PEROT SYSTEMS CORP
Form 10-Q
November 01, 2005

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

(Mark One)

þ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2005

or

o **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to

Commission File Number 0-22495

PEROT SYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	75-2230700
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

2300 WEST PLANO PARKWAY
PLANO, TEXAS
75075
(Address of principal executive offices) (Zip Code)
(972) 577-0000
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). þYes oNo

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

Number of shares of registrant s common stock outstanding as of October 28, 2005: 116,689,670 shares of Class A Common Stock and 2,100,024 shares of Class B Common Stock.

PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
FORM 10-Q
For the Quarter Ended September 30, 2005

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Rule 13a-14 Certification, President and CEO
Rule 13a-14 Certification, Vice President and CFO
Section 1350 Certification, President and CEO
Section 1350 Certification, Vice President and CFO

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ITEM 1: FINANCIAL STATEMENTS (UNAUDITED)

PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2005 AND DECEMBER 31, 2004
(DOLLARS IN THOUSANDS)
(UNAUDITED)

ASSETS

	September 30, 2005	December 31, 2004
Current assets:		
Cash and cash equivalents	$ 230,840	$ 304,786
Accounts receivable, net	283,131	233,875
Prepaid expenses and other	64,567	51,920
Total current assets	578,538	590,581
Property, equipment and purchased software, net	179,080	144,425
Goodwill	438,938	359,033
Deferred contract costs, net	81,482	48,459
Other non-current assets	64,514	81,113
Total assets	$ 1,342,552	$ 1,223,611

LIABILITIES AND STOCKHOLDERS EQUITY

	September 30, 2005	December 31, 2004
Current liabilities:		
Current portion of long-term debt	$	$ 75,498
Accounts payable	40,393	34,114
Accrued liabilities	78,626	98,298
Accrued compensation	62,899	65,706
Income taxes payable	38,187	34,306
Deferred revenue and other current liabilities	26,037	22,626
Total current liabilities	246,142	330,548
Long-term debt	76,505	
Non-current deferred revenue and other non-current liabilities	71,875	31,029
Total liabilities	394,522	361,577
Commitments and contingencies		
Stockholders equity:		

Common stock		1,201		1,173
Additional paid-in capital		495,235		478,266
Retained earnings		467,435		382,962
Treasury stock		(20,655)		
Other stockholders equity		(7,095)		(9,673)
Accumulated other comprehensive income		11,909		9,306
Total stockholders equity		948,030		862,034
Total liabilities and stockholders equity	$	1,342,552	$	1,223,611

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED INCOME STATEMENTS
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004
(DOLLARS AND SHARES IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenue	$ 510,078	$ 454,290	$ 1,471,581	$ 1,307,888
Direct cost of services	403,636	356,256	1,151,889	1,036,785
Gross profit	106,442	98,034	319,692	271,103
Selling, general and administrative expenses	66,098	62,058	185,924	170,072
Operating income	40,344	35,976	133,768	101,031
Interest income	1,758	625	5,597	1,361
Interest expense	(869)	(537)	(2,474)	(1,512)
Other income (expense), net	612	651	599	355
Income before taxes	41,845	36,715	137,490	101,235
Provision for income taxes	16,400	10,114	53,017	33,986
Net income	$ 25,445	$ 26,601	$ 84,473	$ 67,249
Basic and diluted earnings per common share:				
Basic earnings per common share	$ 0.22	$ 0.23	$ 0.72	$ 0.59
Weighted average common shares outstanding	118,098	115,241	117,810	114,617
Diluted earnings per common share	$ 0.21	$ 0.22	$ 0.70	$ 0.56
Weighted average diluted common shares outstanding	121,794	119,855	121,540	119,666

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004
(DOLLARS IN THOUSANDS)
(UNAUDITED)

	Nine months ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net income	$ 84,473	$ 67,249
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	42,823	41,445
Change in deferred taxes	20,979	(7,478)
Other non-cash items	1,942	1,819
Changes in assets and liabilities (net of effects from acquisitions of businesses):		
Accounts receivable, net	(52,533)	(27,066)
Prepaid expenses	(7,969)	(5,430)
Deferred contract costs, net	(36,245)	(26,433)
Accounts payable and accrued liabilities	1,912	(3,626)
Accrued compensation	(11,447)	14,128
Deferred revenue	24,120	14,274
Income taxes	3,863	23,785
Other current and non-current assets	8,689	(9,655)
Other current and non-current liabilities	3,377	990
Net cash provided by operating activities	83,984	84,002
Cash flows from investing activities:		
Purchases of property, equipment and purchased software	(54,116)	(22,260)
Acquisitions of businesses, net of cash acquired of $5,748 and $0, respectively	(93,368)	(8,850)
Net proceeds from the sale of short-term investments		37,725
Other	53	(19)
Net cash (used in) provided by investing activities	(147,431)	6,596
Cash flows from financing activities:		
Repayment of debt	(78,652)	
Proceeds from issuance of long-term debt	76,505	
Proceeds from issuance of common stock	17,319	15,299
Purchase of treasury stock	(20,655)	
Other	(864)	345
Net cash (used in) provided by financing activities	(6,347)	15,644

Effect of exchange rate changes on cash and cash equivalents	(4,152)	187
Net (decrease) increase in cash and cash equivalents	(73,946)	106,429
Cash and cash equivalents at beginning of period	304,786	123,770
Cash and cash equivalents at end of period	$ 230,840	$ 230,199

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(SHARES AND DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

NOTE 1. GENERAL

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. The interim condensed consolidated financial statements include the consolidated accounts of Perot Systems Corporation and its wholly-owned subsidiaries and all significant intercompany transactions have been eliminated. In our opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the interim periods presented have been made. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. These financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2004, in our Annual Report on Form 10-K filed with the SEC on March 9, 2005. Operating results for the three and nine month periods ended September 30, 2005, are not necessarily indicative of the results for the year ending December 31, 2005.

Certain of the 2004 amounts in the accompanying financial statements have been reclassified to conform to the current presentation.

Stock-Based Compensation

As permitted by Statement of Financial Accounting Standards Board No. 123, Accounting for Stock-Based Compensation, and FAS 148, Accounting for Stock-Based Compensation Transition and Disclosure, we have elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for our employee stock options. Under APB 25, compensation expense is recorded when the exercise price of employee stock options is less than the fair value of the underlying stock on the date of grant. We have implemented the disclosure-only provisions of FAS 123 and FAS 148. Had we elected to adopt the expense recognition provisions of FAS 123, the impact on net income and earnings per common share would have been as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income				
As reported	$ 25,445	$ 26,601	$ 84,473	$ 67,249
Add: stock-based compensation expense included in reported net income, net of related tax effects	(75)	683	724	943
Less: total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(2,638)	(6,433)	(10,353)	(16,869)
Pro forma	$ 22,732	$ 20,851	$ 74,844	$ 51,323
Basic earnings per common share				
As reported	$ 0.22	$ 0.23	$ 0.72	$ 0.59
Pro forma	$ 0.19	$ 0.18	$ 0.64	$ 0.45
Diluted earnings per common share				
As reported	$ 0.21	$ 0.22	$ 0.70	$ 0.56
Pro forma	$ 0.19	$ 0.18	$ 0.62	$ 0.45

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We utilize the Black-Scholes option pricing model to calculate our pro forma stock-based compensation expense using the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Weighted average risk free interest rates	4.00%	2.80%	3.87%	2.51%
Weighted average life (in years)	5.0	3.2	5.1	3.5
Volatility	44%	43%	43%	47%
Expected dividend yield	0%	0%	0%	0%
Weighted average grant-date fair value per share of options granted	$ 6.18	$ 4.66	$ 6.14	$ 5.04

The expected life of each grant was generally estimated based on our expectations of exercise behaviors.

Significant Accounting Standards to be Adopted

Statement of Financial Accounting Standards Board No. 123R

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment, which is a revision of FAS 123. FAS 123R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB 25, which is allowed under the original provisions of FAS 123. FAS 123R requires the use of an option pricing model for estimating fair value, which is amortized to expense over the service periods. In April 2005, the SEC changed the effective date of FAS 123R from the first annual or interim fiscal period beginning after June 15, 2005, to the first annual fiscal period beginning after June 15, 2005. If we had applied the provisions of FAS 123R to the financial statements for the three months ending September 30, 2005, net income would have been reduced by approximately $2,713. FAS 123R allows for either modified prospective recognition of compensation expense or modified retrospective recognition, which may be back to the original issuance of FAS 123 or only to interim periods in the year of adoption. We currently plan to apply the provisions of FAS 123R on a modified prospective basis for the recognition of compensation expense for all share-based awards granted on or after January 1, 2006, and any awards that are not fully vested as of December 31, 2005. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in preparing the pro forma disclosures in accordance with the provisions of FAS 123.

Statement of Financial Accounting Standards No. 154

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, which changes the accounting for and the reporting of voluntary changes in accounting principles. FAS 154 requires changes in accounting principles to be applied retrospectively to prior periods financial statements, where practicable, unless specific transition provisions permit alternative transition methods. FAS 154 will be effective in fiscal years beginning after December 15, 2005. Our adoption of FAS 154 is not expected to have a material impact on our consolidated financial statements except to the extent that we adopt a voluntary change in accounting principle in a future period that must be accounted for through a restatement of previous financial statements.

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NOTE 2. ACQUISITIONS

During 2005, it was determined that Soza & Company, Ltd. met their financial targets for 2004, and we paid $17,000 of additional consideration in cash, which was recorded as additional goodwill that was assigned to the Government Services segment and is predominantly nondeductible for tax purposes. There are no additional contingent payments related to this acquisition, and the $5,000 that was previously held in escrow was released to the previous shareholders during the first quarter of 2005.

During 2005, it was determined that ADI Technology Corporation met their financial targets for 2004, and we paid $6,700 of additional consideration in cash. In addition, we paid $178 in cash for other purchase price adjustments. The total amount of $6,878 was recorded as additional goodwill that was assigned to the Government Services segment and is predominantly nondeductible for tax purposes. There are no additional contingent payments related to this acquisition.

In July 2005, we acquired all of the outstanding shares of PrSM Corporation for $7,273 (net of $235 of cash acquired). PrSM is a safety, environmental and engineering services company that provides services to various government agencies, including the U.S. Department of Energy, the U.S. Department of Defense and NASA. The allocation of the PrSM purchase consideration to the assets and liabilities acquired resulted in goodwill of $6,110, which was assigned to the Government Services segment and is nondeductible for tax purposes. This business is not considered to be material to our consolidated results of operations, financial position and cash flows.

On August 12, 2005, we acquired all of the outstanding shares of Technical Management, Inc. and its subsidiaries, including Transaction Applications Group, Inc. (TAG), a leading provider of policy administration and business process services to the life insurance and annuity industry. As a result of the acquisition, we expanded our business process services offerings to include life insurance administration. Total consideration included $59,967 (net of $5,513 of cash acquired), $4,500 of which is being held in an escrow account for up to approximately eighteen months, and may include additional payments totaling up to $18,000 in cash or stock during the next two fiscal years. The possible future payments are contingent upon TAG achieving certain financial targets over the same period, and at our discretion, up to 15% of these payments may be settled in our Class A Common Stock. The results of operations of TAG and the estimated fair value of assets acquired and liabilities assumed are included in our condensed consolidated financial statements beginning on the acquisition date. The allocation of TAG purchase consideration to the assets and liabilities acquired, including goodwill, has not been completed due to the pending completion of tangible and intangible assets appraisals. As of September 30, 2005, the estimated fair values of acquired purchased software and intangible assets totaled $5,000 and $11,500, respectively, resulting in the estimated excess purchase price over net assets acquired of $47,516, which was recorded as goodwill on the condensed consolidated balance sheets, was assigned to the Industry Solutions segment and is not deductible for tax purposes. The appraisals of tangible and intangible assets are expected to be completed in the fourth quarter of 2005.

The following table reflects pro forma combined results of operations as if the acquisition had taken place at the beginning of the calendar year for each of the periods presented. Because our asset appraisals are not complete, the pro forma amounts include an estimate for amortization expense for identifiable intangible assets that were acquired.

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(SHARES AND DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA)
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	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenue	$ 515,687	$ 466,447	$ 1,504,145	$ 1,342,497
Income before taxes	34,676	37,507	132,846	102,501
Net income	18,229	27,106	79,013	68,240
Basic earnings per common share	0.15	0.24	0.67	0.60
Diluted earnings per common share	0.15	0.23	0.65	0.57

The pro forma results for the three and nine months ended September 30, 2005 include a predominantly non-cash charge of $7,051 (approximately $4,372, net of the applicable income tax benefit) resulting primarily from modifications of certain share-based payments to former TAG option holders prior to the acquisition in 2005. In our opinion, the unaudited pro forma combined results of operations are not indicative of the actual results that would have occurred had the acquisition been consummated at the beginning of 2005 or 2004, nor are they indicative of future operations of the combined companies under our ownership and management.

NOTE 3. GOODWILL

The changes in the carrying amount of goodwill for the nine months ended September 30, 2005, by reporting segment are as follows:

	Industry Solutions	**Government Services**	**Applications Solutions**	**Total**
Balance as of December 31, 2004	$ 195,041	$ 97,292	$ 66,700	$ 359,033
Additional goodwill for ADI acquisition		6,878		6,878
Additional goodwill for Soza acquisition		17,000		17,000
Goodwill for PrSM acquisition		6,110		6,110
Estimated goodwill for TAG acquisition	47,516			47,516
Other	2,250		151	2,401
Balance as of September 30, 2005	$ 244,807	$ 127,280	$ 66,851	$ 438,938

The $2,250 included in Other for Industry Solutions relates to additional consideration paid in cash in 2005 for a business that was not material to our consolidated results of operations, financial position and cash flows in the year acquired. This additional consideration was contingent upon targets relating to 2004 financial performance, which we determined had been met during the first quarter of 2005.

NOTE 4. DEFERRED COSTS, NET, AND OTHER NON-CURRENT ASSETS

Deferred Contract Costs, Net

Included in deferred contract costs, net, is $46,987 and $29,291 as of September 30, 2005, and December 31, 2004, respectively, relating to costs deferred on a contract that includes both construction services and non-construction services. The construction services relate to a software development and implementation project. We determined that we could not recognize revenue on the software development and implementation project separately from the non-construction services. As a result, we are deferring both the revenue on the software development and implementation project, consisting of the amounts we are billing for those services, and the related costs, up to the relative fair value of the software development and implementation project. The amount of revenue that has been

deferred on the software development and implementation project as of September 30, 2005, and December 31, 2004, is $18,963 and $14,963, respectively, and is included in non-current deferred revenue and other non-current liabilities on the

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condensed consolidated balance sheets. We expect the total cost of the software development and implementation project will exceed its relative fair value. Actual costs in excess of the relative fair value of the software development and implementation project will be expensed as incurred, which we expect will begin in the fourth quarter of 2005. The remaining balances of deferred contract costs, net, at September 30, 2005, and December 31, 2004, relate primarily to deferred contract set-up costs, which are amortized on a straight-line basis over the lesser of their estimated useful lives or the term of the related contract.

Amortization expense for deferred contract set-up costs was $1,357 and $3,222 for the three and nine months ended September 30, 2005, respectively, and $511 and $1,449 for the three and nine months ended September 30, 2004, respectively.

Identifiable Intangible Assets

Identifiable intangible assets as of September 30, 2005, are recorded in other non-current assets in the condensed consolidated balance sheets and are composed of:

	Gross Carrying Value	Accumulated Amortization	Net Book Value
Service marks	$ 5,761	$ (4,110)	$ 1,651
Customer based assets	33,449	(13,842)	19,607
Other intangible assets	6,430	(3,703)	2,727
Balance at September 30, 2005	$ 45,640	$ (21,655)	$ 23,985

Total amortization expense for identifiable intangible assets was $1,661 and $4,240 for the three and nine months ended September 30, 2005, and $2,508 and $7,521 for the three and nine months ended September 30, 2004. Amortization expense is estimated at $6,300, $7,207, $5,940, $4,233, $2,486 and $1,494 for the years ended December 31, 2005 through 2010, respectively. Identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives, ranging from 1 to 15 years. The weighted average useful life is approximately five years.

NOTE 5. DEBT

Current Portion of Long-term Debt

In June 2000, we entered into an operating lease contract with a variable interest entity for the use of land and office buildings in Plano, Texas, including a data center facility. As part of our adoption of Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities, we began consolidating this entity beginning on December 31, 2003. Upon consolidation, we recorded the debt between the variable interest entity and the financial institutions (the lenders) of $75,498. In March 2005, we borrowed $76,505 under our credit facility to pay the exercise amount of $75,498 for the purchase option under the operating lease and certain other expenses. Our consolidated variable interest entity then repaid the amount due to the lenders.

Long-term Debt

In January 2004, we entered into a three-year credit facility with a syndicate of banks that allows us to borrow up to $100,000. In March 2005, we executed a restated and amended agreement that expanded the facility to $275,000 and extended the term to five years. Borrowings under the credit facility will be either through loans or letter of credit obligations. The credit facility is guaranteed by certain of our domestic subsidiaries. In addition, we have pledged the stock of one of our non-domestic subsidiaries as security on the facility. Interest on borrowings varies with usage and begins at an alternate base rate, as defined in the

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credit facility agreement, or the LIBOR rate plus an applicable spread based upon our debt/EBITDA ratio applicable on such date. We are also required to pay a facility fee based upon the unused credit commitment and certain other fees related to letter of credit issuance. The credit facility matures in March 2010 and requires certain financial covenants, including a debt/EBITDA ratio and a minimum interest coverage ratio, each as defined in the credit facility agreement. As discussed above, in March 2005, we borrowed $76,505 against the credit facility.

NOTE 6. COMPREHENSIVE INCOME

Total comprehensive income, net of tax, was as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income	$ 25,445	$ 26,601	$ 84,473	$ 67,249
Foreign currency translation adjustments	(953)	(1,323)	2,603	2,088
Other		107		357
Total comprehensive income	$ 24,492	$ 25,385	$ 87,076	$ 69,694

NOTE 7. STOCKHOLDERS EQUITY

The components of Other stockholders equity were as follows:

	September 30, 2005	December 31, 2004
Deferred compensation	$ (7,087)	$ (9,761)
Other	(8)	88
Total other stockholders equity	$ (7,095)	$ (9,673)

At September 30, 2005, there were 116,515 shares of our Class A Common Stock outstanding and 2,042 shares of our Class B Common Stock outstanding. At December 31, 2004, there were 115,756 shares of our Class A Common Stock outstanding and 1,517 shares of our Class B Common Stock outstanding. During 2005, we acquired 1,559 shares of Class A Common Stock for $20,655, issued 2,318 shares of Class A Common Stock under incentive plans, and issued 525 shares of Class B Common Stock upon exercise of options to purchase Class B Common Stock.

NOTE 8. INCOME TAXES

Our effective income tax rate for the nine months ended September 30, 2005, was 38.6% as compared to 33.6% for the same period in 2004. Income tax expense for the nine months ended September 30, 2005, includes income tax expense of $2,269 on $39,459 of foreign earnings to be repatriated under the American Jobs Creation Act of 2004 (the Act). The income tax expense on these earnings increased our effective tax rate for the nine months ended September 30, 2005, by 1.7 percentage points. Our effective income tax rate for the nine months ended September 30, 2005, also increased 0.3 percentage points due to income tax expense of $426 on $2,656 of foreign earnings we intend to repatriate in addition to those amounts repatriated under the Act. Our effective income tax rate for the nine months ended September 30, 2004, included a benefit of 3.1 percentage points relating to the resolution of various outstanding tax issues from prior years.

The Act creates a temporary incentive through December 31, 2005, for U.S. companies to repatriate income earned abroad by providing an 85% dividends received deduction on qualifying foreign dividends, resulting

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in a U.S. federal income tax rate on the repatriated earnings of 5.25%. Our effective income tax rate on the qualifying foreign dividends is 5.8% as a result of expenses we incurred in connection with the repatriation that are not deductible under the Act and state income taxes.

All funds repatriated under the Act will be invested in accordance with our domestic reinvestment plan, which provides for the use of amounts repatriated under the Act in the U.S., primarily through payment of non-executive compensation and capital expenditures. Additional adjustments to income tax expense may be required at the time of repatriation depending upon a number of factors, including nondeductible expenses allocated to the repatriated earnings as well as statutory tax rates in effect at the time of repatriation.

NOTE 9. SEGMENT DATA

We offer our services under three primary lines of business: Industry Solutions, Government Services, and Applications Solutions (formerly Technology Services). Industry Solutions, our largest line of business, provides services to our customers primarily under long-term contracts in strategic relationships. These services include technology and business process services, as well as industry domain-based, short-term project and consulting services. The Government Services segment provides consulting, engineering, and technology-based business process solutions for the U.S. Department of Defense, the Department of Homeland Security, various federal intelligence agencies, and other governmental agencies. The Applications Solutions segment provides application development and maintenance, and application systems migration and testing primarily under short-term contracts related to specific projects. Other includes our remaining operating areas and corporate activities, income and expenses that are not related to the operations of the other reportable segments, and the elimination of intersegment revenue and direct cost of services of approximately $12,056 and $8,280 for the three months ended September 30, 2005 and 2004, respectively, and $32,164 and $20,247 for the nine months ended September 30, 2005 and 2004, respectively, related to the provision of services by the Applications Solutions segment to the other segments.

The reporting segments follow the same accounting policies that we use for our consolidated financial statements. Segment performance is evaluated based on income before taxes, exclusive of income and expenses that are included in the Other category. Substantially all corporate and centrally incurred costs are allocated to the segments based principally on expenses, employees, square footage, or usage.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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The following is a summary of certain financial information by reportable segment for the three and nine months ended September 30, 2005 and 2004.

	Industry Solutions	Government Services	Applications Solutions	Other	Total
For the three months ended September 30, 2005:					
Revenue	$ 405,642	$ 69,216	$ 47,276	$ (12,056)	$ 510,078
Income before taxes	24,697	4,609	12,307	232	41,845
For the three months ended September 30, 2004:					
Revenue	$ 356,662	$ 67,829	$ 38,079	$ (8,280)	$ 454,290
Income before taxes	27,151	3,637	5,080	847	36,715
For the nine months ended September 30, 2005:					
Revenue	$ 1,174,295	$ 199,364	$ 130,086	$ (32,164)	$ 1,471,581
Income before taxes	99,782	11,969	26,337	(598)	137,490
For the nine months ended September 30, 2004:					
Revenue	$ 1,020,735	$ 201,000	$ 106,400	$ (20,247)	$ 1,307,888
Income before taxes	72,698	10,841	16,378	1,318	101,235

NOTE 10. EARNINGS PER SHARE

The following chart is a reconciliation of the numerators and the denominators of the basic and diluted earnings per share computations.

	For the three months ended September 30,	
	2005	2004
Basic Earnings per Common Share		
Net income	$ 25,445	$ 26,601
Weighted average common shares outstanding	118,098	115,241
Basic earnings per common share	$ 0.22	$ 0.23
Diluted Earnings per Common Share		
Net income	$ 25,445	$ 26,601
Weighted average common shares outstanding	118,098	115,241
Incremental shares assuming dilution	3,696	4,614

Weighted average diluted common shares outstanding	121,794	119,855
Diluted earnings per common share	$ 0.21	$ 0.22

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	For the nine months ended September 30,	
	2005	2004
Basic Earnings per Common Share		
Net income	$ 84,473	$ 67,249
Weighted average common shares outstanding	117,810	114,617
Basic earnings per common share	$ 0.72	$ 0.59
Diluted Earnings per Common Share		
Net income	$ 84,473	$ 67,249
Weighted average common shares outstanding	117,810	114,617
Incremental shares assuming dilution	3,730	5,049
Weighted average diluted common shares outstanding	121,540	119,666
Diluted earnings per common share	$ 0.70	$ 0.56

For the three and nine months ended September 30, 2005, options to purchase 12,344 and 12,481 shares, respectively, of our common stock were not included in the computation of diluted earnings per common share because the exercise prices for these options were greater than the average market price of our common shares for these periods and, therefore, their inclusion would have been antidilutive. For the three and nine months ended September 30, 2004, options to purchase 13,450 and 13,405 shares, respectively, of our common stock were excluded for the same reason as discussed above.

NOTE 11. COMMITMENTS AND CONTINGENCIES

Litigation

We are, from time to time, involved in various litigation matters. We do not believe that the outcome of the litigation matters in which we are currently a party, either individually or taken as a whole, will have a material adverse effect on our consolidated financial condition, results of operations or cash flows. However, we cannot predict with certainty any eventual loss or range of possible loss related to such matters.

We have purchased, and expect to continue to purchase, insurance coverage that we believe is consistent with coverage maintained by others in the industry. This coverage is expected to limit our financial exposure to claims covered by these policies in many cases.

IPO Allocation Securities Litigation

In July and August 2001, we, as well as some of our current and former officers and directors and the investment banks that underwrote our initial public offering, were named as defendants in two purported class action lawsuits. These lawsuits, Seth Abrams v. Perot Systems Corp. et al. and Adrian Chin v. Perot Systems, Inc. et al., were filed in

the United States District Court for the Southern District of New York. The suits allege violations of Rule 10b-5, promulgated under the Securities Exchange Act of 1934, and Sections 11, 12(a)(2) and 15 of the Securities Act of 1933. Approximately 300 issuers and 40 investment banks have been sued in similar cases. The suits against the issuers and underwriters have been consolidated for pretrial purposes in the IPO Allocation Securities Litigation. The lawsuit involving us focuses on alleged improper practices by the investment banks in connection with our initial public offering in February 1999. The plaintiffs allege that the investment banks, in exchange for allocating public offering

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shares to their customers, received undisclosed commissions from their customers on the purchase of securities and required their customers to purchase additional shares in aftermarket trading. The lawsuit also alleges that we should have disclosed in our public offering prospectus the alleged practices of the investment banks, whether or not we were aware that the practices were occurring. The plaintiffs are seeking unspecified damages, statutory compensation and costs and expenses of the litigation.

During 2002, the current and former officers and directors of Perot Systems Corporation that were individually named in the lawsuits referred to above were dismissed from the cases. In exchange for the dismissal, the individual defendants entered agreements with the plaintiffs that toll the running of the statute of limitations and permit the plaintiffs to refile claims against them in the future. In February 2003, in response to the defendant s motion to dismiss, the court dismissed the plaintiffs Rule 10b-5 claims against us, but did not dismiss the remaining claims.

We have accepted a settlement proposal presented to all issuer defendants under which we would not be required to make any cash payment or have any material liability. Pursuant to the proposed settlement, plaintiffs would dismiss and release all claims against us and our current and former officers and directors, as well as all other issuer defendants, in exchange for an assurance by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases that the plaintiffs will achieve a minimum recovery of $1 billion (including amounts recovered from the underwriters), and for the assignment or surrender of certain claims that the issuer defendants may have against the underwriters. Under the terms of the proposed settlement of claims against the issuer defendants, the insurance carriers for the issuers would pay the difference between $1 billion and all amounts which the plaintiffs recover from the underwriter defendants by way of settlement or judgment. The court has granted a preliminary approval of the proposed settlement which will be subject to approval by the members of the class.

Litigation Relating to the California Energy Market

In June 2002, we were named as a defendant in a purported class action lawsuit that alleges that we conspired with energy traders to manipulate the California energy market. This lawsuit, Art Madrid v. Perot Systems Corporation et al., was filed in the Superior Court of California, County of San Diego. The plaintiffs are seeking unspecified damages, treble damages, restitution, punitive damages, interest, costs, attorneys fees and declaratory relief. In September 2003, we filed a demurrer to the complaint and an alternative motion to strike all claims for monetary relief. In January 2004, the court granted our demurrer and did not grant the plaintiffs leave to amend their complaint. The plaintiffs appealed to the Third Appellate District of the California Court of Appeals. The appellate court affirmed the lower court s dismissal and denied the plaintiffs request for a rehearing. In July 2005, the plaintiffs filed a petition for review with the California Supreme Court. In October 2005, the California Supreme Court denied the plaintiffs petition for review.

In June, July and August 2002, Perot Systems, Ross Perot and Ross Perot, Jr., were named as defendants in eight purported class action lawsuits that allege violations of Rule 10b-5, and, in some of the cases, common law fraud. These suits allege that our filings with the Securities and Exchange Commission contained material misstatements or omissions of material facts with respect to our activities related to the California energy market. All of these eight cases have been consolidated in the Northern District of Texas, Dallas Division in the case of Vincent Milano v. Perot Systems Corporation. On October 19, 2004, the court dismissed the case with leave for plaintiffs to amend. In December 2004, the plaintiffs filed a Second Amended Consolidated Complaint. In February 2005, we filed a motion to dismiss the Second Amended Consolidated Complaint. The plaintiffs are seeking unspecified monetary damages, interest, attorneys fees and costs.

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Other

In addition to the matters described above, we have been, and from time to time are, named as a defendant in various legal proceedings in the normal course of business, including arbitrations, class actions and other litigation involving commercial and employment disputes. Certain of these proceedings include claims for substantial compensatory or punitive damages or claims for indeterminate amounts of damages. We are contesting liability and/or the amount of damages, in each pending matter.

Contract-related Contingencies

In April 2005, we settled a dispute with a former customer that resulted in a payment to Perot Systems of $7,631 and a reduction of liabilities of $2,665, both of which were recorded as a reduction to direct cost of services in the second quarter of 2005. This dispute related to a contract we exited in 2003.

Expected Effects of the End of Our Outsourcing Contracts with Two Customers

UBS AG is our largest customer, and Harvard Pilgrim is one of our other top 10 customers. Our IT outsourcing contract with UBS will end on January 1, 2007, and our contract with Harvard Pilgrim is expected to end in 2007. During the third quarter of 2005, these contracts generated approximately $89,000 of revenue and approximately $20,000 of gross profit. We continue to expect that we will lose a substantial majority of our revenue and profit from these customers when the current contracts end. The impact of the end of these outsourcing agreements on our profits will be based in part on our ability to reduce our costs. We expect that the end of these outsourcing agreements likely will have a disproportionately large effect on our profitability compared to the effect on our revenues.

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This quarterly report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, forecasts, expects, plans, anticipates, believes, estimates, predicts, potential, see, target, projects, position, or continue or the negative of such terms and other comparable terminology. These statements reflect our current expectations, estimates, and projections. These statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that are difficult to predict. Actual events or results may differ materially from what is expressed or forecasted in these forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risks outlined below under the caption Risk Factors. These risk factors describe reasons why our actual results may differ materially from any forward-looking statement. We disclaim any intention or obligation to update any forward-looking statement.

ITEM 2: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and with our Consolidated Financial Statements and the information under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations, which are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

Lines of Business

We offer our services under three primary lines of business: Industry Solutions, Government Services, and Applications Solutions (formerly Technology Services). Industry Solutions, our largest line of business, provides services to our customers primarily under long-term contracts in strategic relationships. These services include technology and business process services, as well as industry domain-based, short-term project and consulting services. The Government Services segment provides consulting, engineering, and technology-based business process solutions for the U.S. Department of Defense, the Department of Homeland Security, various federal intelligence agencies, and other governmental agencies. The Applications Solutions segment provides application development and maintenance, and application systems migration and testing primarily under short-term contracts related to specific projects.

Overview of Our Financial Results for the Third Quarter of 2005

Our financial results are affected by a number of factors, including broad economic conditions, the amount and type of technology spending by our customers, and the business strategies and financial condition of our customers and the industries we serve, which could result in increases or decreases in the amount of services that we provide to our customers and the pricing of such services. Our ability to identify and effectively respond to these factors is important to our future financial growth.

We evaluate our consolidated performance on the basis of several performance indicators. The four key performance indicators we use are revenue growth, earnings growth, free cash flow, and the value of contracts signed. We compare these key performance indicators to annual target amounts established by management and to our performance for prior periods. We establish the targets for these key performance indicators primarily on an annual basis, but we may revise them during the year. We assess our performance using these key indicators on a quarterly and annual basis.

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Revenue Growth

Revenue growth is a measure of the growth we generate through sales of services to new customers, retention of existing contracts, acquisitions, and discretionary services from existing customers. Revenue for the third quarter of 2005 grew by 12.3% as compared to the third quarter of 2004. As discussed in more detail below, this revenue growth came primarily from the following:

- Revenue from contracts signed during the third quarter of 2004 for which we did not recognize a full quarter of revenue in the third quarter of 2004.
- Revenue from contracts signed with new customers during the twelve-month period following the third quarter of 2004.
- An increase in revenue from the expansion of base services and discretionary technology investments by our existing long-term customers, which we believe is due to improved economic conditions.
- Revenue from an acquisition within our Commercial Solutions group in the third quarter of 2005.

Earnings Growth

We measure earnings growth using diluted earnings per share, which is a measure of our effectiveness in delivering profitable growth. Diluted earnings per share for the third quarter of 2005 decreased 4.5% to $0.21 per share from $0.22 per share for the third quarter of 2004. This decrease came primarily from changes in our effective income tax rates for each quarterly period, as discussed in more detail below.

Free Cash Flow

We calculate free cash flow on a trailing twelve month basis as net cash provided by operating activities less purchases of property, equipment and purchased software, as stated in our condensed consolidated statements of cash flows. We use free cash flow as a measure of our ability to generate cash for both our short-term and long-term operating and business expansion needs. We use a twelve-month period to measure our success in this area because of the significant variations that typically occur on a quarterly basis due to the timing of certain cash payments. Free cash flow for the twelve months ended September 30, 2005, was $93.2 million as compared to $81.8 million for the twelve months ended September 30, 2004. Free cash flow, which is a non-GAAP measure, can be reconciled to Net cash provided by operating activities as follows (in millions):

	Twelve Months Ended September 30	
	2005	**2004**
Net cash provided by operating activities	$ 158.3	$ 109.6
Purchases of property, equipment and software	(65.1)	(27.8)
Free cash flow	$ 93.2	$ 81.8

TCV of Contracts Signed

The amount of Total Contract Value (commonly referred to as TCV) that we sell during a twelve-month period is a measure of our success in capturing new business in the various outsourcing and consulting markets in which we provide services and includes contracts with new customers and contracts for new services with existing customers. We measure TCV as our estimate of the total expected revenue from contracts that are expected to generate revenue in excess of a defined amount during a contract term that exceeds a defined length of time.

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Various factors may impact the timing of the signing of contracts with customers, including the complexity of the contract, competitive pressures, and customer demands. As a result, we generally measure our success in this area over a twelve-month period because of the significant variations that typically occur in the amount of TCV signed during each quarterly period. During the three months ending September 30, 2005, the amount of TCV signed was $0.2 billion, which results in the amount of TCV signed for the twelve-month period ending September 30, 2005 of $1.3 billion, as compared to $1.2 billion for the twelve-month period ending September 30, 2004.

Additional Measurements

Each of our three primary lines of business has distinct economic factors, business trends, and risks that could affect our results of operations. As a result, in addition to the four metrics discussed above that we use to measure our consolidated financial performance, we use similar metrics for each of these lines of business and for certain industry groups and operating units within these lines of business.

Comparison of the Three Months Ended September 30, 2005 and 2004

Revenue

Revenue for the third quarter of 2005 increased from revenue for the third quarter of 2004 due to increases in revenue from the Industry Solutions, Government Services and Applications Solutions segments. Below is a summary of our revenue for the third quarter of 2005 as compared to the third quarter of 2004 (amounts in millions):

	Three months ended September 30			
	2005	2004	$ Change	% Change
Industry Solutions	$ 405.7	$ 356.7	$ 49.0	13.7%
Government Services	69.2	67.8	1.4	2.1%
Applications Solutions	47.3	38.1	9.2	24.1%
Elimination of intersegment revenue	(12.1)	(8.3)	(3.8)	45.8%
Total	$ 510.1	$ 454.3	$ 55.8	12.3%

Industry Solutions

The net increase in revenue from the Industry Solutions segment for the third quarter of 2005 as compared to the third quarter of 2004 was primarily attributable to:

$21.0 million from contracts signed during the third quarter of 2004 for which we did not recognize a full quarter of revenue in the third quarter of 2004. This revenue includes $17.5 million and $3.5 million from contracts signed in the third quarter of 2004 in the Healthcare and Commercial Solutions groups, respectively. The services that we are providing to these customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers.

$14.4 million increase from contracts signed with new customers during the twelve-month period following the third quarter of 2004. This increase is composed of $9.6 million and $4.8 million from new contracts signed in the Commercial Solutions and Healthcare groups, respectively. The services that we are providing to these new customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers. The increase in new sales revenue from the markets served by our Commercial Solutions group is primarily the result of improved focus and selectivity in our sales processes, as well as improved collaboration between our consulting and technology outsourcing teams that deliver services to these markets.

$6.9 million net increase from existing accounts and short-term project work. This net increase results from expanding our base services to existing long-term customers and from providing additional

discretionary services to these customers. The discretionary services that we provide, which includes short-term project work, can vary from period-to-period depending on many factors, including specific customer and industry needs and economic conditions. This net increase is primarily related to contracts in the Healthcare group. The state of change in the healthcare industry has required increased system investment, which creates demand for our services. Because of the complexities associated with system changes combined with our customers desire to focus on core functions, the healthcare outsourcing market has experienced increased levels of business.

$6.7 million increase from revenue related to an acquisition within our Commercial Solutions group in the third quarter of 2005. The acquired company is a leading provider of policy administration and business process services to the life insurance and annuity industry.

Government Services

The $1.4 million, or 2.1%, increase in revenue from the Government Services segment for the third quarter of 2005 as compared to the third quarter of 2004 was primarily attributable to the acquisition of a safety, environmental and engineering services company during the third quarter of 2005. Our business with the federal government will fluctuate due to annual federal funding limits and the specific needs of the federal agencies we serve.

Applications Solutions

Revenue from the Applications Solutions segment of $35.2 million for the third quarter of 2005, net of the elimination of intersegment revenue of $12.1 million, increased $5.4 million as compared to revenue of $29.8 million for the third quarter of 2004, net of the elimination of intersegment revenue of $8.3 million. This increase is primarily attributable to an increase in application development and maintenance services in the financial services industry. Intersegment revenue relates to the provision of services by the Applications Solutions segment to our other segments.

UBS

Revenue from UBS, our largest customer, was $75.4 million for the third quarter of 2005, or 14.8% of our total revenue. This revenue is reported within the Industry Solutions and Applications Solutions lines of business and is summarized in the following table (amounts in millions):

	Three months ended September 30		
	2005	**2004**	**Change**
UBS revenue in Industry Solutions	$ 66.0	$ 63.9	3.3%
UBS revenue in Applications Solutions	9.4	8.5	10.6%
Total revenue from UBS	$ 75.4	$ 72.4	4.1%

The increase in revenue from UBS is due primarily to an increase in the number of associates providing services to UBS relating to their business expansion and various short-term projects, partially offset by the elimination of the variable component of our annual fee as part of the Transition Agreement between us and UBS in September of 2004.

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Gross Margin

Gross margin, which is calculated as gross profit divided by revenue, for the third quarter of 2005 was 20.9% of revenue, which is lower than the gross margin for the third quarter of 2004 of 21.6%. This year-to-year decrease in gross margin is primarily due to the following:

- Lower margins in the early phases of contracts signed with new customers during the third quarter of 2004 and in the twelve-month period following the third quarter of 2004. The profitability for commercial customer contracts, particularly our fixed- and unit-priced contracts, tends to improve with the maturity of the contract as we develop operating efficiencies.
- A net decrease in profitability from UBS primarily due to the reversal of an accrued liability in the third quarter of 2004 for the variable component of our annual fee, which was eliminated as part of the Transition Agreement between us and UBS in September of 2004.

Partially offsetting these decreases in gross margin were a reduction in the amount of total associate bonus expense recorded in direct cost of services, which decreased by $5.2 million in the third quarter of 2005 as compared to the prior year period, and an overall net increase in profitability from existing commercial customer contracts, which is primarily due to an increase in the amount of services we performed in addition to our base level of services. The increased services are discretionary in nature, and the associated gross margins are typically higher than those we realize on our base level of services. As discussed above, we have seen increased demand for discretionary investment from several customers, primarily in the healthcare industry.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the third quarter of 2005 increased 6.6% to $66.1 million from $62.0 million for the third quarter of 2004. As a percentage of revenue, SG&A for the third quarter of 2005 was 13.0% of revenue, which is slightly lower than SG&A for the third quarter of 2004 of 13.6% of revenue. This decrease as a percentage of revenue is primarily due to $2.6 million of expense recorded in the third quarter of 2004 associated with exiting a leased facility.

Other Income Statement Items

Interest income for the third quarter of 2005 increased by $1.1 million as compared to the third quarter of 2004 due primarily to higher average cash balances and higher interest rates during the third quarter of 2005 as compared to the same period in 2004.

Our effective income tax rate for the third quarter of 2005 was 39.2% as compared to 27.5% for the same period in 2004. Income tax expense for the third quarter of 2005 includes income tax expense of $1.2 million on $18.6 million of foreign earnings to be repatriated under the American Jobs Creation Act of 2004 (the Act). The income tax expense on these earnings increased our effective income tax rate for the third quarter of 2005 by 2.9 percentage points. The effective income tax rate for the third quarter of 2004 included a benefit of 8.7 percentage points relating to the resolution of various outstanding tax issues from prior years.

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Comparison of the Nine Months Ended September 30, 2005 and 2004

Revenue

Revenue for the nine months ended September 30, 2005, increased from revenue for the nine months ended September 30, 2004, due to increases in revenue from the Industry Solutions and Applications Solutions segments, partially offset by a decrease in revenue from the Government Services segment. Below is a summary of our revenue for the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004 (amounts in millions):

	Nine months ended September 30			
	2005	2004	$ Change	% Change
Industry Solutions	$ 1,174.3	$ 1,020.7	$ 153.6	15.0%
Government Services	199.4	201.0	(1.6)	(0.8%)
Applications Solutions	130.1	106.4	23.7	22.3%
Elimination of intersegment revenue	(32.2)	(20.2)	(12.0)	59.4%
Total	$ 1,471.6	$ 1,307.9	$ 163.7	12.5%

Industry Solutions

The net increase in revenue from the Industry Solutions segment for the first nine months of 2005 as compared to the first nine months of 2004 was primarily attributable to:

$73.5 million increase from contracts signed during the first nine months of 2004 for which we did not recognize a full nine months of revenue in 2004. This increase is composed of $61.0 million and $12.5 million from contracts signed in the Healthcare and Commercial Solutions groups, respectively. The services that we are providing to these new customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers.

The strength in healthcare sales revenue comes from two primary factors:

Our solutions for the healthcare market were developed over several years and are highly customized to the specific business needs of the market. We identified certain aspects of the healthcare market as core to our long-term service offerings several years ago when the market for technology and business process outsourcing was immature. As a result, we have an established presence and brand, which we have strengthened through internal investment in software and solutions and through acquisitions.

The healthcare industry continues to be in a state of change as health systems look to transform their clinical and administrative back-office operations, payer organizations work to develop new consumer-based health models, and as the rate of medical cost inflation continues to be high. Clinical transformation revolutionizes the way in which the healthcare community receives patient-specific data that spans the entire continuum of care, including centralization of patient data and electronic order entry and decision support.

The increase in sales revenue from the markets served by our Commercial Solutions group is primarily the result of improved focus and selectivity in our sales processes, as well as improved collaboration between our consulting and technology outsourcing teams that deliver services to these markets.

$36.8 million net increase from existing accounts and short-term project work. This net increase results from expanding our base services to existing long-term customers and from providing additional discretionary services to

these customers. The discretionary services that we provide, which include short-term offerings and project work, can vary from period-to-period depending on many factors,

including specific customer and industry needs and economic conditions. The increase is related to contracts in the Healthcare and Commercial Solutions groups:

The state of change in the healthcare industry has required increased system investment, which creates demand for our services. Because of the complexities associated with system changes combined with our customers desire to focus on core functions, the healthcare outsourcing market has experienced increased levels of business.

Within the manufacturing market and the construction and engineering market served by our Commercial Solutions group, we have experienced increased levels of business primarily as a result of customers continuing needs to reduce expense and to improve the efficiency of their operations.

$30.4 million increase from contracts signed with new customers during the twelve-month period following the third quarter of 2004. This increase is composed of $20.1 million and $10.3 million from new contracts signed in the Commercial Solutions and Healthcare groups, respectively. The services that we are providing to these new customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers.

$6.7 million increase from revenue related to an acquisition within our Commercial Solutions group in the third quarter of 2005. The acquired company is a leading provider of policy administration and business process services to the life insurance and annuity industry.

$6.2 million termination fee associated with the early termination of a contract in the first quarter of 2005.

Government Services

The $1.6 million, or 0.8%, decrease in revenue from the Government Services segment for the first nine months of 2005 as compared to the first nine months of 2004 was primarily attributable to a loss of business, the majority of which came from the loss of a contract with the Immigration and Naturalization Service that was rebundled by the customer along with other programs for a recompetition bid. The consortium of companies with which we participated for the recompete did not win this business. This loss of business was partially offset by existing program expansion, primarily associated with our support of the Naval Sea Systems Command and services provided to other governmental agencies. Our business with the federal government will fluctuate due to annual federal funding limits and the specific needs of the federal agencies we serve.

Applications Solutions

Revenue from the Applications Solutions segment of $97.9 million for the first nine months of 2005, net of the elimination of intersegment revenue of $32.2 million, increased $11.7 million, as compared to revenue of $86.2 million for the first nine months of 2004, net of the elimination of intersegment revenue of $20.2 million. This increase is primarily attributable to an increase in application development and maintenance services in the financial services industry. Intersegment revenue relates to the provision of services by the Applications Solutions segment to our other segments.

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UBS

Revenue from UBS, our largest customer, was $223.0 million for the first nine months of 2005, or 15.2% of our total revenue. This revenue is reported within the Industry Solutions and Applications Solutions lines of business and is summarized in the following table (amounts in millions):

	Nine months ended September 30		
	2005	**2004**	**Change**
UBS revenue in Industry Solutions	$ 196.6	$ 179.8	9.3%
UBS revenue in Applications Solutions	26.4	24.0	10.0%
Total revenue from UBS	$ 223.0	$ 203.8	9.4%

The increase in revenue from UBS is due primarily to an increase in the number of associates providing services to UBS relating to their business expansion and various short-term projects.

Gross Margin

Gross margin, which is calculated as gross profit divided by revenue, for the nine months ended September 30, 2005, was 21.7% of revenue, which is higher than the gross margin for the nine months ended September 30, 2004, of 20.7%. This year-to-year increase in gross margin is primarily due to the following:

In the second quarter of 2005, we settled a dispute with a former customer. As a result, we received a $7.6 million payment and reduced our liabilities by $2.7 million, both of which were recorded as a reduction to direct cost of services. The dispute related to a contract we exited in 2003. This settlement resulted in a 0.7 percentage point increase in our gross margin for the first nine months ended September 30, 2005.

An overall net increase in profitability for existing commercial customer contracts, which is primarily due to an increase in the amount of services we perform that are in addition to our base level of services. The increased services are discretionary in nature, and the associated gross margins are typically higher than those we realize on our base level of services. As discussed above, we have seen increased demand for discretionary investment from several customers, primarily in the Healthcare and Commercial Solutions Group.

In the first quarter of 2005, we recorded revenue of $6.2 million and related direct cost of services of $0.6 million, resulting in gross profit of $5.6 million, associated with the termination of a contract. This additional gross profit resulted in a 0.3 percentage point increase in our gross margin for the first nine months ended September 30, 2005.

Partially offsetting these increases were lower gross margins in the early phases of contracts signed with new customers during the third quarter of 2004 and in the twelve-month period following the third quarter of 2004. The profitability for commercial customer contracts, particularly our fixed- and unit-priced contracts, tends to improve with the maturity of the contract as we develop operating efficiencies.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the nine months ended September 30, 2005, increased 9.3% to $185.9 million from $170.1 million for the nine months ended September 30, 2004. As a percentage of revenue, SG&A for the first nine months of 2005 was 12.6% of revenue, which is slightly lower than SG&A for the first nine months of 2004 of 13.0% of revenue. This decrease as a percentage of revenue is primarily due to $2.6 million of expense recorded in the nine months ended September 30, 2004, associated with exiting a leased facility.

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Other Income Statement Items

Interest income for the nine months ended September 30, 2005, increased by $4.2 million as compared to the nine months ended September 30, 2004, due primarily to higher average cash balances and higher interest rates during the first nine months of 2005 as compared to the same period in 2004.

Our effective income tax rate for the first nine months of 2005 was 38.6% as compared to 33.6% for the same period in 2004. Income tax expense for the first nine months of 2005 includes income tax expense of $2.3 million on $39.5 million of foreign earnings to be repatriated under the American Jobs Creation Act of 2004 (the Act). Income tax expense on these earnings increased our effective income tax rate for the first nine months of 2005 by 1.7 percentage points. Our effective income tax rate for the first nine months of 2005 also increased 0.3 percentage points due to income tax expense of $0.4 million on $2.7 million of foreign earnings we intend to repatriate in addition to those amounts repatriated under the Act. Our effective income tax rate for the first nine months of 2004 included a benefit of 3.1 percentage points relating to the resolution of various outstanding tax issues from prior years.

The Act creates a temporary incentive through December 31, 2005, for U.S. companies to repatriate income earned abroad by providing an 85% dividends received deduction on qualifying foreign dividends, resulting in a U.S. federal income tax rate on the repatriated earnings of 5.25%. Our effective income tax rate on the qualifying foreign dividends is 5.8% as a result of expenses we incurred in connection with the repatriation that are not deductible under the Act and state income taxes.

All funds repatriated under the Act will be invested in accordance with our domestic reinvestment plan, which provides for the use of amounts repatriated under the Act in the U.S., primarily through payment of non-executive compensation and capital expenditures. Additional adjustments to income tax expense may be required at the time of repatriation depending upon a number of factors, including nondeductible expenses allocated to the repatriated earnings as well as statutory tax rates in effect at the time of repatriation.

Contract-related Matter

We have a contract that includes both non-construction services and construction services, and the construction services relate to a software development and implementation project. As of September 30, 2005, and December 31, 2004, we have deferred contract costs, net, of $47.0 million and $29.3 million, respectively, relating to this contract. We expect the total cost of the software development and implementation project will exceed its relative fair value. Actual costs in excess of the relative fair value of the software development and implementation project will be expensed as incurred to direct cost of services. We currently expect the expense included in direct cost of services for these excess costs to be approximately $1.5 million in the fourth quarter of 2005, approximately $4.0 million in each quarterly period in 2006 and 2007, and may vary from 2007 levels for quarterly periods beyond 2007. We also currently expect the future services under the contract, which includes both the construction and the non-construction services, will be profitable and generate positive cash flows in the aggregate over the remaining contract term. The amount of future profits and cash flows from the contract may differ from our current estimates, which could result in an impairment of a portion of the deferred contract costs, and may materially and adversely affect our results of operations.

Expected Effects of the End of Our Outsourcing Contracts with Two Customers

UBS AG is our largest customer, and Harvard Pilgrim is one of our other top 10 customers. Our IT outsourcing contract with UBS will end on January 1, 2007, and our contract with Harvard Pilgrim is expected to end in 2007. During the third quarter of 2005, these contracts generated approximately $89.0 million of revenue and approximately $20.0 million of gross profit. We continue to expect that we will lose a substantial majority of our revenue and profit from these customers when the current contracts end. The impact of the end of these outsourcing agreements on our profits will be based in part on our ability to

reduce our costs. We expect that the end of these outsourcing agreements likely will have a disproportionately large effect on our profitability compared to the effect on our revenues.

Based on the expected operating results for 2005 and the new expectations discussed above, we now expect to lose approximately $65.0 million of profit from UBS and Harvard Pilgrim in 2007, which is less than previously expected. We also expect to realize approximately $40.0 million in improved profitability above 2005 levels from specific operating efficiencies to be realized on existing fixed- and unit-priced customer contracts and cost reduction actions. These projections are based on estimates that are subject to change. The increase in profitability from existing customer contracts is expected to total approximately $20.0 million and is expected to be realized from operating efficiencies and contractual increases to billing rates. Future contract signings and performance on existing contracts could result in increases or decreases in the total amount of efficiencies that are realized in future periods. The increase in profitability from cost reduction actions relates primarily to a possible reduction in employee-related expenses in 2007. If other operational results and efficiencies produce a similar amount of increased profits, the reduction in employee-related expenses may not be made.

Liquidity and Capital Resources

We expect that existing cash and cash equivalents, expected cash flows from operating activities, and the $198.5 million that is available under our restated and amended credit facility, which is discussed below, will provide us sufficient funds to meet our operating needs for the foreseeable future. During the nine months ended September 30, 2005, cash and cash equivalents decreased 24.3% to $230.8 million from $304.8 million at December 31, 2004.

Operating Activities

Net cash provided by operating activities was consistent at $84.0 million for the nine months ended September 30, 2005 and 2004. The significant increases in net cash provided by operating activities are as follows:

- Net income for the nine months ended September 30, 2005, increased $17.2 million to $84.5 million, which includes the receipt of $7.6 million related to the settlement of a contract dispute with a former customer.
- Cash provided by the changes in other current and non-current assets was $8.7 million for the first nine months of 2005 as compared to cash used of $9.7 million for the same period of the prior year. This change includes a payment of $10.0 million made in the first nine months of 2004 relating to a purchase commitment of air travel mileage that did not recur in 2005.

These increases were offset primarily by the following decreases in cash provided by operating activities:

- The amount of bonuses paid to associates under our bonus plans in the first nine months of 2005 as compared to the same period in 2004 (primarily representing payments of annual bonuses relating to the prior year s bonus plan), which were $64.7 million and $42.3 million, respectively. Included in the bonus amounts that were paid in the first nine months of 2005 and 2004 were approximately $23.7 million and $19.6 million, respectively, of bonus payments that are reimbursable by our customers. The amount of bonuses that we pay each year is based on several factors, including our financial performance and management s discretion.
- We typically collect our accounts receivable within 45 days to 60 days, and therefore our accounts receivable balance at the end of each period can change based on the amount of revenue for that period and the timing of collections from our customers, which can vary significantly from period to period. Our days sales outstanding at September 30, 2005, of 50 days has increased as compared to days sales outstanding at September 30, 2004, of 47 days due to an increase in expenses that are rebillable to customers and the two acquisitions made during the third quarter of 2005 for which we did not

recognize a full quarter of revenue. This increase has negatively impacted our cash provided by operating activities for the first nine months of 2005. Days sales outstanding is calculated as our outstanding accounts receivable balance at the end of the period divided by revenue for the most recent quarterly period and multiplied by 90 days.

Investing Activities

Net cash used in investing activities was $147.4 million for the nine months ended September 30, 2005, as compared to net cash provided by investing activities of $6.6 million for the same period in 2004. This change was primarily attributable to the following:

- During the nine months ended September 30, 2005, we paid $93.4 million for acquisitions, including $60.0 million (net of cash received) for the acquisition of Technical Management, Inc. and its subsidiaries, including Transaction Applications Group, Inc., $17.0 million as additional consideration related to the acquisition of Soza & Company, Ltd., $7.3 million (net of cash received) for the acquisition of PrSM Corporation, $6.9 million as additional consideration related to the acquisition of ADI Technology Corporation, and $2.2 million related to the acquisition of one other company.
- During the nine months ended September 30, 2005, we purchased $54.1 million of property, equipment and purchased software as compared to $22.3 million during the nine months ended September 30, 2004. This increase is primarily related to our business expansion needs for data center and office facilities. We plan to significantly increase our data center capacity in the next 12 months, which could increase our future capital expenditures from current levels and reduce the amount of our available cash balances and borrowing capacity.
- During the nine months ended September 30, 2004 we recorded $37.7 million of net proceeds from the sale of short-term investments relating to the conversion of Applications Solutions short-term investments to cash and cash equivalents.
- During the nine months ended September 30, 2004, we paid $8.8 million as additional consideration for acquisitions, including $6.3 million and $2.5 million related to the acquisitions of Soza and ADI, respectively.

Financing Activities

Net cash used in financing activities was $6.3 million for the nine months ended September 30, 2005, compared to net cash provided by financing activities of $15.6 million for the nine months ended September 30, 2004. This change is primarily due to the repurchase of 1.6 million shares of our Class A Common Stock during the second quarter of 2005 for $20.7 million. As discussed below, our Board of Directors has authorized a program to repurchase up to $75.0 million of our common stock.

We routinely maintain cash balances in certain European and Asian currencies to fund operations in those regions. During the nine months ended September 30, 2005, foreign exchange rate fluctuations had a net negative impact on our non-domestic cash balances of $4.2 million, as the U.S. dollar strengthened against the Euro, the British Pound, Swiss Franc and the Indian Rupee. We hedge foreign exchange exposures that are likely to significantly impact net income or working capital.

Current Portion of Long-term Debt

In June 2000, we entered into an operating lease contract with a variable interest entity for the use of land and office buildings in Plano, Texas, including a data center facility. As part of our adoption of Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities, we began consolidating this entity beginning on December 31, 2003. Upon consolidation, we recorded the debt between the variable interest entity and the financial institutions (the lenders) of $75.5 million. In March

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2005, we borrowed $76.5 million under our credit facility to pay the exercise amount of $75.5 million for the purchase option under the operating lease and certain other expenses. Our consolidated variable interest entity then repaid the amount due to the lenders.

Long-term Debt

In January 2004, we entered into a three-year credit facility with a syndicate of banks that allows us to borrow up to $100.0 million. In March 2005, we executed a restated and amended agreement that expanded the facility to $275.0 million and extended the term to five years. Borrowings under the credit facility will be either through loans or letter of credit obligations. The credit facility is guaranteed by certain of our domestic subsidiaries. In addition, we have pledged the stock of one of our non-domestic subsidiaries as security on the facility. Interest on borrowings varies with usage and begins at an alternate base rate, as defined in the credit facility agreement, or the LIBOR rate plus an applicable spread based upon our debt/EBITDA ratio applicable on such date. We are also required to pay a facility fee based upon the unused credit commitment and certain other fees related to letter of credit issuance. The credit facility matures in March 2010 and requires certain financial covenants, including a debt/EBITDA ratio and a minimum interest coverage ratio, each as defined in the credit facility agreement. As discussed above, in March 2005, we borrowed $76.5 million against the credit facility.

Stock Repurchase Program

In April 2005, our Board of Directors authorized a program to repurchase up to $75.0 million of our common stock. As discussed above, during the second quarter of 2005, we purchased 1.6 million shares of our Class A Common Stock for $20.7 million. We may repurchase shares of our common stock from time to time in the open market, under a Rule 10b5-1 plan, or through privately negotiated, block transactions, which may include substantial blocks purchased from unaffiliated holders.

Significant Accounting Standards to be Adopted

Statement of Financial Accounting Standards No. 123R

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment, which is a revision of FAS 123. FAS 123R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB 25, which is allowed under the original provisions of FAS 123. FAS 123R requires the use of an option pricing mo

of common and common equivalent shares outstanding	15,700,108	13,059,344	15,679,683	12,803,498

See Notes to Consolidated Financial Statements - Unaudited

BBX CAPITAL CORPORATION AND SUBSIDARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME - UNAUDITED

(In thousands, except share and per share data)		For the Three Months Ended June 30, 2012	2011	For the Six Months Ended June 30, 2012	2011
Net (loss) income	$	(12,307)	23,401	(26,515)	514
Other comprehensive (loss) income, net of tax:					
Unrealized (loss) gain on securities available for sale		(60)	461	(584)	(258)
Provision for income taxes		-	-	-	-
Unrealized (loss) gain on securities available for sale, net of tax		(60)	461	(584)	(258)
Reclassification adjustments:					
Net realized (loss) gain on securities available for sale		-	-	-	-
Reclassification adjustments		-	-	-	-
Other comprehensive (loss) income, net of tax		(60)	461	(584)	(258)
Comprehensive (loss) income		(12,367)	23,862	(27,099)	256
Less: comprehensive (loss) income attributable to noncontrolling interest		-	290	-	585
Total comprehensive (loss) income attributable to BBX Capital Corporation	$	(12,367)	23,572	(27,099)	(329)

See Notes to Consolidated Financial Statements - Unaudited

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BBX CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF (DEFICIT) EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND 2011 - UNAUDITED

(In thousands)		Common Stock	Additional Paid-in Capital	(Accumulated Deficit)	Accumulated Other Comprehensive Loss	BBX Capital Corporation (Deficit) Equity	Non-Controlling Interest	Total (Deficit) Equity
BALANCE, DECEMBER 31, 2010	$	125	317,863	(297,615)	(6,088)	14,285	458	14,743
Net loss		-	-	(71)	-	(71)	585	514
Change in other comprehensive loss		-	-	-	(258)	(258)	-	(258)
Non-controlling interest distributions		-	-	-	-	-	(516)	(516)
Issuance of Class A Common Stock		32	10,969	-	-	11,001	-	11,001
Share based compensation expense		-	751	-	-	751	-	751
BALANCE, JUNE 30, 2011	$	157	329,583	(297,686)	(6,346)	25,708	527	26,235
BALANCE, DECEMBER 31, 2011	$	156	329,995	(326,692)	(20,385)	(16,926)	-	(16,926)
Net loss		-	-	(26,515)	-	(26,515)	-	(26,515)
Change in other comprehensive loss		-	-	-	(584)	(584)	-	(584)
Share based compensation expense		1	268	-	-	269	-	269
BALANCE, JUNE 30, 2012	$	157	330,263	(353,207)	(20,969)	(43,756)	-	(43,756)

See Notes to Consolidated Financial Statements - Unaudited

BBX CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED

	For the Six Months Ended June 30,	
(In thousands)	2012	2011
Net cash provided by operating activities	$ 14,856	44,240
Investing activities:		
Proceeds from redemption of tax certificates	22,526	40,259
Purchase of investment securities and tax certificates	(765)	(18,567)
Proceeds from maturities of securities available for sale	12,287	107,036
Proceeds from maturities of interest bearing deposits	5,655	25,283
Redemptions of FHLB stock	9,980	11,943
Net repayments of loans	230,632	232,518
Proceeds from the sales of loans transferred to held for sale	1,000	27,793
Proceeds from sales of real estate owned	20,553	10,197
Purchases of office property and equipment	(81)	(1,467)
Proceeds from the sale of office properties and equipment	1,168	1,247
Net cash outflow from sale of Tampa branches	-	(257,221)
Net cash provided by investing activities	302,955	179,021
Financing activities:		
Net increase (decrease) in deposits	170,446	(145,280)
Net repayments of FHLB advances	-	(170,020)
Net decrease in securities sold under agreements to repurchase	-	(21,524)
Decrease in short-term borrowings	-	(220)
Net proceed from the issuance of Class A common stock	-	11,001
Noncontrolling interest distributions	-	(516)
Net cash provided by (used in) financing activities	170,446	(326,559)
Increase (decrease) in cash and cash equivalents	488,257	(103,298)
Cash and cash equivalents at the beginning of period	764,636	507,908
Change in cash and cash equivalents held for sale	(59,431)	5,850
Cash and cash equivalents at end of period	$ 1,193,462	410,460

Cash paid (received) for:		
Interest on borrowings and deposits	$ 6,583	9,365

Supplementary disclosure of non-cash investing and financing activities:		
Loans and tax certificates transferred to REO	21,887	25,074
Loans receivable transferred to loans held-for-sale	16,140	55,966

See Notes to Consolidated Financial Statements - Unaudited

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

1. Presentation of Interim Financial Statements

Basis of Financial Statement Presentation – BBX Capital Corporation (formerly BankAtlantic Bancorp, Inc.) and its subsidiaries may also be referred to as “the Company”, “we”, “us,” or “our” in the notes to the consolidated financial statements. BBX Capital Corporation (the “Parent Company” or “BBX”) was organized under the laws of the State of Florida in 1994. BBX’s principal asset until July 31, 2012 was its investment in BankAtlantic and its subsidiaries (“BankAtlantic”). BankAtlantic, a federal savings bank headquartered in Fort Lauderdale, Florida, provided traditional retail banking services and a wide range of commercial banking products and related financial services through a broad network of community branches located in Florida. On July 31, 2012, BBX completed its previously announced sale to BB&T Corporation (“BB&T”) of all of the issued and outstanding shares of capital stock of BankAtlantic (the stock sale and related transactions described herein are collectively referred to as the “Transaction”). In connection with the closing of the Transaction with BB&T, BBX has requested from the Federal Reserve deregistration as a savings and loan holding company and pending approval by the Federal Reserve, BBX expects upon such deregistration to no longer be subject to regulation by the Federal Reserve or to be subject to restrictions applicable to a savings and loan holding company.

On November 1, 2011, the Company entered into a definitive agreement to sell BankAtlantic to BB&T, which agreement was amended on March 13, 2012 (“the Agreement”). The Agreement was amended to, among other things, provide for the assumption by BB&T of the Company’s $285.4 million in principal amount of outstanding trust preferred securities (“TruPS”) obligations. At the closing of the Transaction, BB&T assumed the obligations with respect to the Company’s outstanding TruPS, and the Company paid BB&T approximately $51.3 million, representing all accrued and unpaid interest on the TruPS through closing. The Company also paid approximately $2.3 million for certain legal fees and expenses with respect to the now resolved TruPS-related litigation brought in the Delaware Chancery Court against the Company by holders of the TruPS and certain trustees. The Company funded the TruPS accrued interest and the TruPS related legal fees and expenses from proceeds received in the Transaction.

Under the terms of the Agreement, prior to the closing of the Transaction, BankAtlantic formed two subsidiaries, BBX Capital Asset Management, LLC (“CAM”) and Florida Asset Resolution Group, LLC (“FAR”). BankAtlantic contributed to FAR certain performing and non-performing loans, tax certificates and real estate owned that had an aggregate carrying value on BankAtlantic’s balance sheet of approximately $358 million as of June 30, 2012. FAR assumed all liabilities related to these assets. BankAtlantic also contributed approximately $37 million in cash to FAR

and thereafter distributed all of the membership interests in FAR to the Company. At the closing of the Transaction, the Company transferred to BB&T 95% of the outstanding preferred membership interests in FAR in connection with BB&T's assumption of the Company's outstanding TruPS obligations, as described in further detail below. The Company continues to hold the remaining 5% of FAR's preferred membership interests. Under the terms of the Amended and Restated Limited Liability Company agreement of FAR, which was entered into by the Company and BB&T at the closing, BB&T will hold its 95% preferred interest in the net cash flows of FAR until such time as it has recovered $285 million in preference amount plus a priority return of LIBOR + 200 basis points per annum on any unpaid preference amount. At that time, BB&T's interest in FAR will terminate, and the Company will thereafter be entitled to any and all residual proceeds from FAR through its ownership of FAR's Class R units. It is expected that the assets (other than cash) contributed to FAR will be monetized over a period of seven years, or longer provided BB&T's preference amount is repaid within such seven-year period. The Company entered into an incremental $35 million guarantee in BB&T's favor to further assure BB&T's recovery of the $285 million preference amount within seven years.

Prior to the closing of the Transaction, BankAtlantic also contributed to CAM, certain non-performing commercial loans, commercial real estate owned and previously written-off assets that had an aggregate carrying value on BankAtlantic's balance sheet of $126 million as of June 30, 2012. CAM assumed all liabilities related to these assets. BankAtlantic also contributed approximately $81 million in cash to CAM. Prior to the closing of the Transaction, BankAtlantic distributed all of the membership interests in CAM to the Company. CAM remains a wholly-owned subsidiary of the Company.

Pursuant to the Agreement, the cash consideration exchanged by the parties at the closing of the Transaction in connection with the sale of BankAtlantic's stock was based on the deposit premium and the net asset value of BankAtlantic, in each case as calculated pursuant to the terms of the Agreement, including, with respect to the net asset value of BankAtlantic, after giving effect to the asset contributions and membership interest distributions by BankAtlantic. Based on financial information as of June 30, 2012 and the preliminary calculations of the deposit premium (which was estimated to be $315.9 million) and the net asset value of BankAtlantic, the Company received from BB&T a cash payment related to the sale of BankAtlantic's stock of approximately $6.4 million. However, the deposit premium and net asset value of BankAtlantic as well as the resulting cash payment made to the Company are all estimates based on available financial information as of June 30, 2012. Under the terms of the Agreement, these amounts are subject to adjustment post-closing as all relevant financial information is reviewed and approved by the parties, and the cash payment made to the Company may be less than the amount indicated above or the Company may be required to make a net cash payment to BB&T. The Company expects to recognize a $307 million gain in connection with the Transaction, subject to adjustment based on the final balance sheet reconciliation procedures described in the preceding sentence.

Based on the probable sale of BankAtlantic to BB&T, the Company transferred the assets and liabilities anticipated to be transferred to BB&T to "Assets held for sale", "Deposits held for sale" and "Other liabilities held for sale" as of March 31, 2012. As such, the Company presented the assets and liabilities transferred to BB&T, consisting of all of BankAtlantic's assets and liabilities less the assets and liabilities to be retained in CAM and FAR, as "Assets held for sale" and "Liabilities held for sale" in its unaudited Consolidated Statement of Financial Condition as of June 30, 2012. While the majority of cash and interest bearing deposits in other banks were transferred to BB&T upon closing of the Transaction, with the exception of cash at BankAtlantic's branches and automated teller machines, the cash and interest bearing deposits transferred to BB&T are not presented as "Assets held for sale" as of June 30, 2012. The assets and liabilities transferred to BB&T were measured as of June 30, 2012 on a combined basis as a single disposal group at the lower of cost or fair value less costs to sell. Accordingly, the assets and liabilities held for sale are presented in the Company's unaudited Consolidated Statement of Financial Condition as of June 30, 2012 based on their carrying value as the Company recorded a gain associated with the Transaction.

BankAtlantic's community banking, investment, capital services and tax certificate reporting units are reflected as "Discontinued Operations" in the Company's unaudited Consolidated Statements of Operations for all periods presented. The Company is continuing to service and manage and may originate commercial loans following the sale of BankAtlantic to BB&T and as a result, the results of operations for the Commercial Lending reporting unit are included in the Company's unaudited Consolidated Statement of Operations as continuing operations for all periods presented. The assets and liabilities transferred to BB&T were not reclassified to assets and liabilities held for sale in the Company's Consolidated Statement of Financial Condition as of December 31, 2011. The Consolidated Statement of Stockholders' (Deficit) Equity, Consolidated Statements of Comprehensive (Loss) income and Consolidated Statement of Cash Flows remain unchanged from prior period historical presentation for all periods presented. Additionally, pursuant to the Agreement, the Company agreed to sell to BB&T certain assets and liabilities associated with its Commercial Lending reporting unit and these assets and liabilities are included in assets and liabilities held for sale in the Company's Statement of Financial Condition as of June 30, 2012. Similarly, the Company will retain certain assets and liabilities associated with the disposed reporting units and these assets and liabilities are included in the Company's Consolidated Statement of Financial Condition in their respective line items as of June 30, 2012.

The Company’s consolidated financial statements have been prepared on a going concern basis, which reflects the realization of assets and the repayments of liabilities in the normal course of business.

Included in cash and due from banks in the Company’s Consolidated Statement of Financial Condition as of June 30, 2012 and December 31, 2011 was $0.5 million and $5.7 million, respectively, of time deposits with other banks. These time deposits had original maturities of greater than 90 days and are not considered cash equivalents.

All significant inter-company balances and transactions have been eliminated in consolidation. Throughout this document, the term “fair value” in each case is an estimate of fair value as discussed herein.

In management's opinion, the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) as are necessary for a fair statement of the Company's consolidated financial condition at June 30, 2012, the consolidated results of operations and consolidated statement of comprehensive (loss) income for the three and six months ended June 30, 2012 and 2011, and the consolidated stockholders' (deficit) equity and cash flows for the six months ended June 30, 2012 and 2011. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of results of operations that may be expected for the year ended

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December 31, 2012. The consolidated financial statements and related notes are presented as permitted by Form 10-Q and should be read in conjunction with the consolidated financial statements appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Certain amounts for prior years have been reclassified to conform to the revised financial statement presentation for 2012.

2. Assets and Liabilities Held For Sale

The assets and liabilities transferred to BB&T included in the Company’s Consolidated Statement of Financial Condition consisted of the following (in thousands):

		June 30, 2012
Cash and due from banks	$	59,431
Securities available for sale, at fair value		33,550
Tax certificates		17,736
Federal Home Loan Bank stock		8,328
Loans receivable		1,833,738
Accrued interest receivable		11,347
Office properties and equipment		129,734
Goodwill		13,081
Other assets		19,337
Total assets held for sale	$	2,126,282
Deposits		
Interest free checking	$	928,527
Insured money fund savings		699,179
Now accounts		1,114,360
Savings accounts		424,848
Total non-certificate accounts		3,166,914
Certificate accounts		283,615
Total deposits held for sale	$	3,450,529
Subordinated debentures	$	22,000
Other liabilities		36,347
Total other liabilities held for sale	$	58,347
Total liabilities held for sale	$	3,508,876

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The majority of the cash and interest bearing deposits in other banks on the Company's Consolidated Statement of Financial Position were also transferred to BB&T in the Transaction.

BankAtlantic's five reporting units each reflect a component of the BankAtlantic entity and each is the lowest level for which cash flows can be clearly distinguished, operationally and for financial reporting purposes. These five components are Community Banking, Commercial Lending, Tax Certificates, Investments, and Capital Services. Based on the Agreement with BB&T, the Company determined that its Community Banking, Investments, Capital Services and Tax Certificates reporting units should be treated as discontinued operations. The Company sold all operations and the majority of the assets and liabilities of these discontinued reporting units to BB&T on July 31, 2012. Management does not intend to continue in any material respect any activities of or have any continuing involvement with these reporting units. The Company intends to continue Commercial Lending reporting unit activities after the closing of the Transaction. Therefore, although certain assets of this reporting unit will be sold to BB&T and are presented as assets and liabilities held for sale in the Consolidated Statement of Financial Condition as of June 30, 2012, the Commercial Lending reporting unit was not reported as discontinued operations.

Pursuant to the Agreement, FAR will retain in addition to certain assets associated with the Company's continuing Commercial Lending reporting unit, certain assets and liabilities that were associated with the Company's disposed reporting units (Community Banking, Tax Certificates, Investments, and Capital Services reporting units). The Company determined that the ongoing cash flows of the disposed reporting units were not significant relative to the historical cash flows from the activities of each reporting unit; therefore, the income and expenses associated with the disposed reporting units are reported in discontinued operations for each period presented. The carrying value of the disposed reporting units' net assets anticipated to be included in FAR's total assets discussed above was $120 million as of June 30, 2012. The assets held by FAR are expected to be monetized in accordance with the terms of such assets or through orderly transactions over a seven year period. Ninety-five percent of the cash flows from these assets net of operating expenses and a stated preferred return will be applied toward the ongoing repayment of BB&T's preferred interest in FAR.

BBX Capital Corporation

The (loss) income from Community Banking, Investments, Capital Services and Tax Certificates reporting units included in discontinued operations in the Company's Statement of Operations was as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Total interest income	$ 17,924	26,113	38,651	53,780
Total interest expense	3,248	4,242	6,502	8,954
Net interest income	14,676	21,871	32,149	44,826
Provision for loan losses	7,301	6,396	16,518	27,381
Net interest income after provision for loan losses	7,375	15,475	15,631	17,445
Non-interest income:				
Service charges on deposits	7,491	11,226	15,342	23,258
Other service charges and fees	5,958	6,886	11,896	14,077
Securities activities, net	(99)	-	(99)	(24)
Gain on sale of Tampa branches	-	38,656	-	38,656
Other	1,383	2,878	5,118	6,172
Total non-interest income	14,733	59,646	32,257	82,139
Non-interest expense (1):				
Employee compensation and benefits	10,456	13,428	22,146	27,195
Occupancy and equipment	7,159	8,380	14,431	17,502
Advertising and promotion	919	1,378	1,935	2,961
Professional fees	395	637	2,218	1,869
Other	7,126	10,191	12,141	17,636
Total non-interest expense	26,055	34,014	52,871	67,163
(Loss) income from discontinued operations	(3,947)	41,107	(4,983)	32,421
Provision for income taxes	-	-	1	1
Net (loss) income from discontinued operations	$ (3,947)	41,107	(4,984)	32,420

(1) Pursuant to applicable accounting rules, all general corporate overhead was allocated to continuing operations.

3. Liquidity Considerations

BBX had cash of $4.0 million and current liabilities of $5.8 million as of June 30, 2012. In connection with the consummation of the Transaction on July 31, 2012, BBX received net cash proceeds of approximately $29.0 million, consisting of a $6.4 million cash payment from BB&T and approximately $22.5 million of cash held in its wholly-owned subsidiary, CAM, net of transaction costs, trustee fees and costs associated with the TruPS related litigation and payments to BB&T of accrued and unpaid TruPS interest. BBX liquidity is primarily dependent upon the repayments of loans, sales of real estate, and obtaining funds from its 5% preferred interest in FAR. Based on the current and expected liquidity needs and sources, the Company expects to be able to meet its liquidity needs over the next 12 months.

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4. Fair Value Measurement

The following tables present major categories of the Company's assets measured at fair value on a recurring basis as of December 31, 2011 (in thousands):

			Fair Value Measurements Using		
Description		As of December 31, 2011	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Mortgage-backed securities	$	13,418	-	13,418	-
REMICS		31,690	-	31,690	-
Equity securities		1,327	827	500	-
Total	$	46,435	827	45,608	-

The Company had $26,000 of equity securities measured at fair value as of June 30, 2012 based on Level 1 inputs.

There were no recurring liabilities measured at fair value in the Company's financial statements as of June 30, 2012 or December 31, 2011.

The valuation techniques and the inputs used in our financial statements to measure the fair value of our recurring financial instruments are described below.

The fair values of mortgage-backed and real estate mortgage conduit securities ("REMICS") are estimated using independent pricing sources and matrix pricing. Matrix pricing uses a market approach valuation technique and Level 2 valuation inputs as quoted market prices are not available for the specific securities that the Company owns. The independent pricing sources value these securities using observable market inputs including: benchmark yields, reported trades, broker/dealer quotes, issuer spreads and other reference data in the secondary institutional market, which is the principal market for these types of assets. To validate fair values obtained from the pricing sources, the Company reviews fair value estimates obtained from brokers, investment advisors and others to determine the reasonableness of the fair values obtained from independent pricing sources. The Company reviews any price that it

determines may not be reasonable and requires the pricing sources to explain the differences in fair value or re-evaluate its estimated fair value.

Equity securities are generally fair valued using the market approach and quoted market prices (Level 1) or matrix pricing (Level 2) with inputs obtained from independent pricing sources, if available. We also obtain non-binding broker quotes to validate fair values obtained from matrix pricing. We also invest in private limited partnerships that do not have readily determinable fair values. We use the net asset value per share as provided by the partnership to estimate the fair value of these investments. The net asset value of the partnership is a Level 2 input since we have the ability to require the redemption of our investment at its net asset value.

BBX Capital Corporation

The following table presents major categories of assets measured at fair value on a non-recurring basis as of June 30, 2012 (in thousands):

		Fair Value Measurements Using			
		Quoted prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Total Impairments (1) For the Six
Description	June 30, 2012	(Level 1)	(Level 2)	(Level 3)	Months Ended
Impaired real estate owned	$ 27,288	-	-	27,288	3,534
Impaired loans held for sale	9,397	-	-	9,397	459
Total	$ 36,685	-	-	36,685	3,993

(1) Total impairments represent the amount recognized during the six months ended June 30, 2012 on assets that were held and measured at fair value as of June 30, 2012.

Quantitative information about significant unobservable inputs within Level 3 non-recurring major categories of assets is as follows (dollars in thousands):

As of June 30, 2012 Description	Fair Value	Valuation Technique	Unobservable Inputs	Range (Average) (1)
Impaired real estate owned	$ 27,288	Fair Value of Property	Appraisal	$0.4 -6.5 million (3.0 million)
Impaired loans held for sale	9,397	Fair Value of Collateral	Appraisal	$0.9 -3.6 million (1.9 million)
Total	$ 36,685			

(1) Range and average appraised values were reduced by costs to sell.

The following table presents major categories of assets measured at fair value on a non-recurring basis as of June 30, 2011 (in thousands):

		Fair Value Measurements Using			
Description	June 30, 2011	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Impairments (1) For the Six Months Ended
Loans measured for impairment using the fair value of the underlying collateral	$ 265,245	-	-	265,245	24,624
Impaired loans held for sale	27,463	-	-	27,463	6,335
Impaired real estate owned	36,044	-	-	36,044	8,830
Total	$ 328,752	-	-	328,752	39,789

(1) Total impairments represent the amount recognized during the six months ended June 30, 2011 on assets that were measured at fair value as of June 30, 2011.

There were no material liabilities measured at fair value on a non-recurring basis in the Company's financial statements as of June 30, 2012 and December 31, 2011.

Loans Measured For Impairment

Impaired loans are generally valued based on the fair value of the underlying collateral less cost to sell. The Company primarily uses third party appraisals to assist in measuring non-homogenous impaired loans. These appraisals generally use the market or income approach valuation technique and use market observable data to formulate an opinion of the fair value of the loan's collateral. However, the appraiser uses professional judgment in determining the fair value of the collateral or properties, and we may also adjust these values for changes in market conditions subsequent to the appraisal date. When current appraisals are not available for certain loans, we use our judgment on market conditions to adjust the most current appraisal. The sales prices may reflect prices of sales contracts not closed, and the amount of time required to sell out the real estate project may be derived from current appraisals of similar projects. As a consequence, the calculation of the fair value of the collateral are considered Level 3 inputs. The Company generally recognizes impairment losses based on third party broker price opinions or automated valuation services to obtain the fair value of the collateral less cost to sell when impaired homogenous loans become 120 days delinquent. These third party valuations from real estate professionals also use Level 3 inputs in determining fair values. The observable market inputs used to fair value loans include comparable property sales, rent rolls, market capitalization rates on income producing properties, risk adjusted discounts rates and foreclosure period and exposure periods. The fair value of our loans may significantly increase or decrease based on property values as our loans are primarily real estate loans.

Impaired Real Estate Owned

Real estate is generally valued using third party appraisals or broker price opinions. These appraisals generally use the market approach valuation technique and use market observable data to formulate an opinion of the fair value of the properties. The market observable data was generally comparable property sales, rent rolls, market capitalization rates on income producing properties and risk adjusted discount rates. However, the appraisers or brokers use professional judgments in determining the fair value of the properties and we may also adjust these values for changes in market conditions subsequent to the valuation date. As a consequence of using appraisals, broker price opinions and adjustments to appraisals, the fair values of the properties are considered Level 3 inputs.

Loans Held for Sale

Loans held for sale are valued using an income approach with Level 3 inputs as market quotes or sale transactions of similar loans are generally not available. The fair value is estimated by discounting forecasted cash flows, using a discount rate that reflects the risks inherent in the loans held for sale portfolio. For non-performing loans held for sale, the forecasted cash flows are based on the estimated fair value of the collateral less cost to sell adjusted for foreclosure expenses and other operating expenses of the underlying collateral until foreclosure or sale.

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BBX Capital Corporation

Financial Disclosures about Fair Value of Financial Instruments

(in thousands) Description	Carrying Amount As of June 30, 2012	Fair Value Measurements Using As of June 30, 2012	Quoted prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial assets:					
Cash and interest bearing deposits in other banks	$ 1,193,958	1,193,958	1,193,958	-	-
Securities available for sale	26	26	26		
Tax certificates	5,293	5,346	-	-	5,346
Loans receivable including loans held for sale, net	402,823	405,300	-	-	405,300
Financial liabilities:					
Junior subordinated debentures	345,092	307,625	-	307,625	-

(in thousands)	December 31, 2011 Carrying Amount	Fair Value
Financial assets:		
Cash and interest bearing deposits in other banks	$ 770,292	770,292
Securities available for sale	46,435	46,435
Tax certificates	46,488	45,562
Federal home loan bank stock	18,308	18,308
Loans receivable including loans held for sale, net	2,503,804	2,317,144
Financial liabilities:		
Deposits	3,280,083	3,279,562
Subordinated debentures	22,000	21,989

Junior subordinated debentures	337,114	226,991

Management has made estimates of fair value that it believes to be reasonable. However, because there is no active market for many of these financial instruments and management has derived the fair value of the majority of these financial instruments using the income approach technique with Level 3 unobservable inputs, the Company may not receive the estimated value upon sale or disposition of the asset or pay the estimated value upon disposition of the liability in advance of its scheduled maturity. Management estimates used in its net present value financial models rely on assumptions and judgments regarding issues where the outcome is unknown and actual results or values may differ significantly from these

estimates. The Company’s fair value estimates do not consider the tax effect that would be associated with the disposition of the assets or liabilities at their fair value estimates.

Fair values are estimated for loan portfolios with similar financial characteristics. Loans are segregated by category, and each loan category is further segmented into fixed and adjustable rate interest terms and by performing and non-performing categories.

The fair value of performing loans is calculated by using an income approach with Level 3 inputs. The fair value of performing loans is estimated by discounting forecasted cash flows through the estimated maturity using estimated market discount rates that reflect the interest rate risk inherent in the loan portfolio. The estimate of average maturity is based on BankAtlantic's historical experience with prepayments for each loan classification, modified as required, by an estimate of the effect of current economic and lending conditions. Management assigns a credit risk premium and an illiquidity adjustment to these loans based on risk grades and delinquency status. The fair value of non-performing collateral dependent loans is estimated using an income approach with Level 3 inputs. The fair value of non-performing loans utilizes the fair value of the collateral adjusted for operating and selling expenses and discounted over the estimated holding period based on the market risk inherent in the property.

The fair value of tax certificates is calculated using the income approach with Level 3 inputs. The fair value is based on discounted expected cash flows using discount rates that take into account the risk of the cash flows of tax certificates relative to alternative investments.

The fair value of FHLB stock is its carrying amount as the FHLB redeems its stock at par.

As permitted by applicable accounting guidance, the fair value of deposits with no stated maturity, such as non-interest bearing demand deposits, savings and NOW accounts, and money market and checking accounts, is shown in the above table at book value. The fair value of certificates of deposit is based on an income approach with Level 3 inputs. The fair value is calculated by the discounted value of contractual cash flows with the discount rate estimated using current rates offered by BankAtlantic for similar remaining maturities.

The fair value of BankAtlantic’s subordinated debentures was based on discounted values of contractual cash flows at a market discount rate adjusted for non-performance risk (Level 3 inputs).

In determining the fair value of all of the Company's junior subordinated debentures, the Company used NASDAQ price quotes available with respect to its $76.6 million of publicly traded trust preferred securities related to its junior subordinated debentures ("public debentures"). However, $268.5 million of the outstanding trust preferred securities related to its junior subordinated debentures are not traded, but are privately held in pools ("private debentures") and with no liquidity or readily determinable source for valuation. We have deferred the payment of interest with respect to all of our junior subordinated debentures as permitted by the terms of these securities. Based on the deferral status and the lack of liquidity and ability of a holder to actively sell such private debentures, the fair value of these private debentures may be subject to a greater discount to par and have a lower fair value than indicated by the public debenture price quotes. However, due to their private nature and the lack of a trading market, fair value of the private debentures was not readily determinable at June 30, 2012 and December 31, 2011, and as a practical alternative, management used the NASDAQ price quotes of the public debentures to value all of the outstanding junior subordinated debentures whether privately held or public traded. As such, the private debentures were valued using Level 2 inputs.

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BBX Capital Corporation

5. Securities Available for Sale

The following table summarizes securities available for sale (in thousands):

	As of December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Government agency securities:				
Mortgage-backed securities	$ 12,533	885	-	13,418
Real estate mortgage investment conduits	30,561	1,129	-	31,690
Total	43,094	2,014	-	45,108
Equity securities	1,260	67	-	1,327
Total	$ 44,354	2,081	-	46,435

The Company had equity securities available for sale with a cost of $10,000 and a fair value of $26,000 as of June 30, 2012.

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BBX Capital Corporation

6. Loans Receivable

The loan disclosures in this note as of June 30, 2012 includes loans in the Company's asset workout subsidiary and only those loans which were to be transferred to FAR or CAM in connection with the Transaction and excludes $1.8 billion of loans to be transferred to BB&T under the terms of the Agreement. The loans transferred to BB&T are included in assets held for sale as of June 30, 2012.

The loan portfolio consisted of the following (in thousands):

	June 30, 2012	December 31, 2011
Commercial non-real estate	$ 28,167	118,145
Commercial real estate:		
Residential	60,894	104,593
Land	3,496	24,202
Owner occupied	8,100	86,809
Other	161,180	464,902
Small Business:		
Real estate	19,963	184,919
Non-real estate	11,755	99,835
Consumer:		
Consumer - home equity	19,958	545,908
Consumer other	30	10,704
Deposit overdrafts	-	1,971
Residential:		
Residential-interest only	18,077	375,498
Residential-amortizing	31,065	558,026
Total gross loans	362,685	2,575,512
Adjustments:		
Premiums, discounts and net deferred fees	262	2,578
Allowance for loan losses	(7,153)	(129,887)
Loans receivable -- net	$ 355,794	2,448,203
Loans held for sale	$ 47,029	55,601

Loans held for sale - Loans held for sale as of June 30, 2012 consisted of $30.9 million of commercial real estate loans and $16.1 million of residential loans. Loans held for sale as of December 31, 2011 consisted of $35.8 million of commercial real estate loans and $19.8 million of residential loans. The Company transfers loans to held-for-sale when, based on the current economic environment and related market conditions, it does not have the intent to hold those loans for the foreseeable future.

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BBX Capital Corporation

The recorded investment (unpaid principal balance less charge-offs and deferred fees) of non-accrual loans receivable and loans held for sale was (in thousands):

Loan Class	June 30, 2012	December 31, 2011
Commercial non-real estate	$ 5,607	19,172
Commercial real estate:		
Residential	63,381	71,719
Land	12,888	14,839
Owner occupied	3,140	4,168
Other	91,590	123,396
Small business:		
Real estate	4,887	10,265
Non-real estate	1,380	1,751
Consumer	8,261	14,134
Residential:		
Interest only	22,085	33,202
Amortizing	35,005	52,653
Total nonaccrual loans	$ 248,224	345,299

BBX Capital Corporation

An age analysis of the past due recorded investment in loans receivable and loans held for sale as of June 30, 2012 and December 31, 2011 was as follows (in thousands):

June 30, 2012		31-59 Days Past Due	60-89 Days Past Due	90 Days or More	Total Past Due	Current	Total Loans Receivable
Commercial non-real estate	$	2,500	1,093	1,381	4,974	23,193	28,167
Commercial real estate:							
Residential		-	-	46,328	46,328	18,590	64,918
Land		-	-	12,888	12,888	-	12,888
Owner occupied		-	138	3,002	3,140	6,242	9,382
Other		-	-	42,149	42,149	135,085	177,234
Small business:							
Real estate		893	-	4,127	5,020	15,092	20,112
Non-real estate		20	-	-	20	11,735	11,755
Consumer		719	1,134	8,261	10,114	10,003	20,117
Residential:							
Residential-interest only		397	-	21,779	22,176	1,286	23,462
Residential-amortizing		1,358	779	32,292	34,429	7,512	41,941
Total	$	5,887	3,144	172,207	181,238	228,738	409,976

December 31, 2011		31-59 Days Past Due	60-89 Days Past Due	90 Days or More (1)	Total Past Due	Current	Total Loans Receivable
Commercial non-real estate	$	-	2,248	13,292	15,540	102,605	118,145
Commercial real estate:							
Residential		-	-	44,633	44,633	64,134	108,767
Land		681	-	14,839	15,520	18,070	33,590
Owner occupied		2,008	-	4,031	6,039	82,102	88,141
Other		-	5,467	47,841	53,308	431,399	484,707
Small business:							
Real estate		2,089	372	9,449	11,910	173,009	184,919
Non-real estate		-	462	76	538	99,187	99,725
Consumer		5,339	3,996	14,134	23,469	538,569	562,038
Residential:							
Residential-interest only		2,656	3,488	32,317	38,461	343,958	382,419
Residential-amortizing		3,968	4,513	48,189	56,670	514,570	571,240
Total	$	16,741	20,546	228,801	266,088	2,367,603	2,633,691

(1) Includes an $80,000 commercial loan that was past due greater than 90 days and still accruing.

BBX Capital Corporation

The activity in the allowance for loan losses by portfolio segment for the three months ended June 30, 2012 was as follows (in thousands):

		Commercial Non-Real Estate	Commercial Real Estate	Small Business	Consumer	Residential	Total
Allowance for Loan Losses:							
Beginning balance	$	1,359	4,212	1,020	366	210	7,167
Charge-off :		-	(1,778)	(748)	(849)	(1,547)	(4,922)
Recoveries :		386	1,631	128	236	281	2,662
Provision :		(945)	318	-	-	-	(627)
Discontinued operations provision:		-	-	926	654	1,293	2,873
Transfer to assets held for sale:		-	-	-	-	-	-
Ending balance	$	800	4,383	1,326	407	237	7,153
Ending balance individually evaluated for impairment	$	237	1,265	790	-	-	2,292
Ending balance collectively evaluated for impairment		563	3,118	536	407	237	4,861
Total	$	800	4,383	1,326	407	237	7,153
Loans receivable:							
Ending balance individually evaluated for impairment	$	7,361	194,168	957	7,907	40,331	250,724
Ending balance collectively evaluated for impairment	$	20,806	39,502	30,761	12,081	8,811	111,961
Total	$	28,167	233,670	31,718	19,988	49,142	362,685
Purchases of loans	$	-	-	-	-	-	-
Proceeds from loan sales	$	-	-	-	-	-	-
Transfer to loans held for sale	$	-	-	-	-	-	-

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BBX Capital Corporation

The activity in the allowance for loan losses by portfolio segment for the three months ended June 30, 2011 was as follows (in thousands):

	Commercial Non-Real Estate	Commercial Real Estate	Small Business	Consumer	Residential	Total
Allowance for Loan Losses:						
Beginning balance	$ 10,708	79,142	10,125	27,511	27,565	155,051
Charge-offs:	(124)	(15,100)	(2,010)	(6,379)	(5,767)	(29,380)
Recoveries :	57	75	203	492	435	1,262
Provision :	376	3,937	-	-	-	4,313
Discontinued operations provision:	-	-	1,535	3,375	1,487	6,397
Ending balance	$ 11,017	68,054	9,853	24,999	23,720	137,643
Ending balance individually evaluated for impairment	$ 9,618	47,638	1,595	1,671	4,555	65,077
Ending balance collectively evaluated for impairment	1,399	20,416	8,258	23,328	19,165	72,566
Total	$ 11,017	68,054	9,853	24,999	23,720	137,643
Loans receivable:						
Ending balance individually evaluated for impairment	$ 34,569	285,325	10,370	24,576	57,740	412,580
Ending balance collectively evaluated for impairment	$ 90,261	466,287	282,388	568,561	982,126	2,389,623
Total	$ 124,830	751,612	292,758	593,137	1,039,866	2,802,203
Purchases of loans	$ -	-	-	-	9,816	9,816
Proceeds from loan sales	$ -	24,693	-	-	4,983	29,676
Transfer to loans held for sale	$ -	28,444	-	-	-	28,444

BBX Capital Corporation

The activity in the allowance for loan losses by portfolio segment for the six months ended June 30, 2012 was as follows (in thousands):

	Commercial Non-Real Estate	Commercial Real Estate	Small Business	Consumer	Residential	Total
Allowance for Loan Losses:						
Beginning balance	$ 16,407	67,054	7,168	22,554	16,704	129,887
Charge-off :	(14,615)	(53,281)	(2,372)	(7,413)	(11,756)	(89,437)
Recoveries :	440	1,631	270	1,031	1,277	4,649
Provision :	465	(1,857)	-	-	-	(1,392)
Transfer to held for sale:	(1,897)	(9,164)	(4,454)	(20,639)	(12,491)	(48,645)
Discontinued operations Provision:	-	-	714	4,874	6,503	12,091
Ending balance	$ 800	4,383	1,326	407	237	7,153
Purchases of loans	$ -	-	-	-	-	-
Proceeds from loan sales	$ -	1,000	-		-	1,000
Transfer to held for sale	$ -	16,140	-	-	-	16,140

The activity in the allowance for loan losses by portfolio segment for the six months ended June 30, 2011 was as follows (in thousands):

	Commercial Non-Real Estate	Commercial Real Estate	Small Business	Consumer	Residential	Total
Allowance for Loan Losses:						
Beginning balance	$ 10,786	83,859	11,514	32,043	23,937	162,139
Charge-off :	(588)	(26,152)	(4,621)	(14,193)	(13,778)	(59,332)
Recoveries :	848	793	513	900	566	3,620
Provision :	(29)	11,169	-	-	-	11,140
Transfer to held for sale:	-	(1,615)	-	-	(5,691)	(7,306)
Discontinued operations provision:	-	-	2,447	6,249	18,686	27,382
Ending balance	$ 11,017	68,054	9,853	24,999	23,720	137,643
Purchases of loans	$ -	-	-	-	13,680	13,680

Proceeds from loan sales	$	-	27,793	-		12,601	40,394
Transfer to held for sale	$	-	30,894	-	-	25,072	55,966

As part of the transition of the regulation of OTS savings associations to the OCC, the OCC provided guidance to thrifts related to their transition to OCC regulatory reporting, which was to be implemented no later than March 31, 2012, including guidance surrounding specific valuation allowances on collateral dependent loans. Under OCC guidance, where the appraised value of collateral on a collateral dependent loan is less than the recorded investment of the loan, a charge-off of the amount of the deficiency rather than a specific valuation allowance is now generally required. Management considered the appraisals on its impaired collateral dependent loans, including appraised values and appraisal dates and during the first quarter of 2012, the Company charged down the recorded investment of loans by $66.5 million to the fair value of the collateral less cost to sell. This charge down consisted entirely of the charging off of existing specific valuation allowances. As a specific valuation allowance was previously established for these loans, the charge-offs did not impact the provision for loan losses or the net loss during the three months ended March 31, 2012, but did reduce the Company's allowance for loan losses and recorded investment in the loans.

Impaired Loans - Loans are considered impaired when, based on current information and events, the Company believes it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement. For a loan that has been restructured, the contractual terms of the loan agreement refer to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructured agreement. Impairment is evaluated based on past due status for consumer and residential loans. Impairment is evaluated as part of the Company's on-going credit monitoring process for commercial and small business loans which results in the evaluation for impairment of substandard loans. Factors considered in determining if a loan is impaired are past payment history, strength of the borrower or guarantors, and cash flow associated with the collateral or business. If a loan is impaired, a specific valuation allowance is allocated, if necessary, based on the present value of estimated future cash flows using the loan's existing interest rate or based on the fair value of the loan. Collateral dependent impaired loans are charged down to the fair value of collateral less cost to sell. Interest payments on impaired loans for all loan classes are recognized on a cash basis, unless collectability of the principal and interest amount is probable, in which case interest is recognized on an accrual basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Impaired loans held for sale are measured for impairment based on the estimated fair value of the collateral less cost to sell adjusted for foreclosure expenses and other operating expenses of the underlying collateral until foreclosure and sale.

Impaired loans as of June 30, 2012 and December 31, 2011 were as follows (in thousands):

	As of June 30, 2012			As of December 31, 2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With a related allowance recorded:						
Commercial non-real estate	$ 1,174	1,174	237	17,792	17,792	15,408
Commercial real estate:						
Residential	7,544	12,411	67	64,841	70,780	20,986
Land	-	-	-	5,451	5,451	1,765
Owner occupied	-	-	-	1,715	1,715	100
Other	35,307	50,429	1,198	130,771	149,742	29,731
Small business:						
Real estate	-	-	-	6,499	6,499	85
Non-real estate	957	957	790	1,339	1,339	776
Consumer	-	-	-	15,951	17,502	1,454
Residential:						
Residential-interest only	-	-	-	15,441	20,667	2,982
Residential-amortizing	-	-	-	20,554	24,545	3,960
Total with allowance recorded	$ 44,982	64,971	2,292	280,354	316,032	77,247
With no related allowance recorded:						
Commercial non-real estate	$ 6,933	7,059	-	5,922	5,922	-
Commercial real estate:						
Residential	56,297	122,432	-	26,735	71,759	-
Land	12,887	35,768	-	9,388	30,314	-
Owner occupied	4,549	6,523	-	3,882	4,872	-
Other	108,901	147,666	-	63,024	86,052	-
Small business:						
Real estate	10,566	12,167	-	10,265	12,007	-
Non-real estate	744	868	-	792	1,107	-
Consumer	18,723	22,966	-	9,719	13,246	-
Residential:						
Residential-interest only	22,085	38,244	-	17,761	28,042	-
Residential-amortizing	37,075	53,254	-	34,494	45,680	-
Total with no allowance recorded	$ 278,760	446,947	-	181,982	299,001	-
Commercial non-real estate	$ 8,107	8,233	237	23,714	23,714	15,408
Commercial real estate	225,485	375,229	1,265	305,807	420,685	52,582
Small business	12,267	13,992	790	18,895	20,952	861
Consumer	18,723	22,966	-	25,670	30,748	1,454
Residential	59,160	91,498	-	88,250	118,934	6,942
Total	$ 323,742	511,918	2,292	462,336	615,033	77,247

BBX Capital Corporation

Average recorded investment and interest income recognized on impaired loans as of June 30, 2012 were (in thousands):

	For the Three Months Ended June 30, 2012		For the Six Months Ended June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With an allowance recorded:				