinsures a portion of the risk of certain EquiServe clients in connection with EquiServe replacing stock certificates lost by the clients' registered shareholders. Certain of the Company's subsidiaries (lockline) provide administrative services in connection with insurance and warranty products and for selected clients, Vermont Western reinsures all or a portion of the risk underwritten in connection with insurance policies related to damaged equipment replacement. Vermont Western assumes loss risk based on an examination of clients' loss experience history and establishes reserves against loss. However, EquiServe, lockline and Vermont Western do not have control over the loss experience, and actual loss experience results could differ from the estimates. Sufficiently unfavorable client loss experience could have a material adverse effect on the financial condition and results of

operations of the Company.

**Importance of Key Personnel**

The Company's operations and the continuing implementation of its business strategy depend upon the efforts of its technical personnel and senior management. Recruiting and retaining capable personnel, particularly those with expertise in the types of computer hardware and software utilized by the Company, are vital to the Company's success. There is substantial competition for qualified technical and management personnel, and there can be no assurance that the Company will be able to attract or keep the qualified personnel it requires. The loss of key

personnel or the failure to hire qualified personnel could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

### **Lack of Control of Joint Ventures**

The Company's business strategy for growth and expansion includes reliance on joint ventures. The Company derives part of its net income from its pro rata share in the earnings of these unconsolidated companies. Although the Company owns significant equity interests in such companies and has representation on their Boards of Directors or governance structures, the Company is not in a position to exercise control over their operations, strategies or financial decisions without the concurrence of its equity partners. The Company's equity interests in BFDS, Argus Health Systems, Inc., and International Financial Data Services Limited Partnership and International Financial Data Services Limited (collectively, IFDS) are subject to contractual buy/sell arrangements that may restrict the Company's ability to fully dispose of its interest in these companies and that under certain circumstances permit such companies to purchase the Company's interest.

The other parties to the Company's current and future joint venture arrangements may at any time have economic, business or legal interests or goals that are inconsistent with those of the joint venture or of the Company. In addition, if such other parties were unable to meet their economic or other obligations to such ventures, it could, depending upon the nature of such obligations, adversely affect the financial condition, results of operations and cash flow of the Company.

### **Significant Competition from Other Providers**

The Company and its subsidiaries and joint ventures encounter significant competition for the Company's services and products from other third party providers of similar services and products and from potential clients who have chosen not to outsource certain services the Company could provide. The Company's ability to compete effectively depends, in part, on the availability of capital and other resources, and some of these competitors have greater resources and greater access to capital than the Company. The Company also competes for shareowner accounting services with brokerage firms that perform sub-accounting services for the brokerage firms' customers who purchase or sell shares of mutual funds for which the Company serves as transfer agent. Such brokerage firms maintain only an omnibus account with the Company representing the aggregate number of shares of a mutual fund owned by the brokerage firms' customers, thus resulting in fewer mutual fund shareowner accounts being maintained by the Company. Any of these events could have a material adverse effect on the financial condition, results of operations and cash flow, including gross profit margins, of the Company. In addition, competitive factors could influence or alter the Company's overall revenue mix between the various business Segments.

### **Regulation**

As registered transfer agents, the Company, its subsidiary EquiServe, its indirect subsidiary, EquiServe Trust Company, N.A. (EquiServe Trust), its joint venture BFDS and BFDS' subsidiary National Financial Data Services, Inc. (collectively, Domestic Transfer Agent Businesses) are subject to the Securities Exchange Act of 1934, as amended (the Exchange Act) and to the rules and regulations of the Securities and Exchange Commission (SEC) under the Exchange Act which require them to register with the SEC and which impose on them recordkeeping and reporting requirements. Certain of the operations and records of the Domestic Transfer Agent Businesses are subject to examination by the SEC and, as providers of services to financial institutions, to examination by bank and thrift regulatory agencies. In connection with its transfer agency business, EquiServe Trust serves as a limited purpose trust company subject to regulation of the Office of the Comptroller of the Currency. In addition, companies wholly owned by IFDS (IFDS Transfer Agent Businesses) are subject to regulation of similar regulatory agencies in other countries. Any of the Domestic Transfer Agent Businesses or IFDS Transfer Agent Businesses could have its regulatory

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authorizations suspended or revoked if it were to materially violate applicable regulations, which could have an adverse effect on the financial condition, results of operations and cash flow of the Company.

Similarly, certain of the Company's subsidiaries involved in the business of providing administrative services in connection with insurance and warranty products are licensed or registered insurance agencies, service warranty providers or third party administrators and, as such, are subject to applicable state insurance and service warranty laws and to related rules and regulations. These laws and regulations impose on them recordkeeping, reporting, financial, and other requirements and generally regulate the conduct of regulated business operations. In the event any of the subsidiaries materially violate any of these applicable laws or regulations, their regulatory authorizations could be suspended or revoked, which could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

The Company's existing and potential clients are subject to extensive regulation. Certain of the Company's customers are subject to federal and state regulation of investment advisors and broker/dealers. Certain of the Company's clients are also subject to federal and state regulations governing the privacy and use of financial, personal health and other information that is collected and managed by the Company's products and services. Certain of the Company's revenue opportunities may depend on continued deregulation in the worldwide communications industry. Regulatory changes that adversely affect the Company's existing and potential clients, or material violation of regulatory requirements by clients, could diminish the business prospects of such clients. If such conditions were to materially, adversely affect the business of a material client or a material group of the Company's clients, such conditions could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Transfer Agency Investments**

Certain of the Company's transfer agency businesses may invest client funds in greater than one year investments. If the businesses were required by the clients to draw on the investments in excess of the amount of balances invested in immediately liquid assets, the Company could be required or may be forced to liquidate such investments, or a portion thereof, and the Company may be required to recognize what otherwise may be an unrealized loss.

#### **Interest Earnings as a Portion of Revenue**

The Company's transfer agent businesses derive a certain amount of service revenue from investment earnings related to cash balances maintained in transfer agency customer bank accounts. The balances maintained in the bank accounts are subject to fluctuation. A change in interest rates could have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

#### **Anti-Takeover Considerations**

Some provisions of the Company's Certificate of Incorporation could make it more difficult for a third party to acquire control of the Company, even if the change of control would be beneficial to certain stockholders. The Company has also adopted a stockholders' rights plan, which could delay, deter or prevent a change in control of the Company. A few of the Company's client agreements allow the client to terminate its agreement or to obtain rights to use the Company's software used in processing the client's data in the event of an acquisition or change of control of the Company. In the event of a change in control of the Company (as defined in the applicable plan or agreement), vesting of awards (including stock options, restricted stock, and rights to receive stock as deferred compensation) under the Company's Stock Option and Performance Award Plan will be automatically accelerated, certain limited rights related to stock options will become exercisable, and employment continuation provisions will apply under the employment agreements of certain executive officers. Certain of the Company's joint

venture agreements allow other parties to the joint venture to buy the Company's joint venture interests in the event of a change of control of the Company.

**Non-U.S. Operations**

Consolidated revenues from the Company's subsidiaries in Canada, Europe and elsewhere outside the U.S. account for a percentage of the Company's revenues. The Company's current and proposed international business activities are subject to certain inherent risks, including but not limited to specific country, regional or global economic

conditions, exchange rate fluctuation and its impact on liquidity, change in the national priorities of any given country, and cultural differences. There can be no assurance that such risks will not have a material adverse effect on the Company's future international sales and, consequently, the Company's financial condition, results of operations and cash flow.

### **Variability of Quarterly Operating Results**

The Company's quarterly and annual operating results may fluctuate from quarter to quarter and year to year depending on various factors, including but not limited to the impact of significant start-up costs associated with initiating the delivery of contracted services to new clients, the hiring of additional staff, new product development and other expenses, introduction of new products by competitors, pricing pressures, the evolving and unpredictable nature of the markets in which the Company's products and services are sold, and general economic conditions.

### **Client Failure to Renew or Utilize Contracts**

Substantially all of the Company's revenue is derived from the sale of services or products under long-term contracts with its clients. The Company does not have the unilateral option to extend the terms of such contracts upon their expiration. Certain of the Company's service agreements contain termination for convenience clauses that enable clients to cancel the agreements by providing written notice to the Company a specified number of days prior to the desired termination date. Such clauses are sometimes coupled with a requirement for payment by the client of a fee in the event of termination for convenience. In addition, under certain of the Company's agreements, the fees the Company receives are dependent on utilization rates for the Company's services. The failure of clients to renew contracts, a reduction in usage by clients under any contracts or the cancellation of contracts could have a material adverse effect on the Company's financial condition, results of operations, and cash flow.

### **Dependence on Proprietary Technology**

The Company relies on a combination of patent, trade secret and copyright laws, nondisclosure agreements, and other contractual and technical measures to protect its proprietary technology. There can be no assurance that these provisions will be adequate to protect its proprietary rights. There can be no assurance that third parties will not assert infringement claims against the Company or the Company's clients or that such claims, if brought, would not have a material adverse effect on the financial condition, results of operations and cash flow of the Company.

### **Security of Proprietary Customer Information**

The Company's business involves the electronic recordkeeping of proprietary information of the Company's customers, and of the clients of such customers. Such information includes sensitive financial and personal health information. The Company maintains systems and procedures to protect against unauthorized access to such information and against computer viruses ( Security Systems ), and there is no guarantee that the Security Systems are adequate to protect against all security breaches. Rapid advances in technology make it impossible to anticipate or be prepared to address all potential security threats. A material breach of Security Systems could cause the Company's customers to reconsider use of the Company's services and products, affect the Company's reputation, or otherwise have a material adverse effect on the Company's financial condition, results of operations and cash flow.

**Dilution of Company Common Stock**

In August 2003, the Company issued \$840 million aggregate principal amount of convertible senior debentures. The debentures are under specified circumstances convertible into shares of the Company's common stock at a conversion rate of 20.3732 shares per \$1,000 principal amount of debentures, subject to adjustment. Each series of debentures are convertible under any of the following circumstances: (1) during any calendar quarter (and only during such calendar quarter) if the closing price of the Company's common stock, for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the previous calendar quarter, is greater than or equal to 120% of the applicable conversion price; (2) subject to certain exceptions, during the five business day period after any five consecutive trading-day period in which the trading price per \$1,000 original principal amount of the



applicable series of debentures for each day of that period was less than 95% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such day; (3) if the Company calls the debentures for redemption; or (4) upon the occurrence of specified corporate transactions. Upon conversion, the Company will have the right to deliver, in lieu of shares of its common stock, cash or a combination of cash and shares of common stock. The debentures, if converted into common stock, would have a potentially dilutive effect on the Company's common stock.

Under the Company's Employee Stock Purchase Plan, employees have a right, subject to certain limits, to purchase Company common stock at 85% of the lower of the average market price of the stock on the exercise date or the offering date. Under the Company's Stock Option and Performance Award Plan, the Company issues to directors and employees options to purchase shares of the Company's common stock, restricted shares and other equity awards. Purchases under the Employee Stock Purchase Plan, exercises of options, and the granting of equity awards could have a dilutive effect on the Company's common stock.

A change of control under the Company's stockholders' rights plan would cause the issuance of rights to purchase 1/1000th shares of preferred stock of the Company for each share of Company common stock, or, in some circumstances, other securities of the Company, which could have a dilutive effect on the Company's common stock.

#### **Miscellaneous**

In addition to the factors noted above, there may be other factors that cause any forward-looking comment to become inaccurate. One such factor is litigation and claims involving the Company, including but not limited to routine litigation and claims involving transaction processing in which the plaintiffs or claimants allege damages from errors or delays. Plaintiffs or claimants may base such damages on various factors which, for allegedly flawed transfer agency operations, could include unfavorable changes in the market value of securities processed. Litigation can include class action claims based, among other theories, upon various regulatory rules and consumer protection statutes with respect to which class action plaintiffs may attempt to assert private rights of action. Other factors include, but are not limited to, accounting or other fraud that may occur with respect to the financial statements or business of a financial service provider or other client of the Company, changes in management strategies, changes in lines of business or markets, failure of anticipated opportunities to materialize, changes in the cost of necessary supplies, changes in accounting principles, and changes in the economic, political or regulatory environments in the United States and/or the other countries where the Company now competes or may compete in the future.

#### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

In the operations of its businesses, the Company's financial results can be affected by changes in equity pricing, interest rates and currency exchange rates. Changes in interest rates and exchange rates have not materially impacted the consolidated financial position, results of operations or cash flow of the Company. Changes in equity values of the Company's investments have had a material effect on the Company's comprehensive income and financial position.

#### **Available-for-sale equity price risk**

The Company's investments in available-for-sale equity securities are subject to price risk. The fair value of the Company's available-for-sale investments as of March 31, 2005 was approximately \$1.1 billion. The impact of a 10% change in fair value of these investments would be approximately \$65.2 million to comprehensive income. As discussed under "Comprehensive income (loss)" above, net unrealized gains on the

Company's investments in available-for-sale securities have had a material effect on the Company's comprehensive income and financial position.

**Interest rate risk**

The Company and certain of its joint ventures derive a certain amount of their service revenues from investment earnings related to cash balances maintained in transfer agency customer bank accounts that the Company is agent to. The balances maintained in the bank accounts are subject to fluctuation. At March 31, 2005, the Company and its joint ventures had approximately \$2.0 billion of cash balances maintained in such accounts, of which \$1.0 billion are

maintained at the joint ventures. The Company estimates that a 50 basis point change in interest earnings rate would be approximately \$4.1 million of net income (loss). In connection with the pending sale of EquiServe, the cash balances maintained by the Company and its joint ventures in such accounts are expected to decrease by approximately \$800 - \$900 million.

At March 31, 2005, the Company had \$1,513 million of debt, of which \$653.6 million was subject to variable interest rates (Federal Funds rates, LIBOR rates, Prime rates). At March 31, 2005, the Company's proportional share of an unconsolidated affiliate's interest rate swap was a loss of \$9.4 million. The Company estimates that a 10% increase in interest rates would not be material to the Company's consolidated pretax earnings or to the fair value of its debt.

#### **Foreign currency exchange rate risk**

The operation of the Company's subsidiaries in international markets results in exposure to movements in currency exchange rates. The principal currencies involved are the British pound, Canadian dollar and Australian dollar. Currency exchange rate fluctuations have not historically materially affected the consolidated financial results of the Company. At March 31, 2005, the Company's international subsidiaries had approximately \$246 million in total assets and for the quarter ended March 31, 2005, these international subsidiaries produced approximately \$0.6 million in net income. The Company estimates that a 10% change in exchange rates would increase or decrease total assets by approximately \$25 million and would increase or decrease net income by approximately \$65,000.

The Company's international subsidiaries use the local currency as the functional currency. The Company translates all assets and liabilities at year-end exchange rates and income and expense accounts at average rates during the year. While it is generally not the Company's practice to enter into derivative contracts, from time to time the Company and its subsidiaries do utilize forward foreign currency exchange contracts to minimize the impact of currency movements.

#### **Item 4. Controls and Procedures**

As of the end of the fiscal quarter for which this quarterly report on Form 10-Q is filed, the Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures as of March 31, 2005 were effective. There has been no change in the Company's internal control over financial reporting that occurred during the fiscal quarter for which this quarterly report on Form 10-Q is filed that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

In the Company's Form 10-K for 2004, the Company reported a putative class action against one of the Company's joint venture affiliates. No class has been certified, and no material developments have occurred in the litigation.

The Company and its subsidiaries are involved in various other legal proceedings arising in the normal course of their businesses. While the ultimate outcome of such legal proceedings cannot be predicted with certainty, management believes, after consultation with legal counsel, that the final outcome in such proceedings, in the aggregate, would not have a material adverse effect on the consolidated financial condition, results of operations or cash flows of the Company.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Stock repurchases**

The following table sets forth information with respect to shares of Company common stock purchased by the Company during the quarter ended March 31, 2005.

| Period                   | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs |
|--------------------------|----------------------------------|------------------------------|--|--|
| January 1 - January 31   | 2,110,018(1)                     | \$ 50.68                     | 2,085,100  | 3,748,400(2)   |
| February 1 - February 28 | 4,460(1)                         | \$ 42.71                     |  | 3,748,400(2)   |
| March 1 - March 31       | 2,592(1)                         | \$ 43.24                     |  | 3,748,400(2)   |

(1) For the three months ended March 31, 2005, the Company purchased, in accordance with the 1995 Stock Option and Performance Award Plan, 31,970 shares of its common stock for participant income tax withholding in conjunction with stock option exercises, as requested by the participants. These purchases were not made under the publicly announced repurchase plans or programs. Of these shares, 24,918 shares were purchased in January, 4,460 shares were purchased in February and 2,592 shares were purchased in March.

(2) On February 26, 2004, the Company's Board of Directors authorized a stock repurchase plan allowing but not requiring the repurchase of up to 6 million shares of Company common stock in open market and private transactions during the period beginning March 1, 2004 through February 28, 2007. On October 19, 2004, the Company's Board of Directors authorized an additional 5.5 million share repurchase to the plan. On March 31, 2005, the Company had approximately 3.7 million remaining shares to be purchased under this plan.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

If a stockholder desires to have a proposal included in DST's Proxy Statement for the annual meeting of stockholders to be held in 2006, the Corporate Secretary of DST must receive such proposal on or before December 1, 2005, and the proposal must comply with the applicable SEC laws and rules and the procedures set forth in the DST By-laws.

**Item 5. Other Information**

(a) **Disclosure of Unreported 8-K Information**

None.

(b) **Material Changes to Director Nominee Procedures**

None.

**Item 6. Exhibits**

(a) Exhibits:

31.1 Certification of Thomas A. McDonnell, Chief Executive Officer of Registrant

31.2 Certification of Kenneth V. Hager, Chief Financial Officer of Registrant

32 Certification Pursuant to 18 U.S.C. Section 1350 of Thomas A. McDonnell, Chief Executive Officer of Registrant and Kenneth V. Hager, Chief Financial Officer of Registrant

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, and in the capacities indicated, on May 10, 2005.

DST Systems, Inc.

/s/ Kenneth V. Hager

Kenneth V. Hager

Vice President, Chief Financial Officer and Treasurer

(Principal Financial Officer)

