PEROT SYSTEMS CORP
Form 10-Q
May 07, 2007

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

(Mark One)

þ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2007

or

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

Commission File Number 0-22495
PEROT SYSTEMS CORPORATION
(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

þ Large accelerated filer o Accelerated filer o Non-accelerated filer

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

Number of shares of registrant s common stock outstanding as of April 27, 2007: 121,456,320 shares of Class A Common Stock and 816,638 shares of Class B Common Stock.

PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
FORM 10-Q
For the Quarter Ended March 31, 2007

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ITEM 1: FINANCIAL STATEMENTS (UNAUDITED)

PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2007 AND DECEMBER 31, 2006
(UNAUDITED)

	March 31, 2007	December 31, 2006
	(Dollars in millions)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 145	$ 250
Short-term investments	21	133
Accounts receivable, net	421	338
Prepaid expenses and other	77	62
Total current assets	664	783
Property, equipment and purchased software, net	227	220
Goodwill	627	463
Deferred contract costs, net	69	61
Other non-current assets	120	54
Total assets	$ 1,707	$ 1,581
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 63	$ 52
Deferred revenue	42	42
Accrued compensation	42	65
Income taxes payable	22	37
Accrued and other current liabilities	114	105
Total current liabilities	283	301
Long-term debt	159	84
Non-current deferred revenue	83	82
Other non-current liabilities	24	9
Total liabilities	549	476
Commitments and contingencies		
Stockholders equity:		
Common stock	1	1
Additional paid-in capital	554	533
Retained earnings	606	575
Treasury stock	(21)	(21)
Accumulated other comprehensive income	18	17
Total stockholders equity	1,158	1,105

Total liabilities and stockholders equity	$ 1,707	$ 1,581

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED INCOME STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(UNAUDITED)

	Three Months Ended March 31,	
	2007	**2006**
	(Dollars in millions, except per share data)	
Revenue	$ 590	$ 542
Direct cost of services	485	443
Gross profit	105	99
Selling, general and administrative expenses	71	64
Operating income	34	35
Interest income	2	2
Interest expense	(2)	(1)
Income before taxes	34	36
Provision for income taxes	11	13
Net income	$ 23	$ 23
Earnings per share of common stock:		
Basic	$ 0.19	$ 0.19
Diluted	$ 0.19	$ 0.19
Weighted average number of common shares outstanding (in thousands):		
Basic	121,562	118,642
Diluted	124,125	121,553

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(UNAUDITED)

	Three Months Ended March 31,	
	2007	2006
	(Dollars in millions)	
Cash flows from operating activities:		
Net income	$ 23	$ 23
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	24	18
Stock-based compensation	4	4
Change in deferred taxes	(14)	8
Excess tax benefits from stock-based compensation arrangements	(1)	(1)
Other non-cash items		(1)
Changes in assets and liabilities (net of effects from acquisitions of businesses):		
Accounts receivable, net	(29)	(26)
Prepaid expenses	(16)	(11)
Deferred contract costs, net	(12)	(8)
Accounts payable and accrued liabilities	2	19
Accrued compensation	(33)	(25)
Deferred revenue	1	14
Income taxes	13	(6)
Other current and non-current assets		(4)
Other current and non-current liabilities		(1)
Net cash provided by (used in) operating activities	(38)	3
Cash flows from investing activities:		
Purchases of property, equipment and purchased software	(21)	(17)
Acquisitions of businesses, net	(244)	(21)
Purchases of short-term investments	(362)	
Net proceeds from sale of short-term investments	474	
Other	(1)	
Net cash used in investing activities	(154)	(38)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	75	
Proceeds from issuance of common stock	10	4
Proceeds from issuance of treasury stock		8
Excess tax benefits from stock-based compensation arrangements	1	1
Net cash provided by financing activities	86	13
Effect of exchange rate changes on cash and cash equivalents	1	

Net decrease in cash and cash equivalents		(105)		(22)
Cash and cash equivalents at beginning of period		250		260
Cash and cash equivalents at end of period	$	145	$	238

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

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PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. GENERAL

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. The interim condensed consolidated financial statements include the consolidated accounts of Perot Systems Corporation and its majority-owned subsidiaries with all significant intercompany transactions eliminated. In our opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the interim periods presented have been made. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. These financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2006, in our Annual Report on Form 10-K filed with the SEC on February 28, 2007. Operating results for the three-month period ended March 31, 2007, are not necessarily indicative of the results for the year ending December 31, 2007.

Financial instruments

The carrying amounts reflected in our condensed consolidated balance sheets for cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and short-term and long-term debt approximate their respective fair value. Fair values are based primarily on current prices for those or similar instruments.

We use derivative financial instruments for the purpose of managing specific exposures as part of our risk management program and hold all derivatives for purposes other than trading. To date, our use of such instruments has been limited to foreign currency forward contracts and an interest rate swap on borrowings under our credit facility entered into on February 15, 2007. This interest rate swap effectively converts $75 million of our borrowings under our credit facility from a variable-rate instrument into a fixed-rate instrument with an interest rate of 5.64%. We do not currently utilize hedge accounting with regard to these derivatives and record all gains and losses associated with such derivatives in the earnings of the appropriate period. In accordance with Statement of Financial Accounting Standards (FAS) No 133, Accounting for Derivative Instruments and Hedging Activities, we record the net fair value of the derivatives in accounts receivable, net, and accrued and other current liabilities, on the condensed consolidated balance sheets.

Significant accounting standards to be adopted

FASB Statement No. 157

In September 2006, the Financial Accounting Standards Board (FASB) issued Financial Accounting Standard (FAS) No. 157, Fair Value Measurements, which provides guidance for using fair value to measure assets and liabilities. FAS 157 will apply whenever another standard requires or permits assets or liabilities to be measured at fair value. The standard does not expand the use of fair value to any new circumstances. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. Our adoption of FAS 157 is not expected to have a material impact on our consolidated financial statements.

FASB Statement No. 159

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115, which expands the use of fair value accounting but does not affect existing standards which require assets and liabilities to be carried at fair value. Under FAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and other eligible financial instruments. FAS 159 is effective for years beginning after November 15, 2007. Our adoption of FAS 159 is not expected to have a material impact on our consolidated financial statements.

NOTE 2. ACQUISITIONS

On January 30, 2007 we acquired all of the outstanding shares of QSS Group, Inc. (QSS), an information technology services company providing services to the U.S. federal government. As a result of the acquisition, we have gained several significant government-wide contracts and expanded both the scope of services and the areas we serve within the Department of Homeland Security and the Department of Defense. The initial purchase price for QSS was $244 million (net of $1 million of cash acquired), $30 million of which is being held in an escrow account for up to approximately 18 months for potential purchase price adjustments. Additionally, we are required to pay approximately $4 million of state taxes withheld in the second quarter on behalf of the seller,

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which will increase the total purchase price to $248 million. The purchase price was partially funded by $75 million borrowed against our existing credit facility. The results of operations of QSS and the estimated fair value of assets acquired and liabilities assumed are included in our condensed consolidated financial statements beginning on the acquisition date. The allocation of the QSS purchase consideration to the assets and liabilities acquired, including goodwill, has not been concluded due to the pending completion of tangible and intangible assets appraisals and potential contractual purchase price adjustments relating to working capital targets. As of March 31, 2007, the estimated fair value of the acquired intangible assets totaled $50 million, resulting in the estimated excess purchase price over net assets acquired of $170 million, which was recorded as goodwill on the condensed consolidated balance sheets, was assigned to the Government Services segment and is deductible for tax purposes.

The following table summarizes the estimated adjusted fair values of the QSS assets acquired and the liabilities assumed at the date of acquisition, which was January 30, 2007 (in millions):

Current assets	$ 53
Property, equipment and purchased software, net	1
Goodwill	170
Indentifiable intangible assets	50
	274
Current liabilities	(30)
Total consideration paid as of March 31, 2007	$ 244

The following table reflects pro forma combined results of operations as if the acquisition had taken place at the beginning of the calendar year for each of the periods presented and includes an estimate of amortization expense for identifiable intangible assets that were acquired:

	Three months ended March 31,	
	2007	**2006**
	(Unaudited) (in millions, except per share data)	
Revenue	$615	$615
Income before taxes	35	38
Net income	24	24
Basic earnings per common share	$ .20	$ .20
Diluted earnings per common share	$ .19	$ .20

In our opinion, the unaudited pro forma combined results of operations are not indicative of the actual results that would have occurred had the acquisition been consummated at the beginning of 2007 or 2006, nor are they indicative of future operations of the combined companies under our ownership and management.

NOTE 3. GOODWILL

The changes in the carrying amount of goodwill for the three months ended March 31, 2007, by reporting segment are as follows:

Consulting

	Industry Solutions	Government Services	and Applications Solutions	Total
		(in millions)		
Balance as of December 31, 2006	$ 255	$ 128	$ 80	$ 463
Goodwill resulting from QSS acquisition		170		170
Other			(6)	(6)
Balance as of March 31, 2007	$ 255	$ 298	$ 74	$ 627

PEROT SYSTEMS CORPORATION AND SUBSIDIARIES
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NOTE 4. IDENTIFIABLE INTANGIBLE ASSETS

Identifiable intangible assets are recorded in other non-current assets in the condensed consolidated balance sheets and are composed of:

	As of March 31, 2007		
	Gross Carrying Value	Accumulated Amortization	Net Book Value
		(in millions)	
Service mark	$ 1	$ (1)	$
Customer-based assets	82	(19)	63
Other intangible assets	3	(1)	2
Total	$ 86	$ (21)	$ 65

Total amortization expense for identifiable intangible assets was $4 million and $2 million for the three months ended March 31, 2007 and 2006, respectively. Amortization expense is estimated at $16 million, $15 million, $14 million, $13 million, $10 million and $1 million for the years ended December 31, 2007 through 2012, respectively. Identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives, ranging from 1 to 6 years. The weighted average estimated useful life is approximately five years.

NOTE 5. COMPREHENSIVE INCOME

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

	Three Months Ended March 31,	
	2007	2006
	(in millions)	
Net income	$ 23	$ 23
Foreign currency translation adjustments	1	
Total comprehensive income	$ 24	$ 23

NOTE 6. CREDIT FACILITY

In January 2007, we borrowed an additional $75 million against our credit facility in connection with our acquisition of QSS. Interest on this borrowing is at a variable rate based on 3 month LIBOR and was 5.64% at March 31, 2007. On February 15, 2007, we entered into an interest rate swap agreement to effectively convert this borrowing into a fixed-rate instrument with an interest rate of 5.64%. The interest rate at March 31, 2007 for our borrowing of $77 million made in March 2005 was 5.82%.

NOTE 7. STOCKHOLDERS EQUITY

At March 31, 2007, there were 121,251,000 shares of our Class A Common Stock outstanding and 817,000 shares of our Class B Common Stock outstanding. At December 31, 2006, there were 120,229,000 shares of our Class A Common Stock outstanding and 817,000 shares of our Class B Common Stock outstanding.

NOTE 8. STOCK OPTIONS AND STOCK-BASED COMPENSATION

Stock-based compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment, which requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method. Prior to the adoption of FAS 123R and as permitted by FAS 123 and FAS 148, Accounting for Stock-Based Compensation Transition and Disclosure, we elected to follow APB 25 and related interpretations in accounting for our employee stock options and implemented the disclosure-only provisions of FAS 123 and FAS 148. Under APB 25, stock compensation expense was recorded

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when the exercise price of employee stock options was less than the fair value of the underlying stock on the date of grant. We continue to account for options issued prior to our initial public offering under APB 25 as required by FAS 123R.

For the three months ended March 31, 2007 and 2006, stock option compensation expense and costs associated with our employee stock purchase plan (ESPP) recorded in direct cost of services and selling, general and administrative expenses, as well as the decrease in diluted earnings per common share, were as follows:

	Three months ended March 31,	
	2007	**2006**
	(in millions, except per share data)	
Direct cost of services	$ 1	$ 2
Selling, general and administrative expenses	2	2
Total stock compensation expense from stock options and ESPP	3	4
Stock compensation expense from stock options and ESPP, net of tax	2	2
Decrease in diluted earnings per share of common stock	$ .02	$ .02

Stock compensation expense related to restricted stock units was $816,000 ($514,000 net of tax), and $510,000 ($321,000 net of tax) for the three months ended March 31, 2007 and 2006, respectively.

At March 31, 2007, there was $40 million of total unrecognized compensation cost, net of expected forfeitures, related to non-vested options and restricted stock units, which is expected to be recognized over a weighted-average period of 2.2 years.

Activity in our stock-based compensation plans

Activity in stock options for Class A Common Stock was as follows (options in thousands):

	Three months ended March 31,			
	2007		**2006**	
	Options	**Weighted-Average Exercise Price**	**Options**	**Weighted-Average Exercise Price**
Outstanding at January 1	18,169	14.42	25,342	14.81
Granted	26	16.19	41	15.14
Exercised	(876)	8.95	(1,212)	8.43
Forfeited	(512)	16.74	(4,042)	21.37
Outstanding at March 31	16,807	14.64	20,129	13.87
Exercisable at March 31	9,755	15.32	10,873	14.82

For outstanding and exercisable options at March 31, 2007, the weighted average remaining contractual term (in years) is 4.41 and 4.04, respectively. For outstanding and exercisable options at March 31, 2007, the aggregate intrinsic value is $74 million and $43 million, respectively.

NOTE 9. INCOME TAXES

Our effective tax rate for the first quarter of 2007 was 32.4% as compared to 36.1% for the first quarter of 2006. Income tax expense for the first quarter of 2007 included a $2 million tax benefit from the reduction of a valuation allowance against our deferred tax assets in Europe, partially offset by the effect of increased taxes from the expiration of one of our tax holidays in India and increased state income taxes as a result of the Texas margin tax and the acquisition of QSS, which operates in several high-tax states. Income tax expense for the first quarter of 2006 included tax expense of $1 million relating to the resolution of several tax issues raised in an audit by the Internal Revenue Service (IRS), including the impact from similar tax issues in open tax years.

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While we are subject to examination by the tax authorities in each of the jurisdictions where we operate, our principal tax jurisdictions are the United States, India, and the United Kingdom. We are currently under examination by the IRS for tax years 2003 and 2004. We received a closing agreement from the IRS in March 2007, which effectively closed all tax years prior to 2003 from further examination. We are also under examination in India for the fiscal years ended March 31, 2002 through March 31, 2005 and are open for examination in the United Kingdom for calendar year 2005 and forward.

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for and disclosure of uncertainty in tax positions. Additionally, FIN 48 provides guidance on the recognition, measurement, derecognition, classification and disclosure of tax positions and on the accounting for related interest and penalties. As a result of the implementation of FIN 48, we recognized an $18 million decrease in the reserves for uncertain tax positions, which was recognized as an $8 million increase to retained earnings, a $5 million decrease to goodwill to adjust unrecognized benefits recorded in the cost of acquired companies and a $5 million increase to additional paid in capital to adjust uncertain positions recorded as a component of shareholders equity. Following our adoption of FIN 48, the gross balance of unrecognized tax benefits was $15 million at January 1, 2007, which excludes $3 million of offsetting tax benefits, primarily from international tax treaties, which provide for relief from double taxation. The net unrecognized tax benefits of $12 million includes $10 million that, if recognized, would benefit our effective income tax rate and $2 million that, if recognized, would reduce goodwill.

We recognize accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. Accrued interest and penalties related to unrecognized tax benefits were approximately $2 million as of both January 1, 2007 and March 31, 2007. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

NOTE 10. SEGMENT DATA

We offer our services under three primary lines of business: Industry Solutions, Government Services, and Consulting and Applications Solutions. Industry Solutions, our largest line of business, provides services to our customers primarily under long-term contracts in strategic relationships. These services include technology and business process services, as well as industry domain-based, short-term project and consulting services. The Government Services segment provides infrastructure support, application design and development, consulting, engineering, and technology-based business process solutions for the Department of Defense, the Department of Homeland Security, various federal intelligence agencies, and other governmental agencies. Consulting and Applications Solutions provides software-related services, including the implementation of prepackaged software applications, application development and maintenance, and application systems migration and testing primarily under short-term contracts related to specific projects. Other includes our remaining operating areas and corporate activities, income and expenses that are not related to the operations of the other reportable segments, and the elimination of intersegment revenue and direct costs of services of approximately $19 and $11 million for the quarters ended March 31, 2007 and 2006, respectively, related to the provision of services by the Consulting and Applications Solutions segment to the Industry Solutions and Government Services segments.

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

The following is a summary of certain financial information by reportable segment for the quarters ended March 31, 2007 and 2006:

	Industry Solutions	Government Services	Consulting and Applications Solutions	Other	Total
			(in millions)		

For the quarter ended March 31, 2007:					
Revenue	$424	$ 114	$ 71	$(19)	$590
Income before taxes	19	5	10		34
For the quarter ended March 31, 2006:					
Revenue	$418	$ 76	$ 59	$(11)	$542
Income before taxes	23	4	8	1	36

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NOTE 11. EARNINGS PER SHARE

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

	For the Three Months Ended March 31,	
	2007	2006
	(in millions)	
Basic Earnings per Common Share		
Net income	$ 23	$ 23
Weighted average common shares outstanding	121,562	118,642
Basic earnings per common share	$ 0.19	$ 0.19
Diluted Earnings per Common Share		
Net income	$ 23	$ 23
Weighted average common shares outstanding	121,562	118,642
Incremental shares assuming dilution	2,563	2,911
Weighted average diluted common shares outstanding	124,125	121,553
Diluted earnings per common share	$ 0.19	$ 0.19

For the three months ended March 31, 2007 and 2006, outstanding options to purchase 3,829,000 and 6,512,000 shares, respectively, of our common stock were not included in the computation of diluted earnings per common share because including them would be antidilutive. We determined whether an option was dilutive or antidilutive by comparing the average market price of our common shares for that period to the aggregate assumed proceeds from each stock option, measured as the sum of the assumed cash proceeds from and excess tax benefits that would be recorded upon the exercise of each stock option and the average unearned compensation cost on each stock option.

We have both Class A and Class B common stock outstanding. Our Class B shares are non-voting and are convertible on a one-for-one basis into Class A shares at the election of the holder without additional consideration, but otherwise are equivalent to our Class A shares. Because our two classes of common stock have equivalent economic rights, including dividend rights, we have elected to present our earnings per share on a combined basis.

NOTE 12. COMMITMENTS AND CONTINGENCIES

Litigation

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

We currently purchase and intend to continue to purchase the types and amounts of insurance coverage customary for the industry and geographies in which we operate. We have evaluated our risk and consider the coverage we carry to be adequate both in type and amount for the business we conduct.

IPO Allocation Securities Litigation

In July and August 2001, we, as well as some of our current and former officers and directors and the investment banks that underwrote our initial public offering, were named as defendants in two purported class action lawsuits seeking unspecified damages for alleged violations of the Securities Exchange Act of 1934 and the Securities Act of 1933. Theses cases focus on alleged improper

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practices of investment banks. Our case has been consolidated for pretrial purposes with approximately 300 similar cases in the IPO Allocation Sec