

AFFILIATED COMPUTER SERVICES INC

Form 10-Q

February 14, 2003

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**FORM 10-Q**

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D. C. 20549

(Mark One)

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

For the quarterly period ended December 31, 2002

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 0-24787

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

| Title of each class                   | Number of shares<br>outstanding as of<br>February 10, 2003 |
|---------------------------------------|--|
| Class A Common Stock, \$.01 par value | 125,937,089  |
| Class B Common Stock, \$.01 par value | 6,599,372  |



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**Table of Contents****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**

**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands)

|  | <b>December 31,<br/>2002<br/>(Unaudited)</b> | <b>June 30,<br/>2002<br/>(Audited)</b> |
|--|--|--|
| <b>ASSETS</b>                              |  |  |
| Current assets:                            |  |  |
| Cash and cash equivalents                  | \$ 58,900                                    | \$ 33,814                              |
| Accounts receivable, net                   | 769,177                                      | 736,471                                |
| Inventory                                  | 8,837  | 9,740                                  |
| Prepaid expenses and other current assets  | 92,673                                       | 94,464                                 |
|  | <u>          </u>                            | <u>          </u>                      |
| Total current assets                       | 929,587                                      | 874,489                                |
| Property, equipment and software, net      | 430,965                                      | 394,830                                |
| Goodwill, net                              | 1,855,598                                    | 1,846,482                              |
| Intangibles, net                           | 238,703                                      | 234,287                                |
| Long-term investments and other assets     | 55,868                                       | 53,479                                 |
|  | <u>          </u>                            | <u>          </u>                      |
| Total assets                               | <u>\$3,510,721</u>                           | <u>\$3,403,567</u>                     |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |  |  |
| Current liabilities:                       |  |  |
| Accounts payable                           | \$ 47,143                                    | \$ 72,858                              |
| Accrued compensation and benefits          | 98,381                                       | 125,290                                |
| Other accrued liabilities                  | 251,654                                      | 210,003                                |
| Income taxes payable                       | 18,057                                       | 20,452                                 |
| Deferred taxes                             | 22,068                                       | 7,344                                  |
| Current portion of long-term debt          | 626  | 1,330                                  |
| Current portion of unearned revenue        | 56,549                                       | 48,636                                 |
|  | <u>          </u>                            | <u>          </u>                      |
| Total current liabilities                  | 494,478                                      | 485,913                                |
| Convertible notes                          | 316,990                                      | 316,990                                |
| Long-term debt                             | 301,911                                      | 391,243                                |
| Deferred taxes                             | 123,259                                      | 95,394                                 |
| Other long-term liabilities                | 31,475                                       | 18,607                                 |
|  | <u>          </u>                            | <u>          </u>                      |
| Total liabilities                          | <u>1,268,113</u>                             | <u>1,308,147</u>                       |
| Stockholders' equity:                      |  |  |
| Class A common stock                       | 1,257  | 1,254                                  |
| Class B common stock                       | 66   | 66                                     |
| Additional paid-in capital                 | 1,334,367                                    | 1,330,533                              |
| Retained earnings                          | 906,918                                      | 763,567                                |
|  | <u>          </u>                            | <u>          </u>                      |
| Total stockholders' equity                 | <u>2,242,608</u>                             | <u>2,095,420</u>                       |

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|  |             |             |
|--|-------------|-------------|
| Total liabilities and stockholders' equity | \$3,510,721 | \$3,403,567 |
|--|-------------|-------------|

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)**

|   | Three Months Ended<br>December 31, |                   | Six Months Ended<br>December 31, |                   |
|---|------------------------------------|-------------------|----------------------------------|-------------------|
|   | 2002                               | 2001              | 2002                             | 2001              |
| Revenues  | \$ 929,164                         | \$ 750,427        | \$ 1,827,040                     | \$ 1,405,446      |
| Expenses:   |                                    |                   |                                  |                   |
| Wages and benefits                                  | 403,880                            | 327,417           | 806,779                          | 624,290           |
| Services and supplies                               | 264,546                            | 224,707           | 506,331                          | 397,578           |
| Rent, lease and maintenance                         | 86,944                             | 65,980            | 171,279                          | 138,860           |
| Depreciation and amortization                       | 35,717                             | 27,499            | 71,859                           | 51,914            |
| Other operating expenses                            | 13,111                             | 7,403             | 26,171                           | 13,841            |
|   | <u>804,198</u>                     | <u>653,006</u>    | <u>1,582,419</u>                 | <u>1,226,483</u>  |
| Total operating expenses                            |                                    |                   |                                  |                   |
| Operating income                                    | 124,966                            | 97,421            | 244,621                          | 178,963           |
| Interest expense                                    | 6,147                              | 7,583             | 13,201                           | 20,182            |
| Other non-operating (income) expense, net           | 417                                | 942               | 1,889                            | (374)             |
|   | <u>118,402</u>                     | <u>88,896</u>     | <u>229,531</u>                   | <u>159,155</u>    |
| Pretax profit                                       |                                    |                   |                                  |                   |
| Income tax expense                                  | 44,401                             | 33,336            | 86,074                           | 59,682            |
|   | <u>\$ 74,001</u>                   | <u>\$ 55,560</u>  | <u>\$ 143,457</u>                | <u>\$ 99,473</u>  |
| Net income  |                                    |                   |                                  |                   |
| Earnings per common share:                          |                                    |                   |                                  |                   |
| Basic   | \$ .56                             | \$ .47            | \$ 1.09                          | \$ .90            |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Diluted   | \$ .53                             | \$ .42            | \$ 1.03                          | \$ .81            |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Shares used in computing earnings per common share: |                                    |                   |                                  |                   |
| Basic   | 132,175                            | 118,572           | 132,124                          | 110,076           |
| Diluted   | 143,295                            | 140,692           | 143,139                          | 132,018           |

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)**

|  | Six Months Ended<br>December 31, |           |
|--|----------------------------------|-----------|
|  | 2002                             | 2001      |
| <b>Cash flows from operating activities:</b>   |                                  |           |
| Net income   | \$ 143,457                       | \$ 99,473 |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                                  |           |
| Depreciation and amortization  | 71,859                           | 51,914    |
| Impairment of long-term investments  | 2,000                            | 1,000     |
| Other  | 5,880                            | 1,549     |
| <b>Changes in assets and liabilities, net of effects from acquisitions:</b>              |                                  |           |
| Increase in accounts receivable  | (41,638)                         | (44,156)  |
| (Increase) decrease in inventory   | 152                              | (3,606)   |
| Increase in prepaid expenses and other current assets                                    | (4,694)                          | (660)     |
| Change in deferred taxes   | 42,412                           | 20,745    |
| (Increase) decrease in other long-term assets  | 2,498                            | (1,069)   |
| Increase (decrease) in accounts payable  | (25,716)                         | 6,952     |
| Decrease in accrued compensation and benefits  | (27,152)                         | (23,858)  |
| Increase in other accrued liabilities  | 42,453                           | 25,065    |
| Change in income taxes payable   | 1,287                            | 17,869    |
| Increase (decrease) in unearned revenue  | 15,792                           | (2,393)   |
| Increase (decrease) in other long-term liabilities                                       | 4,989                            | (615)     |
|  | 90,122                           | 48,737    |
| Net cash provided by operating activities  | 233,579                          | 148,210   |
| <b>Cash flows from investing activities:</b>   |                                  |           |
| Purchases of property, equipment and software, net of sales                              | (92,540)                         | (78,550)  |
| Payments for acquisitions, net of cash acquired  | (6,381)                          | (878,809) |
| Proceeds from divestitures, net of transaction costs                                     | 5,802                            | (3,401)   |
| Proceeds from sale of investment   | 132                              |           |
| Additions to other intangible assets   | (25,819)                         | (8,523)   |
| Additions to notes receivable  | (2,871)                          | (2,823)   |
| Proceeds received on notes receivable  | 7,555                            | 2,395     |
|  | (114,122)                        | (969,711) |
| <b>Cash flows from financing activities:</b>   |                                  |           |
| Proceeds from issuance of debt   | 519,062                          | 810,360   |
| Repayments of debt   | (613,567)                        | (911,468) |
| Proceeds from equity offering, net of transaction costs                                  |                                  | 715,392   |
| Proceeds from stock options exercised  | 2,037                            | 9,733     |
| Other  | (1,903)                          | (800)     |
|  | (94,371)                         | 623,217   |

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|  |                   |                   |
|--|-------------------|-------------------|
| Net increase (decrease) in cash and cash equivalents | 25,086            | (198,284)         |
| Cash and cash equivalents at beginning of period     | 33,814            | 242,458           |
|  | <u>          </u> | <u>          </u> |
| Cash and cash equivalents at end of period           | \$ 58,900         | \$ 44,174         |
|  | <u>          </u> | <u>          </u> |

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**

The consolidated financial statements include the accounts of Affiliated Computer Services, Inc. ( ACS ) and its majority-owned subsidiaries. All material intercompany profits, transactions and balances have been eliminated. We are a Fortune 1000 company comprised of approximately 37,000 full-time equivalent employees in 48 countries providing business process and technology outsourcing solutions to commercial, state and local government and federal government clients.

The financial information presented should be read in conjunction with our consolidated financial statements for the year ended June 30, 2002. The foregoing unaudited consolidated financial statements reflect all adjustments (all of which are of a normal recurring nature) 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.

All share and per share information is presented after giving effect to the two-for-one stock split of our Class A and Class B common shares declared on January 22, 2002, paid on February 22, 2002 in the form of a stock dividend to shareholders of record as of February 15, 2002.

Significant accounting policies are detailed in our Annual Report on Form 10-K for the year ended June 30, 2002. For discussion of our critical accounting policies, please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations.

**2. DEBT**

In September 2002, we entered into a new \$875 million senior unsecured revolving credit facility with a term of 39 months. This new facility replaced our \$450 million credit facility and the \$375 million interim credit facility, which was used to fund the acquisition of AFSA Data Corporation ( AFSA ) in June 2002. The new revolving credit agreement provides for unsecured borrowings at floating rates and fees based upon LIBOR and ACS credit ratings. As a result, rates will fluctuate with both changes in the overall interest rate environment as well as changes in ACS credit ratings. Currently borrowings bear interest at LIBOR plus 0.575%, a facility fee of 0.175% per annum on the committed amount of the facility plus a usage fee of 0.125% per annum on the total amount of outstanding borrowings. After March 2003, the usage fee will be applicable only when borrowings exceed \$437.5 million. The agreement matures in December 2005 and contains certain financial covenants. As of December 31, 2002, we were in compliance with the covenants of our credit facility.

As of December 31, 2002, we had approximately \$404 million available for use under the new facility, after giving effect to outstanding letters of credit of \$170 million that secure certain contractual performance and other obligations.

**3. GOODWILL AND OTHER INTANGIBLE ASSETS**

The changes in the carrying amount of goodwill for the quarter ended December 31, 2002 are as follow (in thousands):

|                                      | State and<br>Local<br>Government | Commercial | Federal<br>Government | Total        |
|--------------------------------------|----------------------------------|------------|-----------------------|--------------|
| Balance as of September 30, 2002     | \$ 1,054,499                     | \$ 655,566 | \$ 136,402            | \$ 1,846,467 |
| Goodwill activity during the quarter | 42                               | 9,089      |                       | 9,131        |
| Balance as of December 31, 2002      | \$ 1,054,541                     | \$ 664,655 | \$ 136,402            | \$ 1,855,598 |

Current quarter activity primarily reflects contingent consideration due to former shareholders of a prior year acquisition. This contingent consideration has been subsequently paid in January.

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

The following information relates to our intangibles as of December 31, 2002 (in thousands):

|  | <b>Gross Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> |
|--|----------------------------------|-------------------------------------|
| <b>Amortized intangible assets:</b>        |                                  |                                     |
| Acquired customer related intangibles      | \$ 146,600                       | \$(23,349)                          |
| Customer related intangibles               | 103,008                          | (40,341)                            |
| All other                                  | 4,011                            | (2,026)                             |
| <b>Total</b>                               | <b>\$253,619</b>                 | <b>\$(65,716)</b>                   |
| <b>Unamortized intangible asset:</b>       |                                  |                                     |
| Title plant                                | \$ 50,800                        |                                     |
| <b>Total</b>                               | <b>\$ 50,800</b>                 |                                     |
| <b>Aggregate amortization:</b>             |                                  |                                     |
| For the quarter ended December 31, 2002    |                                  | \$ 8,504                            |
| For the six months ended December 31, 2002 |                                  | \$17,290                            |
| <b>Estimated amortization:</b>             |                                  |                                     |
| For the year ended June 30, 2003           |                                  | \$33,482                            |
| For the year ended June 30, 2004           |                                  | \$30,397                            |
| For the year ended June 30, 2005           |                                  | \$27,167                            |
| For the year ended June 30, 2006           |                                  | \$22,074                            |
| For the year ended June 30, 2007           |                                  | \$18,884                            |

Amortization includes amounts charged to amortization expense for customer related intangibles and other intangibles, other than contract inducements. Amortization of contract inducements of \$1.7 million and \$2.9 million for the three and six months ended December 31, 2002, respectively, is recorded as a reduction to related contract revenue. Amortization expense for the three and six months ended December 31, 2002 includes approximately \$3.8 million and \$7.9 million, respectively, for acquired customer related intangibles. Customer related intangibles are amortized over the related contract term, which amortization period equates to a weighted average of approximately 8 years. All other intangibles are amortized over the related contract term, which amortization period equates to a weighted average of 9 years.

#### 4. DERIVATIVES AND COMPREHENSIVE INCOME

During fiscal year 2002, in order to manage interest costs and exposure to changing interest rates on our \$450 million revolving credit agreement, we held two interest rate hedges, designated as cash flow hedges, which were initiated in December 1998. Both interest rate hedges expired in December 2001. Each hedge was structured such that we paid a fixed rate of interest of 4.54%, and received a floating rate of interest based on one month LIBOR.

During fiscal year 2002, we held an investment in a marketable security. In order to manage the volatility of the value of our marketable security investment, we entered into a no-cost collar agreement in June 2001, which was settled and the investment sold in June 2002. The collar, a fair value hedge, was structured so that all fluctuations in the price of the marketable security above or below 100% or 102.5% of its value on the date the collar was entered into were hedged.

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

The components of comprehensive income are as follow (in the thousands):

|  | Three Months Ended<br>December 31, |           | Six Months Ended<br>December 31, |           |
|--|------------------------------------|-----------|----------------------------------|-----------|
|  | 2002                               | 2001      | 2002                             | 2001      |
| Net income   | \$ 74,001                          | \$ 55,560 | \$ 143,457                       | \$ 99,473 |
| Change in fair value of derivatives<br>(net of tax effect of \$0, \$159, \$0<br>and \$159, respectively) |                                    | 249       |                                  | 164       |
| Comprehensive income   | \$ 74,001                          | \$ 55,809 | \$ 143,457                       | \$ 99,637 |

**5. EARNINGS PER SHARE**

In accordance with Statement of Financial Accounting Standard No. 128, Earnings per Share, the following table (in thousands except per share amounts) sets forth the computation of basic and diluted earnings per share after giving effect to the two-for-one stock split paid on February 22, 2002:

|  | Three Months Ended<br>December 31, |           | Six Months Ended<br>December 31, |            |
|--|------------------------------------|-----------|----------------------------------|------------|
|  | 2002                               | 2001      | 2002                             | 2001       |
| <b>Numerator:</b>  |                                    |           |                                  |            |
| Numerator for basic earnings per share - income available to common stockholders   | \$ 74,001                          | \$ 55,560 | \$ 143,457                       | \$ 99,473  |
| Effect of dilutive securities:   |                                    |           |                                  |            |
| Interest on 4% convertible debt, net of tax  |                                    | 1,548     |                                  | 3,085      |
| Interest on 3.5% convertible debt, net of tax                                      | 2,055                              | 2,066     | 4,109                            | 4,118      |
| Numerator for diluted earnings per share - income available to common stockholders | \$ 76,056                          | \$ 59,174 | \$ 147,566                       | \$ 106,676 |
| <b>Denominator:</b>  |                                    |           |                                  |            |
| Weighted average basic shares outstanding  | 132,175                            | 118,572   | 132,124                          | 110,076    |
| Effect of dilutive securities:   |                                    |           |                                  |            |
| 4% convertible debt  |                                    | 10,780    |                                  | 10,780     |
| 3.5% convertible debt  | 7,298                              | 7,300     | 7,298                            | 7,300      |
| Stock options  | 3,822                              | 4,040     | 3,717                            | 3,862      |
| Total potential common shares  | 11,120                             | 22,120    | 11,015                           | 21,942     |
| Denominator for weighted average diluted shares                                    | 143,295                            | 140,692   | 143,139                          | 132,018    |
| Earnings per common share (basic)  | \$ .56                             | \$ .47    | \$ 1.09                          | \$ .90     |
| Earnings per common share assuming dilution  | \$ .53                             | \$ .42    | \$ 1.03                          | \$ .81     |



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

**6. SEGMENT INFORMATION**

Based on the criteria set forth in Statement of Financial Accounting Standards No. 131, Disclosure about Segments of an Enterprise and Related Information, we have three reportable segments: state and local government, commercial and federal government. Certain reclassifications have been made to the segment disclosure as the result of changes to our reporting structure. The following is a summary of certain financial information by reportable segment (in thousands):

|   | <b>State and<br/>Local<br/>Government</b> | <b>Commercial</b> | <b>Federal<br/>Government</b> | <b>Corporate</b> | <b>Consolidated</b> |
|---|---|-------------------|-------------------------------|------------------|---------------------|
| <b>Quarter Ended December 31, 2002</b>    |   |                   |                               |                  |                     |
| Revenues                                  | \$426,749                                 | \$291,747         | \$210,668                     | \$               | \$ 929,164          |
| Operating expenses                        | 346,206                                   | 222,382           | 188,418                       | 11,475           | 768,481             |
| EBITDA (a)                                | 80,543                                    | 69,365            | 22,250                        | (11,475)         | 160,683             |
| Depreciation and amortization expense     | 11,302                                    | 18,129            | 5,468                         | 818              | 35,717              |
| Operating income                          | \$ 69,241                                 | \$ 51,236         | \$ 16,782                     | \$(12,293)       | \$ 124,966          |
| <b>Quarter Ended December 31, 2001</b>    |   |                   |                               |                  |                     |
| Revenues                                  | \$325,258                                 | \$234,028(b)      | \$191,141(c)                  | \$               | \$ 750,427          |
| Operating expenses                        | 256,492                                   | 190,390           | 170,671                       | 7,954            | 625,507             |
| EBITDA (a)                                | 68,766                                    | 43,638            | 20,470                        | (7,954)          | 124,920             |
| Depreciation and amortization expense     | 8,373                                     | 13,934            | 4,662                         | 530              | 27,499              |
| Operating income                          | \$ 60,393                                 | \$ 29,704         | \$ 15,808                     | \$ (8,484)       | \$ 97,421           |
| <b>Six Months Ended December 31, 2002</b> |   |                   |                               |                  |                     |
| Revenues                                  | \$829,426                                 | \$579,275         | \$418,339                     | \$               | \$1,827,040         |
| Operating expenses                        | 671,180                                   | 442,097           | 375,327                       | 21,956           | 1,510,560           |
| EBITDA (a)                                | 158,246                                   | 137,178           | 43,012                        | (21,956)         | 316,480             |
| Depreciation and amortization expense     | 23,223                                    | 36,729            | 10,485                        | 1,422            | 71,859              |
| Operating income                          | \$135,023                                 | \$100,449         | \$ 32,527                     | \$(23,378)       | \$ 244,621          |
| <b>Six Months Ended December 31, 2001</b> |   |                   |                               |                  |                     |
| Revenues                                  | \$569,791                                 | \$454,338(b)      | \$381,317(c)                  | \$               | \$1,405,446         |
| Operating expenses                        | 446,721                                   | 373,082           | 342,197                       | 12,569           | 1,174,569           |
| EBITDA (a)                                | 123,070                                   | 81,256            | 39,120                        | (12,569)         | 230,877             |
| Depreciation and amortization expense     | 15,204                                    | 27,238            | 8,459                         | 1,013            | 51,914              |

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|                  |            |           |           |            |            |
|------------------|------------|-----------|-----------|------------|------------|
| Operating income | \$ 107,866 | \$ 54,018 | \$ 30,661 | \$(13,582) | \$ 178,963 |
|------------------|------------|-----------|-----------|------------|------------|

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- (a) EBITDA consists of earnings before interest income, interest expense, other non-operating income and expense, income taxes, depreciation and amortization. EBITDA is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as an alternative to net income as an indicator of a company's performance or to cash flows from operating activities as a measure of liquidity. Our measure of EBITDA may not be comparable to similarly titled measures of other companies.
- (b) Commercial segment includes \$12.1 million and \$20.2 million for the three months and six months ended December 31, 2001, respectively, of revenue related to divested units.
- (c) Federal government segment includes \$1.6 million and \$3.3 million for the three months and six months ended December 31, 2001, respectively, of revenue related to divested units.



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The following reconciles consolidated operating income to consolidated pretax profit (in thousands):

|   | Three Months Ended<br>December 31, |                  | Six Months Ended<br>December 31, |                   |
|---|------------------------------------|------------------|----------------------------------|-------------------|
|   | 2002                               | 2001             | 2002                             | 2001              |
| Consolidated operating income             | \$ 124,966                         | \$ 97,421        | \$ 244,621                       | \$ 178,963        |
| Interest expense                          | 6,147                              | 7,583            | 13,201                           | 20,182            |
| Other non-operating (income) expense, net | 417                                | 942              | 1,889                            | (374)             |
| Consolidated pretax profit                | <u>\$ 118,402</u>                  | <u>\$ 88,896</u> | <u>\$ 229,531</u>                | <u>\$ 159,155</u> |

**7. RELATED PARTY TRANSACTIONS**

As of June 30, 2002, we held a minority preferred stock interest in DDH Aviation, Inc., a corporate airplane brokerage company organized in 1997 ( DDH ). Our Chairman owns a majority voting interest in DDH and our President and General Counsel, along with our Chairman were directors of DDH. At June 30, 2002, DDH had a \$48 million line of credit with Citicorp USA, Inc., for which we and our Chairman, in exchange for warrants to acquire additional voting stock, acted as partial guarantors. In addition, we obtained access to corporate aircraft at favorable rates in consideration of its guaranty. We had guaranteed up to approximately \$11.5 million of the line of credit and our Chairman guaranteed up to approximately \$17.5 million of the line of credit.

Subsequent to June 30, 2002, our Chairman assumed in full our guaranty obligations to Citicorp and our guaranty to Citicorp was released in full. Our minority preferred stock interest and warrants (with a recorded value of \$100,000 at June 30, 2002) in DDH were cancelled. We have no further contingent liability related to DDH debt and no ownership interest in DDH. Our officers, other than the Chairman, are no longer directors of DDH. In July 2002, we purchased \$1.0 million in prepaid charter flights at favorable rates from DDH.

**8. ACQUISITIONS**

In August 2001, we acquired 100% of the stock of Lockheed Martin IMS Corporation ( IMS ), a wholly owned subsidiary of Lockheed Martin Corporation, for approximately \$825 million plus related transaction costs. The acquisition was funded from a \$550 million 18-month interim credit facility, borrowings from our \$450 million revolving credit facility, and existing cash on hand. The \$550 million 18-month interim credit facility was repaid in October 2001 with the proceeds of our issuance of Class A common stock. IMS results have been included in our consolidated financial statements from the effective date of the acquisition, August 1, 2001.

In June 2002 we acquired AFSA, a subsidiary of FleetBoston Financial Corporation, for approximately \$410 million plus related transaction costs. The acquisition was funded with a combination of a \$375 million 18-month interim credit facility, borrowings from our existing revolving credit facility, and existing cash on hand. The \$375 million interim credit facility was repaid in September 2002 with the proceeds of our \$875 million 39-month revolving credit facility (see Note 2). AFSA s results of operations have been included in our consolidated financial statements from the effective date of the acquisition, June 1, 2002.

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Pro forma Financial Information

The following unaudited pro forma information presents a summary of our consolidated results of operations as if the IMS acquisition and the AFSA acquisition had occurred at the beginning of the periods presented and are not necessarily indicative of future results or actual results that would have been achieved had the acquisition occurred at the beginning of the periods presented.

|                            | For the three months ended<br>December 31, |           | For the six months ended December 31, |             |
|----------------------------|--|-----------|---------------------------------------|-------------|
|                            | 2002                                       | 2001      | 2002                                  | 2001        |
| Revenue                    | \$929,164                                  | \$791,140 | \$1,827,040                           | \$1,535,542 |
| Net income                 | 74,001                                     | 64,633    | 143,457                               | 118,286     |
| Earnings per common share: |  |           |                                       |             |
| Basic                      | \$ .56                                     | \$ .55    | \$ 1.09                               | \$ 1.07     |
| Diluted                    | \$ .53                                     | \$ .49    | \$ 1.03                               | \$ .95      |

**9. COMMITMENTS AND CONTINGENCIES**

On December 16, 1998, a state district court in Houston, Texas entered final judgment against us in a lawsuit brought by 21 former employees of Gibraltar Savings Association and/or First Texas Savings Association (collectively, GSA/FTSA ). The GSA/FTSA employees alleged that they were entitled to the value of 803,082 shares of our stock (adjusted for February 2002 stock split) pursuant to options issued to the GSA/FTSA employees in 1988 in connection with a former technology outsourcing services agreement between GSA/FTSA and us. The judgment against us was for approximately \$17 million, which includes attorneys' fees and pre-judgment interest, but excludes additional attorneys' fees of approximately \$0.9 million and post-judgment interest at the statutorily mandated rate of 10% per annum, which could be awarded in the event the plaintiffs are successful upon appeal and final judgment. The judgment was appealed by the plaintiffs and us.

On August 29, 2002, the Fourteenth Court of Appeals, Houston, Texas, reversed the trial court's judgment and remanded the case to the trial court for further proceedings. However, the court of appeals affirmed the trial court judgment in part as to one of the plaintiffs. The court of appeals also held that the trial court did not err in dismissing certain of our affirmative defenses at a pretrial conference. We and the plaintiffs filed motions for rehearing with the court of appeals. On January 16, 2003, the court of appeals denied both motions for rehearing (except the court reversed its previous ruling that the trial court should have applied prejudgment interest at 6% rather than 10%). We intend to appeal to the Texas Supreme Court.

We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs' claims, and accordingly, have not accrued any amount on our balance sheet related to the lawsuit. We would be subject to a material charge if the Texas Supreme Court upon appeal were to reverse the decision of the court of appeals and affirm the trial court judgment.

**10. NEW ACCOUNTING STANDARDS**

In June 2002, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 146 Accounting for Costs Associated with Exit or Disposal Activities ( SFAS 146 ), which changes the rules for how companies must account for costs associated with exit or disposal activities. Costs typically associated with exit or disposal activities include one-time employee termination costs, contract cancellation provisions, and relocation costs. SFAS 146 nullifies EITF Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The provisions of the new standard are effective for exit or disposal activities initiated after December 31, 2002, with early application encouraged. We do not believe that SFAS 146 will have a material impact on our future earnings and financial condition.

Emerging Issues Task Force Issue 00-21 Accounting for Revenue Arrangements with Multiple Deliverables ( EITF 00-21 ) addresses the accounting treatment for an arrangement to provide the delivery or performance of multiple products and/or services

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where the delivery of a product or system or performance of services may occur at different points in time or over different periods of time. The arrangements are often accompanied by initial installation, initiation, or activation services and involve either a fixed fee or a fixed fee coupled with a continuing payment stream, which may be fixed or variable. The EITF reached a consensus regarding, among other issues, the applicability of the provisions regarding separation of contract elements in EITF 00-21 to contracts where one or more elements fall within the scope of other authoritative literature, such as Statement of Position 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts ( SOP 81-1 ). EITF 00-21 does not impact the use of SOP 81-1 for contracts that fall within the scope of SOP 81-1, such as the implementation or building of an information technology system to client specifications under a long-term contract. Where an implementation or development project is contracted with a client, and the vendor will also provide services or operate the system over a period of time, EITF 00-21 provides the methodology for separating the contract elements and earnings processes. The provisions of EITF 00-21 will be applicable on a prospective basis to transactions entered into in fiscal years beginning after June 15, 2003. We do not believe that EITF 00-21 will have a material impact on our financial position or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 Accounting for Stock-Based Compensation Transition and Disclosure ( SFAS 148 ). SFAS 148 provides alternative methods of transition for companies that voluntarily adopt the fair value based method of accounting for stock-based employee compensation in accordance with Statement of Financial Accounting Standards No. 123 Accounting for Stock-Based Compensation ( SFAS 123 ). SFAS 148 also amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 also amends Accounting Principles Board Opinion No. 28 Interim Financial Reporting ( APB 28 ) to require disclosure about the effect of the method of accounting for stock-based employee compensation on reported results in interim financial reporting. The amendments to SFAS 123 relating to transition and annual disclosure provisions are effective for fiscal years ending after December 15, 2002. The amendments to SFAS 123 and APB 28 relating to disclosure provisions in interim reporting are effective for financial reports for interim periods beginning after December 15, 2002. We intend to adopt the disclosure-only provisions of SFAS 148, therefore, we do not believe that SFAS 148 will have a material impact on our financial position or results of operations.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

All statements in this Management's Discussion and Analysis of Financial Condition and Results of Operations that are not based on historical fact are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and the provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (which Sections were adopted as part of Private Securities Litigation Reform Act of 1995). While management has based any forward-looking statements contained herein on its current expectations, the information on which such expectations were based may change. These forward-looking statements rely on a number of assumptions concerning future events and are subject to a number of risks, uncertainties, and other factors, many of which are outside of our control, that could cause actual results to materially differ from such statements. Such risks, uncertainties, and other factors include, but are not necessarily limited to, those set forth under the caption Risks Related to our Business. In addition, we operate in a highly and rapidly changing environment, and new risks may arise. Accordingly, investors should not place any reliance on forward-looking statements as a prediction of actual results. We disclaim any intention to, and undertake no obligation to, update or revise any forward-looking statement.

**GENERAL**

During the three months ended December 31, 2002, we signed new contracts with new clients and incremental business with existing clients representing \$242 million of annualized recurring revenue, including new contracts with Motorola, Inc. to provide human resource business process outsourcing services; Ingram Micro to manage their IT infrastructure; and with the New Jersey toll agencies to operate the New Jersey E-Z pass toll collection system. The commercial segment contributed 56% of the new contract signings, the state and local governments segment contributed 36% and the federal government segment contributed the remaining 8%. Fiscal year-to-date new business signings represent \$386 million of annualized recurring revenue.

We closed no significant acquisitions in the six months ended December 31, 2002. In the six months ended December 31, 2001, we closed two transactions: the acquisition of Lockheed Martin IMS Corporation (IMS), a wholly-owned subsidiary of Lockheed Martin Corporation, which is now a part of our state and local government segment; and the acquisition of the business process outsourcing services unit of National Processing Company (NPC).

IMS, with its principal offices located in Washington D.C. and approximately 4,800 employees primarily throughout the United States, provides services to state and local government agencies in child support enforcement, welfare and workforce services, child care management, electronic toll collection, and other intelligent transportation services involving the trucking industry, photo enforcement of red-light and speeding violations, parking management, and information technology outsourcing. The transaction, valued at \$825 million plus related transaction costs, was initially funded through a combination of a \$550 million, 18-month interim credit facility, borrowings on our existing credit facility and existing cash on hand, which was repaid in October 2001 with proceeds from our issuance of Class A common stock. IMS operating results are included in our financial statements from the effective date of the acquisition, August 1, 2001.

NPC provides healthcare claims processing, credit card application processing and airline lift ticket processing. As part of the transaction, we acquired all of NPC's offshore operations in Jamaica, the Dominican Republic, Barbados and a majority of NPC's Mexican operations. The transaction value was \$43 million plus related transaction costs. NPC's operating results are included in our financial statements from the effective date of the acquisition, August 1, 2001.

In addition to the IMS and NPC acquisitions that were completed in the six months ended December 31, 2001, we acquired six other companies in fiscal year 2002, the most significant of which are discussed below.

In May 2002, we acquired the finance and accounting business process outsourcing unit of Andersen Worldwide (Andersen). Included in this acquisition are contracts with General Motors (GM) and the University of Phoenix (the University). Under a new 10-year agreement with GM, we will provide transactional accounting services such as payroll processing, disbursement processing, dealer accounting, accounts receivable processing, lease and subsidiary accounting, and expense reporting in the United States and Europe. Under the arrangement with the University, we will provide student financial aid business process outsourcing services to the University including federal eligibility determinations, loan and grant processing, and disbursement of student aid as well as other support services related to student financial aid processing. The transaction was valued at approximately \$65 million plus related transaction costs. Andersen's operating results are included in our financial statements from the effective date of the acquisition, May 1, 2002 for the domestic operations, and June 1, 2002 for the foreign operations.

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In June 2002, we acquired AFSA Data Corporation ( AFSA ), a subsidiary of FleetBoston Financial Corporation, for approximately \$410 million plus related transaction costs. AFSA is the nation's largest educational services company, servicing a student loan portfolio of 8.1 million borrowers with outstanding loans of approximately \$85 billion. Additionally, AFSA is a leading business process outsourcer for federal, state, and local governments for a variety of health and human services programs, including Medicare, Medicaid, children's health insurance programs (CHIP), and welfare-to-workforce services. AFSA's operating results are included in our financial statements from the effective date of the acquisition, June 1, 2002.

Our largest contract for services is with the Department of Education, for which we service student loans under the Department of Education's Direct Student Loan program administered by its Office of Federal Student Aid ( FSA ). Revenues from this contract represent approximately 4% of our consolidated revenues. This contract was scheduled to run through September 30, 2003. In November 2001, the Department extended the contract term through September 30, 2006, with an option for further extension through September 30, 2007. In December 2001, Sallie Mae challenged the Department's sole-source extension in a protest filed with the Department. The FSA initially took the position that the Sallie Mae protest was without merit and that the contract extension was lawful. In July 2002, the Department's deciding official sustained the protest, concluding that further market research was needed to support the sole-source extension of our contract. However, the deciding official declined to rescind our contract extension and directed the FSA to analyze its direct loan servicing needs and procure the services in compliance with law.

On January 31, 2003, after conducting market research to improve FSA's knowledge of industry's capabilities, FSA officials notified us that they intend to conduct a competitive process for servicing of the Direct Student Loan program. We believe we are positioned favorably for this competitive bid process because of our performance record with the Department. However, there can be no assurance that we will be awarded an extension or new contract in the competitive bid process.

**RESULTS OF OPERATIONS**

The following table sets forth certain items from our consolidated statements of income as a percentage of revenues:

|   | Three Months Ended<br>December 31, |                   | Six Months Ended<br>December 31, |                   |
|---|------------------------------------|-------------------|----------------------------------|-------------------|
|   | 2002                               | 2001              | 2002                             | 2001              |
| Revenues                                  | 100%                               | 100%              | 100%                             | 100%              |
| Expenses:                                 |                                    |                   |                                  |                   |
| Wages and benefits                        | 43.5                               | 43.6              | 44.2                             | 44.4              |
| Services and supplies                     | 28.5                               | 29.9              | 27.7                             | 28.3              |
| Rent, lease and maintenance               | 9.4                                | 8.8               | 9.4                              | 9.9               |
| Depreciation and amortization             | 3.8                                | 3.7               | 3.9                              | 3.7               |
| Other operating expenses                  | 1.4                                | 1.0               | 1.4                              | 1.0               |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Total operating expenses                  | 86.6                               | 87.0              | 86.6                             | 87.3              |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Operating income                          | 13.4                               | 13.0              | 13.4                             | 12.7              |
| Interest expense                          | 0.7                                | 1.0               | 0.7                              | 1.4               |
| Other non-operating (income) expense, net | 0.0                                | 0.1               | 0.1                              | 0.0               |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Pretax profit                             | 12.7                               | 11.9              | 12.6                             | 11.3              |
| Income tax expense                        | 4.7                                | 4.5               | 4.7                              | 4.2               |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |
| Net income                                | 8.0%                               | 7.4%              | 7.9%                             | 7.1%              |
|   | <u>          </u>                  | <u>          </u> | <u>          </u>                | <u>          </u> |

**COMPARISON OF THE QUARTER ENDED DECEMBER 31, 2002 TO THE QUARTER ENDED DECEMBER 31, 2001***Revenues*

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In the second quarter of fiscal 2003, our revenue increased \$178.7 million, or 24%, to \$929.2 million from \$750.4 million in the second quarter of fiscal 2002. Internal revenue growth was 17% and the remainder was due to acquisition growth.

Revenue in our state and local governments segment, which represents 46% of revenue for the second quarter of fiscal 2003, increased \$101.5 million, or 31%, to \$426.7 million in the second quarter of fiscal 2003 compared to the same period last year. Internal growth of 25% resulted from ramp up of contracts signed in fiscal year 2002 in our state healthcare, welfare to workforce services and transportation system and services businesses. The remaining growth was primarily due to the impact of the AFSA acquisition in late fiscal 2002.

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Revenue in our commercial segment, which represents 31% of revenue for the second quarter of fiscal 2003, increased \$57.7 million, to \$291.7 million in the second quarter of fiscal 2003 compared to the same period last year. Excluding second quarter fiscal 2002 revenue from divested units, internal growth was 15%. Internal growth was primarily driven by the ramp up of new IT outsourcing and finance and accounting BPO contracts signed in fiscal 2002. The remaining growth was primarily due to the impact of the AFSA and Andersen acquisitions closed in the fourth quarter of fiscal 2002.

Revenue in our federal government segment, which represents 23% of revenue for the second quarter of fiscal 2003, increased \$19.5 million, to \$210.7 million in the second quarter of fiscal 2003 compared to the same period last year. Excluding second quarter fiscal 2002 revenue from divested units, internal growth was 8%. Internal growth for the quarter was primarily driven by growth in services provided to Department of Defense agencies, which represents 57% of our federal government revenue for the second quarter of fiscal 2003, and was adversely impacted by the June 2002 non-renewal of the Senate desktop contract.

### *Operating Expenses*

As a percentage of revenue, our operating expenses decreased 0.4% to 86.6% in the second quarter of fiscal 2003 from 87.0% in the second quarter of fiscal 2002. Our operating expenses increased \$151.2 million, or 23.2% to \$804.2 million in the second quarter of fiscal 2003 from \$653.0 million in the second quarter of fiscal 2002.

Wages and benefits increased \$76.5 million, or 23.4% to \$403.9 million. As a percentage of revenue, wages and benefits decreased 0.1% to 43.5%, primarily due to revenue generated on new contracts in our state and local government and commercial segments that have a lower component of wages and benefits. The decline was partially offset by the shift of costs on the Department of Education contract from services and supplies to wages and benefits as a result of the AFSA acquisition in late fiscal 2002. Prior to the acquisition, AFSA served as a sub-contractor on this contract, and therefore the payments to AFSA were included in services and supplies. Subsequent to the acquisition, AFSA's employee costs related to this contract are included in our wages and benefits.

Services and supplies increased \$39.8 million, or 17.7%, to \$264.5 million. As a percentage of revenue, services and supplies decreased 1.4% to 28.5%, primarily due to the shift of costs on the Department of Education contract discussed above.

Rent, lease and maintenance increased \$21.0 million, or 31.8%, to \$86.9 million. As a percentage of revenue, rent, lease and maintenance increased 0.6% due to new IT outsourcing contracts in our commercial segment.

Depreciation and amortization increased \$8.2 million, or 29.9%, to \$35.7 million. As a percentage of revenue, depreciation and amortization increased 0.1%, to 3.8% due to capital expenditures during fiscal 2002 and the first half of fiscal 2003 and increased intangible asset amortization associated with acquisitions occurring since the second quarter of fiscal 2002.

Other operating expenses increased \$5.7 million, or 77.1%, to \$13.1 million. As a percentage of revenue, other operating expenses increased 0.4% to 1.4% due to several factors, including customer related expenses and legal expenses.

### *Operating Margins*

Our operating margins (defined as operating income divided by revenue) increased 0.4% to 13.4% in the second quarter of fiscal 2003 as compared to 13.0% in the second quarter of fiscal 2002 due primarily to a larger percentage of BPO services in our revenue mix. BPO services typically have higher operating margins than traditional IT outsourcing services.

### *Interest expense*

Interest expense decreased \$1.4 million in the second quarter of fiscal 2003 compared to the second quarter of fiscal 2002, primarily as a result of the conversion to equity of our 4% Subordinated Convertible Notes in March 2002. This was somewhat offset by interest costs related to higher outstanding balances on our revolving credit facility in the second quarter of fiscal 2003 as a result of acquisitions completed in the fourth quarter of fiscal 2002.

### *Tax Expense*

Our effective tax rate of approximately 37.5% in fiscal 2003 exceeds the federal statutory rate of 35% due primarily to the net effect of state income taxes.

## **COMPARISON OF THE SIX MONTHS ENDED DECEMBER 31, 2002 TO THE SIX MONTHS ENDED DECEMBER 31, 2001**

*Revenues*

For the six months ended December 31, 2002, our revenue increased \$421.6 million, or 30%, to \$1.8 billion from \$1.4 billion for the six months ended December 31, 2001. Excluding fiscal 2002 revenue from divested units, internal revenue growth was 19% and the remainder was due to growth from acquisitions.



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Revenue in our state and local segment, which represents 45% of revenue for the first six months of fiscal 2003, increased \$259.6 million, or 46%, to \$829.4 million for the first six months of fiscal 2003 compared to the same period last year. Internal growth of 29% was due to ramp up of contracts signed in fiscal 2002 and early fiscal 2003 in our state healthcare, welfare to workforce services and transportation systems and services businesses. The remaining revenue growth was related to acquisitions.

Revenue in our commercial segment, which represents 32% of revenue for the first six months of fiscal 2003, increased \$124.9 million, or 27%, to \$579.3 million for the first six months of fiscal 2003 compared to the same period last year. Excluding fiscal 2002 revenue from divested units, internal growth was 15%. Internal growth was driven by the ramp up of contracts signed for IT outsourcing and finance and accounting BPO services in fiscal 2002. The remaining revenue growth is primarily due to AFSA and Andersen acquisitions in late fiscal 2002.

Revenue in our federal government segment, which represents 23% of revenue for the first six months of fiscal 2003, increased \$37.0 million, or 10%, to \$418.3 million for the first six months of fiscal 2003 as compared to the same period last year. Excluding fiscal 2002 revenue from divested units, internal growth was 7%. Internal growth was primarily driven by growth in services provided to Department of Defense agencies, which represents 55% of our federal government revenue for the first six months of fiscal 2003. Internal growth was adversely impacted by the June 2002 non-renewal of the Senate desktop contract.

### *Operating Expenses*

As a percentage of revenue, operating expenses decreased 0.7%, to 86.6% for the first six months of fiscal 2003 from 87.3% for the same period last year. Operating expenses increased \$355.9 million, or 29.0%, to \$1.6 billion in the first six months of fiscal 2003 compared to \$1.2 billion for the first six months of fiscal 2002.

Wages and benefits increased \$182.5 million, or 29.2%, to \$806.8 million. As a percentage of revenue, wages and benefits decreased 0.2%, to 44.2% primarily due to increased revenue generated on new contracts in our state and local government segment that do not result in increased headcount and salaries and revenue but result in an increase in outside services and supplies or rent, lease and maintenance. This decline was partially offset by the shift in costs on the Department of Education contract from services and supplies to wages and benefits as a result of the AFSA acquisition. Prior to the acquisition, AFSA served as a sub-contractor on this contract, and therefore the payments to AFSA were included in services and supplies. Post acquisition, AFSA's employee costs related to this contract are included in our wages and benefits.

Services and supplies increased \$108.8 million, or 27.4%, to \$506.3 million. As a percentage of revenue, services and supplies decreased 0.6% due to primarily to the shift of costs on the Department of Education contract from services and supplies to wages and benefits as a result of the AFSA acquisition in late fiscal 2002 discussed above. This decrease was partially offset by increased direct costs on new contracts in our state and local government segment in fiscal 2003 as discussed above as well as costs associated with our pursuit of the potential transaction with Procter & Gamble Co., as negotiations were terminated in September 2002.

Rent, lease and maintenance increased \$32.4 million, or 23.3%, to \$171.3 million. As a percentage of revenue, rent, lease and maintenance decreased 0.5%, to 9.4% due to the increase of BPO services in our revenue mix, which has a lower component of rent, lease and maintenance than traditional IT outsourcing.

Depreciation and amortization increased \$19.9 million, or 38.4%, to \$71.9 million. As a percentage of revenue, depreciation and amortization increased 0.2%, to 3.9% due to increased capital expenditures during fiscal 2002 and the first half of fiscal 2003 and increased intangible amortization as a result of acquisitions occurring since the second quarter of fiscal 2002.

Other operating expenses increased \$12.3 million, or 89.1%, to \$26.2 million. As a percentage of revenue, other operating expenses increased 0.4% to 1.4%, primarily related to costs associated with our pursuit of the potential transaction with Procter & Gamble Co., bad debt expenses, legal expenses and other customer related expenses.

### *Operating Margins*

Our operating margins increased 0.7%, to 13.4% in the first six months of fiscal 2003 from 12.7% in the first six months of fiscal 2002, due to primarily to a larger percentage of BPO services in our revenue mix. BPO services typically have higher operating margins than traditional IT outsourcing services. Margins during the first six months of fiscal 2003 were adversely impacted by the \$2.3 million of costs incurred in pursuing the potential transaction with Procter & Gamble, as negotiations were terminated in September 2002 and the ramp up period related to new business.

### *Interest expense*

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Interest expense decreased \$7.0 million, or 34.6%, to \$13.2 million in the first six months of fiscal 2003 compared to the first six months of fiscal 2002, primarily as a result of the conversion to equity of our 4% Subordinated Convertible Notes in March 2002 and approximately \$1.5 million of one-time financing costs related to the IMS acquisition recorded in the first six months of fiscal 2002.

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### *Other non-operating (income) expense, net*

Other non-operating (income) expense decreased \$2.3 million for the first six months of fiscal 2003 compared to the first six months of fiscal 2002. Other non-operating (income) expense for the six months ended December 31, 2001 includes a \$1 million writedown of a long-term investment. Other non-operating (income) expense for the six months ended December 31, 2002 includes \$2.0 million of writedowns of long-term investments. Interest income on cash and cash equivalents was approximately \$1.8 million lower for the first six months of fiscal year 2003 than 2002, due to lower cash balances. Cash on hand at June 30, 2001 was used to fund the IMS acquisition in August 2001.

### *Tax Expense*

Our effective tax rate of approximately 37.5% in fiscal 2003 exceeds the federal statutory rate of 35% due primarily to the net effect of state income taxes.

## **LIQUIDITY AND CAPITAL RESOURCES**

We finance our ongoing business operations through cash flows from operations and utilize excess cash flow combined with the issuance of debt and equity to finance our acquisition strategy. One of our primary financial goals is to maintain an adequate level of liquidity through active management of assets and liabilities.

During the six months ended December 31, 2002, we generated approximately \$233.6 million in cash flow from operations versus approximately \$148.2 million in the same period in fiscal year 2002. Free cash flow, defined as cash flows from operations of approximately \$233.6 million less property, equipment and purchased software additions of approximately \$92.5 million for the first six months of fiscal 2003, was approximately \$141.0 million for the first six months of fiscal year 2003 compared to approximately \$69.7 million for the same period in fiscal year 2002.

During the six months ended December 31, 2002, we used \$114.1 million for investing activities. This includes \$92.5 million in fiscal year 2003 related to the purchase of property, equipment and software versus \$78.6 million in the same period in fiscal year 2002. Our capital expenditures remain at approximately 5% of total revenues, which we believe is adequate to support our growing business and to meet contractual requirements. We used \$6.4 million in cash for payments related to recent acquisitions, primarily the payment of transaction costs related to the AFSA acquisition in June 2002.

During the first six months of fiscal year 2003, cash used by financing activities was \$94.4 million. We entered into a new \$875 million credit facility on terms generally similar to our existing credit facility, which was partially used to refinance the \$375 million interim credit facility used to fund the AFSA acquisition and which replaced our existing \$450 million credit facility. Financing activities in the six months ended December 31, 2001 included our offering of 18.4 million shares of our Class A common stock (adjusted for stock split). The shares were issued at \$40.50 per share yielding proceeds of \$714.3 million (net of underwriters' fees and other costs), which were used to repay the \$550 million 18-month interim credit facility incurred to fund the IMS acquisition and a portion of the amount outstanding under our revolving credit facility.

As of December 31, 2002, we had approximately \$618.9 million of long-term debt outstanding, which was primarily comprised of approximately \$317 million of our 3.5% Convertible Subordinated Notes due February 15, 2006 and approximately \$301 million outstanding under our \$875 million credit facility. At December 31, 2002, we had approximately \$404 million available on our \$875 million revolving credit facility after considering outstanding letters of credit of \$170 million that secure certain contractual performance and other obligations.

At December 31, 2002, we had cash and cash equivalents of \$58.9 million compared to \$33.8 million at June 30, 2002. Included in the cash balances were \$5.4 million at both December 31, 2002 and June 30, 2002 of restricted cash held on behalf of governmental customers.

Our working capital (defined as current assets of \$929.6 million less current liabilities of \$494.5 million) increased \$46.5 million to \$435.1 million at December 31, 2002 from \$388.6 million at June 30, 2002 due to increased cash balances as a result of strong cash flow from operations for the first six months of fiscal 2002 and higher accounts receivable, net as a result of growth in our business. Our current ratio (defined as total current assets of \$929.6 million divided by total current liabilities of \$494.5 million) was 1.9 and 1.8 at December 31, 2002 and June 30, 2002, respectively, and our debt to capitalization ratio (defined as the sum of short-term and long-term debt divided by the sum of short-term and long-term debt and equity) was 21.7% and 25.3% at December 31, 2002 and June 30, 2002, respectively. Our EBITDA (defined as earnings before interest income, interest expense, other non-operating income and expense, income taxes, depreciation and amortization) to interest coverage ratio was 26 times interest for the quarter ended December 31, 2002 as compared to 17 times interest for the year ended June 30, 2002.

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Due to the terrorist attacks on September 11, 2001 and the well-documented bankruptcies of several large companies (e.g. Enron, Kmart, and WorldCom), the surety bond market has substantially changed, resulting in reduced availability of bonds and increased premiums. Some of our state and local government contracts require either a bond or a letter of credit and future requests for proposal

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may require a surety bond or letter of credit. Notwithstanding the existing condition of the surety bond market, management believes that we have sufficient liquidity from our cash flow and under our revolving credit facility to meet ongoing business needs and to respond to future requests for proposals from state and local governments.

As of June 30, 2002, we held a minority preferred stock interest in DDH Aviation, Inc., a corporate airplane brokerage company organized in 1997 ( DDH ). Our Chairman owns a majority voting interest in DDH and our President and General Counsel, along with our Chairman were directors of DDH. At June 30, 2002, DDH had a \$48 million line of credit with Citicorp USA, Inc., for which we and our Chairman, in exchange for warrants to acquire additional voting stock, acted as partial guarantors. In addition, we obtained access to corporate aircraft at favorable rates in consideration of its guaranty. We had guaranteed up to approximately \$11.5 million of the line of credit and our Chairman guaranteed up to approximately \$17.5 million of the line of credit.

Subsequent to June 30, 2002, our Chairman assumed in full our guaranty obligations to Citicorp and our guaranty to Citicorp was released in full. Our minority preferred stock interest and warrants (with a recorded value of \$100,000 at June 30, 2002) in DDH were cancelled. We have no further contingent liability related to DDH debt and no ownership interest in DDH. Our officers, other than the Chairman, are no longer directors of DDH. In July 2002, we purchased \$1.0 million in prepaid charter flights at favorable rates from DDH.

Management believes that available cash and cash equivalents, together with cash generated from operations and available borrowings under our credit facility, will provide adequate funds for our anticipated internal growth needs, including capital expenditures. Our management also believes that cash provided by operations will be sufficient to satisfy all existing debt obligations as they become due. However, we intend to continue our growth through acquisitions and from time to time to engage in discussions with potential acquisition candidates, which could require significant commitments of capital. In order to pursue such opportunities we may be required to incur debt or to issue additional potentially dilutive securities in the future. No assurance can be given as to our future acquisitions and expansion opportunities and how such opportunities will be financed.

**DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS AS OF DECEMBER 31, 2002 (IN THOUSANDS):**

| Contractual Obligations                   | Payments Due by Period |                  |                   |                   |                  |
|---|------------------------|------------------|-------------------|-------------------|------------------|
|   | Total                  | Less than 1 Year | 1-3 Years         | 3-5 Years         | After 5 Years    |
| Long-term debt                            | \$ 617,990             | \$               | \$ 301,000        | \$ 316,990        | \$               |
| Capital lease obligations                 | 1,537                  | 626              | 911               |                   |                  |
| Operating leases                          | 279,180                | 81,151           | 101,015           | 49,450            | 47,564           |
| <b>Total Contractual Cash Obligations</b> | <b>\$ 898,707</b>      | <b>\$ 81,777</b> | <b>\$ 402,926</b> | <b>\$ 366,440</b> | <b>\$ 47,564</b> |

| Other Commercial Commitments        | Amount of Commitment Expiration per Period |                   |                  |             |               |
|-------------------------------------|--|-------------------|------------------|-------------|---------------|
|                                     | Total Amounts Committed                    | Less than 1 Year  | 1-3 Years        | 3-5 Years   | After 5 Years |
| Standby letters of credit           | \$ 170,455                                 | \$ 170,455        | \$               | \$          | \$            |
| Surety Bonds                        | 329,601                                    | 319,554           | 10,040           | 7           |               |
| <b>Total Commercial Commitments</b> | <b>\$ 500,056</b>                          | <b>\$ 490,009</b> | <b>\$ 10,040</b> | <b>\$ 7</b> | <b>\$</b>     |

We are obligated to make certain contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria. As of December 31, 2002, the maximum aggregate amount of the outstanding contingent obligations is approximately \$17.0 million, of which \$8.0 million has been earned to date which was included in other accrued liabilities as of December 31, 2002 and paid in January 2003. Upon satisfaction of the specified contractual criteria, a corresponding increase in goodwill would be recorded.

**CRITICAL ACCOUNTING POLICIES**

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The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions relating to the reporting of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. We base our estimates on historical experience and on various other assumptions or conditions that

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are believed to be reasonable under the circumstances. Actual results could differ from those estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties and may result in materially different results under different assumptions and conditions. We believe that the following critical accounting policies involve significant judgments and estimates used in the preparation of our consolidated financial statements.

**Revenue recognition.** Our policy follows the guidance from Staff Accounting Bulletin 101 Revenue Recognition in Financial Statements ( SAB 101 ). SAB 101 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements. We recognize revenues when persuasive evidence of an arrangement exists, the product has been shipped or the services have been provided to the client, the sales price is fixed or determinable, and collectibility is reasonably assured.

Approximately two-thirds of our revenue is recognized based on transaction volumes, approximately 15% is related to time and material contracts, approximately 12% is related to cost reimbursable contracts, and less than 5% of our revenues are recognized using percentage-of-completion accounting.

Generally, information technology processing revenues are recognized as services are provided to the client. Revenues from annual maintenance contracts are deferred and recognized ratably over the maintenance period. Revenues from hardware sales are recognized upon delivery to the client and when uncertainties regarding customer acceptance have expired.

Revenues for business process outsourcing services are normally recognized on the basis of the number of accounts or transactions processed.

In the federal government segment, our contracts are typically cost reimbursable, fixed price, unit price, or time and material contracts. Revenues on cost reimbursable contracts are recognized by applying an estimated factor to costs as incurred, such factor being determined by the contract provisions and prior experience. Revenues on unit-price contracts are recognized at the contractual selling prices of work completed and accepted by the client. Revenues on time and material contracts are recognized at the contractual rates as the labor hours and direct expenses are incurred.

Revenues on fixed price contracts are recognized over the contract term based on the percentage of services that are provided during the period compared with the total estimated services to be provided over the entire contract using Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts ( SOP 81-1 ), which requires the use of percentage-of-completion accounting for long-term contracts that are binding agreements between ACS and our customers in which we agree, for compensation, to perform a service to the customer's specifications. Performance will often extend over long periods, and our right to receive payment depends on our performance in accordance with the agreement.

The percentage-of-completion methodology involves recognizing revenue using the percentage of services completed, on a current cumulative cost to total cost basis, using a reasonably consistent profit margin over the period. Due to the long-term nature of these contracts, developing the estimates of costs often requires significant judgment. Factors that must be considered in estimating the progress of work completed and ultimate cost of the contract include, but are not limited to, the availability of labor and labor productivity, the nature and complexity of the work to be performed, the impact of delayed performance, and availability and timing of funding from the client. If changes occur in delivery, productivity or other factors used in developing the estimates of costs or revenues, we revise our cost and revenue estimates, and any revisions are charged to income in the period in which the facts that give rise to that revision become known.

Emerging Issues Task Force Issue 00-21 Accounting for Revenue Arrangements with Multiple Deliverables ( EITF 00-21 ) addresses the accounting treatment for an arrangement to provide the delivery or performance of multiple products and/or services where the delivery of a product or system or performance of services may occur at different points in time or over different periods of time. The arrangements are often accompanied by initial installation, initiation, or activation services and involve either a fixed fee or a fixed fee coupled with a continuing payment stream, which may be fixed or variable. The EITF reached a consensus regarding, among other issues, the applicability of the provisions regarding separation of contract elements in EITF 00-21 to contracts where one or more elements fall within the scope of other authoritative literature, such as Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts ( SOP 81-1 ). EITF 00-21 does not impact the use of SOP 81-1 for contracts that fall within the scope of SOP 81-1, such as the implementation or building of an information technology system to client specifications under a long-term contract. Where an implementation or development project is contracted with a client, and the vendor will also provide services or operate the system over a period of time, EITF 00-21 provides the methodology for separating the contract elements and earnings processes. The provisions of EITF 00-21 will be applicable on a prospective basis to transactions entered into in fiscal years beginning after June 15, 2003. We do not believe that EITF 00-21 will have a material impact on our financial position or results of operations.





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Revenues earned in excess of related billings are accrued, whereas billings in excess of revenues earned are deferred until the related services are provided. Immediate recognition is made of any anticipated losses.

**Valuation of goodwill and intangibles.** Due to the fact that we are a services company, our business acquisitions typically result in goodwill and other intangible assets, which affect the amount of future period amortization expense and possible impairment expense that we could incur. The determination of the value of goodwill and other intangibles requires us to make estimates and assumptions about future business trends and growth. For the IMS, Andersen, and AFSA acquisitions in 2002, we obtained a third-party valuation of the intangible assets. If an event occurs which would cause us to revise our estimates and assumptions used in analyzing the value of our goodwill or other intangibles, such revision could result in an impairment charge that could have a material impact on our financial results.

**Allowance for doubtful accounts.** We make estimates of the collectibility of our accounts receivable. We specifically analyze accounts receivable and historical bad debts, customer credit-worthiness, current economic trends, and changes in our customer payment terms and collection trends when evaluating the adequacy of our allowance for doubtful accounts. Any change in the assumptions used in analyzing a specific account receivable may result in additional allowance for doubtful accounts being recognized in the period in which the change occurs.

## **NEW ACCOUNTING STANDARDS**

In June 2002, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 146 Accounting for Costs Associated with Exit or Disposal Activities ( SFAS 146 ), which changes the rules for how companies must account for costs associated with exit or disposal activities. Costs typically associated with exit or disposal activities include one-time employee termination costs, contract cancellation provisions, and relocation costs. SFAS 146 nullifies EITF Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The provisions of the new standard are effective for exit or disposal activities initiated after December 31, 2002, with early application encouraged. We do not believe that SFAS 146 will have a material impact on our future earnings and financial condition.

EITF 00-21 addresses the accounting treatment for an arrangement to provide the delivery or performance of multiple products and/or services where the delivery of a product or system or performance of services may occur at different points in time or over different periods of time. The arrangements are often accompanied by initial installation, initiation, or activation services and involve either a fixed fee or a fixed fee coupled with a continuing payment stream, which may be fixed or variable. The EITF reached a consensus regarding, among other issues, the applicability of the provisions regarding separation of contract elements in EITF 00-21 to contracts where one or more elements fall within the scope of other authoritative literature, such as SOP 81-1. EITF 00-21 does not impact the use of SOP 81-1 for contracts that fall within the scope of SOP 81-1, such as the implementation or building of an information technology system to client specifications under a long-term contract. Where an implementation or development project is contracted with a client, and the vendor will also provide services or operate the system over a period of time, EITF 00-21 provides the methodology for separating the contract elements and earnings processes. The provisions of EITF 00-21 will be applicable on a prospective basis to transactions entered into in fiscal years beginning after June 15, 2003. We do not believe that EITF 00-21 will have a material impact on our financial position or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 Accounting for Stock-Based Compensation Transition and Disclosure ( SFAS 148 ). SFAS 148 provides alternative methods of transition for companies that voluntarily adopt the fair value based method of accounting for stock-based employee compensation in accordance with Statement of Financial Accounting Standards No. 123 Accounting for Stock-Based Compensation ( SFAS 123 ). SFAS 148 also amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 also amends Accounting Principles Board Opinion No. 28 Interim Financial Reporting ( APB 28 ) to require disclosure about the effect of the method of accounting for stock-based employee compensation on reported results in interim financial reporting. The amendments to SFAS 123 relating to transition and annual disclosure provisions are effective for fiscal years ending after December 15, 2002. The amendments to SFAS 123 and APB 28 relating to disclosure provisions in interim reporting are effective for financial reports for interim periods beginning after December 15, 2002. We intend to adopt the disclosure-only provisions of SFAS 148, therefore, we do not believe that SFAS 148 will have a material impact on our financial position or results of operations.

## **RISKS RELATED TO OUR BUSINESS**

The risks described below should not be considered to be comprehensive and all-inclusive. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our business operations. If any events occur that give rise to the following risks, our business, financial condition, or results of operations could be materially and adversely affected, and as a result, the trading price of our Class A common stock could be materially and adversely impacted. These risk factors should be read in conjunction with other information set forth in this report, including our Consolidated Financial Statements and the related notes.



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Loss of, or reduction of business from, clients. The loss of clients and/or the reduction of volumes and services provided to our clients could materially affect our profitability and cash flows. In addition, we incur a high level of fixed costs related to our technology outsourcing and business process outsourcing clients, therefore the loss of any one of our significant clients could leave us with a significantly higher level of fixed costs than is necessary to serve our remaining clients, thereby reducing our revenues, profitability and cash flow.

Termination of a contract by a client or deterioration of the financial condition of a client. We must make significant capital investments in order to attract and retain large outsourcing agreements. The termination of a client contract or the deterioration of the financial condition or prospects of a client has in the past, and may in the future, result in an impairment of the net book value of the assets recorded, including a portion of our intangible assets, and a reduction in our earnings.

Competition. We expect to encounter additional competition as we address new markets and new competitors enter our existing markets. If we are forced to lower our pricing or if demand for our services decreases, our business, financial condition, results of operations, and cash flow may be materially and adversely affected. Many of our competitors have greater resources, and they may be able to use their resources to adapt more quickly to new or emerging technologies or to devote greater resources to the promotion and sale of their products and services. In addition, we must frequently compete with a client's own internal business process and information technology capabilities, which may constitute a fixed cost for the client.

Difficulties in executing our acquisition strategy. We intend to continue to expand our business through the acquisition of complementary companies. We cannot, however, make any assurances that we will be able to identify any potential acquisition candidates or consummate any additional acquisitions or that any future acquisitions will be successfully integrated or will be advantageous to us. Without additional acquisitions, we are unlikely to maintain historical growth rates.

Rapid technological changes. The markets for our information technology services are subject to rapid technological changes and rapid changes in client requirements. We may be unable to timely and successfully customize products and services that incorporate new technology or to deliver the services and products demanded by the marketplace.

Loss of significant software vendor relationships. Our ability to service our clients depends to a large extent on our use of various software programs that we license from a small number of primary software vendors. If our significant software vendors were to terminate or refuse to renew our contracts with them, we might not be able to replace the related software programs and would be unable to serve our clients, which could have a material adverse effect on our business, revenues, profitability and cash flow.

Exercise of contract termination provisions. Most of our contracts with our clients permit termination in the event our performance is not consistent with service levels specified in those contracts, or provide for credits to our clients for failure to meet service levels. In addition, if clients are not satisfied with our level of performance, our reputation in the industry may suffer, which could materially and adversely affect our business, financial condition, results of operations, and cash flow.

Government clients' termination rights, audits and investigations. A substantial portion of our revenues are derived from contracts with the United States government and its agencies and from contracts with state and local governments and their agencies. Governments and their agencies may terminate most of these contracts at any time, without cause. Also, our federal government contracts are subject to the approval of appropriations being made by the United States Congress to fund the expenditures to be made by the federal government under these contracts. Additionally, government contracts are generally subject to audits and investigations by government agencies. If the government finds that we improperly charged any costs to a contract, the costs are not reimbursable or, if already reimbursed, the cost must be refunded to the government. If the government discovers improper or illegal activities in the course of audits or investigations, the contractor may be subject to various civil and criminal penalties and administrative sanctions, which may include termination of contracts, forfeiture of profits, suspension of payments, fines and suspensions or debarment from doing business with the government. Any resulting penalties or sanctions could have a material adverse effect on our business, financial results and cash flow.

Budget deficits at state and local governments and their agencies. A substantial portion of our revenues are derived from contracts with state and local governments and their agencies. Currently, many state and local governments that we have contracts with are facing potential budget deficits. While this has not had a material adverse impact on our results of operations through the second quarter of fiscal year 2003, it is unclear what impact, if any, these deficits may have on our future business, revenues, results of operations and cash flow.

Inability to provide contract performance guarantees. Certain of our state and local government contracts require we execute surety bonds or letters of credit to ensure that the project is administered and completed as provided for in the contract. Prior to September 11 and the well-documented bankruptcies of several large companies (e.g. Enron, Kmart, and WorldCom), surety bonds were obtainable on relatively favorable terms at minimal pricing. In late 2001, the market for surety bonds changed dramatically with capacity tightening and prices increasing. In certain situations, we have found it more economical to satisfy our obligations under certain state



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and local contracts with letters of credit under our revolving credit facility. The long-term outlook of the surety market, while improving, remains unclear. If conditions require us to continue utilizing letters of credit under our credit facility (in lieu of bonds), we will be limited by the capacity under our revolving credit facility.

International Risks. Recently we have expanded our international operations. International operations are subject to a number of risks including, but limited to the following fluctuations in foreign exchange currency rates; licensing and labor counsel requirements; staffing key managerial positions; general economic conditions in foreign countries; additional expenses and risks inherent in conducting operations in geographically distant locations; laws of those foreign countries; political instability; trade restrictions such as tariffs and duties or other controls affecting foreign operations, and other factors may adversely affect the Company's business, financial condition and operating results.

Pricing Risks. Some of our contracts contain provisions requiring that our services be priced based on a pre-established standard or benchmark regardless of the costs we incur in performing these services. In such situations, we are exposed to the risk that we will incur significant unforeseen costs in performing the contract and the benchmark established will not permit adequate pricing of our services, and may adversely affect our operating results and cash flow.

Terrorist attacks. Terrorist attacks and further acts of violence or war may cause major instability in the U.S. and other financial markets in which we operate. In addition, armed hostilities and further acts of terrorism may directly impact our physical facilities and operations, which are located in North America, Central America, South America, Europe, Africa, Australia, and the Middle East, or those of our clients. These developments subject our worldwide operations to increased risks and, depending on their magnitude, could have a material adverse effect on our business.

Failure to attract and retain necessary technical personnel and skilled management. Our success depends to a significant extent upon our ability to attract, retain and motivate highly skilled and qualified personnel. If we fail to attract, train, and retain, sufficient numbers of these technically-skilled people, our business, financial condition, and results of operations will be materially and adversely affected. Our success also depends on the skills, experience, and performance of key members of our management team. The loss of any key employee could have an adverse effect on our business, financial condition, cash flow and results of operations and prospects.

**ITEM 4. CONTROLS AND PROCEDURES**

Within the 90 days prior to the date of the filing of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Exchange Act Rule 15d-14(c). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in enabling the Company to record, process, summarize and report information required to be disclosed in the Company's periodic filings with the Securities and Exchange Commission within the required time period. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

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**PART II**

**Item 1. Legal Proceedings**

On December 16, 1998, a state district court in Houston, Texas entered final judgment against us in a lawsuit brought by 21 former employees of Gibraltar Savings Association and/or First Texas Savings Association (collectively, "GSA/FTSA"). The GSA/FTSA employees alleged that they were entitled to the value of 803,082 shares of our stock (adjusted for February 2002 stock split) pursuant to options issued to the GSA/FTSA employees in 1988 in connection with a former technology outsourcing services agreement between GSA/FTSA and us. The judgment against us was for approximately \$17 million, which includes attorneys' fees and pre-judgment interest, but excludes additional attorneys' fees of approximately \$0.9 million and post-judgment interest at the statutorily mandated rate of 10% per annum, which could be awarded in the event the plaintiffs are successful upon appeal and final judgment. The judgment was appealed by the plaintiffs and us.

On August 29, 2002, the Fourteenth Court of Appeals, Houston, Texas, reversed the trial court's judgment and remanded the case to the trial court for further proceedings. However, the court of appeals affirmed the trial court judgment in part as to one of the plaintiffs. The court of appeals also held that the trial court did not err in dismissing certain of our affirmative defenses at a pretrial conference. We and the plaintiffs filed motions for rehearing with the court of appeals. On January 16, 2003, the court of appeals denied both motions for rehearing (except the court reversed its previous ruling that the trial court should have applied prejudgment interest at 6% rather than 10%). We intend to appeal to the Texas Supreme Court.

We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs' claims, and accordingly, have not accrued any amount on our balance sheet related to the lawsuit. We would be subject to a material charge if the Texas Supreme Court upon appeal were to reverse the decision of the court of appeals and affirm the trial court judgment.

**Item 5. Other Information**

One of our subsidiaries, ACS Defense, Inc., and other government contractors received a grand jury document subpoena issued by the U.S. District Court for the District of Massachusetts in October 2002. The subpoena was issued in connection with an inquiry being conducted by the Antitrust Division of the U.S. Department of Justice. The inquiry concerns certain IDIQ (Indefinite Delivery - Indefinite Quantity) procurements and their related task orders which occurred in the late 1990's at Hanscom Air Force Base in Massachusetts. Our revenue from the contracts that we believe to be the focus of the Justice Department's inquiry is approximately \$25 million per year representing approximately 0.6% of our annual revenue. We are cooperating fully with the Department of Justice in responding to the subpoena. Due to the preliminary nature of the government's inquiry, we are not able to assess the impact, if any, of this inquiry on ACS.

In December 2002, we appointed American Stock Transfer & Trust Company as our transfer agent, replacing First City Transfer Company.

**Item 6. Exhibits and Reports on Form 8-K**

a.) Exhibits

None.

b.) Reports on Form 8-K

1. On November 14, 2002, the Company filed a Current Report on Form 8-K (dated as of November 14, 2002) reporting that Jeffrey A. Rich, Chief Executive Officer and Warren Edwards, Executive Vice President and Chief Financial Officer, each submitted to the Securities and Exchange Commission his certifications pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 9.06 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 14th day of February, 2003.

**AFFILIATED COMPUTER SERVICES, INC**

By: /s/ Warren D. Edwards

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Warren D. Edwards  
Executive Vice President and  
Chief Financial Officer

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**Certification  
pursuant to and in connection with the  
Quarterly Reports on Form 10-Q  
to be filed under Sections 13 and 15(d) of the Securities Exchange Act of 1934, as amended**

I, Jeffrey A. Rich, Chief Executive Officer of Affiliated Computer Services, Inc. (the Registrant ), certify that:

1. I have reviewed this quarterly report of the Registrant on Form 10-Q for the period ending December 31, 2002;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the Registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date ); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Registrant's ability to record, process, summarize and report financial data and have identified for the Registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal controls; and
6. The Registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 14, 2003

/s/ Jeffrey A. Rich

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Jeffrey A. Rich,  
Chief Executive Officer of Affiliated Computer  
Services, Inc.

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**Certification  
pursuant to and in connection with the  
Quarterly Reports on Form 10-Q  
to be filed under Sections 13 and 15(d) of the Securities Exchange Act of 1934, as amended**

I, Warren D. Edwards, Executive Vice President and Chief Financial Officer of Affiliated Computer Services, Inc. (the Registrant ), certify that:

1. I have reviewed this quarterly report of the Registrant on Form 10-Q for the period ending December 31, 2002;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the Registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date ); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Registrant's ability to record, process, summarize and report financial data and have identified for the Registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal controls; and
6. The Registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 14, 2003

/s/ Warren D. Edwards

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Warren D. Edwards,  
Executive Vice President and Chief  
Financial Officer of Affiliated Computer  
Services, Inc.