

AFFILIATED COMPUTER SERVICES INC

Form 10-Q

January 23, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D. C. 20549  
FORM 10-Q**

(Mark One)

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

For the quarterly period ended **September 30, 2006**

**OR**

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

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

**Commission file number 001-12665  
AFFILIATED COMPUTER SERVICES, INC.  
(Exact name of registrant as specified in its charter)**

Delaware

51-0310342

(State or other jurisdiction of incorporation or organization)

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

2828 North Haskell, Dallas, Texas

75204

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code (214) 841-6111

**Not Applicable**

(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. (Check one):

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

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

| <b>Title of each class</b>            | <b>Number of shares outstanding as of<br/>January 12, 2007</b> |
|---------------------------------------|--|
| Class A Common Stock, \$.01 par value | 92,314,491   |
| Class B Common Stock, \$.01 par value | 6,599,372  |



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**PART I**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**  
**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
**(in thousands)**

|  | <b>September<br/>30,<br/>2006</b> | <b>June 30,<br/>2006</b> |
|--|-----------------------------------|--------------------------|
| <b>ASSETS</b>                              |                                   |                          |
| Current assets:                            |                                   |                          |
| Cash and cash equivalents                  | \$ 142,240                        | \$ 100,837               |
| Accounts receivable, net                   | 1,242,662                         | 1,231,846                |
| Income taxes receivable                    |                                   | 8,090                    |
| Prepaid expenses and other current assets  | 198,159                           | 188,490                  |
| Total current assets                       | 1,583,061                         | 1,529,263                |
| Property, equipment and software, net      | 921,436                           | 870,020                  |
| Goodwill                                   | 2,477,060                         | 2,456,654                |
| Other intangibles, net                     | 487,031                           | 475,701                  |
| Other assets                               | 181,596                           | 170,799                  |
| Total assets                               | \$ 5,650,184                      | \$ 5,502,437             |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |                                   |                          |
| Current liabilities:                       |                                   |                          |
| Accounts payable                           | \$ 90,716                         | \$ 104,473               |
| Accrued compensation and benefits          | 142,536                           | 172,853                  |
| Other accrued liabilities                  | 395,678                           | 354,632                  |
| Income taxes payable                       | 14,947                            |                          |
| Deferred taxes                             | 15,690                            | 18,047                   |
| Current portion of long-term debt          | 35,207                            | 23,074                   |
| Current portion of unearned revenue        | 162,609                           | 152,026                  |
| Total current liabilities                  | 857,383                           | 825,105                  |
| Senior Notes, net of unamortized discount  | 499,388                           | 499,368                  |
| Other long-term debt                       | 1,856,625                         | 1,114,664                |
| Deferred taxes                             | 349,156                           | 331,433                  |
| Other long-term liabilities                | 281,082                           | 275,649                  |
| Total liabilities                          | 3,843,634                         | 3,046,219                |

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Commitments and contingencies (See Notes 2, 7, 13 and 16)

Stockholders' equity:

|   |              |              |
|---|--------------|--------------|
| Class A common stock, \$.01 par value, 500,000 shares authorized, 113,316 and 129,848 shares issued, respectively | 1,133        | 1,299        |
| Class B convertible common stock, \$.01 par value, 14,000 shares authorized, 6,600 shares issued and outstanding  | 66           | 66           |
| Additional paid-in capital  | 1,598,385    | 1,799,778    |
| Accumulated other comprehensive loss, net   | (7,473)      | (10,943)     |
| Retained earnings   | 1,270,407    | 1,836,850    |
| Treasury stock at cost, 21,002 and 23,289 shares, respectively  | (1,055,968)  | (1,170,832)  |
| Total stockholders' equity  | 1,806,550    | 2,456,218    |
| Total liabilities and stockholders' equity  | \$ 5,650,184 | \$ 5,502,437 |

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

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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

**(UNAUDITED)**

**(in thousands, except per share amounts)**

|                                 | <b>Three Months Ended</b> |                      |
|---------------------------------|---------------------------|----------------------|
|                                 | <b>September 30,</b>      |                      |
|                                 | <b>2005</b>               |                      |
|                                 | <b>2006</b>               | <b>(as restated)</b> |
| Revenues                        | \$ 1,385,438              | \$ 1,310,917         |
| Operating expenses:             |                           |                      |
| Cost of revenues:               |                           |                      |
| Wages and benefits              | 666,616                   | 628,685              |
| Services and supplies           | 291,362                   | 290,772              |
| Rent, lease and maintenance     | 179,056                   | 155,172              |
| Depreciation and amortization   | 81,638                    | 68,080               |
| Other                           | 10,614                    | 4,247                |
| Total cost of revenues          | 1,229,286                 | 1,146,956            |
| Other operating expenses        | 15,294                    | 9,764                |
| Total operating expenses        | 1,244,580                 | 1,156,720            |
| Operating income                | 140,858                   | 154,197              |
| Interest expense                | 46,013                    | 12,739               |
| Other non-operating income, net | (2,618)                   | (4,381)              |
| Pretax profit                   | 97,463                    | 145,839              |
| Income tax expense              | 36,080                    | 52,464               |
| Net income                      | \$ 61,383                 | \$ 93,375            |
| Earnings per share:             |                           |                      |
| Basic                           | \$ 0.59                   | \$ 0.74              |
| Diluted                         | \$ 0.59                   | \$ 0.73              |

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Shares used in computing earnings per share:

|         |         |         |
|---------|---------|---------|
| Basic   | 103,452 | 125,429 |
| Diluted | 104,761 | 127,286 |

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

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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**  
**(in thousands)**

|   | <b>Three Months Ended</b> |                      |
|---|---------------------------|----------------------|
|   | <b>September 30,</b>      |                      |
|   | <b>2005</b>               |                      |
|   | <b>2006</b>               | <b>(as restated)</b> |
| Cash flows from operating activities:   |                           |                      |
| Net income  | \$ 61,383                 | \$ 93,375            |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |                      |
| Depreciation and amortization   | 81,638                    | 68,080               |
| Stock-based compensation expense  | 7,744                     | 9,307                |
| Excess tax benefit on stock-based compensation                                    | (31)                      | (5,478)              |
| Provision for uncollectible accounts receivable                                   | (52)                      | 3,250                |
| Deferred income tax expense   | 5,838                     | 15,750               |
| Impairment charges  | 1,231                     |                      |
| Other non-cash activities   | 3,807                     | 1,746                |
| Changes in assets and liabilities, net of effects from acquisitions:              |                           |                      |
| Accounts receivable   | (7,202)                   | (73,805)             |
| Prepaid expenses and other current assets   | (9,442)                   | (8,767)              |
| Other assets  | (2,324)                   | (9,328)              |
| Accounts payable  | (13,762)                  | 9,038                |
| Accrued compensation and benefits   | (33,288)                  | (18,643)             |
| Other accrued liabilities   | 35,607                    | (20,319)             |
| Income taxes payable  | 26,142                    | 32,577               |
| Other long-term liabilities   | (438)                     | (384)                |
| Unearned revenue  | 16,331                    | 12,931               |
| Total adjustments   | 111,799                   | 15,955               |
| Net cash provided by operating activities   | 173,182                   | 109,330              |
| Cash flows from investing activities:   |                           |                      |
| Purchases of property, equipment and software, net                                | (101,498)                 | (94,777)             |
| Additions to other intangible assets  | (9,089)                   | (6,906)              |
| Payments for acquisitions, net of cash acquired                                   | (33,988)                  | (42,644)             |
| Intangible assets acquired in subcontract termination                             |                           | (16,530)             |
| Purchases of investments  | (6,360)                   | (4,515)              |
| Net cash used in investing activities   | (150,935)                 | (165,372)            |
| Cash flows from financing activities:   |                           |                      |
| Proceeds from issuance of long-term debt, net                                     | 1,356,956                 | 383,461              |

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|  |            |           |
|--|------------|-----------|
| Repayments of long-term debt                                   | (615,088)  | (377,708) |
| Purchase of treasury shares                                    | (730,689)  |           |
| Excess tax benefits from stock-based compensation arrangements | 31         | 5,478     |
| Proceeds from stock options exercised                          | 5,023      | 14,739    |
| Proceeds from issuance of treasury shares                      | 2,923      | 1,613     |
| Net cash provided by financing activities                      | 19,156     | 27,583    |
| Net change in cash and cash equivalents                        | 41,403     | (28,459)  |
| Cash and cash equivalents at beginning of period               | 100,837    | 62,685    |
| Cash and cash equivalents at end of period                     | \$ 142,240 | \$ 34,226 |

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

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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

**1. BASIS OF PRESENTATION**

We are a Fortune 500 and S&P 500 company with approximately 58,000 employees providing business process and information technology services to commercial and government clients. We were incorporated in Delaware on June 8, 1988 and are based in Dallas, Texas. Our clients have time-critical, transaction-intensive business and information processing needs, and we typically service these needs through long-term contracts. The consolidated financial statements are comprised of our accounts and our controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The financial information presented should be read in conjunction with our consolidated financial statements for the year ended June 30, 2006. The foregoing unaudited consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the results of the interim periods. The results for the interim periods are not necessarily indicative of results to be expected for the year.

We present cost of revenues in our Consolidated Statements of Income based on the nature of the costs incurred. Substantially all these costs are incurred in the provision of services to our customers. The selling, general and administrative costs included in cost of revenues are not material and are not separately presented in the Consolidated Statements of Income.

Significant accounting policies are detailed in our Annual Report on Form 10-K for the year ended June 30, 2006. For a discussion of our critical accounting policies, please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations herein.

Financial results for the first quarter of the fiscal year 2006 have been restated as a result of the review of our stock option grant practices and other tax matters discussed in Note 2. Please see Note 2 to our Consolidated Financial Statements and our Annual Report on Form 10-K for the year ended June 30, 2006 for further discussion of this restatement.

**2. REVIEW OF STOCK OPTION GRANT PRACTICES**

On March 3, 2006 we received notice from the Securities and Exchange Commission that it is conducting an informal investigation into certain stock option grants made by us from October 1998 through March 2005. On June 7, 2006 and on June 16, 2006 we received requests from the SEC for information on all of our stock option grants since 1994. We have responded to the SEC's requests for information and are cooperating in the informal investigation.

On May 17, 2006, we received a grand jury subpoena from the United States District Court, Southern District of New York requesting production of documents related to granting of our stock option grants. We have responded to the grand jury subpoena and have provided documents to the United States Attorney's Office in connection with the grand jury proceeding. We have informed the Securities and Exchange Commission and the United States Attorney's Office for the Southern District of New York of the results of our internal investigation into our stock option grant practices and will continue to cooperate with these governmental entities and their investigations.

We initiated an internal investigation of our stock option grant practices in response to the pending informal investigation by the Securities and Exchange Commission and a subpoena from a grand jury in the Southern District of New York. The investigation reviewed our historical stock option grant practices during the period from 1994 through 2005, including all 73 stock option grants made by us during this period, and the related disclosure in our Form 10-Q for the quarter ended March 31, 2006, filed May 15, 2006 (the May 2006 Form 10-Q).

The investigation was overseen by a special committee of the Board of Directors which consisted of all the independent members of the Board. The special committee retained Bracewell & Giuliani LLP as independent counsel to conduct the internal investigation. In November 2006 the results of the investigation were reported to the special committee, at which time the committee submitted recommendations for action to the Board. These recommendations are now being implemented by the Board substantially as submitted by the special committee.

During the course of the investigation, more than 2 million pages of electronic and hardcopy documents and emails were reviewed. In addition, approximately 40 interviews of current and former officers, directors, employees and other individuals were conducted. The independent directors, in their role as special committee members and as

independent directors prior to formation of the committee, met extensively since the SEC informal investigation commenced to consider the matters related to the stock option grant practices. The investigation was necessarily limited in that the investigation team did not have access to certain witnesses with relevant

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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

information (including former Chief Executive Officer, Jeffrey A. Rich) and due to the lack of metadata for certain electronic documentation prior to 2000.

The following background pertaining to our historical stock option grant practices was confirmed through the investigation. Option grants were typically initiated by our senior management or Darwin Deason, Chairman of the Board (and chairman of the compensation committee from 1994 through August 2003), on a prospective basis at times when they believed it was appropriate to consider option grants and the price of our common stock was relatively low based on an analysis of, among other things, price-earnings multiples. With respect to each grant of options to senior executives, the Chairman gave a broad authorization to the CEO which included approval of option recipients and the number of stock options to be awarded to each recipient. In the case of non-senior management grants, the Chairman gave his general authorization for the awarding of options and the CEO would subsequently obtain his approval of option recipients and the number of stock options to be awarded. With respect to both senior executive and non-senior management grants, after the Chairman's broad authorization, Jeffrey A. Rich, Mark A. King and/or Warren D. Edwards then selected the date to be recorded as the grant date as they, assisted by employees who reported to them, prepared the paperwork that documented the grant recommendations to be considered by the applicable compensation committee. Thus, between 1994 and 2005, grant dates and related exercise prices were generally selected by Mr. Rich, Mr. King, and/or Mr. Edwards. Mr. Rich served as CFO during the period prior to 1994 and until May 1995, President and Chief Operating Officer from May 1995 until February 1999, President and Chief Executive Officer from February 1999 until August 2002, and Chief Executive Officer from August 2002 until his resignation September 29, 2005. Mr. King served as CFO from May 1995 through March 2001, COO from March 2001 through August 2002, President and COO from August 2002 through September 2005, and President and CEO from September 2005 through November 26, 2006. Mr. Edwards served as CFO from March 2001 through November 26, 2006.

As described in our May 2006 Form 10-Q, our regular and special compensation committees used unanimous written consents signed by all members of the committee ratifying their prior verbal approvals of option grants to senior executives or options granted in connection with significant acquisitions. In connection with option grants to senior executives, the historical practice was for the Chairman, on or about the day he gave senior management his broad authorization to proceed with preparing paperwork for option grants, to call each of the compensation committee members to discuss and obtain approval for the grants. In cases where grants were awarded to senior executives and in large blocks to non-senior management the Chairman and members of the compensation committee discussed grants to senior executives specifically and, on certain occasions, acknowledged generally that a block of grants would be awarded to non-senior management as well. For grants to non-senior management which were not combined with senior executive grants, the Chairman and the committee members generally did not discuss the grants at the time the Chairman gave his broad authorization to senior management to proceed with preparing paperwork for option grants, but unanimous written consents were subsequently signed by the committee members in order to document the effective date of the grants.

The investigation concluded that in a significant number of cases Mr. Rich, Mr. King and/or Mr. Edwards used hindsight to select favorable grant dates during the limited time periods after Mr. Deason had given the officers his authorization to proceed to prepare the paperwork for the option grants and before formal grant documentation was submitted to the applicable compensation committee. No evidence was found to suggest that grant dates which preceded Mr. Deason's broad authorization were ever selected. In a number of instances, our stock price was trending downward at the time Mr. Deason's authorization was given, but started to rise as the grant recommendation memoranda were being finalized. The investigation found that in those instances Mr. Rich, Mr. King and/or Mr. Edwards often looked back in time and selected as the grant date a date on which the price was at a low, notwithstanding that the date had already passed and the stock price on the date of the actual selection was higher. Recommendation memoranda attendant to these grants were intentionally misdated at the direction of Mr. Rich, Mr. King and/or Mr. Edwards to make it appear as if the memoranda had been created at or about the time of the chosen grant date, when in fact, they had been created afterwards. As a result, stock options were awarded at prices

that were at, or near, the quarterly low and we effectively granted in the money options without recording the appropriate compensation expense.

The evidence gathered in the investigation disclosed that aside from Mr. Rich, Mr. King and Mr. Edwards, one other of our current management employees, who is not an executive officer or director, was aware of the intentional misdating of documents. Based on the evidence reviewed, no other current executives, directors or management employees were aware of either the improper use of hindsight in selecting grant dates or the intentional misdating of documents. It was also determined that these improper practices were generally followed with respect to option grants made to both senior executives and other employees. No evidence was found to suggest that the practices were selectively employed to favor executive officers over other employees.

Further, with respect to our May 2006 Form 10-Q, the investigation concluded that Note 3 to the Consolidated Financial Statements which stated, in part, that we did not believe that any director or officer of the Company has engaged in the intentional backdating of stock option grants in order to achieve a more advantageous exercise price, was inaccurate because, at the time the May 2006 Form 10-Q was filed, Mr. King and Mr. Edwards either knew or should have known that we awarded options through a process in which

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favorable grant dates were selected with the benefit of hindsight in order to achieve a more advantageous exercise price and that the term backdating was readily applicable to our option grant process. Neither Mr. King nor Mr. Edwards told our directors, outside counsel or independent accountants that our stock options were often granted by looking back and taking advantage of past low prices. Instead, both Mr. King and Mr. Edwards attributed the disparity between recorded grant dates and the creation dates of the paperwork attendant to the stock option grants to other factors that did not involve the use of hindsight.

The investigation concluded that the conduct of Mr. King and Mr. Edwards with regard to the misdating of recommendation memoranda as well as their conduct with regard to the May 2006 Form 10-Q violated our Code of Ethics for Senior Financial Officers. As a result the special committee recommended that Mr. King and Mr. Edwards should resign. Effective November 26, 2006 each of Mr. King and Mr. Edwards resigned from all executive management positions with us. See Note 14. Departure of Executive Officers for a discussion of the terms of their separation.

The Board of Directors appointed Lynn Blodgett, who had been serving as our Executive Vice President and Chief Operating Officer and as a director since September 2005, as President and Chief Executive Officer, and John Rexford, who had been serving as Executive Vice President Corporate Development since March 2001, as Executive Vice President and Chief Financial Officer and as a director, in each case effective on November 26, 2006. Mr. Blodgett and Mr. Rexford each have served in various executive capacities with us for over ten years. In addition to the resignations of Mr. King and Mr. Edwards and the approval of the terms of their separation, the Board of Directors announced the following actions and decisions, some of which have already been implemented, as the result of the findings of our stock option investigation:

The stock options held by our employees (other than Messrs. King and Edwards and one management employee) will be adjusted as necessary, with the optionee's consent, to avoid adverse tax consequences to the employee, and we will compensate such employees for any increase in exercise price resulting from the matters which were the subject of the internal investigation.

Our non-employee directors, to avoid the appearance of inappropriate gain, voluntarily agreed that with respect to any historical option grants to them which require incremental compensation expense as a result of revised measurement dates, the exercise price will be increased to equal the fair market value of the stock on the revised measurement date, regardless of whether such increase is necessary to avoid adverse tax consequences to the director. The non-employee directors will not be reimbursed to offset any individual loss of economic benefit related to such repriced stock options.

Another employee (not an officer as defined in Rule 16a-1(f) under the Securities Exchange Act of 1934) will be reassigned and all of such employee's stock options will be repriced so that the exercise price equals the fair market value of our stock on the proper measurement date.

We will consider whether to recover certain profits from Jeffrey A. Rich, former Chief Executive Officer, which relate to stock options awarded to Mr. Rich which the internal investigation concluded were awarded through a process in which favorable grant dates were selected after the fact.

We implemented, or are in the process of implementing, a number of changes to our internal controls, including:

- o After reviewing the results of the investigation to date, our Board of Directors determined that it would be appropriate to accept the resignations of Mr. King and Mr. Edwards. Our Board of Directors has since appointed a new Chief Executive Officer and Chief Financial Officer.

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- o Designating internal legal and accounting staffs to oversee the documentation and accounting of all grants of stock options or restricted stock.
- o Monitoring industry and regulatory developments in stock option and restricted stock awards and implementing and maintaining best practices with respect to grants of stock options or restricted stock.
- o Adhering to the practice of making annual grants on a date certain and through board or committee meetings, and not through a unanimous written consent process. This change has already been implemented.

We have concluded that there were accounting errors with respect to a number of stock option grants. In general, these stock options were originally granted with an exercise price equal to the NYSE or NASDAQ closing market price for our common stock on the date



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set forth on unanimous written consents signed by one or more members of the appropriate Compensation Committees. We originally used the stated date of these consents as the measurement date for the purpose of accounting for them under Generally Accepted Accounting Principles ( GAAP ), and as a result recorded no compensation expense in connection with the grants.

We have concluded that a number of unanimous written consents were not fully executed or effective on the date set forth on the consents and that using the date stated thereon as the measurement date was incorrect. We have determined a revised measurement date for each stock option grant based on the information now available to us. The revised measurement date reflects the date for which there is objective evidence that the required granting actions necessary to approve the grants, in accordance with our corporate governance procedures, were completed. The accounting guidelines we used in determining the correct accounting measurement date for our option grants require clear evidence of final corporate granting action approving the option grants. Therefore, while the internal investigation did not conclude that option grant dates with respect to certain grants had been selected with hindsight, we nevertheless concluded in many cases that the accounting measurement dates for these grants should be adjusted because the final corporate granting action occurred after the original grant date reflected in our unanimous written consents. In cases where the closing market price on the revised measurement date exceeded the NYSE or NASDAQ closing market price on the original measurement date, we have recognized compensation expense equal to this excess over the vesting term of each option, in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, ( APB 25 ) for periods ending on or before June 30, 2005. Additionally, beginning July 1, 2005, we have recognized compensation expense in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ) based on the fair value of stock options granted, using the revised measurement dates.

Subsequent to the delivery of the results of the investigation, we, with the approval of our Audit Committee, have determined that the cumulative non-cash stock-based compensation expense adjustment was material and that our consolidated financial statements for each of the first three quarters of fiscal year ended June 30, 2006, each of the quarters in the fiscal year ended June 30, 2005 and each of the fiscal years ended June 30, 2005 and June 30, 2004, as well as the selected consolidated financial data for the fiscal years ended June 30, 2003 and 2002 should be restated to record additional stock-based compensation expense resulting from stock options granted during 1994 to 2005 that were incorrectly accounted for under GAAP, and related income tax effects. Related income tax effects include deferred income tax benefits on the compensation expense, and additional income tax liabilities and estimated penalties and interest related to the application of Internal Revenue Code Section 162(m) and related Treasury Regulations ( Section 162(m) ) to stock-based executive compensation previously deducted, that is now no longer deductible as a result of revised measurement dates of certain stock option grants. We have also included in our restatements additional income tax liabilities and estimated penalties and interest, with adjustments to additional paid-in capital and income tax expense, related to certain cash and stock-based executive compensation deductions previously taken under Section 162(m), which we believe may now be non-deductible as a result of information that has been obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. Our decision to restate our financial statements was based on the facts obtained by management and the special committee.

We have determined that the cumulative, pre-tax, non-cash stock-based compensation expense resulting from revised measurement dates was approximately \$51.2 million during the period from our initial public offering in 1994 through June 30, 2006. The corrections relate to options covering approximately 19.4 million shares. We recorded additional stock-based compensation expense of \$2.1 million for the fiscal year ended June 30, 2006 and \$6.1 million and \$7.5 million for the fiscal years ended June 30, 2005 and 2004, respectively, and \$35.5 million for fiscal years ending prior to fiscal 2004. Previously reported total revenues were not impacted by our restatement. The table below reflects the cumulative effect on our stockholders' equity during the period from our initial public offering in 1994 through June 30, 2006 (in thousands):



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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

|  |             |             |
|--|-------------|-------------|
| Decrease in cumulative net income and retained earnings:   |             |             |
| Stock-based compensation expense   | \$ (51,207) |             |
| Estimated tax related penalties and interest on underpayment deficiencies resulting from disallowed Section 162(m) executive compensation deductions   | (11,562)    |             |
| Decrease in pretax profit  | (62,769)    |             |
| Income tax benefit, net  | 12,918      |             |
| Decrease in cumulative net income and retained earnings  |             | \$ (49,851) |
| Increase to additional paid-in capital:  |             |             |
| Stock-based compensation expense   | 51,207      |             |
| Reduction of excess tax benefits for stock options exercised, due to revised measurement dates (1)   | (10,210)    |             |
| Reduction of excess tax benefits for certain stock options exercised related to disallowed Section 162(m) executive compensation deductions, due to revised measurement dates (2)  | (13,372)    |             |
| Reduction of excess tax benefits for certain stock options exercised related to disallowed executive compensation deductions previously believed to qualify for Section 162(m) exceptions, due to factors unrelated to revised measurement dates (3) | (10,505)    |             |
| Increase in additional paid-in capital   |             | 17,120      |
| Decrease in stockholders' equity at June 30, 2006  |             | \$ (32,731) |

(1) We recorded cumulative deferred income tax benefits of \$15.3 million for the income tax effect related to the stock-based compensation expense adjustments arising from revised measurement dates, of which \$10.2 million has been

realized through  
June 30, 2006  
upon stock  
option exercises  
and has been  
reflected as a  
reduction of  
excess tax  
benefits  
previously  
recorded in  
additional  
paid-in capital.

- (2) Excess tax  
benefits for  
certain  
stock-based  
executive  
compensation  
deductions from  
stock option  
exercises  
previously  
recorded in  
additional  
paid-in capital  
are now  
disallowed  
under Section  
162(m) due to  
revised  
measurement  
dates of certain  
stock option  
grants. See  
Other Tax  
Matters below  
in this  
discussion of  
Review of Stock  
Option Grant  
Practices.

- (3) Excess tax  
benefits for  
certain  
stock-based  
executive  
compensation  
deductions from

stock option  
exercises  
previously  
recorded in  
additional  
paid-in capital  
may now be  
non-deductible  
under Section  
162(m) as a  
result of  
information  
obtained by us  
in connection  
with our internal  
investigation,  
due to factors  
unrelated to  
revised  
measurement  
dates. See Other  
Tax Matters  
below in this  
discussion of  
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The table below reflects the breakdown by year of the cumulative adjustment to retained earnings. Our consolidated financial statements included in previously filed periodic reports with the SEC for such periods have not been amended. The consolidated financial statements included in our Annual Report on Form 10-K for the period ended June 30, 2006 have been restated. (in thousands)

| Years ended June 30,               | Stock-based<br>compensation<br>expense | Estimated<br>interest<br>and<br>penalties<br>(1) | Income<br>tax<br>benefit,<br>net | Total<br>adjustments |
|------------------------------------|--|--|----------------------------------|----------------------|
| 1995                               | \$ (63)                                | \$   | \$ 23                            | \$ (40)              |
| 1996                               | (444)                                  |  | 130                              | (314)                |
| 1997                               | (1,404)                                |  | 301                              | (1,103)              |
| 1998                               | (1,876)                                |  | 405                              | (1,471)              |
| 1999                               | (3,325)                                |  | 717                              | (2,608)              |
| 2000                               | (4,870)                                | (87)   | 511                              | (4,446)              |
| 2001                               | (6,433)                                | (546)  | 1,074                            | (5,905)              |
| 2002                               | (7,833)                                | (1,414)  | 1,636                            | (7,611)              |
| 2003                               | (9,237)                                | (1,454)  | 2,119                            | (8,572)              |
| Cumulative effect at June 30, 2003 | (35,485)                               | (3,501)  | 6,916                            | (32,070)             |

| Years ended June 30,                  | Net<br>income as<br>reported |             |             |           | Net<br>income as<br>restated |            |
|---------------------------------------|------------------------------|-------------|-------------|-----------|------------------------------|------------|
| 2004                                  | \$ 529,843                   | (7,527)     | (2,509)     | 1,921     | (8,115)                      | \$ 521,728 |
| 2005                                  | 415,945                      | (6,061)     | (2,526)     | 2,211     | (6,376)                      | 409,569    |
| 2006                                  |                              | (2,134)     | (3,026)     | 1,870     | (3,290)                      |            |
| Cumulative effect at<br>June 30, 2006 |                              | \$ (51,207) | \$ (11,562) | \$ 12,918 | \$ (49,851)                  |            |

(1) Estimated interest and penalties on income tax underpayment

deficiencies  
resulting from  
disallowed  
executive  
compensation  
deductions  
under  
Section 162(m).

Please see our Consolidated Statement of Income and Consolidated Statement of Cash Flows below for the impact on our September 30, 2005 financial information.

In connection with the restatement of our consolidated financial statements discussed above, we assessed the impact of the findings of our internal investigation into our historical stock option grant practices and other tax matters on our reported income tax benefits and deductions, including income tax deductions previously taken for cash and stock-based executive compensation under the provisions of Section 162(m). In connection with that assessment, we determined that adjustments were required to our (i) income tax expense previously reported in our Consolidated Statements of Income; (ii) the tax benefits on stock option exercises previously reported in our Consolidated Statements of Cash Flows and Consolidated Statement of Changes in Stockholders' Equity and (iii) the deferred tax assets previously reported in our Consolidated Balance Sheets, in order to give effect to the impact of the investigation findings and those of our assessments.

In our Consolidated Statements of Income, we recorded deferred income tax benefits of \$0.8 million, \$2.2 million and \$2.7 million for the fiscal years ending June 30, 2006, 2005 and 2004, respectively, and \$9.6 million for periods prior to fiscal year 2004 related to the stock-based compensation adjustments arising from revised measurement dates. Of these cumulative deferred income tax benefits of \$15.3 million, \$10.2 million has been realized through June 30, 2006 upon stock option exercises and has been reflected as a reduction of excess tax benefits previously recorded in additional paid-in capital. At June 30, 2006 and 2005, we recorded adjustments in our Consolidated Balance Sheets of \$5.1 million and \$9.2 million, respectively, to recognize deferred income tax assets on stock-based compensation relating to unexercised stock options remaining at those dates.

We also recorded current income tax benefits of \$1.1

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million, \$0.6 million and \$0.4 million for the fiscal years ending June 30, 2006, 2005 and 2004, respectively, and \$0.1 million for periods prior to fiscal year 2004 related to the income tax benefit of the estimated deductible interest expense on income tax underpayment deficiencies related to disallowed cash and stock-based executive compensation deductions previously taken under Section 162(m) as discussed in Other tax matters below. These income tax benefits are reduced by current income tax expense of \$0 million, \$0.6 million and \$1.2 million for the fiscal years June 30, 2006, 2005 and 2004, respectively, and \$2.8 million for periods prior to fiscal year 2004 related to disallowed cash based executive incentive compensation deductions that were previously believed to qualify as a deduction under Section 162(m). The sum of these current and deferred income tax adjustments are reflected as income tax benefit, net, in the above tables.

The components of income tax benefit, net, are as follows (in thousands):

|                               | <b>Deferred<br/>income tax<br/>benefit on<br/>stock-based<br/>compensation</b> | <b>Current<br/>income<br/>tax<br/>benefit<br/>on<br/>deductible<br/>interest</b> | <b>Current<br/>income<br/>tax<br/>expense<br/>on<br/>disallowed<br/>deductions<br/>under<br/>Section<br/>162(m)</b> | <b>Income<br/>tax<br/>benefit,<br/>net</b> |
|-------------------------------|--|--|---|--|
| Years ended June 30,          |  |  |   |  |
| 1995                          | \$ 23  | \$   | \$  | \$ 23                                      |
| 1996                          | 130  |  |   | 130  |
| 1997                          | 301  |  |   | 301  |
| 1998                          | 405  |  |   | 405  |
| 1999                          | 717  |  |   | 717  |
| 2000                          | 945  |  | (434)   | 511  |
| 2001                          | 1,598  |  | (524)   | 1,074                                      |
| 2002                          | 2,287  |  | (651)   | 1,636                                      |
| 2003                          | 3,246  | 70   | (1,197)   | 2,119                                      |
| Cumulative effect at June 30, |  |  |   |  |
| 2003                          | 9,652  | 70   | (2,806)   | 6,916                                      |
| Years ended June 30,          |  |  |   |  |
| 2004                          | 2,702  | 387  | (1,168)   | 1,921                                      |
| 2005                          | 2,194  | 576  | (559)   | 2,211                                      |
| 2006                          | 774  | 1,096  |   | 1,870                                      |



|                                       |    |        |    |       |    |         |    |        |
|---------------------------------------|----|--------|----|-------|----|---------|----|--------|
| Cumulative effect at June 30,<br>2006 | \$ | 15,322 | \$ | 2,129 | \$ | (4,533) | \$ | 12,918 |
|---------------------------------------|----|--------|----|-------|----|---------|----|--------|

*Other tax matters*

The revision of measurement dates for certain stock option grants in connection with our internal investigation required us to assess our previous performance-based cash and stock-based executive compensation income tax deductions previously claimed under Section 162(m) during the applicable periods. As a result of those assessments, we have determined that certain previously claimed stock-based executive compensation deductions under Section 162(m) upon stock option exercise are no longer deductible as a result of revised in-the-money measurement dates. Accordingly, our restatements include adjustments to record additional income taxes payable in the amount of \$13.4 million with a corresponding reduction of excess tax benefits previously recorded in additional paid-in capital. Our restatements also include adjustments to record additional income taxes payable in the amount of approximately \$15 million with a corresponding reduction of excess tax benefits previously recorded in additional paid-in capital of \$10.5 million and an increase in current income tax expense of \$4.5 million, related to certain cash and stock-based executive compensation deductions previously taken under Section 162(m), which we believe may now be non-deductible as a result of information that has been obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. We have also recorded estimated penalties and interest in the amount of \$3 million, \$2.5 million and \$2.5 million for the years ended June 30, 2006, 2005 and 2004, respectively, and \$3.5 million for periods prior to fiscal year 2004 for these estimated income tax payment deficiencies.

At September 30, 2006, we have recorded approximately \$38.5 million of additional income taxes payable, including estimated interest and penalties related to disallowed Section 162(m) executive compensation deductions either resulting from revised measurement dates or due to factors unrelated to revised measurement dates, but which were previously believed to qualify for Section 162(m) deductions. At this time, we cannot predict when the Section 162(m) underpayment deficiencies, together with interest and penalties, if any, will be paid. We expect to fund any such payment from cash flows from operating activities.

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Section 409A of the Internal Revenue Code ( Section 409A ) provides that option holders with options granted with a below-market exercise price, to the extent the options were not vested as of December 31, 2004, may be subject to adverse Federal income tax consequences. Holders of these options will likely be required to recognize taxable income at the date of vesting for those options vesting after December 31, 2004, rather than upon exercise, on the difference between the amount of the fair market value of our Class A common stock on the date of vesting and the exercise price, plus an additional 20 percent penalty tax and interest on any income tax to be paid. We will be amending the exercise price of certain outstanding stock options to avoid adverse tax consequences to individual option holders under Section 409A and all of our employees and executives (other than Mark A. King, former President and Chief Executive Officer; Warren D. Edwards, former Executive Vice President and Chief Financial Officer; and one management employee) will be reimbursed to offset any loss of economic benefit related to such re-priced stock options. We will not be re-pricing all option grants for which accounting measurement dates were adjusted. Option grants to executives, employees and certain former employees whose options remain outstanding will be re-priced only to the extent necessary to avoid adverse tax consequences to the individuals, other than Mr. King, Mr. Edwards and one management employee. Grants to certain current and former officers and employee directors were required to be repriced on or before December 31, 2006 in order to comply with income tax regulations, and accordingly, on December 28, 2006, we repriced awards totaling 876,800 shares held by certain current and former officers and employee directors.

We expect to pay to certain current and former employees approximately \$8 million in order to compensate such individuals for any increase in exercise price resulting from the matters which were the subject of the internal investigation, in order to avoid the adverse individual income tax impact of Section 409A due to revised measurement dates. The \$8 million related to Section 409A will be paid to the affected individuals beginning in January 2008 and as the related stock options vest. We expect to fund any such payment from cash flows from operating activities, however, we have not yet determined the impact to our results of operations and financial condition. The increase in the exercise prices to be paid by optionholders upon their exercise is expected to offset, in the aggregate, the \$8 million; however, the timing of any such exercises cannot be determined.

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The tables below reflect the adjustments on our consolidated financial statements as of and for the quarter ended September 30, 2005:

| <b>Consolidated Statement of Income</b>         |                        |                      |                        |
|---|------------------------|----------------------|------------------------|
| <b>For the three months ended September 30,</b> |                        |                      |                        |
| <b>2005</b>                                     |                        |                      |                        |
|   | <b>As<br/>Reported</b> | <b>Adjustments</b>   | <b>As<br/>Restated</b> |
| Revenues  | \$ 1,310,917           | \$                   | \$ 1,310,917           |
| Operating expenses:                             |                        |                      |                        |
| Cost of revenues:                               |                        |                      |                        |
| Wages and benefits                              | 628,119                | 566 <sup>(1)</sup>   | 628,685                |
| Services and supplies                           | 290,772                |                      | 290,772                |
| Rent, lease and maintenance                     | 155,172                |                      | 155,172                |
| Depreciation and amortization                   | 68,080                 |                      | 68,080                 |
| Other   | 4,247                  |                      | 4,247                  |
| Cost of revenues                                | 1,146,390              | 566                  | 1,146,956              |
| Other operating expenses                        | 9,764                  |                      | 9,764                  |
| Total operating expenses                        | 1,156,154              | 566                  | 1,156,720              |
| Operating income                                | 154,763                | (566)                | 154,197                |
| Interest expense                                | 12,128                 | 611 <sup>(2)</sup>   | 12,739                 |
| Other non-operating income, net                 | (4,381)                |                      | (4,381)                |
| Pretax profit                                   | 147,016                | (1,177)              | 145,839                |
| Income tax expense                              | 52,892                 | (428) <sup>(3)</sup> | 52,464                 |
| Net income                                      | \$ 94,124              | \$ (749)             | \$ 93,375              |
| Earnings per share:                             |                        |                      |                        |
| Basic   | \$ 0.75                | \$ (0.01)            | \$ 0.74                |
| Diluted   | \$ 0.74                | \$ (0.01)            | \$ 0.73                |

Shares used in computing earnings  
per share:

|                        |         |                   |         |
|------------------------|---------|-------------------|---------|
| Basic                  | 125,429 |                   | 125,429 |
| Diluted <sup>(5)</sup> | 127,222 | 64 <sub>(4)</sub> | 127,286 |

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**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
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**Consolidated Statement of Cash Flows**  
**Three months ended September 30, 2005**  
**As**

|   | <b>As<br/>Reported</b> | <b>Adjustments</b>   | <b>Restated</b> |
|---|------------------------|----------------------|-----------------|
| <b>Cash flows from operating activities:</b>                                      |                        |                      |                 |
| Net income  | \$ 94,124              | \$ (749)             | \$ 93,375       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                        |                      |                 |
| Depreciation and amortization   | 68,080                 |                      | 68,080          |
| Stock-based compensation expense  | 8,741                  | 566 <sup>(1)</sup>   | 9,307           |
| Excess tax benefit on stock-based compensation                                    | (6,982)                | 1,504                | (5,478)         |
| Provision for uncollectible accounts receivable                                   | 3,250                  |                      | 3,250           |
| Deferred income tax expense   | 13,928                 | 1,822 <sup>(6)</sup> | 15,750          |
| Other non-cash activities   | 1,746                  |                      | 1,746           |
| Changes in assets and liabilities, net of effects from acquisitions:              |                        |                      |                 |
| Accounts receivable   | (73,805)               |                      | (73,805)        |
| Prepaid expenses and other current assets   | (8,767)                |                      | (8,767)         |
| Other assets  | (9,328)                |                      | (9,328)         |
| Accounts payable  | 9,038                  |                      | 9,038           |
| Accrued compensation and benefits   | (18,643)               |                      | (18,643)        |
| Other accrued liabilities   | (20,319)               |                      | (20,319)        |
| Income taxes receivable/payable   | 32,577                 |                      | 32,577          |
| Other long-term liabilities   | 1,255                  | (1,639)              | (384)           |
| Unearned revenue  | 12,931                 |                      | 12,931          |
| Total adjustments   | 13,702                 | 2,253                | 15,955          |
| Net cash provided by operating activities   | 107,826                | 1,504                | 109,330         |
| <b>Cash flows from investing activities:</b>                                      |                        |                      |                 |
| Purchases of property, equipment and software, net                                | (94,777)               |                      | (94,777)        |
| Additions to other intangible assets  | (6,906)                |                      | (6,906)         |
| Payments for acquisitions, net of cash acquired                                   | (42,644)               |                      | (42,644)        |
| Intangibles acquired in subcontract termination                                   | (16,530)               |                      | (16,530)        |
| Purchases of investments  | (4,515)                |                      | (4,515)         |
| Net cash used in investing activities   | (165,372)              |                      | (165,372)       |

**Cash flows from financing activities:**

|  |           |         |           |
|--|-----------|---------|-----------|
| Proceeds from issuance of long-term debt, net    | 383,461   |         | 383,461   |
| Payments of long-term debt                       | (377,708) |         | (377,708) |
| Excess tax benefit on stock-based compensation   | 6,982     | (1,504) | 5,478     |
| Proceeds from stock options exercised            | 14,739    |         | 14,739    |
| Proceeds from issuance of treasury shares        | 1,613     |         | 1,613     |
| Net cash provided by financing activities        | 29,087    | (1,504) | 27,583    |
| Net change in cash and cash equivalents          | (28,459)  |         | (28,459)  |
| Cash and cash equivalents at beginning of period | 62,685    |         | 62,685    |
| Cash and cash equivalents at end of period       | \$ 34,226 | \$      | \$ 34,226 |

- (1) Stock-based compensation expense.
- (2) Estimated interest expense on Section 162(m) deduction disallowances.
- (3) Income tax benefits for additional stock-based compensation expense and estimated interest expense.
- (4) Adjustment to dilutive shares resulting from changes in unrecognized compensation and excess tax benefits.
- (5) Basic earnings per share of common stock is computed

using the weighted average number of our common shares outstanding during the periods. Diluted earnings per share is adjusted for the incremental shares that would be outstanding upon the assumed exercise of stock options. Shares used in computing diluted earnings per share includes the weighted average shares outstanding for the period used in calculating basic earnings per share, plus the dilutive effect of stock options outstanding during the period. Share dilution for the quarter presented excludes the effect of options outstanding that were considered antidilutive because the average market price of the underlying stock did not exceed the sum of the

option exercise  
price,  
unrecognized  
compensation  
expense and  
windfall tax  
benefits

- (6) Deferred  
income tax  
associated with  
additional  
stock-based  
compensation  
expense, net of  
reversals related  
to stock option  
exercises.



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**3. ACQUISITION**

In July 2006, we completed the acquisition of Primax Recoveries, Inc. ( Primax ), one of the industry's oldest and largest health care cost recovery firms. The transaction was valued at approximately \$40 million, plus related transaction costs excluding contingent consideration of up to \$10 million based upon future financial performance and was funded from cash on hand and borrowings on our Credit Facility (defined below). The purchase price was allocated to assets acquired and liabilities assumed based on estimated fair value as of the date of acquisition. We acquired assets of \$63.8 million and assumed liabilities of \$23.8 million. We recorded \$19.6 million in goodwill, which is not deductible for income tax purposes, and intangible assets of \$20.5 million. The \$20.5 million of intangible assets is attributable to customer relationships and non-compete agreements with weighted average useful lives of 11 years. We believe this acquisition expands our payor offering to include subrogation and overpayment recovery services to help clients improve profitability while maintaining their valued relationships with plan participants, employers and providers. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, July 12, 2006.

**4. DIVESTITURES**

In December 2005, we completed the divestiture of substantially all of our Government welfare-to-workforce services business (the WWS Divestiture ) to Arbor E&T, LLC ( Arbor ), a wholly owned subsidiary of ResCare, Inc., for approximately \$69 million, less transaction costs. Assets sold were approximately \$30.3 million and liabilities assumed by Arbor were approximately \$0.2 million, both of which were included in the Government segment. We retained the net working capital related to the WWS Divestiture. We recognized a pretax gain of \$0.7 million (\$0.4 million, net of income tax) and \$0 in the first quarter of fiscal years 2007 and 2006, respectively, upon the assignment of customer contracts to Arbor. During fiscal year 2006, we recorded a gain of \$33.5 million (\$20.1 million, net of income tax). Approximately \$3 million of the consideration relates to certain customer contracts whose assignment to Arbor was not complete as of September 30, 2006, and is reflected as deferred proceeds in other accrued liabilities in our Consolidated Balance Sheet as of September 30, 2006. We completed the transfers of these remaining contracts to Arbor in the second quarter of fiscal year 2007. The after tax proceeds from the divestiture were primarily used for general corporate purposes.

Revenues from the WWS Divestiture were \$0.6 million and \$53.5 million for the first quarter of fiscal years 2007 and 2006, respectively. Operating (loss) income from the WWS Divestiture, excluding the gain on sale, was (\$0.5 million) and \$4.5 million for the first quarter of fiscal years 2007 and 2006, respectively.

The welfare-to-workforce services business is no longer strategic or core to our operating philosophy. This divestiture allows us to focus on our technology-enabled business process outsourcing and information technology service offerings.

At September 30, 2006, we classified as assets held for sale certain customer contracts related to the WWS Divestiture whose transfer to Arbor was not complete as of September 30, 2006. The following table sets forth the assets held for sale included in prepaid expenses and other current assets in our Consolidated Balance Sheets (in thousands):

|   | <b>September 30,<br/>2006</b> | <b>June 30,<br/>2006</b> |
|---|-------------------------------|--------------------------|
| Intangible assets related to the WWS Divestiture, net | \$ 447                        | \$ 634                   |
| Goodwill related to the WWS Divestiture               | 772                           | 1,096                    |
| Total assets held for sale                            | \$ 1,219                      | \$ 1,730                 |

**5. RESTRUCTURING ACTIVITIES**

During fiscal year 2006, we began a comprehensive assessment of our operations, including our overall cost structure, competitive position, technology assets and operating platform and foreign operations. As a result, we began certain

restructuring initiatives and activities that are expected to enhance our competitive position in certain markets, and recorded certain restructuring charges and asset impairments arising from our discretionary decisions. We estimate a total of 2,100 employees will be involuntarily terminated as a result of these initiatives, consisting primarily of offshore processors and related management; however, we anticipate that a majority of these positions will be migrated to lower cost markets. As of September 30, 2006, approximately 2,000 employees have been involuntarily terminated.

In our Commercial segment, we recorded a restructuring charge for involuntary termination of employees of \$4.7 million for the three months ended September 30, 2006, which is reflected in wages and benefits in our Consolidated Statements of Income, and \$0.9

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million for the three months ended September 30, 2006, for impairments of facility costs and facility shutdown charges, which are reflected as part of total operating expenses in our Consolidated Statements of Income. In our Government segment, we recorded a restructuring charge for involuntary termination of employees of \$0.4 million for the three months ended September 30, 2006, which is reflected in wages and benefits in our Consolidated Statements of Income.

The following table summarizes activity for the accrual for involuntary termination of employees for the three months ended September 30, 2006 (in thousands), exclusive of the Acquired HR Business (defined below):

|                                   |              |
|-----------------------------------|--------------|
| Balance at June 30, 2006          | \$ 899       |
| Accrual recorded                  | 5,058        |
| Payments                          | (907)        |
| <br>Balance at September 30, 2006 | <br>\$ 5,050 |

The September 30, 2006 accrual for involuntary termination of employees is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

During fiscal year 2005, we acquired the human resources consulting and outsourcing businesses of Mellon Financial Corporation (the "Acquired HR Business"). In the fourth quarter of fiscal year 2006, we substantially completed the integration of the Acquired HR Business. The integration included the elimination of redundant facilities, marketing and overhead costs, and the consolidation of processes from the historical cost structure of the acquired Mellon organization. The liabilities recorded at closing for the Acquired HR Business include \$22.3 million in involuntary employee termination costs for employees of the Acquired HR Business in accordance with Emerging Issues Task Force Issue No. 95-3 "Recognition of Liabilities in Connection with a Purchase Business Combination." During the first quarter of fiscal year 2007, \$0.4 million in involuntary employee termination payments were made and charged against accrued compensation bringing the total payments made to \$16.1 million. We also recorded a \$3.1 million and a \$1.2 million reduction to the accrual and to goodwill in fiscal year 2006 and the first quarter of fiscal year 2007, respectively, as a result of a change in our estimates of severance to be paid. As of September 30, 2006, the balance of the related accrual was \$1.9 million and is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

## **6. GOODWILL AND OTHER INTANGIBLE ASSETS**

The changes in the carrying amount of goodwill for the three months ended September 30, 2006 are as follows (in thousands):

|                                      | <b>Commercial</b> | <b>Government</b> | <b>Total</b>     |
|--------------------------------------|-------------------|-------------------|------------------|
| Balance as of June 30, 2006          | \$ 1,282,053      | \$ 1,174,601      | \$ 2,456,654     |
| Acquisition activity                 | 17,721            | 2,074             | 19,795           |
| Foreign currency translation         | 1,460             | (849)             | 611              |
| <br>Balance as of September 30, 2006 | <br>\$ 1,301,234  | <br>\$ 1,175,826  | <br>\$ 2,477,060 |

Goodwill activity for the first quarter of fiscal year 2007 was primarily due to the acquisition of Primax (see Note 3). Approximately \$2 billion, or 80.3%, of the original gross amount of goodwill recorded is deductible for income tax purposes.

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The following information relates to our other intangible assets (in thousands):

|                                       | <b>September 30, 2006</b>            |                                     | <b>June 30, 2006</b>                 |                                     |
|---------------------------------------|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
|                                       | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> |
| Amortizable intangible assets:        |                                      |                                     |                                      |                                     |
| Acquired customer-related intangibles | \$ 405,658                           | \$ (115,086)                        | \$ 384,738                           | \$ (104,901)                        |
| Customer-related intangibles          | 230,208                              | (97,361)                            | 222,268                              | (90,326)                            |
| All other                             | 15,613                               | (6,889)                             | 15,147                               | (6,113)                             |
| <b>Total</b>                          | <b>\$ 651,479</b>                    | <b>\$ (219,336)</b>                 | <b>\$ 622,153</b>                    | <b>\$ (201,340)</b>                 |
| Non-amortizable intangible assets:    |                                      |                                     |                                      |                                     |
| Title plant                           | \$ 51,045                            |                                     | \$ 51,045                            |                                     |
| Trade name                            | 3,843                                |                                     | 3,843                                |                                     |
| <b>Total</b>                          | <b>\$ 54,888</b>                     |                                     | <b>\$ 54,888</b>                     |                                     |

## Aggregate Amortization:

|  |           |
|--|-----------|
| For the quarter ended September 30, 2006 | \$ 18,765 |
| For the quarter ended September 30, 2005 | 18,012    |

## Estimated amortization for the years ended

|          |           |
|----------|-----------|
| June 30, |           |
| 2007     | \$ 75,932 |
| 2008     | 71,825    |
| 2009     | 61,996    |
| 2010     | 53,066    |
| 2011     | 46,686    |

Aggregate amortization includes amounts charged to amortization expense for customer-related intangibles and other intangibles, other than contract inducements. Amortization of contract inducements of \$3.8 million and \$3.7 million for the three months ended September 30, 2006 and 2005, respectively, is recorded as a reduction of related contract revenue. Amortization expense includes approximately \$10.2 million and \$9.8 million for acquired customer-related intangibles for the three months ended September 30, 2006 and 2005, respectively. Amortizable intangible assets are amortized over the related contract term. The amortization period of customer-related intangible assets ranges from 1 to 17 years, with a weighted average of approximately 9 years. The amortization period for all other intangible assets, including trademarks, ranges from 3 to 20 years, with a weighted average of approximately 6 years.

**7. LONG-TERM DEBT***Credit Facility*

On July 6, 2006, we amended our secured term loan facility ( *Term Loan Facility* ) under our Credit Agreement dated March 20, 2006 ( *Credit Facility* ) and borrowed an additional \$500 million on July 6, 2006 and an additional \$500 million on August 1, 2006. As a result of the increase to the facility, the Applicable Margin, as defined in the Credit Facility, increased to LIBOR plus 200 basis points. We used the proceeds of the Term Loan Facility increase to

finance the purchase of shares of our Class A common stock under the June 2006 \$1 billion share repurchase authorization (See Note 8) and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility.

Following the Tender Offer, our credit ratings were downgraded by Moody's and Standard and Poor's, both to below investment grade. Standard & Poor's further downgraded us to BB upon our announcement in June 2006 of the approval by our Board of Directors of a new \$1 billion share repurchase plan. Fitch initiated its coverage of us in August 2006 at a rating of BB, except for our Senior Notes (defined below) which were rated BB-. Standard & Poor's downgraded our credit rating further, to B+, following our announcement on September 28, 2006 that we would not be able to file our Annual Report on Form 10-K for the period ending June 30, 2006 by the September 28, 2006 extended deadline.

On September 26, 2006, we received an amendment, consent and waiver from the lenders under our Credit Facility with respect to, among other provisions, waiver of any default or event of default arising under the Credit Facility as a result of our failure to comply

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with certain reporting covenants relating to other indebtedness, including covenants purportedly requiring the filing of reports with either the SEC or the holders of such indebtedness, so long as those requirements are complied with by December 31, 2006. As consideration for this amendment, consent and waiver, we paid a fee of \$2.6 million. On December 21, 2006, we received an amendment, consent and waiver from lenders under our Credit Facility. The amendment, consent and waiver includes the following provisions, among others:

- (1) Consent to the delivery, on or prior to February 14, 2007, of (i) the financial statements, accountant's report and compliance certificate for the fiscal year ended June 30, 2006 and (ii) financial statements and related compliance certificates for the fiscal quarters ended June 30, 2006 and September 30, 2006, and waiver of any default arising from the failure to deliver any such financial statements, reports or certificates within the applicable time period provided for in the Credit Agreement, provided that any such failure to deliver resulted directly or indirectly from the previously announced investigation of the Company's historical stock option grant practices (the Options Matter).
- (2) Waiver of any default or event of default arising from the incorrectness of representations and warranties made or deemed to have been made with respect to certain financial statements previously delivered to the Agent as a result of any restatement, adjustment or other modification of such financial statements resulting directly or indirectly from the Options Matter.
- (3) Waiver of any default or event of default which may arise from the Company's or its subsidiaries' failure to comply with reporting covenants under other indebtedness that are similar to those in the Credit Agreement (including any covenant to file any report with the Securities and Exchange Commission or to furnish such reports to the holders of such indebtedness), provided such reporting covenants are complied with on or prior to February 14, 2007.
- (4) Amendments to provisions relating to the permitted uses of the proceeds of revolving loans under the Credit Agreement that (i) increase to \$500 million from \$350 million the aggregate principal amount of revolving loans that may be outstanding, the proceeds of which may be used to satisfy the obligations under the Company's 4.70% Senior Notes due 2010 or 5.20% Senior Notes due 2015 and (ii) until June 30, 2007, decrease to \$200 million from \$300 million the minimum liquidity (i.e., the aggregate amount of the Company's unrestricted cash in excess of \$50 million and availability under the Credit Agreement's revolving facility) required after giving effect to such use of proceeds.

As consideration for this amendment, waiver and consent, we paid a fee of \$1.3 million.

*Senior Notes*

On September 22, 2006, we received a letter from CEDE & Co. (CEDE) sent on behalf of certain holders of our 5.20% Senior Notes due 2015 (the 5.20% Senior Notes) issued by us under that certain Indenture dated June 6, 2005 (the Indenture) between us and The Bank of New York Trust Company, N.A. (the Trustee) advising us that we were in default of our covenants under the Indenture. The letter alleged that our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, was a default under the terms of the Indenture. On September 29, 2006, we received a letter from CEDE sent on behalf of the same persons declaring an acceleration with respect to the 5.20% Senior Notes, as a result of our failure to remedy the default set forth in the September 22 letter related to our failure to timely file our Annual Report on Form 10-K for the period ended June 30, 2006. The September 29 letter declared that the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes were due and payable immediately, and demanded payment of all amounts owed in respect of the 5.20% Senior Notes.

On September 29, 2006 we received a letter from the Trustee with respect to the 5.20% Senior Notes. The letter alleged that we were in default of our covenants under the Indenture with respect to the 5.20% Senior Notes, as the

result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. On October 6, 2006, we received a letter from the Trustee declaring an acceleration with respect to the 5.20% Senior Notes as a result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. The October 6, 2006 letter declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes to be due and payable immediately, and demanded payment of all