

AFFILIATED COMPUTER SERVICES INC

Form 10-Q

November 07, 2008

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

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

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

For the period from _____ to _____

Commission file number 001-12665

AFFILIATED COMPUTER SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware

51-0310342

(State or other jurisdiction of incorporation or organization)

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

2828 North Haskell, Dallas, Texas

75204

(Address of principal executive offices)

(Zip Code)

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

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

(Do not check if a smaller reporting company)

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

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

Title of each class	Number of shares outstanding as of October 29, 2008
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Class A Common Stock, \$.01 par value	90,951,472
Class B Common Stock, \$.01 par value	6,599,372

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

	September 30, 2008	June 30, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 434,815	\$ 461,883
Accounts receivable, net	1,459,272	1,378,285
Income taxes receivable		7,076
Prepaid expenses and other current assets	261,953	255,872
Total current assets	2,156,040	2,103,116
Property, equipment and software, net	897,785	920,637
Goodwill	2,764,591	2,785,164
Other intangibles, net	428,356	444,479
Other assets	199,121	216,003
Total assets	\$ 6,445,893	\$ 6,469,399
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 197,167	\$ 198,191
Accrued compensation and benefits	154,443	244,888
Other accrued liabilities	354,351	338,861
Income taxes payable	21,493	
Deferred taxes	83,072	82,017
Current portion of long-term debt	46,978	47,373
Current portion of unearned revenue	172,921	173,809
Total current liabilities	1,030,425	1,085,139
Senior Notes, net of unamortized discount	499,549	499,529
Other long-term debt	1,824,143	1,858,012
Deferred taxes	424,812	411,836
Other long-term liabilities	299,719	306,509
Total liabilities	4,078,648	4,161,025

Commitments and contingencies (See Note 11)

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Stockholders' equity:

Class A common stock, \$.01 par value, 500,000 shares authorized, 111,803 and 111,660 shares issued, respectively	1,117	1,116
Class B convertible common stock, \$.01 par value, 14,000 shares authorized, 6,600 shares issued and outstanding	66	66
Additional paid-in capital	1,714,701	1,702,340
Accumulated other comprehensive income (loss), net	(18,296)	18,830
Retained earnings	1,725,625	1,641,990
Treasury stock at cost, 21,002 shares	(1,055,968)	(1,055,968)
 Total stockholders' equity	 2,367,245	 2,308,374
 Total liabilities and stockholders' equity	 \$ 6,445,893	 \$ 6,469,399

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

Table of Contents**AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED)****(in thousands, except per share amounts)**

	Three months ended September 30,	
	2008	2007
Revenues	\$ 1,604,454	\$ 1,493,083
Operating expenses:		
Cost of revenues:		
Wages and benefits	734,016	699,949
Services and supplies	373,505	341,766
Rent, lease and maintenance	202,143	184,918
Depreciation and amortization	97,606	90,824
Other	10,348	6,915
Cost of revenues	1,417,618	1,324,372
Other operating expenses	14,088	23,310
Total operating expenses	1,431,706	1,347,682
Operating income	172,748	145,401
Interest expense	35,208	43,970
Other non-operating expense (income), net	3,700	(680)
Pretax profit	133,840	102,111
Income tax expense	50,205	35,967
Net income	\$ 83,635	\$ 66,144
Earnings per share:		
Basic	\$ 0.86	\$ 0.66
Diluted	\$ 0.85	\$ 0.65
Shares used in computing earnings per share:		
Basic	97,307	99,721

Diluted

98,091

100,986

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

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

	Three months ended	
	September 30,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 83,635	\$ 66,144
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	97,606	90,824
Stock-based compensation expense	5,695	7,601
Excess tax benefit on stock-based compensation	(80)	(1,955)
Deferred income tax expense	14,319	3,791
Loss on long-term investments	5,987	1,853
Gain on sale of business units	(441)	
Other non-cash activities	12,054	6,846
Changes in assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(84,192)	(130,635)
Prepaid expenses and other current assets	(13,257)	(4,222)
Other assets	1,840	(3,598)
Accounts payable	(1,202)	51,547
Accrued compensation and benefits	(90,483)	(106,925)
Other accrued liabilities	9,564	(2,796)
Income taxes receivable/payable	29,301	36,322
Other long-term liabilities	(8,988)	5,058
Unearned revenue	1,244	(11,832)
Total adjustments	(21,033)	(58,121)
Net cash provided by operating activities	62,602	8,023
Cash flows from investing activities:		
Purchases of property, equipment and software, net	(64,550)	(65,841)
Additions to other intangible assets	(9,541)	(9,481)
Payments for acquisitions, net of cash acquired	(4,751)	(23,697)
Proceeds from divestitures, net of transaction costs	9,307	
Purchases of investments	(2,596)	
Proceeds from sale of investments	10,551	
Net cash used in investing activities	(61,580)	(99,019)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt, net		22,961
Payments of long-term debt	(33,688)	(22,365)

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Excess tax benefit on stock-based compensation	80	1,955
Proceeds from stock options exercised	5,599	27,276
Other, net	(81)	(102)
Net cash provided by (used in) financing activities	(28,090)	29,725
Net decrease in cash and cash equivalents	(27,068)	(61,271)
Cash and cash equivalents at beginning of period	461,883	307,286
Cash and cash equivalents at end of period	\$ 434,815	\$ 246,015

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

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

1. BASIS OF PRESENTATION

We are a Fortune 500 and S&P 500 company with approximately 63,000 employees providing business process outsourcing and information technology services to commercial and government clients. We were incorporated in Delaware on June 8, 1988 and our corporate headquarters is located in Dallas, Texas. Our clients have time-critical, transaction-intensive business and information processing needs, and we typically service these needs through long-term contracts.

The consolidated financial statements are comprised of our accounts and the accounts of our controlled subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The financial information presented should be read in conjunction with our consolidated financial statements for the year ended June 30, 2008. The foregoing unaudited consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the results of the interim period. The results for the interim period are not necessarily indicative of results to be expected for the year.

Significant accounting policies are detailed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

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

2. GOODWILL AND OTHER INTANGIBLE ASSETS, NET

The changes in the carrying amount of goodwill for the three months ended September 30, 2008 are as follows (in thousands):

	Commercial	Government	Total
Balance as of June 30, 2008	\$ 1,546,870	\$ 1,238,294	\$ 2,785,164
Acquisition activity during the period	(3)	2,843	2,840
Divestiture activity during the period		(2,834)	(2,834)
Foreign currency translation adjustments	(15,229)	(5,350)	(20,579)
Balance as of September 30, 2008	\$ 1,531,638	\$ 1,232,953	\$ 2,764,591

Approximately \$2.2 billion, or 78%, of the original gross amount of goodwill recorded is deductible for income tax purposes. The acquisition activity during the three months ended September 30, 2008 is primarily due to the payment of contingent consideration earned during the three months ended September 30, 2008 on a prior year acquisition. The divestiture activity during the three months ended September 30, 2008 is due to the sale of the bindery business as discussed in Note 10.

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

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

	As of September 30, 2008		As of June 30, 2008	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible assets:				
Acquired customer-related intangibles	\$ 424,489	\$ (177,969)	\$ 445,753	\$ (184,400)
Customer contract costs	251,423	(130,388)	251,837	(130,319)
All other	19,038	(13,125)	19,121	(12,401)
	\$ 694,950	\$ (321,482)	\$ 716,711	\$ (327,120)
Non-amortizable intangible assets:				
Title plant	\$ 51,045		\$ 51,045	
Tradename	3,843		3,843	
	\$ 54,888		\$ 54,888	

	Three months ended September 30,	
	2008	2007
Amortization:		
Contract inducements	\$ 3,872	\$ 3,727
Acquired customer-related intangibles	11,205	11,034
All other intangibles	8,213	6,364
Total amortization	\$ 23,290	\$ 21,125

Aggregate amortization includes amounts charged to amortization expense for customer-related intangibles and other intangibles, other than contract inducements. Amortization of contract inducements is recorded as a reduction of related contract revenue. Amortizable intangible assets are amortized over the related contract term. The amortization period of customer-related intangible assets ranges from 1 to 17 years, with a weighted average of approximately 9 years. The amortization period for all other intangible assets, including trademarks, ranges from 3 to 20 years, with a weighted average of approximately 5 years.

Estimated amortization for the years ending June 30, (in thousands)

2009	\$87,864
2010	73,555
2011	62,212
2012	43,250
2013	29,784

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

3. PENSION AND OTHER POST-EMPLOYMENT PLANS*Net periodic benefit cost*

The following table provides the components of net periodic benefit cost (in thousands):

	Three months ended September 30,			
	2008		2007	
	Non-U.S.	U.S.	Non-U.S.	U.S.
<u>Components of net periodic benefit cost</u>				
Defined benefit plans:				
Service cost	\$ 1,732	\$ 894	\$ 1,528	\$ 926
Interest cost	1,994	191	1,632	123
Expected return on assets	(1,786)	(240)	(1,800)	(173)
Recognized net actuarial gain	1			
Amortization of prior service costs		55		54
Net periodic benefit cost for defined benefit plans	\$ 1,941	\$ 900	\$ 1,360	\$ 930

Contributions

We made contributions to the pension plans of approximately \$3.6 million during the three months ended September 30, 2008. We expect to contribute approximately \$15 million to our pension plans during fiscal year 2009.

4. EQUITY*Share repurchase programs*

On November 25, 2007, our Board of Directors endorsed a new \$1 billion share repurchase program and authorized the purchase of up to \$200 million of our Class A common stock under this program. The program allowed us to repurchase our shares on the open market, from time to time, in accordance with the requirements of the SEC rules and regulations, including shares that could be purchased pursuant to SEC Rule 10b5-1. The number of shares to be purchased and the timing of purchases will be based on the level of cash and debt balances, general business conditions, and other factors, including alternative investment opportunities. During the three months ended December 31, 2007, we repurchased approximately 4.5 million shares at an average cost of approximately \$44.18 per share (approximately \$200 million) all of which have been retired. The purchase of these shares was funded with cash on hand and borrowings under our Credit Facility.

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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(UNAUDITED)

5. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share, the following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three months ended September	
	30,	
	2008	2007
Numerator:		
Net Income	\$ 83,635	\$ 66,144
Denominator:		
Basic weighted average shares	97,307	99,721
Effect of dilutive securities:		
Stock options	784	1,265
Total potential common shares	784	1,265
Diluted weighted average shares	98,091	100,986
Earnings per share		
Basic	\$ 0.86	\$ 0.66
Diluted	\$ 0.85	\$ 0.65

Additional dilution from assumed exercises of stock options is dependent upon several factors, including the market price of our common stock. Weighted average stock options to purchase approximately 9.6 million and 8.2 million shares of common stock during the three months ended September 30, 2008 and 2007, respectively, were outstanding but were not included in the computation of diluted earnings per share because the average market price of the underlying stock did not exceed the sum of the option exercise price, unrecognized compensation expense and the windfall tax benefit.

The calculation of diluted earnings per share requires us to make certain assumptions related to the use of proceeds that would be received upon the assumed exercise of stock options. These assumed proceeds include the excess tax benefit that we receive upon assumed exercises. We calculate the assumed proceeds from excess tax benefits based on the deferred tax assets actually recorded without consideration of as if deferred tax assets calculated under the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)).

6. COMPREHENSIVE INCOME

SFAS No. 130, Reporting Comprehensive Income (SFAS 130), establishes standards for reporting and display of comprehensive income and its components in financial statements. The objective of SFAS 130 is to report a measure of all changes in equity of an enterprise that result from transactions and other economic events of the period other than transactions with owners. Comprehensive income is the total of net income and all other non-owner changes within a company s equity.

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

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

	Three months ended	
	September 30,	
	2008	2007
Net income	\$ 83,635	\$ 66,144
Other comprehensive income (loss):		
Foreign currency translation adjustment	(36,334)	11,743
Unrealized losses on foreign exchange forward agreements (net of income tax of \$(694) and \$(114), respectively)	(1,145)	(201)
Amortization of unrealized loss on forward interest rate agreements (net of income tax of \$240 and \$240, respectively)	396	396
Unrealized gains (losses) on interest rate swap agreement (net of income tax of \$159 and \$(4,489), respectively)	264	(8,014)
Unrealized losses on interest rate collar agreements (net of income tax of \$(207) and \$0, respectively)	(342)	
Amortization of prior service costs (net of income tax of \$20 and \$20, respectively)	35	34
Comprehensive income	\$ 46,509	\$ 70,102

The following table represents the components of accumulated other comprehensive income (in thousands):

	As of	As of
	September 30,	June 30,
	2008	2008
Foreign currency gains	\$ 5,668	\$ 42,002
Unrealized gains on foreign exchange forward agreements (net of income tax of \$259 and \$953, respectively)	510	1,655
Unrealized loss on forward interest rate agreements (net of income tax of \$(3,972) and \$(4,212), respectively)	(6,633)	(7,029)
Unrealized losses on interest rate swap agreement (net of income tax of \$(6,018) and \$(6,177), respectively)	(9,960)	(10,224)
Unrealized gains on interest rate collar agreements (net of income tax of \$572 and \$779, respectively)	947	1,289
Unrecognized prior service costs (net of income tax of \$(508) and \$(528), respectively)	(898)	(933)
Unrealized losses on funded status of pension and other benefit plans (net of income tax of \$(3,259) and \$(3,259), respectively)	(7,930)	(7,930)
Total	\$ (18,296)	\$ 18,830

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

7. DERIVATIVES AND HEDGING INSTRUMENTS*Interest rate hedges*

In January 2008, we entered into a zero cost interest rate collar with an interest rate cap of 3.281% and a floor of 2.425%. The notional amount of the collar is \$500 million executed in two transactions each having two year terms, \$300 million of which expires on January 30, 2010 and \$200 million of which expires on February 11, 2010. In March 2007, we entered into a five-year amortizing interest rate swap agreement structured so that we pay a fixed interest rate of 4.897%, and receive a floating interest rate equal to the one-month LIBOR rate. At September 30, 2008, the notional amount of the interest rate swap was \$600 million. The interest rate collar and interest rate swap are designated as a cash flow hedge of forecasted interest payments on up to \$1.1 billion of outstanding floating rate debt. The transactions had a fair market value of zero at inception. The unrealized loss on the transactions as of September 30, 2008 of \$14.5 million (\$9.0 million, net of income tax) is reflected in accumulated other comprehensive income, net and the fair market value of \$(14.5 million) is reflected in other long-term liabilities. There was no deemed ineffectiveness related to these cash flow hedges. The unrealized loss on the transactions as of June 30, 2008 of \$14.3 million (\$8.9 million, net of income tax) is reflected in accumulated other comprehensive income (loss), net and the fair market value of \$(14.3 million) was reflected in other long-term liabilities.

In order to hedge the variability of future interest payments related to our Senior Notes issuance, we entered into forward interest rate agreements in April 2005. The agreements were designated as cash flow hedges of forecasted interest payments in anticipation of the issuance of the Senior Notes. The notional amount of the agreements totaled \$500 million and the agreements were terminated in June 2005 upon issuance of the Senior Notes. The settlement of the forward interest rate agreements of \$19 million (\$12 million, net of income tax) was recorded in accumulated other comprehensive income (loss), net, and is being amortized as an increase in reported interest expense over the term of the Senior Notes, with approximately \$2.5 million to be amortized over the next 12 months. We amortized approximately \$0.6 million to interest expense during both the three months ended September 30, 2008 and 2007. The amount of gain or loss related to hedge ineffectiveness was not material.

Foreign currency forward agreements

We utilize derivative financial instruments to manage our exposure to foreign currencies related to our domestic and international operations. We enter into foreign currency forward agreements in order to hedge the exchange rate risk associated with specific forecasted transactions, including payments and receipts from customers and suppliers, and funding of operating expenses of our offshore operations. We designate only those contracts which closely match the terms of the underlying transaction as cash flow hedges for accounting purposes. The forward contracts are assessed for effectiveness at inception and on an ongoing basis. During the three months ended September 30, 2008 and 2007, there was no material deemed ineffectiveness related to cash flow hedges, and no reclassification to earnings due to hedged transactions no longer expected to occur. The contracts will expire at various times over the next 24 months, with the majority expiring within the next 12 months. The net gain or loss on the contracts will be recognized in earnings when the contracts are settled.

As of September 30, 2008 and June 30, 2008, the notional amount of our cash flow hedges was \$25.5 million and \$42.6 million, respectively. As of September 30, 2008, the unrealized gain on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was \$0.8 million (\$0.5 million, net of income tax) and the fair market value of \$0.8 million is reflected in other current assets. As of June 30, 2008, the unrealized gain on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was \$2.6 million (\$1.7 million, net of income tax) and the fair market value of \$2.6 million was reflected in other current assets.

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

The table below provides additional information as of September 30, 2008 about our foreign currency forward contracts designated as cash flow hedges (in thousands):

Hedged Transaction	Notional Amount in \$US (Functional currency in \$US)	Functional Currency	Counter Currency	Weighted Average Contract Rate	Cumulative Unrealized Gain in \$US		
Receipt of revenue	\$ 1,145	EUR	793	CAD	1,091	0.727	\$ 90
Payment of operating expenses	17,215	USD	17,215	MXN	193,000	11.198	260
Receipt of revenue	3,683	CHF	4,038	NOK	20,284	0.199	254
Receipt of revenue	396	CHF	434	EUR	269	1.623	10
Payment for merchandise	3,032	USD	3,032	CHF	3,549	1.171	155
Total	\$ 25,471						\$ 769

As part of the acquisition of the Transport Revenue division of Ascom AG in December 2005, we acquired foreign exchange forward agreements that hedge our French operation's Euro foreign exchange exposure related to its Canadian dollar and U.S. dollar revenues. These agreements do not qualify for hedge accounting under SFAS 133. In addition, we have entered into certain other foreign currency contracts not designated as hedges for accounting purposes, although management believes they are essential economic hedges. We recorded a loss on non-qualified hedging instruments of approximately \$0.7 million (\$0.5 million, net of income tax) for the three months ended September 30, 2008, in other non-operating expense (income), net in our Consolidated Statements of Income. We recorded a loss on hedging instruments of approximately \$0.2 million (\$0.1 million, net of income tax) for the three months ended September 30, 2007, in other non-operating expense (income), net in our Consolidated Statements of Income. As of September 30, 2008 and June 30, 2008, the notional amount of these agreements was \$12.7 million and \$21.5 million, respectively, and will expire at various times over the next 24 months, with the majority expiring within the next 6 to 12 months. A liability was recorded for the related fair value of approximately \$(1.3 million) and \$(0.6 million) as of September 30, 2008 and June 30, 2008, respectively.

8. FAIR VALUE MEASUREMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157) for financial assets and liabilities. SFAS 157 establishes a hierarchy that prioritizes fair value measurements based on the types of inputs used for the various valuation techniques (market approach, income approach, and cost approach). SFAS 157 is applied under existing accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. We adopted SFAS 157 effective July 1, 2008. There was no impact to our results of operations or financial condition as a result of the adoption of SFAS 157.

In February 2008, FASB issued FASB Staff Position FAS 157-2 (FSP FAS 157-2), Effective Date of FASB Statement No. 157 which provides a one-year deferral of the effective date of SFAS 157 for non-financial assets and liabilities except those that are recognized or disclosed in the financial statements at fair value at least annually. We are currently evaluating the impact, if any, that FSP FAS 157-2 will have on our financial condition and results of

operations.

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

The fair value framework requires the categorization of assets and liabilities into three levels based upon the assumptions (inputs) used to price the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment. The three levels are defined as follows:

- Level 1: Observable inputs such as quoted prices in active markets for identical assets or liabilities.
- Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly; these include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
- Level 3: Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability.

The following table presents information about the Company's financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2008 and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value. (In thousands)

Description	Level 1	Level 2	Level 3	Total	Balance Sheet Classification
ASSETS					
Foreign currency derivatives (a)	\$	\$ 769	\$	\$ 769	Other current assets
Deferred compensation investments in cash surrender value life insurance (b)		55,482		55,482	Other long-term assets
Deferred compensation investments in mutual funds (c)		26,388		26,388	Other long-term assets
Total assets	\$	\$ 82,639	\$	\$ 82,639	
LIABILITIES					
Foreign currency derivatives (a)	\$	\$ 1,272	\$	\$ 1,272	Other current liabilities
Deferred Compensation investment liabilities (d)		80,005		80,005	Other long-term liabilities
Interest rate swap and collar (e)		14,460		14,460	Other long-term liabilities
Total liabilities	\$	\$ 95,737	\$	\$ 95,737	

- (a) Foreign currency derivatives consist of foreign currency forward agreements. Fair value is determined using observable market inputs such as the forward pricing curve, currency volatilities, currency correlations and interest rates, and considers nonperformance risk of the Company and that of its counterparties.
- (b) Fair value is reflected as the cash surrender value of company owned life insurance.
- (c) Fair value is based on quoted market prices for actively traded assets similar to those held by the deferred compensation plan.
- (d) Fair value of the deferred compensation liability is based on the fair value of investments corresponding to employees investment selections, based

on quoted prices
for similar assets
in actively
traded markets.

- (e) The fair values
of the interest
rate swap and
collar are
determined
using prices
obtained from
pricing agencies
and financial
institutions who
develop values
based on inputs
observable in
active markets,
including
interest rates
with
consideration
given to the
nonperformance
risk of the
Company and
that of its
counterparties.

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9. SEGMENT INFORMATION

The following is a summary of certain financial information by reportable segment (in thousands):

	Commercial	Government	Corporate	Consolidated
<u>Three months ended September 30, 2008</u>				
Revenues (a)	\$ 959,417	\$ 645,037	\$	\$ 1,604,454
Operating expenses (excluding depreciation and amortization)	798,225	511,195	24,680	1,334,100
Depreciation and amortization expense	70,619	26,352	635	97,606
Operating income (loss)	\$ 90,573	\$ 107,490	\$ (25,315)	\$ 172,748
<u>Three months ended September 30, 2007</u>				
Revenues (a)	\$ 878,879	\$ 614,204	\$	\$ 1,493,083
Operating expenses (excluding depreciation and amortization)	730,254	480,710	45,894	1,256,858
Depreciation and amortization expense	65,896	24,514	414	90,824
Operating income (loss)	\$ 82,729	\$ 108,980	\$ (46,308)	\$ 145,401

(a) Revenues in our Commercial segment include revenues from operations divested through the September 30, 2008 of \$2.9 million for the three months ended September 30, 2007. Revenues in our Government segment include revenues from operations divested through September 30, 2008 of \$0.3 million and \$5.2 million for

the three months
ended
September 30,
2008 and 2007,
respectively.

10. DIVESTITURES

Sale of bindery business

During the three months ended September 30, 2008, we completed the sale of our bindery business in our Government segment and recorded a pre-tax gain on the sale of approximately \$0.2 million (\$0.8 million loss, net of income tax) in other operating expense in our Consolidated Statements of Income. The bindery business was not strategic to our ongoing operations.

Revenues from the bindery business were \$0.3 million and \$3.4 million for the three months ended September 30, 2008 and 2007, respectively. Operating income from the bindery business, excluding the gain on sale, was \$0 and \$0.8 million for the three months ended September 30, 2008 and 2007, respectively.

Sale of Unclaimed Property Reporting and Recovery Business

During the three months ended June 30, 2008, we completed the sale of Unclaimed Property Reporting and Recovery (UPRR) in our Commercial segment. During the three months ended June 30, 2008, we recorded a pre-tax gain on the sale of approximately \$1.0 million (\$0.6 million, net of income tax) and during the three months ended September 30, 2008, we recorded an additional \$0.3 million (\$0.2 million, net of income tax) in other operating expenses in our Consolidated Statements of Income. The UPRR business was not strategic to our ongoing operations.

Revenues from the UPRR business were \$2.9 million for the three months ended September 30, 2007. Operating income from the UPRR business, excluding the gain on sale, was \$0.1 million for the three months ended September 30, 2007.

Sale of our decision support business

During the three months ended December 31, 2007, we completed the sale of our decision support business in our Government segment and recorded a pre-tax gain on the sale of approximately \$2.4 million (\$1.6 million, net of income tax) in other operating expense in our Consolidated Statements of Income. The decision support business was not strategic to our ongoing operations.

Revenues from the decision support business were \$1.8 million for the three months ended September 30, 2007. Operating income from the decision support business was \$0.7 million for the three months ended September 30, 2007.

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11. COMMITMENTS AND CONTINGENCIES

Regulatory Agency Investigations Relating to Stock Option Grant Practices

On March 3, 2006, we received notice from the SEC that it was conducting an investigation into certain stock option grants made by us from October 1998 through March 2005. On June 7, 2006 and on June 16, 2006, we received requests from the SEC for information on all of our stock option grants since 1994. We have been providing supplemental information to the SEC on a voluntary basis following the initial SEC requests. The SEC issued its formal order of investigation in August 2006.

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

We initiated an internal investigation of our stock option grant practices in response to the pending informal investigation by the SEC and a subpoena from a grand jury in the Southern District of New York. The investigation reviewed our historical stock option grant practices during the period from 1994 through 2005, including all 73 stock option grants made by us during this period, and the related disclosure in our Form 10-Q for the three months ended March 31, 2006, filed May 15, 2006 (the May 2006 Form 10-Q). The results of our internal investigation are fully disclosed in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Subsequent to the delivery of the results of the investigation, we, with the approval of our Audit Committee, determined that the cumulative non-cash stock-based compensation expense adjustment and related income tax effects were material. Our decision to restate our financial statements was based on the facts obtained by management and a special committee comprised of all of the then independent members of the Board of Directors, which oversaw the internal investigation. We determined that the cumulative, pre-tax, non-cash stock-based compensation expense resulting from revised measurement dates was approximately \$51.2 million during the period from our initial public offering in 1994 through June 30, 2006. The corrections relate to options covering approximately 19.4 million shares. Previously reported total revenues were not impacted by our restatement. The impact of the restatement on each year of our previously issued financial statements is more fully disclosed in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Related income tax effects included deferred income tax benefits on the compensation expense, and additional income tax liabilities and estimated penalties and interest related to the application of Internal Revenue Code Section 162(m) and related Treasury Regulations (Section 162(m)) to stock-based executive compensation previously deducted, that was no longer deductible as a result of revised measurement dates of certain stock option grants. We also included in our restatements additional income tax liabilities and estimated penalties and interest, with adjustments to additional paid-in capital and income tax expense, related to certain cash and stock-based executive compensation deductions previously taken under Section 162(m), which we believed may be non-deductible as a result of information that has been obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. During the three months ended March 31, 2007, we paid approximately \$35 million of estimated income taxes, penalties and interest related to Section 162(m) issues. This payment is reflected in cash flows from operating activities at June 30, 2007. During fiscal year 2008, we resolved Section 162(m) executive compensation issues for fiscal years 2001 through 2003 with the Internal Revenue Service and used the same resolution criteria to adjust the liabilities for fiscal years 2004 and 2005, resulting in a revised liability of \$26.9 million of income tax, interest and penalties. During fiscal year 2008, \$5.9 million was released to income tax expense and \$0.5 million was credited to additional paid-in capital. At this time, we cannot predict when these Section 162(m) issues will be resolved for fiscal years 2004 and 2005.

In December 2006, we amended the exercise price of outstanding stock options of certain current executive officers, other executive officers and former executive officers in order to re-price all or a portion of the respective option grant to the revised measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. We paid cash payments in the aggregate amount of \$2.4 million in accordance with the terms of the amendment in fiscal year 2008 from cash flows from operating activities. Of the \$2.4 million cash payment, approximately \$0.5 million was charged to wages and benefits in our Consolidated Statement of Income in fiscal year 2007, and the balance was charged to additional paid-in capital in our Consolidated Balance Sheet.

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On June 18, 2007, we initiated a tender offer to amend certain options (the Eligible Options) to purchase an aggregate of 1,703,650 shares (as amended) of our Class A common stock in order to re-price all or a portion of the respective option grant to the revised measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. The Eligible Options included options that (i) were granted under our 1997 Stock Incentive Plan, as amended; (ii) had exercise prices per share that were less, or may have been less, than the fair market value per share of our common stock on the revised measurement dates for such options, as determined by us for accounting and tax purposes; (iii) were unexercised and unvested, either in whole or in part, as of January 1, 2005; (iv) were outstanding as of the expiration time of this tender offer; and (v) were held by individuals who (x) were employed by the Company through the expiration time of this tender offer (other than any executive officer or director) and (y) are subject to income taxation in the United States. Eligible participants could elect to (i) amend Eligible Options to increase the exercise price per share to the fair market value of the Company's Class A common stock on the respective option's measurement date or (ii) receive a cash payment equal to the difference between the new exercise price per share of each amended option and the original exercise price per share of such amended option, multiplied by the number of unexercised shares of the Company's Class A common stock subject to such amended option.

The tender offer expired on July 17, 2007. Pursuant to the offer, we accepted for amendment options to purchase 1,696,650 shares of our Class A common stock, which represented 99.6% of the shares of our Class A common stock subject to all Eligible Options. We paid cash payments in the aggregate amount of \$4 million in accordance with the terms of the tender offer in the three months ended March 31, 2008 from cash flow from operating activities. During fiscal year 2008, we charged approximately \$1.3 million to wages and benefits in our Consolidated Statement of Income and charged the balance of the estimated cash payments to additional paid-in capital in our Consolidated Balance Sheet.

In July 2007, we notified certain former employees with vested, unexercised and outstanding options which had exercise prices per share that were less, or may have been less, than the fair market value per share of ACS Class A common stock on the revised measurement dates for such options, as determined by us for accounting and tax purposes, that we will pay them the additional 20% income tax imposed by Section 409A based on the excess, if any, of the fair market value of our Class A common stock (up to \$62 per share or up to \$1.9 million in the aggregate) on the date a triggering event occurs or condition exists that under Section 409A results in the excess being recognized and reported as income on the former employee's W-2 and the exercise price of the affected option (reduced by any gain that had become subject to tax in a prior year because of an earlier triggering event). As of September 30, 2008, we anticipate that these income tax reimbursements will be up to approximately \$1.1 million based on the current fair market value of our Class A common stock on the exercise date and will be paid from cash flows from operating activities as the triggering event occurs for each option holder. During the three months ended September 30, 2008 and 2007, we (credited)/charged approximately \$(0.3 million) and \$0.8 million, respectively, to wages and benefits in our Consolidated Statement of Income related to these income tax reimbursements based on the current fair market value of our Class A common stock as of September 30, 2008 and 2007, respectively. The estimated liability related to these income tax reimbursements will be adjusted to reflect changes in the current fair market value of our Class A common stock each quarter until the options are exercised.

In the three months ended September 30, 2007, we amended the exercise price of outstanding stock options of certain current executive officers in order to re-price all or a portion of the respective option grants to the revised measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. We paid cash payments in the aggregate amount of \$0.3 million in accordance with the terms of the amendment in fiscal year 2008 from cash flows from operating activities. Of the \$0.3 million cash payment, approximately \$43,000 was charged to wages and benefits in our Consolidated Statement of Income in the three months ended September 30, 2007, and the balance was charged to additional paid-in capital in our Consolidated Balance Sheet.

Lawsuits Related to Stock Option Grant Practices

Several derivative lawsuits have been filed in connection with our stock option grant practices, generally alleging claims related to breach of fiduciary duty and unjust enrichment by certain of our directors and senior executives. Those cases have been consolidated into three venues as follows:

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Dallas County Texas State District Court

Merl Huntsinger, Derivatively on Behalf of Nominal Defendant Affiliated Computer Services, Inc., Plaintiff, v. Darwin Deason, Mark A. King, J. Livingston Kosberg, Dennis McCuistion, Joseph P. O Neill, Jeffrey A. Rich and Frank A. Rossi, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, Cause No. 06-03403 in the District Court of Dallas County, Texas, 193rd Judicial District filed on April 7, 2006.

Robert P. Oury, Derivatively on Behalf of Nominal Defendant Affiliated Computer Services, Inc., Plaintiff, v. Darwin Deason, Mark A. King, J. Livingston Kosberg, Dennis McCuistion, Joseph P. O Neill, Jeffrey A. Rich and Frank A. Rossi, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, Cause No. 06-03872 in the District Court of Dallas County, Texas, 193rd Judicial District filed on April 21, 2006.

Anchorage Police & Fire Retirement System, derivatively on behalf of nominal defendant Affiliated Computer Services Inc., Plaintiff v. Jeffrey Rich; Darwin Deason; Mark King; Joseph O Neill; Frank Rossi; Dennis McCuistion; J. Livingston Kosberg; Gerald Ford; Clifford Kendall; David Black; Henry Hortenstine; Peter Bracken; William Deckelman; and Affiliated Computer Services Inc., Cause No. 06-5265-A in the District Court of Dallas County, Texas, 14th Judicial District filed on June 2, 2006.

The Huntsinger, Oury, and Anchorage lawsuits were consolidated into one case on June 5, 2006, under the caption In Re Affiliated Computer Services, Inc. Derivative Litigation in the District Court of Dallas County, Texas, 193rd Judicial District (the "Texas State Derivative Action"). Plaintiffs seek to recover damages sustained by the Company, equitable relief, including disgorgement, and reimbursement for fees and expenses incurred in connection with the suits, including attorney's fees. On March 26, 2007, plaintiffs filed a Third Amended Consolidated Complaint in which the plaintiffs alleged certain of the defendants breached their fiduciary duties in evaluating the buyout offer from Cerberus and any other offers (see further discussion below in "Litigation Arising from Buy-out Offer"). Defendant Jeff Rich has filed a motion for summary judgment on the basis of his purported release that has not been heard yet by the court. Additionally, the individual defendants filed a motion for partial summary judgment on the basis that plaintiffs lack standing concerning certain option grants that has not yet been heard by the court. On June 5, 2008, the parties filed a Stipulation to Stay Proceedings, ceasing all case activity for 60 days and on August 7, 2008 ACS filed an agreed motion to extend the stay. There is no pending trial date at this time. Please see "Regarding the Texas State Derivative Action and the Delaware Chancery Case" below for more information.

Court of Chancery for the State of Delaware

Jan Brandin, in the Right of and for the Benefit of Affiliated Computer Services, Inc., Plaintiff, v. Darwin Deason, Jeffrey A. Rich, Mark A. King, Joseph O Neill and Frank Rossi, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, Civil Action No. 2123-VCL, pending before the Court of Chancery of the State of Delaware in and for New Castle County, filed on May 2, 2006.

On August 15, 2006, plaintiff filed a First Amended Complaint in the Brandin lawsuit (the "Delaware Chancery Case"). The First Amended Complaint added Lynn R. Blodgett, David W. Black, Henry Hortenstine, Peter A. Bracken, William L. Deckelman, Jr., Warren Edwards, John M. Brophy, John Rexford, Dennis McCuistion, J. Livingston Kosberg and Clifford M. Kendall. On April 5, 2007, plaintiff Brandin filed a Motion for Summary Judgment against Darwin Deason, Jeffrey Rich and Mark King. Each of the parties has filed their respective briefs and a hearing on the Motion for Summary Judgment was held on February 5, 2008. In addition, on October 16, 2007, each of the individual defendants filed a Motion for Partial Dismissal, based on plaintiff's lack of standing to challenge most of the stock option grants at issue. On June 3, 2008, an Unopposed Motion to Stay Pending SLC Determination was filed, which automatically granted a 60 day stay in this matter with a later court order extending the stay for an additional 30 days. The stay was extended an additional 60 days by agreement of all parties on August 7, 2008. There is no pending trial date at this time. Please see "Regarding the Texas State Derivative Action and the Delaware Chancery Case" below for more information.

United States District Court for the Northern District of Texas

Alaska Electrical Fund, derivatively on behalf of Affiliated Computer Services Inc. v. Jeffrey Rich; Joseph O. Neill; Frank A. Rossi; Darwin Deason; Mark King; Lynn Blodgett; J. Livingston Kosberg; Dennis McCuistion; Warren Edwards; John Rexford and John M. Brophy, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, Cause No. 3-06CV1110-M, in the United States District Court for the Northern District of Texas, Dallas Division, filed on June 22, 2006.

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Bennett Ray Lunceford and Ann M. Lunceford, derivatively on behalf of Affiliated Computer Services Inc. v. Jeffrey Rich; Joseph O. Neill; Frank A. Rossi; Darwin Deason; Mark King; Lynn Blodgett; J. Livingston Kosberg; Dennis McCuiston; Warren Edwards; John Rexford and John M. Brophy, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, Cause No. 3-06CV1212-M, filed on July 7, 2006, in the United States District Court for the Northern District of Texas, Dallas Division.

The Alaska Electrical and Lunceford cases were consolidated into one case on August 1, 2006, under the caption In Re Affiliated Computer Services Federal Derivative Litigation, in the United States District Court for the Northern District of Texas, Master File No. 3:06-CV-1110-M (the Texas Federal Derivative Action). On April 6, 2007, the plaintiffs filed an Amended Verified Consolidated Shareholder Derivative Complaint (Amended Complaint), adding causes of action related to the announced buy-out transaction, and adding as defendants Clifford Kendall, David Black, Henry Hortenstine, Peter A. Bracken, William Deckelman, Jr., PricewaterhouseCoopers LLP, and Cerberus Capital Management, L.P. Plaintiffs seek equitable relief and recovery of unspecified monetary damages sustained by the Company. On June 4, 2007, ACS and the individual defendants filed a motion to dismiss the Amended Complaint, including the grounds that the buy-out claims were not yet ripe for adjudication. Plaintiffs voluntarily dismissed David Black, PricewaterhouseCoopers LLP and Cerberus Capital Management, L.P.

On December 17, 2007, after a hearing on August 1, 2007, the judge dismissed all buy-out related causes of action, dismissed the section 16(b) claims against defendants Jeff Rich and Mark King without prejudice, and dismissed the section 10(b) causes of action against defendants Lynn Blodgett, John Rexford, and John Brophy with prejudice. The judge determined that the section 10(b) and 14(a) claims against other individual defendants were insufficiently pled, and granted plaintiffs leave to amend their complaint to state these claims with sufficient particularity.

On February 1, 2008, plaintiffs filed their Second Amended Derivative Complaint. Defendants have filed motions to dismiss this complaint and have filed a motion to strike the complaint for failing to comply with the parameters of the December 17, 2007 order permitting plaintiffs to file an amended complaint. All briefing on the motion to dismiss and the motion to strike is complete and is under consideration by the court.

On May 23, 2008, plaintiffs filed a Motion Seeking an Order re Defendants Efforts to Compromise the Claims which seeks an injunction against settlement of either the Delaware or Texas derivative matters (the Injunction Motion). On May 30, 2008, ACS filed a Motion to Stay Pending SLC Determination (the ACS Stay Motion). On September 18, 2008, the judge denied the ACS Stay Motion and the Injunction Motion. The Private Securities Litigation Relief Act stay remains in effect until such time as the pending motions to dismiss are ruled upon.

The Texas Federal Derivative Action is being vigorously defended. We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs' claims, and accordingly, have not accrued any amount on our balance sheet related to the lawsuits. However, it is not possible at this time to reasonably estimate the possible loss or range of loss, if any, should an unfavorable outcome occur for the Texas Federal Derivative Action.

Regarding the Texas State Derivative Action and the Delaware Chancery Case

On October 21, 2008, a Special Litigation Committee previously formed by the Company's Board of Directors completed its review of the Texas State Derivative Action and the Delaware Chancery Case. The Special Litigation Committee formally recommended that these cases be settled pursuant to the terms of a Memorandum of Understanding which was signed by the Company, the individual defendants in these cases and the plaintiffs in these cases on October 28, 2008.

The Company will file a Motion for Preliminary Approval of the Settlement with the Dallas County Texas State District Court. If approved by that court, a notice by publication will be given to the Company's stockholders giving them an opportunity to object to the settlement, including the award and amount of attorneys' fees to the plaintiffs. The proposed settlement includes the release of all state and federal derivative claims related to our prior stock option grant practices, the dismissal of the Texas State Derivative Action and the Delaware Chancery Case, the payment of an amount up to \$13 million in legal fees by the Company to the plaintiffs' law firms and the collection of

approximately \$1.8 million from certain current and former executive officers and other monetary and non-monetary benefits to the Company, such as the cancellation of amounts claimed to be owed by the Company and the cancellation or repricing of stock options by some of the defendants. The cancellation or repricing of such stock options was completed in previous periods. The proposed settlement also requires the Company to make or have made specified corporate governance and other changes.

It is probable that there will be an objection to the settlement from at least the plaintiffs in the Texas Federal Derivative Action since they have already filed the Injunction Motion described above, which was denied on September 18, 2008. There will be a final hearing when the court rules on any stockholder objections and decides whether or not to approve the final settlement. An award of attorneys' fees to the plaintiffs is not final until the court rules on the anticipated objections to the settlement and approves the settlement.

We have assessed the probability of loss pursuant to Statement of Financial Accounting Standards No. 5 "Accounting for Contingencies" ("SFAS 5"). Due to the uncertainty related to the approval of the terms in the Memorandum of Understanding or the amounts that may be paid or collected upon reaching a settlement and final approval by the Court and resolution of the expected appeal process, we do not believe it is possible at this time to reasonably estimate the possible loss or range of loss, if any, related to the execution of the Memorandum of Understanding and therefore have not recorded any amounts in our financial statements for these claims.

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United States District Court of Texas for the Northern District of Texas

Based on the same set of facts as alleged in the above cases, two lawsuits were filed under the Employee Retirement Income Security Act (ERISA) alleging breach of ERISA fiduciary duties by the directors and officers as well as the ACS Benefits Administrative Committee, in connection with the retention of ACS Class A common stock as an investment option in the ACS Savings Plan, and by causing the ACS Savings Plan to invest in ACS Class A common stock in light of the alleged stock option issues, as follows:

Terri Simeon, on behalf of Herself and All Others Similarly Situated, Plaintiff, vs. Affiliated Computer Services, Inc., Darwin Deason, Mark A. King, Lynn R. Blodgett, Jeffrey A. Rich, Joseph O. Neill, Frank Rossi, J. Livingston Kosberg, Dennis McCuistion, The Retirement Committee of the ACS Savings Plan, and John Does 1-30, Civil Action No. 306-CV-1592P, in the United States District Court for the Northern District of Texas, Dallas Division, filed August 31, 2006.

Kyle Burke, Individually and on behalf of All Others Similarly Situated, Plaintiff, vs. Affiliated Computer Services, Inc., the ACS Administrative Committee, Lora Villarreal, Kellar Nevill, Gladys Mitchell, Meg Cino, Mike Miller, John Crysler, Van Johnson, Scott Bell, Anne Meli, David Lotocki, Randall Booth, Pam Trutna, Brett Jakovac, Jeffrey A. Rich, Mark A. King, Darwin Deason, Joseph P. O. Neill and J. Livingston Kosberg, Case No. 306-CV-02379-M, United States District Court for the Northern District of Texas, Dallas Division, filed on September 15, 2006.

On February 12, 2007, the Simeon case and the Burke case were consolidated into one case, under the caption, In re Affiliated Computer Systems [sic] ERISA Litigation, Master File No. 3:06-CV-1592-M. On December 20, 2007, an Order Preliminarily Approving Settlement was entered in the In re Affiliated Computer Systems [sic] ERISA Litigation consolidated case. Principally, the settlement provides for a payment to the plaintiffs and the ACS Savings Plan of a total of \$1.5 million, which includes attorney fees, and received the final approval of the court at a hearing held on October 23, 2008. We recorded a charge of \$1.5 million (\$1 million, net of income tax) in other operating expense in our Consolidated Statements of Income during the three months ended December 31, 2007.

Litigation Arising from Buy-Out Offer

Several lawsuits have been filed in connection with the announced buyout transaction, generally alleging claims related to breach of fiduciary duty, and seeking class action status. The plaintiffs in each case purport to be ACS stockholders bringing a class action on behalf of all of our public stockholders. Each plaintiff alleges that the proposal (Proposal) presented to us by Darwin Deason and Cerberus on March 20, 2007, to acquire our outstanding stock, was unfair to shareholders, because the consideration offered in the Proposal is alleged to be inadequate and to have resulted from an unfair process.

In the Delaware Chancery Court, six cases were filed, as follows:

Momentum Partners v. Darwin Deason, Lynn R. Blodgett, Joseph P. O. Neill, Frank A. Rossi, J. Livingston Kosberg, Robert B. Holland, Dennis McCuistion, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2814-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on March 20, 2007.

Mark Levy v. Darwin Deason, Lynn Blodgett, John Rexford, Joseph P. O. Neill, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2816-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on March 21, 2007.

St. Clair Shores Police and Fire Retirement System v. Darwin Deason, Lynn Blodgett, Joseph P. O. Neill, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Robert B. Holland, Cerberus Capital Management, L.P., Citigroup Global Markets Inc., and Affiliated Computer Services, Inc., Civil Action No. 2821-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on March 22, 2007.

Louisiana Municipal Police Employees Retirement System v. Darwin Deason, Joseph P. O Neill, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Robert B. Holland, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2839-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on March 26, 2007.

Edward R. Koller v. Darwin Deason, Frank A. Rossi, J. Livingston Kosberg, Robert B. Holland, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2908-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on April 20, 2007.

Suzanne Sweeney Living Trust v. Darwin Deason, Lynn R. Blodgett, John H. Rexford, Joseph P. O Neill, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Robert B. Holland, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2915-VCL, in the Court of Chancery of the State of Delaware in and for New Castle County, filed on April 24, 2007.

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On May 4, 2007, each of the six Delaware buy-out cases was consolidated into one case, pending in the Delaware Chancery Court, entitled In Re Affiliated Computer Services, Inc. Shareholder Litigation, Civil Action No. 2821-VCL. On October 30, 2007, Cerberus withdrew its offer to acquire ACS. On November 2, 2007, a Consolidated Amended Class Action and Derivative Complaint was filed by the plaintiffs, adding allegations of breach of fiduciary duties related to the events surrounding the resignation of the outside directors. Plaintiffs seek equitable relief and recovery of unspecified monetary damages sustained by the Company. On April 8, 2008, a Verified Consolidated Second Amended Class and Derivative Action Complaint was filed alleging class and derivative claims of breach of fiduciary duty against all individual defendants and class and derivative for aiding and abetting against Cerberus and Citigroup. On May 23, 2008, all defendants, including ACS, filed their respective motions to dismiss. All briefing on the motions to dismiss is complete and the hearing on the motions occurred on October 22, 2008.

In the District Court of Dallas County, Texas, two stand-alone buy-out cases were filed, as follows:

Steamship Trade Association/International Longshoreman s Association Pension Fund v Affiliated Computer Services, Inc., Darwin Deason, Lynn Blodgett, John Rexford, Joseph P. O Neill, Gerardo I. Lopez, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuiston, Robert B. Holland, and Cerberus [sic] Capital Management, L.P., Cause No. 07-02691 in the District Court of Dallas County, Texas, 44th Judicial District, filed on March 22, 2007. The City of Birmingham, Alabama Retirement and Relief System v. Darwin Deason, Robert B. Holland, III, J. Livingston Kosberg, Frank A. Rossi, Joseph P. O Neill, Lynn R. Blodgett, John H. Rexford, Dennis McCuiston, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Cause No. 07-02768 in the District Court of Dallas, Texas, 160th Judicial District, filed on March 28, 2007.

In addition, in the Texas State Court Consolidated stock option derivative case, on March 26, 2007, plaintiffs filed a Third Amended Consolidated Complaint, adding causes of action related to the announced buy-out transaction as well. On May 1, 2007, ACS and the individual defendants filed a Special Exceptions Motion, on the grounds that plaintiffs buy-out claims were not yet ripe for adjudication, i.e., no claim related to the Proposal can properly be the subject of litigation, because the Proposal has not been accepted or recommended by either the Company or by the Special Committee formed to evaluate the Proposal and strategic alternatives to the Proposal, and that plaintiffs cannot bring both direct and derivative claims in a single lawsuit. The Third Amended Petition also alleges breach of fiduciary duty premised upon an allegation that our assets and information were misappropriated by Mr. Deason and Cerberus in order to facilitate their preparation of the Proposal, and that the Proposal represents an attempt to extinguish the derivative claims related to stock option practices by eliminating the standing of the plaintiff stockholders to pursue those claims. The Third Amended Petition also suggests that the consideration offered to stockholders in the Proposal is inadequate and seeks to enjoin consummation of the Proposal. Plaintiffs seek equitable relief and recovery of unspecified monetary damages sustained by the Company.

Also, on March 29, 2007, the two stand-alone buy-out cases pending in the District Court of Dallas County, Texas were consolidated into the Texas State Court Consolidated stock option derivative case.

In the Texas Federal Court Consolidated stock option derivative case, on April 5, 2007, the plaintiffs filed an Amended Complaint, adding causes of action related to the announced buy-out transaction as well, and adding as defendants, Clifford Kendall, David Black, Henry Hortenstine, Peter A. Bracken, William Deckelman, Jr., PricewaterhouseCoopers LLP, and Cerberus Capital Management, L.P. Like the Third Amended Petition in the Texas State Court Derivative Action, the Amended Complaint in the Texas Federal Court Derivative Action challenged both the process through which the Proposal was generated, and the substance of the Proposal. On June 4, 2007, ACS and the individual defendants filed a Motion to Dismiss the Amended Complaint, including the grounds that the buy-out claims were not yet ripe for adjudication, i.e., no claim related to the Proposal can properly be the subject of litigation, because the Proposal has not been accepted or recommended by either the Company or by the Special Committee formed to evaluate the Proposal and strategic alternatives to the Proposal. Plaintiffs voluntarily dismissed David Black, PricewaterhouseCoopers LLP and Cerberus Capital Management, L.P. On December 17, 2007, the judge

dismissed all buy-out related causes of action, dismissed the section 16(b) claims against defendants Jeff Rich and Mark King and dismissed the section 10(b) causes of action against defendants Lynn Blodgett, John Rexford and John Brophy with prejudice. The judge also determined that the section 10(b) and section 14(a) claims against the other defendants were insufficiently pled, and granted plaintiffs leave to amend their complaint to state these claims with sufficient particularity. Plaintiffs filed their Second Amended Derivative Complaint on February 1, 2008 in response to the December 17, 2007 order. The Second Amended Derivative Complaint does not contain any allegations concerning the buy-out. Defendants have filed motions to dismiss this complaint and have filed a motion to strike the complaint for failing to comply with the parameters of the December 17, 2007 order permitting plaintiffs to file an amended complaint. All briefing on the motion to dismiss and the motion to strike is complete and is under consideration by the court.

On May 23, 2008, Plaintiffs filed a Motion Seeking an Order re Defendants Efforts to Compromise the Claims. The motion seeks an injunction against settlement of either the Delaware or Texas derivative matters. On May 30, 2008, we filed a Motion to Stay Pending SLC Determination. The judge set this matter on an expedited briefing schedule, which concluded

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on June 13, 2008. The briefing on Plaintiffs Motion Seeking an Order re Defendants Efforts to Compromise the Claims and our Motion to Stay Pending SLC Determination is before the court.

All of the litigation arising from the buy-out offer is being vigorously defended. We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs claims, and accordingly, have not accrued any amount on our balance sheet related to these lawsuits. However, it is not possible at this time to reasonably estimate the possible loss or range of loss, if any, should an unfavorable outcome occur for the matters noted above.

Declaratory Action with Respect to Alleged Default and Purported Acceleration of our Senior Notes and Amendment, Consent and Waiver for our Credit Facility

On June 6, 2005, we completed a public offering of \$250 million aggregate principal amount of 4.70% Senior Notes due June 1, 2010 and \$250 million aggregate principal amount of 5.20% Senior Notes due June 1, 2015 (collectively, the Senior Notes). Interest on the Senior Notes is payable semiannually. We may redeem some or all of the Senior Notes at any time prior to maturity, which may include prepayment penalties determined according to pre-established criteria. The Senior Notes were issued pursuant to that certain Indenture dated June 6, 2005 (which, along with any Supplemental Indentures entered into subsequent thereto and in connection therewith, is referred to as the Indenture) between us and The Bank of New York Trust Company, N.A. (BONY), as trustee, with the Wilmington Trust Company having replaced BONY as trustee on December 19, 2006 (the Trustee).

As the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, certain holders of the Senior Notes sent various notices alleging that we were in default of our covenants under the Indenture. Subsequently, those certain holders declared an acceleration of the Senior Notes, as a result of our failure to remedy the purported default set forth in their earlier notices and demanded payment of all amounts owed in respect of the Senior Notes.

It is our position that no default has occurred under the Indenture and that no acceleration has occurred with respect to the Senior Notes or otherwise under the Indenture. Further we filed a lawsuit against the Trustee in the United States District Court, Northern District of Texas, Dallas Division, seeking a declaratory judgment affirming our position. The Trustee filed an answer and counterclaim seeking immediate payment of all principal and accrued and unpaid interest on the Senior Notes. Alternatively, the counterclaim sought damages measured by the difference between the fair market value of the Senior Notes on or about September 22, 2006 and par value of the Senior Notes. On February 12, 2008, the judge granted our Motion for Summary Judgment, awarded us our court costs, and dismissed all counter-claims against us. Subsequently, Defendant Wilmington Trust Co. filed its Notice of Appeal and Appellant Brief. We have filed our Appeal; however, at this time it is unclear whether the 5th Circuit will require oral argument on this matter.

Unless and until there is a final judgment rendered in the lawsuit described above (including any appellate proceedings), no legally enforceable determination can be made as to whether the failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 is a default under the Indenture as alleged by the letters referenced above. If there is a final legally enforceable determination that the failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 is a default under the Indenture, and that acceleration with respect to the Senior Notes was proper, the principal and premium, if any, and all accrued and unpaid interest, if any, on the Senior Notes would be immediately due and payable.

In the event the claim of default against us made by certain holders of the Senior Notes is upheld in a court of law and we are required to pay off the Senior Notes, it is most likely that we would utilize cash on hand and borrowings under our Credit Facility to fund such payoff. Under the terms of the Credit Facility, we can utilize borrowings under the Revolving Facility, subject to certain liquidity requirements, or may seek additional commitments for funding under the Term Loan Facility of the Credit Facility. We estimate we have sufficient liquidity to meet both the needs of our operations and any potential payoff of the Senior Notes. While we do have availability under our Credit Facility to draw funds to repay the Senior Notes, there may be a decrease in our credit availability that could otherwise be used for other corporate purposes, such as acquisitions and share repurchases.

If our Senior Notes are refinanced or the determination is made that the outstanding balance is due to the noteholders, the remaining unrealized loss on forward interest rate agreements reported in other comprehensive income of \$10.6 million (\$6.6 million, net of income tax), unamortized deferred financing costs of \$1.9 million (\$1.2 million, net of income tax) and unamortized discount of \$0.5 million (\$0.3 million, net of income tax) associated with our Senior Notes as of September 30, 2008 may be adjusted and reported as interest expense in our Consolidated Statement of Income in the period of refinancing or demand.

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Investigation Concerning Procurement Process at Hanscom Air Force Base

One of our subsidiaries, ACS Defense, LLC, and several other government contractors received a grand jury document subpoena issued by the U.S. District Court for the District of Massachusetts in October 2002. The subpoena was issued in connection with an inquiry being conducted by the Antitrust Division of the Department of Justice (DOJ). The inquiry concerns certain IDIQ (Indefinite Delivery Indefinite Quantity) procurements and their related task orders, which occurred in the late 1990s at Hanscom Air Force Base in Massachusetts. In February 2004, we sold the contracts associated with the Hanscom Air Force Base relationship to ManTech International Corporation (ManTech); however, we have agreed to indemnify ManTech with respect to this DOJ investigation. The DOJ is continuing its investigation, but we have no information as to when the DOJ will conclude this process. We have cooperated with the DOJ in producing documents in response to the subpoena, and our internal investigation and review of this matter through outside legal counsel will continue through the conclusion of the DOJ investigatory process. We are unable to express an opinion as to the likely outcome of this matter at this time. It is not possible at this time to reasonably estimate the possible loss or range of loss, if any, should an unfavorable outcome occur for the matters noted above.

Investigations Regarding Florida Workforce Contracts

On January 30, 2004, the Florida Agency for Workforce Innovation s (AWI) Office of Inspector General (OIG) issued a report that reviewed 13 Florida workforce regions, including Dade and Monroe counties, and noted concerns related to the accuracy of customer case records maintained by our local staff. We had no revenue related to our workforce contracts in the state of Florida in fiscal years 2008 and 2007, as this business was sold during fiscal year 2006. In March 2004, we filed our response to the OIG report. The principal workforce policy organization for the State of Florida, which oversees and monitors the administration of the State s workforce policy and the programs carried out by AWI and the regional workforce boards, is Workforce Florida, Inc. (WFI). On May 20, 2004, the Board of Directors of WFI held a public meeting at which the Board of Directors of WFI announced that WFI did not see a systemic problem with our performance of these workforce services and that it considered the issue closed. There were also certain contract billing issues that arose during the course of our performance of our workforce contract in Dade County, Florida, which ended in June 2003. However, during the three months ended September 30, 2004, we settled all financial issues with Dade County with respect to our workforce contract with that county and the settlement was fully reflected in our results of operations for the three months ended September 30, 2004. We were also advised in February 2004 that the SEC had initiated an informal investigation into the matters covered by the OIG s report, although we have not received any request for information or documents since the middle of calendar year 2004. On March 22, 2004, ACS State and Local Solutions (ACS SLS) received a grand jury document subpoena issued by the U.S. District Court for the Southern District of Florida. The subpoena was issued in connection with an inquiry being conducted by the DOJ and the Inspector General s Office of the U.S. Department of Labor (DOL) into the subsidiary s workforce contracts in Dade and Monroe counties in Florida, which also expired in June 2003, and which were included in the OIG s report. On August 11, 2005, the South Florida Workforce Board notified us that all deficiencies in our Dade County workforce contract have been appropriately addressed and all findings are considered resolved.

On August 25, 2004, ACS SLS received a grand jury document subpoena issued by the U.S. District Court for the Middle District of Florida in connection with an inquiry being conducted by the DOJ and the Inspector General s Office of the DOL. The subpoena related to a workforce contract in Pinellas County, Florida, for the period from January 1999 to the contract s expiration in March 2001, which was prior to our acquisition of this business from Lockheed Martin Corporation in August 2001. Further, we settled a civil lawsuit with Pinellas County in December 2003, with respect to claims related to the services rendered to Pinellas County by Lockheed Martin Corporation prior to our acquisition of ACS SLS (those claims having been transferred with ACS SLS as part of the acquisition), and the settlement resulted in Pinellas County paying ACS SLS an additional \$600,000. We are continuing to cooperate with the DOJ and DOL in connection with their investigations. At this stage of these

investigations, we are unable to express an opinion as to their likely outcome. It is not possible at this time to reasonably estimate the possible loss or range of loss, if any. During the three months ended December 31, 2005, we completed the divestiture of substantially all of our welfare-to-workforce business. However, we retained the liabilities for this business which arose from activities prior to the date of closing, including the contingent liabilities discussed above.

On January 3, 2003, a Complaint was filed under seal in the United States District Court, Middle District of Florida, Tampa Division, by a former Pinellas County Administrator under the *Qui Tam* provisions of the False Claims Act. On October 23, 2006, the United States filed a notice with the court that it would not intervene in the Complaint. The court then entered an order to unseal the Complaint and we were subsequently served with the Complaint. The allegations in this Complaint arise from the workforce contract in Pinellas County, Florida, that is the subject of the grand jury document subpoena issued by the U.S. District Court for the Middle District of Florida in connection with an inquiry being conducted by the DOJ and

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the Inspector General's Office of the DOL (as discussed above). The plaintiff is seeking statutory penalties for each violation.

On September 20, 2008, a court ordered mediation was held in Tampa, Florida. ACS asked that Plaintiff or his counsel set forth facts which demonstrate a single instance in which Plaintiff was the original source of information evidencing a fraudulent act. They refused to do so and the mediation reached an impasse without settlement. We intend to vigorously defend this case. However, it is not possible at this time to reasonably estimate the likelihood of liability or range of loss, if any.

Litigation arising from alleged patent infringement

On April 4, 2008, JP Morgan Chase & Co. (JPMorgan) filed a lawsuit against Affiliated Computer Services, Inc. and ACS State & Local Solutions, Inc. (collectively, ACS) in U.S. District Court in Wilmington, Delaware. JPMorgan seeks certain declarations as well as unspecified monetary damages related to alleged violations by ACS of JPMorgan's electronic payment card, lockbox, and check processing and imaging patents. ACS is vigorously defending this lawsuit and has counterclaimed against JPMorgan seeking certain declarations as well as monetary damages related to JPMorgan's violations of ACS's payment processing patents. At this time, we are unable to express an opinion as to the likely outcome of this matter and it is not possible to reasonably estimate either the range of recovery or range of loss, if any.

Other

Certain contracts, primarily in our Government segment, require us to provide a surety bond or a letter of credit as a guarantee of performance. As of September 30, 2008, \$642.5 million of our outstanding surety bonds and \$54.9 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately \$18.8 million of our letters of credit secure our casualty insurance and vendor programs and other corporate obligations. In general, we would only be liable for the amount of these guarantees in the event of default in our performance of our obligations under each contract; the probability of which we believe is remote. We believe that we have sufficient capacity in the surety markets and liquidity from our cash flow and our Credit Facility to respond to future requests for proposals.

Our Commercial education business performs third party student loan servicing in the Federal Family Education Loan program (FFEL) on behalf of various financial institutions. We service these loans for investors under outsourcing arrangements and do not acquire any servicing rights that are transferable by us to a third party. At September 30, 2008, we serviced a FFEL portfolio of approximately 3 million loans with an outstanding principal balance of approximately \$41.2 billion. Some servicing agreements contain provisions that, under certain circumstances, require us to purchase the loans from the investor if the loan guaranty has been permanently terminated as a result of a loan default caused by our servicing error. If defaults caused by us are cured during an initial period, any obligation we may have to purchase these loans expires. Loans that we purchase may be subsequently cured, the guaranty reinstated and the loans repackaged for sale to third parties. We evaluate our exposure under our purchase obligations on defaulted loans and establish a reserve for potential losses, or default liability reserve, through a charge to the provision for loss on defaulted loans purchased. The reserve is evaluated periodically and adjusted based upon management's analysis of the historical performance of the defaulted loans. As of September 30, 2008, other accrued liabilities include reserves which we believe to be adequate.

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We are obligated to make certain contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During the three months ended September 30, 2008 and 2007, we made contingent consideration payments of \$2.9 million and \$23.7 million, respectively, related to acquisitions completed in prior years. As of September 30, 2008, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities was approximately \$39.5 million. Any such payments primarily result in a corresponding increase in goodwill.

In addition to the foregoing, we are subject to certain other legal proceedings, inquiries, claims and disputes, which arise in the ordinary course of business. Although we cannot predict the outcomes of these other proceedings, we do not believe these other actions, in the aggregate, will have a material adverse effect on our financial position, results of operations or liquidity.

12. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS 157 which defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. The statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The statement emphasizes that fair value is a market-based measurement and not an entity-specific measurement. It also establishes a fair value hierarchy used in fair value measurements and expands the required disclosures of assets and liabilities measured at fair value. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We adopted SFAS 157 effective July 1, 2008. Please see Note 8 for a discussion of the adoption of SFAS 157 for financial assets and liabilities. There was no impact on our financial condition and results of operations as a result of the adoption of SFAS 157.

In February 2008, FASB issued FASB Staff Position FAS 157-2 (FSP FAS 157-2), Effective Date of FASB Statement No. 157 which provides a one-year deferral of the effective date of SFAS 157 for non-financial assets and liabilities except those that are recognized or disclosed in the financial statements at fair value at least annually. We are currently evaluating the impact, if any, that FSP FAS 157-2 will have on our financial condition and results of operations.

In October 2008, the FASB issued FASB Staff Position FAS 157-3 (FSP FAS 157-3), Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. FSP FAS 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 is effective upon issuance, including prior periods for which financial statements have not been issued. We adopted FSP FAS 157-3 effective with the financial statements ended September 30, 2008. The adoption of FSP FAS 157-3 had no impact on our financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 provides entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. We adopted SFAS 159 effective July 1, 2008. We did not elect the fair value option under SFAS 159 for any of our financial assets or liabilities upon adoption. The adoption of SFAS 159 did not have a material impact on our financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised), Business Combinations (SFAS 141R), which establishes principles and requirements for how an acquirer accounts for business combinations. SFAS 141R includes guidance for recognizing and measuring the assets acquired, liabilities assumed, and any noncontrolling or minority interests in an acquisition. SFAS 141R applies prospectively and will become effective for business combinations

occurring on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We are currently evaluating the impact, if any, that SFAS 141R will have on our financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51, (SFAS 160). SFAS 160 establishes accounting and reporting standards that require noncontrolling interests to be reported as a separate component of equity, and net income attributable to the parent and to the noncontrolling interest to be separately identified in the income statement. SFAS 160 also requires changes in a parent s

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ownership interest while the parent retains its controlling interest to be accounted for as equity transactions, and any retained noncontrolling equity investment upon the deconsolidation of a subsidiary to be initially measured at fair value. SFAS 160 applies prospectively and is effective for the Company beginning July 1, 2009. Certain presentation requirements of SFAS 160 are effective retrospectively. We are currently evaluating the impact, if any, that SFAS 160 will have on our financial condition and results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures about an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS 161 applies to all derivative instruments within the scope of SFAS 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. SFAS 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. We are currently evaluating the impact, if any, that SFAS 161 will have on our financial statement disclosures.

13. SUBSEQUENT EVENTS

On October 30, 2008, we announced that we intend to implement an off-shoring initiative in order to lower future labor costs. Under this initiative, approximately 4,200 full-time employee positions in the United States and elsewhere are currently expected to be eliminated by the end of the first quarter of fiscal year 2010 while additional employees are hired in other locations outside the United States. The total pre-tax cost to eliminate these employee positions under this initiative is currently estimated at \$38 million to \$42 million, of which severance costs are currently estimated to be \$14 million to \$16 million and transition and other expenses are currently estimated to be \$24 million to \$26 million. We currently expect that almost all of these expenses will be cash expenditures. Additionally, we will be required to open additional facility sites and expand current facility sites outside of the United States in order to accommodate the increased offshore headcount. Capital expenditures related to these facilities are currently estimated at \$15 million to \$20 million over the next four quarters. We currently expect to incur a pre-tax charge for severance costs of \$14 million to \$16 million and transition and other expenses of \$7 million to \$9 million during the three months ended December 31, 2008 related to this initiative.

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All statements and assumptions contained or referenced in this Quarterly Report and its exhibits that are not based on historical fact, such as statements with respect to our financial condition, results of operations, cash flows, business strategies, operating efficiencies, indebtedness, litigation, competitive positions, growth opportunities and plans and objectives of management, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and the provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (which Sections were adopted as part of the Private Securities Litigation Reform Act of 1995). Such forward-looking statements and assumptions include, among other things, statements with respect to our financial condition, results of operations, cash flows, business strategies, operating efficiencies, indebtedness, litigation, competitive positions, growth opportunities, plans and objectives of management, and other matters. Such forward-looking statements are based upon management's current knowledge and assumptions about future events and are subject to numerous assumptions, risks, uncertainties and other factors, many of which are outside of our control, which could cause actual results to differ materially from the anticipated results, prospects, performance or achievements expressed or implied by such statements. Such risks and uncertainties include, but are not limited to: (a) the cost and cash flow impact of our debt and our ability to obtain further financing; (b) a reversal, on appeal, of a lower court's determination that we have not defaulted on our Senior Notes and that those Notes have not been accelerated; (c) the complexity of the legal and regulatory environments in which we operate, including the effect of claims and litigation; (d) our oversight by the SEC and other regulatory agencies and investigations by those agencies; (e) our credit rating or further reductions of our credit rating; (f) a decline in revenues from or a loss or failure of significant clients; (g) our ability to recover capital investments in connection with our contracts; (h) possible period-to-period fluctuations in our non-recurring revenues and related cash flows; (i) competition and our ability to compete effectively; (j) dissatisfaction with our services by our clients; (k) our dependency to a significant extent on third party providers, such as subcontractors, a relatively small number of primary software vendors, utility providers and network providers; (l) our ability to identify, acquire or integrate other businesses or technologies; (m) our ability to manage our operations and our growth; (n) termination rights, audits and investigations related to our Government contracts; (o) delays in signing and commencing new business; (p) the effect of some provisions in contracts and our ability to control costs; (q) claims associated with our actuarial consulting and benefit plan management services; (r) claims of infringement of third-party intellectual property rights; (s) laws relating to individually identifiable information; (t) potential breaches of our security system; (u) the impact of budget deficits and/or fluctuations in the number of requests for proposals issued by governments; (v) risks regarding our international and domestic operations; (w) fluctuations in foreign currency exchange rates; (x) our ability to attract and retain necessary technical personnel, skilled management and qualified subcontractors; (y) risks associated with loans that we service; (z) the effect of certain provisions of our certificate of incorporation, bylaws and Delaware law and our stock ownership; and (aa) the price of our Class A common stock.

For more details on factors that may cause actual results to differ materially from such forward-looking statements, please see Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended June 30, 2008, and other reports from time to time we file with or furnish to the SEC. Forward-looking statements contained or referenced in this Quarterly Report and its exhibits speak only as of the date of this Report and forward-looking statements in documents incorporated by reference speak only as to the date of those documents. We disclaim, and do not undertake any obligation to, update or release any revisions to any forward-looking statement.

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

We provide non-core, mission critical services that our clients need to run their day-to-day business. We believe the market for our services is vast. The demand for our services has grown in recent years and we believe that this demand will continue to grow as the overall acceptance of outsourcing increases in both the Commercial and Government segments. The cornerstone of our business strategy is our focus on vertical markets and technology solutions that we can leverage across our business and client base.

We enter into long-term relationships with clients to provide services that meet their ongoing business requirements while supporting their mission critical business process or information technology needs. We derive our revenues from delivering comprehensive business process outsourcing and information technology services solutions to commercial and government clients. A substantial portion of our revenues is derived from recurring monthly charges to our clients under service contracts with initial terms that vary from one to ten years. The recurring nature of our revenue provides us with predictable revenue streams during differing economic cycles. We define recurring revenues as revenues derived from services that our clients use each year in connection with their ongoing businesses, and accordingly, exclude software license fees, short-term contract

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programming and consulting engagements, product installation fees, and hardware and software sales. However, if we add consulting or other services to enhance the value delivered and offered to our clients that are primarily short-term in nature, we may experience variations in our mix of recurring versus non-recurring revenues.

New Business Pipeline

Management focuses on various metrics in analyzing our business and its performance and outlook. One such metric is our sales pipeline, which was approximately \$2 billion of annual recurring revenues as of September 30, 2008. Our sales pipeline includes potential business opportunities that will be contracted within the next six months and excludes business opportunities with estimated annual recurring revenue that are in excess of \$100 million. Both the Commercial and Government pipelines have significant, quality opportunities within our vertical markets and horizontal solutions. As of September 30, 2008, the Commercial segment comprised approximately 55% of our pipeline and the Government segment comprised the remaining 45%. By service line, approximately 81% of our pipeline is business process outsourcing and approximately 19% of the pipeline is information technology solutions as of September 30, 2008. The Commercial segment pipeline includes opportunities in information technology services, commercial healthcare, transactional business process outsourcing and finance and accounting outsourcing. The Government segment pipeline includes opportunities in our domestic and international transportation business, in the state and local market for information technology and eligibility services, in government healthcare and with the federal government.

While the magnitude of our sales pipeline is an important indicator of potential new business signings and potential future internal revenue growth, actual new business signings and internal revenue growth depend on a number of factors including the effectiveness of our sales pursuit teams, competition for a deal, deal pricing, cash flow generation qualities of each deal and are subject to risks described further in Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

New Business Signings

We define new business signings as estimated annual recurring revenue from new contracts and the incremental portion of renewals that are signed during the period, which represents the estimated first twelve months of revenue to be recorded under the contracts after full implementation. We use new business signings to forecast prospective revenues and to estimate capital commitments. Revenues for new business signings are measured under generally accepted accounting principles in the United States (GAAP). There are no third party standards or requirements governing the calculation of new business signings and our measure may not be comparable to similarly titled measures of other companies. We define total contract value as the estimated total revenues from contracts signed during the period. We use total contract value as an additional measure of estimating total revenue represented by contractual commitments, both to forecast prospective revenues and to estimate capital commitments. Revenues for annual recurring revenue and total contract value are measured under GAAP.

During the three months ended September 30, 2008, we signed contracts with new clients and incremental business with existing clients representing \$203.4 million of annual recurring revenue with an estimated \$774.3 million in total contract value. The Commercial segment contributed 45% of the new contract signings (based on annual recurring revenues) including new contracts with Ingersoll Rand for information technology services, Indiana Public Employees Retirement Fund for human resources outsourcing and Apple Computer, Inc. for customer service call center support. The Government segment contributed 55% of the new contract signings (based on annual recurring revenues) including new contracts with the Department of Education for loan servicing under the Federal Family Education Loan program and Montgomery County, Maryland for speed enforcement services.

Internal Revenue Growth

We use internal revenue growth as a measure of the organic growth of our business. Internal revenue growth is measured as total revenue growth less revenues from acquisitions and revenues from divested operations. At the date of an acquisition, we identify the trailing twelve months of revenue of the acquired company as the pre-acquisition revenue of acquired companies. Pre-acquisition revenue of the acquired companies is considered acquired revenues in our calculation, and actual revenues from the acquired company, either above or below acquired revenues are components of internal growth in our calculation. Revenues from divested operations are excluded from the internal revenue growth calculation in the periods following the effective date of the divestiture. We believe these adjustments

to historical reported results are necessary to accurately reflect our internal revenue growth. Prior period internal revenue growth calculations are not restated for current period divestitures. Our measure of internal revenue growth may not be comparable to similarly titled measures of other companies. During the three months ended September 30, 2008, total revenue grew 8% over the prior year period excluding divestitures and internal revenue grew 5% over the prior year period.

Client Renewal Rates

We focus on the performance of our contractual obligations and continually monitor client satisfaction. Renewal rates are the best indicator of client satisfaction. We calculate our renewal rate based on the total annual recurring revenue of renewals

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won as a percentage of total annual recurring revenue of all renewals sought. During the three months ended September 30, 2008, we renewed approximately 76% of total renewals sought, totaling \$304.3 million of annual recurring revenue with a total contract value of approximately \$1.1 billion. The decline of our renewal rate during the three months ended September 30, 2008 is primarily due to the non-renewal of the Georgia Medicaid contract, for which our protest of the award to a competitor was denied during the quarter. We will continue to earn revenue under our Georgia Medicaid contract until the end of fiscal year 2010. We do not expect a permanent drop in our renewal rates. Average contract life for renewals varies between our government and commercial segments. The average contract life of renewals in the government segment is often longer than those in the commercial segment.

Capital Intensity

Management responds to technological advances and the rapid changes in the requirements of our clients by committing substantial amounts of our resources to the operation of multiple hardware platforms, the customization of products and services that incorporate new technology on a timely basis and the continuous training of our personnel. Management continually assesses the capital intensity of these technological advances and client requirements, addressing the challenge to stay ahead of the competition for innovative solutions and provide a lower cost solution for clients.

We monitor the capital intensity, defined as the total of capital expenditures and additions to intangible assets as a percentage of revenue, of new business signings. Understanding the capital intensity of new business signings is critical in determining the future free cash flow generating levels of our business. Historically, the capital intensity in our business has ranged between 5% and 7% of revenue. During the three months ended September 30, 2008 and 2007, the overall capital intensity of our business was approximately 5% of revenues. We expect that as our new business signings ramp, we will incur capital expenditures associated with the new business, which could result in increased capital intensity over the fiscal year 2008 percentage, but we expect that the capital intensity will remain within our historical range. We believe the expected capital intensity range of our new business signings reflects a healthy competitive environment and the related risks we are taking with respect to our new business process outsourcing business and information technology services business.

Employees

Attracting, retaining and training our employees has been a key component to our historical success and will continue to be a major factor in our future success. Because we operate in intensely competitive markets, our success depends to a significant extent on our ability to attract, retain and motivate highly skilled and qualified personnel. We review our employee retention rates on a regional and global basis to ensure that we are competitive in hiring, retaining and motivating our employees. We utilize activity based compensation as a means to motivate certain of our employees in both segments of our business and believe our use of activity based compensation is a competitive advantage for ACS.

Other

We identified a number of risk factors in Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended June 30, 2008. Management monitors the general economic conditions, changes in technology and other developments in the markets we serve, competitive pricing trends and contractual terms for future impact on the Company in order to be able to respond effectively and on a timely basis to these developments.

We report our financial results in accordance with GAAP. However, we believe that certain non-GAAP financial measures and ratios, used in managing our business, may provide users of this financial information with additional meaningful comparisons between current results and prior reported results. Certain of the information set forth herein and certain of the information presented by us from time to time (including free cash flow and internal revenue growth) may constitute non-GAAP financial measures within the meaning of Regulation G adopted by the SEC. We have presented herein and we will present in other information we publish that contains any of these non-GAAP financial measures a reconciliation of these measures to the most directly comparable GAAP financial measure. The presentation of this non-GAAP information is not meant to be considered in isolation or as a substitute for comparable amounts determined in accordance with GAAP.

Significant Developments

Deason/Cerberus Proposal

Please see Note 3 to our Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008 for a discussion of the Deason/Cerberus proposal to purchase the Company. During the three months ended September 30, 2008 and 2007, we recognized approximately \$0.1 million and \$4.1 million, respectively, in legal and other costs related to this potential transaction and \$0.7 million and \$0.8 million, respectively, related to stockholder derivative lawsuits related to this potential transaction as discussed in Note 11 to our Consolidated Financial Statements.

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Subsequent Events

On October 30, 2008, we announced that we intend to implement an off-shoring initiative in order to lower future labor costs. Under this initiative, approximately 4,200 full-time employee positions in the United States and elsewhere are currently expected to be eliminated by the end of the first quarter of fiscal year 2010 while additional employees are hired in other locations outside the United States. The total pre-tax cost to eliminate these employee positions under this initiative is currently estimated at \$38 million to \$42 million, of which severance costs are currently estimated to be \$14 million to \$16 million and transition and other expenses are currently estimated to be \$24 million to \$26 million. We currently expect that almost all of these expenses will be cash expenditures. Additionally, we will be required to open additional facility sites and expand current facility sites outside of the United States in order to accommodate the increased offshore headcount. Capital expenditures related to these facilities are currently estimated at \$15 million to \$20 million over the next four quarters. We currently expect to incur a pre-tax charge for severance costs of \$14 million to \$16 million and transition and other expenses of \$7 million to \$9 million during the three months ended December 31, 2008 related to this initiative.

Table of Contents**Revenue Growth**

Internal revenue growth is measured as total revenue growth less acquired revenue from acquisitions and revenues from divested operations. At the date of acquisition, we identify the trailing twelve months of revenue of the acquired company as the pre-acquisition revenue of acquired companies. Pre-acquisition revenue of the acquired companies is considered acquired revenues in our calculation, and revenues from the acquired company, either above or below that amount are components of internal growth in our calculation. We use the calculation of internal revenue growth to measure revenue growth excluding the impact of acquired revenues and the revenue associated with divested operations and we believe these adjustments to historical reported results are necessary to accurately reflect our internal revenue growth. Revenues from divested operations are excluded from the internal revenue growth calculation in the periods following the effective date of the divestiture. Internal revenue growth calculations reported in prior periods are not restated for current period divestitures. Our measure of internal revenue growth may not be comparable to similarly titled measures of other companies. The following table sets forth the calculation of internal revenue growth (in thousands):

Three Months Ended September 30,

	2008	2007	\$ Growth	Growth %
<u>Consolidated</u>				
Total Revenues	\$ 1,604,454	\$ 1,493,083	\$ 111,371	7%
Less: Divestitures	(316)	(8,116)	7,800	
Adjusted	\$ 1,604,138	\$ 1,484,967	\$ 119,171	8%
Acquired revenues	\$ 48,511	\$	\$ 48,511	3%
Internal revenues	1,555,627	1,484,967	70,660	5%
Total	\$ 1,604,138	\$ 1,484,967	\$ 119,171	8%
<u>Commercial</u>				
Total Revenues (a)	\$ 959,417	\$ 878,879	\$ 80,538	9%
Less: Divestitures	(24)	(2,902)	2,878	
Adjusted	\$ 959,393	\$ 875,977	\$ 83,416	10%
Acquired revenues	\$ 34,244	\$	\$ 34,244	4%
Internal revenues	925,149	875,977	49,172	6%
Total	\$ 959,393	\$ 875,977	\$ 83,416	10%
<u>Government</u>				
Total Revenues (b)	\$ 645,037	\$ 614,204	\$ 30,833	5%
Less: Divestitures	(292)	(5,214)	4,922	
Adjusted	\$ 644,745	\$ 608,990	\$ 35,755	6%

Acquired revenues	\$ 14,267	\$	\$ 14,267	2%
Internal revenues	630,478	608,990	21,488	4%
Total	\$ 644,745	\$ 608,990	\$ 35,755	6%

(a) The Commercial segment includes revenues from operations divested through September 30, 2008 of \$2.9 million for the three months ended September 30, 2007.

(b) The Government segment includes revenues from operations divested through September 30, 2008 of \$0.3 million and \$5.2 million for the three months ended September 30, 2008 and 2007, respectively.

Table of Contents**Results of Operations**

The following table sets forth the items from our Consolidated Statements of Income expressed as a percentage of revenues. Please refer to the comparisons below for discussion of items affecting these percentages.

	Three months ended September 30,	
	2008	2007
Revenues	100.0%	100.0%
Operating expenses:		
Cost of revenues:		
Wages and benefits	45.7%	46.9%
Services and supplies	23.3%	22.9%
Rent, lease and maintenance	12.6%	12.4%
Depreciation and amortization	6.1%	6.1%
Other	0.7%	0.4%
Cost of revenues	88.4%	88.7%
Other operating expenses	0.8%	1.6%
Total operating expenses	89.2%	90.3%
Operating income	10.8%	9.7%
Interest expense	2.2%	2.9%
Other non-operating expense (income), net	0.3%	0.0%
Pretax profit	8.3%	6.8%
Income tax expense	3.1%	2.4%
Net income	5.2%	4.4%

Comparison of the three months ended September 30, 2008 to the three months ended September 30, 2007*Revenues*

During the three months ended September 30, 2008, our revenues increased \$111.4 million, or 7%, to \$1.6 billion from \$1.5 billion during the three months ended September 30, 2007. Excluding operations divested through September 30, 2008, revenues increased \$119.2 million, or 8%. Internal revenue growth for the three months ended September 30, 2008 was 5% and the remainder of the revenue growth was related to acquisitions.

Revenue in our Commercial segment, which represents 60% of consolidated revenue for the three months ended September 30, 2008, increased \$80.5 million, or 9%, to \$959.4 million during the three months ended September 30, 2008 compared to the same period last year. Excluding operations divested through September 30, 2008, revenues increased \$83.4 million, or 10%. Internal revenue growth was 6% and growth from acquisitions was 4%. Internal revenue growth was due primarily to growth in contracts with Verizon Wireless, Sprint Nextel Corporation, Allergan,

Inc., GlaxoSmithKline, and Caremark, Inc. We also experienced growth in our learning process outsourcing and human resources consulting lines of business. The items discussed above collectively represent approximately 73% of our internal revenue growth for the period in this segment.

Revenue in our Government segment, which represents 40% of consolidated revenue for the three months ended September 30, 2008, increased \$30.8 million, or 5%, to \$645 million during the three months ended September 30, 2008 compared to the same period last year. Excluding revenues from operations divested through September 30, 2008, revenues increased \$35.8 million, or 6%. Internal revenue growth was 4% and growth from acquisitions was 2%. We experienced growth in the following areas (i) our government healthcare line of business for Medicaid contracts with the District of Columbia and the states of Alaska, North Dakota and Tennessee, contracts with Florida Healthy Kids Corporation and Florida Choice

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Counseling and a contract with the state of Pennsylvania for medical management review systems offset by declines due to the loss of the Florida Medicaid contract; (ii) our government constituent services line of business for contracts with the Texas Department of Housing and Community Affairs for eligibility determination and project management, the states of Pennsylvania, North Carolina and Nevada for unemployment insurance payment processing and the state of Indiana for electronic card payment processing; and (iii) our contract with the Department of Education. These increases were offset by a decline in our transportation business due to nonrecurring fare collection work in fiscal year 2008 for the city of Melbourne, Australia and lower unclaimed property business during the three months ended September 30, 2008. The areas discussed above collectively represent approximately 80% of our internal revenue growth for the period in this segment.

Operating expenses

Wages and benefits increased \$34.1 million, or 4.9% during the three months ended September 30, 2008 compared to the same period in the prior year. As a percentage of revenue wages and benefits decreased 1.2% to 45.7% from 46.9% during the same period in the prior year. During the three months ended September 30, 2008 and 2007, we recorded \$(0.3 million) and \$0.8 million for estimated costs related to certain former employees' stock options as discussed in Note 11 to our Consolidated Financial Statements. During the three months ended September 30, 2007, we recorded \$1.2 million of compensation expense related to amending certain employee stock options as discussed in Note 11 to our Consolidated Financial Statements. During the three months ended September 30, 2008, we recorded lower compensation expense related to our deferred compensation plans as a result of decreases in the value of the liability to employees. The remaining decrease is primarily due to growth in our information technology business for which there was lower wages and benefits than our other operations.

Services and supplies increased \$31.7 million, or 9.3%, to \$373.5 million during the three months ended September 30, 2008 compared to the same period in the prior year. As a percentage of revenue, services and supplies increased 0.4% to 23.3% from 22.9% during the same period of the prior year. During the three months ended September 30, 2008, we recorded \$0.1 million in costs related to our ongoing stock option investigation. During the three months ended September 30, 2007, we recorded \$3.7 million in costs related to the potential sale of the Company as discussed in Significant Developments above.

Rent, lease and maintenance expenses increased \$17.2 million, or 9.3%, to \$202.1 million during the three months ended September 30, 2008 compared to the same period in the prior year. As a percentage of revenue, rent, lease and maintenance expenses increased 0.2%, to 12.6% from 12.4% during the same period in the prior year. During the three months ended September 30, 2008 and 2007, we recorded \$0.6 million and \$0.5 million, respectively, for electronic data storage costs related to our ongoing stock option investigation.

Other operating expenses decreased \$9.2 million, or 39.6%, to \$14.1 million during the three months ended September 30, 2008 compared to the same period in the prior year. As a percentage of revenue, other operating expenses decreased 0.8%, to 0.8%. During the three months ended September 30, 2008 and 2007, we recorded \$3.6 million and \$10.7 million, respectively, for legal costs related to our ongoing stock option investigation and stockholder derivative lawsuits as discussed in Note 11 to our Consolidated Financial Statements. During the three months ended September 30, 2008 and 2007, we recorded \$0.7 million and \$1.2 million, respectively, for legal costs related to the potential sale of the Company and stockholder derivative lawsuits. During the three months ended September 30, 2008, we recorded a pre-tax gain of approximately \$0.2 million related to the sale of our bindery business as discussed in Note 10 to our Consolidated Financial Statements.

Table of Contents*Operating income*

Operating income increased \$27.3 million, or 18.8%, to \$172.7 million. As a percentage of revenue, operating income increased 1.1% to 10.8% during the three months ended September 30, 2008 from 9.7% during the same period of the prior year. Operating income during the three months ended September 30, 2008 and 2007 was impacted by the items discussed above, including the following (in millions):

	Three months ended September 30,	
	2008	2007
Government segment:		
Gain on sale of bindery business	\$ 0.2	\$
Corporate segment:		
Legal costs associated with the ongoing stock option investigations and stockholder derivative lawsuits	(4.4)	(11.1)
Legal costs associated with the potential sale of the Company and stockholder derivative lawsuits	(0.8)	(4.9)
Cost related to amending certain employee stock options		(1.2)
Cost related to certain former employees' stock options	0.3	(0.8)
Total	\$ (4.7)	\$ (18.0)
As a percentage of revenue	-0.3%	-1.2%
Change as a percentage of revenue explained above	0.9%	
Other net change as a percentage of revenue	0.2%	
Total change as a percentage of revenue	1.1%	

Interest expense

Interest expense decreased \$8.8 million during the three months ended September 30, 2008 compared to the same period in the prior year, to \$35.2 million primarily due to lower interest rates on outstanding debt.

Other non-operating expense (income), net

Other non-operating expense (income), net increased \$4.4 million during the three months ended September 30, 2008 compared to the same period in the prior year primarily due to losses on the investments supporting our deferred compensation plans.

Income tax expense

Our effective income tax rate increased to 37.5% for the three months ended September 30, 2008 from 35.2% for the three months ended September 30, 2007. The effective tax rate for the three months ended September 30, 2007 included interest credits on expected tax refunds. Our effective income tax rate is higher than the 35% federal statutory rate primarily due to the effect of state income taxes.

Liquidity and Capital Resources*Cash flow*

During the three months ended September 30, 2008, we generated approximately \$62.6 million in cash flows provided by operating activities compared to \$8 million in the three months ended September 30, 2007. Our cash flows provided by operating activities were impacted by higher collections on accounts receivable and lower payments to employees for annual incentive compensation plans offset by timing of payments to vendors for accounts payable and accrued liabilities.

Accounts receivable fluctuations may have a significant impact on our cash flows provided by operating activities. Accounts receivable can be negatively impacted by growth in revenues in one fiscal year or quarter compared to the prior fiscal year or quarter, where collections typically lag behind the related client billings, resulting in a use of cash for operating activities. Conversely, when revenue growth slows, then accounts receivable is positively impacted, resulting in a source of cash for operating activities. Additionally, accounts receivable is impacted by contracts where we apply percentage-of-completion accounting in the recognition of revenues. Under such contracts we may receive a different amount of payments from the clients during that fiscal year or quarter than the amount that we record as revenues during the same period. Such payments are typically dependent on original contract negotiations as to the timing of when such payments are due, and based on actual operational performance in the delivery of the contract milestones and associated client acceptance required under the contracts.

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Free cash flow is measured as cash flow provided by operating activities (as reported in our Consolidated Statements of Cash Flows), less capital expenditures (purchases of property, equipment and software, net, as reported in our Consolidated Statements of Cash Flows) less additions to other intangible assets (as reported in our Consolidated Statements of Cash Flows). We believe this free cash flow metric provides an additional measure of available cash flow after we have satisfied the capital expenditure requirements of our operations, and should not be taken in isolation to be a measure of cash flow available for us to satisfy all of our obligations and execute our business strategies. We also rely on cash flows from financing activities which, together with free cash flow, are expected to be sufficient for us to execute our business strategies. Our measure of free cash flow may not be comparable to similarly titled measures of other companies. The following table sets forth the calculations of free cash flow (in thousands):

	Three months ended September 30,	
	2008	2007
Net cash provided by operating activities	\$ 62,602	\$ 8,023
Purchases of property, equipment and software, net	(64,550)	(65,841)
Additions to other intangible assets	(9,541)	(9,481)
Free cash flow	\$ (11,489)	\$ (67,299)

During the three months ended September 30, 2008, net cash used in investing activities was \$61.6 million compared to \$99 million during the same period of the prior year. During the three months ended September 30, 2008, we used \$4.8 million for acquisitions, primarily for contingent consideration and a working capital settlement related to prior year acquisitions. During the three months ended September 30, 2007, we used \$23.7 million for acquisitions, net of cash acquired, primarily for contingent consideration payments for prior year acquisitions. Cash used for the purchase of property, equipment and software and additions to other intangible assets was \$74.1 million and \$75.3 million for the three months ended September 30, 2008 and 2007, respectively. During the three months ended September 30, 2008, we received \$10.6 million in proceeds on investments which matured during the quarter and purchased \$2.6 million of investments to support our deferred compensation plans.

During the three months ended September 30, 2008 and 2007, net cash provided by (used in) financing activities was \$(28.1 million) and \$29.7 million, respectively. Such financing activities include net borrowings on our Credit Agreement with Citicorp USA, Inc., as Administrative Agent (Citicorp), Citigroup Global Markets Inc., as Sole Lead Arranger and Book Runner, and with Morgan Stanley Bank, SunTrust Bank, Bank of Tokyo-Mitsubishi UFJ, Ltd., Wachovia Bank National Association, Bank of America, N.A., Bear Stearns Corporate Lending and Wells Fargo Bank, N.A., as Co-Syndication Agents, and various other lenders and issuers (the Credit Facility), proceeds from the exercise of stock options and excess tax benefits from stock-based compensation.

Credit arrangements

Draws made under our Credit Facility are made to fund cash acquisitions and share repurchases and for general working capital requirements. During the last twelve months, the balance outstanding under our credit facilities for borrowings ranged from \$1.82 billion to \$1.87 billion. At September 30, 2008, we have approximately \$864.1 million of unused commitment under our revolving credit facility after giving effect to outstanding indebtedness of \$62.3 million and \$73.7 million of outstanding letters of credit that secure certain contractual performance and other obligations. Based on the current leverage ratios under our Credit Facility, we have approximately \$379.3 million available for current draw under this revolving facility. At September 30, 2008, we had \$1.82 billion outstanding under our Credit Facility, of which \$1.8 billion is reflected in long-term debt and \$18 million is reflected in current portion of long-term debt. Approximately \$1.79 billion of our outstanding Credit Facility bore interest from 4.45% to 6.25% and approximately \$31.9 million bore interest from 3.74% to 3.91%. Please see Note 7 to our Consolidated Financial Statements for a discussion of the interest rate swap and interest rate collar agreements related to interest rates on our Credit Facility. We are in compliance with the covenants of our Credit Facility, as amended, as of the date of filing of this report.

Please see Note 11 to our Consolidated Financial Statements for a discussion of our outstanding surety bonds and letters of credit.

Please see Note 11 to our Consolidated Financial Statements for a discussion of the declaratory action with respect to the alleged default and purported acceleration of our Senior Notes.

Table of Contents*Capital and Credit Market Risk*

Due to the tightening of the capital and credit markets, we have performed assessments to determine the impact, if any, of recent market developments on our financial statements. Our additional assessment has included a review of access to liquidity in the credit market, counterparty creditworthiness, and operational risk. While we believe that the defensive nature of our business model provides us with predictable revenue streams during differing economic cycles, the current market volatility may create additional risks in the future.

Credit ratings

On March 20, 2007, following the announcement that ACS founder Darwin Deason and private equity fund Cerberus proposed to buy the Company, Fitch, Moody's and Standard & Poor's placed us on review for potential downgrade. On December 3, 2007, Fitch removed us from Rating Watch Negative and on December 20, 2007 affirmed our rating at BB with a Stable Outlook, except for our Senior Notes which remain at BB-. On January 3, 2008, Standard & Poor's removed us from CreditWatch with negative implications and confirmed our credit rating at BB with a negative outlook. On January 28, 2008, Moody's concluded their review of ACS for potential downgrade and confirmed our rating at Ba2 with a stable outlook. On August 8, 2008, S&P confirmed our BB rating and revised our outlook to stable. There may be additional reductions in our ratings depending on the timing and amounts that may be drawn under our Credit Facility. As a result, the terms of any financings we choose to enter into in the future may be adversely affected. In addition, as a result of these downgrades, the sureties which provide performance bonds backing our contractual obligations could reduce the availability of these bonds, increase the price of the bonds to us or require us to provide collateral such as a letter of credit. However, we believe that we will continue to have sufficient capacity in the surety markets and liquidity from our cash flow and Credit Facility to respond to future requests for proposals. In addition, certain of our commercial outsourcing contracts provide that, in the event our credit ratings are downgraded to certain specified levels, the client may elect to terminate its contract with us and either pay a reduced termination fee or in some limited instances, no termination fee. While we do not anticipate that the downgrading of our credit ratings will result in a material loss of commercial outsourcing revenue due to the client's exercise of these termination rights, there can be no assurance that such a credit ratings downgrade will not adversely affect these client relationships.

Derivative instruments and hedging activities

Please see Note 7 to our Consolidated Financial Statements for a discussion of our derivative instruments and hedging activities.

Share Repurchase Program

Please see Note 4 to our Consolidated Financial Statements for a discussion of our share repurchase program.

Stock Option Repricing

Please see Note 11 to our Consolidated Financial Statements for a discussion of our offer to former employees related to stock option revised measurement dates as the result of our internal investigation of our stock option grant practices.

Other

At September 30, 2008, we had cash and cash equivalents of \$434.8 million compared to \$461.9 million at June 30, 2008. Our working capital (defined as current assets less current liabilities) increased \$107.6 million to \$1.13 billion at September 30, 2008 from \$1.02 billion at June 30, 2008. Our current ratio (defined as total current assets divided by total current liabilities) was 2.1 and 1.9 at September 30, 2008 and June 30, 2008, respectively. Our debt-to-capitalization ratio (defined as the sum of short-term and long-term debt divided by the sum of short-term and long-term debt and equity) was 50% and 51% at September 30, 2008 and June 30, 2008, respectively.

We believe that available cash and cash equivalents, together with cash generated from operations and available borrowings under our Credit Facility, will provide adequate funds for our anticipated internal growth and operating needs, including capital expenditures, and will meet the cash requirements of our contractual obligations. Should interest rates rise, our interest expense could increase and impact our results of operations and cash flows. In addition, we intend to continue our growth through acquisitions, which could require significant commitments of capital. In order to pursue such opportunities we may be required to incur debt or to issue additional potentially dilutive securities in the future. No assurance can be given as to our future acquisitions and expansion opportunities and how

such opportunities will be financed.

Table of Contents**Disclosures about Contractual Obligations and Commercial Commitments as of September 30, 2008 (in thousands):**

Contractual Obligations	Total	Less than 1 Year	Payments Due by Period		After 5 Years
			1-3 Years	4-5 Years	
Long-term debt (1)	\$ 1,818,251	\$ 18,278	\$ 36,076	\$ 1,763,840	\$ 57
Senior Notes, net of unamortized discount (1)	499,549		249,971		249,578
Capital lease obligations (1)	52,870	28,700	22,854	1,316	
Operating leases (2)	925,262	320,813	442,331	108,993	53,125
Purchase obligations (3) (4)	42,181	13,647	28,534		
Total Contractual Cash Obligations	\$ 3,338,113	\$ 381,438	\$ 779,766	\$ 1,874,149	\$ 302,760

Other Commercial Commitments	Total Amounts Committed	Amount of Commitment Expiration per Period			
		Less than 1 Year	1-3 Years	4-5 Years	After 5 Years
Standby letters of credit	\$ 73,677	\$ 65,677	\$ 8,000	\$	\$
Surety bonds	642,527	549,673	92,854		
Total Commercial Commitments	\$ 716,204	\$ 615,350	\$ 100,854	\$	\$

(1) Excludes accrued interest of \$11 million at September 30, 2008.

(2) We have various contractual commitments to lease hardware and software and for the purchase of maintenance on such leased assets with varying terms through fiscal year 2013, which are included in operating leases in the table.

(3)

We have entered into various contractual agreements to purchase telecommunications services. These agreements provide for minimum annual spending commitments, and have varying terms through fiscal year 2011, and are included in purchase obligations in the table.

- (4) In June 2006, we entered into a two year agreement with Rich Capital, LLC, an M&A advisory firm owned by Jeffery A. Rich, a former Chief Executive Officer, to provide us with advisory services in connection with potential acquisition candidates. This contractual obligation is included in purchase obligations in the table above. However, we have currently suspended payment under this agreement pending determination whether Rich Capital, LLC is capable of performing its obligations under the contract in view of the internal investigation s conclusions

regarding stock
options awarded to
Mr. Rich.

We made contributions of approximately \$3.6 million to our pension plans during the three months ended September 30, 2008 and expect to contribute approximately \$15 million to our pension plans during fiscal year 2009. Minimum pension funding requirements are not included in the table above as such amounts are zero for our pension plans as of September 30, 2008. Please see Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies for discussion of our pension plans.

As of September 30, 2008, we had gross reserves for uncertain tax positions totaling \$34.4 million, which excludes \$8.4 million of offsetting tax benefits recorded in accordance with FIN 48 (defined in Critical Accounting Policies *Income Taxes* below). We anticipate a significant change in the next 12 months to the total amount of FIN 48 unrecognized benefits due to ongoing negotiations with taxing authorities. However, due to the uncertain nature of the settlement process, we are unable to make a reasonable estimate as to when cash settlements of these uncertain tax positions with taxing authorities will occur.

Please see Note 11 to our Consolidated Financial Statements for a discussion of our outstanding surety bonds and letters of credit.

Please see Note 11 to our Consolidated Financial Statements for a discussion of our obligation to make contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions.

As discussed in Note 11 to our Consolidated Financial Statements, as of September 30, 2008 we accrued approximately \$1.1 million to be paid to former employees related to stock option revised measurement dates as the result of our internal investigation of our stock option grant practices.

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Please see Note 11 to our Consolidated Financial Statements for a discussion of our exposure under our Commercial contract to perform third party student loan servicing in the Federal Family Education Loan program (FFEL) on behalf of various financial institutions.

Critical Accounting Policies

The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. We base our estimates on historical experience and on various other assumptions or conditions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates under different assumptions or conditions.

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

Revenue Recognition

A significant portion of our revenue is recognized based on objective criteria that do not require significant estimates or uncertainties. For example, transaction volumes and time and material and cost reimbursable arrangements are based on specific, objective criteria under the contracts. Accordingly, revenues recognized under these methods do not require the use of significant estimates that are susceptible to change. Revenue recognized using the percentage-of-completion accounting method does require the use of estimates and judgment as discussed below. Our policy follows the guidance from SEC Staff Accounting Bulletin 104, Revenue Recognition (SAB 104), unless the transaction is within the scope of other specific authoritative guidance. SAB 104 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements. We recognize revenues when persuasive evidence of an arrangement exists, the services have been provided to the client, the fee is fixed or determinable, and collectibility is reasonably assured.

During fiscal year 2008, approximately 74% of our revenue was recognized based on transaction volumes, approximately 8% was fixed fee based, wherein our revenue is earned as we fulfill our performance obligations under the arrangement, approximately 6% was related to cost reimbursable contracts, approximately 6% of our revenue was recognized using percentage-of-completion accounting and the remainder is related to time and material contracts.

Our revenue mix is subject to change due to the impact of acquisitions, divestitures and new business.

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

Revenues for business process outsourcing services are recognized as services are rendered, generally on the basis of the number of accounts or transactions processed. Information technology processing revenues are recognized as services are provided to the client, generally at the contractual selling prices of resources consumed or capacity utilized by our clients. Revenues from annual maintenance contracts are deferred and recognized ratably over the maintenance period. Revenues from hardware sales are recognized upon delivery to the client and when uncertainties regarding client acceptance have expired.

Revenues on certain fixed price contracts where we provide information technology system development and implementation services are recognized over the contract term based on the percentage of development and implementation services that are provided during the period compared with the total estimated development and implementation services to be provided over the entire contract using Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1). SOP 81-1 requires the use of percentage-of-completion accounting for long-term contracts that are binding agreements between us and our clients in which we agree, for compensation, to perform a service to the client's specifications. These services require that we perform significant, extensive and complex design, development, modification and implementation activities for our clients' systems. Performance will often extend over long periods, and our right to receive future payment depends on our future performance in accordance with the agreement.

The percentage-of-completion methodology involves recognizing probable and reasonably estimable revenue using the percentage of services completed, on a current cumulative cost to estimated total cost basis, using a reasonably consistent profit margin over the period. Due to the longer term nature of these projects, developing the estimates of costs often requires

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significant judgment. Factors that must be considered in estimating the progress of work completed and ultimate cost of the projects include, but are not limited to, the availability of labor and labor productivity, the nature and complexity of the work to be performed, and the impact of delayed performance. If changes occur in delivery, productivity or other factors used in developing the estimates of costs or revenues, we revise our cost and revenue estimates, which may result in increases or decreases in revenues and costs, and such revisions are reflected in income in the period in which the facts that give rise to that revision become known.

At times, we may contract with a client to provide more than one service; for instance, we may contract for an implementation or development project and also provide services or operate the system over a period of time. In these situations, we follow the guidance of Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21). EITF 00-21 provides the methodology for separating the contract elements and allocating total arrangement consideration to the contract elements but does not stipulate the revenue recognition methodology that should be applied to these separate elements. Once the contract has been separated under the guidance of EITF 00-21 and arrangement consideration allocated, revenue recognition for each of the segments follows the applicable revenue recognition method, as described above. In certain instances where revenue cannot be allocated to a contract element delivered earlier than other elements, costs of delivery are deferred and recognized as the subsequent elements are delivered. Costs deferred cannot exceed the relative fair value of the related element and are tested for impairment regularly.

Revenues earned in excess of related billings are accrued, whereas billings in excess of revenues earned are deferred until the related services are provided. We recognize revenues for non-refundable, upfront implementation fees on a straight-line basis over the period between the initiation of the ongoing services through the end of the contract term.

Cost of Revenues

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

Contingencies

We account for claims and contingencies in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies (SFAS 5). SFAS 5 requires that we record an estimated loss from a claim or loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business. Our contracts with clients typically span several years. We continuously review and reassess our estimates of contract profitability. If our estimates indicate that a contract loss will occur, a loss accrual is recorded in the Consolidated Financial Statements in the period it is first identified, if allowed by relevant accounting guidance. Circumstances that could potentially result in contract losses over the life of the contract include variances from expected costs to deliver our services, and other factors affecting revenues and costs.

Valuation of Goodwill and Intangibles

Due to the fact that we are primarily a services company, our business acquisitions typically result in significant amounts of goodwill and other intangible assets, which affect the amount of future period amortization expense and possible expense we could incur as a result of an impairment. In addition, in connection with our revenue arrangements, we incur costs to originate long-term contracts and to perform the transition and setup activities necessary to enable us to perform under the terms of the arrangement. We capitalize certain incremental direct costs which are related to the contract origination or transition, implementation and setup activities and amortize them over the term of the arrangement. From time to time, we also provide certain inducements to clients in the form of various arrangements, including contractual credits, which are capitalized and amortized as a reduction of revenue over the term of the contract. The determination of the value of goodwill and other intangibles requires us to make estimates and assumptions about future business trends and growth. In addition to our annual impairment testing, we continually

evaluate whether events and circumstances have occurred that indicate the balance of goodwill or intangible assets may not be recoverable. In evaluating goodwill for impairment, we compare the estimated fair value of the reporting unit to its underlying book value. In evaluating intangible assets for impairment, we compare the estimated fair value of the intangible asset to its underlying book value. Such evaluation is significantly impacted by estimates and assumptions of future revenues, costs and expenses and other factors. If an event occurs which would cause us to revise our estimates and assumptions used in analyzing the value of our goodwill or other intangible assets, such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

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Valuation of Property, Equipment and Software

We continually evaluate whether events and circumstances have occurred that indicate the balance of our property, equipment and software may not be recoverable. Such evaluation is significantly impacted by estimates and assumptions of future revenues, costs and expenses and other factors. If an event occurs which would cause us to revise our estimates and assumptions used in analyzing the value of our property, equipment and software, such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

Stock-Based Compensation

SFAS No. 123 (revised 2004), Share-based Payment (SFAS 123(R)) requires us to recognize compensation expense for all stock-based payment arrangements based on the fair value of the stock-based payment on the date of grant. In determining the fair value of stock options, we use the Black-Scholes option pricing model that employs the following assumptions:

Expected volatility of our stock price based on historical monthly volatility over the expected term.

Expected term of the option based on historical employee stock option exercise behavior and the vesting and contractual terms of the respective option.

Risk-free interest rate for periods within the expected term of the option.

Expected dividend yield.

Our stock price volatility and expected option lives are based on management's best estimates at the time of grant, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the vesting term of the option.

SFAS 123(R) requires that we recognize compensation expense for only the portion of stock-based payment arrangements that are expected to vest. Therefore, we apply estimated forfeiture rates that are based on historical employee termination behavior. We periodically adjust the estimated forfeiture rates so that only the compensation expense related to stock-based payment arrangements that vest are included in wages and benefits. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

Pension and Post-Employment Benefits

SFAS No. 87, Employers' Accounting for Pensions (SFAS 87), establishes standards for reporting and accounting for pension benefits provided to employees. On June 30, 2007, we adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An Amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). This Statement requires recognition of the funded status of a defined benefit plan in the statement of financial position as an asset or liability if the plan is overfunded or underfunded, respectively. Changes in the funded status of a plan are required to be recognized in the year in which the changes occur, and reported in comprehensive income as a separate component of stockholders' equity. Further, certain gains and losses that were not previously recognized in the financial statements are required to be reported in comprehensive income, and certain disclosure requirements were changed.

We made assumptions of discount rate, long-term rate of return on assets and rate of increase in compensation levels in order to determine our benefit obligations and net periodic benefit costs. These assumptions are described in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008. There have been no changes to our assumptions since that filing.

Allowance for Doubtful Accounts

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

Income Taxes

We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing the timing and amounts of deductible and taxable items. We establish reserves when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be challenged and that we may not succeed. We adjust these reserves in light of changing facts and circumstances. Our provision for income taxes includes the impact of these reserve changes. In the event that there is a significant unusual or

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one-time item recognized in our operating results, the taxes attributable to that item would be separately calculated and recorded at the same time as the unusual or one-time item.

Deferred income taxes are determined based on the difference between financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the years in which such differences are expected to reverse. We routinely evaluate all deferred tax assets to determine the likelihood of their realization.

Effective July 1, 2007, we adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* and interpretation of FASB Statement No. 109 (*FIN 48*), which clarifies the accounting for and disclosure of uncertainty in tax positions. Additionally, FIN 48 provides guidance on the recognition, measurement, de-recognition, classification and disclosure of tax positions and on the accounting for related interest and penalties.

Fair Value Measurements

We adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (*SFAS 157*) effective July 1, 2008. SFAS 157 establishes a hierarchy that prioritizes fair value measurements based on the types of inputs used for the various valuation techniques (market approach, income approach, and cost approach). SFAS 157 is applied under existing accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. There was no impact on our financial condition and results of operations as a result of the adoption of SFAS 157.

In February 2008, FASB issued FASB Staff Position FAS 157-2 (*FSP FAS 157-2*), *Effective Date of FASB Statement No. 157* which provides a one-year deferral of the effective date of SFAS 15