WADDELL & REED FINANCIAL INC
Form 10-Q
April 25, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from to

Commission file number 001-13913

WADDELL & REED FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**51-0261715**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6300 Lamar Avenue

Overland Park, Kansas 66202

(Address, including zip code, of Registrant s principal executive offices)

(913) 236-2000

(Registrant s telephone number, including area code)

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 ý No o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ý Accelerated Filer o Non-accelerated Filer o

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

Shares outstanding of each of the registrant s classes of common stock as of the latest practicable date:

Class	**Outstanding as of April 21, 2006**
Class A common stock, $.01 par value	84,745,219

Waddell & Reed Financial, Inc.

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Quarter Ended March 31, 2006

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Part I. Financial Information

Item I. Financial Statements

WADDELL & REED FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(in thousands)

		March 31, 2006 (unaudited)	December 31, 2005
Assets			
Assets:			
Cash and cash equivalents	$	186,940	162,775
Investment securities		50,342	51,701
Receivables:			
Funds and separate accounts		31,353	33,405
Customers and other		44,048	43,261
Deferred income taxes		911	1,978
Prepaid expenses and other current assets		8,425	6,602
Total current assets		322,019	299,722
Property and equipment, net		51,475	52,963
Deferred sales commissions, net		17,309	15,899
Goodwill		195,309	195,309
Intangible assets		54,999	54,999
Other assets		14,660	13,379
Total assets	$	655,771	632,271
Liabilities and Stockholders Equity			
Liabilities:			
Accounts payable	$	66,338	60,930
Accrued sales force compensation		18,410	18,412
Accrued other compensation		11,862	14,536
Short-term notes payable			1,746
Income taxes payable		18,246	11,975
Other current liabilities		46,517	49,185
Total current liabilities		161,373	156,784
Long-term debt		199,933	198,230
Accrued pensions and post-retirement costs		10,187	8,303
Deferred income taxes		13,480	15,707
Other		5,726	5,873
Total liabilities		390,699	384,897

Commitments and contingencies (Note 9)			
Stockholders equity :			
Common stock - $0.01 par value: 250,000 shares authorized; 99,701 shares issued; 83,811 shares outstanding (83,804 at December 31, 2005)		997	997
Additional paid-in capital		200,608	195,315
Retained earnings		405,056	393,043
Cost of 15,890 common shares in treasury (15,897 at December 31, 2005)		(342,990)	(343,100)
Accumulated other comprehensive income		1,401	1,119
Total stockholders equity		265,072	247,374
Total liabilities and stockholders equity	$	655,771	632,271

See accompanying notes to unaudited consolidated financial statements.

WADDELL & REED FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

(Unaudited, in thousands, except for per share data)

		For the three months ended March 31, 2006	2005
Revenues:			
Investment management fees	$	74,049	63,582
Underwriting and distribution fees		77,012	67,345
Shareholder service fees		22,009	19,810
Total revenues		173,070	150,737
Operating expenses:			
Underwriting and distribution		84,754	74,289
Compensation and related costs (including share-based compensation of $6.0 million and $2.8 million, respectively)		29,446	22,609
General and administrative		10,246	10,234
Subadvisory fees		6,549	3,521
Depreciation		2,853	2,376
Total operating expenses		133,848	113,029
Operating income		39,222	37,708
Investment and other income		2,264	1,364
Interest expense		(3,254)	(3,254)
Income before provision for income taxes		38,232	35,818
Provision for income taxes		13,961	13,068
Net income before cumulative effect of change in accounting principle		24,271	22,750
Cumulative effect of change in accounting principle, net of tax		321	
Net income	$	24,592	22,750
Earnings per share before cumulative effect of change in accounting principle:			
- Basic	$	0.30	0.28
- Diluted	$	0.29	0.28
Earnings per share:			
- Basic	$	0.30	0.28
- Diluted	$	0.30	0.28
Weighted average shares outstanding:			
- Basic		81,204	80,920
- Diluted		82,943	82,106
Dividends declared per common share	$	0.1500	0.1500

See accompanying notes to unaudited consolidated financial statements.

WADDELL & REED FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited, in thousands)

	For the three months ended March 31, 2006	2005
Net income	$ 24,592	22,750
Other comprehensive income:		
Available-for sale investments:		
Net unrealized appreciation (depreciation) of investments during the period, net of income taxes of $445 and $(119)	758	(204)
Derivatives:		
Net unrealized loss on derivatives, net of income taxes of $(174) and $0	(297)	
Reclassification adjustment for amounts included in net income, net of income taxes of $(107) and $(381)	(179)	(648)
Comprehensive income	$ 24,874	21,898

See accompanying notes to unaudited consolidated financial statements.

WADDELL & REED FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders Equity

For the Three Months Ended March 31, 2006

(Unaudited, in thousands)

	Common stock Shares	Common stock Amount	Additional paid-in capital	Retained earnings	Treasury stock	Accumulated other comprehensive income	Total stockholders equity
Balance at December 31, 2005	99,701	$ 997	$ 195,315	$ 393,043	$ (343,100)	$ 1,119	$ 247,374
Net income				24,592			24,592
Share-based compensation			5,439	8			5,447
Issuance of restricted shares			(276)		276		
Dividends accrued				(12,587)			(12,587)
Exercise of stock options			(467)		1,266		799
Tax benefit from equity awards			597				597
Other stock transactions					(1,432)		(1,432)
Change in fair value of derivatives						(297)	(297)
Reclassification for amounts included in net income						(179)	(179)
Unrealized gain on investment securities						758	758
Balance at March 31, 2006	99,701	$ 997	$ 200,608	$ 405,056	$ (342,990)	$ 1,401	$ 265,072

See accompanying notes to unaudited consolidated financial statements.

WADDELL & REED FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	For the three months ended March 31, 2006	2005
Cash flows from operating activities:		
Net income	$ 24,592	22,750
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,962	2,758
Share-based compensation	5,447	2,790
Gain on sale of available-for-sale investments	(1,039)	(1,029)
Net purchases and sales of trading securities	(566)	28
Loss (gain) on trading securities	(279)	159
Write down of investment securities	750	
Loss on sale and retirement of property and equipment	62	42
Capital gains and dividends reinvested	(46)	(32)
Deferred income taxes	(1,325)	(89)
Changes in assets and liabilities:		
Receivables from funds and separate accounts	2,052	(3,235)
Other receivables	(797)	3,925
Other assets	(3,314)	(1,693)
Accounts payable	5,408	(11,484)
Other liabilities	1,060	6,080
Net cash provided by operating activities	$ 34,967	20,970
Cash flows from investing activities:		
Purchases of available-for-sale investment securities	(200)	
Proceeds from sales of available-for-sale investment securities	3,524	7,819
Proceeds from maturity of available-for-sale investment securities	50	599
Additions to property and equipment	(1,427)	(1,979)
Cash paid for acquisitions		(15)
Net cash provided by investing activities	$ 1,947	6,424
Cash flows from financing activities:		
Proceeds from long term debt and interest rate swap termination	199,863	
Repayment of long term debt	(200,000)	
Net short-term borrowings (repayments)		(11,000)
Cash dividends	(12,576)	(12,424)
Purchase of treasury stock		(5,213)
Exercise of stock options	799	838
Excess tax benefits from share-based payment arrangements	597	
Other stock transactions	(1,432)	(938)
Net cash used in financing activities	$ (12,749)	(28,737)
Net increase in cash and cash equivalents	24,165	(1,343)
Cash and cash equivalents at beginning of period	162,775	83,900

Cash and cash equivalents at end of period	$	186,940	82,557

See accompanying notes to unaudited consolidated financial statements.

WADDELL & REED FINANCIAL, INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. The Company and Significant Accounting Policies

Waddell & Reed Financial, Inc. and Subsidiaries

Waddell & Reed Financial, Inc. and subsidiaries (hereinafter referred to as the Company, we, our and us) derive revenues primarily from investment management, investment product underwriting and distribution, and shareholder services administration provided to the Waddell & Reed Advisors Group of Mutual Funds (the Advisors Funds), W&R Target Funds, Inc. (the Target Funds), Ivy Funds, Inc. and the Ivy Funds portfolios (collectively, the Ivy Funds), and Waddell & Reed InvestEd Portfolios, Inc. (InvestEd) (collectively, the Funds), and institutional and separately managed accounts. The Funds and the institutional and separately managed accounts operate under various rules and regulations set forth by the United States Securities and Exchange Commission (the SEC). Services to the Funds are provided under investment management agreements that set forth the fees to be charged for these services. The majority of these agreements are subject to annual review and approval by each Fund s board of directors/trustees and shareholders. Our revenues are largely dependent on the total value and composition of assets under management, which include mainly domestic equity securities, but also debt securities and international equities. Accordingly, fluctuations in financial markets and composition of assets under management impact revenues and results of operations.

Basis of Presentation

We have prepared the accompanying unaudited consolidated financial statements included herein pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations, although we believe that the disclosures are adequate to enable a reasonable understanding of the information presented. The information in this Quarterly Report on Form 10-Q should be read in conjunction with Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations and our audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005. Certain amounts in the prior years financial statements have been reclassified for consistent presentation.

The accompanying unaudited consolidated financial statements have been prepared consistently with the accounting policies described in Note 2 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005, which include the following: use of estimates, cash and cash equivalents, disclosures about fair value of financial instruments, investment securities and investments in affiliated mutual funds, property and equipment, software developed for internal use, goodwill and intangible assets, deferred sales commissions, revenue recognition, advertising and promotion, stock-based compensation, income taxes, and derivatives and hedging activities.

In our opinion, the accompanying unaudited consolidated financial statements reflect all adjustments (consisting of only a normal and recurring nature) necessary to present fairly our financial position at March 31, 2006 and December 31, 2005 and the results of operations and cash flows for the three months ended March 31, 2006 and 2005, in conformity with accounting principles generally accepted in the United States.

Change in Method of Recognition of Rule 12b-1 Service Fee Revenues and Expenses

The Company collects Rule 12b-1 service and distribution fees pursuant to sales and servicing plan agreements (compensatory and/or reimbursement) with the mutual funds, predominantly the Advisors Funds

Class A reimbursement plan. Effective as of the second quarter of 2005, the Company changed its method of reporting Rule 12b-1 service fee revenue to the gross basis of presentation. Previously, the Company used the net basis of presentation, whereby such service fee revenue was recorded as an offset against related underwriting and distribution expenses and presented as a reduction of expenses in Underwriting and distribution expenses. Rule 12b-1 revenues and associated distribution expenses are now reported on a gross basis as Underwriting and distribution fees and Underwriting and distribution expenses in the Consolidated Statements of Operations. The revised presentation of operations for the first quarter of 2005, as presented herein, had no effect on gross margin dollars, net income, cash flows, working capital or stockholders equity amounts previously reported, and will not affect such amounts in future periods.

2. Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and short-term investments. We consider all highly liquid investments with original or remaining maturities of 90 days or less at the date of purchase to be cash equivalents. Cash and cash equivalents at March 31, 2006 and December 31, 2005 include amounts of $38.7 million and $26.1 million, respectively, for the benefit of customers segregated in compliance with federal and other regulations. Substantially all cash balances are in excess of federal deposit insurance limits.

3. Indebtedness

On January 13, 2006, the Company issued $200 million in principal amount 5.6% senior notes due in 2011 (the New Notes) resulting in net proceeds of approximately $198.2 million (net of discounts, commissions and estimated expenses). The Company used the net proceeds, together with cash on hand, to repay the entire $200 million aggregate principal amount outstanding of its 7.5% senior notes due January 18, 2006 (the 7.5% Notes). In 2002, the 7.5% Notes were effectively converted to variable rate debt by entering into an interest rate swap agreement. We accounted for the interest rate swap as a fair value hedge of the 7.5% Notes. The swap was considered 100% effective in hedging the changes in the fair value of the 7.5% Notes arising from changes in interest rates, and accordingly, there was no impact on earnings resulting from any ineffectiveness associated with the transaction throughout its term.

The New Notes represent senior unsecured obligations and are rated Baa2 by Moody s and BBB by Standard & Poor s. Interest is payable semi-annually on January 15 and July 15 at a rate of 5.6% per annum. The Company may, at its option, call the New Notes at any time pursuant to a make whole redemption provision, which would compensate holders for any changes in interest rate levels of the notes upon early extinguishment. The Company currently has no intention to call the New Notes.

During 2005, the Company entered into two forward starting interest rate swap agreements with five year fixed swap rates of 4.57% and 4.84%, respectively, on notional amounts of $100 million for each swap. The swaps were put in place to hedge against changes in forecasted interest payments on the 7.5% Notes attributable to changes in the LIBOR swap rate prior to the time we anticipated refinancing the 7.5% Notes in January 2006. We assessed the effectiveness of the swaps as hedges at their inception and in subsequent periods, and considered these swaps to be completely effective cash flow hedges under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.* As of December 31, 2005, net unrealized gains attributed to the forward swap cash flow hedges were approximately $1.6 million and were included as a component of other comprehensive income.

On January 10, 2006, the Company terminated the two 2005 forward interest rate swap agreements upon the closing of the New Notes. In connection with the termination of the swap agreements, the Company received a net cash settlement of $1.1 million. Such amount has been recorded in accumulated other comprehensive income and will be amortized into earnings as a reduction to interest expense over the five year term of the New Notes.

4. Investments

Investments are as follows:

	Market Value March 31, 2006	Market Value December 31, 2005
	(in thousands)	
Available-for-sale securities:		
United States government-backed mortgage securities	$ 12	$ 214
Municipal bonds	11,776	12,134
Corporate bonds		719
Affiliated mutual funds	28,164	29,927
	$ 39,952	$ 42,994
Trading securities:		
United States government-backed mortgage securities	146	
Corporate bonds	593	
Affiliated mutual funds	9,651	8,707
	$ 10,390	$ 8,707
Total investments	$ 50,342	$ 51,701

Certain information related to our available-for-sale securities is as follows:

	March 31, 2006	December 31, 2005
	(in thousands)	
Cost - available-for-sale securities	$ 30,637	$ 34,654
Gross unrealized gains	9,334	8,937
Gross unrealized losses	(19)	(597)
Market value - available-for-sale securities	$ 39,952	$ 42,994

Purchases and sales of trading securities for the three months ended March 31, 2006 were $700 thousand and $134 thousand, respectively.

In the first quarter of 2006, the Company recorded a $750 thousand write-down for other-than-temporary impairment of a municipal bond classified as available-for-sale.

5. Stockholders   Equity

Earnings per Share

The components of basic and diluted earnings per share were as follows:

	Three months ended March 31, 2006	2005
	(in thousands, except per share data)	
Net income, as reported	$ 24,592	22,750
Weighted average shares outstanding - basic	81,204	80,920
Dilutive potential shares from stock options and restricted stock awards, computed under the treasury stock method	1,739	1,186
Weighted average shares outstanding - diluted	82,943	82,106
Earnings per share before cumulative effect of change in accounting principle		
Basic	$ 0.30	$ 0.28
Diluted	$ 0.29	$ 0.28
Earnings per share		
Basic	$ 0.30	$ 0.28
Diluted	$ 0.30	$ 0.28

Anti-dilutive Securities

Anti-dilutive potential common shares resulting from options to purchase shares of common stock that were excluded from the diluted earnings per share calculation were 2.79 million shares and 2.83 million shares for the three months ended March 31, 2006 and March 31, 2005, respectively. Excluded from the diluted earnings per share calculation were 33,466 shares of anti-dilutive unvested restricted stock for the three months ended March 31, 2005.

Dividends

On February 22, 2006, the Board of Directors (the   Board) approved a dividend in the amount of $0.15 per share to stockholders of record as of April 7, 2006 to be paid on May 1, 2006. The total dividend to be paid is approximately $12.6 million.

Common Stock Repurchases

The Board has authorized the repurchase of our common stock in the open market and/or private purchases. The acquired shares may be used for corporate purposes, including shares issued to employees in our stock based compensation programs. There were no common shares repurchased on the open market for the three months ended March 31, 2006. For the three months ended March 31, 2005, there were 292,600 common shares repurchased on the open market.

6. Share-Based Compensation

At March 31, 2006, the Company had three stock-based compensation plans: the Company 1998 Stock Incentive Plan, as amended and restated (the SI Plan), the Company 1998 Executive Stock Award Plan, as amended and restated (the ESA Plan) and the Company 1998 Non-Employee Director Stock Award Plan, as amended and restated (the NED Plan) (collectively, the Stock Plans).

The SI Plan allows us to grant equity compensation awards, including, among other awards, non-qualified stock options and restricted stock as part of our overall compensation program to attract and retain key personnel and encourage a greater personal financial investment in the Company. A maximum of 30,000,000 shares of common stock are authorized for issuance under the SI Plan. The Stock Plans also allow us to grant non-qualified stock options and/or restricted stock to promote the long-term growth of the Company. A maximum of 3,750,000 and 1,200,000 shares of common stock are authorized for issuance under the ESA Plan and NED Plan, respectively. In addition, we make incentive payments under the Company 2003 Executive Incentive Plan, as amended and restated (the EIP) in the form of cash, stock options, restricted stock or a combination thereof. Incentive awards paid under the EIP in the form of stock options or restricted stock are issued out of shares reserved for issuance under the SI and ESA Plans. Generally, shares of common stock covered by terminated, surrendered or cancelled options, by forfeited restricted stock, or by the forfeiture of other awards that do not result in issuance of shares of common stock are again available for awards under the plan from which they were terminated, surrendered, cancelled or forfeited.

Under our Stock Plans, the exercise price of a stock option is equal to the market price of the stock on the date of grant. The maximum term of non-qualified options granted under the SI Plan is ten years and two days and the options generally vest in 33⅓% increments on the second, third and fourth anniversaries of the grant date. The maximum term of non-qualified options granted under the ESA Plan and NED Plan is 11 years and the options generally vest 10% each year, beginning on the first anniversary of the grant date. Our Stock Plans include a Stock Option Restoration Program (the SORP) feature that allows, on the first trading day of August, an employee to pay the exercise price on vested in-the-money options by surrendering common stock of the Company that has been owned for at least six months. This feature also permits an employee exercising an option to be granted new options in an amount equal to the number of common shares used to satisfy both the exercise price and withholding taxes due upon exercise. New options are granted with an expiration date equal to that of the original option and vest six months after the grant date. The SORP, which facilitates ownership of our common stock by management and key employees, results in a net issuance of shares of common stock and fewer stock options outstanding. We receive a current income tax benefit for stock option exercises.

Prior to January 1, 2006, the Company used the intrinsic value method as described in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) to measure employee stock-based compensation as permitted by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). Under this method, compensation expense was measured as the difference between the current value of the shares involved and the price the employee is required to pay on the grant date, if any. Compensation expense is generally measured on the date the awards are granted and recognized over the vesting period, which approximates the anticipated service period.

Restricted stock awards are valued on the date of grant, have no purchase price and, with the exception of those issued in the stock option tender in 2003, vest over four years in 33⅓% increments on the second, third and fourth anniversaries of the grant date. Under the Stock Plans, unvested shares of restricted stock may be forfeited upon the termination of employment with the Company or service on the Board, dependent upon the circumstances of termination. Except for restrictions placed on the transferability of restricted stock, holders of restricted stock have full stockholders rights during the term of restriction, including voting rights and the rights to receive cash dividends. Restricted shares issued in the

stock option tender offer were fully vested upon issuance, but remain subject to transfer restrictions that lapse in 33⅓% increments annually beginning March 14, 2005.

Had compensation cost for the Company s stock-based compensation plans been determined using the fair value method as described in SFAS 123, the Company s net income and earnings per share for the three months ended March 31, 2005 would have approximated the pro forma amounts indicated below:

		Three months ended March 31, 2005 (in thousands, except per share data)
Net income, as reported	$	22,750
Deduct:		
Total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects.		(188)
Pro forma net income	$	22,562
Basic earnings per share		
As reported	$	0.28
Pro forma	$	0.28
Diluted earnings per share		
As reported	$	0.28
Pro forma	$	0.27

The weighted-average fair value of each stock option included in the preceding pro forma amounts was estimated using a Black-Scholes option-pricing model and is amortized over the vesting period of the underlying options. The following assumptions were utilized:

	2005
Dividend yield	3.10%
Risk-free interest rate	4.03%
Expected volatility	27.10%
Expected life (in years) (1)	2.24

(1) Restoration options with vesting periods of six months were the only options granted during 2005.

A summary of stock option activity and related information for the three months ended March 31, 2006 follows:

	Options	Weighted average exercise price
Outstanding, December 31, 2005	7,115,837	$ 22.27
Granted		

Exercised	(58,685)		13.63
Terminated/Cancelled	(5,000)		31.93
Outstanding, March 31, 2006	7,052,152	$	22.33
Exercisable, March 31, 2006	7,052,152	$	22.33

Following is a summary of options outstanding at March 31, 2006:

	Outstanding Options				Exercisable Options	
Exercise Price Range	**Number**	**Weighted Average Remaining Contractual Life (in years)**		**Weighted Average Exercise Price**	**Number**	**Weighted Average Exercise Price**
$ 5.95 to $9.99	74,207	0.79	$	7.81	74,207	$ 7.81
$ 10.00 to $14.99	657,467	2.75		14.29	657,467	14.29
$ 15.00 to $19.99	3,515,917	2.96		17.19	3,515,917	17.19
$ 20.00 to $29.99	906,833	3.30		25.92	906,833	25.92
$ 30.00 to $34.19	1,897,728	3.09		33.50	1,897,728	33.50
	7,052,152	3.00	$	22.33	7,052,152	$ 22.33

No stock options have been granted in 2006. Option expense recorded in the first quarter 2006 related to 2005 SORP grants was $138 thousand and those grants are now fully amortized.

On April 25, 2005, the Compensation Committee of the Board approved the accelerated vesting of all then outstanding unvested options to purchase common stock of the Company previously awarded to employees, financial advisors, officers and directors. This resulted in the accelerated vesting of options to purchase 624,267 shares of common stock of the Company. Of these options, 447,497 were in-the-money options having an exercise price less than the then current market price of the Company s common stock and a weighted average exercise price of $13.90 per share. In order to prevent unintended personal benefits to directors and executive officers with such options, the Board imposed restrictions on any shares received through the exercise of accelerated options held by those individuals. These restrictions prevent the sale of any stock obtained through exercise of an accelerated option prior to its original vesting date, other than the disposition of stock as payment for the exercise price of options and associated income taxes, if any.

The Board approved the accelerated vesting of these options based on the belief that it was in the best interest of the stockholders to reduce future compensation expense that the Company would otherwise be required to report in its statement of operations upon adoption of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment, (revised 2004)* (SFAS 123R) in the first quarter of 2006. We anticipate that holders of in-the-money accelerated options will remain employed with the Company throughout the original vesting term of such options, and therefore, no expense will be recorded for these options unless option holders are able to exercise an option that would have expired unexercisable pursuant to its original terms.

Effective January 1, 2006, the Company adopted SFAS 123R. The revised standard eliminated the intrinsic value method of accounting required under APB 25. The Company adopted SFAS 123R using the modified prospective transition method of adoption, which does not require restatement of prior periods. Under that transition method, compensation expense recognized in 2006 for all share-based awards granted subsequent to December 31, 2005 is based on the grant date fair value of the stock grants less estimated forfeitures.

In its computation of stock-based compensation expense under APB 25, the Company recognized actual forfeitures when they occurred. Under SFAS 123R, the Company is required to estimate forfeitures at the grant date. The Company recognized a cumulative effect of change in accounting principle of $503 thousand ($321 thousand after-tax) on January 1, 2006, the adoption date, in order to adjust for expected forfeitures on all restricted stock grants made prior to December 31, 2005.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits of deductions resulting from the exercise of share-based awards as operating cash flows in the consolidated statement of cash flows. SFAS 123R requires the cash flows resulting from the tax benefits generated from tax deductions in excess of the compensation costs recognized for the share-based awards (excess tax benefits) be classified as financing cash flows. The excess tax benefit of $597 thousand recorded for the three months ended March 31, 2006, classified as a financing tax inflow, would have been classified as an operating cash flow prior to the Company s adoption of SFAS 123R.

The Board approved grants of restricted shares of the Company s Class A common stock in lieu of stock options beginning in 2002. As of March 31, 2006, a total of 2,492,883 shares of unvested restricted stock were outstanding. A summary of restricted share activity and related fair value for the three months ended March 31, 2006 follows:

	Shares	Fair Value
Nonvested at January 1, 2006	2,686,569	$ 21.71
Granted	35,617	21.19
Vested	(206,508)	19.18
Forfeited	(22,795)	21.52
Nonvested at March 31, 2006	2,492,883	$ 21.91

Consistent with the provisions of APB 25, the Company recorded the fair value of restricted stock grants and an offsetting deferred compensation amount within stockholders equity for unearned stock compensation cost. Under SFAS 123R guidance, the Company has reclassified its deferred compensation balance to additional paid-in capital on the consolidated balance sheet. As of March 31, 2006, there was $32.6 million of unamortized restricted stock compensation related to nonvested restricted stock grants awarded under the Company s Stock Plans. The remaining unamortized expense is expected to be recognized over a weighted average period of 1.47 years. For the three months ended March 31, 2006 and 2005, share-based compensation totaled $6.0 million (excluding the cumulative effect of change in accounting principle) and $2.8 million, respectively. The Company recognized related tax benefits of share-based awards of $597 thousand and $290 thousand for the three months ended March 31, 2006 and 2005, respectively.

For restricted stock awards granted prior to the adoption of SFAS 123R, the Company will continue to recognize compensation expense over the full vesting period. Had compensation expense for restricted stock awards issued prior to January 1, 2006 been determined based on the date a participant first becomes eligible for retirement, the Company s net income in the three month periods ended March 31, 2006 and 2005 would have decreased by $348,000 and $24,000 respectively.

On April 2, 2006, we granted 1,057,900 shares of restricted stock with a fair market value of $23.10 per share under the SI and ESA Plans. The value of those shares, aggregating $24.4 million, will be amortized to expense over the four year vesting period.

7. Goodwill and Identifiable Intangible Assets

Goodwill

Goodwill represents the excess of the purchase price over the tangible assets and identifiable intangible assets of an acquired business. At March 31, 2006 and December 31, 2005, gross goodwill was $233.9 million and accumulated amortization was $38.6 million. There were no changes to the carrying amount of goodwill during the three months ended March 31, 2006. Our goodwill is not deductible for tax purposes.

Identifiable Intangible Assets

Identifiable intangible assets (all considered indefinite lived) are summarized as follows:

	March 31, 2006	December 31, 2005
	(in thousands)	
Unamortized intangible assets:		
Mutual fund management advisory contracts.	$ 38,699	$ 38,699
Mutual fund subadvisory management contracts.	16,300	16,300
Total	$ 54,999	$ 54,999

8. Pension Plan and Postretirement Benefits Other Than Pension

We provide a non-contributory retirement plan that covers substantially all employees and certain vested employees of our former parent company (the Pension Plan). Benefits payable under the Pension Plan are based on employees years of service and compensation during the final ten years of employment. We also sponsor an unfunded defined benefit postretirement medical plan that covers substantially all employees, including Waddell & Reed and Legend advisors. The medical plan is contributory with retiree contributions adjusted annually. The following table presents the components of net periodic benefit cost related to these plans.

	Pension Benefits Three months ended March 31, 2006	2005	Other Postretirement Benefits Three months ended March 31, 2006	2005
	(in thousands)			
Components of net periodic benefit cost:				
Service cost	$ 1,485	1,365	75	105
Interest cost	1,216	1,170	52	77
Expected return on plan assets	(1,405)	(1,385)		
Actuarial loss (gain) amortization	254	304	(9)	22
Prior service costs amortization	109	109	5	6
Transition obligation amortization	1	1		
Total	$ 1,660	1,564	123	210

We anticipate that our contribution to the Pension Plan for 2006 will range from $0 to $7 million. During the three month period ended March 31, 2006, we did not make any contribution to the Pension Plan.

9. Contingencies

The Company is involved from time to time in various legal proceedings, regulatory investigations and claims incident to the normal conduct of business. Our pending legal and regulatory actions include proceedings that are specific to us and others generally applicable to business practices within the industries in which we operate. A substantial legal liability or a significant regulatory action against us could have an adverse effect on our business, financial condition and on the results of operations in a particular quarter or year.

SEC/New York Attorney General/Kansas Securities Commission

During the third and fourth quarters of 2003, the Company received a subpoena from the New York Attorney General s office and requests for information from the SEC and Kansas Securities Commission with regard to their investigations of market-timing within the mutual fund industry. We are currently engaged in settlement discussions with these regulators in an attempt to resolve these matters. We have submitted a signed offer of settlement to the SEC, which provides for material monetary payments by us, as well as specified compliance and oversight procedures. As of the date hereof, it is uncertain whether this offer will be accepted by the SEC. In the opinion of management, the ultimate resolution and outcome of this matter is uncertain. The ultimate resolution of this matter (including acceptance of our settlement offer), or an adverse determination against us could have a material adverse impact on our financial position and results of operations. However, this possible impact is unknown and not reasonably determinable; therefore, no liability has been recorded in the consolidated financial statements.

Williams Excessive Fee Litigation

On March 22, 2004, three individuals who purchased shares of certain registered investment companies (mutual funds) for which certain of the Company s subsidiaries provide services, as either investment manager or distributor/underwriter, filed a derivative Complaint in the United States District Court for the Western District of Missouri, Central Division on behalf of the mutual funds, alleging that the Company breached its fiduciary duties to the mutual funds by collecting excessive investment advisory fees and/or excessive Rule 12b-1 fees in violation of the Investment Company Act of 1940, as amended, (the ICA). This case is substantially similar, if not identical, to suits brought against other mutual fund complexes over the past few years. Plaintiffs seek declaratory and injunctive relief and monetary damages. Money damages at this time are speculative.

The Company denies that any of its subsidiaries breached their fiduciary duties to the mutual funds at issue and believes that all fees collected were proper based upon the nature of the services rendered and were approved by the mutual funds boards of directors in conformity with the requirements of the ICA.

The Company was successful on its Motion to Transfer Venue from where the case was initially filed to the United States District Court for the District of Kansas. Discovery is required to be completed by May 2006. Trial is currently set for October 2006.

In the opinion of management, the ultimate resolution and outcome of this matter is uncertain. At this stage of the litigation, the Company is unable to estimate the expense or exposure, if any, that it may represent. The ultimate resolution of this matter, or an adverse determination against the Company, could have a material adverse impact on the financial position and results of operations of the Company. However, this possible impact is unknown and not reasonably determinable; therefore, no liability has been recorded in the consolidated financial statements.

Waddell & Reed Financial, Inc. vs. Torchmark Corporation

Pursuant to the terms of the Separation Agreement and the Disaffiliation Agreement executed at the time of the Company s spin-off from Torchmark, the Company and Torchmark Corporation (Torchmark) agreed upon the parties respective obligations and entitlements with respect to Kansas state income tax liabilities and refunds for original and amended tax returns filed, and to be filed, for the period 1993 through 1997 and a stub period for 1998 when the Company was a direct affiliate/subsidiary of Torchmark. The referenced tax returns were all filed by Torchmark on a combined basis with the Company using complex unitary filing rules for the tax years in question. The State of Kansas held the returns under audit for an extended period of time and determined that it would contest the basis on which the returns had been filed. Torchmark disputed the determination of the state tax examiners and contested the matter under the rules of the Kansas Department of Revenue.

In April 2004, Torchmark entered into a Tax Settlement Agreement with the State of Kansas and finalized and closed the above referenced income tax returns. The tax returns were accepted, as filed, using the unitary filing status. Torchmark and its affiliates were determined to have no additional tax liabilities and received significant refunds of taxes that the Company had originally paid to the State of Kansas. Following the completion of the Kansas Tax Settlement, Torchmark made demand on the Company and subsequently filed suit in May 2004 in Alabama state court for $7.8 million, representing the amounts, plus interest, that Torchmark alleged the Company s stand alone liability to the State of Kansas would have been but for the use of Torchmark s losses in the previously filed tax returns.

In the fourth quarter of 2004, pursuant to the terms and conditions of the Disaffiliation Agreement, the Company obtained a stay of the Alabama suit pending resolution of an arbitration proceeding before the American Arbitration Association. In its Demand for Arbitration, the Company seeks a declaration from the arbitrators that it is not liable to Torchmark for the amounts claimed by Torchmark. In addition, the Company seeks an arbitration award in its favor with respect to refunds received by Torchmark from the State of Kansas pursuant to the Tax Settlement Agreement. It is anticipated that this arbitration will occur during the second quarter of 2006.

In the opinion of management, the ultimate resolution and outcome of this matter is uncertain. The ultimate resolution of the matter, or an adverse determination against the Company could have a material adverse impact on the financial position and results of operations of the Company.

NASD Enforcement Action

As previously disclosed, in June 2003, the Company received notification from the staff of the National Association of Securities Dealers (the NASD) indicating that the staff was considering recommending the NASD bring an action against the Company and certain of its current and former officers alleging possible violations of NASD rules and regulations relating to the exchange of certain United Investors Life Insurance Company variable annuity policies for Nationwide variable annuity policies from January 2001 through August 2002. These alleged violations included questioning the suitability of certain of these exchanges and the adequacy of the Company s supervisory systems in place at the time of these exchanges. On January 14, 2004, the NASD commenced an enforcement action against the Company, one of its current officers and one of its retired officers relating to variable annuity exchanges. In the complaint, the NASD charged the Company with suitability and supervisory violations, as well as a single books and records violation.

On April 29, 2005, the Company reached a settlement with the NASD regarding this matter. The settlement consisted of a fine payable to the NASD in the amount of $5 million and the establishment of an $11 million restitution fund for certain variable annuity clients. In agreeing to the terms of the settlement, the Company neither admitted nor denied the NASD s allegations. Clients eligible for restitution may elect to receive those funds either by check or by deposit directly into their existing variable annuity. As a condition to the settlement, the Company will not receive any commissions or mortality and expense fees from funds deposited directly into variable annuity accounts. Subsequently, in working with the independent distribution consultant in determining the disbursement of the $11 million restitution fund, it was determined that there were a number of additional variable annuity exchanges not covered by the original settlement with the NASD that also should have been eligible for restitution. In order to resolve this matter in its entirety and to remedy all variable annuity exchanges at issue in the NASD settlement, the Company has agreed to pay additional restitution in the amount of $3.5 million to bring the total restitution amount payable under the NASD settlement to $14.5 million. The $3.5 million restitution plus an additional $0.8 million in estimated legal fees, consulting fees and mortality exposure was recorded in the fourth quarter of 2005 as part of the revised settlement. This additional exposure was entirely offset by amounts to be received by the Company under an agreement reached with our insurance carrier to cover certain legal defense costs previously incurred in connection with this matter, which was also recorded in the fourth quarter of 2005. On March 31, 2006, restitution of approximately $10.9 million of the $14.5 million was paid by the Company to variable annuity clients. Of this $10.9 million, approximately $3.7 million was to be deposited back into the clients existing variable annuities. The remainder was remitted directly to the annuity holders. It is anticipated that the remainder of the restitution amount will be distributed to the remaining affected annuity clients on May 30, 2006. This final payment will resolve the matter. The Company will have an ongoing responsibility to monitor and identify all of the variable annuity clients who exchanged policies during the effected time period who had a decrease in minimum guaranteed death benefit, and to reimburse that client upon their death for the reduction in death benefit, if any, at that time.

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

Certain statements contained in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, hopes, beliefs, intentions or strategies regarding the future. All statements, other than statements of historical fact included in this Form 10-Q regarding our financial position, business strategy and other plans and objectives for future operations are forward-looking statements. All forward-looking statements included in this Form 10-Q are based on information available to us on the date hereof, and we assume no obligation to update such forward-looking statements, whether as a result of new information, future events or otherwise. Although we believe that the assumptions and expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to have been correct or that we will take any actions that may presently be planned and neither us nor any other person will be responsible for the accuracy or completeness of any such forward-looking statements. Certain important factors that could cause actual results to differ materially from our expectations are disclosed in the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2005, which include, without limitation, the adverse effect from a decline in securities markets or a decline in our products performance, regulatory settlements, reduction of investment management fees, failure to renew investment management agreements, adverse results of litigation and/or arbitration, acts of terrorism and/or war, competition, changes in government regulation, and availability and terms of capital. Should one or more of these risks materialize or should the underlying assumptions prove incorrect, actual results could differ materially from those forecasted or expected. All subsequent written or oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by such factors.

The information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in this Form 10-Q and the audited financial statements and notes thereto in our 2005 Annual Report on Form 10-K, as well as a more detailed explanation of risk factors at the end of this Item 2 under the heading entitled Forward Looking Information.

Overview

Our earnings and cash flows are heavily dependent on financial market conditions. Significant increases or decreases in the various securities markets, particularly United States equity markets, can have a material impact on our results of operations, financial condition and cash flows.
We derive our revenues primarily from providing investment management, distribution and administrative services to the Funds and institutional and separately managed accounts. Investment management fees, a substantial source of revenues, are based on the amount of average assets under management and are affected by sales levels, financial market conditions, redemptions and the composition of assets. Underwriting and distribution revenues, another substantial source of revenues, consist of commissions derived from sales of investment and insurance products, distribution fees on certain variable products, and fees earned on fee-based asset allocation products, as well as advisory services. The products sold have various commission structures and the revenues received from product sales vary based on the type and amount sold. Our products are distributed through either our sales force of registered financial advisors (the Advisors channel) or third-party distribution methods such as other broker-dealers and other registered investment advisors (including the retirement advisors of the Legend group of subsidiaries (Legend)) (the Wholesale channel). Our institutional efforts include defined benefit plans, pension plans, endowments, subadvisory relationships and high net worth clients (the Institutional channel). Rule 12b-1 service and distribution fees earned for servicing and/or distributing certain mutual fund shares are based upon a percentage of assets and fluctuate based on sales, redemptions and financial market conditions. Other service fees include transfer agency fees, custodian fees for retirement plan accounts and portfolio accounting.

Highlights for the current quarter include:

- Overall gross sales increased 51% to $2.2 billion compared to the first quarter of 2005.
- Total assets under management increased $3.0 billion compared to the first quarter of 2005.
- Shareholder accounts grew to 2.73 million at quarter-end.

Recent Accounting Developments

In December 2004, the Financial Accounting Standards Board issued SFAS 123R, which the Company adopted effective January 1, 2006. The revised standard eliminated the intrinsic value method of accounting required under APB 25 and requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The Company adopted SFAS 123R using the modified prospective transition method of adoption, which does not require restatement of prior periods. Under that transition method, compensation expense recognized in 2006, for all share-based payments granted subsequent to December 31, 2005, is based on the grant date fair value of the stock grants less estimated forfeitures.

Results of Operations Three Months Ended March 31, 2006 as Compared with Three Months Ended March 31, 2005

Net Income

Net income increased 8.1% in the first quarter of 2006 to $24.6 million, or $0.30 per diluted share, compared to $22.8 million, or $0.28 per diluted share for the same period in 2005. The increase in net income can be attributed primarily to an increase in average assets under management of 14%, offset by higher share-based compensation and employee separation costs during the period. In connection with the adoption of SFAS 123R in the first quarter 2006, we recognized a cumulative effect of change in accounting principle. In prior periods, we chose to record forfeitures of restricted stock when they occurred rather than estimate their impact on the date of grant. Upon implementation, we recognized expected forfeitures on awards granted prior to the adoption of SFAS 123R as an adjustment to compensation cost. The cumulative effect of this adjustment, net of tax, was income of $0.3 million.

Investment Management Fee Revenues

Investment management fee revenues were $74.0 million, an increase of $10.5 million, or 16%, from last year s first quarter. Total average assets under management for the current quarter were $43.8 billion compared to $38.4 billion for the first quarter of 2005, up 14%.

Revenues from investment management services provided to our retail mutual funds, which are distributed through both the Advisors and the Wholesale channels, increased $11.4 million, or 22%, while the related retail average assets increased 19% to $35.7 billion. Investment management fee revenues increased more than the related retail average asset increase due to significant sales growth in Ivy specialty funds, which tend to have higher management fee rates. Retail sales in the first quarter of 2006 were $2.0 billion, a 67% increase over sales in the first quarter of 2005. Institutional and separate account revenues decreased 9% while related average assets decreased 5% over last year s first quarter. Over half of the decrease was due to a reduction in management fee revenues earned by our subsidiary, Austin, Calvert & Flavin, Inc. (ACF) based on a decline in average assets of 14% compared to the first quarter of last year. The remaining decrease was primarily due to a management fee rate decrease on other institutional accounts.

The following tables provide information regarding the composition of our average assets under management by asset class and distribution channel.

	First Quarter 2006			
	Advisors	Wholesale	Institutional	Total
	(in millions)			
Asset Class:				
Equity	$ 23,566	7,168	7,422	$ 38,156
Fixed Income	3,880	343	611	4,834
Money Market	713	54		767
Total	$ 28,159	7,565	8,033	$ 43,757

	First Quarter 2005			
	Advisors	Wholesale	Institutional	Total
	(in millions)			
Asset Class:				
Equity	$ 20,355	4,480	7,837	$ 32,672
Fixed Income	3,992	324	638	4,954
Money Market	694	53		747
Total	$ 25,041	4,857	8,475	$ 38,373

Change in Assets Under Management

The following tables summarize the changes in our assets under management by distribution channel. All sales are net of commissions. The activity includes all Funds and institutional business, including money market funds and net asset value accounts for which we receive no commissions.

	First Quarter 2006			
	Advisors	Wholesale	Institutional	Total
	(in millions)			
Beginning Assets	$ 27,188	6,729	7,946	$ 41,863
Sales (net of commissions)	843	1,151	172	2,166
Redemptions	(849)	(348)	(450)	(1,647)
Net Sales	(6)	803	(278)	519
Net Exchanges	(64)	60		(4)
Reinvested Dividends & Capital Gains	48	10	29	87
Net Flows	(22)	873	(249)	602