

DST SYSTEMS INC  
Form 10-Q  
May 10, 2007

**UNITED STATES  
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 March 31, 2007

or

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

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

Commission File Number 1-14036

**DST SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**43-1581814**

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

**333 West 11th Street, Kansas City, Missouri**

(Address of principal executive offices)

**64105**

(Zip Code)

**(816) 435-1000**

(Registrant's telephone number, including area code)

**No Changes**

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

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

Yes  No

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

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Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Number of shares outstanding of the Company's common stock as of April 30, 2007:  
Common Stock \$0.01 par value 64,457,888

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**DST Systems, Inc.**  
**Form 10-Q**  
**March 31, 2007**  
**Table of Contents**

	<b>Page(s)</b>
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements (unaudited)</u>	
<u>Introductory Comments</u>	3
<u>Condensed Consolidated Balance Sheet</u> <u>March 31, 2007 and December 31, 2006</u>	4
<u>Condensed Consolidated Statement of Income</u> <u>Three Months Ended March 31, 2007 and 2006</u>	5
<u>Condensed Consolidated Statement of Cash Flows</u> <u>Three Months Ended March 31, 2007 and 2006</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7-18
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19-33
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	34
<u>Item 4.</u>	
<u>Controls and Procedures</u>	34-35
<u>Item 4T.</u>	
<u>Controls and Procedures</u>	35
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	35
<u>Item 1A.</u>	
<u>Risk Factors</u>	35 - 40
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	40
<u>Item 3.</u>	
<u>Defaults Upon Senior Securities</u>	40
<u>Item 4.</u>	
<u>Submission of Matters to a Vote of Security Holders</u>	41
<u>Item 5.</u>	
<u>Other Information</u>	41
<u>Item 6.</u>	
<u>Exhibits</u>	41
<u>SIGNATURE</u>	41

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

**DST Systems, Inc.**  
**Form 10-Q**  
**March 31, 2007**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Introductory Comments**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( "DST" or the "Company" ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The results of operations for the three months ended March 31, 2007, are not necessarily indicative of the results to be expected for the full year 2007.

3

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**DST Systems, Inc.**  
**Consolidated Balance Sheet**  
*(unaudited and dollars in millions, except per share amounts)*

	March 31, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 85.9	\$ 60.6
Transfer agency investments	72.1	125.6
Accounts receivable	376.9	369.5
Inventories	17.4	17.9
Deferred income taxes	40.6	39.5
Other assets	39.0	39.4
	631.9	652.5
Investments	1,704.3	1,647.4
Properties	522.8	542.8
Goodwill	112.9	164.7
Intangibles	24.5	41.2
Other assets	66.6	70.5
Total assets	\$ 3,063.0	\$ 3,119.1
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Current portion of long-term debt	\$ 968.4	\$ 948.0
Transfer agency deposits	72.1	125.6
Accounts payable	75.4	100.0
Accrued compensation and benefits	82.0	94.2
Deferred revenues and gains	76.3	71.5
Other liabilities	125.4	138.2
Income taxes payable		118.8
	1,399.6	1,596.3
Long-term debt	518.0	493.2
Deferred income taxes	394.9	401.6
Income taxes payable	65.7	
Other liabilities	61.4	55.7
	2,439.6	2,546.8
Commitments and contingencies (Note 8)		
Stockholders equity		
Common stock, \$0.01 par; 400 million shares authorized, 95.3 million shares issued	1.0	1.0
Additional paid-in capital	123.1	120.6
Retained earnings	1,519.6	1,434.9
Treasury stock (30.2 million and 29.6 million shares, respectively), at cost	(1,574.0)	(1,519.3)
Accumulated other comprehensive income	553.7	535.1
Total stockholders equity	623.4	572.3
Total liabilities and stockholders equity	\$ 3,063.0	\$ 3,119.1

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

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Operating revenues	\$ 426.2	\$ 382.7
Out-of-pocket reimbursements	159.1	193.3
Total revenues	585.3	576.0
Costs and expenses	475.8	477.3
Depreciation and amortization	29.9	29.3
Income from operations	79.6	69.4
Interest expense	(18.2 )	(29.5 )
Other income, net	12.8	24.5
Gain on sale of business		52.8
Equity in earnings of unconsolidated affiliates	24.8	16.1
Income before income taxes	99.0	133.3
Income taxes	33.6	51.6
Net income	\$ 65.4	\$ 81.7
Average common shares outstanding	63.1	67.9
Diluted shares outstanding	71.8	73.4
Basic earnings per share	\$ 1.04	\$ 1.20
Diluted earnings per share	\$ 0.90	\$ 1.11

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

**DST Systems, Inc.**  
**Condensed Consolidated Statement of Cash Flows**  
*(in millions)*  
*(unaudited)*

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows operating activities:</b>		
Net income	\$ 65.4	\$ 81.7
Depreciation and amortization	29.9	29.3
Net realized gain on investments	(4.2 )	(16.1 )
Gains on sale of businesses and properties	(0.3 )	(52.8 )
Share-based compensation expense	6.4	6.3
Amortization of debt issuance costs	0.1	12.7
Deferred income taxes	1.1	23.8
Equity in earnings of unconsolidated affiliates	(24.8 )	(16.1 )
Cash dividend from unconsolidated affiliates		25.1
Changes in accounts receivable	(7.6 )	26.2
Changes in other assets	10.8	5.4
Changes in transfer agency investments	53.4	23.9
Changes in transfer agency deposits	(53.4 )	(23.9 )
Changes in accounts payable and accrued liabilities	(36.3 )	(2.7 )
Changes in income taxes payable	27.2	19.8
Changes in deferred revenues and gains	4.8	(0.1 )
Changes in accrued compensation and benefits	(5.9 )	(22.1 )
Other, net	(7.5 )	6.2
Total adjustments to net income	(6.3 )	44.9
Net	59.1	126.6
<b>Cash flows investing activities:</b>		
Capital expenditures	(19.0 )	(35.4 )
Proceeds from sale of investments	16.5	97.4
Investments in securities	(46.1 )	(23.9 )
Proceeds from (investments in and advances to) unconsolidated affiliates	36.7	(10.7 )
Proceeds from sale of properties	5.2	
Other, net		(0.8 )
Net	(6.7 )	26.6
<b>Cash flows financing activities:</b>		
Proceeds from issuance of common stock	28.0	21.7
Principal payments on long-term debt	(7.7 )	(22.6 )
Net increase in revolving credit facilities	41.3	16.0
Common stock repurchased	(94.0 )	(153.0 )
Excess tax benefits from share based compensation	5.3	3.8
Net	(27.1 )	(134.1 )
Net increase in cash and cash equivalents	25.3	19.1
Cash and cash equivalents at beginning of period	60.6	80.2
Cash and cash equivalents at end of period	\$ 85.9	\$ 99.3

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





**DST Systems, Inc.**  
**Notes to Condensed Consolidated Financial Statements**  
*(unaudited)*

**1. Summary of Accounting Policies**

The Condensed Consolidated Financial Statements of DST Systems, Inc. ( *DST* or the *Company* ) included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( *GAAP* ) have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. The Condensed Consolidated Balance Sheet as of December 31, 2006 has been derived from the audited Consolidated Balance Sheet at that date, but does not include all of the information and notes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the Company's audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of normal interim closing procedures) necessary to present fairly the financial position of the Company and its subsidiaries at March 31, 2007, and the results of operations for the three months ended March 31, 2007 and 2006, and cash flows for the three months ended March 31, 2007 and 2006.

The results of operations for the three months ended March 31, 2007, are not necessarily indicative of the results to be expected for the full year 2007.

**2. Asurion Corporation Transaction**

DST acquired an approximate 37.4% ownership interest in Asurion Corporation ( *Asurion* ) on January 1, 2006 when it merged its DST lockline, Inc. subsidiary into a wholly-owned subsidiary of Asurion. In April 2007, the Board of Directors of Asurion approved a transaction whereby certain private equity firms will own a significant stake in Asurion. Based on the terms of the transaction, DST estimates that its subsidiary's interest in Asurion will be converted into a 6% continuing ownership interest and after-tax cash proceeds of approximately \$600 million.

Asurion's transaction is subject to regulatory approval and satisfaction of standard pre-closing conditions. Upon closing, which is expected to occur in either the second or third quarter of 2007, DST will no longer account for its investment in Asurion under the equity method of accounting, but rather will account for its continuing ownership interest under the cost basis of accounting.

**3. Investments**

Investments are as follows (in millions):

	<b>2007 Ownership Percentage</b>	<b>Carrying Value March 31, 2007</b>	<b>December 31, 2006</b>
<b>Available-for-sale securities:</b>			
State Street Corporation	3%	\$ 732.4	\$ 762.7
Computershare Ltd.	5%	259.7	207.8
Euronet Worldwide	5%	50.6	56.0
Other available-for-sale securities		293.3	249.4
		1,336.0	1,275.9
<b>Unconsolidated affiliates:</b>			
Boston Financial Data Services	50%	127.9	120.0
International Financial Data Services, U.K.	50%	47.2	41.8
International Financial Data Services, Canada	50%	20.5	17.8
Argus Health Systems	50%	15.0	13.8
Asurion Corporation	37%	20.0	8.6
Unconsolidated real estate affiliates		59.1	95.9
Other unconsolidated affiliates		26.0	26.3
		315.7	324.2
<b>Other:</b>			
Trading securities		48.6	42.9
Held-to-maturity		4.0	4.4
		52.6	47.3
<b>Total investments</b>		<b>\$ 1,704.3</b>	<b>\$ 1,647.4</b>

The following table summarizes certain information related to the Company's available-for-sale securities (in millions):

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
Book cost basis	\$ 462.9	\$ 426.9
Gross unrealized gains	874.9	850.6
Gross unrealized losses	(1.8)	(1.6)
Market value	\$ 1,336.0	\$ 1,275.9

The Company has a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. Invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company had \$72.1 million and \$125.6 million of transfer agency investments and deposits at March 31, 2007 and December 31, 2006, respectively.

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The following table summarizes the fair value and gross unrealized losses of the Company's investments by the length of time that the securities have been in a continuous loss position, as of March 31, 2007 (in millions):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common Stock	\$ 35.3	\$ 1.8	\$	\$	\$ 35.3	\$ 1.8

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

The Company recognized \$0.5 million of investment impairments for the three months ended March 31, 2007, which the Company believed were other than temporary. No impairments were recorded during the three months ended March 31, 2006. The impairments recorded during the three months ended March 31, 2007 related to available for sale investments in the Investments and Other Segment and other investments held by the Financial Services segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted or derived market value and is reflected in the other income, net line in the statement of income.

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

	For the Three months Ended March 31,	
	2007	2006
Boston Financial Data Services, Inc.	\$ 7.9	\$ 6.6
International Financial Data Services, U.K.	3.5	1.2
International Financial Data Services, Canada	2.4	0.2
Argus Health Systems	1.2	1.0
Asurion Corporation	11.4	7.8
Other	(1.6 )	(0.7 )
	\$ 24.8	\$ 16.1

#### 4. Goodwill and Intangible Assets

##### *Goodwill*

The following table summarizes the changes in the carrying amount of goodwill for the three months ended March 31, 2007, by segment (in millions):

	December 31,	Acquisitions	Disposals	Other	March 31,
	2006				2007
Financial Services	\$ 155.4			\$ (51.8 )	\$ 103.6
Output Solutions	9.3				9.3
Total	\$ 164.7			\$ (51.8 )	\$ 112.9

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As further described in Note 6, DST adopted a new income tax accounting standard on January 1, 2007. The adoption of this accounting standard resulted in a reduction in goodwill of approximately \$52.6 million and intangible assets of approximately \$16.5 million that were acquired during the April 2005 acquisition of DST Health Solutions, Inc.

### *Intangible Assets*

The following table summarizes intangible assets (in millions):

	<b>March 31, 2007 Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>December 31, 2006 Gross Carrying Amount</b>	<b>Accumulated Amortization</b>
<b>Amortizable intangible assets:</b>				
Customer relationships	\$ 27.1	\$ 2.9	\$ 45.3	\$ 5.0
Other	1.0	0.7	3.0	2.1
<b>Total</b>	<b>\$ 28.1</b>	<b>\$ 3.6</b>	<b>\$ 48.3</b>	<b>\$ 7.1</b>

Amortization of intangible assets for the three months ended March 31, 2007 and 2006 was approximately \$0.6 million. The Company estimates that amortization expense attributable to intangible assets recorded as of March 31, 2007 will be approximately \$1.6 million for the remainder of 2007, \$2.1 million for 2008, \$2.0 million for each of 2009 and 2010 and \$1.9 million for each of 2011 and 2012.

## **5. Debt**

### *Senior Convertible Debentures*

Holders of the Company's \$840 million senior convertible debentures were eligible to convert these bonds during the three months ended March 31, 2007 as a result of DST's common stock trading above 120% of the applicable conversion price (\$49.08) for at least 20 trading days during the period of 30 consecutive trading days ended December 31, 2006. Actual conversions through March 31, 2007 have been less than \$0.1 million and cash was used to settle the principal portion of these conversions. The senior debentures continue to be convertible through June 30, 2007 as the stock price conversion feature was still in effect at March 31, 2007. Conversion rights, and ultimate classification as a current or non-current liability, for subsequent quarters will be a function of future DST stock prices.

### *Equipment Promissory Note*

During the three months ended March 31, 2007, DST purchased \$11.3 million of computer equipment with a promissory note. The note matures on April 1, 2010 and is secured by the equipment. Interest accrues at a fixed rate of approximately 4.9% per year.

### *BFDS Promissory Note*

As previously announced, the Company entered into a promissory note with Boston Financial Data Services, Inc. (BFDS). The agreement provides for unsecured revolving borrowings by the Company of up to \$50 million and matures on July 1, 2010. In March 2007, an amendment to the existing promissory note between the Company and BFDS was executed. The amendment increased the unsecured revolving borrowings limit from \$50 million to \$100 million. The amount outstanding under this loan agreement was \$60.0 million at March 31, 2007. For the three months ended March 31, 2007, the Company recorded interest expense related to this loan of \$0.7 million.

## 6. Income Taxes

Effective January 1, 2007, DST adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB No. 109 (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements. FIN 48 indicates that the impact from adoption should be reflected as a cumulative effect adjustment from a change in accounting principle to the beginning retained earnings amount reported for that fiscal year, unless the amount relates to a previous business combination, in which case the impact would be recorded as an adjustment to the purchase price allocation for the previous business combination. The adjustment to the purchase price allocation would first reduce remaining goodwill and identified intangibles related to the business combination and the residual would be reflected as a cumulative effect adjustment to beginning retained earnings.

DST's adoption resulted in approximately \$87.5 million of previously recorded liabilities for uncertain tax positions being released, of which \$68.2 million (net of related deferred income taxes) resulted in a reduction in previously recorded identified intangibles (including capitalized software) relating to the Company's April 2005 acquisition of DST Health Solutions, and the remainder of \$19.3 million was recorded as an increase in stockholders' equity as a cumulative effect adjustment. The reduction in the identified intangibles resulted in a reduction in amortization expense of approximately \$1.5 million during first quarter 2007 as compared to 2006. The reduced amortization will continue in the future, as no identified intangibles remain from the DST Health Solutions acquisition.

Prior to the adoption of FIN 48, the Company classified all income tax uncertainties as current liabilities. Upon adoption of FIN 48, the Company reclassified approximately \$64.0 million of income tax uncertainties that are estimated to take more than 12 months to resolve to non-current liabilities.

The amount of gross unrecognized tax benefits as of January 1, 2007 is \$53.8 million. Included in the Company's net unrecognized tax benefit at January 1, 2007 are \$47.3 million of tax positions which, if recognized, would affect the effective tax rate. Also included in the net unrecognized tax benefit at January 1, 2007 are \$3.7 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period. The amount of unrecognized tax benefits did not materially change as of March 31, 2007.

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in income taxes, which is consistent with the recognition of these items in prior reporting periods. As of January 1, 2007, the Company had \$13.1 million of interest and penalties accrued associated with unrecognized tax benefits. The liability for interest and penalties did not materially change as of March 31, 2007.

It is expected that the amount of unrecognized tax benefits will change during the next year; however, the Company does not expect the change to have a significant impact on its results of operations or financial position.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS examination of the tax years ended December 31, 1999 through 2001 concluded during 2006. In connection with the examination of the Company's 2000 tax return, the IRS is continuing to examine a transaction the Company consummated in that year. An IRS examination for the tax years ended December 31, 2002 through 2005 began during 2006. As of March 31, 2007, the IRS has not proposed any significant adjustments which would be material to the Company's financial statements. Various state, local, and foreign income tax returns are also under examination by taxing authorities. The Company does not believe that the outcome of any examination will have a material impact on our financial statements.

In general, the Company records income tax expense during interim periods based on its best estimate of the full year's effective tax rate. Certain items, however, are given discrete period treatment and, as a result, the tax effects of such items are reported in full in the relevant interim period. The Company's effective tax rate was 33.9% for the three months ended March 31, 2007 compared to 38.7% for the same period in 2006. The lower effective tax rate for 2007 is due to the absence of the gain relating to the lockline merger with Asurion which attracted a higher effective

tax rate and due to a reduction in the interest accruals relating to unrecognized tax benefits resulting from the adoption of FIN 48. Excluding the effects of discrete period items, the Company estimates its recurring tax rate for the remainder of 2007 to be 33.4%. The full year 2007 effective tax rate can be affected as a result of variances among the estimates and amounts of full year sources of taxable income (e.g. domestic consolidated, joint venture and/or international), the realization of tax credits (e.g. historic rehabilitation, research and experimentation and state incentive), adjustments which may arise from the resolution of tax matters under review and the Company's assessment of its liability for unrecognized tax benefits.

## 7. Stockholders' Equity

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 65.4	\$ 81.7
Dilutive securities at unconsolidated affiliates	(0.5 )	(0.3 )
Net income for dilutive computation	\$ 64.9	\$ 81.4
Average common shares outstanding (excluding restricted stock)	63.1	67.9
Incremental shares from assumed conversions of stock options, vesting of stock based compensation and debenture conversion	8.7	5.5
Diluted potential common shares	71.8	73.4
Basic earnings per share	\$ 1.04	\$ 1.20
Diluted earnings per share	\$ 0.90	\$ 1.11

The Company had approximately 65.2 million and 69.6 million shares outstanding at March 31, 2007 and 2006, respectively. For financial reporting purposes, however, unvested restricted shares in the amount of 2.5 million at March 31, 2007 and 2006 are excluded from the determination of average common shares outstanding used in the calculation of basic earnings per share in the above table. Shares from options to purchase common stock that were excluded from the diluted earnings per share calculation because they were anti-dilutive totaled 0.1 million and 0.9 million for the three months ended March 31, 2007 and 2006, respectively. The Company has issued convertible senior debentures that if converted in the future would have a potentially dilutive effect on the Company's stock. The Series A debentures are convertible into 11.0 million shares of common stock and the Series B debentures are convertible into 6.1 million shares of common stock, subject to adjustment. The Company intends to settle any conversions with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts. Related to the debentures, the calculation of diluted earnings per share includes an incremental amount of shares assumed to be issued for the conversion spread when the Company's average daily stock price exceeds \$49.08 per share. For the three months ended March 31, 2007 and 2006, there was additional dilution of approximately 5.3 million shares and 2.6 million shares, respectively, related to the Company's average daily share price exceeding \$49.08 per share.

The Company repurchased approximately 1,136,900 million shares of DST common stock for \$81.6 million or approximately \$71.77 per share during the three months ended March 31, 2007. Cash proceeds from operations and borrowings on debt facilities were used to repurchase these shares. At March 31, 2007, approximately 2.8 million shares remained under the existing share repurchase authorization plan. On May 8, 2007, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization.

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 65.4	\$ 81.7
Other comprehensive income (loss):		
Unrealized gains on investments:		
Unrealized holding gains arising during the period	25.4	107.3
Proportional share of unconsolidated affiliate interest rate swap	0.4	6.1
Less reclassification adjustments for net gains included in net income	(4.2 )	(16.1 )
Foreign currency translation adjustments	5.5	0.3
Deferred income taxes	(8.5 )	(37.6 )
Other comprehensive income	18.6	60.0
Comprehensive income	\$ 84.0	\$ 141.7

## 8. Commitments and Contingencies

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

The Company has letters of credit of \$18.8 million and \$21.0 million outstanding at March 31, 2007 and December 31, 2006, respectively. Letters of credit are secured by the Company's debt facility. Letters of credit at March 31, 2007 include \$14.1 million related to real estate joint ventures discussed below.

The Company has entered into agreements with certain officers whereby upon defined circumstances constituting a change in control of the Company, certain benefit entitlements are automatically funded and such officers are entitled to specific cash payments upon termination of employment.

The Company has established trusts to provide for the funding of corporate commitments and entitlements of Company officers, directors, employees and others in the event of a change in control of the Company. Assets held in such trusts at March 31, 2007 were not significant.

As a result of recent court decisions, customers of the Company's 50% joint venture, International Financial Data Services, U.K. Limited (IFDS U.K.), may seek refunds of past value added tax (VAT) payments charged by IFDS U.K. Protective refund claims have been filed by IFDS U.K. for customers having potential claims for past VAT paid. IFDS U.K. plans to make disbursements to its clients based upon the net amount received from the refund claims. However, the amounts recoverable and payable to customers are uncertain. The Company currently estimates that the resolution of this matter will not result in a significant financial impact to the Company.

The Company has entered into an agreement to guarantee 50% of the obligations of a 50% owned joint venture as a tenant under a real estate lease for an office building. The initial term of the lease is 10 years and 7 months, commencing March 1, 2007 and expiring September 30, 2017, with two five-year options to extend. The base rent for the initial term is \$4.8 million per year, plus all operating expenses for the building.

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The Company has entered into an agreement to guarantee 50% of a construction loan made to a 50% owned joint venture. The construction loan becomes due and the Company's guarantee thereof expires in June 2008 and allows for borrowings up to \$2.6 million. At March 31, 2007, total borrowings against the loan were \$0.4 million.

The Company has entered into an agreement to guarantee 50% of a \$10.0 million line of credit provided to a 50% owned real estate joint venture. The line of credit becomes due and the Company's guarantee thereof expires on December 16, 2007. At March 31, 2007, total borrowings against the line of credit were \$9.1 million.

The Company entered into an agreement to guarantee 10% of any amounts between \$10.0 million and \$20.0 million, and 20% of any amounts thereafter, related to a \$48.2 million construction loan to a 50% owned real estate joint venture. The \$48.2 million loan matures on the earlier of the completion of the project or December 31, 2007. At March 31, 2007, total borrowings on the loan were \$29.6 million, resulting in a guarantee of \$2.9 million by the Company.

The Company entered into an agreement to guarantee \$1.0 million (which, in the event a certain debt service coverage ratio requirement is not met, will increase to \$2.0 million) plus any enforcement costs related to a \$32.0 million mortgage loan to a 33% owned real estate joint venture. The \$32.0 million loan matures on July 1, 2010. At March 31, 2007, total borrowings on the loan were \$28.4 million and the Company's guarantee totaled \$1.0 million.

The Company is a 50% partner in a limited purpose real estate joint venture. The real estate joint venture was formed to develop and lease approximately 1.1 million square feet of office space to the U.S. government. The project is estimated to cost approximately \$362 million and has been financed with \$315.4 million of non-recourse insured bonds (issued June 2004) with the remainder in the form of equal equity contributions from the Company and its real estate joint venture partner. At March 31, 2007, the Company and its joint venture partner had each contributed \$28.5 million. The Company and its joint venture partner have each committed up to \$14.1 million of additional equity investments in the aggregate in the event of delays in construction or lease commencement. The remaining equity contributions up to \$14.1 million each have been secured through letters of credit that will begin expiring in 2007 through 2008. The Company is responsible for \$14.1 million of the letters of credit at March 31, 2007. At March 31, 2007, there were no outstanding borrowings against the letters of credit.

The Company and State Street have each guaranteed 50% of a lease obligation of IFDS U.K., which requires IFDS U.K. to make annual rent payments of approximately \$4.0 million through 2017, for its use of a commercial office building. The commercial office building is owned by a wholly-owned affiliate of International Financial Data Services, (Canada) Limited ( IFDS Canada ) and is financed with a \$20.4 million mortgage loan from a bank. The loan has a floating interest rate based upon LIBOR and fully amortizes over a 15-year term. To fix the rate of borrowing costs, IFDS Canada entered into a 15-year interest rate hedge agreement with the same bank. The interest rate hedge, which has an initial notional amount value of approximately \$20.4 million and scheduled reductions that coincide with the scheduled principal payments for the mortgage loan, was entered into for the purpose of fixing the borrowing costs of the mortgage at approximately 6.3%. The Company and State Street have each guaranteed 50% of the amounts of the interest rate hedge obligations. Upon default, the Company would be required to pay 50% of the total amount to close out of the hedge, which is approximately \$0.1 million at March 31, 2007.

The Company's 50% owned joint ventures are generally governed by shareholder or partnership agreements. The agreements generally entitle the Company to elect one-half of the directors to the board in the case of corporations and to have 50% voting/managing interest in the case of partnerships. The agreements generally provide that the Company or the other party has the option to establish a price payable in cash, or a promise to pay cash, for all of the other's ownership in the joint venture and to submit an offer, in writing, to the other party to sell to the other party all of its ownership interests in the joint venture or to purchase all ownership interests owned by the other party at such offering price. The party receiving the offer generally has a specified period of time to either accept the offer to purchase, or to elect to purchase the offering party's interest at the offering price. The Company cannot estimate the potential aggregate offering price that it could be required to receive or elect to pay in the event this option becomes operable; however, the amount could be material.

### *Guarantees*

In addition to the guarantees entered into as mentioned above, the Company has also guaranteed certain obligations of certain joint ventures under service agreements entered into by the joint ventures and their customers. The amount of such obligations is not stated in the agreements. Depending on the negotiated terms of the guaranty and/or the



underlying service agreement, the Company's liability under the guaranty may be subject to time and materiality limitations, monetary caps and other conditions and defenses.

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

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

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

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

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

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

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

In connection with the leasing of real estate by the Company, as landlord and as tenant, the Company has entered into occupancy leases containing indemnification provisions, the terms of which vary depending on the negotiated terms of each respective lease, but which are generally described as follows: (i) in connection with leases in which the Company is the tenant, the Company has agreed to indemnify the landlord against third party claims relating to the

Company's occupancy of the subject property, including claims arising from loss of life, bodily injury and/or damage to property thereon, and (ii) in connection with leases in which the Company is the landlord, the Company has agreed to indemnify the tenant against third party claims to the extent occasioned wholly or in part by any negligent act or omission of the Company or arising from loss of life, bodily injury and/or damage to property in or upon any of the common areas or other areas under the Company's control.

At March 31, 2007 and December 31, 2006, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect indebtedness of others in accordance with FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.

## 9. New Accounting Standards

### *Fair Value Measurements*

In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. The Company will be required to adopt this standard in the first quarter of 2008. Management is currently evaluating the requirements of SFAS 157 and has not yet determined the impact on the consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. The Company will be required to adopt this standard in the first quarter of 2008. Management is currently evaluating the requirements of SFAS 159 and has not yet determined the impact on the consolidated financial statements.

### *Earnings Per Share*

The FASB previously issued an exposure draft on a proposed accounting standard that would amend SFAS No. 128, Earnings per Share (SFAS 128), to clarify guidance for mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the if-converted method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle conversions of its convertible debentures with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128, if amended as proposed. The final statement has yet to be issued. Retrospective application would be required for all changes to SFAS 128, except that retrospective application would be prohibited for contracts that were either settled in cash prior to adoption or modified prior to adoption to require cash settlement. For DST, adoption of this statement, as proposed, will require retroactive restatement of the Company's diluted earnings per share calculations subsequent to the issuance of the convertible debentures. In calculating diluted earnings per share under the revised SFAS 128 if converted method included in the exposure draft, the Company would need to increase net income for the interest expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion by 17.1 million shares (less shares already included in diluted earnings per share), the amount of shares that would be issued if all \$840 million of convertible debentures would be converted to equity. Under this if converted method, diluted earnings per share would have been \$0.84 and \$1.08 (versus reported diluted earnings per share of \$0.90 and \$1.11) for the three months ended March 31, 2007 and 2006, respectively. The above pro-forma information presents only the effect on diluted earnings

per share of the if converted method included in the exposure draft, but does not include any other computational changes (i.e., treasury stock method considerations) discussed in the exposure draft. DST is continuing to monitor the FASB's progress towards finalizing this proposed accounting standard.

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

The estimated impact of this new accounting standard reflects the Company's current estimates based upon the exposure draft in its current form. There may be material differences between these estimates and the actual impact of the standard when issued as final.

## 10. Segment Information

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

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

	March 31, 2007	December 31, 2006
Financial Services	\$ 2,251.4	\$ 2,332.9
Output Solutions	374.5	374.4
Investments and Other	2,181.0	2,174.8
Eliminations	(1,743.9 )	(1,763.0 )
	\$ 3,063.0	\$ 3,119.1

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

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

	<b>Three Months Ended March 31, 2007</b>				<b>Consolidated</b>
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Eliminations</b>	<b>Total</b>
Operating revenues	\$ 273.7	\$ 149.2	\$ 3.3	\$	\$ 426.2
Intersegment operating revenues	1.8		12.5	(14.3 )	
Out-of-pocket reimbursements	16.3	142.8	0.1	(0.1 )	159.1
Total revenues	291.8	292.0	15.9	(14.4 )	585.3
Costs and expenses	209.6	270.6	10.0	(14.4 )	475.8
Depreciation and amortization	18.4	9.1	2.4		29.9
Income from operations	63.8	12.3	3.5		79.6
Other income, net	3.2		9.6		12.8
Equity in earning (losses) of unconsolidated affiliates	26.7		(1.9 )		24.8
Earnings before interest and income taxes	\$ 93.7	\$ 12.3	\$ 11.2	\$	\$ 117.2

	<b>Three Months Ended March 31, 2006</b>				<b>Consolidated</b>
	<b>Financial Services</b>	<b>Output Solutions</b>	<b>Investments/ Other</b>	<b>Eliminations</b>	<b>Total</b>
Operating revenues	\$ 242.2	\$ 135.8	\$ 4.7	\$	\$ 382.7
Intersegment operating revenues	1.2		10.7	(11.9 )	
Out-of-pocket reimbursements	16.3	177.4	0.1	(0.5 )	193.3
Total revenues	259.7	313.2	15.5	(12.4 )	576.0
Costs and expenses	177.9	301.9	9.9	(12.4 )	477.3
Depreciation and amortization	19.3	7.1	2.9		29.3
Income from operations	62.5	4.2	2.7		69.4
Other income, net	3.8		20.7		24.5
Gain on sale of business	52.8				52.8
Equity in earnings (losses) of unconsolidated affiliates	17.0		(0.9 )		16.1
Earnings before interest and income taxes	\$ 136.1	\$ 4.2	\$ 22.5	\$	\$ 162.8

Earnings before interest and income taxes in the segment reporting information above less interest expense of \$18.2 million and \$29.5 million for the three months ended March 31, 2007 and 2006, respectively, is equal to the Company's income before income taxes on a consolidated basis for the corresponding periods.

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

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

*The information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Condensed Consolidated Financial Statements and Notes thereto included in this Form 10-Q and the audited consolidated financial statements and notes thereto in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.*

### **INTRODUCTION**

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

### **Financial Services**

The Company's Financial Services Segment provides sophisticated information processing and computer software services and products primarily to mutual funds, investment managers, insurance companies, healthcare providers, banks, brokers, financial planners, healthcare payers, third party administrators and medical practice groups. The Company's proprietary software systems include mutual fund shareowner and unit trust recordkeeping systems for U.S. and international mutual fund companies; a defined-contribution participant recordkeeping system for the U.S. retirement plan market; investment management systems offered to U.S. and international investment managers and fund accountants; a business process management and customer contact system offered to mutual funds, insurance companies, brokerage firms, banks, cable television operators, healthcare providers and mortgage servicing organizations; record-keeping systems to support managed account investment products; and healthcare processing systems and services, including consumer directed healthcare administration solutions, offered to healthcare payers, third party administrators and medical practice groups.

The Financial Services Segment distributes its services and products on a direct basis and through subsidiaries and joint venture affiliates in the U.S., United Kingdom (U.K.), Canada, Europe, Australia, South Africa and Asia-Pacific and, to a lesser degree, distributes such services and products through various strategic alliances.

As more fully described in Note 3 Significant Business Transactions to the Company's Consolidated Financial Statements included in its 2006 Annual Report on Form 10-K, the Company acquired Amisys Synertech, Inc. on October 2, 2006 through a merger with a wholly-owned subsidiary of DST Health Solutions, Inc.

### **Output Solutions**

The Company's Output Solutions Segment provides single source, integrated print and electronic statement and billing output solutions. The Output Solutions Segment also offers a variety of related professional services,



including marketing and personalization services, and postal optimization solutions. The Output Solutions Segment also provides electronic presentment, payment and distribution solutions.

The Output Solutions Segment conducts its operations from five production facilities located throughout North America and the U.K. DST Output is among the largest First-Class mailers in the U.S. DST Output Canada offers customer communications and document automation solutions to the Canadian market. DST International Output provides personalized print and electronic communications principally in the U.K.

The Output Solutions Segment distributes its products directly to customers and through relationships in which its services are combined with or offered concurrently through providers of data processing services. The Output Solutions Segment's products are also distributed or bundled with product offerings to customers of the Financial Services Segment.

#### **Investments and Other**

The Investments and Other Segment holds investments in equity securities and certain financial interests and the Company's real estate subsidiaries and affiliates. The assets held by the Investments and Other Segment are primarily passive in nature. The Investments and Other Segment holds investments in equity securities with a market value of approximately \$1.3 billion at March 31, 2007, including approximately 11.3 million shares of State Street Corporation (State Street), 29.6 million shares of Computershare and 1.9 million shares of Euronet Worldwide, Inc., with a market value of \$732.4 million, \$259.7 million and \$50.6 million, respectively, based on closing exchange values at March 31, 2007. Additionally, the Company owns and operates real estate mostly in the U.S. and U.K., which is held primarily for lease to the Company's other business Segments. The Company is a partner in certain real estate joint ventures that lease office space to the Company, certain of its unconsolidated affiliates and unrelated third parties.

20

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**RESULTS OF OPERATIONS**

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

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Revenues</b>		
<b>Operating revenues</b>		
Financial Services	\$ 275.5	\$ 243.4
Output Solutions	149.2	135.8
Investments and Other	15.8	15.4
Eliminations	(14.3 )	(11.9 )
	426.2	382.7
% change from prior year period	11.4	%
<b>Out-of-pocket reimbursements</b>		
Financial Services	16.3	16.3
Output Solutions	142.8	177.4
Investments and Other	0.1	0.1
Eliminations	(0.1 )	(0.5 )
	159.1	193.3
% change from prior year period	(17.7	%)
<b>Total revenues</b>	<b>\$ 585.3</b>	<b>\$ 576.0</b>
% change from prior year period	1.6	%
<b>Income from operations</b>		
Financial Services	\$ 63.8	\$ 62.5
Output Solutions	12.3	4.2
Investments and Other	3.5	2.7
	79.6	69.4
Interest expense	(18.2 )	(29.5 )
Other income, net	12.8	24.5
Gain on sale of business		52.8
Equity in earnings of unconsolidated affiliates	24.8	16.1
<b>Income before income taxes</b>	<b>99.0</b>	<b>133.3</b>
Income taxes	33.6	51.6
<b>Net income</b>	<b>\$ 65.4</b>	<b>\$ 81.7</b>
Basic earnings per share	\$ 1.04	\$ 1.20
Diluted earnings per share	\$ 0.90	\$ 1.11



### Consolidated revenues

Consolidated total revenues (including out-of-pocket ( OOP ) reimbursements) for the three months ended March 31, 2007, increased \$9.3 million or 1.6% compared to the same period in 2006. Consolidated operating revenues for the three months ended March 31, 2007 increased \$43.5 million or 11.4% as compared to the same period in 2006 primarily from the inclusion of ASI operating revenues which was acquired on October 2, 2006, higher license fees for international investment management and AWD software and higher Output Solutions volumes.

Consolidated OOP reimbursements during the three months ended March 31, 2007 decreased \$34.2 million or 17.7% due to lower Output Solutions OOP reimbursement revenues as a result of certain clients supplying their own postage in 2007 rather than have Output Solutions acquire postage on behalf of the client.

Financial Services Segment total revenues for the three months ended March 31, 2007 increased \$32.1 million or 12.4% over the same period in 2006. Financial Services Segment operating revenues for the three months ended March 31, 2007 increased \$32.1 million or 13.2% compared to the same period in 2006 primarily from the inclusion of ASI revenues and higher license fees for international investment management and AWD software, higher mutual fund and AWD revenues.

Output Solutions Segment total revenues for the three months ended March 31, 2007, decreased \$21.2 million or 6.8% compared to the same period in 2006. Output Solutions Segment operating revenues for the three months ended March 31, 2007 increased \$13.4 million or 9.9% over the same period in 2006, principally from higher U.S. processing volumes, a contract termination fee of \$3.1 million and revenues from new international clients.

Investments and Other Segment operating revenues, primarily rental income for facilities leased to the Company's operating segments, for the three months ended March 31, 2007 were \$15.8 million, an increase of \$0.4 million or 2.6% compared to the same period in 2006.

### Income from operations

Consolidated income from operations for the three months ended March 31, 2007 was \$79.6 million, an increase of \$10.2 million or 14.7% compared to the same period in 2006, primarily from higher license fees for international investment management and AWD software, higher contributions from Output Solutions, including a \$3.1 million contract termination fee, and higher contributions from mutual fund shareowner processing.

Financial Services Segment income from operations for the three months ended March 31, 2007 increased \$1.3 million or 2.0% from the prior year quarter to \$63.8 million, attributable to higher license fee revenues and the elimination of amortization of DST Health Solutions, Inc. intangibles from the adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB No. 109 ( FIN 48 ). The reduction in amortization expense during first quarter 2007 was approximately \$1.5 million compared to first quarter 2006. The reduced amortization will continue in the future as no identified intangibles remain from the April 2005 acquisition of DST Health Solutions. These increases in 2007 operating income are partially offset by higher personnel costs in 2007 to support business growth.

Output Solutions Segment income from operations for the three months ended March 31, 2007 increased \$8.1 million as compared to the prior year quarter, primarily from higher U.S. processing volumes, increased revenues from new international clients, a \$3.1 million contract termination fee, and cost efficiencies realized from the implementation of new proprietary printing and inserting technologies.

Investments and Other Segment income from operations totaled \$3.5 million for the three months ended March 31, 2007, an increase of \$0.8 million or 29.6% compared to the same period in 2006 attributable to a \$0.3 million gain from the sale of a property, higher rental income and operational cost improvements.

**Interest expense**

Interest expense was \$18.2 million for the three months ended March 31, 2007, a decrease of \$11.3 million as compared to the three months ended March 31, 2006. Included in interest expense during the three months ended March 31, 2006 is the write-off of the Company's convertible debentures debt issuance costs in the amount of \$12.7 million. Absent this item, interest expense increased during 2007 due to higher average debt balances and higher average interest rates.

**Other income, net**

Other income was \$12.8 million for the three months ended March 31, 2007, a decrease of \$11.7 million as compared to the three months ended March 31, 2006, principally from lower gains from securities transactions in 2007. Included in the three months ended March 31, 2006 were net gains of approximately \$16.1 million, principally resulting from the sale of approximately 1.5 million shares of State Street Corporation, compared to \$3.3 million of net gains from securities transactions during 2007. In addition, 2007 other income includes a gain related to the recovery in a non-operating Chapter 11 bankruptcy claim of an amount due from a previous client, in the amount of \$1.0 million. Absent the gains on securities transactions and the recovery of the bankruptcy claim, other income increased during 2007 by approximately \$0.1 million as a result of higher dividend income.

**Gain on sale of business**

During the three months ended March 31, 2006, the Company recognized a \$52.8 million net gain from the January 1, 2006 lockline merger with Asurion.

**Equity in earnings (losses) of unconsolidated affiliates**

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

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
BFDS	\$ 7.9	\$ 6.6
IFDS - U.K.	3.5	1.2
IFDS - Canada	2.4	0.2
Argus	1.2	1.0
Asurion	11.4	7.8
Other	(1.6 )	(0.7 )
	<b>\$ 24.8</b>	<b>\$ 16.1</b>

DST equity in earnings of BFDS for the three months ended March 31, 2007, increased \$1.3 million due to increased mutual fund shareowner servicing revenues from an increase in shareowner accounts processed and improvements in operations.

DST's equity in IFDS U.K. earnings for the three months ended March 31, 2007 increased \$2.3 million compared to the same period in 2006, primarily from increased revenues and improvements in operations. Accounts serviced by IFDS U.K. were 5.8 million at March 31, 2007, an increase of 0.2 million or 3.6% from December 31, 2006 and an increase of 0.5 million or 9.4% from March 31, 2006.

DST's equity in IFDS Canada earnings for the three months ended March 31, 2007 increased \$2.2 million compared to the same period in 2006, primarily from improvements in operations and a \$1.2 million deferred income tax benefit. Accounts serviced by IFDS Canada were 7.3 million at March 31, 2007, an increase of 0.2 million or 2.8% from December 31, 2006 and an increase of 0.5 million or 7.4% from March 31, 2006.

DST's equity in Argus earnings for the three months ended March 31, 2007 increased \$0.2 million compared to the same period in 2006, from higher levels of pharmacy claims processed, principally Medicare Part D claims, partially offset by an increase in personnel costs and data processing support costs charged by DST.

DST's equity in Asurion earnings for the three months ended March 31, 2007 increased \$3.6 million compared to the same period in 2006, from higher revenues, primarily from higher subscribers to Asurion's handset insurance programs and operational cost improvements, partially offset by increased interest expense for the debt incurred in third quarter 2006 to finance a distribution to shareholders.

#### **Income taxes**

In general, the Company records income tax expense during interim periods based on its best estimate of the full year's effective tax rate. Certain items, however, are given discrete period treatment and, as a result, the tax effects of such items are reported in full in the relevant interim period. The Company's effective tax rate was 33.9% for the three months ended March 31, 2007 compared to 38.7% for the same period in 2006. The lower effective tax rate for 2007 is due to the absence of the gain relating to the lockline merger with Asurion which attracted a higher effective tax rate and due to a reduction in the interest accruals relating to unrecognized tax benefits resulting from the adoption of FIN 48. Excluding the effects of discrete period items, the Company estimates its recurring tax rate for the remainder of 2007 to be 33.4%. The full year 2007 effective tax rate can be affected as a result of variances among the estimates and amounts of full year sources of taxable income (e.g. domestic consolidated, joint venture and/or international), the realization of tax credits (e.g. historic rehabilitation, research and experimentation and state incentive), adjustments which may arise from the resolution of tax matters under review and the Company's assessment of its liability for unrecognized tax benefits.

#### **Business Segment Comparisons**

##### **FINANCIAL SERVICES SEGMENT**

#### **Revenues**

Financial Services Segment total revenues for the three months ended March 31, 2007 were \$291.8 million, an increase of \$32.1 million or 12.4% as compared to the same period in 2006. Financial Services Segment operating revenues for the three months ended March 31, 2007 were \$275.5 million, an increase of \$32.1 million or 13.2% as compared to the same period in 2006, primarily from the inclusion of ASI revenues and higher license fees for international investment management and AWD software, higher mutual fund and AWD revenues.

U.S. operating revenues for the three months ended March 31, 2007 were \$236.0 million, an increase of \$23.3 million or 10.9% as compared to the same period in 2006, primarily from the inclusion of ASI revenues and higher mutual fund and AWD revenues. International operating revenues for the three months ended March 31, 2007 were \$39.5 million, an increase of \$8.8 million as compared to the same period in 2006, primarily attributable to higher license fees for investment management and AWD software.

U.S. mutual fund open shareowner accounts processed totaled 108.2 million at March 31, 2007, a net increase of 2.4 million or 2.3% from the 105.8 million serviced at December 31, 2006, and an increase of 4.7 million or 4.5% from the 103.5 million accounts serviced at March 31, 2006. Tax-advantaged retirement and educational savings accounts serviced (which include 529 and Coverdell savings plan accounts) totaled 41.4 million at March 31, 2007, a net increase of 0.9 million accounts or 2.2% since December 31, 2006 and an increase of 1.4 million or 3.5% from the 40.0 million accounts at March 31, 2006. In addition, previously announced new mutual fund client commitments of approximately 7.6 million accounts, based on current account levels, are expected to convert in the second and third quarters of 2007.

Financial Services Segment software license fee revenues are derived principally from DST International (investment management systems), AWD (workflow management and CRM solutions) and DST Health Solutions (medical claims processing systems). Operating revenues include approximately \$16.7 million of software license fee revenues for

the three months ended March 31, 2007, an increase of \$5.0 million compared to the same period in 2006, due primarily to higher international investment management and AWD license fee revenues. While license revenues are not a significant percentage of DST's total operations, they can significantly impact earnings in the period in which they are recognized. Revenues and operating results from individual license sales depend heavily on the timing, size and nature of the contract.

#### **Costs and expenses**

Financial Services Segment costs and expenses (including OOP costs) during the three months ended March 31, 2007 increased \$31.7 million or 17.8% compared to first quarter 2006, primarily due to the inclusion of ASI, increased personnel costs to support business growth and ASI merger integration costs of approximately \$2.8 million.

#### **Depreciation and amortization**

Financial Services Segment depreciation and amortization costs decreased \$0.9 million or 4.7% in first quarter 2007 as compared to the first quarter 2006. The net decrease was attributable to lower depreciation of computer equipment and the absence of amortization of DST Health Solutions, Inc. intangible assets resulting from the adoption of FIN 48, which is partially offset by the inclusion of amortization of ASI intangible assets. The reduced amortization will continue in the future as no identified intangibles remain from the April 2005 acquisition of DST Health Solutions.

#### **Income from operations**

Financial Services Segment income from operations for the three months ended March 31, 2007 increased \$1.3 million or 2.0% from the prior year quarter to \$63.8 million, attributable to higher license fee revenues and the elimination of amortization of DST Health Solutions, Inc. intangibles from the adoption of FIN 48.

### **OUTPUT SOLUTIONS SEGMENT**

#### **Revenues**

Output Solutions Segment total revenues for the three months ended March 31, 2007 were \$292.0 million, a decrease of \$21.2 million or 6.8% as compared to the same period in 2006. Output Solutions Segment operating revenues for the three months ended March 31, 2007 were \$149.2 million, an increase of \$13.4 million or 9.9% as compared to the same period in 2006, principally from higher U.S. processing volumes, a contract termination fee of \$3.1 million and revenues from new international clients.

Output Solutions Segment images produced for the three months ended March 31, 2007 were 4.3 billion, an increase of 22.2% compared to the same period in 2006. Items mailed during the three months ended March 31, 2007 were 694.2 million, an increase of 11.7% as compared to the same period in 2006. Revenues per image and package have declined principally as a result of higher relative volume increases from customers with lower unit pricing.

#### **Costs and expenses**

Output Solutions Segment costs and expenses (including OOP costs) decreased \$31.3 million or 10.4% from first quarter 2006 attributable to lower OOP costs associated with a reduction in OOP reimbursement revenues of approximately \$34.6 million resulting from certain clients purchasing postage directly, offset by higher material and equipment costs associated with increased volumes.

#### **Depreciation and amortization**

Output Solutions Segment depreciation and amortization during the three months ended March 31, 2007, increased \$2.0 million or 28.1% compared to the same period in 2006 attributable to depreciation on new proprietary printing and inserting equipment.



**Income from operations**

Output Solutions Segment income from operations for the three months ended March 31, 2007 was \$12.3 million, an increase of \$8.1 million compared to the same period in 2006. Contributing to the increase were higher U.S. volumes and revenues from new international clients, a \$3.1 million contract termination fee and cost efficiencies realized from the implementation of new proprietary printing and inserting technologies. As previously announced, a client completed its internalization of its print / mail operations as a result of a merger with a company with in-house capabilities at the end of the first quarter of 2006. The loss of this client will adversely affect revenues and operating income for the remainder of 2007. Operating revenues from this client were approximately \$20.3 million for the year ended December 31, 2006.

**INVESTMENTS AND OTHER SEGMENT**

**Revenues**

Investments and Other Segment operating revenues, primarily rental income from facilities leased to the Company's operating segments, were \$15.8 million for the three months ended March 31, 2007, an increase of \$0.4 million or 2.6%, as compared to the same period in 2006 due to higher rental activities.

**Costs and expenses**

Investments and Other Segment costs and expenses increased \$0.1 million during the three months ended March 31, 2007 as compared to the same period in 2006. Increased costs and expenses associated with increased revenues during 2007 were partially offset by the sale of a property in 2007 that resulted in a gain of approximately \$0.3 million, which was included as a net reduction in costs and expenses, and operational cost improvements.

**Depreciation and amortization**

Investments and Other Segment depreciation and amortization decreased \$0.5 million during the three months ended March 31, 2007 as compared to the same period in 2006 due to the sale of a property during the fourth quarter of 2006 and the sale of another property during the middle of first quarter of 2007.

**Income from operations**

Investments and Other Segment income from operations totaled \$3.5 million for the three months ended March 31, 2007, an increase of \$0.8 million or 29.6% compared to the same period in 2006 attributable to a \$0.3 million gain from the sale of a property, higher rental income and operational cost improvements.

**Segment Operating Data**

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

	March 31, 2007	December 31, 2006
<b>Financial Services Operating Data</b>		
Mutual fund shareowner accounts processed (millions)		
U.S.		
Non-retirement accounts	66.8	65.3
IRA mutual fund accounts	23.7	23.3
Other retirement accounts	6.1	4.2
TRAC mutual fund accounts	4.4	6.1
Section 529 and Educational IRA's	7.2	6.9
	108.2	105.8
International		
United Kingdom (1)	5.8	5.6
Canada (2)	7.3	7.1
TRAC participants (millions)	4.6	4.5
Automated Work Distributor workstations (thousands)	124.0	120.8
DST Health Solutions covered lives (millions)	25.7	25.3
Asurion supported consumers (millions)	61.1	58.8
	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Output Solutions Operating Data</b>		
Images produced (millions)	4,273	3,497
Items mailed (millions)	694	621
<b>Other Operating Data</b>		
Pharmacy claims processed by Argus (millions)	146.8	119.4

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

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

## LIQUIDITY AND CAPITAL RESOURCES

### Sources and Uses of Cash

The Company's primary source of liquidity has historically been cash provided by operations. During the year ended December 31, 2006, the Company realized significant cash flows from investing activities related to the sale of investments and dividends from unconsolidated affiliates. Principal uses of cash are operations, reinvestment in the Company's proprietary technologies, capital expenditures, stock repurchases, and payments on debt. Information on the Company's consolidated cash flows for the three months ended March 31, 2007 and 2006 is presented in the condensed consolidated statement of cash flows, categorized by operating activities, investing activities, and financing activities.

### Operating Activities

The Company's cash flow from operating activities totaled \$59.1 million and \$126.6 million for the three months ended March 31, 2007 and 2006, respectively. The decrease in operating cash flows during 2007 is attributable to a \$25.1 million dividend from an unconsolidated affiliate received in 2006, lower accounts receivable collections and higher payments on accounts payable and accrued liabilities. Operating cash flows during 2007 resulted principally from net income of \$65.4 million and non-cash items included in the determination of net income, including depreciation and amortization expense of \$29.9 million and equity in earnings of unconsolidated affiliates of \$24.8 million. Significant working capital related adjustments to net income include decreases in accounts receivable of \$7.6 million, accounts payable and accrued liabilities of \$36.3 million and decreases in accrued compensation and benefits of \$5.9 million. The Company had \$85.9 million of cash and cash equivalents at March 31, 2007, an increase of \$25.3 million from December 31, 2006.

### *Cash Management Service*

The Company has a cash management service for full service mutual fund transfer agency clients, whereby end of day available client bank balances are invested overnight by and in the name of the Company into credit-quality money market funds. All invested balances are returned to the full service mutual fund transfer agency client accounts the following business day. The Company had \$72.1 million and \$125.6 million of mutual fund transfer agency client investments and deposits at March 31, 2007 and December 31, 2006, respectively.

### Investing Activities

Cash flows used in investing activities totaled \$6.7 million during the three months ended March 31, 2007, as compared to cash flows provided by investing activities in the amount of \$26.6 million during the three months ended March 31, 2006. The decrease in cash provided by investing activities during 2007 was attributable to lower cash proceeds from the sale of investments during 2007 and higher investment purchases, partially offset by the repayment of loans by unconsolidated affiliates.

### *Capital Expenditures*

The Company continues to make significant investments in capital equipment, software, systems and facilities.

During the three months ended March 31, 2007, the Company expended \$19.0 million on capital expenditures. Of this total, approximately \$1.0 million related to the Investments and Other Segment, which consists primarily of acquisitions of buildings and building improvements. The Output Solutions Segment expenditures were approximately \$5.5 million primarily for new printing and inserting technologies that will be used to support new and existing business. Future capital expenditures are expected to be funded primarily by cash flows from operating activities, secured term notes or draws from bank lines of credit, as required.

### *Investments*

The Company made \$46.1 million of investments in available-for-sale securities during the three months ended March 31, 2007, and received payments from unconsolidated affiliates of approximately \$36.7 million. During the



three months ended March 31, 2007, the Company received \$16.5 million from the sale of investments in available-for-sale and other securities.

### **Financing Activities**

Cash flows used in financing activities totaled \$27.1 million and \$134.1 million for the three months ended March 31, 2007 and 2006, respectively.

#### *Common Stock Issuances and Repurchases*

The Company received proceeds of \$28.0 million and \$21.7 million from the issuance of common stock upon the exercise of employee stock options during the three months ended March 31, 2007 and 2006, respectively.

The Company repurchased approximately 1,136,900 shares of DST common stock for \$81.6 million or approximately \$71.77 per share during the three months ended March 31, 2007. Cash flows from operations and borrowings on debt facilities were used to repurchase these shares.

On August 1, 2006, DST's Board of Directors authorized the repurchase of an additional 6.0 million shares under the existing share repurchase authorization plan. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through July 31, 2008. The Company may enter into one or more plans with its brokers or banks for pre-authorized purchases within defined limits pursuant to Rule 10b5-1 to affect all or a portion of such share repurchases. At March 31, 2007, the Company had approximately 2.8 million shares remaining to be purchased under this plan. On May 8, 2007, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization.

Payments made for tax withholding obligations arising from the exercise of options to purchase the Company's stock are included in common stock repurchased in the Consolidated Statement of Cash Flows. The amount of such share withholdings for option exercises was \$12.4 million and \$8.5 million during the three months ended March 31, 2007 and 2006, respectively.

#### *Debt Activity*

The Company has used the following primary sources of debt financing: the syndicated line of credit facility; convertible debentures; subsidiary line of credit facilities; secured promissory notes; and loans from unconsolidated affiliates. The Company has also utilized bridge loans as necessary to augment the above sources of debt financing. The net increase in the Company's line of credit facilities was \$41.3 million during the three months ended March 31, 2007. The Company had \$1,486.4 million and \$1,441.2 million of debt outstanding at March 31, 2007 and December 31, 2006, respectively.

#### *Senior Convertible Debentures*

Holders of the Company's \$840 million senior convertible debentures were eligible to convert these bonds during the three months ended March 31, 2007 as a result of DST's common stock trading above 120% of the applicable conversion price (\$49.08) for at least 20 trading days during the period of 30 consecutive trading days ended December 31, 2006. Actual conversions through March 31, 2007 have been less than \$0.1 million and cash was used to settle the principal portion of these conversions. The senior debentures continue to be convertible through June 30, 2007 as the stock price conversion feature was still in effect at March 31, 2007. Conversion rights, and ultimate classification as a current or non-current liability, for subsequent quarters will be a function of future DST stock prices.

#### *Equipment Promissory Note*

During the three months ended March 31, 2007, DST purchased \$11.3 million of computer equipment with a promissory note. The note matures on April 1, 2010 and is secured by the equipment. Interest accrues at a fixed rate of approximately 4.9% per year.

*BFDS Promissory Note*

As previously announced, the Company entered into a promissory note with Boston Financial Data Services, Inc. ( BFDS ). The agreement provides for unsecured revolving borrowings by the Company of up to \$50 million and matures on July 1, 2010. In March 2007, an amendment to the existing promissory note between the Company and BFDS was executed. The amendment increased the unsecured revolving borrowings limit from \$50 million to \$100 million. The amount outstanding under this loan agreement was \$60.0 million at March 31, 2007. For the three months ended March 31, 2007, the Company recorded interest expense related to this loan of \$0.7 million.

*Overall Liquidity*

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

*Guarantees*

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

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

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

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

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

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

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

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

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

At March 31, 2007 and December 31, 2006, the Company had not accrued any liability on the aforementioned guarantees or indemnifications as they relate to future performance criteria or indirect indebtedness of others in accordance with FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.

### **Significant Transactions**

#### *Asurion Corporation Transaction*

DST acquired an approximate 37.4% ownership interest in Asurion Corporation on January 1, 2006 when it merged its DST lockline, Inc. subsidiary into a wholly-owned subsidiary of Asurion. In April 2007, the Board of Directors of Asurion approved a transaction whereby certain private equity firms will own a significant stake in Asurion. Based on the terms of the transaction, DST estimates that its subsidiary's interest in Asurion will be converted into a 6% continuing ownership interest and after-tax cash proceeds of approximately \$600 million.

Asurion's transaction is subject to regulatory approval and satisfaction of standard pre-closing conditions. Upon closing, which is expected to occur in either the second or third quarter of 2007, DST will no longer account for its investment in Asurion under the equity method of accounting, but rather will account for its continuing ownership interest under the cost basis of accounting. Excluding the gain to be recognized on this transaction, on a pro-forma basis, the transaction is not expected to have a material impact on DST's net income or earnings per share for 2007; however, it is expected to significantly impact DST's equity in earnings of unconsolidated affiliates.

### **OTHER**

**Comprehensive income (loss).** The Company's comprehensive income totaled \$84.0 million for the three months ended March 31, 2007, compared to comprehensive income of \$141.7 million for the three months ended March 31, 2006. Comprehensive income includes net income of \$65.4 million for the three months ended March 31, 2007, compared to \$81.7 million for the three months ended March 31, 2006, and other comprehensive income of \$17.7 million for the three months ended March 31, 2007, compared to other comprehensive income of \$60.0 million for the three months ended March 31, 2006. Other comprehensive income consists of unrealized gains and losses on



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

**Other than temporary impairments.** At March 31, 2007, the Company's available-for-sale securities had unrealized holding losses of \$1.8 million. If it is determined that a reduction in a security's net realizable value is other than temporary, a realized loss will be recognized in the statement of operations and the cost basis of the security reduced to its estimated fair value. The Company does not believe that the unrealized losses at March 31, 2007 are other than temporary.

The Company recognized investment impairments of \$0.5 million for the three months ended March 31, 2007 which the Company believed were other than temporary. No impairments were recorded during the three months ended March 31, 2006. The impairments related to investments held by the Investments and Other Segment. A decline in a security's net realizable value that is other than temporary is treated as a loss based on quoted market value and is reflected in the Other income, net line in the statement of income.

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

#### **New Accounting Standards**

##### *Accounting for Uncertainty in Income Taxes*

On January 1, 2007, DST adopted FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements. FIN 48 indicates that the impact from adoption should be reflected as a cumulative effect adjustment from a change in accounting principle to the beginning retained earnings amount reported for that fiscal year, unless the amount relates to a previous business combination, in which case the impact would be recorded as an adjustment to the purchase price allocation for the previous business combination. The adjustment to the purchase price allocation would first reduce remaining goodwill and identified intangibles related to the business combination and the residual would be reflected as a cumulative effect adjustment to beginning retained earnings. DST's adoption of this standard resulted in approximately \$87.5 million of previously recorded liabilities for uncertain tax positions being released, of which \$68.2 million (net of deferred taxes) resulted in a reduction in previously recorded intangible assets (including capitalized software) and goodwill relating to the Company's April 2005 acquisition of DST Health Solutions, Inc., and the remainder of \$19.3 million was recorded as an increase in stockholders' equity as a cumulative effect adjustment in retained earnings. Prior to the adoption of FIN 48, the Company classified all income tax uncertainties as current liabilities. Upon adoption of FIN 48, the Company reclassified income tax uncertainties that are estimated to take more than 12 months to resolve as non-current.

##### *Fair Value Measurements*

In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. The Company will be required to adopt this standard in the first quarter of 2008. Management is currently evaluating the requirements of SFAS 157 and has not yet determined the impact on the consolidated financial statements.



In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (SFAS 159)*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. The Company will be required to adopt this standard in the first quarter of 2008. Management is currently evaluating the requirements of SFAS 159 and has not yet determined the impact on the consolidated financial statements.

#### *Earnings Per Share*

The FASB previously issued an exposure draft on a proposed accounting standard that would amend SFAS No. 128, *Earnings per Share (SFAS 128)*, to clarify guidance for mandatorily convertible instruments, the treasury stock method, contingently issuable shares, and contracts that may be settled in cash or shares.

The proposed amendment, which is designed for convergence with international accounting standards, would require the use of the *if-converted* method from the date of issuance of the convertible debentures. The proposed amendment would remove the ability of a company to support the presumption that the convertible securities will be satisfied in cash and not converted into shares of common stock. Accordingly, the Company's stated intention to settle conversions of its convertible debentures with cash for the principal and accrued and unpaid interest and issue common stock for any conversion value amount over the principal and accrued and unpaid interest amounts would no longer be accepted under SFAS 128, if amended as proposed. The final statement has yet to be issued. Retrospective application would be required for all changes to SFAS 128, except that retrospective application would be prohibited for contracts that were either settled in cash prior to adoption or modified prior to adoption to require cash settlement. For DST, adoption of this statement, as proposed, will require retroactive restatement of the Company's diluted earnings per share calculations subsequent to the issuance of the convertible debentures. In calculating diluted earnings per share under the revised SFAS 128 *if-converted* method included in the exposure draft, the Company would need to increase net income for the interest expense associated with the convertible debentures, net of tax, and increase the incremental shares assumed to be issued upon conversion by 17.1 million shares (less shares already included in diluted earnings per share), the amount of shares that would be issued if all \$840 million of convertible debentures would be converted to equity. Under this *if-converted* method, diluted earnings per share would have been \$0.84 and \$1.08 (versus reported diluted earnings per share of \$0.90 and \$1.11) for the three months ended March 31, 2007 and 2006, respectively. The above pro-forma information presents only the effect on diluted earnings per share of the *if-converted* method included in the exposure draft, but does not include any other computational changes (i.e., treasury stock method considerations) discussed in the exposure draft. DST is continuing to monitor the FASB's progress towards finalizing this proposed accounting standard.

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

The estimated impact of this new accounting standard reflects the Company's current estimates based upon the exposure draft in its current form. There may be material differences between these estimates and the actual impact of the standard when issued as final.

#### *EITF Issue No. 07-2*

EITF Issue No. 07-2, *Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion* was discussed at the March 15, 2007 meeting of the Emerging Issues Task Force. The issue is how a company should account for a convertible instrument that requires or permits partial cash settlement upon conversion if the embedded conversion option is not required to be separately accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. At the March 2007 meeting, the Task Force requested that the FASB staff form a working group to discuss (a) the scope of this Issue, (b) diluted earnings per share considerations, and (c) other potential short-term improvements to the accounting for convertible instruments. This Issue will be discussed further at a future meeting. DST is continuing to monitor the EITF's progress on this issue.

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

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

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

The Company's investments in available-for-sale equity securities are subject to price risk. The fair value of the Company's available-for-sale investments as of March 31, 2007 was approximately \$1.3 billion. The impact of a 10% change in fair value of these investments would be approximately \$82.0 million to comprehensive income. As discussed under Comprehensive income (loss) above, net unrealized gains on the Company's investments in available-for-sale securities have had a material effect on the Company's comprehensive income and financial position.

**Interest rate risk**

The Company and certain of its joint ventures derive a certain amount of their service revenues from investment earnings related to cash balances maintained in transfer agency customer bank accounts that the Company is agent for. The balances maintained in the bank accounts are subject to fluctuation. At March 31, 2007, the Company and its joint ventures had approximately \$2.0 billion of cash balances maintained in such accounts, of which \$1.9 billion was maintained at the joint ventures. The Company estimates that a 50 basis point change in interest earnings rate would increase or decrease net income by approximately \$2.2 million.

At March 31, 2007, the Company had approximately \$1.5 billion of debt, of which \$574.9 million was subject to variable interest rates (Federal Funds rates, LIBOR rates, prime rates). At March 31, 2007, the Company's proportional share of an unconsolidated affiliate's interest rate swap was a gain of \$8.1 million. The Company estimates that a 10% increase in interest rates would not be material to the Company's consolidated pretax earnings or to the fair value of its debt.

**Foreign currency exchange rate risk**

The operation of the Company's subsidiaries in international markets results in exposure to movements in currency exchange rates. The principal currencies involved are the British pound, Canadian dollar, Australian dollar, Thai baht and Indian rupee. Currency exchange rate fluctuations have not historically materially affected the consolidated financial results of the Company. At March 31, 2007, the Company's international subsidiaries had approximately \$193.0 million in total assets, and for the three months ended March 31, 2007, these international subsidiaries produced approximately \$3.9 million in net income. The Company estimates that a 10% change in exchange rates could change total consolidated assets by approximately \$19.3 million. Furthermore, a 10% change in exchange rates based upon historical earnings in international operations could change consolidated net income by approximately \$0.4 million.

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

**Item 4. Controls and Procedures**

As of the end of the fiscal quarter for which this quarterly report on Form 10-Q is filed, the Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures as of March 31, 2007 were effective. There has been no change in



the Company's internal control over financial reporting that occurred during the fiscal quarter for which this quarterly report on Form 10-Q is filed that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 4T. Controls and Procedures**

Not applicable.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There are many risks and uncertainties that can affect our future business, financial performance or share price. Many of these are beyond our control. Here is a brief description of some of the important factors that could have a material negative impact on our future business, operating results, financial condition or share price. This discussion includes a number of forward-looking statements. You should refer to the description of the qualifications and limitations on forward-looking statements in the first paragraph under Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q. Unless otherwise indicated or the context otherwise requires, reference in this section to we, ours, us or similar terms means the Company, together with its subsidiaries. The level of importance of each of the following trends and risks may vary from time to time, and the trends and risks are not listed in any specific order of importance. These risks, however, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Trends or events affecting our clients or their industries could decrease the demand for our products and services.**

We derive our consolidated revenues from the delivery of products and services to clients in the mutual fund, investment management, healthcare, telecommunications and utilities, video/broadband/satellite TV, other financial service (i.e. brokerage, insurance, banking, financial planning and mortgage) and other industries. A decline or lack of growth in demand for our products and services in the any of the industries we serve could adversely affect our business and earnings. Demand for our products and services among companies in those industries could decline for many reasons. Consolidation or limited growth in an industry could reduce the number of our clients and potential clients. Events that adversely affect our clients' businesses, rates of growth or numbers of customers they serve, including decreased demand for our customers products and services, adverse conditions in our customers' markets or adverse economic conditions generally, could decrease demand for our products and services and the number of transactions we process. We cannot always predict the needs of changing industries or whether potential customers will accept our products or services. Concentrating our resources based on trends or events that do not occur as we expected could negatively impact any of our various businesses.

**The demand for our products and services could decrease if we do not continually address our and our clients' technology and capacity requirements.**

Our clients use computer technology-based products and services in the complex and rapidly changing markets in which they operate. We must substantially invest in technology and systems to meet customer demand for transaction processing and volume capacities. If we do not meet clients' technology and capacity demands in advance of our

competitors or if the investments we make are not cost-effective or do not result in successful products or services, our businesses could be adversely affected.

**Damage to our facilities or declining real estate values could impact our operations or financial condition.**

We own, lease and manage real estate as part of our business. The performance of our services also depends upon facilities that house central computer operations or operating centers or in which we process information, images, bills or statements. Declining property values in the markets in which we own investment properties may adversely affect our financial condition. Significant damage to any of our operating facilities could interrupt the operations at those facilities and interfere with our ability to serve customers.

**We may be unable to attract and retain capable technical personnel for our processing businesses or quality executives to manage the complex structure of our business.**

Our success depends on recruiting and retaining adept management and personnel with expertise in software and systems development and the types of computer hardware and software we utilize. Losing key personnel or not hiring qualified personnel could have a material adverse effect on our operations. Companies in our industry compete fiercely for qualified management and technical personnel. We cannot guarantee that we will be able to adequately compete for or keep qualified personnel. Lack of qualified management could increase the risk of unfavorable business strategies, especially in a complex business like ours with multiple segments and operating entities. Lack of qualified technical personnel could also affect our ability to develop the systems and services our clients demand.

**Our businesses are subject to substantial competition.**

We are subject to intense competition from other established service providers in all industries we serve. Competitors may offer more appealing pricing structures. Some of our clients have developed or are developing the in-house capacity to perform the transaction processing, recordkeeping, and output services they have paid us to perform. Some of our competitors and clients have greater financial and human resources and access to capital than we do. Our mutual fund transfer agency competition includes brokerage firms that perform sub-accounting services for customers who purchase or sell shares of our clients' mutual funds. A brokerage firm typically maintains an omnibus account with us that represents the aggregate number of shares of a mutual fund owned by the brokerage firm's customers. The omnibus account structure results in fewer mutual fund shareowner accounts on our systems, which adversely affects our revenues. Our failure to successfully compete in any of our operating segments could have a material adverse effect on our financial results. Competition could also affect the revenue mix of services we provide, resulting in decreased revenues in lines of business with higher profit margins.

**We and companies in which we own a significant interest are subject to government regulation. Any regulatory violations could adversely affect our business.**

A number of our businesses are subject to U.S. or foreign regulatory oversight, as well as recordkeeping and reporting obligations. Any violation of those obligations or related laws or regulations could expose us or those businesses to costly fines or sanctions or damage our reputation, which could adversely affect our business or financial performance.

**Our clients are subject to government regulation which could affect our business.**

Our clients are subject to extensive government regulation, including investment adviser, broker/dealer and financial and healthcare privacy regulations. Any violation by our clients of applicable laws and regulations could diminish their business or financial condition and thus their demand for our products and services. Demand could also decrease if we do not continue to offer products and services that help our clients comply with regulations.

**We operate internationally and are thus exposed to foreign political, economic and other conditions that could adversely affect our revenues from or support by foreign operations.**

Consolidated revenues from our subsidiaries in Canada, Europe and elsewhere outside the U.S. are an important element of our revenues. Inherent risks in our international business activities could decrease our international sales and have a material adverse effect on our overall financial condition, results of operations and cash flow. These risks include potentially unfavorable foreign economic conditions, political conditions or national priorities, foreign government regulation, potential expropriation of assets by foreign governments, the failure to bridge cultural differences, and limited or prohibited access to our foreign operations and the support they provide. We may also have difficulty repatriating profits or be adversely affected by exchange rate fluctuations in our international business.

**Various events may cause our financial results to fluctuate from quarter to quarter or year to year. The nature of these events might inhibit our ability to anticipate and act in advance to counter them.**

We cannot always control when and whether events occur that could cause varying financial results. Unfavorable results may occur that we did not anticipate or take advance action to address. The various reasons our quarterly and annual results may fluctuate include unanticipated economic conditions and costs for starting up significant client operations, for hiring staff, and for developing products. Our results may also vary as a result of pricing pressures, increased cost of supplies, timing of license fees, the evolving and unpredictable markets in which our products and services are sold, changes in accounting principles, and competitors' new products or services.

**Our revenues and profit margins could decrease if clients cancel contracts, fail to renew contracts, renegotiate contracts or use our services at less than anticipated rates.**

Client contract terminations, non-renewals, renegotiations or under-utilization of our services could decrease our revenues and profit margins. We derive revenue by selling products and services under long-term contracts. We cannot unilaterally extend the terms of these contracts when they expire. Some of these contracts contain termination for convenience clauses, which enable clients to cancel the agreements by providing written notice to us. Any failure to extend these contracts under their current terms, or any early termination of these contracts by customers, could adversely affect our business.

**Claims against us, including claims for the lost market value of securities and class action claims, could cause significant liability and damage our reputation and business prospects.**

We may be subject to damage claims, including class-action claims, for delays in transaction processing; for calculation errors, errors resulting in disclosure of confidential information, or other processing or operational errors; or for mismanagement of claims or other processes. Because of the sensitive nature of the financial and healthcare transactions we process, our liability and alleged damages may significantly exceed the fees we receive for performing the service at issue. Litigation can include class action claims based, among other theories, upon various regulatory requirements and consumer protection and privacy laws that class action plaintiffs may attempt to use to assert private rights of action. Any of these claims and related settlements or judgments could affect our profitability, damage our reputation, decrease demand for our services, or cause us to make costly operating changes.

**We are substantially dependent on our intellectual property rights, and a claim for infringement or a requirement to indemnify a client for infringement could adversely affect us.**

We have made substantial investments in software and other intellectual property on which our business is highly dependent. Any loss of our intellectual property rights, or any significant claim of infringement or indemnity for violation of the intellectual property rights of others, could have a material adverse effect on our financial condition, results of operations and cash flow. We rely on patent, trade secret and copyright laws, nondisclosure agreements, and other contractual and internal security measures to protect our proprietary technology. We cannot guarantee these measures will be effective. Our products and services rely on technology developed by others, including open source software, and we have no control over possible infringement of someone else's intellectual property rights by the provider of this technology. The owner of the rights could seek damages from us rather than or in addition to the persons who provide the technology to us. We could be subject at any time to intellectual property infringement claims that are costly to evaluate and defend. Our clients may also face infringement claims, allege that such claims relate to our products and services, and seek indemnification from us.

**Failure to protect the confidential information of our clients could hurt our business.**

We often maintain trade secrets and proprietary information, including sensitive financial and personal health information of our clients customers, electronically. A material breach of our security systems and procedures could lead to significant claims for liability, cause our customers to reconsider using our services and products, damage our reputation, or otherwise have a material adverse effect on us. We maintain systems and procedures to protect against unauthorized access to electronic information and computer viruses, but we cannot guarantee these systems and procedures will always protect us. Rapid advances in technology may prevent us from anticipating all potential security threats, and the limits of technology and skills or the prohibitive cost of more advanced security solutions might prevent us from addressing these threats.

**We do not control certain businesses in which we have significant ownership.**

We invest in joint ventures and other unconsolidated affiliates as part of our business strategy, and part of our net income is derived from our pro rata share of the earnings of those businesses. Despite owning significant equity interests in those companies and having directors on their boards, we do not control their operations, strategies or financial decisions. The other owners may have economic, business or legal interests or goals that are inconsistent with our goals or the goals of the businesses we co-own. Our pro rata share of any losses due to unfavorable performance of those companies could impact our financial statements.

**We own interests in companies under agreements that may inhibit our ability to sell our interests and the other owners may ask us to increase our investment.**

We own interests in Boston Financial Data Services, International Financial Data Services Limited Partnership, International Financial Data Services Limited, and Argus Health Systems, Inc. Our interests in these companies are subject to buy/sell arrangements which may restrict our ability to sell our interests when we believe it is prudent to do so. These arrangements may also require that we purchase the other owners interests to prevent someone else from acquiring them. The businesses or other owners may encourage us to increase our investment in or make contributions to the businesses at an inopportune time.

**The financial results of our reinsurance subsidiary could be adversely affected if actual loss experience exceeds estimated loss experience.**

Our subsidiary, Vermont Western Assurance, Inc., which we refer to as Vermont Western, reinsures a portion of the risk in connection with replacing lost stock certificates for registered shareholders of unrelated companies. Vermont Western utilizes underwriting procedures and actuarial advisors to assess risk and establish reserves against loss. Vermont Western does not control clients' loss experience. Vermont Western could inaccurately assess risk at any time and actual loss experience could exceed estimates. Vermont Western's results, if unfavorable, could have a material adverse effect on our financial condition, operating results or cash flow.

**We hold equity investments in companies that operate in various industries, and the value of those investments could decrease.**

We hold significant investments in available-for-sale equity securities of other companies that are subject to fluctuations in market prices. A significant decline in the value of our equity investments could have a material adverse effect on our financial condition or results of operations. We may not always be able to resell those investments at higher prices than we paid for them or than the value of the consideration used to acquire them.

**Various plans, agreements, laws and organizational documents may make more difficult or prevent a change in control.**

Provisions in our Certificate of Incorporation, Bylaws, certain plans and agreements, and applicable laws could make it more difficult for a party to make a tender offer for our shares or complete a takeover which is not approved by our Board of Directors. The provisions include:

- super-majority stockholder approval required for certain actions
- staggered terms for directors
- specific procedures for stockholders to nominate new directors
- cumulative voting in election of directors
- the Board's authority to issue and set the terms of preferred stock
- a stockholders' rights plan giving stockholders rights to purchase preferred stock if certain changes in our ownership occur
- various rights of debenture holders, joint venture co-owners, lenders and certain customers and executives in the event of a change in control
- public reporting of ownership and of changes in ownership by stockholders with at least a 5% interest in us
- legal restrictions on business combinations with certain stockholders

**Because of contractual commitments, a change in control could affect our operating results and weaken our management retention and incentive tools.**

A change in control of the Company would trigger various rights and obligations in service agreements with our customers, in agreements governing our joint ventures, and in incentive award and employment agreements with our management. A change in control could also allow some clients to terminate their agreements with us or to obtain rights to use our processing software. We are parties to joint venture agreements that allow other co-owners to buy our equity interests if we undergo a change in control. A change in control or a termination of employment without cause or their resignation for good reason (each as defined in applicable agreements) after a change in control could accelerate certain restricted stock and other awards we have granted to our management employees. This award vesting may decrease an employee's incentive to continue employment with us. Certain executive officers have agreements with us that require us to continue to employ them for three years after a change in control or to pay certain amounts if we terminate their employment without cause or they resign for good reason following a change in control. The executives might not be incented to achieve results for the new owners of our business, and the cost of keeping the executives on the payroll might deter potential new owners from acquiring us or hinder new owners from hiring replacement management.

**Our equity incentive and stockholders' rights plans could have a dilutive effect on our common stock.**

Our directors, officers and certain managers have received restricted stock and options to purchase our common stock as part of their compensation. These equity grants could have a dilutive effect on our common stock. A change of control would trigger the right of stockholders under our stockholders' rights plan to purchase 1/1000th shares of our preferred stock for each share of our common stock, which could be dilutive in value to common stockholders who do not exercise those rights.

**Conversion of our debentures could have a dilutive effect on our common stock or affect our liquidity.**

In August 2003, we issued \$840 million aggregate principal amount of convertible senior debentures. Issuing common stock to settle conversions could be dilutive to the price of our common stock, and settlement of conversions for cash could affect our financial condition, operating results and cash flow. The debentures are convertible into shares of common stock under specified circumstances, which we refer to as Conversion Triggers. We cannot accurately predict



when certain Conversion Triggers outside of our control may occur. To satisfy a conversion notice subsequent to a Conversion Trigger, we must deliver our common stock unless we properly notify the holder that we will settle with cash or a combination of cash and shares of common stock. How we settle a conversion notice will depend on liquidity, financial needs, or other circumstances existing at the time of a Conversion Trigger.

**We own a minority interest in Asurion, and risks in Asurion's business could affect our financial results.**

We own approximately 35% in Asurion Corporation, which provides services related to communications devices and/or the communications industry. Asurion's business depends on timely and cost-effectively developing and adapting services to meet client demands for the latest communications technology. It also depends on Asurion's relationships with insurance companies that provide coverage for the products and services of Asurion's clients and on Asurion's assessment of risk and loss experience. Asurion must comply with various insurance regulations. Failure to satisfy client demands, termination of business relationships with insurance companies, inaccurate assessment of risk prior to assuming loss, or sanctions for regulatory violations could adversely affect Asurion's business and the value of our investment in Asurion.

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

**Stock repurchases**

The following table sets forth information with respect to shares of Company common stock purchased by the Company during the three months ended March 31, 2007.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
January 1 - January 31	205,673(1)	66.96	86,900	3,899,200(2)
February 1 - February 28	526,355(1)	72.07	475,000	3,424,200(2)
March 1 - March 31	583,279(1)	72.50	575,000	2,849,200(2)

(1) For the three months ended March 31, 2007, the Company purchased, in accordance with the 2005 Equity Incentive Plan (formerly the 1995 Stock Option and Performance Award Plan), 178,407 shares of its common stock for participant income tax withholding in conjunction with stock option exercises, as requested by the participants. These purchases were not made under the publicly announced repurchase plans or programs, but were allowed by the rules of the Compensation Committee of the DST Board of Directors. Of these shares, 118,773 shares were purchased in January 2007, 51,355 shares were purchased in February 2007 and 8,279 shares were purchased in March 2007.

(2) On August 1, 2006, DST's Board of Directors authorized the repurchase of an additional 6.0 million shares under the existing share repurchase authorization plan. The plan allows, but does not require, the repurchase of common stock in open market and private transactions through July 31, 2008. The Company may enter into one or more plans with its brokers or banks for pre-authorized purchases within defined limits pursuant to Rule 10b5-1 to effect all or a portion of such share repurchases. At March 31, 2007, the Company had approximately 2.8 million shares remaining to be purchased under this plan. On May 8, 2007, DST's Board of Directors authorized the repurchase of an additional 5.0 million shares under the existing share repurchase authorization.

**Item 3. Defaults Upon Senior Securities**

None.

40

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

None.

**Item 5. Other Information**

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

On May 8, 2007, DST's Board of Directors authorized an additional 5.0 million shares under the existing share repurchase authorization plan. This plan allows, but does not require, the repurchase of common stock in open market and private transactions through July 31, 2008. When combined with the shares remaining under the existing share repurchase authorization plan at March 31, 2007, there are approximately 7.8 million shares authorized for repurchase from May 8, 2007 through July 31, 2008. The Company may enter into one or more plans with its brokers or banks for pre-authorized purchases within defined limits pursuant to Rule 10b5-1 to effect all or a portion of such share repurchases.

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

None.

**Item 6. Exhibits**

**(a) Exhibits:**

31.1 Certification of Chief Executive Officer of Registrant

31.2 Certification of Chief Financial Officer of Registrant

32 Certification Pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer of Registrant and Chief Financial Officer of Registrant

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, and in the capacities indicated, on May 10, 2007.

DST Systems, Inc.

/s/ Kenneth V. Hager

Kenneth V. Hager  
Vice President, Chief Financial Officer and Treasurer  
(Principal Financial Officer)

41

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