

INTERCEPT INC
Form 10-Q
August 14, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003.

OR

TRANSACTION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____, 19__.

Commission file number: 01-14213

InterCept, Inc.

(Exact name of registrant as specified in its charter)

Georgia

(State or other jurisdiction of incorporation or organization)

58 2237359

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

3150 Holcomb Bridge Road, Suite 200, Norcross, Georgia 30071
(Address of principal executive offices)

(770) 248-9600
(Registrant's telephone number including area code)

N/A
(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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

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Class
Common Stock, no par value

Outstanding at August 10, 2003
20,175,168

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INTERCEPT, INC.

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InterCept, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets
(in thousands, except share amounts)

	June 30, 2003	December 31, 2002
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	4,647	24,071
Restricted short term investments	18,346	19,239
Accounts receivable, less allowance for doubtful accounts of \$2,256 and \$2,729 at June 30, 2003 and December 31, 2002, respectively	29,432	29,229
Advances to SLM	3,654	7,485
Deferred tax assets	2,599	2,536
Prepaid expenses	14,757	6,782
Inventory and other	7,930	15,537
Total current assets	81,365	104,879
Property and equipment, net	48,541	42,324
Intangible assets, net	80,102	83,418
Goodwill	212,159	216,144
Other noncurrent assets	21,651	25,849
Total assets	\$ 443,818	\$ 472,614
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 48,557	\$ 23,740
Accounts payable and accrued liabilities	18,192	19,364
Client payouts	42,513	58,740
Deferred revenue	11,211	11,825
Total current liabilities	120,473	113,669
Long-term debt, less current portion		39,425
Deferred revenue	361	376
Deferred tax liability	4,978	3,832
Total liabilities	125,812	157,302
Minority interest	283	253
Shareholders' equity:		
Preferred stock, no par value; 1,000,000 shares authorized; no shares issued or outstanding		
Common stock, no par value; 50,000,000 shares authorized; 20,111,093 and 19,976,764 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively	301,699	301,152
Retained earnings	16,380	14,255
Accumulated other comprehensive loss	(356)	(348)

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Total shareholders' equity	<u>317,723</u>	<u>315,059</u>
Total liabilities and shareholders' equity	<u>\$ 443,818</u>	<u>\$ 472,614</u>

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

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InterCept, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues:				
Financial institution services	\$ 44,855	\$ 38,216	\$ 88,382	\$ 75,206
Merchant services	15,508	14,385	32,953	14,860
Customer reimbursements	3,707	2,498	7,968	5,213
Total revenues	64,070	55,099	129,303	95,279
Costs of services:				
Costs of financial institution services	21,979	17,347	43,730	34,095
Costs of merchant services	6,225	5,870	14,459	5,899
Customer reimbursements	3,707	2,498	7,968	5,213
Selling, general and administrative expenses	22,718	18,360	46,548	30,334
Depreciation and amortization	4,978	3,893	9,760	6,307
Total operating expenses	59,607	47,968	122,465	81,848
Operating income	4,463	7,131	6,838	13,431
Other (expense) income, net	(3,309)	573	(3,313)	1,751
Income before provision for income taxes, equity in loss of affiliates and minority interest	1,154	7,704	3,525	15,182
Provision for income taxes	467	2,850	1,372	5,606
Equity in income (loss) of affiliates	(23)		(4)	(1,487)
Minority interest	(16)	(9)	(29)	(16)
Net income	\$ 648	\$ 4,845	\$ 2,120	\$ 8,073
Net income per common share:				
Basic	\$ 0.03	\$ 0.26	\$ 0.11	\$ 0.44
Diluted	\$ 0.03	\$ 0.25	\$ 0.10	\$ 0.42
Weighted average shares outstanding:				
Basic	19,788	18,477	19,755	18,238
Diluted	20,277	19,101	20,229	19,157

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

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InterCept, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(in thousands)

	Six Months Ended	
	June 30,	
	2003	2002
Cash flows from operating activities:		
Net income	2,120	8,073
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	9,760	6,307
Loan cost amortization	36	37
Minority interest	29	16
Deferred income tax provision	1,082	1,940
Loss on sale of property and equipment	37	7
Gain due to stock issuance of subsidiary		(25)
Equity in net loss of affiliates	19	1,487
Income tax benefit related to exercise of stock options		766
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	(197)	2,407
Inventory, prepaid expenses, and other current assets	4,483	467
Other assets	(9,409)	(909)
Accounts payable and accrued liabilities	2,858	(6,867)
Client payouts	(16,227)	784
Interest accrued on notes receivable	(35)	(11)
SLM Note Receivable	3,390	(168)
Deferred revenue	(630)	1,435
Net cash (used in) / provided by operating activities	(2,684)	15,746
Cash flows from investing activities:		
Acquisitions, net of cash acquired	5,897	(104,829)
Advances to EPX prior to acquisition		(8,585)
Proceeds from sale of investments, net	1,092	13,317
(Advances to) repayments from affiliate, net	3,210	(650)
Purchases of property and equipment, net	(11,641)	(6,160)
Patent costs incurred		(17)
Increases in capitalized software	(1,030)	(844)
Net cash used in investing activities	(2,472)	(107,768)
Cash flows from financing activities:		
Proceeds from line of credit	55,854	117,580
Payments on notes payable and line of credit	(70,668)	(40,975)
Proceeds from employee stock purchase plan	433	253
Proceeds from exercise of stock options	113	1,355
Net cash (used in) provided by financing activities	(14,268)	78,213
Net (decrease) increase in cash and cash equivalents	(19,424)	(13,809)
Cash and cash equivalents at beginning of the period	24,071	24,917

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Cash and cash equivalents at end of the period	\$ 4,647	\$ 11,108
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 898	\$ 565
Cash paid for income taxes	\$ 167	\$ 4,026

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Basis of Presentation

InterCept, Inc. (InterCept) is a single-source provider of a broad range of technologies, products and services that work together to meet the electronic commerce and operating needs of financial institutions and merchants in the United States. Over 2,000 of these financial institutions have contracted with InterCept for one or more of InterCept's technologies, products and services, which include electronic funds transfer transactions, core bank processing systems, credit and debit card processing, check imaging systems, data communications management networks, laser document printing and automated mailing services, as well as services related to each of these products and systems. InterCept also offers a single-source end-to-end transaction processing solution that enables merchants to accept and process real-time payments for goods and services purchased from multiple distribution channels including internet, traditional point of sale, mail order and telephone order channels.

The consolidated financial statements include the accounts of InterCept and its wholly-owned subsidiaries: InterCept Communications Technologies, Inc., SBS Data Services, Inc., C-TEQ, Inc., InterCept Services, LLC, ICPT Acquisition I, LLC, DPSC Acquisition Corp., InterCept TX I, LLC, InterCept Payment Solutions, Inc., Internet Billing Company, LLC (iBill), InterCept Output Solutions, LP, and InterCept Supply, LP. In addition, ProImage, Inc., a corporation in which InterCept has a 67% ownership interest as of June 30, 2003, has been consolidated in InterCept's consolidated financial statements since its inception, due to InterCept's control of ProImage. Management of InterCept has responsibility for all day-to-day operations of ProImage and has and will continue to provide complete financial support for ProImage due to legal limitations on the other shareholder's ability to fund losses. All significant intercompany accounts and transactions have been eliminated in consolidation. Minority interest represents the minority shareholder's proportionate share of the equity and earnings of ProImage.

Through December 31, 2002, InterCept accounted for its investment in Netzee, Inc. under the equity method, under which the operations of Netzee were recorded on a single line item in the statements of operations, equity in loss of affiliate. During 2002, InterCept continued to record equity method losses in Netzee, resulting in the reduction of its investment in common stock of Netzee to zero. InterCept then applied EITF 99-10, Percentage Used to Determine the Amount of Equity Method Losses, which addresses the percentage of ownership that an investor should use to compute equity method losses when the investment in a company's common stock has been reduced to zero and the investor holds other securities of the company such as preferred stock or loans to the company. Netzee had preferred stock outstanding. InterCept owned none of Netzee's preferred stock. Netzee also had an \$18.0 million line of credit, of which InterCept loaned approximately 78%. Under EITF 99-10, InterCept did not record any additional equity method losses until the preferred stockholders' investment was reduced to zero by absorbing Netzee's losses. During the third quarter of 2002, the preferred stockholders completed the reduction of their investment in Netzee to zero and InterCept then applied its relative ownership percentage in the next most senior level of capital the line of credit to record its share of Netzee's remaining losses. As of December 31, 2002, InterCept owned approximately 28% of Netzee's common stock. On December 31, 2002, Netzee sold substantially all of its assets to Certegy, Inc.

The accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosure

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normally included in the annual financial statements, prepared in accordance with generally accepted accounting principles, have been omitted pursuant to those rules and regulations, although InterCept believes that the disclosures made are adequate to make information presented not misleading.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all necessary adjustments and reclassifications (all of which are of a normal, recurring nature) that are necessary for fair presentation for the periods presented. The results of the three and six month periods are not necessarily indicative of the results to be expected for the full fiscal year. Please read these unaudited consolidated financial statements in conjunction with the audited consolidated financial statements and the notes thereto included in InterCept's latest annual report to the Securities and Exchange Commission on Form 10-K for the year ended December 31, 2002.

2. Business Segment Reporting

InterCept's operations were classified as one business segment in 2001 and the first quarter of 2002. The acquisitions of iBill and InterCept Payment Solutions, Inc. (formerly named Electronic Payment Exchange, Inc. and sometimes referred to as EPX) during the three months ended June 30, 2002 have added merchant processing to InterCept's product offerings. Therefore, the operations are now classified into two business segments: financial institution services and merchant services. Summarized financial information by business segment is as follows (in thousands):

InterCept, Inc. and Subsidiaries
Segment Information
(in thousands)

	Three Months Ended, June 30, 2003			Three Months Ended, June 30, 2002			Six Months Ended, June 30, 2003			Six Months Ended, June 30, 2002		
	Financial		Total	Financial		Total	Financial		Total	Financial		Total
	Institution	Merchant		Institution	Merchant		Institution	Merchant		Institution	Merchant	
	Services	Services		Services	Services		Services	Services		Services	Services	
(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)(unaudited)												
Revenues:												
Service fee	40,064	15,508	55,572	33,877	14,385	48,262	78,359	32,953	111,312	67,227	14,860	82,087
Data communications management	2,519		2,519	2,262		2,262	4,957		4,957	4,236		4,236
Equipment and product sales, services and other	2,272		2,272	2,077		2,077	5,066		5,066	3,743		3,743
Customer reimbursements	3,707		3,707	2,498		2,498	7,968		7,968	5,213		5,213
Total revenues	48,562	15,508	64,070	40,714	14,385	55,099	96,350	32,953	129,303	80,419	14,860	95,279
Costs of services:												
Costs of service fees	18,251	6,225	24,476	14,334	5,870	20,204	36,020	14,459	50,479	28,433	5,899	34,332
Costs of data communications	1,925		1,925	1,349		1,349	3,733		3,733	2,712		2,712
Costs of equipment and product sales, services and other	1,804		1,804	1,664		1,664	3,978		3,978	2,950		2,950

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Customer reimbursements	3,707		3,707	2,498		2,498	7,968		7,968	5,213		5,213
Selling, general and administrative expenses	15,727	6,991	22,718	12,937	5,423	18,360	32,018	14,530	46,548	24,660	5,674	30,334
Depreciation and amortization	3,406	1,572	4,978	2,511	1,382	3,893	6,685	3,075	9,760	4,920	1,387	6,307
Total operating expenses	44,820	14,788	59,608	35,293	12,675	47,968	90,402	32,064	122,466	68,888	12,960	81,848
Operating income	\$ 3,742	\$ 720	\$ 4,462	\$ 5,421	\$ 1,710	\$ 7,131	\$ 5,948	\$ 889	\$ 6,837	\$ 11,531	\$ 1,900	\$ 13,431

Total assets for the Financial Institution Services segment and Merchant Services segment were approximately \$243.0 million and \$200.8 million, respectively, as of June 30, 2003.

3. Net Income Per Share

Basic earnings per share is computed based on the weighted average number of common shares outstanding, excluding the weighted average number of shares held in escrow to satisfy contingencies related to certain acquisitions. Diluted earnings per share is computed based on the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options using the treasury stock method, which is based on the average stock price for the period. The effects of anti-dilutive options have been excluded. The weighted average number of anti-dilutive options totaled approximately 3.5 million and 952,000 for the three months ended June 30, 2003 and 2002, respectively. Amounts shown are in thousands, except earnings per share data.

	Three Months Ended June 30, 2003			Three Months Ended June 30, 2002		
	Income	Shares	EPS	Income	Shares	EPS
Basic EPS	\$ 648	19,788	\$ 0.03	\$ 4,845	18,477	\$ 0.26
Dilutives:						
Stock options		270	\$		293	\$
Shares held in escrow to satisfy contingencies		65	\$		247	\$
Contingently issuable shares subject to earnout provisions		154	\$		84	\$
Diluted EPS	\$ 648	20,277	\$ 0.03	\$ 4,845	19,101	\$ 0.25

	Six Months Ended June 30, 2003			Six Months Ended June 30, 2002		
	Income	Shares	EPS	Income	Shares	EPS
Basic EPS	\$ 2,120	19,755	\$ 0.11	\$ 8,073	18,238	\$ 0.44
Dilutives:						
Stock options		270	\$		643	\$
Shares held in escrow to satisfy contingencies		65	\$		192	\$

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Contingently issuable shares subject to earnout provisions		139	\$		84	\$
Diluted EPS	\$ 2,120	20,229	\$ 0.10	\$ 8,073	19,157	\$ 0.42
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

4. Comprehensive Income

Comprehensive income is the total of net income and all other unrealized gains (losses) on securities, net of tax. The following table sets forth the calculation of InterCept's comprehensive income for the periods indicated below (in thousands):

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	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
Net income, as reported	\$ 648	\$4,845	\$2,120	\$8,073
Unrealized loss on securities, net of tax:	(1)	13	(8)	13
Comprehensive income	\$ 647	\$4,858	\$2,112	\$8,086

5. Acquisitions

Effective April 8, 2002, InterCept acquired substantially all of the assets of Internet Billing Company, Ltd., a Florida limited partnership that provides transaction processing for internet merchants. These assets included shares of several subsidiaries and affiliated companies of Internet Billing Company, Ltd. InterCept paid cash of \$104.3 million, net of cash received of \$7.7 million. Costs associated with the acquisition totaled approximately \$2.7 million. In February 2003, InterCept amended the iBill asset purchase agreement to settle outstanding issues related to escrow and earnout provisions. At the closing of the original agreement on April 8, 2002, InterCept placed a portion of the purchase price in escrow to secure representations and warranties of the former owners. Under the amendment, InterCept received \$8.0 million from the escrow, and the former owners received the remaining \$2.5 million. Of the \$8.0 million received by InterCept, \$1.7 million was applied to InterCept's claim against the former owners of iBill for indemnification related to iBill's working capital deficit as of the closing date. The remainder of the \$8.0 million was credited to goodwill from the iBill acquisition during the first quarter of 2003. In the February 2003 amendment, the former owners also agreed to eliminate the earnout provisions in the purchase agreement. InterCept agreed to indemnify the former owners for any claims resulting from processing-related activities that occurred before April 8, 2002.

On May 24, 2002, we acquired all of the outstanding stock of Electronic Payment Exchange, Inc. (EPX, which is now named InterCept Payment Solutions, Inc.), a provider of transaction processing services based in New Castle, Delaware. Under the merger agreement, we issued 1,349,877 shares of our common stock to the stockholders of EPX. In accordance with Statement of Financial Accounting Standard No. 141, Business Combinations, we recorded the purchase price at \$37.71 per share, representing the average closing price for the three trading days before and after the announcement of the acquisition.

In June 2002, we acquired certain item and remittance processing and statement rendering assets from Affiliated Computer Services, Inc. (ACS). The assets include two locations in Woodbury and Utica, New York. Consideration for this purchase was approximately \$7.5 million plus certain prepaid items.

6. Goodwill and Intangibles

InterCept adopted Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets, as of January 1, 2002. Under this statement, InterCept no longer amortizes goodwill but assesses it annually or whenever events or changes in circumstances occur for impairment. Additionally, InterCept no longer recognizes assembled workforce apart from goodwill in accordance with the Statement of Financial Accounting Standard No. 141, Business Combinations, and has reclassified the cost previously allocated to workforce of \$800,000, less accumulated amortization of \$300,000, to goodwill.

As it has implemented these new accounting rules, InterCept has completed the initial goodwill impairment test. To accomplish this, InterCept identified its reporting units and determined the carrying value of each reporting unit by assigning the assets and liabilities, including existing goodwill and intangible assets, to those reporting units as of the date of adoption, January 1, 2002. InterCept then determined the fair value of each reporting unit and compared it to the reporting unit's carrying amount. Based on this comparison, InterCept concluded that goodwill was not impaired as of December 31, 2002. InterCept will continue to test for impairment on an annual basis or on an interim basis if circumstances change that would more likely than not reduce the fair value of InterCept's reporting units below the carrying amounts.

InterCept reviews its long-lived assets, including intangible assets subject to amortization, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment is recognized when the undiscounted future cash flows estimated to be generated by the asset are not sufficient to recover the unamortized balance of the asset. An impairment loss would be

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recognized based on the difference between the carrying values and estimated fair value. The estimated fair value will be determined based on either the discounted future cash flows or other appropriate fair value methods with the amount of any such deficiency charged to income in the current year. Estimates of future cash flows are based on many factors, including current operating results, management's plans with respect to operations, expected market trends and competitive influences. InterCept also evaluates the amortization periods assigned to its intangible assets to determine whether events or changes in circumstances warrant revised estimates of useful lives. In the fourth quarter of 2002, InterCept recorded an impairment loss of \$20.0 million related to its intangibles.

Intangible assets as of June 30, 2003 and December 31, 2002 were as follows (in thousands):

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	June 30, 2003			December 31, 2002		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Amortized intangible assets:						
Product technology	11,567	(3,433)	8,134	10,544	(2,628)	7,916
Customer contracts	60,453	(10,976)	49,477	60,453	(8,495)	51,958
Marketing agreement	825	(131)	694	825	(110)	715
Patented technology	19,282	(2,362)	16,920	18,745	(1,424)	17,321
Non-compete agreements	1,091	(475)	616	1,091	(335)	756
Domain Names	88	(11)	77	88	(6)	82
	93,306	(17,388)	75,918	91,746	(12,998)	78,748
Nonamortized intangible assets:						
Trade names and trademarks	4,184		4,184	4,693	(23)	4,670
Total intangible assets	97,490	(17,388)	80,102	96,439	(13,021)	83,418

Amortization expense of intangible assets was \$2.2 million for both the three months ended June 30, 2003 and 2002, and \$4.4 million and \$3.3 million for the six months ended June 30, 2003 and 2002, respectively. As of June 30, 2003, estimated future annual amortization expense of other intangible assets is as follows:

2004	\$ 8,940,000
2005	\$ 8,734,000
2006	\$ 8,547,000
2007	\$ 8,218,000
2008	\$ 7,768,000

7. Long-Term Debt and Capital Lease Obligations

Long-term debt and capital lease obligations at June 30, 2003 and December 31, 2002 consisted of the following (in thousands):

	June 30, 2003	December 31, 2002
\$ 50.0 million line of credit with Wachovia Bank, National Association (formerly First Union National Bank), as amended, interest payable at the LIBOR rate plus 2.0% as defined (approximately 3.11% as of June 30, 2003); payable in full January 1, 2004, guaranteed by substantially all assets of InterCept.	\$ 31,297	\$ 39,350
Note with The Peoples Bank of Winder, interest payable monthly at prime minus .375 paid in full during January 2003.		18,221
Note with the BankersBank, interest payable monthly at prime minus .375 (3.875% as of June 30, 2003); payable in full on August 30, 2003, secured by certain certificates of deposit pledged by InterCept.	16,916	0
Note with Wachovia Bank, National Association, interest payable monthly at the LIBOR rate plus applicable margins paid in full January 16, 2003.		5,000

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Equipment under capital lease with payments ranging from \$720 to \$34,794 with maturity dates ranging from September 2003 to May 2004.	344	588	
Other		6	
	48,557	63,165	
Less current maturities	48,557	(23,740)	
	\$	\$ 39,425	

InterCept signed an amendment to the Wachovia Bank credit facility on March 31, 2003. This amendment included the following terms:

Wachovia agreed to waive our non-compliance with the Funded Debt to EBITDA covenant under the credit agreement through the date of the amendment;

InterCept will pay interest at 2% over one-month LIBOR;

the maturity date of the facility was changed to January 1, 2004 from June 1, 2004;

InterCept paid a \$125,000 fee in connection with the amendment and agreed to pay additional fees of \$250,000 each on July 1, 2003 and October 1, 2003 if the credit facility is still in effect on those dates;

InterCept is required to maintain borrowing availability under the credit facility in an amount not less than \$10 million through September 30, 2003 (thus the outstanding balance cannot exceed \$40.0 million), and in an amount not less than \$20 million thereafter (thus the outstanding balance cannot exceed \$30.0 million); and

the Funded Debt to EBITDA covenant has been eliminated and replaced with required minimum EBITDA amounts for each of the second and third quarters of 2003.

As of July 1, 2003, the Wachovia facility remained in place, and InterCept paid Wachovia \$250,000 as required under the amended loan agreement. As a result of the \$3,750,000 in charges related to SLM described in the following Note 8, InterCept failed to meet the minimum required EBITDA amount as of June 30, 2003, which caused InterCept not to comply with one of the covenants under the Wachovia facility. Wachovia agreed to waive this noncompliance until September 30, 2003 to give InterCept the opportunity to refinance the facility with another lender. We paid Wachovia \$50,000 to waive the non-compliance and will have to pay additional fees if we do not refinance the loan by September 30, 2003. InterCept has signed a commitment letter from Bank of America, N.A. for a new \$50 million credit facility, which would provide sufficient borrowing capacity to repay Wachovia in full and provide funds for working capital, capital expenditures and acquisitions permitted under the terms of the credit facility. Although InterCept believes that it will close the Bank of America financing and pay off Wachovia within the waiver period, it may be unable to do so. If InterCept fails to pay Wachovia in full by the waiver deadline and Wachovia fails to grant another waiver, InterCept will again be in default under the Wachovia facility. In that event, Wachovia could choose to exercise its remedies under the loan documents, which would have a severely adverse effect on InterCept and its business.

8. Advances to SLM

On December 3, 2001, InterCept entered into a loan agreement with SLMsoft.com Inc., an Ontario corporation (SLM Canada), and SLMsoft.com Inc., a Kansas corporation, (SLM Kansas, and together with SLM Canada, SLM). Under the loan agreement, InterCept loaned SLM \$7.0 million in exchange for cash and settlement of indemnification obligations that SLM owed to InterCept. The loan was secured by the pledge of shares of InterCept stock. The SLM loan agreement was amended on September 30, 2002. Under the amended loan agreement, borrowings bear interest at prime plus 2%. Interest was payable on January 2, 2003 for all interest accrued through that date, and SLM sold 30,000 of the pledged shares in

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January 2003, which generated \$551,000 used to pay off the accrued interest and a small portion of the principal. During the second quarter of 2003, SLM Kansas filed in Kansas for protection under the U.S. bankruptcy laws, and SLM Canada became the subject of bankruptcy proceedings in Ontario, Canada. The loan matured on June 30, 2003, has not been repaid, and is secured by 371,636 shares of InterCept common stock.

In light of the current market value of the pledged shares and the uncertainties inherent in the two bankruptcy proceedings, InterCept has determined that a loss on the SLM loan is probable as of June 30, 2003. Based on the facts now known to InterCept, it has estimated that loss at \$3,500,000. InterCept has also determined that it is unlikely to collect approximately \$250,000 in indemnification obligations and accounts receivable from SLM. Accordingly, InterCept has charged a total of \$3,750,000 in the statements of operations for the quarter ended June 30, 2003 in the line item Other (expense) income (loss), net. There is a reasonable possibility that InterCept may incur additional losses on the SLM loan in the future as the bankruptcy proceedings progress, and it is also possible that the loss may ultimately prove to be less than the second quarter charge. Because the collateral that secures the loan consists of shares of InterCept stock, there may also be additional expense or income due to the fluctuation of InterCept's stock price until the SLM situation is resolved. InterCept cannot now estimate whether any further charges will be necessary, and if so, the amount of these charges. Accordingly, in future periods as this situation becomes more certain, InterCept may incur additional charges or receive additional income. As of June 30, 2003, the balance of the note receivable on the balance sheet was \$3.7 million.

9. MCI (formerly WorldCom)

MCI, which is currently subject to federal bankruptcy proceedings, provides various services to InterCept, including frame relay circuits, network and internet backbone, and billing and collection for iBill's WEB 900 billing service. WEB 900 allows a consumer to make a purchase by dialing a 900 telephone number. The charge for the purchase appears on the consumer's telephone bill. iBill sends amounts for the purchase to its internet merchant, as it would for any other internet purchase. MCI collects for the charges when the consumer pays its telephone bill, and then remits the amounts collected to ICN Ltd., iBill's WEB 900 service provider, which then forwards the monies to iBill. During the third quarter of 2002, MCI failed to remit to ICN certain amounts collected from consumers before MCI's bankruptcy filing, and accordingly ICN was unable to remit those amounts to iBill. As of September 30, 2002, ICN owed iBill approximately \$2.1 million for WEB900 services, net of fees owed to ICN of \$300,000. Of this \$2.1 million, iBill had remitted to its customers approximately \$700,000 and had recognized gross profit of approximately \$300,000 related to its WEB900 service offering. In addition, iBill deposited \$1.4 million with ICN as a reserve against charge-backs. ICN deposited these amounts with MCI for reserves. MCI has notified ICN that it will not refund reserve amounts held on behalf of ICN, and ICN has notified iBill that it will not return iBill's \$1.4 million cash reserve to iBill. As of September 30, 2002, InterCept had reserved a total of \$2.4 million against the \$1.4 million deposit, the \$700,000 that iBill has paid to its merchants, and the \$300,000 million of gross profits. During the three months ended December 31, 2002, ICN sold the MCI receivable, ICN paid iBill approximately \$0.3 million for amounts due from MCI related to May 2002 and InterCept reduced the \$2.4 million reserve and expense by this amount. During the three months ended June 30, 2003, ICN paid iBill for additional amounts due from MCI. InterCept's net recovery was approximately \$0.4 million, and as of June 30, 2003, InterCept reduced the reserve to \$1.7 million from the \$2.1 million reserved as of March 31, 2003. InterCept previously provided statement and printing services for MCI. As of June 30, 2003, InterCept has reserved \$70,000 for MCI's failure to pay for these services and is seeking to collect that amount.

10. Recent Accounting Pronouncements

InterCept adopted Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, effective January 1, 2002. This Standard provides

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a single, comprehensive accounting model for impairment and disposal of long-lived assets and discontinued operations. The adoption of this Standard did not have an effect on InterCept's financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which replaces Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. SFAS No. 146 requires that liabilities associated with exit or disposal activities be recognized when they are incurred. Under EITF Issue No. 94-3, a liability for exit costs is recognized at the date of a commitment to an exit plan. SFAS No. 146 also requires that the liability be measured and recorded at fair value. Accordingly, the adoption of this standard may affect the timing of recognizing future restructuring costs as well as the amounts recognized. InterCept has adopted the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002.

In December 2002, the FASB issued Statement No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure an amendment of FASB Statement No. 123, (SFAS 148). SFAS 148 amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation and to require prominent disclosures about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. SFAS 148 also amends APB Opinion No. 28, Interim Financial Reporting, to require disclosures about those effects in interim financial information. InterCept currently accounts for its stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and provides the disclosures required by SFAS No. 123. InterCept currently intends to continue to account for its stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and has adopted the disclosure provisions of SFAS 148 as of December 31, 2002.

In November 2002, the FASB issued Interpretation No. 45 Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires that a liability be recognized at fair value at the inception of certain guarantees for the obligations undertaken by the guarantor. FIN 45 also requires additional disclosures for certain guarantee contracts. The disclosure provisions of FIN 45 are effective for financial statements ending after December 15, 2002, while the recognition and initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. InterCept does not believe the impact of the recognition and measurement provisions of FIN 45 on its financial statements will be material to its results of operations or financial condition.

In January 2003, the FASB issued Interpretation No. 46 Consolidation of Variable Interest Entities (FIN 46). FIN 46 provides guidance on the identification of variable interest entities, and the assessment of a company's interests in a variable interest entity to determine whether consolidation is appropriate. FIN 46 requires the consolidation of a variable interest entity by the primary beneficiary if the entity does not effectively disperse risks among the parties involved. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and is effective for periods beginning after June 15, 2003 for existing variable interest entities. Because InterCept has no material exposures to special purpose entities or other off-balance sheet arrangements, InterCept anticipates that the effects of adopting FIN 46 will not be material to the results of operations or financial condition.

11. Contingencies

Litigation

Other than as described below, InterCept is not a party to, and none of its material properties is subject to, any material litigation other than routine litigation incidental to its business.

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(1) InterCept brought an action on March 15, 2002 against Midwest Payment Systems, Inc. (MPS) in the U.S. District Court in the Eastern District of Tennessee seeking a declaration as to the rights and legal relations of InterCept, MPS and the customer banks under the contracts that InterCept and the banks have with MPS and asserting a claim for tortious interference with contractual relations. On April 3, 2002, InterCept and MPS agreed to a consent order pursuant to which MPS agreed to continue to provide services on a month-to-month basis so that InterCept can continue to service its customers who use MPS for ATM/EFT services. Both InterCept and MPS agreed not to solicit the ATM/EFT business of the customer banks until final resolution of the lawsuit, and both companies agreed to limited communications with the customers regarding the lawsuit. MPS has answered InterCept's complaint and has brought its own claims against InterCept, including tortious interference with contract, breach of contract and breach of fiduciary duty. InterCept believes that MPS's claims are without merit and intends to defend them vigorously if the lawsuit is not settled. InterCept is presently engaged in settlement discussions with MPS. If settlement efforts are unsuccessful, the case is scheduled to go to trial in March 2004.

(2) On September 30, 2002, Perfect10, Inc. filed a lawsuit in the Central District of California against iBill; CCBill, LLC; Paycom Billing Services, Inc; IMA Enterprises, Inc.; Cybertech Communications NV; Network Authentication Systems Corporation; Cavcreek Wholesale Internet Exchange; Netpass Systems, Inc; Internet Key, Inc; and other defendants asserting causes of action for copyright infringement, trademark infringement, violations of privacy rights, RICO, false advertising, unfair competition and related claims. The complaint seeks a broad range of remedies, including actual damages, treble damages, an accounting of profits attributable to the allegedly infringing conduct, injunctive relief and other remedies. The plaintiff contends that iBill, which rendered billing services in connection with certain websites, is liable under theories of secondary liability and conspiracy for the alleged wrongdoing.

Discovery in the suit has not yet begun. InterCept believes the claims are without merit and will vigorously defend the lawsuit and assert applicable defenses. It is too early in the proceeding to evaluate the probability of a favorable or unfavorable outcome, or the amount of any potential loss that InterCept would suffer in the event of an unfavorable outcome.

(3) InterCept, three of its officers John W. Collins, G. Lynn Boggs, and Scott R. Meyerhoff and its former officer, Garrett M. Bender, were named as defendants in a shareholder class action lawsuit filed in the U.S. District Court for the Northern District of Georgia (Civil Action No. 03-CV0567). The plaintiff sought to represent a class of individuals who purchased InterCept common stock between September 16, 2002 and January 9, 2003. The plaintiff alleged that InterCept and the individual defendants made material misrepresentations and/or omitted to make material disclosures throughout the class period due to their false assurances that the adult entertainment portion of the company's merchant services business was insignificant and their failure to disclose the impact of the implementation of new Visa regulations in November 2002. The plaintiff alleged violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated under Section 10(b), and Section 20(a) of the Exchange Act. Similar actions were filed by multiple plaintiffs, and on May 2, 2003, the plaintiffs filed a motion to consolidate the claims. On June 23, 2003, the court denied the plaintiffs' motions to consolidate. On July 11, 2003, the plaintiffs filed a new motion for consolidation.

On August 7, 2003, InterCept, Collins, Boggs and Meyerhoff filed motions to dismiss all of the actions, and on August 12, 2003, they filed answers to each of the complaints denying liability and stating affirmative defenses. InterCept believes the claims are without merit and will continue to vigorously defend the lawsuits.

Due to the inherent uncertainties of the litigation process and the judicial system, the company is unable to predict the outcome of such litigation matters. If the outcome of this matter is adverse to the company, it could have a material adverse effect on the company's business, financial condition and results of operation.

Other Contingencies

InterCept acquired the iBill assets from Internet Billing Company, Ltd. (Old iBill) in April 2002. On February 11, 2003, InterCept amended the iBill asset purchase agreement to settle outstanding issues related to the \$10.5 million remaining in the purchase price escrow that secured representations and warranties of the former owners, including those related to potential Visa and MasterCard fines for excessive charge-backs. Under the recent amendment, InterCept received \$8.0 million from the escrow, and the former owners of Old iBill received the \$2.5 million then remaining in the escrow. In the amendment, the former owners also agreed to eliminate the earnout provisions in the purchase agreement. InterCept agreed to indemnify the former owners for any claims resulting from processing-related activities that occurred before April 8, 2002.

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Because InterCept is not a bank, it cannot belong to or directly access the Visa and MasterCard credit card associations or the ACH payment network. To provide transaction processing services, InterCept must be designated a certified processor by, and be a member service provider of, MasterCard and be designated as an internet payment services provider of Visa. In cases of fraud or disputes between cardholders and merchants, InterCept faces charge-backs when cardholders dispute items for which they have been billed. Charge-backs may arise from the unauthorized use of the cardholder's name or bank account information or from a cardholder's claim that a merchant failed to perform. If a billing dispute between a credit card holder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant, and the purchase price is refunded to the cardholder. If InterCept's charge-back rate becomes excessive, credit card associations can fine InterCept or terminate InterCept's ability to accept credit cards for payment. InterCept delays a portion of merchant payouts for a period of six months to cover its potential liability for merchant processing card activities including potential charge-back penalties.

InterCept processes MasterCard and Visa transactions through First Financial Bank and its affiliate, First Data Merchant Services Corporation (together referred to as First Data). On March 14, 2003, First Data was notified by MasterCard of an estimated assessment with respect to iBill's noncompliance with MasterCard's charge-back rules. First Data notified InterCept that MasterCard has reviewed the historical charge-back percentages for InterCept and Old iBill for the period from January 1, 2001 through February 28, 2003 and has determined that those percentages exceeded MasterCard's limits. On March 31, 2003, First Data notified InterCept that MasterCard had determined the final amount of the assessment to be \$5.85 million. Of the \$5.85 million, \$3.5 million was recorded as an adjustment of the iBill purchase price, \$1.9 million was recorded as an expense for the quarter ended December 31, 2002 and \$450,000 was recorded during the first quarter of 2003. For the quarters ended March 31, 2003 and June 30, 2003, InterCept reserved \$330,000 and \$237,000, respectively, for potential fines. As of March 31, 2003, First Data was holding a reserve of approximately \$11.0 million owed to InterCept to cover InterCept's potential liability for merchant processing card activities, including potential charge-back penalties. During the quarter ended June 30, 2003, First Data deducted from the reserve \$5.5 million of the \$5.85 million assessment. The balance in the reserve of \$5.3 million as of June 30, 2003 is included in the line item "Other noncurrent assets" in the balance sheet contained in the condensed consolidated financial statements included in this report.

InterCept also faces the possibility of fines from Visa for similar charge-back violations. Before InterCept acquired Old iBill in April 2002, Visa fined Old iBill for excessive charge-backs in the months of August and September of 2001 and January and February of 2002 in the aggregate amount of approximately \$4.5 million. Old iBill also exceeded the Visa charge-back allowed rate in March 2002, and iBill exceeded the allowed charge-back rate in November 2002. In addition, Visa may deem iBill to have exceeded its charge-back levels in other months, but Visa has imposed no fines on iBill for excess charge-backs to date. InterCept has concluded that Visa fines in excess of amounts withheld by InterCept from merchant payouts are not probable, and accordingly, InterCept has not recorded a liability under Statement of Financial Accounting Standard No. 5, "Accounting for Contingencies" (SFAS 5) issued by the FASB. InterCept also faces the possibility of fines from Visa and MasterCard for any future charge-back violations if Visa and/or MasterCard decide to impose fines.

In March 2002, MasterCard implemented a rule that requires all banks that submit transactions on behalf of a merchant to have a valid merchant agreement with that merchant. This rule applies whether the card is presented directly to the merchant or to a third-party payment facilitator, such as iBill. As a result, MasterCard has notified iBill's former and current acquiring banks for MasterCard transactions that iBill has acquired transactions from merchants without the required merchant agreements. Because of this determination, MasterCard has stated that it will impose assessments on the acquiring banks of \$2,500 per day, retroactive to the day that the first noncompliant transaction was acquired through iBill. For the quarters ended March 31, 2003 and June 30, 2003, InterCept incurred \$225,000 and \$10,000, respectively, of expense related to these potential assessments. On April 4, 2003, MasterCard notified iBill's acquiring

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bank that MasterCard had accepted iBill's plan to achieve compliance with MasterCard's rules and that MasterCard had granted a suspension of the \$2,500 per day assessments through August 22, 2003 to give iBill time to achieve full compliance. If iBill cannot achieve compliance by August 22, 2003, MasterCard could impose additional assessments. InterCept expects to achieve full compliance no later than the required deadline and thus has not accrued any additional expense beyond April 4, 2003 for these assessments.

In June 2003, iBill became aware, and subsequently informed Visa, that it had processed certain transactions for merchants who were not registered with Visa. Visa has assessed iBill \$300,000, for these violations. InterCept paid the assessment and recognized it as an expense in the second quarter of 2003, but may appeal the assessment since we self-reported the violation. Visa has also informed First Data that it intends to send a third party to review iBill's processes to ensure that iBill has procedures in place to prevent additional processing of unregistered merchants in the future. If the results of this audit are unsatisfactory, Visa could assess additional fines for improper processing.

InterCept cannot predict with certainty whether Visa and MasterCard will fine it for excess charge-backs, merchant violations or other violations of card association rules, and if so, the amounts of those fines. Any fines could materially adversely affect InterCept's financial condition and result of operations.

12. Stock Based Compensation

Stock based compensation to employees is accounted for based on the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under APB 25, if the exercise price of employee stock options equals the market price of the underlying stock on the grant date, no compensation expense is recorded. InterCept has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123).

Because InterCept has adopted the disclosure-only provisions of SFAS 123, no compensation cost has been recognized for the stock option plans. Had compensation cost for InterCept's stock option plans been determined based on the fair value at the grant date for awards for the three and six months ended June 30, 2003 and 2002 consistent with the provisions of SFAS 123, InterCept's pro forma net income would have been as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net Income				
As Reported	\$ 648	\$ 4,845	\$ 2,120	\$ 8,073
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	\$ (2,476)	\$ (4,171)	\$ (4,899)	\$ (8,342)
Pro-forma	(1,828)	674	(2,779)	(269)
Number of Basic Shares	19,788	18,477	19,755	18,238
Basic (loss) Income Per Share				
As Reported	0.03	0.26	0.11	0.44
Pro-forma	(0.09)	0.04	(0.14)	(0.01)
Number of Diluted Shares	20,277	19,101	20,229	19,157
Diluted (Loss) Income Per Share				
As Reported	0.03	0.25	0.10	0.42
Pro-forma	(0.09)	0.04	(0.14)	(0.01)

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

Our operations are comprised of two business segments: financial institution services and merchant services. In our financial institution services segment, we derive revenues primarily by providing software systems, data processing services and related equipment and services to financial institutions. In our merchant services division, we provide credit card and other merchant processing services to financial institutions and merchants. This Overview section explains how we generate and recognize revenues and also summarizes certain other information that we believe is useful in evaluating our financial statements and performance. Please see the following section, Recent Developments, for information about recent events and trends in our business and financial condition.

Financial Institution Services

The products and services included in our financial institution services segment include:

Core data processing and check imaging systems, support, maintenance and related services and software sales,

EFT processing services,

Data communications management and

Equipment and product sales, services and other, including:

sales of banking-related equipment and complementary products and

equipment maintenance and technical support services.

In our service bureau operations, we generate core data processing revenues from service and processing fees based primarily on the number of accounts we service for our financial institution customers and the number of transactions we process. We recognize these revenues as we perform the services. We also generate revenues from the licensing of our core data processing systems. We recognize revenues for licensing these systems in accordance with Statement of Position 97-2 on Software Revenue Recognition, using the residual method prescribed in SOP 98-9 issued by the American Institute of Certified Public Accountants. We recognize software license fees and hardware and installation revenue when we have signed a non-cancelable license agreement, installed the product and satisfied all significant obligations to the customer. We recognize maintenance fees over the term of the maintenance period. We sell some of our software and hardware products through five-year, sales-type lease agreements under which customers make annual installment payments. These annual payments include the initial installation and an ongoing license fee. Revenue attributable to installation fees and the sale of equipment is recognized upon installation. License fees are deferred and recognized ratably over the period of the lease.

We license Renaissance Imaging® check imaging software on an in-house basis, and we generate revenues from up-front license fees and recurring annual maintenance fees charged for this system. We recognize revenues primarily from the licensing of Renaissance Imaging in accordance with Statement of Position 97-2, as discussed above. We also provide check processing and imaging in a service bureau environment under which we generate recurring revenues. On a service bureau basis, we generate revenues primarily based on the volume of items processed. We recognize this revenue as we provide the service.

We derive EFT revenues principally from processing ATM and debit card transactions. We receive a base fee for providing our ATM processing services and an additional fee for each additional ATM serviced. Once the number of transactions by a financial institution exceeds established levels for that customer, we charge additional fees for these transactions. For some debit card transactions, we receive a portion of the interchange fees generated by our financial institution customers, and we charge a monthly fee if our customers transactions do not meet a specified minimum dollar amount of transactions for a particular month. Most charges under our EFT service agreements are due and paid monthly. During the second quarter of 2002, we began implementation of a new debit card pricing structure, under which we receive a flat fee for each transaction processed. Under the new pricing, we do not receive a portion of the interchange fee for processing debit card transactions. The change to our pricing structure has reduced our per-transaction earnings from debit card processing by approximately \$50,000 per month, but it has also materially reduced our

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exposure to the changes in interchange fees that have been or may be implemented by Visa and MasterCard. See Risk Factors Risks Related to Financial Institution Services Industry Our revenues may decrease as a result of legal actions against Visa and MasterCard.

We generate our data communications management service revenues principally from network management and from equipment configuration services and installation. We charge a regular monthly fee on an ongoing basis for providing telecommunications connectivity and network management. We recognize revenues from data communications management as we perform the services.

We recognize revenues from sales of equipment and complementary products at the time of shipment or, if we are responsible for installation, upon installation of the product. We recognize maintenance and technical support service ratably over the period during which the services are performed.

Merchant Services

In our merchant services segment, we provide payment processing services and merchant portfolio management services. Revenues from merchant processing services are recognized as services are performed. Our service offerings allow merchants to accept and process real-time payments for goods and services purchased over the Internet using our merchant account in which event revenue recognized is equal to the service fees that we charge to the merchant. This fee is generally based on a percentage of the total transaction amount. Merchants can also establish their own merchant account with our acquiring bank partners and utilize our end-to-end processing solution, which eliminates the need for the merchant to establish multiple relationships with banks, front-end system providers, gateways, and back-end processors. We recognize revenues related to this service offering net of certain costs that we do not control primarily interchange and other fees charged by credit card associations.

For merchants using our merchant account, we delay a portion of our merchant payouts for a period of six months to cover potential merchant credit losses that can arise as a result of, among other things, disputes between cardholders and merchants or association fines related to charge-back activity. The withheld amount is sometimes referred to as the holdback. If disputes are not resolved in the merchant's favor, the transaction is charged back to us and the purchase price is refunded to the merchant's customer. If we are unable to collect from the merchant, we bear the credit risk for the full amount of the transaction. Our acquiring bank partners also establish and hold reserves for merchant credit losses for merchants using our solution. If transactions are charged back to our banks and our banks are unable to collect from the merchants, we bear the credit risk for amounts in excess of reserves held by the banks. The holdback provides us with funds to address these credit risks. After the six month holdback period expires, we refund the holdback to the merchant. For merchants who continue to use our services, we withhold and refund holdbacks in a rolling process so that as new transactions are processed we withhold a portion as the holdback, while at the same time refunding the holdbacks for which the six month period has expired. Our aggregate liability to refund the holdback is included in the line item Client payouts in the balance sheet contained in the condensed consolidated financial statements included in this report.

Recurring Revenues and Customer Reimbursements

For the three and six months ended June 30, 2003, approximately 92% of our total revenues were recurring revenues. Recurring revenues result from regular monthly, quarterly or annual payments by our customers for ongoing services they use in connection with their businesses and for transaction processing of debit, ATM, credit and ACH transactions that occur under long-term agreements. These revenues do not include conversion or de-conversion fees, initial software license fees, installation fees, hardware sales or similar activities. Customer reimbursements reflect pass-through items, primarily postage, that we bill to our customers.

Netzee, Inc.

Until December 31, 2002, we offered internet banking and voice response products through Netzee, Inc., and we owned approximately 28% of Netzee's outstanding common stock. We accounted for our investment in

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Netzee under the equity method, which required us to record Netzee's results of operations in a single line item in our statement of operations titled equity in loss of affiliate.

On December 31, 2002, Certegy, Inc. acquired substantially all of the assets of Netzee for approximately \$10.4 million. In January 2003, we received approximately \$2.3 million in payment on the line of credit that we jointly provided with John H. Harland Company to Netzee and \$473,000 for the purchase of the common stock of Netzee that we owned. As of December 31, 2002, we recorded a one-time charge of \$5.4 million related to the sale of Netzee. We received approximately \$400,000, which is recorded in Other Income (expense) Net in the financial statements from escrow accounts established at the time of closing and may receive additional payouts.

2002 Acquisitions

As of April 8, 2002, we acquired substantially all of the assets of Internet Billing Company, Ltd., a Ft. Lauderdale-based provider of transaction processing for Web merchants. We paid cash of \$104.3 million, net of cash received of \$7.7 million. Costs associated with the acquisition totaled approximately \$2.7 million. In February 2003, InterCept amended the iBill asset purchase agreement to settle outstanding issues related to escrow and earnout provisions. At the closing of the original agreement on April 8, 2002, InterCept placed a portion of the purchase price in escrow to secure representations and warranties of the former owners. Under the amendment, InterCept received \$8.0 million from the escrow, and the former owners received the remaining \$2.5 million. Of the \$8.0 million received by InterCept, \$1.7 million was applied to InterCept's claim against the former owners of iBill for indemnification related to iBill's working capital deficit as of the closing date. The remainder of the \$8.0 million was credited to goodwill from the iBill acquisition during the first quarter of 2003. In the February 2003 amendment, the former owners also agreed to eliminate the earnout provisions in the purchase agreement. InterCept agreed to indemnify the former owners for any claims resulting from processing-related activities that occurred before April 8, 2002.

On May 24, 2002, we acquired all of the outstanding stock of Electronic Payment Exchange, Inc. (EPX, which is now named InterCept Payment Solutions, Inc.), a provider of transaction processing services based in New Castle, Delaware. Under the merger agreement, we issued 1,349,877 shares of our common stock to the stockholders of EPX. In accordance with Statement of Financial Accounting Standard No. 141, Business Combinations, we recorded the purchase price at \$37.71 per share, representing the average closing price for the three trading days before and after the announcement of the acquisition.

In June 2002, we acquired certain item and remittance processing and statement rendering assets from Affiliated Computer Services, Inc. (ACS). The assets include two locations in Woodbury and Utica, New York. Consideration for this purchase was approximately \$7.5 million plus certain prepaid items.

Recent Developments

Sovereign Bank

In January 2003, we executed a definitive agreement with Sovereign Bank for item processing and check imaging services. Sovereign is a \$41 billion financial institution headquartered in Pennsylvania with approximately 530 community banking offices in New England and the Mid-Atlantic states. To accommodate Sovereign's item and check processing needs, we have opened two of our previously announced four new check image processing centers and significantly expanded another center, and to date have hired 75 new employees with plans to hire approximately 30 more employees during August and another 90 by year-end. We began transitioning Sovereign Bank's item and check processing services to us on July 25, 2003 and have completed the transition of 255 of

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Sovereign's community banking offices located in the New England area. We anticipate completing the conversion of the remaining Sovereign community banking offices to our check image processing services by year-end. Once we convert all of Sovereign Bank's item processing and check imaging operations to our centers, Sovereign will be our largest customer. We anticipate that we will recognize more than \$120 million in total revenue over the 6-year term of the agreement with Sovereign. We issued 375,000 shares of our common stock to Sovereign upon execution of the letter of intent in October 2002 for us to provide Sovereign with item processing and check imaging services, and the value of the shares will be amortized over the term of the processing agreement.

As previously disclosed, we have incurred a higher level of capital expenditures and other costs in the first half of the year related to the commencement of item processing services for Sovereign Bank. We expect most of the quarter-over-quarter revenue increase from the Sovereign contract to occur in the fourth quarter of 2003.

Default by SLMsoft.com Inc.

On December 3, 2001, we entered into a loan agreement with SLMSoft.com Inc., an Ontario corporation (SLM Canada), and SLMSoft.com Inc., a Kansas corporation, (SLM Kansas, and together with SLM Canada, SLM). Under the loan agreement, we loaned SLM \$7.0 million in exchange for cash and settlement of indemnification obligations that SLM owed to us. The loan was secured by the pledge of shares of InterCept stock. The SLM loan agreement was amended on September 30, 2002. Under the amended loan agreement, borrowings bear interest at prime plus 2%. Interest was payable on January 2, 2003 for all interest accrued through that date, and SLM sold 30,000 of the pledged shares in January 2003, which generated \$551,000 used to pay off the accrued interest and a small portion of the principal. During the second quarter of 2003, SLM Kansas filed in Kansas for protection under the U.S. bankruptcy laws, and SLM Canada became the subject of bankruptcy proceedings in Ontario, Canada. The loan matured on June 30, 2003, has not been repaid, and is secured by 371,636 shares of InterCept common stock. As of June 30, 2003, the balance on the balance sheet was \$3.7 million.

In light of the current market value of the pledged shares and the uncertainties inherent in the two bankruptcy proceedings, we have determined that a loss on the SLM loan is probable as of June 30, 2003. Based on the facts now known to us, we have estimated that loss at \$3,500,000. We have also determined that we are unlikely to collect approximately \$250,000 in indemnification obligations and accounts receivable from SLM. Accordingly, we have charged a total of \$3,750,000 in the statements of operations for the quarter ended June 30, 2003 in the line item Other (expense) income (loss), net. There is a reasonable possibility that we may incur additional losses on the SLM loan in the future as the bankruptcy proceedings progress, and it is also possible that the loss may ultimately prove to be less than our second quarter charge. Because the collateral that secures the loan consists of shares of InterCept stock, there may also be additional expense or income due to the fluctuation of InterCept's stock price until the SLM situation is resolved. We cannot now estimate whether any further charges will be necessary, and if so, its amount. Accordingly, in future periods as this situation becomes more certain, we may incur additional charges or receive additional income.

Wachovia Credit Facility

Our principal credit facility is with Wachovia Bank. We owed \$31.3 million under that facility as of June 30, 2003. The \$3,750,000 in charges related to SLM described above caused InterCept not to comply with a financial covenant in the Wachovia facility. Wachovia waived this non-compliance until September 30, 2003 to give us the opportunity to refinance the facility with another lender. We paid Wachovia \$50,000 to waive the non-compliance and will have to pay additional fees if we do not refinance the loan by September 30, 2003. We have signed a commitment letter from Bank of America, N.A. for a new three year \$50 million credit facility, which would provide sufficient borrowing capacity to repay Wachovia in full and provide additional working capital to us. Although we believe that we will close the Bank of America financing and pay off Wachovia within the waiver period, we may be unable to do so. If we fail to repay Wachovia in full by the waiver deadline and Wachovia fails to grant another waiver, we will again be in default under the Wachovia facility. In that event, Wachovia could choose to exercise its remedies under the loan documents, which would have a severe adverse effect on us and our business.

Fines from Card Associations

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Because we are not a bank, we cannot belong to or directly access the Visa and MasterCard credit card associations or the ACH payment network. To provide transaction services, we must be designated a certified processor by, and be a member service provider of, MasterCard and be designated as an internet payment services provider of Visa. In cases of fraud or disputes between cardholders and merchants, we face charge-backs when cardholders dispute items for which they have been billed. Charge-backs may arise from the unauthorized use of the cardholder's name or bank account information or from a cardholder's claim that a merchant failed to perform. If a billing dispute between a credit card holder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant, and the purchase price is refunded to the cardholder. If our charge-back rate becomes excessive, credit card associations can fine us or terminate our ability to accept credit cards for payment. We delay a portion of merchant payouts to cover our potential liability for merchant processing card activities including potential charge-back penalties.

As noted above we acquired the iBill assets from Internet Billing Company, Ltd. (Old iBill) in April 2002. On February 11, 2003, we amended the iBill asset purchase agreement to settle outstanding issues related to the \$10.5 million remaining in the purchase price escrow that secured representations and warranties of the former owners, including those related to potential Visa and MasterCard fines for excessive charge-backs. Under the amendment, we received \$8.0 million from the escrow, and the former owners of Old iBill received the \$2.5 million then remaining in the escrow. In the amendment, the former owners also agreed to eliminate the earnout provisions in the purchase agreement. We agreed to indemnify the former owners for any claims resulting from processing-related activities that occurred before April 8, 2002.

We process MasterCard and Visa transactions through First Data. On March 14, 2003, First Data was notified by MasterCard of an estimated assessment with respect to iBill's noncompliance with MasterCard's charge-back rules. First Data notified us that MasterCard has reviewed the historical charge-back percentages for InterCept and Old iBill for the period from January 1, 2001 through February 28, 2003 and has determined that those percentages exceeded MasterCard's limits. On March 31, 2003, First Data notified us that MasterCard had determined the final amount of the assessment to be \$5.85 million. Of the \$5.85 million, \$3.5 million was recorded as an adjustment of the iBill purchase price, \$1.9 million was recorded as an expense for the quarter ended December 31, 2002 and \$450,000 was recorded during the first quarter of 2003. For the quarters ended March 31, 2003 and June 30, 2003, we reserved \$330,000 and \$237,000, respectively, for potential fines. As of March 31, 2003, First Data was holding a reserve of approximately \$11.0 million owed to us to cover our potential liability for merchant processing card activities, including potential charge-back penalties. During the quarter ended June 30, 2003, First Data deducted from the reserve \$5.5 million of the \$5.85 million assessment. The balance in the First Data reserve of \$5.3 million as of June 30, 2003 is included in the line item "Other noncurrent assets" and the remaining \$300,000 is included in the line item "Inventory and other" in the balance sheet contained in the condensed consolidated financial statements included in this report.

We also face the possibility of fines from Visa for similar charge-back violations. Before our April 2002 acquisition of the iBill assets, Visa fined Old iBill for excessive charge-backs in the months of August and September of 2001 and January and February of 2002 in the aggregate amount of approximately \$4.5 million. Old iBill also exceeded the Visa charge-back allowed rate in March 2002, and iBill exceeded the allowed charge-back rate in November 2002. In addition, Visa may deem us to have exceeded its charge-back levels in other months, but no fines have been assessed by Visa to date. We have concluded that Visa fines in excess of amounts withheld by us from merchant payouts are not probable, and accordingly, we have not recorded a liability under SFAS 5. We also face the possibility of fines from Visa and MasterCard for similar charge-back violations if we fail to comply with MasterCard and Visa charge-back rules in the future and if Visa and/or MasterCard decide to impose fines.

In March 2002, MasterCard implemented a rule that requires all banks that submit transactions on behalf of a merchant to have a valid merchant agreement with that merchant. This rule applies whether the card is presented directly to the merchant or to a third-party payment facilitator, such as iBill. MasterCard has notified iBill's former and current acquiring banks for MasterCard transactions that iBill has acquired transactions from merchants without the required merchant agreements. Because of this determination, MasterCard has stated that it will impose assessments on the acquiring banks of \$2,500 per day, retroactive to the day that the first noncompliant transaction

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was acquired through iBill. For the quarters ended March 31, 2003 and June 30, 2003, InterCept incurred \$225,000 and \$10,000, respectively, of expense related to these potential assessments. On April 4, 2003, MasterCard notified iBill's acquiring bank that MasterCard had accepted iBill's plan to achieve compliance with MasterCard's rules and that MasterCard had granted a suspension of the \$2,500 per day assessments through August 22, 2003 to give iBill time to achieve full compliance. If iBill cannot achieve compliance by August 22, 2003, MasterCard could impose additional assessments. We expect to achieve full compliance no later than the required deadline and thus have not accrued any additional expense beyond April 4, 2003 for these assessments.

In June 2003, iBill became aware and subsequently informed Visa that it had processed certain transactions for merchants who were not registered with Visa. Visa has assessed iBill \$300,000, for these violations. InterCept paid the assessment and recognized it as an expense in the second quarter of 2003, but may appeal the assessment since we self-reported the violation. Visa has also informed First Data that it intends to send a third party to review iBill's processes to ensure that iBill has procedures in place to prevent additional processing of unregistered merchants in the future. If the results of this audit are unsatisfactory, Visa could assess additional fines for improper processing.

We cannot predict with certainty whether Visa and MasterCard will fine if and as so, the amounts of those fines. Any fines could materially adversely affect our financial condition and result of operations.

International Acquiring Bank

On Wednesday, August 13, 2003, our acquiring bank for Visa transactions in Europe threatened to close our account, allegedly due to transactions placed into the Visa system by unauthorized merchants sponsored by iBill. Although we have explained to our acquiring bank and to Visa that iBill is not responsible for the transactions and have taken action to terminate the accounts of the merchants in question, our acquiring bank may still suspend our account, which may effectively terminate our ability to process Visa transactions in Europe. Those transactions contribute approximately 4-6% of our aggregate merchant processing revenues. Although we are continuing discussions with the bank and with Visa, and intend to pursue all available legal remedies to address this problem, we could lose a majority, if not all, of the revenues from our Visa transactions in Europe if our account is suspended.

Customer Attrition in Merchant Services Division

Because of our efforts to bring our iBill operations into compliance with card association rules, we have terminated a number of adult entertainment merchants. Although we have made steady progress in growing the mainstream segment of the iBill portion of our merchant services division, the overall loss of customers has resulted in a decline in merchant service revenues from \$17.4 million in the first quarter of 2003 to \$15.5 million in the second quarter of 2003.

Disclosure Regarding Forward-Looking Statements

We make forward-looking statements in this report. These statements are subject to risks and uncertainties, and we can provide no assurances that they will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like believe, expect, anticipate, predict, project, potential, seek, continue, will, may, could, intend, plan, pro forma, similar expressions, we are making forward-looking statements. We believe that the expectations reflected in our forward-looking statements are reasonable, but we cannot be sure that we will actually achieve these expectations. Projections or estimates of our future performance are necessarily subject to a high degree of uncertainty and may vary materially from actual results. In evaluating forward-looking statements, please carefully consider the various factors discussed below.

Risks Related to Our Operations

We may be unable to refinance our Wachovia credit facility with Bank of America as we intend.

Our principal credit facility is with Wachovia Bank. We owed \$31.3 million under that facility as of June 30, 2003. The \$3,750,000 in charges related to SLM described above caused InterCept not to comply with a financial covenant in the Wachovia facility. Wachovia waived this non-compliance until September 30, 2003 to give us the opportunity to refinance the facility with another lender. We paid Wachovia \$50,000 to waive the noncompliance and will have to pay additional fees if we do not refinance the loan by September 30, 2003. We have signed a commitment letter from Bank of America, N.A. for a new three year \$50 million credit facility, which would provide sufficient borrowing capacity to repay Wachovia in full and provide additional working capital to us. Although we believe that we will close the Bank of America financing and pay off Wachovia within the waiver period, we may be unable to do so. If we fail to repay Wachovia in full by the waiver deadline and Wachovia fails to grant another waiver, we will again be in default under the Wachovia facility. In that event, Wachovia could choose to exercise its remedies under the loan documents, which would have a severe adverse effect on us and our business.

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Our rapid growth could strain our managerial, operational and financial resources, and our failure to manage our growth could cause our business to suffer.

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Our internal growth and acquisitions since our initial public offering in June 1998 have placed great demands on our business, particularly our managerial, operational and financial personnel and systems. For example, we have grown from approximately 170 employees on March 31, 1998 to approximately 2,000 employees on June 30, 2003. Additional internal growth and acquisitions may further strain our resources. We can provide no assurances that our systems, procedures, controls and existing facilities will be adequate to support the expansion of our operations, while maintaining adequate levels of customer service and satisfaction. Our future operating results will depend substantially on the ability of our officers and key employees to manage changing business conditions and to implement and improve our technical, administrative, financial control and reporting systems. Our failure to respond to and manage changing business conditions as we expand could diminish the quality of our products and services, result in the loss of customers and weaken our operating results.

The failure to sustain our current growth rates or to achieve expected growth rates could adversely affect the price of our common stock.

We have experienced significant growth since our inception. Our revenues have increased from \$33.3 million in 1998 to \$226.7 million for 2002. This revenue growth has resulted from both internal growth of our business and through acquisitions we have completed. Our growth rate declined in the fourth quarter of 2002, and we failed to achieve growth rates expected by stock market analysts. Our stock price has declined substantially. Either our internal growth rate or our total growth rate, or both, may again decline in the future due to factors within or beyond our control. Our failure to sustain our growth rates, or achieve growth rates expected by stock market analysts, could again have a material adverse impact on the trading price of our common stock.

Our acquisitions have resulted and could again result in integration difficulties, unexpected expenses, diversion of management's attention and other negative consequences.

As part of our growth strategy, we have made numerous acquisitions since our initial public offering in June 1998. Assuming we have access to adequate levels of debt and equity capital, we plan to continue to acquire complementary businesses, products and services as a key element of our growth strategy. We must integrate the technology, products and services, operations, systems and personnel of acquired businesses with our own and attempt to grow the acquired businesses as part of our company. The integration of other businesses is a complex process and places significant demands on our management, financial, technical and other resources. The successful integration of businesses we have acquired in the past and may acquire in the future is critical to our future success. If we are unsuccessful in integrating these businesses, our financial and operating performance could suffer. The risks and challenges associated with the acquisition and integration of acquired businesses include:

we may be unable to centralize and consolidate our financial, operational and administrative functions with those of the businesses we acquire;

our management's attention may be diverted from other business concerns;

we may be unable to retain and motivate key employees of an acquired company;

we may enter markets in which we have little or no prior direct experience;

litigation, indemnification claims and other unforeseen claims and liabilities may arise from the acquisition or operation of acquired businesses;

the costs necessary to complete integration may exceed our expectations or outweigh some of the intended benefits of the transactions we complete;

we may be unable to maintain the customers or goodwill of an acquired business; and

the costs necessary to improve or replace the operating systems, products and services of acquired businesses may exceed our expectations.

We may be unable to integrate our acquisitions successfully with our operations on schedule or at all. We have been forced to deal with many of the risks listed above in connection with our acquisitions of iBill and EPX, which we acquired in 2002. We can provide no assurances that we will not incur large accounting charges or other expenses in connection with business units we acquire, divest, or close. We have in fact incurred a large impairment charge in connection with our acquisitions of iBill and EPX, and we can provide no assurances that we can avoid incurring similar charges in the

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future if these businesses do not perform as we expect or our plans with respect to such businesses change. Further, we can provide no assurances that acquisitions will result in cost savings or sufficient revenues or earnings to justify our investment in, or our expenses related to, these acquisitions.

We may suffer further losses in seeking to collect the SLM note receivable.

SLM Kansas and SLM Canada together owe us approximately \$7.2 million, secured by 371,636 shares of InterCept common stock. Both of the SLM entities are the subject of bankruptcy proceedings. The loan matured on June 30, 2003 and has not been repaid. We have also determined that we are unlikely to collect approximately \$250,000 in indemnification obligations and accounts receivable from SLM. In light of the current market value of the pledged shares and the uncertainties inherent in the two bankruptcy proceedings, we have determined that a loss on the SLM loan and other SLM obligations is probable as of June 30, 2003, and based on the facts now known to us, we have estimated that loss at \$3,750,000 and have incurred a charge of that amount in the statements of operations for the quarter ended June 30, 2003. There is a reasonable possibility that we may incur additional losses on the SLM loan in the future as the bankruptcy proceedings progress.

The slower economy in the United States may continue to affect our operations adversely.

We continue to see sluggishness in item volumes in our financial institution services segment, and we believe that the economy continues to affect this part of our business. We believe that the economy and the unsettled international situation will continue to influence transaction volumes negatively. This problem may be exacerbated if additional events of terrorism occur within the United States or elsewhere.

If we do not continue to expand our sales force and our marketing relationships, we may be unable to continue our growth.

Our ability to expand our business will depend significantly upon our ability to expand our sales and marketing force and our strategic marketing relationships. Competition for experienced sales and marketing personnel is intense, and we may not be able to retain our existing personnel or locate and attract additional qualified personnel in the future. In addition, if we lose any of the relationships with various banking-related organizations for the marketing and endorsement of our products and services or are unable to enter into new ones, growth in our customer base and revenues could be impaired.

Competition may impede our ability to acquire other businesses and may inhibit our growth.

Acquisitions have generated a significant part of our historic growth. We anticipate that a portion of our future growth may be accomplished through acquisitions, although we expect to focus on improving our current operations until we have access to the debt and equity capital we need to finance acquisitions. The success of our acquisition strategy depends upon our ability to identify suitable acquisition candidates, reach agreements to acquire these companies and obtain necessary financing on acceptable terms. In pursuing acquisition and investment opportunities, we may compete with other companies that have similar growth strategies. Some of these competitors may be larger and have greater financial and other resources than we have. This competition may render us unable to acquire businesses that could improve our growth or expand our operations. This competition will be particularly strong, given our current stock price and limited access to capital.

The decline in our stock price may impair our ability to acquire other businesses.

We have financed the acquisitions we have completed since our initial public offering with a combination of our common stock, cash from common stock offerings, cash from our operations and borrowings made under our line of credit. Because our stock price has declined substantially from its historical high in early 2002, the shareholders of businesses that we seek to acquire may be unwilling to accept our common stock in exchange for their businesses. As a result, we will be required to use larger portions of our line of credit (which may already be fully drawn or reserved for other purposes) or cash from operations to continue to complete acquisitions, which

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would decrease our working capital and increase our interest expense. The unavailability of capital to finance future acquisitions could have a material negative effect on our financial performance and results of operations.

Our current credit facility with Wachovia Bank restricts our ability to complete acquisitions without the bank's consent.

We cannot presently draw on our Wachovia facility to fund acquisitions. Assuming we obtain a new credit facility from Bank of America as we intend, we will be required to comply with the financial and other covenants of that credit facility to be able to draw on it to fund our acquisitions. If we are unable to borrow funds under our credit line, we may be unable to make acquisitions that could be helpful to our business.

The loss of our chief executive officer or other key employees could have a material adverse effect on our business.

John W. Collins, our chief executive officer, has substantial experience with our operations and our industry and has contributed significantly to our growth. Although we maintain key man life insurance on Mr. Collins and we have an employment agreement with him, our customer and marketing relationships would likely be impaired and our business would likely suffer if we lost the services of Mr. Collins for any reason.

In addition, in our merchant services operations, we rely on several key employees for software programming and other information technology issues. In the event that any of these employees leaves the company for any reason or otherwise refuses to perform his duties, we could experience problems in our merchant services operations, which may result in a loss of revenue or customers.

If our processing centers or communications network suffers a systems failure or interruption, we may face customer service issues and be liable for damage suffered by our customers.

Our operations depend upon our ability to protect our processing centers, network infrastructure and equipment. Damage to our systems or equipment or those of third parties that we use may be caused by natural disasters, human error, power and telecommunications failures, intentional acts of vandalism and similar events. Although we do have data and item processing centers in several locations that serve as back-ups for each other, we maintain only a single data communications switching facility and do not maintain a back-up location for our frame relay network hardware. Interruption in our processing or communications services could delay transfers of our customers' data, or damage or destroy the data. Sudden increases in ATM usage or debit card activity could result in slow response times in our network. Any of these occurrences could result in lawsuits or loss of customers and may also harm our reputation.

We depend on other providers for products and services necessary to our business, and if we cannot obtain satisfactory products and services on favorable terms, or at all, our business could suffer.

We rely on other providers for internet and telephone banking products and services, ATM and debit card manufacturing, fiber optic communications and other products and services that are essential to our business. If any of these providers is permanently or temporarily unable to provide its products and services to us as the result of natural disasters, technical difficulties or otherwise, we may be unable to provide our products and services to our customers. If the performance of these third party products and services does not meet our customers' expectations, it may damage our current customer relationships, harm our reputation and inhibit our ability to obtain new customers.

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We depend on MCI for various services, and its bankruptcy could negatively affect our business.

MCI, Inc. provides various services to us, including frame relay circuits, network and internet backbone and collection for WEB 900 billing. If MCI's services are interrupted for any reason, including its bankruptcy, we could experience a disruption in the services that we provide to our customers. Any interruption of services by MCI could force us to seek other vendors to provide these services, which could increase our costs, result in delays or disruptions in our own services or make it difficult or impossible to provide the services if we cannot engage another vendor. During the third quarter of 2002, iBill's WEB 900 service provider, ICN Ltd., withheld certain amounts from iBill because MCI did not send the monies to ICN. InterCept reserved \$2.4 million, which represents deposits held for WEB 900 billing, amounts that iBill has paid to its merchants but not received from ICN, and related gross profits. During the fourth quarter of 2002, ICN sold its receivables to a third party and paid us \$288,000 related to May 2002. During the second quarter of 2003, we received an additional \$0.4 million, and as of June 30, 2003, we reduced the reserve to \$1.7 million. We have fully reserved for the account receivable and are seeking to recover the remaining \$1.7 million owed as of June 30, 2003, but we can offer no assurances that these efforts will be successful.

If our products and services contain errors, we may lose customers and revenues and be subject to claims for damages.

Our new products and services, and enhancements to our existing products and services, may have undetected errors or failures, or could fail to achieve market acceptance, despite testing by our current and potential customers and by us. If we discover errors after we have introduced a new or updated product to the marketplace, we could experience, among other things:

delayed or lost revenues while we correct the errors;

a loss of customers or delay in market acceptance; and

additional and unexpected expenses to fund further product development.

Our agreements with our customers generally contain provisions designed to limit our exposure to potential product liability claims, such as disclaimers of warranties and limitations on liability for special, consequential and incidental damages. These provisions may not be effective because of existing or future federal, state or local laws or ordinances, or unfavorable judicial decisions. If our products and services fail to function properly, we could be subject to product liability claims, which could result in increased litigation expense, damage awards and harm to our business reputation.

Our failure to successfully convert existing customers to our new EFT platform or customer dissatisfaction with that platform could cause a loss of revenue.

The current mainframe computer that we use to run our EFT platform has reached its limit for expansion. To accommodate our anticipated growth in EFT transaction volume, we have substantially rewritten our EFT platform software to run on a Stratus mainframe computer, which we believe will have significantly greater capacity. Although we have tested the new platform software, as we convert customers to this new platform, we could experience software errors or conversion problems. In addition, we could lose customers if they are dissatisfied with our new platform. If these errors or problems cause us to lose customers, it may cause a loss of revenue and adversely impact our business. Currently, we have successfully converted approximately 83% of our customers to the new platform and anticipate we will have all customers converted by September 30, 2003.

Because our business involves the electronic storage and transmission of data, security breaches and computer viruses could adversely affect us.

Our online transaction processing systems electronically store and transmit sensitive business information of our customers. The difficulty of securely storing confidential information electronically has been a significant issue in conducting electronic transactions. We may be required to spend significant capital and other resources to

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protect against the threat of security breaches and computer viruses, or to alleviate problems caused by breaches or viruses. To the extent that our activities or the activities of our customers involve the storage and transmission of confidential information, such as banking records or credit information, security breaches and viruses could expose us to claims, litigation and other possible liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and terminate their agreements with us, and could inhibit our ability to attract new customers.

Technological changes may reduce the demand for our products and services or render them obsolete.

The introduction of new technologies and financial products and services can render existing technology products and services obsolete. We expect other vendors to introduce new products and services, as well as enhancements to their existing products and services, that will compete with our products and services. To be successful, we must anticipate evolving industry trends, continue to apply advances in technology, enhance our existing products and services and develop or acquire new products and services to meet the demands of our customers. We may not be successful in developing, acquiring or marketing new or enhanced products or services that respond to technological change or evolving customer needs. We may also incur substantial costs in developing and employing new technologies. If we fail to adapt to changes in technologies, we could lose customers and revenues, and fail to attract new customers or otherwise realize the benefits of costs we incur.

We may not be able to protect our intellectual property rights.

We attempt to protect our software, documentation and other written materials under trade secret and copyright laws, confidentiality procedures and contractual provisions, which afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. We cannot be sure that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

If others claim that we have infringed their intellectual property rights, we could be liable for significant damages.

We do not believe that any of our products infringe the proprietary rights of third parties. We cannot be sure, however, that others will not make infringement claims, and we have agreed to indemnify many of our customers against those claims. We anticipate that the number of infringement claims will increase as the number of products and services increases and the functionality of products in different industry segments overlaps. Any of those claims, whether with or without merit, could be time-consuming, result in costly litigation and may not be resolved on terms favorable to us.

Fluctuations in our operating results have negatively affected the trading price of our common stock and may do so again.

Our operating results have varied in the past and may fluctuate significantly in the future as a result of many factors. These factors include:

the possible negative impact of implementing our growth and acquisition strategies, including accounting charges and other expenses associated with our acquisitions;

the loss of customers or strategic relationships;

competition and pricing pressures;

a reduction in recurring revenues as a percentage of total revenues;

increased operating expenses due to launches of new products and services, and sales and marketing efforts;

changes in interchange and transaction fees of MasterCard and Visa; and

finances from non-compliance with MasterCard and Visa regulations.

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Many factors that affect our operating results are outside of our control. Because of these factors, it is likely that in some future period our financial results will again fall below the expectations of securities analysts or investors. In that event, the trading price of our common stock would likely decline, perhaps significantly.

If we fail to comply with privacy regulations imposed on providers of services to financial institutions, our business could be harmed.

As a provider of services to financial institutions, we are required to comply with privacy regulations. We are bound by the same limitations on disclosure of the information received from our customers as apply to the financial institutions themselves. If we fail to comply with these regulations, we could damage our customer relationships, harm our reputation and inhibit our ability to obtain new customers.

Our limited combined operating history makes it difficult to evaluate our business.

Since our incorporation in May 1996, we have completed numerous acquisitions, including several large acquisitions in 2002. We have a limited combined operating history, and our historical results of operations and our other financial information may not be an accurate indication of our future results of operations or prospects.

Risks Related to Our Merchant Services Operations

The failure of our merchant services operations to perform as we expect could result in a loss of revenue, damage to customer relationships, and additional financial losses.

Our management has developed a business plan for our merchant services division, and we have significantly restructured that division. If our business plan for that division does not prove to be successful, we may have to pursue other alternatives for it. Those alternatives may include the sale of all or a portion of the division, the further restructuring of the division, or the suspension of the operations of the division. The occurrence of any of these events could result in a loss of substantial revenue and customers, and we may be required to incur a significant impairment charge to write down the value of the assets used in the division. In addition, any event of that nature could harm our business reputation and relationships with our financial institution customers and prospects.

Our business depends upon our continued Visa and MasterCard certification and financial institution sponsorship, and loss or suspension of this certification and sponsorship could adversely affect our business.

Because we are not a bank, we cannot belong to or directly access the Visa and MasterCard credit card associations or the ACH payment network. To provide our transaction processing services, we must be designated a certified processor by, and be a member service provider of, MasterCard and be designated as an internet payment services provider of Visa. These designations depend on our being sponsored by member clearing banks of both organizations and our continuing adherence to the standards of the Visa and MasterCard associations. The member financial institutions of Visa and MasterCard, some of which are our competitors, set the standards with which we must comply. If we fail to comply with these standards, our designation as a certified processor, a member service provider or an internet payment services provider could be suspended or terminated. The termination of our member service provider status or our status as a certified processor, or any changes in the Visa and MasterCard rules that prevent our registration, or otherwise limit our ability to provide transaction processing and marketing services for the Visa or MasterCard organizations:

may increase our costs of compliance with those rules;

could result in the loss of business from Visa or MasterCard customers; and

could lead to a severe reduction in our transactions and an increase in our charge-back percentages.

If member banks were to decline to sponsor us, we would be unable to process transactions for our customers, which could cause our revenues to decline significantly. We cannot guarantee that our current sponsor banks will not terminate their sponsorship of us in the future.

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If we are unable to maintain a relationship with a foreign bank to sponsor our international transactions, we could lose all revenues from our Visa transactions in Europe.

We are not able to acquire Visa transactions on behalf of foreign sponsored merchants unless the transactions are from an acquirer within the sponsored merchant's region. We have signed an agreement with a foreign bank to serve as iBill's acquiring bank for Visa transactions in Europe. On Wednesday, August 13, 2003, our acquiring bank threatened to close our account, allegedly due to transactions placed into the Visa system by unauthorized merchants sponsored by iBill. Although we have explained to our acquiring bank and to Visa that iBill is not responsible for the transactions and have taken action to terminate the accounts of the merchants in question, our acquiring bank may still suspend our account, which may effectively terminate our ability to process Visa transactions in Europe. Those transactions contribute approximately 4-6% of our aggregate merchant processing revenues. Although we are continuing discussions with the bank and with Visa, and intend to pursue all available legal remedies to address this problem, we could lose a majority, if not all, of the revenues from our Visa transactions in Europe if our account is suspended.

If our charge-back rate is excessive, credit card associations can fine us or terminate our ability to accept credit cards for payment.

In cases of fraud or disputes between cardholders and merchants, we face charge-backs when cardholders dispute items for which they have been billed. Charge-backs may arise from the unauthorized use of the cardholder's name or bank account information or from a cardholder's claim that a merchant failed to perform. If a billing dispute between a credit card holder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant, and the purchase price is refunded to the cardholder. If our charge-back rate becomes excessive, credit card associations can fine us or terminate our ability to accept credit cards for payment. If we are prohibited from accepting credit cards for payment, our ability to compete could be impaired and our business would suffer.

In March 2003, MasterCard imposed a fine of approximately \$5.85 million on us. Continued fines of this magnitude would materially adversely affect our financial condition and results of operations. We also face the possibility of fines from Visa for similar charge-back violations. We cannot predict with certainty, however, whether or when MasterCard or Visa will fine us, and if so, the amounts of those fines. In addition to the risk of possible fines, either or both MasterCard or Visa could terminate our ability to accept their credit cards for payment, which would materially adversely affect our financial condition and results of operations.

Visa recently announced revisions to its chargeback monitoring program which are designed to reduce the impact of charge-backs on the Visa payment system and heighten the scrutiny on problematic merchants. The new rules place greater responsibility on acquirers like iBill to respond to merchants with excessive levels of chargebacks. Currently, merchants that exceed a 2.5% charge-back threshold (for either Visa USA or Visa International) become subject to Visa's charge-back monitoring program, which results in greater scrutiny of transactions, potential fee payments and possible suspension from the Visa payments system. Effective October 1, 2003, the charge-back threshold will be reduced from 2.5% to 1.0% for Visa USA transactions, and effective January 1, 2004, the chargeback threshold will drop to 2.0% for Visa international transactions. In addition, Visa has issued a detailed program that specifies the responsibilities of the acquirer and the fees and actions required when a merchant is placed into the charge-back monitoring program. We have taken measures to reduce the charge-backs of the merchants we sponsor, including the termination of some problematic merchants. However, the implementation of the new rules by Visa will require us to further reduce the charge-back activity of our sponsored merchants. In the event that any of our merchants do not meet the new Visa thresholds, Visa could impose fees and take further action, including termination of the merchant. Any such fines or termination could negatively affect our results of operation.

We face significant charge-back liability if our merchants refuse or cannot reimburse charge-backs resolved in favor of their customers, and we face potential liability for merchant or customer fraud.

In addition to the possible consequences from the card associations as described in the previous risk factor, we face potential liabilities for charge-backs associated with the transactions we process. If we, or our processing banks, are unable to collect a charge-back from the merchant's account, or if the merchant refuses, or is financially unable due to bankruptcy or other reasons, to reimburse the merchant's bank for the charge-back, we bear the loss for the amount of the refund paid to the cardholder's bank.

Merchant fraud occurs when a merchant, rather than a customer, knowingly uses a stolen or counterfeit card or card number to record a false sales transaction, or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. When a merchant is unable to satisfy a charge-back, we are responsible for that charge-back. Our charge-back liability will increase if we fail to manage this risk effectively.

We also have potential liability for losses caused by fraudulent credit card transactions by customers. Card fraud occurs when a merchant's customer uses a stolen card, or a stolen card number in a card-not-present transaction, to purchase merchandise or services. In a traditional card-present transaction, if the merchant swipes the card, receives authorization for the transaction from the card issuing bank and verifies the

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signature on the back of the card against the paper receipt signed by the customer, the card issuing bank remains liable for any loss. In a fraudulent card-not-present transaction, even if the merchant receives authorization for the transaction, the merchant is liable for any loss arising from the transaction. Many of the merchants that we serve transact all or a substantial percentage of their sales over the Internet. Because their sales are card-not-present transactions, these merchants are more vulnerable to customer fraud than traditional brick and mortar merchants, which in turn exposes us to greater risks to this type of fraud.

Changes in card association fees, products or practices could increase our costs or otherwise limit our operations.

In March 2002, MasterCard implemented a rule that requires all banks that submit transactions on behalf of a merchant to have a valid merchant agreement with that merchant. This rule applies whether the card is presented directly to the merchant or to a third-party payment facilitator, such as iBill. MasterCard has notified iBill's former and current acquiring banks for MasterCard transactions that iBill has acquired transactions from merchants without the required merchant agreements. Because of this determination, MasterCard has stated that it will impose assessments on the acquiring banks of \$2,500 per day, retroactive to the day that the first noncompliant transaction was acquired through iBill. The total amount of this fine through April 4, 2003 is approximately \$540,000, which is

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recorded in the financial statements. On April 4, 2003, MasterCard notified iBill's acquiring bank that MasterCard had accepted iBill's plan to achieve compliance with MasterCard's rules and that MasterCard had granted a suspension of the \$2,500 per day assessments through August 22, 2003 to give iBill time to achieve full compliance. If iBill cannot achieve compliance by August 22, 2003, MasterCard could impose additional assessments.

From time to time, the card associations increase the interchange fees that they charge processors and the sponsoring banks. For example, Visa increased its interchange fees by 0.19% in April 2003. At their sole discretion, our sponsoring banks may seek to increase their Visa and MasterCard sponsorship fees to us, all of which are based upon the dollar amount of the payment transactions we process. Competitive pressures might force us to absorb a portion of those increases in the future, which would increase our operating costs and reduce our margins. Furthermore, the rules and regulations of the various card associations and networks prescribe certain capital requirements for settlement banks. Any increase in that capital requirement may adversely affect a bank's ability to serve as our settlement bank.

Online payment processing systems might be used for illegal or improper purposes, which could expose us to additional liability and harm our business.

Despite our efforts to review and monitor the types of transactions we process, all online payment processing systems remain susceptible to potentially illegal or improper uses. These may include illegal online gaming, fraudulent sales of goods and services, software and other intellectual property piracy, child pornography trafficking, prohibited sales of alcoholic beverages and tobacco products and online securities fraud. Our business could suffer if customers use our system for illegal or improper purposes.

Unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise, could expose us to protracted and costly litigation.

We collect and store sensitive data about merchants and cardholders, including names, addresses, social security numbers, drivers license numbers, checking and savings account numbers and payment history records, such as account closures and returned checks. In addition, we maintain a database of cardholder data relating to specific transactions, including payment card numbers and cardholder addresses, to process the transactions and for fraud prevention and other internal processes. If a person penetrates our network security or otherwise misappropriates sensitive merchant or cardholder data, we could be subject to liability or business interruption.

Hackers have in the past penetrated computer systems of payment processors. If we suffer such an attack, we may be subject to liability, including claims for unauthorized purchases with misappropriated card information, impersonation or other similar fraud claims. We could also be subject to liability for claims relating to misuse of personal information, such as unauthorized marketing purposes. These claims also could result in protracted and costly litigation.

After November 1, 2003, state and local governments will be permitted to levy additional taxes on Internet access and electronic commerce transactions, which could adversely affect our business.

In 1998, the federal government imposed a three-year moratorium on state and local governments from imposing new taxes on Internet access or electronic commerce transactions. This moratorium has been extended until November 1, 2003. After that date, unless the moratorium is renewed, state and local governments may levy additional taxes on Internet access and electronic commerce transactions. An increase in applicable taxes may make electronic commerce transactions less attractive for merchants and businesses, which could result in a decrease in the volume of transactions we process and reduce our revenues. Additionally, if a tax is levied against the merchants or service providers we serve, they may attempt to pass this additional cost along to us, thereby decreasing our revenues.

Our product features may infringe the patents of others, which could affect our business and profitability.

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We could be sued for patent infringement. If all or any portion of our service were found to infringe a patent and we are unable to obtain a license, or if a preliminary injunction were issued, we could be required to restructure our payment system, stop offering our payment product altogether, or pay substantial damages, which could have a material adverse effect on our business, prospects, results of operations and financial condition. Even if we prevail in a lawsuit, litigation can be expensive and can consume substantial amounts of management's time and attention.

Because some of the transactions we process are for the adult entertainment industry, our reputation with our customers and in the investment community may be harmed and the price of our common stock may decline.

We process transactions for merchants in many different industries, including the adult entertainment industry. Certain current and potential customers as well as investors, lenders, and others may be reluctant or refuse to do business with us, participate in the market for our common stock, provide financing, or offer related services because we process transactions for the adult entertainment industry. This may negatively affect our business, financial results, the price of our common stock or limit our ability to raise capital in the future.

Our customers may not adopt our online payment methods as soon as we intend, which would limit our growth and may cause our stock price to decline.

Our future profitability will depend, in part, on our ability to implement our strategy to increase adoption of our online payment methods. We can provide no assurances that the relatively new market for online payment mechanisms will remain viable. We expect to invest substantial amounts:

- to drive merchant awareness of electronic payments;
- to encourage merchants to sign up for and use our electronic payment products;
- to enhance our infrastructure to handle seamless processing of transactions;
- to continue to develop our technology;
- to diversify our customer base; and
- to establish international relationships.

We may fail to increase the adoption of our electronic payment methods as we intend, which would adversely affect revenues and cause our business to suffer.

We face strong competition in the merchant processing and online processing businesses.

In our online processing business, we compete with other online processing companies. In our merchant processing business, we compete with large merchant processors like Chase Merchant Services, National Processing Company, Paymentech, U.S. Bancorp/NOVA, First Data Corporation, Concord EFS and others. In each of these areas, many of our competitors have longer operating histories, greater name recognition and substantially greater resources than we do. We can provide no assurances that we will be able to compete successfully with these and other existing or new competitors.

Risks Related to Our Financial Institution Services Operations

Because many of our competitors have significantly greater resources than we do, we may be unable to gain market share.

Because our business includes a variety of products and services, we generally face different competitors within each area of our business. In our core banking and data processing business, we compete with numerous companies that have national operations and significant assets. Our principal EFT competitors include regional ATM networks, regional and local banks that perform processing functions, non-bank processors and other independent technology and data communications organizations. In each of these areas, many of our competitors have longer operating histories, greater name recognition and substantially greater resources than we do. If we compete with them for the same geographic market, their financial strength could prevent us from capturing market

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share in those areas. In addition, the competitive pricing pressures that would result from an increase in competition from these companies could have a material adverse effect on our business, financial condition and results of operations. Some of our competitors have established cooperative relationships among themselves or with third parties to increase their ability to address customer needs. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We can provide no assurances that we will be able to compete successfully with existing or new competitors. If we fail to adapt to emerging market demands or to compete successfully with existing and new competitors, our business, financial condition and results of operations would be materially adversely affected.

Our revenues may decrease as a result of legal actions against Visa and MasterCard.

We generate revenue from interchange fees, which are the interbank fees paid by merchants when they accept credit and debit cards. Visa and MasterCard set the interchange rates. Visa and MasterCard have been sued by the Department of Justice, or DOJ, for alleged violation of the Federal antitrust laws arising out of their respective functionally identical policies of (a) allowing members in the respective organization to issue cards participating in the other organization's system, and (b) prohibiting their members from issuing cards in competing systems other than Visa, MasterCard or Citigroup, the largest owner/member of Visa and MasterCard. The potential impact of this litigation on us depends upon whether or not the DOJ is successful, and if it is successful, the relief ordered by the court.

As a result of the settlement of a class action case brought by Wal-Mart and other merchants, Visa and MasterCard have announced new interchange rates for debit transactions that are approximately 33% lower than previous interchange rates. We have converted approximately 82% of our customers to a new pricing structure, under which we receive a flat fee for each transaction. Until all of our customers are converted to flat fee pricing the revenues that we continue to derive from interchange fees may be reduced by changes in interchange rates for debit transactions.

Financial institutions are subject to industry consolidation, and we may lose customers with little notice.

The banking industry is prone to consolidations that result from mergers and acquisitions. Our existing customers may be acquired by or merged with other financial institutions. Any purchase or merger may result in a lost customer for us because the acquiring financial institution may not use our products and services. Although we have included in most of our contracts a charge for early termination of the contract without cause, these charges would be insufficient to replace the recurring revenues that we would have received if the financial institution had continued as a customer.

We face risks in connection with our contract with Sovereign Bank.

In January 2003, we executed a definitive agreement with Sovereign Bank to provide Sovereign with item processing and check imaging services. Once we convert all of Sovereign Bank's item processing and check imaging operations to our centers, Sovereign will be our largest customer. To accommodate the Sovereign business, we have incurred and will continue to incur substantial costs to open four new item processing centers, expand two existing centers and add approximately 200 new employees. Sovereign can terminate the agreement at any time, including upon its acquisition or for convenience and in that event would be required to pay us liquidated damages. Although the amount of those damages would be significant, they may not compensate us adequately for the loss of the business. Sovereign also has the ability to terminate the agreement without paying liquidated damages for various events of default that include Sovereign's reasonable belief that its prospects of receiving services from us are materially impaired due to the occurrence of a material adverse change, as defined in the agreement. Depending on when a termination of the Sovereign agreement occurred, it could have a material adverse effect on our business, prospects, results of operations and financial condition.

The banking industry is highly regulated, and changes in banking regulations could negatively affect our business.

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Our banking customers are subject to the supervision of several state and federal government regulatory agencies. If bank regulations change, or if new regulations are adopted to regulate the products and services offered or used by community financial institutions, we could suffer an increase in the costs of providing our products and services. Moreover, if any new or revised regulations diminish the need for our services, we could lose customers and suffer a decline in revenues.

We are subject to government and private regulation, and an increase in regulatory requirements or tax burdens could place a strain on our business.

Various federal and state regulatory agencies examine our operations from time to time. These agencies can make findings or recommendations regarding various aspects of our operations, and we generally must follow those recommendations to continue our operations. If we fail to comply with these regulations, our operations and processing revenues could be negatively affected.

Our ATM network operations are subject to federal regulations governing consumers' rights. Fees charged by ATM owners are currently regulated in several states, and legislation regulating ATM fees has been proposed in several other states. Additional legislation may be proposed and enacted in the future, or existing consumer protection laws may be expanded to apply to ATM fees. If the number of ATMs decreases as a result of such legislation, then our EFT revenues may decline. Furthermore, we are subject to the regulations and policies of various ATM and debit card associations and networks. If we lost our privileges to provide transaction processing services across these networks, our revenues from ATM and debit card transaction processing would decrease significantly.

As a transaction processing company, we may be subject to state taxation of certain portions of the fees charged for our services. Application of this tax is an emerging issue in the industry, and the states have not yet adopted uniform guidelines implementing these regulations. If we are required to bear all or a portion of these costs and are unable to pass these costs through to our customers, our financial condition and results of operations would be adversely affected.

Other Risks of Owning Our Stock

If our stock price remains depressed for an extended period of time, we may be required to incur a significant impairment charge to reduce the carrying value of our intangible assets

Our stock price has declined significantly, although it has rebounded somewhat from its low in March 2003. As a result, our market value is substantially lower than the carrying value of our intangible assets on our balance sheet. If the price of our stock does not increase significantly, we may be required to incur an impairment charge to reduce the carrying value of our intangible assets to correspond to the market value of our stock. Any impairment charge of that nature may result in a large net loss for the period in which the impairment charge is incurred, which could cause a default under our credit facility, result in the loss of customers or prospects, and otherwise negatively affect our business.

A few people control a large portion of our stock and may vote their shares in ways contrary to our shareholders' interests.

Our executive officers and directors beneficially own approximately 18.1% of our outstanding common stock as of June 30, 2003. As a result, our executive officers and directors can exercise a significant degree of control over our company and have the power to influence the election of a majority of the directors, the appointment of management and the approval of actions requiring a majority vote of our shareholders. Their interests may conflict with our shareholders' interest, and our executive officers and directors could use their power to delay or prevent a change in control, even if a majority of the shareholders desired a change.

Future sales of shares of our common stock may negatively affect our stock price.

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To carry out our growth strategies, we may acquire other businesses and products using a combination of our stock and cash, and we may also sell additional shares of our stock to raise money for expanding our operations. Sales of substantial amounts of common stock in the public market or the prospect of such sales could adversely affect the market for our common stock. These sales also might make it more difficult for us to sell equity securities in the future at a time and price that we deem appropriate. As of June 30, 2003, we had 20,111,093 shares of common stock outstanding and options outstanding to acquire an additional 4,278,157 shares of common stock. Additionally, approximately 500,000 shares of common stock may be issued under our employee stock purchase plan, and approximately 1.0 million shares may be granted in the future under our stock option plans. If these issuances occur, it would dilute our existing shareholders' ownership interest in the company.

Georgia law, our articles of incorporation and bylaws and some of our employment agreements contain provisions that could discourage a third party from attempting to acquire our outstanding shares at a premium to the market price.

Some provisions of our articles of incorporation, our bylaws and Georgia law make it more difficult for a third party to acquire control of our company, even if a change in control would be beneficial to our shareholders. Some of our executive officers have entered into employment agreements with us that contain change in control provisions. These provisions may discourage or prevent a tender offer, proxy contest or other attempted takeover. In addition, we have in the past and may in the future create and issue new classes of preferred stock that have greater rights than our common stock. These superior rights may include greater voting rights, entitlement to dividends and preferential treatment in the event of a change in control, liquidation, consolidation or other circumstances. Any shares of preferred stock that we issue may discourage a third party from attempting to acquire our shares of common stock at a premium price.

We cannot predict every event and circumstance that may adversely affect our business and, therefore, the risks and uncertainties discussed above may not be the only ones we face. The risks and uncertainties discussed above are in addition to those that apply to most businesses generally. In addition, as we continue to grow our business, we may encounter other risks of which we are not aware at this time. These additional risks may cause serious damage to our business in the future, the impact of which we cannot estimate at this time.

Results of Operations

The following table provides the percentage of revenues represented by certain line items in our condensed consolidated statements of operations for the periods indicated.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
Revenues	100.0%	100.0%	100.0%	100.0%
Costs of services	49.8	46.7	51.2	47.5
Selling, general, and administrative expenses	35.4	33.3	36.0	31.8
Depreciation and amortization	7.8	7.1	7.5	6.6
Total operating expenses	93.0	87.1	94.7	85.9
Operating income	7.0	12.9	5.3	14.1
Other income, net	(5.2)	1.1	(2.6)	1.8
Income before provision for income taxes, equity in loss of affiliates and minority interest	1.8	14.0	2.7	15.9
Provision for income taxes	0.7	5.2	1.1	5.9
Equity in income (loss) of affiliates	(0.1)	0.0	0.0	(1.5)
Minority Interest	0.0	0.0	0.0	0.0
Net income	1.0%	8.8%	1.6%	8.5%

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Three Months Ended June 30, 2003 Compared to Three Months Ended June 30, 2002

Revenues. Revenues increased 16.3% to \$64.1 million for the three months ended June 30, 2003 from \$55.1 million for the three months ended June 30, 2002. The \$9.0 million increase was comprised of:

- (a) a \$1.1 million increase in merchant processing service fee income,
- (b) a \$6.7 million increase in financial institution service income and
- (c) a \$1.2 million increase in customer reimbursements.

The \$6.7 million increase in financial institution service income is comprised of a \$6.2 million increase in service fee income, a \$257,000 increase in data communications management income and a \$195,000 increase in hardware sales. The increases are attributable to both internal growth and the acquisition of ACS during July 2002 and not to any significant increases in prices.

Costs of Services. Costs of services increased 24.1% to \$31.9 million for the three months ended June 30,

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2003 from \$25.7 million for the three months ended June 30, 2002. The \$6.2 million increase was comprised of:

- (a) \$355,000 in costs associated with merchant processing services,
- (b) \$4.6 million in costs related to financial institution service income and
- (c) a \$1.2 million increase in customer reimbursements.

The \$4.6 million increase in financial institution service costs was due primarily to a \$3.9 million increase in service fee costs associated with the increase in service fee revenues. The increase in financial institution service costs also reflects a \$576,000 increase in data communications management costs and a \$140,000 increase in hardware sales costs. The increases are attributable to both internal growth and the acquisition of ACS during July 2002. Gross margins decreased to 50.2% for the three months ended June 30, 2003 from 53.3% for the three months ended June 30, 2002. This decrease is partially due to the requirement of EITF 01-14 to include customer reimbursements, which have no gross margin, as revenue and partially due to pricing pressure associated with InterCept's EFT offering. Customer reimbursements increased to \$3.7 million for the three months ended June 30, 2003 from \$2.5 million for the three months ended June 30, 2002. Gross margins have increased from the 47.5% during the first quarter of 2003 to 53.3% for the three months ended June 30, 2003.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 23.7% to \$22.7 million for the three months ended June 30, 2003 from \$18.4 million for the three months ended June 30, 2002. The \$4.4 million increase was comprised of (a) \$2.8 million related to financial institution service expenses and (b) \$1.6 million of merchant processing service expenses. The increase in financial institution service expenses was primarily due to personnel added from acquisitions, additional personnel to support our growth and other miscellaneous expenses. The increase in merchant processing service expenses was primarily due to the operations of iBill and EPX being included for the full quarter in 2003 and only a part of the 2002 second quarter. Selling, general and administrative expenses as a percentage of revenues increased to 35.4% for the three months ended June 30, 2003 from 33.3% for the three months ended June 30, 2002.

Depreciation and Amortization. Depreciation and amortization increased \$1.1 million to \$5.0 million for the three months ended June 30, 2003 from \$3.9 million for the three months ended June 30, 2002. The increase was primarily attributable to purchases of property, plant and equipment.

Other Income, Net. Other income, net decreased to expense of \$3.3 million for the three months ended June 30, 2003 from income of \$573,000 for the three months ended June 30, 2002. The decrease resulted from a \$3.5 million impairment of the SLM note receivable and lower interest income in 2003 due to the repayment of debt incurred for our acquisitions, compared with higher interest income in 2002 resulting from the investment of proceeds from our August 2001 public offering. The decrease was partially offset by \$400,000 received from the escrow resulting from the December 31, 2002 sale of Netzee to Certegy and lower interest expense due to the repayment of debt with proceeds from the maturity of several certificates of deposit. The interest rate we receive from the remaining certificates of deposit range from 4.93% to 5.0% per annum, while the interest rate we pay on the debt is a floating rate based on the prime rate.

Provision (benefit) for Income Taxes. The effective tax rate for the three months ended June 30, 2003 was 40.4% as compared to 37.0% for the three months ended June 30, 2002. The increase in the effective rate is mainly due to generating profits in states which impose higher tax rates.

Equity in Loss of Affiliate. Equity in loss of affiliate for the three months ended June 30, 2003 was \$23,000, and represented our 50% ownership in Interactive Payments, LLC through our wholly owned subsidiary, Internet Billing Company, LLC. For the three months ended June 30, 2002, there was no equity in loss of affiliate.

Minority Interest. Minority interest increased to a charge of \$16,000 for the three months ended June 30, 2003 from a charge of \$9,000 for the three months ended June 30, 2002.

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Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2002

Revenues. Revenues increased 35.7% to \$129.3 million for the six months ended June 30, 2003 from \$95.3 million for the six months ended June 30, 2002. The \$34.0 million increase was comprised of:

- (a) \$18.1 million of merchant processing service fee income primarily related to the 2002 acquisitions of iBill and EPX,
- (b) a \$13.2 million increase in financial institution service income and
- (c) a \$2.7 million increase in customer reimbursements.

The \$13.2 million increase in financial institution service income is comprised of an \$11.2 million increase in service fee income, a \$1.3 million increase in hardware sales and a \$721,000 increase in data communications management income. The increases are attributable to both internal growth and acquisitions and not to any significant increases in prices.

Costs of Services. Costs of services increased 46.3% to \$66.2 million for the six months ended June 30, 2003 from \$45.2 million for the six months ended June 30, 2002. The \$21.0 million increase was comprised of:

- (a) \$8.6 million in costs associated with merchant processing services resulting from the 2002 acquisitions of iBill and EPX,
- (b) \$9.6 million in costs related to financial institution service income and
- (c) a \$2.8 million increase in customer reimbursements.

The \$9.6 million increase in financial institution service costs was due primarily to a \$7.6 million increase in service fee costs associated with the increase in revenue. The increase in financial institution service costs also reflects a \$1.0 million increase in hardware sales costs and a \$1.0 million increase in data communications management costs. The increases are attributable to both internal growth and acquisitions. Gross margins decreased to 48.8% for the six months ended June 30, 2003 from 52.6% for the six months ended June 30, 2002. This decrease is partially due to the requirement of EITF 01-14 to include customer reimbursements, which have no gross margin, as revenue. Customer reimbursements increased to \$8.0 million for the six months ended June 30, 2003 from \$5.2 million for the six months ended June 30, 2002.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 53.5% to \$46.5 million for the six months ended June 30, 2003 from \$30.3 million for the six months ended June 30, 2002. The \$16.2 million increase was comprised of (a) \$7.3 million related to financial institution service expenses and (b) \$8.9 million of merchant processing service expenses. The increase in financial institution service expenses was primarily due to personnel added from acquisitions, additional personnel to support our growth and other miscellaneous expenses. The increase in merchant processing service expenses was primarily due to the operations of iBill and EPX being included for the full six month period in 2003 compared with only a portion of the same period in 2002. Selling, general and administrative expenses as a percentage of revenues increased to 36.0% for the six months ended June 30, 2003 from 31.8% for the six months ended June 30, 2002.

Depreciation and Amortization. Depreciation and amortization increased \$3.5 million to \$9.8 million for the six months ended June 30, 2003 from \$6.3 million for the six months ended June 30, 2002. The increase was primarily attributable to depreciation and amortization resulting from the acquisitions of iBill and EPX and additional property, plant and equipment depreciation.

Other Income, Net. Other income, net decreased to expense of \$3.3 million for the six months ended June 30, 2003 from income of \$1.8 million for the six months ended June 30, 2002. The decrease resulted primarily from

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a \$3.75 million impairment to the SLM note receivable and other SLM obligations, partially offset by \$400,000 received from the remaining escrow from the sale of Netzee to Certegy as of December 31, 2002.

Provision (benefit) for Income Taxes. The effective tax rate for the six months ended June 30, 2003 was 38.9% as compared to 36.9% for the six months ended June 30, 2002. The increase in the effective rate is mainly due to generating profits in states which impose higher tax rates.

Equity in Loss of Affiliate. For the six months ended June 30, 2002, equity in loss of affiliate was \$1.5 million due to the recording of equity losses in Netzee. Equity in loss of affiliate for the six months ended June 30, 2003 was \$4,000, and represented our 50% ownership in Interactive Payments, LLC through our wholly owned subsidiary, Internet Billing Company, LLC.

Minority Interest. Minority interest increased to a charge of \$29,000 for the six months ended June 30, 2003 from a charge of \$16,000 for the six months ended June 30, 2002.

Liquidity and Capital Resources

Since our incorporation, we have financed our operations and capital expenditures through cash from operations, borrowings from banks and sales of our common stock, including:

our initial public offering in June 1998, which resulted in net proceeds to us of \$14.4 million,

our public offering in February 2000, which resulted in net proceeds to us of \$66.0 million, and

our public offering in August and September 2001, which resulted in net proceeds to us of \$107.5 million.

Cash and cash equivalents were \$4.6 million at June 30, 2003 and \$24.1 million at December 31, 2002. Short-term investments with a maturity of one year or less were \$18.3 million at June 30, 2003. Net cash used in operating activities was \$2.7 million for the six months ended June 30, 2003 and net cash provided by operating activities was \$15.7 million for the six months ended June 30, 2002. The decrease in the net cash provided by operating activities was primarily attributable to decreased client payouts and reserves due to the customer attrition in the merchant services segment.

Net cash used in investing activities was \$2.5 million for the six months ended June 30, 2003 and net cash used in investing activities was \$107.8 million for the six months ended June 30, 2002. The increase in net cash used in investing activities was primarily due to the amendment of the iBill purchase agreement in February 2003.

Net cash used in financing activities was \$14.3 million for the six months ended June 30, 2003 and net cash provided by financing activities was \$78.2 million for the six months ended June 30, 2002. The increase in net cash used in financing activities was primarily due to the repayment of debt with the proceeds from the maturity of several certificates of deposit.

On December 3, 2001, we entered into a loan agreement with SLMsoft.com Inc., an Ontario corporation (SLM Canada), and SLMsoft.com Inc., a Kansas corporation, (SLM Kansas, and together with SLM Canada, SLM). Under the loan agreement, we loaned SLM \$7.0 million in exchange for cash and settlement of indemnification obligations that SLM owed to us. The loan was secured by the pledge of shares of InterCept stock. The SLM loan agreement was amended on September 30, 2002. Under the amended loan agreement, borrowings bear interest at prime plus 2%. Interest was payable on January 2, 2003 for all interest accrued through that date, and SLM sold 30,000 of the pledged shares in January 2003, which generated \$551,000 used to pay off the accrued interest and a small portion of the principal. During the second quarter of 2003, SLM Kansas filed in Kansas for protection under the U.S. bankruptcy laws, and SLM Canada became the subject of bankruptcy proceedings in Ontario, Canada. The loan matured on June 30, 2003, has not been repaid, and is secured by 371,636 shares of InterCept common stock. As of June 30, 2003, the balance on the loan was \$7.2 million.

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In light of the current market value of the pledged shares and the uncertainties inherent in the two bankruptcy proceedings, we have determined that a loss on the SLM loan is probable as of June 30, 2003. Based on the facts now known to us, we have estimated that loss at \$3,500,000. We have also determined that we are unlikely to collect approximately \$250,000 in indemnification obligations and accounts receivable from SLM. Accordingly, we have charged a total of \$3,750,000 in the statements of operations for the quarter ended June 30, 2003 in the line item Other (expense) income (loss), net. There is a reasonable possibility that we may incur additional losses on the SLM loan in the future as the bankruptcy proceedings progress, and it is also possible that the loss may ultimately prove to be less than our second quarter charge. Because the collateral that secures the loan consists of shares of InterCept stock, there may also be additional expense or income due to the fluctuation of InterCept's stock price until the SLM situation is resolved. We cannot now estimate whether any further charges will be necessary, and if so, its amount. Accordingly, in future periods as this situation becomes more certain, we may incur additional charges or receive additional income.

Our principal credit facility is with Wachovia Bank. We owed \$31.3 million under that facility as of June 30, 2003. The \$3,750,000 in charges related to SLM described above caused InterCept not to comply with a financial covenant in the Wachovia facility. Wachovia waived this non-compliance until September 30, 2003 to give us the opportunity to refinance the facility with another lender. We paid Wachovia \$50,000 to waive the noncompliance and will have to pay additional fees if we do not refinance the loan by September 30, 2003. We have signed a commitment letter from Bank of America, N.A. for a new three year \$50 million credit facility, which would provide sufficient borrowing capacity to repay Wachovia in full and provide additional working capital to us. Although we believe that we will close the Bank of America financing and pay off Wachovia within the waiver period, we may be unable to do so. If we fail to repay Wachovia in full by the waiver deadline and Wachovia fails to grant another waiver, we will again be in default under the Wachovia facility. In that event, Wachovia could choose to exercise its remedies under the loan documents, which would have a severe adverse effect on us and our business.

The Bank of America commitment letter provides for a syndicated \$50 million revolving credit facility that will mature three years after the closing date and be secured by substantially all of our assets. Bank of America, N.A. will be the administrative agent and Banc of America Securities LLC will be the lead arranger and book manager for the syndication. The amount available to be borrowed under the facility will be reduced by \$5.0 million per year on a quarterly basis, and may be further reduced up to a maximum of \$2.5 million a year by payments from our excess cash flow. Notwithstanding these reductions, however, the amount available to be borrowed will not decrease below \$35 million. The applicable interest rate on the facility will be LIBOR plus 2.25% to 3.00% (or an alternate rate based on the Bank of America prime rate or the Federal Funds rate plus .50%). We expect to pay Bank of America and the other lenders approximately \$1,375,000 in fees at or before closing, plus closing expenses. Although we expect to close this facility on generally these terms, the final terms may vary, and we may be unable to close the facility as we expect. The commitment contains customary conditions to closing, including negotiation of definitive loan documents, the occurrence of no material adverse change in our business, and the lenders having concluded a due diligence investigation of us that is satisfactory to them.

In January 2003, we executed a definitive agreement with Sovereign Bank for item processing and check imaging services. To accommodate Sovereign's item and check processing needs, we have opened two of our previously announced four new check image processing centers and significantly expanded another center, and to date have hired 75 new employees with plans to hire approximately 30 more employees during August and another 90 by year-end. Once we convert all of Sovereign Bank's item processing and check imaging operations to our centers, Sovereign will be our largest customer. We have used approximately \$9.0 million of our working capital to fund the capital improvements and other expenses necessary for us to prepare to provide services to Sovereign. We intend to refinance a portion of these capital expenditures with lease financing that will provide us with approximately \$5.0 million in cash that we can use for working capital and other corporate purposes.

During 2002, we borrowed \$30.0 million from The Peoples Bank of Winder, Georgia and \$6.7 million from The Bankers Bank. Interest was payable monthly at prime minus .375% under both notes. The notes were secured by certificates of deposit pledged by us and were payable in full on December 31, 2002. We repaid the \$200,000 loan from The Bankers Bank on December 30, 2002, when the final certificate of deposit that secured that loan matured. During 2002, we repaid approximately \$11.8 million of the loan from The Peoples Bank. On January 6, 2003, we borrowed \$18.2 million from The Bankers Bank to repay the loan to The Peoples Bank. The second

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Bankers Bank loan matures on August 31, 2003 and is fully secured by certificates of deposit that were previously pledged to the Peoples Bank. During February 2003, we repaid \$1.4 million we owed under the Bankers Bank note when a certificate of deposit that secured that note matured. As of June 30, 2003, the balance due to The Bankers Bank was \$16.9 million.

Because InterCept is not a bank, it cannot belong to or directly access the Visa and MasterCard credit card associations or the ACH payment network. To provide transaction processing services, Intercept must be designated a certified processor by, and be a member service provider of, MasterCard and be designated as an internet payment services provider of Visa. In cases of fraud or disputes between cardholders and merchants, Intercept faces charge-backs when cardholders dispute items for which they have been billed. Charge-backs may arise from the unauthorized use of the cardholder's name or bank account information or from a cardholder's claim that a merchant failed to perform. If a billing dispute between a credit card holder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant, and the purchase price is refunded to the cardholder. If Intercept's charge-back rate becomes excessive, credit card associations can fine Intercept or terminate Intercept's ability to accept credit cards for payment. Intercept withholds certain merchant payouts for a period of six months to cover its potential liability for merchant processing card activities including potential charge-back penalties.

As noted above, we acquired the iBill assets from Internet Billing Company, Ltd. (Old iBill) in April 2002. On February 11, 2003, we amended the iBill asset purchase agreement to settle outstanding issues related to the \$10.5 million remaining in the purchase price escrow that secured representations and warranties of the former owners, including those related to potential Visa and MasterCard fines for excessive charge-backs. Under the amendment, we received \$8.0 million from the escrow, and the former owners of Old iBill received the \$2.5 million then remaining in the escrow. In the amendment, the former owners also agreed to eliminate the earnout provisions in the purchase agreement. We agreed to indemnify the former owners for any claims resulting from processing-related activities that occurred before April 8, 2002.

We process MasterCard and Visa transactions through First Financial Bank and its affiliate, First Data Merchant Services Corporation (together referred to as First Data). On March 14, 2003, First Data was notified by MasterCard of an estimated assessment with respect to iBill's noncompliance with MasterCard's charge-back rules. First Data notified us that MasterCard had reviewed the historical charge-back percentages for Intercept and Old iBill for the period from January 1, 2001 through February 28, 2003 and had determined that those percentages exceeded MasterCard's limits. On March 31, 2003, First Data notified us that MasterCard had determined the final amount of the assessment to be \$5.85 million. Of the \$5.85 million, \$3.5 million was recorded as an adjustment of the iBill purchase price, \$1.9 million was recorded as an expense for the quarter ended December 31, 2002 and \$450,000 was recorded during the first quarter of 2003. As of June 30, 2003, First Data was holding a reserve of approximately \$5.3 million of money owed to us to cover our potential liability for merchant processing card activities, including potential charge-back penalties. This \$5.3 million amount is included in Other Noncurrent Assets in the balance sheet contained in our consolidated financial statements. The MasterCard fine was deducted from that reserve.

We also face the possibility of fines from Visa for similar charge-back violations. Before our April 2002 acquisition of the iBill assets, Visa fined Old iBill for excessive charge-backs in the months of August and September of 2001 and January and February of 2002 in the aggregate amount of approximately \$4.5 million. Old iBill also exceeded the Visa charge-back allowed rate in March 2002, and iBill exceeded the allowed charge-back rate in November 2002. In addition, Visa may deem us to have exceeded its charge-back levels in other months, but no fines have been assessed by Visa to date. We have concluded that Visa fines in excess of amounts withheld by us from merchant payouts are not probable, and accordingly, we have not recorded a liability under SFAS 5. Any fines could materially adversely affect our financial condition or results of operations.

In June 2003, iBill became aware, and subsequently informed Visa, that it had processed certain transactions for merchants who were not registered with Visa. Visa has assessed iBill \$300,000 for these violations. InterCept paid the assessment and recognized it as an expense in the second quarter of 2003, but we may appeal the assessment since we self-reported the violation. Visa has also informed First Data that it intends to send a third party to review iBill's processes to ensure that iBill has procedures in place to prevent additional processing of unregistered merchants in the future. If the results of this audit are unsatisfactory, Visa could assess

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additional fines for improper processing.

We also face the possibility of fines from Visa and MasterCard for similar charge-back violations if we fail to comply with MasterCard and Visa charge-back rules in the future and if Visa and/or MasterCard decide to impose fines. We cannot predict with certainty whether Visa and MasterCard will fine us, and if so, the amounts of those fines. Any fines could materially adversely affect our financial condition and result of operations.

We have limited availability on our lines of credit and as a result, our operating cash flows will be our principal source of short-term liquidity. We believe that to the extent that we rely on cash flows from operations to meet our short-term funding requirements, a decrease in demand for our products and services would not result in a material reduction in the availability of those funds. Because most of our customer contracts require the payment of monthly charges and have original terms of three to five years, we have a high percentage of recurring revenues.

As noted above, we are seeking to refinance the Wachovia facility with Bank of America before the Wachovia non-compliance waiver expires on September 30, 2003. Assuming that we are able to replace our Wachovia credit facility as we intend, we believe that borrowings from that facility and funds provided by operations will be sufficient to meet our anticipated capital expenditures and liquidity requirements for at least the next 12 months.

Historically, we have grown, in part, through strategic acquisitions. Assuming we are able to raise additional capital or obtain sufficient credit, we expect to make additional expenditures to make acquisitions and integrate the acquired companies. We can give no assurances with respect to the actual timing and amount of the capital we may raise or of the acquisitions we may make with the capital so raised. In addition, we can give no assurance that we will complete any acquisitions on terms favorable to us, if at all, or that additional sources of financing will be available to us. As a result of the foregoing, in 2003 we have been and expect to continue to be significantly less active in acquiring other businesses that we have been in the past, and we intend to focus on improving our existing operations.

Critical Accounting Policies

Management's discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Actual results may differ materially from these estimates under different assumptions or conditions.

We believe the following critical accounting policies involve the most complex or subjective decisions or assessments and affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

a) **Revenue recognition**

Revenues include service fees; debit and credit card processing fees; data communication management fees; revenues from equipment sales, installation and maintenance; software license fees; and software maintenance fees. We recognize service fee income and data communication management fees as services are performed. We recognize revenue from equipment sales and installations upon installation of the product, and we recognize any related maintenance revenue ratably over the period during which the services are performed. We also generate revenues from the licensing of our core data processing systems. We recognize revenue for licensing these systems in accordance with Statement of Position 97-2, Software Revenue Recognition, using the residual method prescribed in SOP 98-9 issued by the American Institute of Certified Public Accountants. We recognize software license, hardware and installation revenue after we have a signed non-cancelable license agreement, have installed the products and have fulfilled all significant obligations to the customer. We recognize maintenance fees over the term of the maintenance period. We sell some of our software and hardware products under five-year, sales-type lease agreements under which customers make annual installment payments. These annual payments include the

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initial installation and an ongoing license fee. Revenue attributable to installation fees and the sale of equipment is recognized upon installation. License fees are deferred and recognized ratably over the period of the lease.

Merchant processing services revenues are recognized as services are performed. Our service offerings allow merchants to accept and process real-time payments for goods and services purchased over the Internet using our merchant account, in which event revenue recognized is equal to service fees that we charge to the merchant. This fee is generally based on a percentage of the total transaction amount. Merchants can also establish their own merchant account with our acquiring bank partners and utilize our end-to-end processing solution, which eliminates the need for the merchant to establish multiple relationships with banks, front-end system providers, gateways, and back-end processors. We recognize revenues related to this service offering net of certain costs that we do not control - primarily interchange and other fees charged by credit card associations. For merchants using our merchant account, we delay a portion of our merchant payouts for a period of six months to cover for merchant credit losses that arise as a result of, among other things, disputes between cardholders and merchants or association fines related to charge-back activity. If disputes are not resolved in the merchant's favor, the transaction is charged back to us and the purchase price is refunded to the merchant's customer. If we are unable to collect from the merchant, we bear the credit risk for the full amount of the transaction. Our acquiring bank partners also establish and hold reserves for merchant credit losses for merchants using our end-to-end solution. If transactions are charged back to our banks and our banks are unable to collect from the merchants, we bear the credit risk for amounts in excess of reserves held by the banks.

Commitments and Contingencies

We record commitments and contingencies in accordance with SFAS 5. SFAS 5 requires that when a loss contingency exists, the likelihood that the contingency will result in the impairment of an asset or the incurrence of a liability be identified as remote, reasonably possible or probable. The identification as remote, reasonably possible or probable and whether the amount can be reasonably estimated determines whether the potential loss is recorded in the financial statements or disclosed in the notes to the financial statements or both.

As described in detail above in Liquidity and Capital Resources, we have been fined by MasterCard and may be fined by Visa. On March 14, 2003, First Data was notified by MasterCard of an estimated assessment with respect to iBill's noncompliance with MasterCard's charge-back rules. First Data notified us that MasterCard has reviewed the historical charge-back percentages for InterCept and Old iBill for the period from January 1, 2001 through February 28, 2003 and had determined that those percentages have exceeded MasterCard's limits. On March 31, 2003, First Data notified Intercept that MasterCard had determined the final amount of the assessment to be \$5.85 million. Of the \$5.85 million, \$3.5 million was recorded as an adjustment of the iBill purchase price, \$1.9 million was recorded as an expense for the quarter ended December 31, 2002 and \$450,000 was recorded during the first quarter of 2003. As of June 30, 2003, First Data was holding a reserve of approximately \$5.3 million owed to us to cover our potential liability for merchant processing card activities, including potential charge-back penalties. This \$5.3 million amount is included in Other Noncurrent Assets in the balance sheet contained in our consolidated financial statements.

We have concluded that the probability of Visa fines in excess of amounts withheld from merchant payouts is reasonably possible, but not probable, and accordingly, we have not recorded a liability under SFAS 5. We cannot predict with certainty whether or when Visa will fine us, and if so, the amounts of those fines.

In June 2003, iBill became aware, and subsequently informed Visa, that it had processed certain transactions for merchants who were not registered with Visa. Visa has assessed iBill \$300,000, for these violations. InterCept paid the assessment and recognized it as an expense in the second quarter of 2003, but may appeal the assessment since we self-reported the violation. Visa has also informed First Data that it intends to send a third party to review iBill's processes to ensure that iBill has procedures in place to prevent additional processing of unregistered merchants in the future. If the results of this audit are unsatisfactory, Visa could assess additional fines for improper processing.

b) Allowance for doubtful accounts

We record an allowance for doubtful accounts based on estimates of losses related to customer receivables

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balances. We develop estimates by evaluating specific customer accounts for risk of loss as well as historical credit memo data and other known factors for billing disputes that arise in the normal course of business.

c) Fair value of assets acquired and liabilities assumed in purchase combinations

Our purchase combinations require us to estimate the fair value of the assets acquired and liabilities assumed in our business. In general, we determine the fair value based upon information supplied by the management of the acquired entities and valuations by independent appraisal experts. The valuations have been based primarily upon future cash flow projections for the acquired assets, discounted to present value using a risk-adjusted discount rate. In connection with our acquisitions, we have recorded a significant amount of intangible assets. These assets are being amortized over the expected economic lives of the assets, generally ranging from five to 20 years. We are required to evaluate the remaining useful lives of our intangible assets that are being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. We are also required to test the carrying amount of these assets for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

During the fourth quarter of 2002, our revenues and earnings for our merchant services segment fell below original estimates due to several factors, including the implementation of new credit card association rules in November 2002, the termination of certain merchants due to noncompliance with credit card association rules and the transfer of iBill's transaction processing from EPX to a third party processor. As a result, we determined that the carrying amounts of intangible assets in the merchant services segment may not be recoverable. We estimated the undiscounted future cash flows associated with the assets and compared the amounts to the carrying values of the assets. Based on this comparison, we determined that certain assets were impaired. In order to quantify the impairment loss, we estimated the fair value of the assets based on the discounted future cash flows associated with the assets and recorded an impairment loss of \$20.0 million equal to the difference in the fair value and carrying amount of the assets. We also evaluated the remaining useful lives of our intangible assets subject to amortization. Based on changes in merchant attrition rates in the EPX reporting unit, we have shortened the useful life of EPX customer relationships from 20 years to 10 years. We will amortize the revised carrying amount after the impairment loss above based on a 10-year life. We concluded that the remaining useful lives of all other intangible assets were appropriate as of December 31, 2002. We will continue to evaluate these lives on an annual basis, and if we determine that we have over-estimated the economic life of these assets, we will begin to amortize the remaining unamortized carrying value of the assets over the newly estimated life. Accordingly, depreciation and amortization expense could be increased, and the amount of any increase could be material to our results of operations.

We also recorded a significant amount of goodwill in connection with our acquisitions. Through the end of 2001, we evaluated goodwill for impairment whenever indicators of impairment existed based on undiscounted projected future cash flows. If the carrying value of the goodwill were less than the undiscounted projected future cash flows, no impairment was recognized. Beginning in 2002, we have been required to evaluate our goodwill for impairment on an annual basis or whenever indicators of impairment exist. The evaluation will be based upon a comparison of the estimated fair value of the unit of our business to which the goodwill has been assigned to the sum of the carrying value of the assets and liabilities of that unit. The fair values used in this evaluation will be estimated based upon discounted future cash flow projections for the unit as well as comparable industry revenue and earnings multiples. These cash flow projections will be based on a number of assumptions as discussed above.

Investment in and Advances to Netzee

Until December 31, 2002, we owned approximately 28% of Netzee's common stock. We accounted for our investment in Netzee using the equity method of accounting, under which the operations of Netzee were recorded on a single line item in our statements of operations, equity in loss of affiliate. We did not consolidate Netzee's results of operations with our results of operations.

We reviewed our investment in Netzee in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. APB Opinion No. 18 provides that a loss in value of an investment which is other than a temporary decline should be recognized. We compared our

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carrying value of the investment to the fair market value of the stock over time in order to determine when a loss in value that is other than temporary has occurred. For the three months ended March 31, 2002, we continued to record equity method losses in Netzee, resulting in the reduction of our investment in common stock of Netzee to zero.

Beginning in the second quarter of 2002, we then applied EITF 99-10, Percentage Used to Determine the Amount of Equity Method Losses, which addresses the percentage of ownership that an investor should use to compute equity method losses when the investment in a company's common stock has been reduced to zero and the investor holds other securities of the company such as preferred stock or loans to the company. Netzee had preferred stock outstanding; we owned none of that preferred stock. Netzee also had an \$18.0 million line of credit, of which we loaned or were obligated to loan approximately 78%. Under EITF 99-10, we did not record any additional equity method losses until the preferred stockholders had reduced their investments to zero by absorbing \$7.8 million of losses. During the three months ended September 30, 2002, we used our relative ownership percentage in the next most senior level of capital the line of credit to record our share of Netzee's losses. On December 31, 2002, Certegy, Inc. acquired substantially all of the assets of Netzee. We received approximately \$2.3 million in payment on our line of credit and \$473,000 for our Netzee stock which resulted in a loss of \$5.4 million. This loss is included in equity in loss of affiliate. In 2003, we have received approximately \$400,000 from escrow accounts established at the time of closing and may receive additional payouts.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We do not use derivative financial instruments in our operations or investments and do not have significant operations subject to fluctuations in foreign currency exchange rates. Borrowings under our Wachovia credit facility accrue interest at a fluctuating rate equal to the one month LIBOR plus 2%. As of June 30, 2003, \$31.3 million was outstanding under this facility. Changes in interest rates that increase the interest rate on the credit facility would make it more costly to borrow under that Wachovia facility and may impede our acquisition and growth strategies if we determine that the costs associated with borrowing funds are too high to implement these strategies. Changes in interest rates that increase the interest rate by 1.0% would increase our interest expense by approximately \$313,000 per year.

We owe \$16.9 million to The Bankers Bank. This loan is secured by certificates of deposit in amounts equal to the principal amounts of the loans. Interest on these loans is based on the prime rate. Changes in interest rates that increase the interest rate by 1.0% would increase our interest expense by approximately \$169,000 per year.

Item 4. Controls and Procedures

As of June 30, 2003, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Exchange Act Rule 13a-14(c). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our current disclosure controls and procedures are effective as of June 30, 2003.

The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Other than as described below, we are not a party to, and none of our material properties is subject to, any material litigation other than routine litigation incidental to our business.

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(1) We brought an action on March 15, 2002 against Midwest Payment Systems, Inc. (MPS) in the U.S. District Court in the Eastern District of Tennessee seeking a declaration as to the rights and legal relations of InterCept, MPS and the customer banks under the contracts that we and the banks have with MPS and asserting a claim for tortious interference with contractual relations. On April 3, 2002, InterCept and MPS agreed to a consent order pursuant to which MPS agreed to continue to provide services on a month-to-month basis so that InterCept can continue to service its customers who use MPS for ATM/EFT services. Both InterCept and MPS agreed not to solicit the ATM/EFT business of the customer banks until final resolution of the lawsuit, and both companies agreed to limited communications with the customers regarding the lawsuit. MPS has answered our complaint and has brought its own claims against us, including tortious interference with contract, breach of contract and breach of fiduciary duty. InterCept believes that MPS' s claims are without merit and intends to defend them vigorously if the lawsuit is not settled. We are presently engaged in settlement discussions with MPS. If settlement efforts are unsuccessful, the case is scheduled to go to trial in March 2004.

(2) On September 30, 2002, Perfect10, Inc. filed a lawsuit in the Central District of California against iBill; CCBill, LLC; Paycom Billing Services, Inc; IMA Enterprises, Inc.; Cybertech Communications NV; Network Authentication Systems Corporation; Cavcreek Wholesale Internet Exchange; Netpass Systems, Inc; Internet Key, Inc; and other defendants asserting causes of action for copyright infringement, trademark infringement, violations of privacy rights, RICO, false advertising, unfair competition and related claims. The complaint seeks a broad range of remedies, including actual damages, treble damages, an accounting of profits attributable to the allegedly infringing conduct, injunctive relief and other remedies. The plaintiff contends that iBill, which rendered billing services in connection with certain websites, is liable under theories of secondary liability and conspiracy for the alleged wrongdoing.

Discovery in the suit has not yet begun. We believe the claims are without merit and will vigorously defend the lawsuit and assert applicable defenses. It is too early in the proceeding to evaluate the probability of a favorable or unfavorable outcome, or the amount of any potential loss that we would suffer in the event of an unfavorable outcome.

(3) InterCept, three of its officers John W. Collins, G. Lynn Boggs, and Scott R. Meyerhoff and its former officer, Garrett M. Bender, were named as defendants in a shareholder class action lawsuit filed in the U.S. District Court for the Northern District of Georgia (Civil Action No. 03-CV0567). The plaintiff sought to represent a class of individuals who purchased InterCept common stock between September 16, 2002 and January 9, 2003. The plaintiff alleged that InterCept and the individual defendants made material misrepresentations and/or omitted to make material disclosures throughout the class period due to their false assurances that the adult entertainment portion of the company' s merchant services business was insignificant and their failure to disclose the impact of the implementation of new Visa regulations in November 2002. The plaintiff alleged violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated under Section 10(b), and Section 20(a) of the Exchange Act. Similar actions were filed by multiple plaintiffs, and on May 2, 2003, the plaintiffs filed a motion to consolidate the claims. On June 23, 2003, the court denied the plaintiffs' motions to consolidate. On July 11, 2003, the plaintiffs filed a new motion for consolidation.

On August 7, 2003, InterCept, Collins, Boggs and Meyerhoff filed motions to dismiss all of the actions, and on August 12, 2003, they filed answers to each of the complaints denying liability and stating affirmative defenses. InterCept believes the claims are without merit and will continue to vigorously defend the lawsuits.

Due to the inherent uncertainties of the litigation process and the judicial system, the company is unable to predict the outcome of such litigation matters. If the outcome of this matter is adverse to the company, it could have a material adverse effect on the company's business, financial condition and results of operation.

Item 2. Changes in Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

Our principal credit facility is with Wachovia Bank. We owed \$31.3 million under that facility as of June 30, 2003. We have made all required payments of principal and interest to Wachovia. One of the financial covenants in the Wachovia facility, however, requires us to have a minimum amount of EBITDA for each quarter. As a result of the \$3,750,000 in charges related to SLM described in Note 8 to the condensed consolidated financial statements included in this report, we fell below the minimum required EBITDA amount as of June 30, 2003, which caused us not to comply with a financial covenant under the Wachovia facility. Wachovia waived this non-compliance until

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September 30, 2003 to give us the opportunity to refinance the facility with another lender. We paid Wachovia \$50,000 to waive the non-compliance and will have to pay additional fees if we do not refinance the loan by September 30, 2003. We have signed a commitment letter from Bank of America, N.A. for a new three year \$50 million credit facility, which would provide sufficient borrowing capacity to repay Wachovia in full and provide additional working capital to us. Although we believe that we will close the Bank of America financing and pay off Wachovia within the waiver period, we may be unable to do so. If we fail to repay Wachovia in full by the waiver deadline and Wachovia fails to grant another waiver, we will again be in default under the Wachovia facility. In that event, Wachovia could choose to exercise its remedies under the loan documents, which would have a severe adverse effect on us and our business.

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

On June 4, 2003, we held our annual meeting of shareholders. At the meeting, the only proposal submitted to a shareholder vote was the election of two directors, Boone A. Knox and John D. Schneider, Jr., both of whom were re-elected to three-year terms. The results were as follows, and there were no abstentions or broker non-votes:

	<u>For</u>	<u>Withheld</u>
Boone A. Knox	14,998,329	481,124
John D. Schneider, Jr.	15,000,161	479,292

The terms of office of Jon R. Burke, John W. Collins, and Glenn W. Sturm as a directors continued after the meeting.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits required by Item 601 of Regulation S-K.

Exhibit

<u>No.</u>	<u>Description</u>
31	Certifications of John W. Collins and Scott R. Meyerhoff pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certifications of John W. Collins and Scott R. Meyerhoff pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is not filed for purposes of Section 18 of the Securities Exchange Act of 1934 but is instead furnished as provided by applicable rules of the SEC.

- (b) Reports on Form 8-K filed during the three months ended June 30, 2003

Form 8-K dated March 31, 2003, filed on April 2, 2003, reporting under Item 9 the press release regarding a revision to InterCept's 2002 earnings previously announced on March 5, 2003.

Form 8-K dated April 17, 2003, filed on April 22, 2003, reporting under Item 9 that InterCept held a meeting with analysts to discuss operations and earnings. The full text of the slideshow presentation from the meeting is included as an exhibit.

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Form 8-K dated May 7, 2003, filed on May 9, 2003, reporting under Item 9 the press release announcing InterCept's earnings for the three months ended March 31, 2003.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INTERCEPT, INC.

August 13, 2003 /s/ JOHN W. COLLINS

Date **John W. Collins**
Chairman of the Board
and Chief Executive
Officer
(principal executive
officer)

August 13, 2003 /s/ SCOTT R.
MEYERHOFF

Date **Scott R. Meyerhoff**
Chief Financial Officer
(principal financial and
accounting officer)

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EXHIBIT INDEX

Exhibit

No. Description

- 31 Certifications of John W. Collins and Scott R. Meyerhoff pursuant to Section 302 of the Sarbanes Oxley Act of 2002
- 32 Certifications of John W. Collins and Scott R. Meyerhoff pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is not filed for purposes of Section 18 of the Securities Exchange Act of 1934 but is instead furnished as provided by applicable rules of the SEC.