AFFILIATED COMPUTER SERVICES INC
Form 10-Q
February 14, 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 December 31, 2006

OR

o **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 þ No o

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

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

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

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 February 8, 2007**
Class A Common Stock, $.01 par value	92,314,491
Class B Common Stock, $.01 par value	6,599,372

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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PART I

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

	December 31, 2006	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 333,155	$ 100,837
Accounts receivable, net	1,253,575	1,231,846
Income taxes receivable		8,090
Prepaid expenses and other current assets	205,051	188,490
Total current assets	1,791,781	1,529,263
Property, equipment and software, net	935,902	870,020
Goodwill	2,536,361	2,456,654
Other intangibles, net	484,557	475,701
Other assets	180,064	170,799
Total assets	$ 5,928,665	$ 5,502,437
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 88,909	$ 104,473
Accrued compensation and benefits	161,910	172,853
Other accrued liabilities	353,954	354,632
Income taxes payable	1,508	
Deferred taxes	11,923	18,047
Current portion of long-term debt	44,411	23,074
Current portion of unearned revenue	156,682	152,026
Total current liabilities	819,297	825,105
Senior Notes, net of unamortized discount	499,408	499,368
Other long-term debt	2,067,169	1,114,664
Deferred taxes	362,702	331,433
Other long-term liabilities	289,452	275,649
Total liabilities	4,038,028	3,046,219

Commitments and contingencies (See Notes 2, 7, 14 and 18)

Stockholders equity:		
Class A common stock, $.01 par value, 500,000 shares authorized, 113,316 and 129,848 shares issued, respectively	1,133	1,299
Class B convertible common stock, $.01 par value, 14,000 shares authorized, 6,600 shares issued and outstanding	66	66
Additional paid-in capital	1,604,025	1,799,778
Accumulated other comprehensive loss, net	(1,100)	(10,943)
Retained earnings	1,342,481	1,836,850
Treasury stock at cost, 21,002 and 23,289 shares, respectively	(1,055,968)	(1,170,832)
Total stockholders equity	1,890,637	2,456,218
Total liabilities and stockholders equity	$ 5,928,665	$ 5,502,437

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

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

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005 (as restated)	Six Months Ended December 31, 2006	Six Months Ended December 31, 2005 (as restated)
Revenues	$ 1,426,761	$ 1,347,587	$ 2,812,199	$ 2,658,504
Operating expenses:				
Cost of revenues:				
Wages and benefits	667,852	633,461	1,334,468	1,262,146
Services and supplies	317,618	305,889	608,980	596,661
Rent, lease and maintenance	177,099	163,541	356,155	318,713
Depreciation and amortization	85,228	70,444	166,866	138,524
Other	9,141	7,511	19,755	11,758
Total cost of revenues	1,256,938	1,180,846	2,486,224	2,327,802
Gain on sale of business		(29,765)		(29,765)
Other operating expenses	19,495	21,084	34,789	30,848
Total operating expenses	1,276,433	1,172,165	2,521,013	2,328,885
Operating income	150,328	175,422	291,186	329,619
Interest expense	48,085	14,056	94,098	26,795
Other non-operating income, net	(9,686)	(1,994)	(12,304)	(6,375)
Pretax profit	111,929	163,360	209,392	309,199
Income tax expense	39,855	60,990	75,935	113,454
Net income	$ 72,074	$ 102,370	$ 133,457	$ 195,745
Earnings per share:				
Basic	$ 0.73	$ 0.82	$ 1.32	$ 1.56
Diluted	$ 0.72	$ 0.81	$ 1.30	$ 1.54

Shares used in computing earnings per share:				
Basic	98,914	124,849	101,183	125,139
Diluted	100,152	126,926	102,457	127,106

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

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

	Six Months Ended December 31, 2006	2005 (as restated)
Cash flows from operating activities:		
Net income	$ 133,457	$ 195,745
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	166,866	138,524
Stock-based compensation expense	15,592	18,509
Excess tax benefit on stock-based compensation	(31)	(7,658)
Gain on sale of business units	(2,459)	(29,765)
Provision for uncollectible accounts receivable	(1,007)	4,495
Deferred income tax expense	15,485	37,072
Impairment charges	1,231	5,755
Gain on investments	(5,440)	(4,903)
Other non-cash activities	11,786	10,857
Changes in assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(5,496)	(26,848)
Prepaid expenses and other current assets	(15,143)	(5,044)
Other assets	2,433	2,987
Accounts payable	(21,399)	8,451
Accrued compensation and benefits	(17,880)	(21,866)
Other accrued liabilities	(2,519)	(31,058)
Income taxes payable	13,398	41,138
Other long-term liabilities	4,744	1,659
Unearned revenue	11,096	19,521
Total adjustments	171,257	161,826
Net cash provided by operating activities	304,714	357,571
Cash flows from investing activities:		
Purchases of property, equipment and software, net	(170,441)	(184,973)
Additions to other intangible assets	(14,969)	(13,046)
Payments for acquisitions, net of cash acquired	(102,338)	(153,760)
Intangible assets acquired in subcontract termination		(16,530)
Purchases of investments	(6,406)	(25,439)
Other	1,276	24
Net cash used in investing activities	(292,878)	(393,724)

Cash flows from financing activities:		
Proceeds from issuance of long-term debt, net	1,648,287	1,003,629
Payments of long-term debt	(705,093)	(835,213)
Purchase of treasury shares	(730,689)	(115,804)
Excess tax benefit on stock-based compensation	31	7,658
Stock option settlement with Jeffrey A. Rich, former chief executive officer		(18,353)
Proceeds from stock options exercised	5,023	30,965
Proceeds from issuance of treasury shares	2,923	7,849
Net cash provided by financing activities	220,482	80,731
Net change in cash and cash equivalents	232,318	44,578
Cash and cash equivalents at beginning of period	100,837	62,685
Cash and cash equivalents at end of period	$ 333,155	$ 107,263

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

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

1. BASIS OF PRESENTATION

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

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

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

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

Financial results for the three and six months ended December 31, 2005 have been restated as a result of the review of our stock option grant practices and other tax matters discussed in Note 2. Please see Note 2 to our Consolidated Financial Statements and our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 for further discussion of this restatement.

2. REVIEW OF STOCK OPTION GRANT PRACTICES

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

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

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

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

During the course of the investigation, more than 2 million pages of electronic and hardcopy documents and emails were reviewed. In addition, approximately 40 interviews of current and former officers, directors, employees and other individuals were conducted. The independent directors, in their role as special committee members and as independent directors prior to formation of the committee, met extensively since the SEC informal investigation commenced to consider the matters related to the stock option grant practices. The investigation was necessarily limited in that the investigation team did not have access to certain witnesses with relevant information (including former Chief Executive Officer, Jeffrey A. Rich) and due to the lack of metadata for certain electronic documentation prior to 2000.

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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(UNAUDITED)

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

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

The investigation concluded that in a significant number of cases Mr. Rich, Mr. King and/or Mr. Edwards used hindsight to select favorable grant dates during the limited time periods after Mr. Deason had given the officers his authorization to proceed to prepare the paperwork for the option grants and before formal grant documentation was submitted to the applicable compensation committee. No evidence was found to suggest that grant dates which preceded Mr. Deason s broad authorization were ever selected. In a number of instances, our stock price was trending downward at the time Mr. Deason s authorization was given, but started to rise as the grant recommendation memoranda were being finalized. The investigation found that in those instances Mr. Rich, Mr. King and/or Mr. Edwards often looked back in time and selected as the grant date a date on which the price was at a low, notwithstanding that the date had already passed and the stock price on the date of the actual selection was higher. Recommendation memoranda attendant to these grants were intentionally misdated at the direction of Mr. Rich, Mr. King and/or Mr. Edwards to make it appear as if the memoranda had been created at or about the time of the chosen grant date, when in fact, they had been created afterwards. As a result, stock options were awarded at prices that were at, or near, the quarterly low and we effectively granted in the money options without recording the appropriate compensation expense.

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

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

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

The investigation concluded that the conduct of Mr. King and Mr. Edwards with regard to the misdating of recommendation memoranda as well as their conduct with regard to the May 2006 Form 10-Q violated our Code of Ethics for Senior Financial Officers. As a result the special committee recommended that Mr. King and Mr. Edwards should resign. Effective November 26, 2006 each of Mr. King and Mr. Edwards resigned from all executive management positions with us. See Note 15. Departure of Executive Officers for a discussion of the terms of their separation.

The Board of Directors appointed Lynn Blodgett, who had been serving as our Executive Vice President and Chief Operating Officer and as a director since September 2005, as President and Chief Executive Officer, and John Rexford, who had been serving as Executive Vice President Corporate Development since March 2001, as Executive Vice President and Chief Financial Officer and as a director, in each case effective on November 26, 2006. Mr. Blodgett and Mr. Rexford each have served in various executive capacities with us for over ten years.

In addition to the resignations of Mr. King and Mr. Edwards and the approval of the terms of their separation, the Board of Directors announced the following actions and decisions, some of which have already been implemented, as the result of the findings of our stock option investigation:

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

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

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

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

- We implemented, or are in the process of implementing, a number of changes to our internal controls, including:
  - o After reviewing the results of the investigation to date, our Board of Directors determined that it would be appropriate to accept the resignations of Mr. King and Mr. Edwards. Our Board of Directors has since appointed a new Chief Executive Officer and Chief Financial Officer.

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

We have concluded that there were accounting errors with respect to a number of stock option grants. In general, these stock options were originally granted with an exercise price equal to the NYSE or NASDAQ closing market price for our common stock on the date set forth on unanimous written consents signed by one or more members of the appropriate Compensation Committees. We originally

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

used the stated date of these consents as the measurement date for the purpose of accounting for them under Generally Accepted Accounting Principles (GAAP), and as a result recorded no compensation expense in connection with the grants.

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

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

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

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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(UNAUDITED)

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

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

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

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

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

exercises previously recorded in additional paid-in capital may now be non-deductible under Section 162(m) as a result of information obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. See Other Tax Matters below in this discussion of Review of Stock Option Grant Practices.

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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The table below reflects the breakdown by year of the cumulative adjustment to retained earnings. Our consolidated financial statements included in previously filed periodic reports with the SEC for such periods have not been amended. The consolidated financial statements for the three and six months ended December 31, 2005 included in this Quarterly Report on Form 10-Q have been restated. (in thousands)

	Net income as reported	Stock-based compensation expense	Estimated interest and penalties (1)	Income tax benefit, net	Total adjustments	Net income as restated
Years ended June 30,						
1995		$ (63)	$	$ 23	$ (40)	
1996		(444)		130	(314)	
1997		(1,404)		301	(1,103)	
1998		(1,876)		405	(1,471)	
1999		(3,325)		717	(2,608)	
2000		(4,870)	(87)	511	(4,446)	
2001		(6,433)	(546)	1,074	(5,905)	
2002		(7,833)	(1,414)	1,636	(7,611)	
2003		(9,237)	(1,454)	2,119	(8,572)	
Cumulative effect at June 30, 2003		(35,485)	(3,501)	6,916	(32,070)	
Years ended June 30,						
2004	$ 529,843	(7,527)	(2,509)	1,921	(8,115)	$ 521,728
2005	415,945	(6,061)	(2,526)	2,211	(6,376)	409,569
2006		(2,134)	(3,026)	1,870	(3,290)	
Cumulative effect at June 30, 2006		$ (51,207)	$ (11,562)	$ 12,918	$ (49,851)	

(1) Estimated interest and penalties on income tax underpayment deficiencies resulting from disallowed

executive
compensation
deductions
under
Section 162(m).

Please see our Consolidated Statement of Income and Consolidated Statement of Cash Flows below for the impact on our December 31, 2005 financial information.

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

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

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We also recorded current income tax benefits of $1.1 million, $0.6 million and $0.4 million for the fiscal years ending June 30, 2006, 2005 and 2004, respectively, and $0.1 million for periods prior to fiscal year 2004 related to the income tax benefit of the estimated deductible interest expense on income tax underpayment deficiencies related to disallowed cash and stock-based executive compensation deductions previously taken under Section 162(m) as discussed in Other tax matters below. These income tax benefits are reduced by current income tax expense of $0 million, $0.6 million and $1.2 million for the fiscal years June 30, 2006, 2005 and 2004, respectively, and $2.8 million for periods prior to fiscal year 2004 related to disallowed cash based executive incentive compensation deductions that were previously believed to qualify as a deduction under Section 162(m). The sum of these current and deferred income tax adjustments are reflected as income tax benefit, net, in the above tables.

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

	Deferred income tax benefit on stock-based compensation	Current income tax benefit on deductible interest	Current income tax expense on disallowed deductions under Section 162(m)	Income tax benefit, net
Years ended June 30,				
1995	$ 23	$	$	$ 23
1996	130			130
1997	301			301
1998	405			405
1999	717			717
2000	945		(434)	511
2001	1,598		(524)	1,074
2002	2,287		(651)	1,636
2003	3,246	70	(1,197)	2,119
Cumulative effect at June 30, 2003	9,652	70	(2,806)	6,916
Years ended June 30,				
2004	2,702	387	(1,168)	1,921
2005	2,194	576	(559)	2,211
2006	774	1,096		1,870
Cumulative effect at June 30, 2006	$ 15,322	$ 2,129	$ (4,533)	$ 12,918

Other tax matters

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

At December 31, 2006, we have recorded approximately $39.5 million of additional income taxes payable, including estimated interest and penalties related to disallowed Section 162(m) executive compensation deductions either resulting from revised measurement dates or due to factors unrelated to revised measurement dates, but which were previously believed to qualify for Section 162(m) deductions. At this time, we cannot predict when the Section 162(m) underpayment deficiencies, together with interest and penalties, if any, will be paid. We expect to fund any such payments from cash flows from operating activities.

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

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

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The tables below reflect the adjustments on our consolidated financial statements for the three and six months ended December 31, 2005 (in thousands):

	Consolidated Statements of Income					
	Three Months ended December 31, 2005			Six Months ended December 31, 2005		
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Revenues	$ 1,347,587	$	$ 1,347,587	$ 2,658,504	$	$ 2,658,504
Operating expenses:						
Cost of revenues:						
Wages and benefits	632,889	572(1)	633,461	1,261,008	1,138(1)	1,262,146
Services and supplies	305,889		305,889	596,661		596,661
Rent, lease and maintenance	163,541		163,541	318,713		318,713
Depreciation and amortization	70,444		70,444	138,524		138,524
Other	7,511		7,511	11,758		11,758
Cost of revenues	1,180,274	572	1,180,846	2,326,664	1,138	2,327,802
Gain on sale of business	(29,765)		(29,765)	(29,765)		(29,765)
Other operating expenses	21,084		21,084	30,848		30,848
Total operating expenses	1,171,593	572	1,172,165	2,327,747	1,138	2,328,885
Operating income	175,994	(572)	175,422	330,757	(1,138)	329,619
Interest expense	13,333	723(2)	14,056	25,461	1,334(2)	26,795
Other non-operating income, net	(1,994)		(1,994)	(6,375)		(6,375)
Pretax profit	164,655	(1,295)	163,360	311,671	(2,472)	309,199
Income tax expense	61,459	(469)(3)	60,990	114,351	(897)(3)	113,454
Net income	$ 103,196	$ (826)	$ 102,370	$ 197,320	$ (1,575)	$ 195,745
Earnings per share:						
Basic	$ 0.83	$ (0.01)	$ 0.82	$ 1.58	$ (0.02)	$ 1.56
Diluted	$ 0.81	$	$ 0.81	$ 1.55	$ (0.01)	$ 1.54

Shares used in computing earnings per share:						
Basic	124,849		124,849	125,139		125,139
Diluted [5]	126,865	61(4)	126,926	127,044	62(4)	127,106

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	Consolidated Statement of Cash Flows For the six months ended December 31, 2005		
	As Reported	**Adjustments**	**As Restated**
Cash flows from operating activities:			
Net income	$ 197,320	$(1,575)	$ 195,745
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	138,524		138,524
Stock-based compensation expense	17,371	1,138(1)	18,509
Excess tax benefit on stock-based compensation	(9,480)	1,822	(7,658)
Gain on sale of business units	(29,765)		(29,765)
Provision for uncollectible accounts receivable	4,495		4,495
Deferred income tax expense	34,698	2,374(6)	37,072
Impairment charges	5,755		5,755
Other non-cash activities	5,954		5,954
Changes in assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(26,848)		(26,848)
Prepaid expenses and other current assets	(5,044)		(5,044)
Other assets	2,987		2,987
Accounts payable	8,451		8,451
Accrued compensation and benefits	(21,866)		(21,866)
Other accrued liabilities	(31,058)		(31,058)
Income taxes receivable/payable	41,138		41,138
Other long-term liabilities	3,596	(1,937)	1,659
Unearned revenue	19,521		19,521
Total adjustments	158,429	3,397	161,826
Net cash provided by operating activities	355,749	1,822	357,571
Cash flows from investing activities:			
Purchases of property, equipment and software, net	(184,973)		(184,973)
Additions to other intangible assets	(13,046)		(13,046)
Payments for acquisitions, net of cash acquired	(153,760)		(153,760)
Intangibles acquired in subcontract termination	(16,530)		(16,530)
Purchases of investments	(25,439)		(25,439)
Other	24		24
Net cash used in investing activities	(393,724)		(393,724)

Cash flows from financing activities:			
Proceeds from issuance of long-term debt, net	1,003,629		1,003,629
Payments of long-term debt	(835,213)		(835,213)
Purchase of treasury shares	(115,804)		(115,804)
Excess tax benefit on stock-based compensation	9,480	(1,822)	7,658
Stock option settlement with Jeffrey A. Rich, former chief executive officer	(18,353)		(18,353)
Proceeds from stock options exercised	30,965		30,965
Proceeds from issuance of treasury shares	7,849		7,849
Net cash provided by financing activities	82,553	(1,822)	80,731
Net change in cash and cash equivalents	44,578		44,578
Cash and cash equivalents at beginning of period	62,685		62,685
Cash and cash equivalents at end of period	$ 107,263	$	$ 107,263

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(1) Stock-based compensation expense.

(2) Estimated interest expense on Section 162(m) deduction disallowances.

(3) Income tax benefits for additional stock-based compensation expense and estimated interest expense.

(4) Adjustment to dilutive shares resulting from changes in unrecognized compensation and excess tax benefits.

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

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

3. ACQUISITIONS

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

In October 2006, we completed the acquisition of Systech Integrators, Inc. (Systech), an information technology solutions company offering an array of SAP software services. Systech s services include SAP consulting services, systems integration and custom application development and maintenance. The transaction was valued at approximately $63.8 million plus contingent payments of up to $40 million based on future financial performance. The transaction was funded with a combination of cash on hand and borrowings under our Credit Facility. We acquired assets of $75.3 million and assumed liabilities of $11.5 million. We recorded $54.2 million in goodwill, which is deductible for income tax purposes, and intangible assets of $6.6 million. The $6.6 million of intangible assets is attributable to customer relationships and non-compete agreements with weighted average useful lives of 4 years. We believe this acquisition will enhance our position as a comprehensive provider of SAP services across numerous markets. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, October 2, 2006.

We completed one other small acquisition during the six months ended December 31, 2006 which is included in our Government segment.

These acquisitions are not considered material to our results of operations, either individually or in the aggregate; therefore, no pro forma information is presented.

4. DIVESTITURES

In December 2005, we completed the divestiture of substantially all of our Government welfare-to-workforce services business (the WWS Divestiture) to Arbor E&T, LLC (Arbor), a wholly owned subsidiary of ResCare, Inc., for approximately $69 million, less transaction costs. Assets sold were approximately $31.6 million and liabilities assumed by Arbor were approximately $0.2 million, both of which were included in the Government segment. We retained the net working capital related to the WWS Divestiture. We recognized a pretax gain of $1.7 million ($1 million, net of income tax) and $2.5 million ($1.5 million, net of income tax) in the three and six months ended December 31, 2006, respectively, upon the assignment of customer contracts to Arbor. During fiscal year 2006, we recorded a gain of $33.5 million ($20.1 million, net of income tax). The after tax proceeds from the divestiture were primarily used for general corporate purposes.

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Revenues from the WWS Divestiture were $0.3 million and $47.6 million for the three months ended December 31, 2006 and 2005, respectively, and $0.9 million and $101.1 million for the six months ended December 31, 2006 and 2005, respectively. Operating (loss) income from the WWS Divestiture, excluding the gain on sale, was ($0.5 million) and $1.4 million for the three months ended December 31, 2006 and 2005, respectively, and ($1 million) and $6.3 million for the six months ended December 31, 2006 and 2005, respectively.

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

5. RESTRUCTURING ACTIVITIES

During fiscal year 2006, we began a comprehensive assessment of our operations, including our overall cost structure, competitive position, technology assets and operating platform and foreign operations. As a result, we began certain restructuring initiatives and activities that are expected to enhance our competitive position in certain markets, and recorded certain restructuring charges and asset impairments arising from our discretionary decisions. We estimate a total of 2,100 employees will be involuntarily terminated as a result of these initiatives, consisting primarily of offshore processors and related management; however, we anticipate that a majority of these positions will be migrated to lower cost markets. As of December 31, 2006, approximately 2,100 employees have been involuntarily terminated.

In our Commercial segment, we recorded a restructuring charge for involuntary termination of employees of $4.7 million during the first quarter of fiscal year 2007, which is reflected in wages and benefits in our Consolidated Statements of Income, and $0.9 million during the first quarter of fiscal year 2007, for impairments of facility costs and facility shutdown charges, which are reflected as part of total operating expenses in our Consolidated Statements of Income. In our Government segment, we recorded a restructuring charge for involuntary termination of employees of $0.4 million during the first quarter of fiscal year 2007, which is reflected in wages and benefits in our Consolidated Statements of Income. In our Corporate segment, we determined that the costs related to the ownership of a corporate aircraft outweighed the benefits to the Company. We recorded an asset impairment charge of $4.1 million in the six months ended December 31, 2005 related to the corporate aircraft, which is reflected in other operating expenses in our Consolidated Statements of Income. No restructuring charges were recorded in the second quarter of fiscal year 2007.

The following table summarizes activity for the accrual for involuntary termination of employees for the three and six months ended December 31, 2006 (in thousands), exclusive of the Acquired HR Business (defined below):

Balance at September 30, 2006	$ 5,050
Accrual recorded	2
Payments	(3,915)
Balance at December 31, 2006	$ 1,137

Balance at June 30, 2006	$ 899
Accrual recorded	5,060
Payments	(4,822)
Balance at December 31, 2006	$ 1,137

The December 31, 2006 accrual for involuntary termination of employees is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

During fiscal year 2005, we acquired the human resources consulting and outsourcing businesses of Mellon Financial Corporation (the Acquired HR Business). In the fourth quarter of fiscal year 2006, we substantially completed the integration of the Acquired HR Business. The integration included the elimination of redundant facilities, marketing and overhead costs, and the consolidation of processes from the historical cost structure of the acquired Mellon organization. The liabilities recorded at closing for the Acquired HR Business include $22.3 million in involuntary employee termination costs for employees of the Acquired HR Business in accordance with Emerging Issues Task Force Issue No. 95-3 Recognition of Liabilities in Connection with a Purchase Business Combination. During the three and six months ended December 31, 2006, $0.9 million and $1.3 million in involuntary employee termination payments, respectively, were made and charged against accrued compensation bringing the total payments made to $17 million. We also recorded a $3.1 million and a $1.2 million reduction to the accrual and to goodwill in fiscal year 2006 and the first quarter of fiscal year 2007, respectively, as a result of a change in our estimates of severance to be paid. As of December 31, 2006, the balance of the related accrual was $1 million and is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

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6. GOODWILL AND OTHER INTANGIBLE ASSETS

The changes in the carrying amount of goodwill for the six months ended December 31, 2006 are as follows (in thousands):

	Commercial	Government	Total
Balance as of June 30, 2006	$ 1,282,053	$ 1,174,601	$ 2,456,654
Acquisition activity	71,825	2,890	74,715
Foreign currency translation	3,052	1,940	4,992
Balance as of December 31, 2006	$ 1,356,930	$ 1,179,431	$ 2,536,361

Goodwill activity for the first six months of fiscal year 2007 was primarily due to the Primax and Systech acqusitions (see Note 3). Approximately $2 billion, or 78.6%, of the original gross amount of goodwill recorded is deductible for income tax purposes.

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

	December 31, 2006		June 30, 2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible assets:				
Acquired customer-related intangibles	$ 412,425	(125,772)	$ 384,738	$ (104,901)
Customer-related intangibles	238,979	(104,510)	222,268	(90,326)
All other	16,241	(7,694)	15,147	(6,113)
Total	$ 667,645	(237,976)	$ 622,153	$ (201,340)
Non-amortizable intangible assets:				
Title plant	$ 51,045		$ 51,045	
Trade name	3,843		3,843	
Total	$ 54,888		$ 54,888	
Aggregate Amortization:				
For the quarter ended December 31, 2006			$ 19,893	
For the quarter ended December 31, 2005			18,089	
For the six months ended December 31, 2006			38,658	
For the six months ended December 31, 2005			36,101	
Estimated amortization for the years ended June 30,				
2007			$ 82,831	
2008			74,831	

2009	65,176
2010	55,484
2011	47,863

Aggregate amortization includes amounts charged to amortization expense for customer-related intangibles and other intangibles, other than contract inducements. Amortization of contract inducements of $3.9 million and $3.9 million for the three months ended December 31, 2006 and 2005, respectively, and $7.7 million and $7.6 million for the six months ended December 31, 2006 and 2005, respectively, is recorded as a reduction of related contract revenue. Amortization expense includes approximately $10.6 million and $9.4 million for acquired customer-related intangibles for the three months ended December 31, 2006 and 2005, respectively, and $20.8 and $19.2 million for the six months ended December 31, 2006 and 2005, respectively. Amortizable intangible assets are amortized over the related contract term. The amortization period of customer-related intangible assets ranges from 1 to 17 years, with a weighted average of approximately 9 years. The amortization period for all other intangible assets, including trademarks, ranges from 3 to 20 years, with a weighted average of approximately 6 years.

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7. LONG-TERM DEBT

Credit Facility

On July 6, 2006, we amended our secured term loan facility (Term Loan Facility) under our Credit Agreement dated March 20, 2006 (Credit Facility) and borrowed an additional $500 million on July 6, 2006 and an additional $500 million on August 1, 2006. As a result of the increase to the facility, the Applicable Margin, as defined in the Credit Facility, increased to LIBOR plus 200 basis points. We used the proceeds of the Term Loan Facility increase to finance the purchase of shares of our Class A common stock under the June 2006 $1 billion share repurchase authorization (see Note 8) and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility.

At December 31, 2006, we had approximately $584.3 million available under our revolving credit facility after giving effect to outstanding indebtedness of $275 million and $140.7 million of outstanding letters of credit that secure certain contractual performance and other obligations and which reduce the availability of our revolving credit facility. At December 31, 2006, we had $2.1 billion outstanding under our Credit Facility, of which $2.1 billion is reflected in long-term debt and $18 million is reflected in current portion of long-term debt, and of which $1.8 billion bore interest at approximately 7.36%, $223.6 million bore interest at approximately 6.6% and the remainder bore interest from 3.3% to 4.9%. As of December 31, 2006, we were in compliance with the covenants of our Credit Facility, as amended, as described further below.

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

On September 26, 2006, we received an amendment, consent and waiver from the lenders under our Credit Facility with respect to, among other provisions, waiver of any default or event of default arising under the Credit Facility as a result of our failure to comply with certain reporting covenants relating to other indebtedness, including covenants purportedly requiring the filing of reports with either the SEC or the holders of such indebtedness, so long as those requirements are complied with by December 31, 2006. As consideration for this amendment, consent and waiver, we paid a fee of $2.6 million.

On December 21, 2006, we received an amendment, consent and waiver from lenders under our Credit Facility. The amendment, consent and waiver includes the following provisions, among others:

(1) Consent to the delivery, on or prior to February 14, 2007, of (i) the financial statements, accountant s report and compliance certificate for the fiscal year ended June 30, 2006 and (ii) financial statements and related compliance certificates for the fiscal quarters ended June 30, 2006 and September 30, 2006, and waiver of any default arising from the failure to deliver any such financial statements, reports or certificates within the applicable time period provided for in the Credit Agreement, provided that any such failure to deliver resulted directly or indirectly from the previously announced investigation of the Company s historical stock option grant practices (the Options Matter).

(2) Waiver of any default or event of default arising from the incorrectness of representations and warranties made or deemed to have been made with respect to certain financial statements previously delivered to the Agent as a result of any restatement, adjustment or other modification of such financial statements resulting directly or indirectly from the Options Matter.

(3)

Waiver of any default or event of default which may arise from the Company s or its subsidiaries failure to comply with reporting covenants under other indebtedness that are similar to those in the Credit Agreement (including any covenant to file any report with the Securities and Exchange Commission or to furnish such reports to the holders of such indebtedness), provided such reporting covenants are complied with on or prior to February 14, 2007.

(4) Amendments to provisions relating to the permitted uses of the proceeds of revolving loans under the Credit Agreement that (i) increase to $500 million from $350 million the aggregate principal amount of revolving loans that may be outstanding, the proceeds of which may be used to satisfy the obligations under the Company s 4.70% Senior Notes due 2010 or 5.20% Senior Notes due 2015 and (ii) until June 30, 2007, decrease to $200 million from $300 million the minimum liquidity (i.e., the aggregate amount of the Company s unrestricted cash in excess of $50 million and availability under the Credit Agreement s revolving facility) required after giving effect to such use of proceeds.

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As consideration for this amendment, waiver and consent, we paid a fee of $1.3 million. We filed our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 on February 1, 2007 and our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 on January 23, 2007.

Senior Notes

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

On September 29, 2006 we received a letter from the Trustee with respect to the 5.20% Senior Notes. The letter alleged that we were in default of our covenants under the Indenture with respect to the 5.20% Senior Notes, as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. On October 6, 2006, we received a letter from the Trustee declaring an acceleration with respect to the 5.20% Senior Notes as a result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. The October 6, 2006 letter declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed in respect of the 5.20% Senior Notes.

In addition, our 4.70% Senior Notes due 2010 (the 4.70% Senior Notes) were also issued under the Indenture and have identical default and acceleration provisions as the 5.20% Senior Notes. On October 9, 2006, we received letters from certain holders of the 4.70% Senior Notes issued by us under the Indenture, advising us that we were in default of our covenants under the Indenture. The letters alleged that our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, was a default under the terms of the Indenture. On November 9, 10 and 16, 2006, we received letters from CEDE sent on behalf of certain holders of our 4.70% Senior Notes, declaring an acceleration of the 4.70% Senior Notes as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006. The November 9, 10 and 16, 2006 letters declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 4.70% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed under the 4.70% Senior Notes.

It is our position that no default has occurred under the Indenture and that no acceleration has occurred with respect to the 5.20% Senior Notes or the 4.70% Senior Notes (collectively, the Senior Notes) or otherwise under the Indenture. Further we have 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.

On December 19, 2006, we entered into an Instrument of Resignation, Appointment and Acceptance with the Trustee and Wilmington Trust Company (herein so called), whereby the Trustee resigned as trustee, as well as other offices or agencies, with respect to the Senior Notes, and was replaced by Wilmington Trust Company. On January 8, 2007, the Court entered an order substituting Wilmington Trust Company for the Bank of New York. On January 16, 2007, Wilmington Trust Company filed an answer and counterclaim. The counterclaim seeks immediate payment of all principal and accrued and unpaid interest on the Senior Notes. Alternatively, the counterclaim seeks 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 5, 2007, we filed our answer denying Wilmington Trust Company s counterclaim.

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 payoff the Senior Notes, it is most likely that we would utilize the Credit Facility to fund such payoff. Under the terms of the Credit Facility, we can utilize borrowings under the revolving credit 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

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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 $15.1 million ($9.4 million, net of income tax), unamortized deferred financing costs of $2.9 million ($1.8 million, net of income tax) and unamortized discount of $0.6 million ($0.4 million, net of income tax) associated with our Senior Notes as of December 31, 2006 may be adjusted and reported as interest expense in our Consolidated Statement of Income in the period of refinancing or demand.

8. EQUITY

On August 15, 2006, the Compensation Committee of the Board of Directors granted 2,091,500 options to employees under the 1997 Stock Incentive Plan. Based on executive management s recommendation, no stock option grants were made to corporate executive management pending substantive determination regarding corporate executive management s actions in the matters related to the informal stock option investigation by the Securities and Exchange Commission and the grand jury subpoena issued by the United States District Court, Southern District of New York. However, the Compensation Committee of the Board of Directors agreed to grant options of 100,000 shares each to Ann Vezina, Chief Operating Officer, Commercial Solutions Group and Tom Burlin, Chief Operating Officer, Government Solutions Group, but those grants were deferred. The delay in the grants to Ms. Vezina and Mr. Burlin was necessary at the time because there were insufficient shares remaining in the 1997 Stock Incentive Plan to make the grants to Ms. Vezina and Mr. Burlin. Subsequent to August 15, 2006, there were a number of options granted under the 1997 Stock Incentive Plan that terminated, which options then became available to grant to other employees, including Ms. Vezina and Mr. Burlin.

Because of the investigation into our stock option grant practices, we were unable to timely file our Annual Report on Form 10-K and our Annual Meeting of Stockholders was delayed, and the regularly scheduled meeting of our Board of Directors that was to have occurred in November 2006 was focused solely on stock option investigation matters and any other matters for consideration were deferred. Under our stock option granting policy, the day prior to or the day of that regularly scheduled November Board meeting, the Compensation Committee could have granted options to new hires, employees receiving a grant in connection with a promotion, or persons who become ACS employees as a result of an acquisition. On the morning of December 9, 2006, the Compensation Committee met to discuss whether options, which were now available under the 1997 Stock Incentive Plan, should be granted to new hires, employees receiving a grant in connection with a promotion, or persons who became ACS employees as a result of an acquisition. After consideration of the fact that options would have been granted in November, if the regularly scheduled Board meeting had not deferred consideration of matters other than the stock option investigation, the Compensation Committee met on December 9, 2006 and, as a result of their actions at that meeting, a grant of 692,000 was made to new hires, employees receiving a grant in connection with a promotion, or persons who become ACS employees as a result of an acquisition, with such grants including 140,000 shares to Lynn Blodgett, who had been promoted to President and Chief Executive Officer; 75,000 shares to John Rexford who had been promoted to Executive Vice President and Chief Financial Officer and named a director; and 100,000 shares each to Ms. Vezina and Mr. Burlin which grants were in recognition of their recent promotions to Chief Operating Officers of the Commercial and Government segments, respectively, and had been approved by the Compensation Committee on August 15, 2006 but were deferred until shares were available for grant.

In June and August 2006, our Board of Directors authorized two share repurchase programs of up to $1 billion each of our Class A common stock. The programs, which are open ended, allow 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. As of December 31, 2006, we had repurchased approximately 19.9 million shares under the June 2006 authority at an average cost of approximately $50.30 per share (approximately $1 billion) all of which have been retired, of which 14.4 million shares with an average cost of approximately $50.64 per share (approximately $730.7 million) were purchased and retired in the first six months of fiscal year 2007. No repurchases have been made under the August 2006 authority as of the date of this filing. We expect to fund repurchases under this additional share repurchase program from borrowings under our Credit Facility.

In the first quarter of fiscal year 2007, we reissued approximately 57,000 treasury shares for proceeds totaling approximately $2.9 million to fund contributions to our employee stock purchase plan.

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9. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards 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 December 31,		Six Months Ended December 31,	
	2006	2005 (as restated)	2006	2005 (as restated)
Numerator:				
Income available to common stockholders	$ 72,074	$ 102,370	$ 133,457	$ 195,745
Denominator:				
Basic weighted average shares outstanding	98,914	124,849	101,183	125,139
Dilutive effect of stock options	1,238	2,077	1,274	1,967
Denominator for earnings per share assuming dilution	100,152	126,926	102,457	127,106
Basic earnings per share	$ 0.73	$ 0.82	$ 1.32	$ 1.56
Diluted earnings per share	$ 0.72	$ 0.81	$ 1.30	$ 1.54

Additional dilution from assumed exercises of stock options is dependent upon several factors, including the market price of our common stock. Options to purchase approximately 7,058,000 and 5,626,000 shares of common stock during the three months ended December 31, 2006 and 2005, respectively, and 6,670,000 and 6,226,000 shares of common stock during the six months ended December 31, 2006 and 2005, 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 SFAS 123(R).

10. COMPREHENSIVE INCOME

Statement of Financial Accounting Standards 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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The components of comprehensive income are as follows (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005 (as restated)	2006	2005 (as restated)
Net income	$ 72,074	$ 102,370	$ 133,457	$ 195,745
Other comprehensive income (loss):				
Foreign currency translation adjustment	5,597	(3,385)	8,312	(3,610)
Amortization of unrealized loss on forward interest rate agreements (net of income tax of $0.2 million, $0.2 million, $0.5 million and $0.4 million, respectively)	397	397	793	794
Unrealized gains on foreign exchange forward agreements (net of income tax of $0.2 million, $0.2 million, $0.4 million and $0.2 million, respectively)	379	277	738	277
Comprehensive income	$ 78,447	$ 99,659	$ 143,300	$ 193,206

The amortization of unrealized loss on forward interest rate agreements relates to interest rate hedges, which were settled in June 2005. The agreements were designated as cash flow hedges of forecasted interest payments in anticipation of the issuance of our Senior Notes. The settlement of the forward interest rate agreements of $19 million ($12 million, net of income tax) is reflected in accumulated other comprehensive loss, net, and will be 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 during both the three months ended December 31, 2006 and 2005, and approximately $1.3 million during both the six months ended December 31, 2006 and 2005 to interest expense.

We hedge the variability of a portion of our anticipated future Mexican peso cash flows through foreign exchange forward agreements. The agreements are designated as cash flow hedges of forecasted payments related to certain operating costs of our Mexican operations. As of December 31, 2006, the notional amount of these agreements totaled 497.5 million pesos ($44.7 million) and expire at various dates over the next 12 months. Upon termination of these agreements, we will purchase Mexican pesos at the exchange rates specified in the forward agreements to be used for payments on our forecasted Mexican peso operating costs. The unrealized gain (loss) on these foreign exchange forward agreements is reflected in accumulated other comprehensive loss, net.

The following table represents the components of accumulated other comprehensive loss, net (in thousands):

	As of December 31, 2006	As of June 30, 2006
Foreign currency gains (losses)	$ 7,886	$ (426)
Unrealized loss on forward interest rate agreements (net of income tax of $5.6 million and $6.1 million, respectively)	(9,408)	(10,201)
Unrealized gains (losses) on foreign exchange forward agreements (net of income tax of $253 and ($193), respectively)	422	(316)

Total	$	(1,100)	$	(10,943)

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11. FINANCIAL INSTRUMENTS

As part of the Transport Revenue acquisition, we acquired foreign exchange forward agreements that hedge our French operation s Euro foreign exchange exposure related to its Canadian dollar and United States dollar revenues. These agreements do not qualify for hedge accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities. As a result, we recorded a gain on hedging instruments of $3.1 million ($2.1 million, net of income tax) and $2.3 million ($1.5 million, net of income tax) for the three and six months ended December 31, 2006, respectively, in other non-operating income, net in our Consolidated Statements of Income. As of December 31, 2006, the notional amount of these agreements totaled $44.4 million Canadian dollars and $4.4 million U.S. dollars, respectively, and are set to expire at various times over the next four years. As of December 31, 2006, a liability was recorded for the related fair value of approximately $2 million.

12. 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 December 31,			
	2006		2005	
	U.S. Plan	Non-U.S. Plans	U.S. Plan	Non-U.S. Plans
Components of net periodic benefit cost:				
Defined benefit plans:				
Service cost	$ 834	$ 1,510	$ 345	$ 1,155
Interest cost	63	1,426	10	1,160
Expected return on assets	(54)	(1,366)	(15)	(1,218)
Amortization of gains/losses	(6)			
Amortization of prior service costs	63		20	
Net periodic benefit cost for defined benefit plans	$ 900	$ 1,570	$ 360	$ 1,097

	Six Months ended December 31,			
	2006		2005	
	U.S. Plan	Non-U.S. Plans	U.S. Plan	Non-U.S. Plans
Components of net periodic benefit cost:				
Defined benefit plans:				
Service cost	$ 1,758	$ 2,894	$ 345	$ 2,565
Interest cost	126	2,792	10	2,326
Expected return on assets	(108)	(2,708)	(15)	(2,445)
Amortization of gains/losses	(12)			
Amortization of prior service costs	126		20	
Net periodic benefit cost for defined benefit plans	$ 1,890	$ 2,978	$ 360	$ 2,446

Contributions

We made contributions to the pension plans of approximately $2.8 million and $4 million in the three and six months ended December 31, 2006, respectively. We expect to contribute approximately $11 million to our pension plans during fiscal year 2007.

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13. SEGMENT INFORMATION

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

	Commercial	Government	Corporate	Consolidated
Three months ended December 31, 2006				
Revenues (a)	$ 858,103	$ 568,658	$	$ 1,426,761
Operating expenses (excluding depreciation and amortization)	706,289	442,808	42,108	1,191,205
Depreciation and amortization	61,755	23,116	357	85,228
Operating income	$ 90,059	$ 102,734	$ (42,465)	$ 150,328
Three months ended December 31, 2005 (as restated)				
Revenues (a)	$ 784,767	$ 562,820	$	$ 1,347,587
Operating expenses (excluding depreciation and amortization)	650,829	449,099	31,558	1,131,486
Gain on sale of business		(29,765)		(29,765)
Depreciation and amortization	47,544	22,514	386	70,444
Operating income	$ 86,394	$ 120,972	$ (31,944)	$ 175,422
Six months ended December 31, 2006				
Revenues (a)	$ 1,699,805	$ 1,112,394	$	$ 2,812,199
Operating expenses (excluding depreciation and amortization)	1,415,926	868,642	69,579	2,354,147
Depreciation and amortization	119,067	47,087	712	166,866
Operating income	$ 164,812	$ 196,665	$ (70,291)	$ 291,186
Six months ended December 31, 2005 (as restated)				
Revenues (a)	$ 1,550,773	$ 1,107,731	$	$ 2,658,504
Operating expenses (excluding depreciation and amortization)	1,287,383	871,775	60,968	2,220,126
Gain on sale of business		(29,765)		(29,765)
Depreciation and amortization	92,630	45,086	808	138,524
Operating income	$ 170,760	$ 220,635	$ (61,776)	$ 329,619

(a) Revenues in our Government

segment include revenues from operations divested during fiscal year 2006 of $0.3 million and $47.8 million for the three months ended December 31, 2006 and 2005, respectively, and $0.9 million and $101.4 million for the six months ended December 31, 2006 and 2005, respectively.

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14. COMMITMENTS AND CONTINGENCIES

Regulatory Agency Investigations Relating to Stock Option Grant Practices

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

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

Please see Note 2. Review of Stock Option Grant Practices and Note 15. Departure of Executive Officers in these Notes to Consolidated Financial Statements for discussions of our internal investigation of our stock option grant practices and subsequent restatement of previously filed financial statements and the departure of our Chief Executive Officer and Chief Financial Officer as a result of that investigation.

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 as follows:

Dallas County District Court

Merl Huntsinger, Derivatively on Behalf of Nominal Defendant Affiliated Computer Services, Inc., Plaintiff, vs. 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, vs. Darwin Deason, Mark A. King, J. Livingston Kosberg, Dennis McCuistion, Joseph P. O Neill, Jeffrey A. Rich and Frank A. Rossi, 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 McCuiston; J. Livingston Kosberg; Gerald Ford; Clifford Kendall; David Black; Henry Hortenstine; Peter Bracken; William Deckelman; 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 in the Dallas District Court on June 5, 2006, and are now collectively known as the In Re Affiliated Computer Services, Inc. Derivative Litigation case.

U.S. District Court of Delaware

Jeffrey T. Strauss, derivatively on behalf of Affiliated Computer Services Inc. v. Jeffrey A. Rich; Mark A. King; and Affiliated Computer Services, Inc., as defendants U.S. District Court of Delaware, Cause No. 06-318, filed on May 16, 2006.

Delaware Chancery Court

Jan Brandin, in the Right of and for the Benefit of Affiliated Computer Services, Inc., Plaintiff, vs. 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. CA2123-N, pending before the Court of Chancery of the State of Delaware in and for New Castle County, filed on May 2, 2006.

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U.S. District Court, 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, U.S. District Court, Northern District of Texas, Dallas Division, Cause No. 3-06CV1110-M, filed on June 22, 2006.

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, U.S. District Court, Northern District of Texas, Dallas Division, Cause No. 3-06CV1212-M, filed on July 7, 2006.

The Alaska Electrical and Lunceford cases were consolidated into one case in the U.S. District Court of Texas on August 1, 2006, and are now collectively known as the In Re Affiliated Computer Services Derivative Litigation case.

Based on the same set of facts as alleged in the above causes of action, two lawsuits have been 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 for retaining ACS common stock as an investment option in the ACS Savings Plan in light of the alleged stock option issues, as follows:

U.S. District Court of Texas, Northern District of Texas

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, Defendants, U. S. District Court, Northern District of Texas, Dallas Division, Civil Action No. 306-CV-1592P 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, U. S. District Court, Northern District of Texas, Dallas Division, Case No. 306-CV-02379-M.

On January 10, 2007, the Simeon case and the Burke case were consolidated and we expect that a consolidated amended complaint will be filed.

The cases described above are being vigorously defended. However, it is not possible at this time to reasonably estimate the possible loss or range of loss, if any.

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

Please see Note 7. Long-Term Debt for a discussion of the Alleged Default and Purported Acceleration of our Senior Notes and waivers, amendments, and consents obtained for our Credit Facility.

Investigation Regarding Photo Enforcement Contract in Edmonton, Alberta, Canada

We and one of our Canadian subsidiaries, ACS Public Sector Solutions, Inc., received a summons issued February 15, 2006 by the Alberta Department of Justice requiring us and our subsidiary to answer a charge of a violation of a Canadian Federal law which prohibits giving, offering or agreeing to give or offer any reward, advantage or benefit as consideration for receiving any favor in connection with a business relationship. The charge covers the period from January 1, 1998 through June 4, 2004 and references the involvement of certain Edmonton, Alberta police officials. Two Edmonton police officials have been separately charged for violation of this law. The alleged violation relates to the subsidiary s contract with the City of Edmonton for photo enforcement services. We acquired this subsidiary and contract from Lockheed Martin Corporation in August 2001 when we acquired Lockheed Martin IMS Corporation. The contract currently is on a month-to-month term with revenues of approximately $0.7 million (U.S. dollars) in the second quarter of both fiscal years 2007 and 2006 and $1.3 million and $1.2 million (U.S. dollars) for the first six months of fiscal year 2007 and 2006, respectively. A renewal contract had been awarded to our subsidiary in 2004 on a sole source basis, but this

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renewal award was rescinded by the City of Edmonton and a subsequent request for proposals for an expanded photo enforcement contract was issued in September 2004. Prior to announcement of any award, however, the City of Edmonton suspended this procurement process pending the completion of the investigation by the Royal Canadian Mounted Police which led to the February 15, 2006 summons. We conducted an internal investigation of this matter, and based on our findings from our internal investigation, we believe that our subsidiary has sustainable defenses to the charge. We notified the U.S. Department of Justice and the U.S. Securities and Exchange Commission upon our receipt of the summons and continue to periodically report the status of this matter to them.

On October 31, 2006, legal counsel to the Alberta government withdrew the charge against ACS. The charge against our subsidiary has not been withdrawn and a preliminary hearing on this matter has been scheduled for September 7, 2007. 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.

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 U.S. 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.

Investigation Regarding Certain Child Support Payment Processing Contracts

Another of our subsidiaries, ACS State & Local Solutions, Inc. (ACS SLS), and a teaming partner of this subsidiary, Tier Technologies, Inc. (Tier), received a grand jury document subpoena issued by the U.S. District Court for the Southern District of New York in May 2003. The subpoena was issued in connection with an inquiry being conducted by the Antitrust Division of the DOJ. We believe that the inquiry concerns the teaming arrangements between ACS SLS and Tier on child support payment processing contracts awarded to ACS SLS, and Tier as a subcontractor to ACS SLS, in New York, Illinois and Ohio but may also extend to the conduct of ACS SLS and Tier with respect to the bidding process for child support contracts in certain other states. Effective June 30, 2004, Tier was no longer a subcontractor to us in Ohio. Our revenue from the contracts for which Tier was a subcontractor was approximately $11.5 million and $11.6 million for the second quarter of fiscal years 2007 and 2006, respectively, representing approximately 0.8% and 0.9% of our revenues for the first quarter of fiscal years 2007 and 2006, respectively, and $22.4 million and $22.9 million for the first six months of fiscal year 2007 and 2006, respectively, representing approximately 0.8% and 0.9% of our revenues for the first six months of fiscal year 2007 and 2006, respectively. Our teaming arrangement with Tier also contemplated the California child support payment processing request for proposals, which was issued in late 2003; however, we did not enter into a teaming agreement with Tier for the California request for proposals. Based on Tier s filings with the Securities and Exchange Commission, we understand that on November 20, 2003 the DOJ granted conditional amnesty to Tier in connection with this inquiry pursuant to the DOJ s Corporate Leniency Policy. The policy provides that the DOJ will not bring any criminal charges against Tier as long as it continues to fully cooperate in the inquiry (and makes restitution payments if it is determined that parties were injured as a result of impermissible anticompetitive conduct). In May 2006 we were advised that one of our current employees (who has not been active in our government business segment since June 2005) and one former employee of ACS SLS, both of whom held senior management positions in the subsidiary during the period in question, have received target letters from the DOJ related to this inquiry. 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.

Investigation 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. Our total revenue generated from the Florida workforce services amounts to approximately 0.8% of our revenues for both the three and six months ended December 31, 2005. We had no revenue related to this contract in the first six months of fiscal year 2007. In March 2004, we filed our response to the OIG report. The principal

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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 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 first quarter of fiscal year 2005, we settled all financial issues with Dade County with respect to our workforce contract with that county and the settlement is fully reflected in our results of operations for the first quarter of fiscal year 2005. 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 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 relates to a workforce contract in Pinellas County in 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 our internal investigation of these matters through outside legal counsel and 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 second quarter of fiscal year 2006, we completed the divestiture of substantially all of our welfare-to-workforce business (See Note 4 Divestitures for further information). 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, Florida Assistant 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 is not intervening at this time 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 in 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 the Inspector General's Office of the DOL (as discussed above). We intend to vigorously defend this case. However, it is not possible at this time to reasonably estimate the possible loss 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 December 31, 2006, outstanding surety bonds of $521.8 million and $93.3 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $47.4 million of letters of credit and $1.9 million of surety bonds 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.
In fiscal year 2006, we purchased approximately $17.3 million of U.S. Treasury Notes in conjunction with a contract in our Government segment, and pledged them in accordance with the terms of the contract to secure our performance. The U.S. Treasury Notes are accounted for as held to maturity pursuant to Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities and reflected in other assets in our Consolidated Balance Sheets.
We are obligated to make contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During the six months of fiscal year 2007, we made contingent consideration payments of $3 million related to acquisitions completed in prior years. As of December 31, 2006, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities is approximately $108.9 million. Upon satisfaction of the specified contractual criteria, such payments primarily result in a corresponding increase in goodwill.
We have indemnified Lockheed Martin Corporation against certain specified claims from certain pre-sale litigation, investigations, government audits and other issues related to the sale of the majority of our Federal business to Lockheed Martin Corporation in fiscal year 2004. Our contractual maximum exposure under these indemnifications is $85 million; however, we believe the actual exposure to be significantly less. As of December 31, 2006, other accrued liabilities include a reserve for these claims in an amount we believe to be adequate at this time.
Our Education Services business, which is included in our Commercial segment, 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 December 31,

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2006, we serviced a FFEL portfolio of approximately 2.1 million loans with an outstanding principal balance of approximately $31.3 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 then we repackage the loans 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 December 31, 2006, other accrued liabilities include reserves which we believe to be adequate.

In April 2004, we were awarded a contract by the North Carolina Department of Health and Human Services (DHHS) to replace and operate the North Carolina Medicaid Management Information System (NCMMIS). There was a protest of the contract award; however, DHHS requested that we commence performance under the contract. One of the parties protesting the contract has continued to seek administrative and legal relief to set aside the contract award. However, we continued our performance of the contract at the request of DHHS. On June 12, 2006, we reported that contract issues had arisen and each of ACS and DHHS alleged that the other party has breached the contract. The parties entered into a series of standstill agreements in order to permit discussion of their respective issues regarding the contract and whether the contract would be continued or terminated. On July 14, 2006, the DHHS sent us a letter notifying us of the termination of the contract. We do not believe the agency has a valid basis for terminating the contract and intend to pursue legal action against DHHS. We filed in the General Court of Justice, Superior Court Division, in Wake County, North Carolina, a complaint and motion to preserve records related to the contract. Subsequent to the filing of the complaint, North Carolina produced records and represented to the Court that all records had been produced, after which the complaint was dismissed. In a letter dated August 1, 2006, DHHS notified us of its position that the value of reductions in compensation assessable against the compensation otherwise due to us under the contract is approximately $33 million. On August 14, 2006, we provided a detailed response to that August 1, 2006 letter contending that there should be no reductions in compensation owed to us. Also, on August 14, 2006 and in accordance with the contract, we submitted our Termination Claim to DHHS seeking additional compensation of approximately $27.1 million. On January 22, 2007, we filed a complaint in the General Court of Justice, Superior Court Division, in Wake County, North Carolina against DHHS and the Secretary of DHHS seeking to recover damages in excess of $40 million that we have suffered as the result of actions of DHHS and its Secretary. Our claim is based on breach of contract; breach of implied covenant of good faith and fair dealing; breach of warranty; and misappropriation of our trade secrets. In the complaint we are also requesting the court to grant a declaratory judgment that we were not in default under the contract; and a permanent injunction against the State from using our proprietary materials and disclosing our proprietary material to third parties.

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.

DEPARTURE OF EXECUTIVE OFFICERS

On November 26, 2006, Mark A. King resigned as our President, Chief Executive Officer and as a director. In connection therewith, on November 26, 2006 we and Mr. King entered into a separation agreement (the King Agreement). The King Agreement provides, among other things, that Mr. King will remain with us as an employee providing transitional services until June 30, 2007. In addition, under the terms of the King Agreement, all unvested stock options held by Mr. King have been terminated as of November 26, 2006, excluding options that would have otherwise vested prior to August 31, 2007 which will be permitted to vest on their regularly scheduled vesting dates provided that Mr. King does not materially breach certain specified provisions of the King Agreement. The King

Agreement also provides that the exercise price of Mr. King s vested stock options will be increased to an amount determined by us in a manner consistent with the final determination of the review performed by us in conjunction with the audit of our financial statements for the fiscal year ending June 30, 2006 and the exercise price of certain vested options will be further increased by the amount by which the aggregate exercise price of stock options previously exercised by Mr. King would have been increased had the stock options not been previously exercised. Mr. King s vested options, if unexercised, will expire no later than June 30, 2008. The King Agreement also subjects Mr. King to non-competition and non-solicitation covenants until December 31, 2009. In addition, the King Agreement provides that Mr. King s severance agreement with us is terminated, Mr. King s salary will be reduced during the transition period and Mr. King will not be eligible to participate in our bonus plans. Mr. King will be eligible to receive certain of our provided health benefits through December 31, 2009 the estimated cost of which is not material.

On November 26, 2006, Warren D. Edwards resigned as our Executive Vice President and Chief Financial Officer. In connection therewith, on November 26, 2006 we and Mr. Edwards entered into a separation agreement (the Edwards Agreement). The Edwards Agreement provides, among other things, that Mr. Edwards will remain with us as an employee providing transitional services until

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June 30, 2007. In addition, under the terms of the Edwards Agreement, all unvested stock options held by Mr. Edwards have been terminated as of November 26, 2006, excluding options that would have otherwise vested prior to August 31, 2007 which will be permitted to vest on their regularly scheduled vesting dates provided that Mr. Edwards does not materially breach certain specified provisions of the Edwards Agreement. The Edwards Agreement also provides that the exercise price of Mr. Edwards vested stock options will be increased to an amount determined by us in a manner consistent with the final determination of the review performed by us in conjunction with the audit of our financial statements for the fiscal year ending June 30, 2006. Mr. Edwards vested options, if unexercised, will expire no later than June 30, 2008. The Edwards Agreement also subjects Mr. Edwards to non-competition and non-solicitation covenants until December 31, 2009. In addition, the Edwards Agreement provides that Mr. Edwards severance agreement with us is terminated, Mr. Edwards salary will be reduced during the transition period and Mr. Edwards will not be eligible to participate in our bonus plans. Mr. Edwards will be eligible to receive certain of our provided health benefits through December 31, 2009, the estimated cost of which is not material.

On September 29, 2005, Jeffrey A. Rich submitted his resignation as a director and Chief Executive Officer. On September 30, 2005 we entered into an Agreement with Mr. Rich, which, among other things, provided the following: (i) Mr. Rich remained on our payroll and was paid his current base salary (of $820 thousand annually) through June 30, 2006; (ii) Mr. Rich was not eligible to participate in our performance-based incentive compensation program in fiscal year 2006; (iii) we purchased from Mr. Rich all options previously granted to Mr. Rich that were vested as of the date of the Agreement in exchange for an aggregate cash payment, less applicable income and payroll taxes, equal to the amount determined by subtracting the exercise price of each such vested option from $54.08 per share and all such vested options were terminated and cancelled; (iv) all options previously granted to Mr. Rich that were unvested as of the date of the Agreement were terminated (such options had an in-the-money value of approximately $4.6 million based on the closing price of our stock on the New York Stock Exchange on September 29, 2005); (v) Mr. Rich received a lump sum cash payment of $4.1 million; (vi) Mr. Rich continued to receive executive benefits for health, dental and vision through September 30, 2007; (vii) Mr. Rich also received limited administrative assistance through September 30, 2006; and (viii) in the event Mr. Rich established an M&A advisory firm by January 1, 2007, we agreed to retain such firm for a two year period from its formation for $250 thousand per year plus a negotiated success fee for completed transactions. The Agreement also contains certain standard restrictions, including restrictions on soliciting our employees for a period of three years and soliciting our customers or competing with us for a period of two years. Mr. Rich has established an M&A advisory firm and in June 2006, we entered into an agreement with Rich Capital LLC, an M&A advisory firm owned by Mr. Rich. The agreement is for two years, during which time we will pay a total of $0.5 million for M&A advisory services, payable in equal quarterly installments. We paid $63 thousand related to this agreement through June 30, 2006. However, we have currently suspended payment under this agreement pending a 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.

16. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158), SFAS 158 amends SFAS 87, Employers Accounting for Pensions , SFAS 88, Employers Accounting fo Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits , SFAS 106, Employers Accounting for Postretirement Benefits Other Than Pensions , and SFAS 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits . SFAS 158 requires employers to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status. It also requires employers to measure plan assets and obligations that determine its funded status as of the end of the fiscal year. Lastly, employers are required to recognize changes in the funded status of a defined benefit postretirement plan in the year that the changes occur with the changes reported in comprehensive income. SFAS 158 is required to be adopted

by entities with fiscal years ending after December 15, 2006. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.
In September 2006, the FASB issued SFAS No. 157 Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, 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. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.

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In September 2006, the SEC released SEC Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, (SAB 108), which addresses how uncorrected errors in previous years should be considered when quantifying errors in current-year financial statements. SAB 108 requires registrants to consider the effect of all carry over and reversing effects of prior-year misstatements when quantifying errors in current-year financial statements. SAB 108 does not change the SEC staff s previous guidance on evaluating the materiality of errors. It allows registrants to record the effects of adopting SAB 108 guidance as a cumulative-effect adjustment to retained earnings. This adjustment must be reported in the annual financial statements of the first fiscal year ending after November 15, 2006. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which prescribes comprehensive guidelines for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on tax returns. FIN 48, effective for fiscal years beginning after December 15, 2006, seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. We are currently assessing the impact of FIN 48 on our consolidated financial position and results of operations.

17. RELATED PARTY TRANSACTIONS

Prior to 2002 we had guaranteed $11.5 million of certain loan obligations owed to Citicorp USA, Inc. by DDH Aviation, Inc., a corporate airplane brokerage company organized in 1997 (as may have been reorganized subsequent to July 2002, herein referred to as DDH). Our Chairman owned a majority interest in DDH. In consideration for that guaranty, we had access to corporate aircraft at favorable rates. In July 2002, our Chairman assumed in full our guaranty obligations to Citicorp and Citicorp released in full our guaranty obligations. As partial consideration for the release of our corporate guaranty, we agreed to provide certain administrative services to DDH at no charge until such time as DDH meets certain specified financial criteria. We anticipate that these administrative services will cease prior to June 30, 2007 as a result of the wind down of the DDH operations. In the first quarter of fiscal year 2003, we purchased $1 million in prepaid charter flights at favorable rates from DDH. As of June 30, 2006, we had $0.6 million remaining in prepaid flights with DDH. In the second quarter of fiscal year 2007, we were notified by DDH of its intent to wind down operations; therefore, we recorded a charge of $0.6 million related to the unused prepaid charter flights.

18. SUBSEQUENT EVENT

Contract with the Department of Education

The CSB contract is our largest contract. We have provided loan servicing for the Department of Education s Direct Student Loan program for over ten years. In 2003 the Department conducted a competitive procurement for its Common Services for Borrowers initiative (CSB). CSB was a modernization initiative which integrated a number of services for the Department, allowing the Department to increase service quality while saving overall program costs.

In November 2003 the Department awarded us the CSB contract. Under this contract we provide comprehensive loan servicing, consolidation loan processing, debt collection services on delinquent accounts, IT infrastructure operations and support, maintenance and development of information systems, and portfolio management services for the Department of Education s Direct Student Loan program. We are also developing software for use in delivering these services. The CSB contract has a 5-year base term which began in January 2004 and provides the Department of Education five one-year options to extend after the base term. We estimate that our revenues from the CSB contract will exceed $1 billion in total over the base term of the contract. Annual revenues from this contract represent approximately 4% of our fiscal year 2006 revenues.

Through December 31, 2006 our capitalized expenditures for software development under the CSB contract have totaled approximately $113 million, of which approximately $38 million has been implemented with the current production system. Our model for development of software under the CSB contract may change and we may only be able to use a portion of the uncompleted software with the current production system. As a result, we may incur a material, non-cash, impairment of a portion of our remaining capitalized software development costs, which aggregate approximately $75 million. However, we currently cannot determine the amount, if any, of this potential impairment of our capitalized development costs.

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

All statements in this Management s Discussion and Analysis of Financial Condition and Results of Operations that are not based on historical fact are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and the provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (which Sections were adopted as part of the Private Securities Litigation Reform Act of 1995). While management has based any forward-looking statements contained herein on its current expectations, the information on which such expectations were based may change. These forward-looking statements rely on a number of assumptions concerning future events and are subject to a number of risks, uncertainties, and other factors, many of which are outside of our control, that could cause actual results to materially differ from such statements. Such risks, uncertainties, and other factors include, but are not necessarily limited to, those set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006. In addition, we operate in a highly competitive and rapidly changing environment, and new risks may arise. Accordingly, investors should not place any reliance on forward-looking statements as a prediction of actual results. We disclaim any intention to, and undertake no obligation to, update or revise any forward-looking statement.

We report our financial results in accordance with generally accepted accounting principles in the United States (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 Securities and Exchange Commission (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 additional information is not meant to be considered in isolation or as a substitute for comparable amounts determined in accordance with generally accepted accounting principles in the United States.

OVERVIEW

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. 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 programming and consulting engagements, product installation fees, and hardware and software sales. However, as we add, through acquisitions or new service offerings, consulting or other services to enhance the value delivered and offered to our clients, which are primarily short-term in nature, we may experience variations in our mix of recurring versus non-recurring revenues. Since inception, our acquisition program has resulted in growth and diversification of our client base, expansion of services and products offered, increased economies of scale and geographic expansion.

Management focuses on various metrics in analyzing our business and its performance and outlook. One such metric is our sales pipeline, which was approximately $1.4 billion of annual recurring revenues as of December 31, 2006. Our sales pipeline is a qualified pipeline of deals with signings anticipated within the next six months and excludes deals with annual recurring revenue over $100 million. Both the commercial and government pipelines have significant, quality opportunities across multiple lines of business and in multiple verticals, including business process outsourcing, commercial and government information technology services and healthcare. We analyze the cash flow generation qualities of each deal in our pipeline and make decisions based on its cash return characteristics. 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 and other risks described further in Item 1A. Risk Factors in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

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 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. Our measure of internal revenue growth may not be comparable to similarly titled measures of other companies. Prior period internal revenue growth calculations are not restated for current period divestitures.

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Management analyzes new business signings on a trailing twelve month basis as it is generally a better indicator of future growth than quarterly new business signings which can vary due to timing of contract execution. We define new business signings as recurring revenue from new contracts, including the incremental portion of renewals, signed during the period and represent the estimated first twelve months of revenue to be recorded under that contract after full implementation. We use new business signings as additional measures of estimating total revenue represented by contractual commitments, both to forecast prospective revenues and to estimate capital commitments. Revenues for new business signings are measured under 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.

Renewal rates are a key indicator of client satisfaction. We calculate our renewal rate based on the total annual recurring revenue of renewals won as a percentage of total annual recurring revenue of all renewals sought. During the second quarter, we renewed approximately 90% of total renewals sought this quarter totaling approximately $162 million of annual recurring revenue with a total contract value of approximately $553 million. For the first half of fiscal 2007, we renewed approximately 95% of total renewals sought, totaling $468 million of annual recurring revenue with a total contract value of approximately $1.5 billion. Average contract life for renewals typically varies between our government and commercial segments, with the average contract life of renewals in the government segment often shorter than those in the commercial segment. While we track renewal rates on a quarterly basis, we believe it is appropriate to analyze our renewal rates on an annual basis due to the timing of renewal opportunities. We define total contract value as the estimated total revenues from contracts signed during the period and represents estimated total revenue over the term of the contract. 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.

We compete for new business in the competitive IT services and business process outsourcing markets. The overall health of these markets and the competitive environment can be determined by analyzing several key metrics. One of the metrics we monitor is the overall expected operating margin of our new business signings which is a good indicator of our expected future operating margin given the long-term nature of our customer contracts. We are seeing that the overall expected operating margin of new business signings is consistent with our historical operating margin. We focus on the expected operating margins of the new business we are signing to ensure the operating margins we expect to generate are commensurate with the capital intensity of the deal, the risk profile of the services we are providing and the overall return on capital.

Another metric of new business signings that we monitor is capital intensity, defined as capital expenditures and additions to intangible assets, of new business signings. Understanding the capital intensity of new business signings is helpful in determining the future free cash flow generating levels of our business. Historically the capital intensity in our business has ranged between 5-7%. During the first six months of fiscal year 2007, the overall capital intensity of our business was approximately 6.6%. During fiscal year 2006, the overall capital intensity of our business was slightly in excess of 8% due to approximately $60 million in investments that we made in certain areas of our business. These investments included investments related to integrating the Acquired HR Business (defined below) and expanding our human resources outsourcing technology platform; investments made in our Government healthcare technology platforms; the expansion of our data center capacity with the addition of a new data center and investments to increase global production both in existing locations and new geographies. The expected capital intensity of new business signings during fiscal year 2006 and the first six months of fiscal year 2007 was consistent with 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 respects to our new IT services and business process outsourcing business.

Retaining and training our employees is a key ingredient to our historical success and will continue to be a major factor in our future success. We consistently review our retention rates on a regional and global basis to ensure that we are competitive in hiring, retaining and motivating our employees. We perform benchmarking studies against some markets in which we compete to ensure our competitiveness in compensation and benefits and utilize employee surveys to gauge our employees level of satisfaction. We provide our employees ongoing technological and leadership training and will continue to do so to develop our employees and remain competitive. We utilize incentive based compensation as a means to motivate certain of our employees in both segments of our business and anticipate increasing our use of incentive based compensation in fiscal year 2007. We believe our use of incentive based compensation is a competitive advantage for ACS.

REVIEW OF STOCK OPTION GRANT PRACTICES

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

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

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

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

During the course of the investigation, more than 2 million pages of electronic and hardcopy documents and emails were reviewed. In addition, approximately 40 interviews of current and former officers, directors, employees and other individuals were conducted. The independent directors, in their role as special committee members and as independent directors prior to formation of the committee, met extensively since the SEC informal investigation commenced to consider the matters related to the stock option grant practices. The investigation was necessarily limited in that the investigation team did not have access to certain witnesses with relevant information (including former Chief Executive Officer, Jeffrey A. Rich) and due to the lack of metadata for certain electronic documentation prior to 2000.

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

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

The investigation concluded that in a significant number of cases Mr. Rich, Mr. King and/or Mr. Edwards used hindsight to select favorable grant dates during the limited time periods after Mr. Deason had given the officers his authorization to proceed to prepare the paperwork for the option grants and before formal grant documentation was submitted to the applicable compensation committee. No evidence was found to suggest that grant dates which preceded Mr. Deason s broad authorization were ever selected. In a number of instances, our stock price was trending downward at the time Mr. Deason s authorization was given, but started to rise as the grant recommendation memoranda were being finalized. The investigation found that in those instances Mr. Rich, Mr. King and/or Mr. Edwards often looked back in time and selected as the grant date a date on which the price was at a low, notwithstanding that the

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date had already passed and the stock price on the date of the actual selection was higher. Recommendation memoranda attendant to these grants were intentionally misdated at the direction of Mr. Rich, Mr. King and/or Mr. Edwards to make it appear as if the memoranda had been created at or about the time of the chosen grant date, when in fact, they had been created afterwards. As a result, stock options were awarded at prices that were at, or near, the quarterly low and we effectively granted in the money options without recording the appropriate compensation expense.

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

The Company has made only one individual stock option grant to Mr. Deason since the Company was founded in 1988. The investigation, after extensive analysis of the available evidence, could not conclude that the reported grant date for this stock option grant, July 23, 2002, was selected using hindsight. Mr. Deason has never exercised any options under this single individual option grant. (Two other option grants to Mr. Deason are being used by the Company as a means to partially fund its retirement obligations to Mr. Deason).

Further, with respect to our May 2006 Form 10-Q, the investigation concluded that Note 3 to the Consolidated Financial Statements which stated, in part, that we did not believe that any director or officer of the Company has engaged in the intentional backdating of stock option grants in order to achieve a more advantageous exercise price, was inaccurate because, at the time the May 2006 Form 10-Q was filed, Mr. King and Mr. Edwards either knew or should have known that we awarded options through a process in which favorable grant dates were selected with the benefit of hindsight in order to achieve a more advantageous exercise price and that the term backdating was readily applicable to our option grant process. Neither Mr. King nor Mr. Edwards told our directors, outside counsel or independent accountants that our stock options were often granted by looking back and taking advantage of past low prices. Instead, both Mr. King and Mr. Edwards attributed the disparity between recorded grant dates and the creation dates of the paperwork attendant to the stock option grants to other factors that did not involve the use of hindsight.

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

The Board of Directors appointed Lynn Blodgett, who had been serving as our Executive Vice President and Chief Operating Officer and as a director since September 2005, as President and Chief Executive Officer, and John Rexford, who had been serving as Executive Vice President Corporate Development since March 2001, as Executive Vice President and Chief Financial Officer and as a director, in each case effective on November 26, 2006.

Mr. Blodgett and Mr. Rexford each have served in various executive capacities with us for over ten years.

In addition to the resignations of Mr. King and Mr. Edwards and the approval of the terms of their separation, the Board of Directors announced the following actions and decisions, some of which have already been implemented, as the result of the findings of our stock option investigation:

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

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

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

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

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

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

- o Designating internal legal and accounting staffs to oversee the documentation and accounting of all grants of stock options or restricted stock.

- o Monitoring industry and regulatory developments in stock option and restricted stock awards and implementing and maintaining best practices with respect to grants of stock options or restricted stock.

- o Adhering to the practice of making annual grants on a date certain and through board or committee meetings, and not through a unanimous written consent process.

We have concluded that there were accounting errors with respect to a number of stock option grants. In general, these stock options were originally granted with an exercise price equal to the NYSE or NASDAQ closing market price for our common stock on the date set forth on unanimous written consents signed by one or more members of the appropriate Compensation Committees. We originally used the stated date of these consents as the measurement date for the purpose of accounting for them under Generally Accepted Accounting Principles (GAAP), and as a result recorded no compensation expense in connection with the grants.

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

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

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

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

(1) We recorded cumulative deferred income tax benefits of $15.3 million for the income tax effect related to the stock-based compensation expense adjustments arising from revised

measurement dates, of which $10.2 million has been realized through June 30, 2006 upon stock option exercises and has been reflected as a reduction of excess tax benefits previously recorded in additional paid-in capital.

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

(3) Excess tax benefits for certain

stock-based executive compensation deductions from stock option exercises previously recorded in additional paid-in capital may now be non-deductible under Section 162(m) as a result of information obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. See Other Tax Matters below in this discussion of Review of Stock Option Grant Practices.

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The table below reflects the breakdown by year of the cumulative adjustment to retained earnings. Our consolidated financial statements included in previously filed periodic reports with the SEC for such periods have not been amended. The consolidated financial statements for the three and six months ended December 31, 2005 included in this Quarterly Report on Form 10-Q have been restated. (in thousands)

	Net income as reported	Stock-based compensation expense	Estimated interest and penalties (1)	Income tax benefit, net	Total adjustments	Net income as restated
Years ended June 30,						
1995		$ (63)	$	$ 23	$ (40)	
1996		(444)		130	(314)	
1997		(1,404)		301	(1,103)	
1998		(1,876)		405	(1,471)	
1999		(3,325)		717	(2,608)	
2000		(4,870)	(87)	511	(4,446)	
2001		(6,433)	(546)	1,074	(5,905)	
2002		(7,833)	(1,414)	1,636	(7,611)	
2003		(9,237)	(1,454)	2,119	(8,572)	
Cumulative effect at June 30, 2003		(35,485)	(3,501)	6,916	(32,070)	
Years ended June 30,						
2004	$ 529,843	(7,527)	(2,509)	1,921	(8,115)	$ 521,728
2005	415,945	(6,061)	(2,526)	2,211	(6,376)	409,569
2006		(2,134)	(3,026)	1,870	(3,290)	
Cumulative effect at June 30, 2006		$ (51,207)	$ (11,562)	$ 12,918	$ (49,851)	

(1) Estimated interest and penalties on income tax underpayment deficiencies resulting from disallowed executive compensation deductions under Section 162(m).

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

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

We also recorded current income tax benefits of $1.1 million, $0.6 million and $0.4 million for the fiscal years ending June 30, 2006, 2005 and 2004, respectively, and $0.1 million for periods prior to fiscal year 2004 related to the income tax benefit of the estimated deductible interest expense on income tax underpayment deficiencies related to disallowed cash and stock based executive compensation deductions previously taken under Section 162(m) as discussed in Other tax matters below. These income tax benefits are reduced by current income tax expense of $0 million, $0.6 million and $1.2 million for the fiscal years June 30, 2006, 2005 and 2004, respectively, and $2.8 million for periods prior to fiscal year 2004 related to disallowed cash based executive incentive compensation deductions that were previously believed to qualify as a deduction under Section 162(m). The sum of these current and deferred income tax adjustments are reflected as income tax benefit, net, in the above tables.

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

	Deferred income tax benefit on stock-based compensation	Current income tax benefit on deductible interest	Current income tax expense on disallowed deductions under Section 162(m)	Income tax benefit, net
Years ended June 30,				
1995	$ 23	$	$	$ 23
1996	130			130
1997	301			301
1998	405			405
1999	717			717
2000	945		(434)	511
2001	1,598		(524)	1,074
2002	2,287		(651)	1,636
2003	3,246	70	(1,197)	2,119
Cumulative effect at June 30, 2003	9,652	70	(2,806)	6,916
Years ended June 30,				
2004	2,702	387	(1,168)	1,921
2005	2,194	576	(559)	2,211
2006	774	1,096		1,870
Cumulative effect at June 30, 2006	$ 15,322	$ 2,129	$ (4,533)	$ 12,918

Other tax matters

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

At December 31, 2006, we have recorded approximately $39.5 million of additional income taxes payable, including estimated interest and penalties related to disallowed Section 162(m) executive compensation deductions either resulting from revised measurement dates or due to factors unrelated to revised measurement dates, but which were previously believed to qualify for Section 162(m) deductions. At this time, we cannot predict when the Section 162(m) underpayment deficiencies, together with interest and penalties, if any, will be paid. We expect to fund any such payments from cash flows from operating activities.

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

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

DEPARTURE OF EXECUTIVE OFFICERS

On November 26, 2006, Mark A. King resigned as our President, Chief Executive Officer and as a director. In connection therewith, on November 26, 2006 we and Mr. King entered into a separation agreement (the King Agreement). The King Agreement provides, among other things, that Mr. King will remain with us as an employee providing transitional services until June 30, 2007. In addition, under the terms of the King Agreement, all unvested stock options held by Mr. King have been terminated as of November 26, 2006, excluding options that would have otherwise vested prior to August 31, 2007 which will be permitted to vest on their regularly scheduled vesting dates provided that Mr. King does not materially breach certain specified provisions of the King Agreement. The King Agreement also provides that the exercise price of Mr. King s vested stock options will be increased to an amount determined by us in a manner consistent with the final determination of the review performed by us in conjunction with the audit of our financial statements for the fiscal year ending June 30, 2006 and the exercise price of certain vested options will be further increased by the amount by which the aggregate exercise price of stock options previously exercised by Mr. King would have been increased had the stock options not been previously exercised. Mr. King s vested options, if unexercised, will expire no later than June 30, 2008. The King Agreement also subjects Mr. King to non-competition and non-solicitation covenants until December 31, 2009. In addition, the King Agreement provides that Mr. King s severance agreement with us is terminated, Mr. King s salary will be reduced during the transition period and Mr. King will not be eligible to participate in our bonus plans. Mr. King will be eligible to receive certain of our provided health benefits through December 31, 2009 the estimated cost of which is not material.

On November 26, 2006, Warren D. Edwards resigned as our Executive Vice President and Chief Financial Officer. In connection therewith, on November 26, 2006 we and Mr. Edwards entered into a separation agreement (the Edwards Agreement). The Edwards Agreement provides, among other things, that Mr. Edwards will remain with us as an employee providing transitional services until June 30, 2007. In addition, under the terms of the Edwards Agreement, all unvested stock options held by Mr. Edwards have been terminated as of November 26, 2006, excluding options that would have otherwise vested prior to August 31, 2007 which will be permitted to vest on their regularly scheduled vesting dates provided that Mr. Edwards does not materially breach certain specified provisions of the Edwards Agreement. The Edwards Agreement also provides that the exercise price of Mr. Edwards vested stock options will be increased to an amount determined by us in a manner consistent with the final determination of the review performed by us in conjunction with the audit of our financial statements for the fiscal year ending June 30, 2006. Mr. Edwards vested options, if unexercised, will expire no later than June 30, 2008. The Edwards Agreement also subjects Mr. Edwards to non-competition and non-solicitation covenants until December 31, 2009. In addition, the Edwards Agreement provides that Mr. Edwards severance agreement with us is terminated, Mr. Edwards salary will be reduced during the transition period and Mr. Edwards will not be eligible to participate in our bonus plans. Mr. Edwards will be eligible to receive certain of our provided health benefits through December 31, 2009, the estimated cost of which is not material.

On September 29, 2005, Jeffrey A. Rich submitted his resignation as a director and Chief Executive Officer. On September 30, 2005 we entered into an Agreement with Mr. Rich, which, among other things, provided the following: (i) Mr. Rich remained on our payroll and was paid his current base salary (of $820 thousand annually) through June 30, 2006; (ii) Mr. Rich was not eligible to participate in our performance-based incentive compensation program in fiscal year 2006; (iii) we purchased from Mr. Rich all options previously granted to Mr. Rich that were vested as of the date of the Agreement in exchange for an aggregate cash payment, less applicable income and payroll taxes, equal to the amount determined by subtracting the exercise price of each such vested option from $54.08 per share and all such vested options were terminated and cancelled; (iv) all options previously granted to Mr. Rich that were unvested as of the date of the Agreement were terminated (such options had an in-the-money value of approximately $4.6 million based on the closing price of our stock on the New York Stock Exchange on September 29, 2005); (v) Mr. Rich received a lump sum cash payment of $4.1 million; (vi) Mr. Rich continued to receive executive benefits for health, dental and vision through September 30, 2007; (vii) Mr. Rich also received limited administrative assistance through September 30, 2006; and (viii) in the event Mr. Rich established an M&A advisory firm by January 1, 2007, we agreed to retain such firm for a two year period from its formation for $250 thousand per year plus a negotiated success fee for completed transactions. The Agreement also contains certain standard restrictions, including restrictions on soliciting our employees for a period of three years and soliciting our customers or competing with us for a period of two years. Mr. Rich has established an M&A advisory firm and in June 2006, we entered into an agreement with Rich Capital LLC, an M&A advisory firm owned by Mr. Rich. The agreement is for two years, during which time we will pay a total of $0.5 million for M&A advisory services, payable in equal quarterly installments. We paid $63 thousand related to this agreement through June 30, 2006. However, we have currently suspended payment under this agreement pending a 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.

SIGNIFICANT DEVELOPMENTS

New Business

During the second quarter of fiscal year 2007, we signed contracts with new clients and incremental business with existing clients representing $165.8 million of annualized recurring revenue and $1.1 billion in total contract value. We define new business signings as recurring revenue from new contracts, including the incremental portion of renewals, signed during the period and represent the estimated first twelve months of revenue to be recorded under that contract after full implementation. The Commercial segment contributed 31% of the new contract signings (based on annual recurring revenues) including contracts to expand our services with Sprint Corporation and Office Depot. The Government segment contributed 69% of the new contract signings (based on annual recurring revenues) including contracts with the Indiana Family and Social Services Administration and Florida Healthy Kids Corporation.

Acquisitions

In July 2006, we completed the acquisition of Primax Recoveries, Inc. (Primax), one of the industry s oldest and largest health care cost recovery firms. The transaction was valued at approximately $40 million, plus related transaction costs excluding contingent consideration of up to $10 million based upon future financial performance and was funded from cash on hand and borrowings on our Credit Facility (defined in Liquidity and Capital Resources). We believe this acquisition expands our payor offering to include subrogation and overpayment recovery services to help clients improve profitability while maintaining their valued relationships with plan participants, employers and providers. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, July 12, 2006.

In October 2006, we completed the acquisition of Systech Integrators, Inc. (Systech), an information technology solutions company offering an array of SAP software services. Systech s services include SAP consulting services, systems integration and custom application development and maintenance. The transaction was valued at approximately $65 million plus contingent payments of up to $40 million based on future financial performance. The transaction was funded with a combination of cash on hand and borrowings under our Credit Facility. We believe this acquisition will enhance our position as a comprehensive provider of SAP services across numerous markets. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, October 2, 2006.

Review of Stock Option Grant Practices

Please see Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Review of Stock Option Grant Procedures for a discussion of the results of our internal investigation of our stock option grant practices during the second quarter of fiscal year 2007.

Departure of Executive Officers

Please see Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Departure of Executive Officers for a discussion of the departure of our executive officers during the second quarter of fiscal year 2007.

Credit Arrangements

Please see Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources *Credit Facility* for a discussion of the amendments, consents and waivers we have received from the lenders under our Credit Facility.

Please see Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources *Senior Notes* for a discussion of the declaratory action with respect to the alleged default and purported acceleration of our Senior Notes.

Restructuring and other activities

During fiscal year 2006, we began a comprehensive assessment of our operations, including our overall cost structure, competitive position, technology assets and operating platform and foreign operations. As a result, we began certain restructuring initiatives and activities that are expected to enhance our competitive position in certain markets, and recorded certain restructuring charges and asset impairments arising from our discretionary decisions. We estimate a total of 2,100 employees will be involuntarily terminated as a result of these initiatives, consisting primarily of offshore processors and related management; however, we anticipate that a majority of these positions will be migrated to lower cost markets. As of December 31, 2006, approximately 2,100 employees have been involuntarily terminated. We anticipate the costs savings related to these involuntary terminations will be approximately $105 million ($75 million related to terminations in the first quarter of fiscal year 2007) of wages and benefits per year; however, some of the cost savings from these involuntary terminations will be reinvested in subject matter experts, project management talent and sales personnel as we look to further promote those lines of businesses that reflect the greatest potential for growth. Our assessment activities are ongoing and may result in further restructuring and related charges, the amount and timing of which cannot be determined at this time.

In our Commercial segment, we recorded a restructuring charge for involuntary termination of employees of $4.7 million during the first quarter of fiscal year 2007, which is reflected in wages and benefits in our Consolidated Statements of Income, and $0.9 million during the first quarter of fiscal year 2007, for impairments of facility costs and facility shutdown charges, which are reflected as part of total operating expenses in our Consolidated Statements of Income. In our Government segment, we recorded a restructuring charge for involuntary termination of employees of $0.4 million during the first quarter of fiscal year 2007, which is reflected in wages and benefits in our Consolidated Statements of Income. In our Corporate segment, we determined that the costs related to the ownership of a corporate aircraft outweighed the benefits to the Company. We recorded an asset impairment charge of $4.1 million in the six months ended December 31, 2005 related to the corporate aircraft, which is reflected in other operating expenses in our Consolidated Statements of Income. No restructuring charges were recorded in the second quarter of fiscal year 2007.

The following table summarizes activity for the accrual for involuntary termination of employees for the three and six months ended December 31, 2006 (in thousands), exclusive of the Acquired HR Business (defined below):

Balance at September 30, 2006	$ 5,050
Accrual recorded	2
Payments	(3,915)
Balance at December 31, 2006	$ 1,137

Balance at June 30, 2006	$ 899
Accrual recorded	5,060
Payments	(4,822)
Balance at December 31, 2006	$ 1,137

The December 31, 2006 accrual for involuntary termination of employees is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

During fiscal year 2005, we acquired the human resources consulting and outsourcing businesses of Mellon Financial Corporation (the Acquired HR Business). In the fourth quarter of fiscal year 2006, we substantially completed the integration of the Acquired HR Business. The integration included the elimination of redundant facilities, marketing and overhead costs, and the consolidation of processes from the historical cost structure of the acquired Mellon organization. The liabilities recorded at closing for the Acquired HR Business include $22.3 million in involuntary employee termination costs for employees of the Acquired HR Business in accordance with Emerging Issues Task Force Issue No. 95-3 Recognition of Liabilities in Connection with a Purchase Business Combination. During the three and six months ended December 31, 2006, $0.9 million and $1.3 million in involuntary employee termination payments were made and charged against accrued compensation bringing the total payments made to $17 million. We also recorded a $3.1 million and a $1.2 million reduction to the accrual and to goodwill in fiscal year 2006 and the first quarter of fiscal year 2007, respectively, as a result of a change in our estimates of severance to be paid. As of December 31, 2006, the balance of the related accrual was $1 million and is expected to be paid primarily in fiscal year 2007 from cash flows from operating activities.

Share Repurchase Programs

In June and August 2006, our Board of Directors authorized two share repurchase programs of up to $1 billion each of our Class A common stock. The programs, which are open ended, allow 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. As of December 31, 2006, we had repurchased approximately 19.9 million shares under the June 2006 authority at an average cost of approximately $50.30 per share (approximately $1 billion) all of which have been retired, of which 14.4 million shares with an average cost of approximately $50.64 per share (approximately $730.7 million) were purchased and retired in the first quarter of fiscal year 2007. No repurchases have been made under the August 2006 authority as of the date of this filing. We expect to fund repurchases under this additional share repurchase program from borrowings under our Credit Facility.

Stock option grants

Because of the ongoing stock option investigation, we were unable to timely file our Annual Report on Form 10-K and our Annual Meeting of Stockholders was delayed, and the regularly scheduled meeting of our Board of Directors that was to have occurred in November 2006 was focused solely on stock option investigation matters and any other matters for consideration were deferred. Under our stock option granting policy, the day prior to or the day of that regularly scheduled November Board meeting, the Compensation Committee could have granted options to new hires, employees receiving a grant in connection with a promotion, or persons who become ACS employees as a result of an acquisition. On the morning of December 9, 2006 the Compensation Committee met to discuss whether options, that were now available under the 1997 Stock Incentive Plan, should be granted to new hires, employees receiving a grant in connection with a promotion, or persons who became ACS employees as a result of an acquisition. After consideration of the fact that options would have been granted in November, if the regularly scheduled Board meeting had not deferred consideration of matters other than the stock option investigation, the Compensation Committee met on December 9, 2006 and, as a result of their actions at that meeting, a grant of 692,000 shares was made to new hires, employees receiving a grant in connection with a promotion, or persons who become ACS employees as a result of an acquisition, with such grants including 140,000 shares to Lynn Blodgett, who had been promoted to President and Chief Executive Officer; 75,000 shares to John Rexford who had been promoted to Executive Vice President and Chief Financial Officer; and 100,000 shares each to Ann Vezina and Tom Burlin which grants were in recognition of their recent promotions to Chief Operating Officers of the Commercial and Government segments, respectively, and had been approved by the Compensation Committee on August 15, 2006 but were deferred until shares were available for grant.

Related Party Transactions

Prior to 2002 we had guaranteed $11.5 million of certain loan obligations owed to Citicorp USA, Inc. by DDH Aviation, Inc., a corporate airplane brokerage company organized in 1997 (as may have been reorganized subsequent to July 2002, herein referred to as DDH). Our Chairman owned a majority interest in DDH. In consideration for that guaranty, we had access to corporate aircraft at favorable rates. In July 2002, our Chairman assumed in full our guaranty obligations to Citicorp and Citicorp released in full our guaranty obligations. As partial consideration for the release of our corporate guaranty, we agreed to provide certain administrative services to DDH at no charge until such time as DDH meets certain specified financial criteria. We anticipate that these administrative services will cease prior to June 30, 2007 as a result of the wind down of the DDH operations. In the first quarter of fiscal year 2003, we purchased $1 million in prepaid charter flights at favorable rates from DDH. As of June 30, 2006, we had $0.6 million remaining in prepaid flights with DDH. In the second quarter of fiscal year 2007, we were notified by DDH of its intent to wind down operations; therefore, we recorded a charge of $0.6 million related to the unused prepaid charter flights.

SUBSEQUENT EVENT

Contract with the Department of Education

The CSB contract is our largest contract. We have provided loan servicing for the Department of Education s Direct Student Loan program for over ten years. In 2003 the Department conducted a competitive procurement for its Common Services for Borrowers initiative (CSB). CSB was a modernization initiative which integrated a number of services for the Department, allowing the Department to increase service quality while saving overall program costs. In November 2003 the Department awarded us the CSB contract. Under this contract we provide comprehensive loan servicing, consolidation loan processing, debt collection services on delinquent accounts, IT infrastructure operations and support, maintenance and development of information systems, and portfolio management services for the Department of Education s Direct Student Loan program. We are also developing software for use in delivering these services. The CSB contract has a 5-year base term which began in January 2004 and provides the Department of Education five one-year options to extend after the base term. We estimate that our revenues from the CSB contract will exceed $1 billion in total over the base term of the contract. Annual revenues from this contract represent approximately 4% of our fiscal year 2006 revenues.

Through December 31, 2006 our capitalized expenditures for software development under the CSB contract have totaled approximately $113 million, of which approximately $38 million has been implemented with the current production system. Our model for development of software under the CSB contract may change and we may only be able to use a portion of the uncompleted software with the current production system. As a result, we may incur a material, non-cash, impairment of a portion of our remaining capitalized software development costs, which aggregate approximately $75 million. However, we currently cannot determine the amount, if any, of this potential impairment of our capitalized development costs.

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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. 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. The following table sets forth the calculation of internal revenue growth (in thousands):

	Three months ended December 31,				Six months ended December 31,			
	2006	2005	$ Growth	Growth %	2006	2005	$ Growth	Growth %
Consolidated								
Total Revenues	$ 1,426,761	$ 1,347,587	$ 79,174	6%	$ 2,812,199	$ 2,658,504	$ 153,695	6%
Less: Divestitures	(271)	(47,751)	47,480		(856)	(101,369)	100,513	
Adjusted	$ 1,426,490	$ 1,299,836	$ 126,654	10%	$ 2,811,343	$ 2,557,135	$ 254,208	10%
Acquired revenues	$ 92,713	$ 15,333	$ 77,380	6%	$ 169,901	$ 15,333	$ 154,568	6%
Internal revenues	1,333,777	1,284,503	49,274	4%	2,641,442	2,541,802	99,640	4%
Total	$ 1,426,490	$ 1,299,836	$ 126,654	10%	$ 2,811,343	$ 2,557,135	$ 254,208	10%
Commercial								
Total Revenues	$ 858,103	$ 784,767	$ 73,336	9%	$ 1,699,805	$ 1,550,773	$ 149,032	10%
Less: Divestitures								
Adjusted	$ 858,103	$ 784,767	$ 73,336	9%	$ 1,699,805	$ 1,550,773	$ 149,032	10%
Acquired revenues	$ 46,545	$	$ 46,545	6%	$ 77,733	$	$ 77,733	5%
Internal revenues	811,558	784,767	26,791	3%	1,622,072	1,550,773	71,299	5%
Total	$ 858,103	$ 784,767	$ 73,336	9%	$ 1,699,805	$ 1,550,773	$ 149,032	10%

Government

Total Revenues	$ 568,658	$ 562,820	$ 5,838	1%	$ 1,112,394	$ 1,107,731	$ 4,663	0%
Less: Divestitures	(271)	(47,751)	47,480		(856)	(101,369)	100,513	
Adjusted	$ 568,387	$ 515,069	$ 53,318	10%	$ 1,111,538	$ 1,006,362	$ 105,176	10%
Acquired revenues	$ 46,168	$ 15,333	$ 30,835	6%	$ 92,168	$ 15,333	$ 76,835	7%
Internal revenues	522,219	499,736	22,483	4%	1,019,370	991,029	28,341	3%
Total	$ 568,387	$ 515,069	$ 53,318	10%	$ 1,111,538	$ 1,006,362	$ 105,176	10%

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RESULTS OF OPERATIONS

Information for the three and six months ended December 31, 2005 has been restated in the following table, as discussed in Management s Discussion and Analysis of Financial Condition and Results of Operations. Review of Stock Option Grant Practices.

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 December 31,		Six months ended December 31,	
	2006	**2005 (as restated)**	**2006**	**2005 (as restated)**
Revenues	100.0%	100.0%	100.0%	100.0%
Operating expenses:				
Cost of revenues:				
Wages and benefits	46.8	47.1	47.4	47.4
Services and supplies	22.3	22.7	21.7	22.5
Rent, lease and maintenance	12.4	12.1	12.7	12.0
Depreciation and amortization	6.0	5.2	5.9	5.2
Other	0.6	0.5	0.7	0.5
Total cost of revenues	88.1	87.6	88.4	87.6
Gain on sale of business		(2.2)		(1.1)
Other operating expenses	1.4	1.6	1.2	1.1
Total operating expenses	89.5	87.0	89.6	87.6
Operating income	10.5	13.0	10.4	12.4
Interest expense	3.4	1.1	3.4	1.1
Other non-operating income, net	(0.7)	(0.2)	(0.4)	(0.3)
Pretax profit	7.8	12.1	7.4	11.6
Income tax expense	2.7	4.5	2.7	4.2
Net income	5.1%	7.6%	4.7%	7.4%

COMPARISON OF THE THREE MONTHS ENDED DECEMBER 31, 2006 TO THE THREE MONTHS ENDED DECEMBER 31, 2005

Revenues

In the second quarter of fiscal year 2007, our revenues increased $79.2 million, or 6%, to $1.4 billion from $1.3 billion in the second quarter of fiscal year 2006. Internal revenue growth for the second quarter of fiscal year

2007 was 4% and the remainder of the revenue growth was related to acquisitions. Excluding revenues related to divested operations, revenues increased $126.7 million, or 10% from the second quarter of fiscal year 2006.

Revenue in our Commercial segment, which represents 60% of consolidated revenue for the second quarter of fiscal year 2007, increased $73.3 million, or 9%, to $858.1 million in the second quarter of fiscal year 2007 compared to the same period last year. Internal revenue growth was 3%, due primarily to increased revenue related to contracts with Sprint/Nextel, MeadWestvaco, Glaxo-Smith-Kline, Humana, and Unum Provident offset by decreases for SBC Communications and General Motors. The items discussed above collectively represent approximately 90% of our internal revenue growth for the period in this segment. Revenue growth from acquisitions was 6% for the three months ended December 31, 2006, primarily related to the Intellinex, Primax and Systech acquisitions completed in May, July and October 2006, respectively.

Revenue in our Government segment, which represents 40% of consolidated revenue for the second quarter of fiscal year 2007, increased $5.8 million, to $568.7 million in the second quarter of fiscal year 2007 compared to the same period last year. Revenue growth from acquisitions was 6% primarily due to the Transport Revenue acquisition completed in the second quarter of fiscal year 2006. Excluding revenues related to divested operations, revenues increased $53.3 million, or 10% from the second quarter of fiscal year 2006. Internal revenue growth was 4%. We experienced increased revenue in our transportation contracts including Los Angeles Transit Authority, City of Houston, Pennsylvania Department of Transportation, Maryland EZPass, various Transport Revenue (defined below) clients and our commercial vehicle operations contract. Revenues increased in our healthcare contracts with various states including Texas Medicaid, Florida Choice, North Dakota, New Hampshire, Mississippi, Ohio, New Mexico, Wyoming, Colorado and Missouri offset by decreases with Texas CHIP, Georgia and North Carolina. Revenue for our children and family services contracts increased for payment processing and electronic benefit transfer services with Michigan, Ohio, New Jersey, New York, Maryland, Denver County, and Massachusetts offset by decreases with Mississippi and Texas. Revenues increased for our information technology contracts including contracts with Maryland, Orange County and North Carolina Community College offset by decreases with Oklahoma City and various court projects. We also had increased revenues related to our contract with the Social Security Administration. These increases were offset by decreases in our Department of Education contract and lower revenues in our unclaimed property business. The items discussed above collectively represent approximately 82% of our internal revenue growth for the period in this segment.

Operating Expenses

Wages and benefits increased $34.4 million or 5.4% to $667.9 million. As a percentage of revenue, wages and benefits decreased 0.3% to 46.8% in the second quarter of fiscal year 2007 from 47.1% in the second quarter of fiscal year 2006. During the second quarter of fiscal year 2006, we recorded $4.7 million, or 0.3% as a percentage of revenue, of compensation expense related to our restructuring activities.

Services and supplies increased $11.7 million, or 3.8%, to $317.6 million. As a percentage of revenue, services and supplies decreased 0.4% to 22.3% in the second quarter of fiscal year 2007 from 22.7% in the second quarter of fiscal year 2006. The decrease was primarily due to the sale of our Government welfare-to-workforces business in the second quarter of fiscal year 2006. This business had a higher component of services and supplies than our ongoing operations. During the second quarter of fiscal year 2007, we recorded $0.5 million in other costs associated with the ongoing stock option investigations and shareholder derivative lawsuits.

Rent, lease and maintenance increased $13.6 million, or 8.3%, to $177.1 million. As a percentage of revenue, rent, lease and maintenance increased 0.3%, to 12.4%, in the second quarter of fiscal year 2007 from 12.1% in the second quarter of fiscal year 2006. This increase was primarily due to increased software and hardware costs related to our information technology services business.

Depreciation and amortization increased $14.8 million, or 21%, to $85.2 million. As a percentage of revenue, depreciation and amortization increased 0.8%, to 6%, in the second quarter of fiscal year 2007 from 5.2% in the second quarter of fiscal year 2006. This increase was due to capital expenditures during fiscal year 2006 and the first six months of fiscal year 2007 primarily in our information technology services business.

Other expenses increased $1.6 million, or 21.7%, to $9.1 million. As a percentage of revenue, other expenses increased 0.1%, to 0.6%, in the second quarter of fiscal year 2007 from 0.5% in the second quarter of fiscal year 2006. During the second quarter of fiscal year 2006 we recorded asset impairment charges of $1.7 million, or 0.1% as a percentage of revenue, related to our restructuring activities.

Gain on sale of business for the three months ended December 31, 2005 was related to the sale of our Government welfare-to-workforce services business in the second quarter of fiscal year 2006.

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Other operating expenses decreased $1.6 million or 7.5% to $19.5 million. As a percentage of revenue other operating expenses decreased 0.2%, to 1.4% from 1.6% and includes the following (in millions).

	For the three months ending December 31, 2006	2005
Government segment:		
Provision for estimated legal settlement and uncollectible accounts receivable related to the welfare-to-workforce services business	$	$ 3.3
Corporate segment:		
Aircraft impairment		4.1
Legal settlements and related costs		3.2
Legal costs associated with the ongoing stock option investigations and shareholder derivative lawsuits	13.3	
Legal costs associated with the review of certain recapitalization options related to our dual class structure and an unsolicited offer regarding a potential sale of the Company		2.6
Total	$ 13.3	$ 13.2
As a percentage of revenue	1.0%	0.9%

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Operating Income

Operating income decreased $25.1 million, or 14.3%, to $150.3 million. As a percentage of revenue operating income decreased 2.5% to 10.5% in the second quarter of fiscal year 2007 from 13% in the second quarter of fiscal 2006. Operating income in the second quarter of fiscal years 2007 and 2006 was impacted by the following (in millions):

	For the three months ending December 31, 2006	2005
Commercial segment:		
Costs related to our restructuring activities	$	$ (4.6)
Government segment:		
Gain on sale of Government welfare-to-workforce services business		29.8
Provision for estimated legal settlement and uncollectible accounts receivable related to the welfare-to-workforce services business		(3.3)
Costs related to our restructuring activities		(1.7)
Corporate segment:		
Aircraft impairment		(4.1)
Legal and other costs associated with the ongoing stock option investigations and shareholder derivative lawsuits	(13.8)	
Legal settlements and related costs		(3.2)
Legal costs associated with the review of certain recapitalization options related to our dual class structure and an unsolicited offer regarding a potential sale of the Company		(2.7)
Total	$ (13.8)	$ 10.2
As a percentage of revenue	(1.0%)	0.8%

Interest Expense

Interest expense increased $34 million, to $48.1 million. As a percentage of revenue, interest expense increased 2.3% to 3.4% primarily due to interest expense on cash borrowed to finance our share repurchase programs during fiscal years 2006 and 2007, as well as approximately $1.0 million ($0.7 million, net of income tax) of estimated interest related to disallowed Section 162(m) executive compensation deductions discussed above in Management s Discussion and Analysis of Financial Condition and Results of Operations Review of Stock Option Grant Practices.

Other non-operating income, net

Other non-operating income, net, increased $7.7 million to $9.7 million primarily due to gains on long-term investments and increased interest income on cash investments as a result of higher average cash balances during the current year quarter. We also recorded $3.1 million in gains related to foreign exchange forward agreements that hedge our French operation s Euro foreign exchange exposure related to its Canadian dollar and United States dollar revenue during the second quarter of fiscal year 2007 (see Note 11 to our Consolidated Financial Statements for further discussion).

Income tax expense

Our effective income tax rate decreased to 35.6% in the second quarter of fiscal year 2007 from 37.3% in the second quarter of fiscal year 2006. The effective income tax rates for the second quarter of fiscal years 2007 and 2006 are comprised of an effective income tax rate of 35.5% and 36.8%, respectively, on operations and 39.9% related to the sale of our welfare-to-workforce services business in the second quarter of fiscal year 2006. Our effective income tax rate decreased primarily due to lower foreign income taxes and an increase in other deductions and credits. Our effective income tax rate is higher than the 35% federal statutory rate primarily due to the effect of state income taxes.

COMPARISON OF THE SIX MONTHS ENDED DECEMBER 31, 2006 TO THE SIX MONTHS ENDED DECEMBER 31, 2005

Revenues

In the first six months of fiscal year 2007, our revenues increased $153.7 million, or 6%, to $2.8 billion from $2.7 billion in the first six months of fiscal year 2006. Internal revenue growth for the first six months of fiscal year 2007 was 4% and the remainder of the revenue growth was related to acquisitions. Excluding revenues related to divested operations, revenues increased $254.2 million, or 10% from the first six months of fiscal year 2006.

Revenue in our Commercial segment, which represents 60% of consolidated revenue for the first six months of fiscal year 2007, increased $149 million, or 10%, to $1.7 billion in the first six months of fiscal year 2007 compared to the same period last year. Internal revenue growth was 5%, due primarily to increased revenue related to contracts with Sprint/Nextel, MeadWestvaco, Glaxo-Smith-Kline, Humana, Disney, Unum Provident and Aetna offset by decreases for General Motors and SBC Communications. The items discussed above collectively represent 96% of our internal revenue growth for the period in this segment. Revenue growth from acquisitions was 5% for the six months ended December 31, 2006, primarily related to the Intellinex, Primax and Systec acquisitions completed in May, July and October 2006, respectively.

Revenue in our Government segment, which represents 40% of consolidated revenue for the first six months of fiscal year 2007, increased $4.7 million, to $1.1 billion in the first six months of fiscal year 2007 compared to the same period last year. Revenue growth from acquisitions was 7% primarily due to the acquisition of the Transport Revenue division of Ascom AG (Transport Revenue) completed in the second quarter of fiscal year 2006. Excluding revenues related to divested operations, revenues increased $105.2 million, or 10% from the first six months of fiscal year 2006. Internal revenue growth was 3% for the first six months of fiscal year 2007. We experienced increased revenue in our transportation contracts including Los Angeles Transit Authority, Pennsylvania Department of Transportation, Maryland EZPass, various Transport Revenue clients and our commercial vehicle operations. Revenues increased related to our healthcare contracts with various states including Texas Medicaid, Florida Choice, North Dakota, New Hampshire, Mississippi, Ohio, New Mexico, Wyoming, Colorado and Missouri offset by decreases with Texas CHIP, Georgia and North Carolina. Revenue for our children and family services contracts increased for payment processing and electronic benefit transfer services with Michigan, Ohio, New Jersey, New York, Maryland, Denver County and Massachusetts offset by decreases with Mississippi and Texas. Revenues increased in our information technology contracts including contracts with Maryland, Orange County and North Carolina Community College offset by decreases with Oklahoma City and various court projects. We also had increased revenues related to our contract with the Social Security Administration. These increases were offset by decreases in our Department of Education contract and lower revenues in our unclaimed property business. The items discussed above collectively represent 90% of our internal revenue growth for the period in this segment.

Operating Expenses

Wages and benefits increased $72.3 million, or 5.7%, to $1.3 billion. As a percentage of revenue, wages and benefits was 47.4% for both the first six months of fiscal year 2007 and 2006. In the first six months of fiscal years 2007 and 2006, we recorded $5.1 million, or 0.2% as a percentage of revenue, and $4.7 million, or 0.2%, as a percentage of revenue, respectively, related to our restructuring activities. In the first quarter of fiscal year 2006 we recorded compensation expense of $5.4 million, or 0.2% as a percentage of revenue, related to the departure of Jeffrey A. Rich, a former Chief Executive Officer. In the first six months of fiscal year 2007, we recorded compensation expense of $1.1 million related to our efforts to relocate domestic functions to offshore facilities.

Services and supplies increased $12.3 million, or 2.1%, to $607 million. As a percentage of revenue, services and supplies decreased 0.8% to 21.7% in the first six months of fiscal year 2007 from 22.5% in the first six months of fiscal year 2006. The decrease was primarily due to the sale of our Government welfare-to-workforces business in the first six months of fiscal year 2006. This business had a higher component of services and supplies than our ongoing operations. During the first six months of fiscal year 2007, we recorded $0.7 million in other costs associated with the ongoing stock option investigations and shareholder derivative lawsuits.

Rent, lease and maintenance increased $37.4 million, or 11.7%, to $356.2 million. As a percentage of revenue, rent, lease and maintenance increased 0.7%, to 12.7%, in the first six months of fiscal year 2007 from 12% in the first six months of fiscal year 2006. This increase was due to increased hardware and software costs primarily in our information technology services business.

Depreciation and amortization increased $28.3 million, or 20.5%, to $166.9 million. As a percentage of revenue, depreciation and amortization increased 0.7%, to 5.9%, in the first six months of fiscal year 2007 from 5.2% in the first six months of fiscal year 2006. This increase was primarily due to capital expenditures during fiscal year 2006 and the first six months of fiscal year 2007 in our information technology services business.

Other expenses increased $8 million, or 68%, to $19.8 million. As a percentage of revenue, other expenses increased 0.2%, to 0.7%, in the first six months of fiscal year 2007 from 0.5% in the first six months of fiscal year 2006. During the first six months of fiscal year 2007, we recorded $0.9 million related to asset impairments and other charges. During the first six months of fiscal year 2007 and 2006 we recorded charges of $0.4 million and $1.7 million, respectively, related to our restructuring activities.

Gain on sale of business for the six months ended December 31, 2005 was related to the sale of our Government welfare-to-workforce services business in the second quarter of fiscal year 2006.

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Other operating expense increased $3.9 million to $34.8 million. As a percentage of revenue, other operating expense increased 0.1%, to 1.2% and includes the following (in millions):

	For the six months ending December 31, 2006	2005
Commercial segment:		
Provision for doubtful accounts for an assessment of risk related to the bankruptcies of certain airline clients	$	$ 3.0
Government segment:		
Provision for estimated legal settlement and uncollectible accounts receivable related to the welfare-to-workforce services business		3.3
Corporate segment:		
Aircraft impairment		4.1
Legal settlements and related costs		3.2
Legal costs associated with the ongoing stock option investigations and shareholder derivative lawsuits	21.0	
Legal costs associated with the review of certain recapitalization options related to our dual class structure and an unsolicited offer regarding a potential sale of the Company		2.6
Total	$ 21.0	$ 16.2
As a percentage of revenue	0.7%	0.6%

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Operating Income

Operating income decreased $38.4 million, or 11.7%, to $291.2 million in the first six months of fiscal year 2007 compared to the prior year. In the first quarter of fiscal year 2007, we recorded $2.1 million of asset impairment and other charges related to internal use software impairments and facility shutdowns included in various cost of revenues accounts. As a percentage of revenues, operating income decreased 2%. Operating income in the first six months of fiscal years 2007 and 2006 were impacted by the following (in millions):

	For the six months ending December 31,	
	2006	**2005**
Commercial segment:		
Costs related to our restructuring activities	$ (5.6)	$ (4.6)
Asset impairments and other charges	(2.1)	
Provision for doubtful accounts for an assessment of risk related to the bankruptcies of certain airline clients		(3.0)
Government segment:		
Gain on sale of Government welfare-to-workforce services business		29.8
Provision for estimated legal settlement and uncollectible accounts receivable related to the welfare-to-workforce services business		(3.3)
Cost related to our restructuring activities	(0.4)	(1.7)
Corporate segment:		
Aircraft impairment		(4.1)
Legal and other costs associated with the ongoing stock option investigations and shareholder derivative lawsuits	(21.7)	
Compensation expense related to the departure of Jeffrey A. Rich, our former Chief Executive Officer		(5.4)
Legal settlements and related costs		(3.2)
Legal costs associated with the review of certain recapitalization options related to our dual class structure and an unsolicited offer regarding a potential sale of the Company		(2.7)
Total	$ (29.8)	$ 1.8
As a percentage of revenue	(1.1%)	0.1%

Interest Expense

Interest expense increased $67.3 million, to $94.1 million. As a percentage of revenue, interest expense increased 2.3% to 3.4% primarily due to interest expense on cash borrowed to finance our share repurchase programs during fiscal years 2006 and 2007. Interest expense also includes $2.6 million in charges related to a waiver fee on our Credit Facility in the first six months of fiscal year 2007, as well as approximately $2.0 million ($1.3 million, net of income tax) of estimated interest related to disallowed Section 162(m) executive compensation deductions discussed above in Management s Discussion and Analysis of Financial Condition and Results of Operations Review of Stock Option Grant Practices.

Other non-operating income, net

Other non-operating income, net increased $5.9 million to $12.3 million primarily due to gains on long-term investments recorded in the first six months of fiscal year 2006 and increased interest income on cash investments as a result of higher average cash balances during the current fiscal year. We also recorded $2.3 million in gains related to foreign exchange forward agreements that hedge our French operation s Euro foreign exchange exposure related to its Canadian dollar and United States dollar revenue during the first six months of fiscal year 2007 (see Note 11 to our Consolidated Financial Statements for further discussion).

Income tax expense

Our effective income tax rate decreased to 36.3% in the first six months of fiscal year 2007 from 36.7% in the first six months of fiscal year 2006. The effective income tax rates for the first six months of fiscal years 2007 and 2006 are comprised of an effective income tax rate of 36.2% and 36.3%, respectively, on operations and 39.9% related to the sale of our welfare-to-workforce services business in the second quarter of fiscal year 2006. Our effective income tax rate decreased primarily due to lower foreign income taxes and an increase in other deductions and credits. 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 first six months of fiscal year 2007, we generated approximately $304.7 million in cash flows provided by operating activities compared to $357.6 million in the first six months of fiscal year 2006. Decreased net income and payments for hardware and software maintenance in the first six months of fiscal year 2007 contributed to this decrease, offset by increased collections on accounts receivable during the first six months of fiscal year 2007. During the first six months of fiscal year 2007, we paid approximately $81.8 million in interest on our outstanding debt, and received interest on cash investments of $4.6 million. We also paid approximately $18.6 million in legal and other costs related to the investigations into our stock option grant practices discussed above and derivative lawsuits related to our stock option grant practices discussed in Note 14 to our Consolidated Financial Statements. During the first six months of fiscal year 2006, we paid approximately $21.2 million in interest on our outstanding debt, and received interest on cash investments of $1.0 million.

Accounts receivable fluctuations may have a significant impact on our cash flows provided by operating activities. The payments received from clients on our billed accounts receivables and the increase in such accounts receivable are reflected as a single component of our cash flows provided by operating activities, and the timing of collections of these receivables may have either a positive or negative impact on our liquidity.

Free cash flow is measured as cash flow provided by operating activities (as reported in our consolidated statements of cash flow), less capital expenditures (purchases of property, equipment and software, net of sales, as reported in our consolidated statements of cash flow) 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 investing and 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):

	Six months ended December 31,	
	2006	**2005 As restated**
Net cash provided by operating activities	$ 304,714	$ 357,571
Purchases of property, equipment and software, net	(170,441)	(184,973)
Additions to other intangible assets	(14,969)	(13,046)
Free cash flow	$ 119,304	$ 159,552

During the first six months of fiscal year 2007, net cash used in investing activities was $292.9 million compared to $393.7 million in the first six months of fiscal year 2006. In the first six months of fiscal year 2007, we used $102.3 million for acquisitions, primarily for the purchases of Systech and Primax, net of cash acquired, and contingent consideration payments on prior year acquisitions. In the first six months of fiscal year 2006, we used $153.8 million for acquisitions, primarily for the purchases of Transport Revenue, LiveBridge, Inc., contingent consideration payments for Heritage Information Systems, Inc. and a payment related to the first quarter fiscal year 2005 BlueStar Solutions, Inc. acquisition. Cash used for the purchase of property, equipment and software and additions to other intangible assets was $185.4 million and $198.0 million for the six months ended December 31, 2006 and 2005, respectively. During the first six months of fiscal year 2006, we used $16.5 million to acquire intangible assets in connection with the termination of a subcontractor arrangement. During the first six months of fiscal years 2007 and 2006, we used $6.4 million and $25.4 million to purchase long-term investments primarily related to our deferred compensation plans.

During the first six months of fiscal year 2007 and 2006, net cash provided by financing activities was $220.5 million and $80.7 million, respectively. Such financing activities include net borrowings on our Credit Facility, proceeds from the exercise of stock options, excess tax benefits from stock-based compensation and proceeds from the issuance of treasury shares offset by purchases of treasury shares under our share repurchase programs. During the first six months of fiscal year 2007, we determined that it would be prudent to retain a portion of our cash flows provided by operating activities rather than pay down outstanding debt, due to the delay in filing our Annual Report on Form 10-K/A for the year ended June 30, 2006 and Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 and a reduced ability to access the capital markets during that delay. We filed these reports on February 1, 2007 and January 23, 2007, respectively, and anticipate that we will begin to utilize a portion of our cash on hand and cash flows provided by operating activities to reduce outstanding debt in the third quarter of fiscal year 2007.

Credit Facility

On July 6, 2006, we amended our secured term loan facility (Term Loan Facility) under our Credit Agreement dated March 20, 2006 (Credit Facility) and borrowed an additional $500 million on July 6, 2006 and an additional $500 million on August 1, 2006.

As a result of the increase to the facility, the Applicable Margin, as defined in the Credit Facility, increased to LIBOR plus 200 basis points. We used the proceeds of the Term Loan Facility increase to finance the purchase of shares of our Class A common stock under our June 2006 authorization and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility. The borrowing rate under the Term Loan Facility as of February 9, 2007 was approximately 7.4%.

Draws made under our credit facilities are made to fund cash acquisitions, share repurchases and for general working capital requirements. During the trailing twelve months ended December 31, 2006, the balance outstanding under our credit facilities for borrowings ranged from $282 million to $2.1 billion. At December 31, 2006, we had approximately $584.3 million available under our revolving credit facility after giving effect to outstanding indebtedness of $275 million and $140.7 million of outstanding letters of credit that secure certain contractual performance and other obligations and which reduce the availability of our revolving credit facility. At December 31, 2006, we had $2.1 billion outstanding under our Credit Facility, of which $2.1 billion is reflected in long-term debt and $18 million is reflected in current portion of long-term debt, and of which $1.8 billion bore interest at approximately 7.36%, $223.6 million bore interest at approximately 6.6% and the remainder bore interest from 3.3% to 4.9%. As of December 31, 2006, we were in compliance with the covenants of our Credit Facility, as amended, as described further below.

On September 26, 2006, we received an amendment, consent and waiver from the lenders under our Credit Facility with respect to, among other provisions, waiver of any default or event of default arising under the Credit Facility as a result of our failure to comply with certain reporting covenants relating to other indebtedness, including covenants purportedly requiring the filing of reports with either the SEC or the holders of such indebtedness, so long as those requirements are complied with by December 31, 2006. As consideration for this amendment, consent and waiver, we paid a fee of $2.6 million.

On December 21, 2006, we received an amendment, consent and waiver from lenders under our Credit Facility. The amendment, consent and waiver includes the following provisions, among others:

(1) Consent to the delivery, on or prior to February 14, 2007, of (i) the financial statements, accountant s report and compliance certificate for the fiscal year ended June 30, 2006 and (ii) financial statements and related compliance certificates for the fiscal quarters ended June 30, 2006 and September 30, 2006, and waiver of any default arising from the failure to deliver any such financial statements, reports or certificates within the applicable time period provided for in the Credit Agreement, provided that any such failure to deliver resulted directly or indirectly from the previously announced investigation of the Company s historical stock option grant practices (the Options Matter).

(2) Waiver of any default or event of default arising from the incorrectness of representations and warranties made or deemed to have been made with respect to certain financial statements previously delivered to the Agent as a result of any restatement, adjustment or other modification of such financial statements resulting directly or indirectly from the Options Matter.

(3) Waiver of any default or event of default which may arise from the Company s or its subsidiaries failure to comply with reporting covenants under other indebtedness that are similar to those in the Credit Agreement (including any covenant to file any report with the Securities and Exchange Commission or to furnish such reports to the holders of such indebtedness), provided such reporting covenants are complied with on or prior to February 14, 2007.

(4)

Amendments to provisions relating to the permitted uses of the proceeds of revolving loans under the Credit Agreement that (i) increase to $500 million from $350 million the aggregate principal amount of revolving loans that may be outstanding, the proceeds of which may be used to satisfy the obligations under the Company s 4.70% Senior Notes due 2010 or 5.20% Senior Notes due 2015 and (ii) until June 30, 2007, decrease to $200 million from $300 million the minimum liquidity (i.e., the aggregate amount of the Company s unrestricted cash in excess of $50 million and availability under the Credit Agreement s revolving facility) required after giving effect to such use of proceeds.

As consideration for this amendment, waiver and consent, we paid a fee of $1.3 million. We filed our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 on February 1, 2007 and our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 on January 23, 2007.

Senior Notes

On September 22, 2006, we received a letter from CEDE & Co. (CEDE) sent on behalf of certain holders of our 5.20% Senior Notes due 2015 (the 5.20% Senior Notes) issued by us under that certain Indenture dated June 6, 2005 (the Indenture) between us and The Bank of New York Trust Company, N.A. (the Trustee) advising us that we were in default of our covenants under the

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Indenture. The letter alleged that our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, was a default under the terms of the Indenture. On September 29, 2006, we received a letter from CEDE sent on behalf of the same persons declaring an acceleration with respect to the 5.20% Senior Notes, as a result of our failure to remedy the default set forth in the September 22 letter related to our failure to timely file our Annual Report on Form 10-K for the period ended June 30, 2006. The September 29 letter declared that the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes were due and payable immediately, and demanded payment of all amounts owed in respect of the 5.20% Senior Notes. On September 29, 2006 we received a letter from the Trustee with respect to the 5.20% Senior Notes. The letter alleged that we were in default of our covenants under the Indenture with respect to the 5.20% Senior Notes, as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. On October 6, 2006, we received a letter from the Trustee declaring an acceleration with respect to the 5.20% Senior Notes as a result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. The October 6, 2006 letter declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed in respect of the 5.20% Senior Notes.

In addition, our 4.70% Senior Notes due 2010 (the 4.70% Senior Notes) were also issued under the Indenture and have identical default and acceleration provisions as the 5.20% Senior Notes. On October 9, 2006, we received letters from certain holders of the 4.70% Senior Notes issued by us under the Indenture, advising us that we were in default of our covenants under the Indenture. The letters alleged that our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, was a default under the terms of the Indenture. On November 9, 10 and 16, 2006, we received letters from CEDE sent on behalf of certain holders of our 4.70% Senior Notes, declaring an acceleration of the 4.70% Senior Notes as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006. The November 9, 10 and 16, 2006 letters declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 4.70% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed under the 4.70% Senior Notes.

It is our position that no default has occurred under the Indenture and that no acceleration has occurred with respect to the 5.20% Senior Notes or the 4.70% Senior Notes (collectively, the Senior Notes) or otherwise under the Indenture. Further we have 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.

On December 19, 2006, we entered into an Instrument of Resignation, Appointment and Acceptance with the Trustee and Wilmington Trust Company (herein so called), whereby the Trustee resigned as trustee, as well as other offices or agencies, with respect to the Senior Notes, and was replaced by Wilmington Trust Company. On January 8, 2007, the Court entered an order substituting Wilmington Trust Company for the Bank of New York. On January 16, 2007, Wilmington Trust Company filed an answer and counterclaim. The counterclaim seeks immediate payment of all principal and accrued and unpaid interest on the Senior Notes. Alternatively, the counterclaim seeks 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 5, 2007, we filed our answer denying Wilmington Trust Company s counterclaim.

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 payoff the Senior Notes, it is most likely that we would utilize the Credit Facility to fund such payoff. Under the terms of the Credit Facility, we can utilize borrowings under the revolving credit 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 $15.1 million ($9.4 million, net of income tax), unamortized deferred financing costs of $2.9 million ($1.8 million, net of income tax) and unamortized discount of $0.6 million ($0.4 million, net of income tax) associated with our Senior Notes as of December 31, 2006 may be adjusted and reported as interest expense in our Consolidated Statement of Income in the period of refinancing or demand.

Other credit arrangements

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 December 31, 2006, outstanding surety bonds of $521.8 million and $93.3 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $47.4 million of letters of credit and $1.9 million of surety bonds 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.

Credit Ratings

Following our tender offer completed in March 2006, our credit ratings were downgraded by Moody s and Standard & Poor s, both to below investment grade. Standard & Poor s further downgraded us to BB upon our announcement in June 2006 of the approval by our Board of Directors of a new $1 billion share repurchase plan. Fitch initiated its coverage of us in August 2006 at a rating of BB, except for our Senior Notes which were rated BB-. Standard & Poor s downgraded our credit rating further, to B+, following our announcement on September 28, 2006 that we would not be able to file our Annual Report on Form 10-K for the period ending June 30, 2006 by the September 28, 2006 extended deadline. 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 customer may elect to terminate its contract with us and either pay a reduced termination fee or in some 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 customer s exercise of these termination rights, there can be no assurance that such a credit ratings downgrade will not adversely affect these customer relationships.

Derivative instruments and hedging activities

We hedge the variability of a portion of our anticipated future Mexican peso cash flows through foreign exchange forward agreements. The agreements are designated as cash flow hedges of forecasted payments related to certain operating costs of our Mexican operations. As of December 31, 2006, the notional amount of these agreements totaled 497.5 million pesos ($44.7 million) and expire at various dates over the next 12 months. Upon termination of these agreements, we will purchase Mexican pesos at the exchange rates specified in the forward agreements to be used for payments on our forecasted Mexican peso operating costs. As of December 31, 2006, the unrealized gain on these foreign exchange forward agreements, reflected in accumulated other comprehensive loss, net, was approximately $0.7 million ($0.4 million, net of income tax). As of June 30, 2006, the unrealized loss on these foreign exchange forward agreements, reflected in accumulated other comprehensive loss, was approximately $0.5 million ($0.3 million, net of income tax).

As part of the Transport Revenue acquisition, we acquired foreign exchange forward agreements that hedge our French operation s Euro foreign exchange exposure related to its Canadian dollar and United States dollar revenues. These agreements do not qualify for hedge accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities. As a result, we recorded a gain on hedging instruments of $3.1 million ($2.1 million, net of income tax) and $2.3 million ($1.5 million, net of income tax) for the three and six months ended December 31, 2006, respectively, in other non-operating income, net in our Consolidated Statements of Income. As of December 31, 2006, the notional amount of these agreements totaled $44.4 million Canadian dollars and $4.4 million U.S. dollars, respectively, and are set to expire at various times over the next four years. As of December 31, 2006, a liability was recorded for the related fair value of approximately $2 million.

Share Repurchase Programs

In June and August 2006, our Board of Directors authorized two share repurchase programs of up to $1 billion each of our Class A common stock. The programs, which are open ended, allow us to repurchase our shares on the open market, from time to time, in accordance with the requirements of the Securities and Exchange Commission (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. As of December 31, 2006, we had repurchased approximately 19.9 million shares under the June 2006 authority at an average cost of approximately $50.30 per share (approximately $1 billion) all of which have been retired, of which 14.4 million shares with an average cost of approximately $50.64 per share (approximately $730.7 million) were purchased and retired in the first quarter of fiscal year 2007. No repurchases have been made under the August 2006 authority as of the date of this filing. We expect to fund repurchases under this additional share repurchase program from borrowings under our Credit Facility.

Other

As discussed in Review of Stock Option Grant Practices above, as a result of our internal investigation into our stock option grant practices, we restated certain of our previously filed consolidated financial statements and recorded cumulative adjustments for non-cash stock-based compensation expense totaling $51.2 million. While these expenses are non-cash, the income tax related impacts are expected to require the use of cash. At December 31, 2006, we have recorded approximately $39.5 million of additional income taxes payable, including estimated interest and penalties related to certain disallowed Section 162(m) executive compensation deductions. We also expect to pay to certain current and former employees approximately $8 million in order to compensate such individuals for any increase in exercise price resulting from the matters which were the subject of the internal investigation, in order to avoid the adverse individual income tax impact of Section 409A due to revised measurement dates. The $8 million related to Section 409A will be paid to the affected individuals beginning in January 2008 and as the related stock options vest. We expect to fund any such payment from cash flows from operating activities; however, we have not yet determined the impact to our results of operations and financial condition. The increased exercise prices to be paid by optionholders upon their exercise is expected to offset, in the aggregate, the $8 million; however, the timing of any such exercises cannot be determined. At this time, we cannot predict when the Section 162(m) underpayment deficiencies, together with interest and penalties, if any, will be paid.

At December 31, 2006, we had cash and cash equivalents of $333.2 million compared to $100.8 million at June 30, 2006. Our working capital (defined as current assets less current liabilities) increased $268.3 million to $972.5 million at December 31, 2006 from $704.2 million at June 30, 2006. Our current ratio (defined as total current assets divided by total current liabilities) was 2.2 and 1.9 at December 31, 2006 and June 30, 2006, 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 58% and 40% at December 31, 2006 and June 30, 2006, 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. However, due to the additional borrowings made in relation to our share repurchase programs and if we utilize the unused portion of our Credit Facility to repay the Senior Notes or for other corporate purposes, our indebtedness and interest expense would increase, possibly significantly, and our indebtedness could be substantial in relation to our stockholders equity. We believe that our expected cash flow provided by operating activities, and anticipated access to the unused portion of our new Credit Facility and capital markets will be adequate for our expected liquidity needs, including capital expenditures, and to meet the cash requirements of our contractual obligations. 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.

DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS AS OF DECEMBER 31, 2006 (IN THOUSANDS):

		Payments Due by Period			
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Senior Notes, net of unamortized discount (1)	$ 499,408	$	$	$249,941	$ 249,467
Long-term debt (1)	2,063,851	19,588	36,062	36,067	1,972,134
Capital lease obligations (1)	47,729	24,824	22,634	271	
Operating leases (2)	1,184,215	323,175	512,384	272,571	76,085
Purchase obligations (3) (4)	39,834	16,047	23,787		
Total Contractual Cash Obligations	$3,835,037	$383,634	$594,867	$558,850	$2,297,686

	Total	**Amount of Commitment Expiration per Period**

Other Commercial Commitments	**Amounts Committed**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Standby letters of credit	$ 140,719	$ 140,719	$	$	$
Surety bonds	523,699	453,875	46,126	21,836	1,862
Total Commercial Commitments	$ 664,418	$ 594,594	$ 46,126	$ 21,836	$ 1,862

(1) Excludes accrued interest of $20.2 million at December 31, 2006.

(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 2010, and are included in purchase obligations in the table.

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(4) We have 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 expect to contribute approximately $11 million to our pension plans in fiscal year 2007. Minimum pension funding requirements are not included in the table above as such amounts are zero for our pension plans as of December 31, 2006. See Critical Accounting Policies for discussion of our pension plans.

As discussed above, 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 December 31, 2006, outstanding surety bonds of $521.8 million and $93.3 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $47.4 million of letters of credit and $1.9 million of surety bonds 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.

We are obligated to make contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During the first six months of fiscal year 2007, we made contingent consideration payments of $3 million related to acquisitions completed in prior years. As of December 31, 2006, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities is approximately $108.9 million. Upon satisfaction of the specified contractual criteria, such payments primarily result in a corresponding increase in goodwill.

We have indemnified Lockheed Martin Corporation against certain specified claims from certain pre-sale litigation, investigations, government audits and other issues related to the sale of a majority of our Federal government business to Lockheed Martin Corporation completed in November 2003. Our contractual maximum exposure under these indemnifications is $85 million; however, we believe the actual exposure to be significantly less. As of December 31, 2006, other accrued liabilities include a reserve for these claims in an amount we believe to be adequate at this time.

As discussed in Note 14 to our Consolidated Financial Statements, we have agreed to indemnify ManTech International Corporation with respect to the DOJ investigation related to purchasing activities at Hanscom during the period 1998-2000.

Our Education Services business, which is included in our Commercial segment, 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 December 31, 2006, we serviced a FFEL portfolio of approximately 2.1 million loans with an outstanding principal balance of approximately $31.3 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 then we repackage the loans 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 December 31, 2006 and June 30, 2006, other accrued liabilities include reserves which we believe to be adequate.

CRITICAL ACCOUNTING POLICIES

The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions relating to the reporting of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. We base our estimates on historical experience and on various other assumptions or conditions that 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 costs under 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). SAB 104 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements and updates Staff Accounting Bulletin Topic 13 to be consistent with Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21). We recognize revenues when persuasive evidence of an arrangement exists, the services have been provided to the client, the sales price is fixed or determinable, and collectibility is reasonably assured.

During fiscal year 2006, approximately 77% of our revenue was recognized based on transaction volumes, approximately 10% was fixed fee based, wherein our revenue is earned as we fulfill our performance obligations under the arrangement, approximately 7% was related to cost reimbursable contracts, approximately 4% 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 customer 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 customers in which we agree, for compensation, to perform a service to the customer s specifications. These services require that we perform significant, extensive and complex design, development, modification and implementation activities for our customers 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 revenue using the percentage of services completed, on a current cumulative cost to total cost basis, using a reasonably consistent profit margin over the period. Due to the longer term nature of these projects, developing the estimates of costs often requires significant judgment. Factors that must be considered in estimating the progress of work completed and ultimate cost of the 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.

EITF 00-21 addresses the accounting treatment for an arrangement to provide the delivery or performance of multiple products and/or services where the delivery of a product or system or performance of services may occur at different points in time or over different periods of time. The Emerging Issues Task Force reached a consensus regarding, among other issues, the applicability of the provisions regarding separation of contract elements in EITF 00-21 to contracts where one or more elements fall within the scope of other authoritative literature, such as SOP 81-1. EITF 00-21 does not impact the use of SOP 81-1 for contract elements that fall within the scope of SOP 81-1, such as the implementation or development of an information technology system to client specifications under a long-term contract. Where an implementation or development project is contracted with a client, and we will also provide services or operate the system over a period of time, EITF 00-21 provides the methodology for separating the contract elements and allocating total arrangement consideration to the contract elements. We adopted the provisions of EITF 00-21 on a prospective basis to transactions entered into after July 1, 2003.

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 over the period between the initiation of the ongoing services through the end of the contract term on a straight-line basis.

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 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.
Contingencies
We account for claims and contingencies in accordance with Statement of Financial Accounting Standards 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. Circumstances that could potentially result in contract losses over the life of the contract include decreases in volumes of transactions, 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 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 customers 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. We continually evaluate whether events and circumstances have occurred that indicate the balance of goodwill or intangible assets may not be recoverable. In evaluating impairment, we estimate the sum of expected future cash flows derived from the goodwill or intangible asset. 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.
Share-Based Compensation
We adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)) as of July 1, 2005. SFAS 123(R) requires us to recognize compensation expense for all share-based payment arrangements based on the fair value of the share-based payment on the date of grant. We elected the modified prospective application method for adoption, which requires compensation expense to be recorded for all stock-based awards granted after July 1, 2005 and for all unvested stock options outstanding as of July 1, 2005, beginning in the first quarter of adoption. For all unvested options outstanding as of July 1, 2005, the remaining previously measured but unrecognized compensation expense, based on the fair value using revised grant dates as determined in connection with our internal investigation into our stock option grant practices (see Review of Stock Option Grant Practices above) will be recognized as wages and benefits in the Consolidated Statements of Income on a straight-line basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized in the Consolidated Statements of Income in wages and benefits on a straight-line basis over the vesting period. 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 based on daily closing stock prices.

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

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

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.

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SFAS 123(R) requires that we recognize compensation expense for only the portion of share-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 share-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

Statement of Financial Accounting Standards No. 87, Employers Accounting for Pensions (SFAS 87), establishes standards for reporting and accounting for pension benefits provided to employees. We have pension plans for employees located in Canada and the United Kingdom (UK). These defined benefit plans provide benefits for participating employees based on years of service and average compensation for a specified period before retirement. We have established June 30 as our measurement date for these defined benefit plans. The net periodic benefit costs for these plans are included in wages and benefits in our Consolidated Statements of Income.

The measurement of the pension benefit obligation of the plans at the acquisition date was accounted for using the business combination provisions in SFAS 87, therefore, all previously existing unrecognized net gain or loss, unrecognized prior service cost, or unrecognized net obligation or net asset existing prior to the date of the acquisition was included in our calculation of the pension benefit obligation recorded at acquisition.

In addition to these pension plans, we assumed a post-employment medical plan for Acquired HR Business employees and retirees in Canada. The amount of health care benefits is limited to lifetime maximum and age limitations as described in the plan.

In December 2005, we adopted a pension plan for the U.S. employees of Buck Consultants, LLC, a wholly owned subsidiary, which was acquired in connection with the Acquired HR Business. The U.S. pension plan is a funded plan. We have established June 30 as our measurement date for this plan. The plan recognizes service for eligible employees from May 26, 2005, the date of the acquisition of the Acquired HR Business. We recorded prepaid pension costs and projected benefit obligation related to this prior service which will be amortized over approximately 9.3 years and included in the net periodic benefit costs which is included in wages and benefits in our Consolidated Statements of Income. The plan is unfunded as of December 31, 2006.

A small group of employees located in Germany participate in a pension plan. This plan is not material to our results of operations or financial position and is not included in the disclosures below. A group of employees acquired with Transport Revenue participate in a multi-employer pension plan in Switzerland. Contributions to the plan are not considered material to our Consolidated Statements of Income.

The following table summarizes the weighted-average assumptions used in the determination of our benefit obligation:

	As of June 30,			
	2006		2005	
	Pension Plans	**Other Benefit Plan**	**Pension Plans**	**Other Benefit Plan**
Non-U.S. Plans				
Discount rate	5.00% - 5.75%	5.75%	5.00% - 5.25%	5.25%
Rate of increase in compensation levels	4.25% - 4.40%	N/A	4.25% - 4.40%	N/A
U.S. Plan				
Discount rate	6.50%	N/A	N/A	N/A
Rate of increase in compensation levels	3.50%	N/A	N/A	N/A

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The following table summarizes the assumptions used in the determination of our net periodic benefit cost:

	For the year ended June 30, 2006		For the period from May 1, 2005 through June 30, 2005	
	Pension Plans	**Other Benefit Plan**	**Pension Plans**	**Other Benefit Plan**
Non-U.S. Plans				
Discount rate	5.00% - 5.75%	5.75%	5.25% - 5.75%	5.75%
Long-term rate of return on assets	7.00% - 7.50%	N/A	7.00% - 7.50%	N/A
Rate of increase in compensation levels	4.25% - 4.40%	N/A	4.25% - 4.40%	N/A
U.S. Plan				
Discount rate	5.75%	N/A	N/A	N/A
Long-term rate of return on assets	N/A	N/A	N/A	N/A
Rate of increase in compensation levels	3.00%	N/A	N/A	N/A

Our discount rate is determined based upon high quality corporate bond yields as of the measurement date. The table below illustrates the effect of increasing or decreasing the discount rates by 25 basis points (in thousands):

	For the year ended June 30, 2006		For the period from May 1, 2005 through June 30, 2005	
	Plus .25%	Less .25%	Plus .25%	Less .25%
Non-U.S. Plans				
Effect on pension benefit obligation	$(5,055)	$5,155	$ (4,490)	$ 4,692
Effect on service and interest cost	$ (432)	$ 450	$ (380)	$ 399
U.S. Plan				
Effect on pension benefit obligation	$ (164)	$ 174	N/A	N/A
Effect on service and interest cost	$ (104)	$ 110	N/A	N/A

We estimate the long-term rate of return on non-U.S. plan assets and U.S. plan assets will be 7% and 7.5%, respectively, based on the long-term target asset allocation. As of December 31, 2006, the U.S. plan was not funded. We expect to fund the U.S. plan in fiscal year 2007 upon adoption of investment policies for the plan. Expected returns for the following asset classes used in the plans are based on a combination of long-term historical returns and current and expected market conditions.

The UK pension scheme s target asset allocation is 50% equity securities, 40% debt securities and 10% in real estate. External investment managers actively manage all of the asset classes. The target asset allocation has been set by the plan s trustee board with a view to meeting the long-term return assumed for setting the employer s contributions while also reducing volatility relative to the plan s liabilities. The managers engaged by the trustees manage their assets with a view to seeking moderate out-performance of appropriate benchmarks for each asset class. At this time, the trustees do not engage in any alternative investment strategies, apart from UK commercial property.

The Canadian funded plan s target asset allocation is 37% Canadian provincial and corporate bonds, 33% larger capitalization Canadian stocks, 25% developed and larger capitalization Global ex Canada stocks (mainly U.S. and international stocks) and 5% cash and cash equivalents. A single investment manager actively manages all of the asset classes. This manager uses an equal blend of large cap value and large cap growth for stocks in order to participate in the returns generated by stocks in the long-term, while reducing year-over-year volatility. The bonds are managed using a core approach where multiple strategies are engaged such as interest rate anticipation, credit selection and yield curve positioning to mitigate overall risk. At this time, the manager does not engage in any alternative investment strategies.

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Statement of Financial Accounting Standards No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions (SFAS 106) requires the disclosure of assumed healthcare cost trend rates for next year used to measure the expected cost of benefits covered. For measurement purposes, an 8.3% composite annual rate of increase in the per capita costs of covered healthcare benefits was assumed for fiscal year 2007; this rate was assumed to decrease gradually to 4.5% by 2013 and remain at that level thereafter. The healthcare cost trend rate assumption may have a significant effect on the SFAS 106 projections. The table below illustrates the effect of increasing or decreasing the assumed healthcare cost trend rates by one percentage point for each future year (in thousands):

	For the year ended June 30, 2006		**For the period from May 1, 2005 through June 30, 2005**	
	Plus 1%	Less 1%	Plus 1%	Less 1%
Effect on pension benefit obligation	$30	$(27)	$ 55	$ (48)
Effect on service and interest cost	$ 4	$ (4)	$ 7	$ (6)

Allowance for doubtful accounts

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

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. Our provision for income taxes includes the impact of these reserve changes. We adjust these reserves in light of changing facts and circumstances. In the event that there is a significant unusual or 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.

NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158), SFAS 158 amends SFAS 87, Employers Accounting for Pensions , SFAS 88, Employers Accounting fo Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits , SFAS 106, Employers Accounting for Postretirement Benefits Other Than Pensions , and SFAS 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits . SFAS No. 158 requires employers to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status. Secondly, it requires employers to measure the plans assets and obligations that determine its funded status as of the end of the fiscal year. Lastly, employers are required to recognize changes in the funded status of a defined benefit postretirement plan in the year that the changes occur with the changes reported in comprehensive income. SFAS 158 is required to be adopted by entities with fiscal years ending after December 15, 2006. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.

In September 2006, the FASB issued SFAS No. 157 Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, 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. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.

In September 2006, the Securities and Exchange Commission (SEC) released SEC Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, (SAB 108), which addresses how uncorrected errors in previous years should be considered when quantifying errors in current-year financial statements.

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SAB 108 requires registrants to consider the effect of all carry over and reversing effects of prior-year misstatements when quantifying errors in current-year financial statements. SAB 108 does not change the SEC staff s previous guidance on evaluating the materiality of errors. It allows registrants to record the effects of adopting SAB 108 guidance as a cumulative-effect adjustment to retained earnings. This adjustment must be reported in the annual financial statements of the first fiscal year ending after November 15, 2006. The adoption of this standard is not expected to have a material impact on our financial condition, results of operation or liquidity.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which prescribes comprehensive guidelines for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on tax returns. FIN 48, effective for fiscal years beginning after December 15, 2006, seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. We are currently assessing the impact of FIN 48 on our consolidated financial position and results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk from changes in interest rates and foreign currency exchange rates.

Our Credit Facility (see Note 7 to our Consolidated Financial Statements) is a variable rate facility and is subject to market risk from changes in interest rates. Risk can be estimated by measuring the impact of a near-term adverse movement of 10% in short-term market interest rates. If these rates at December 31, 2006 were 10% higher or lower, and if the amount of our debt outstanding as of December 31, 2006 under the Credit Facility had been outstanding for the three and six months ended December 31, 2006, our results of operations would have been approximately $2.3 million and $4.7 million, net of income tax, respectively, lower or higher, respectively.

As of December 31, 2006, there have been no other material changes in our market risk from June 30, 2006. For further information regarding our market risk, refer to our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

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ITEM 4. CONTROLS AND PROCEDURES

Management s Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934) as of December 31, 2006. Disclosure controls and procedures are designed to ensure that information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation our management, including our Chief Executive Officer and Chief Financial Officer, has concluded that our disclosure controls and procedures were operating effectively as of December 31, 2006.

Remediation of Material Weaknesses in Internal Control over Financial Reporting

To remediate the material weaknesses related to the (1) ineffective control environment and (2) ineffective controls over completeness, valuation, presentation and disclosure of stock-based compensation expense as disclosed in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006, we have implemented the following changes in our internal controls:

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

2. Designating internal legal and accounting staffs to oversee the documentation and accounting of all grants of stock options or restricted stock.

3. Adhering to the practice of making annual grants on a date certain and through board or committee meetings, and not through a unanimous written consent process. This process was implemented during the fourth quarter of fiscal 2006 and reported as a change in Internal Control over Financial Reporting within our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006.

Changes in Internal Control over Financial Reporting

There were the following changes in our internal control over financial reporting, during the quarter ended December 31, 2006, that have materially affected or are reasonably likely to materially affect internal control over financial reporting related to the remediation of previously identified material weaknesses:

1. The resignations of the prior Chief Executive Officer and prior Chief Financial Officer have been accepted. Our Board of Directors has since appointed a new Chief Executive Officer and Chief Financial Officer.

2. Designating internal legal and accounting staffs to oversee the documentation and accounting of all grants of stock options or restricted stock.

We have evaluated the design and operating effectiveness of the controls described above, and have concluded that they are both designed and operating effectively as of December 31, 2006. As a result, we have concluded that the material weaknesses related to the (1) ineffective control environment and (2) ineffective controls over completeness, valuation, presentation and disclosure of stock-based compensation expense have been remediated as of December 31, 2006.

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PART II

ITEM 1. LEGAL PROCEEDINGS

Information regarding legal proceedings is incorporated by reference from Note 14 to our consolidated financial statements set forth in Part I of this report.

ITEM 1A. RISK FACTORS

As of the date of filing of this report, there had not been any material changes to the information related to the Item IA. Risk Factors disclosed in our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 filed with the SEC on February 1, 2007.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There were no repurchases on our August 2006 share repurchase plan during the quarter ended December 31, 2006 and therefore our remaining availability under this plan is $1 billion. Please refer to Liquidity and Capital Resources Share Repurchase Programs in Part I. Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations for a discussion of our share repurchase programs.

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs
Inception through September 30, 2006		$		$ 1,000,000,000
October 1 October 31, 2006				1,000,000,000
November 1 November 30, 2006				1,000,000,000
December 1 December 31, 2006				1,000,000,000
Total Quarter ended December 31, 2006				1,000,000,000
Inception through December 31, 2006		$		$ 1,000,000,000

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

On July 6, 2006, we amended our secured term loan facility (Term Loan Facility) under our Credit Agreement dated March 20, 2006 (Credit Facility) and borrowed an additional $500 million on July 6, 2006 and an additional $500 million on August 1, 2006. As a result of the increase to the facility, the Applicable Margin, as defined in the Credit Facility, increased to LIBOR plus 200 basis points. We used the proceeds of the Term Loan Facility increase to finance the purchase of shares of our Class A common stock under our June 2006 authorization and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility.

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

On September 26, 2006, we received an amendment, consent and waiver from the lenders under our Credit Facility with respect to, among other provisions, waiver of any default or event of default arising under the Credit Facility as a result of our failure to comply with certain reporting covenants relating to other indebtedness, including covenants purportedly requiring the filing of reports with either the SEC or the holders of such indebtedness, so long as those requirements are complied with by December 31, 2006. As consideration for this amendment, consent and waiver, we paid a fee of $2.6 million.

On December 21, 2006, we received an amendment, consent and waiver from lenders under our Credit Facility. The amendment, consent and waiver includes the following provisions, among others:

(1) Consent to the delivery, on or prior to February 14, 2007, of (i) the financial statements, accountant s report and compliance certificate for the fiscal year ended June 30, 2006 and (ii) financial statements and related compliance certificates for the fiscal quarters ended June 30, 2006 and September 30, 2006, and waiver of any default arising from the failure to deliver any such financial statements, reports or certificates within the applicable time period provided for in the Credit Agreement, provided that any such failure to deliver resulted directly or indirectly from the previously announced investigation of the Company s historical stock option grant practices (the Options Matter).

(2) Waiver of any default or event of default arising from the incorrectness of representations and warranties made or deemed to have been made with respect to certain financial statements previously delivered to the Agent as a result of any restatement, adjustment or other modification of such financial statements resulting directly or indirectly from the Options Matter.

(3) Waiver of any default or event of default which may arise from the Company s or its subsidiaries failure to comply with reporting covenants under other indebtedness that are similar to those in the Credit Agreement (including any covenant to file any report with the Securities and Exchange Commission or to furnish such reports to the holders of such indebtedness), provided such reporting covenants are complied with on or prior to February 14, 2007.

(4) Amendments to provisions relating to the permitted uses of the proceeds of revolving loans under the Credit Agreement that (i) increase to $500 million from $350 million the aggregate principal amount of revolving loans that may be outstanding, the proceeds of which may be used to satisfy the obligations under the Company s 4.70% Senior Notes due 2010 or 5.20% Senior Notes due 2015 and (ii) until June 30, 2007, decrease to $200 million from $300 million the minimum liquidity (i.e., the aggregate amount of the Company s unrestricted cash in excess of $50 million and availability under the Credit Agreement s revolving facility) required after giving effect to such use of proceeds.

As consideration for this amendment, waiver and consent, we paid a fee of $1.3 million. We filed our Annual Report on Form 10-K/A for the fiscal year ended June 30, 2006 on February 1, 2007 and our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 on January 23, 2007.

Senior Notes

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

On September 29, 2006 we received a letter from the Trustee with respect to the 5.20% Senior Notes. The letter alleged that we were in default of our covenants under the Indenture with respect to the 5.20% Senior Notes, as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. On October 6, 2006, we received a letter from the Trustee declaring an acceleration with respect to the 5.20% Senior Notes as a result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 on or before September 28, 2006. The October 6, 2006 letter declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 5.20% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed in respect of the 5.20% Senior Notes.

In addition, our 4.70% Senior Notes due 2010 (the 4.70% Senior Notes) were also issued under the Indenture and have identical default and acceleration provisions as the 5.20% Senior Notes. On October 9, 2006, we received letters from certain holders of the 4.70% Senior Notes issued by us under the Indenture, advising us that we were in default of our covenants under the Indenture. The letters alleged that our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006 by September 13, 2006, was a default under the terms of the Indenture. On November 9, 10 and 16, 2006, we received letters from CEDE sent on behalf of certain holders of our 4.70% Senior Notes, declaring an acceleration of the 4.70% Senior Notes as the result of our failure to timely file our Annual Report on Form 10-K for the period ending June 30, 2006. The November 9, 10 and 16, 2006 letters declared the principal amount and premium, if any, and accrued and unpaid interest, if any, on the 4.70% Senior Notes to be due and payable immediately, and demanded payment of all amounts owed under the 4.70% Senior Notes.

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It is our position that no default has occurred under the Indenture and that no acceleration has occurred with respect to the 5.20% Senior Notes or the 4.70% Senior Notes (collectively, the Senior Notes) or otherwise under the Indenture. Further we have 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.

On December 19, 2006, we entered into an Instrument of Resignation, Appointment and Acceptance with the Trustee and Wilmington Trust Company (herein so called), whereby the Trustee resigned as trustee, as well as other offices or agencies, with respect to the Senior Notes, and was replaced by Wilmington Trust Company. On January 8, 2007, the Court entered an order substituting Wilmington Trust Company for the Bank of New York. On January 16, 2007, Wilmington Trust Company filed an answer and counterclaim. The counterclaim seeks immediate payment of all principal and accrued and unpaid interest on the Senior Notes. Alternatively, the counterclaim seeks 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 5, 2007, we filed our answer denying Wilmington Trust Company s counterclaim.

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 payoff the Senior Notes, it is most likely that we would utilize the Credit Facility to fund such payoff. Under the terms of the Credit Facility, we can utilize borrowings under the revolving credit 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 $15.1 million ($9.4 million, net of income tax), unamortized deferred financing costs of $2.9 million ($1.8 million, net of income tax) and unamortized discount of $0.6 million ($0.4 million, net of income tax) associated with our Senior Notes as of December 31, 2006 may be adjusted and reported as interest expense in our Consolidated Statement of Income in the period of refinancing or demand.

ITEM 6. EXHIBITS

Reference is made to the Index to Exhibits beginning on page 68 for a list of all exhibits filed as part of this report.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 14th day of February, 2007.

AFFILIATED COMPUTER SERVICES, INC.

By: /s/ John H. Rexford
John H. Rexford
Executive Vice President and
Chief Financial Officer

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
2.1	Stock Purchase Agreement, dated as of July 31, 2003 between Lockheed Martin Corporation and Affiliated Computer Services, Inc. (filed as Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed November 14, 2003 and incorporated herein by reference).
2.2	Asset Purchase Agreement, dated as of July 31, 2003 between Lockheed Martin Service, Inc. and Affiliated Computer Services, Inc. (filed as Exhibit 10.2 to our Quarterly Report on Form 10-Q, filed November 14, 2003 and incorporated herein by reference).
2.3	Purchase Agreement, dated as of March 15, 2005, among Mellon Financial Corporation, Mellon Consultants European Holdings Limited, Affiliated Computer Services, Inc., ACS Business Process Solutions Limited and Affiliated Computer Services of Germany GmbH (filed as Exhibit 2.1 to our Current Report on Form 8-K, filed March 17, 2005 and incorporated herein by reference).
2.4	Amendment No. 1 to Purchase Agreement, dated as of May 25, 2005, among Mellon Financial Corporation, Mellon Consultants European Holdings Limited, Affiliated Computer Services, Inc., ACS Business Process Solutions Limited and Affiliated Computer Services of Germany GmbH (filed as Exhibit 2.1 to our Current Report on Form 8-K, filed June 1, 2005 and incorporated herein by reference).
2.5	Amendment No. 2 to Purchase Agreement, dated as of November 11, 2005, among Mellon Financial Corporation, Mellon Consultants European Holdings Limited, Affiliated Computer Services, Inc., ACS Business Process Solutions Limited and Affiliated Computer Services of Germany GmbH (filed as Exhibit 2.1 to our Current Report on Form 8-K, filed November 16, 2005 and incorporated herein by reference).
3.1	Certificate of Incorporation of Affiliated Computer Services, Inc. (filed as Exhibit 3.1 to our Registration Statement on Form S-3, filed March 30, 2001, File No. 333-58038 and incorporated herein by reference).
3.2	Certificate of Correction to Certificate of Amendment of Affiliated Computer Services, Inc., dated August 30, 2001 (filed as Exhibit 3.2 to our Annual Report on Form 10-K, filed September 17, 2003 and incorporated herein by reference).
3.3	Bylaws of Affiliated Computer Services, Inc., as amended and in effect on September 11, 2003 (filed as Exhibit 3.3 to our Quarterly Report on Form 10-Q, filed February 17, 2004 and incorporated herein by reference).
4.1	Form of New Class A Common Stock Certificate (filed as Exhibit 4.3 to our Registration Statement on Form S-1, filed May 26, 1994, File No. 33-79394 and incorporated herein by reference).
4.2	Amended and Restated Rights Agreement, dated April 2, 1999, between Affiliated Computer Services, Inc. and First City Transfer Company, as Rights Agent (filed as Exhibit 4.1 to our Current Report on Form 8-K, filed May 19, 1999 and incorporated herein by reference).
4.3	Amendment No. 1 to Amended and Restated Rights Agreement, dated as of February 5, 2002, by and between Affiliated Computer Services, Inc. and First City Transfer Company (filed as Exhibit 4.1 to our

Current Report on Form 8-K, filed February 6, 2002 and incorporated herein by reference).

4.4	Form of Rights Certificate (included as Exhibit A to the Amended and Restated Rights Agreement (Exhibit 4.3) filed as Exhibit 4.1 to our Current Report on Form 8-K filed May 19, 1999 and incorporated herein by reference).
4.5	Indenture, dated as of June 6, 2005, by and between Affiliated Computer Services, Inc. as Issuer and The Bank of New York Trust Company, N.A. as Trustee (filed as Exhibit 4.1 to our Current Report on Form 8-K, filed June 6, 2005 and incorporated herein by reference).
4.6	First Supplemental Indenture, dated as of June 6, 2005, by and between Affiliated Computer Services, Inc. as Issuer and The Bank of New York Trust Company, N.A. as Trustee, relating to our 4.70% Senior Notes due 2010 (filed as Exhibit 4.2 to our Current Report on Form 8-K, filed June 6, 2005 and incorporated herein by reference).

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
4.7	Second Supplemental Indenture, dated as of June 6, 2005, by and between Affiliated Computer Services, Inc. as Issuer and The Bank of New York Trust Company, N.A. as Trustee, relating to our 5.20% Senior Notes due 2015 (filed as Exhibit 4.3 to our Current Report on Form 8-K, filed June 6, 2005 and incorporated herein by reference).
4.8	Specimen Note for 4.70% Senior Notes due 2010 (filed as Exhibit 4.4 to our Current Report on Form 8-K, filed June 6, 2005 and incorporated herein by reference).
4.9	Specimen Note for 5.20% Senior Notes due 2015 (filed as Exhibit 4.5 to our Current Report on Form 8-K, filed June 6, 2005 and incorporated herein by reference).
9.1	Voting Agreement dated February 9, 2006 by and between Affiliated Computer Services, Inc. and Darwin Deason. (filed as Exhibit 9.1 to our Quarterly Report on Form 10-Q filed February 9, 2006 and incorporated herein by reference).
10.1	Credit Agreement, dated March 20, 2006, by and among Affiliated Computer Services, Inc., and certain subsidiary parties thereto, as Borrowers, Citicorp USA, Inc., as Administrative Agent, Citigroup Global Markets Inc., as Sole Lead Arranger and Book Runner, and various other agents, lenders and issuers (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.2	Amendment No. 1 to Credit Agreement dated as of March 30, 2006, by and among Affiliated Computer Services, Inc., and certain subsidiary parties thereto, as Borrowers, and Citicorp USA, Inc., as Administrative Agent (filed as Exhibit 10.25 to our Annual Report on Form 10-K, filed January 23, 2007 and incorporated herein by reference).
10.3	Amendment No. 2 to Credit Agreement dated as of July 6, 2006, by and among Affiliated Computer Services, Inc., and certain subsidiary parties thereto, as Borrowers, and Citicorp USA, Inc., as Administrative Agent (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed July 7, 2006 and incorporated herein by reference).
10.4	Amendment No. 3, Consent and Waiver to Credit Agreement, by and among Affiliated Computer Services, Inc., and certain subsidiary parties thereto and Citicorp USA, Inc., as Administrative Agent (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed September 28, 2006 and incorporated herein by reference).
10.5	Amendment No. 4, Consent and Waiver to Credit Agreement, by and among Affiliated Computer Services, Inc., and certain subsidiary parties thereto and Citicorp USA, Inc., as Administrative Agent (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed December 22, 2006 and incorporated herein by reference).
10.6	1997 Stock Incentive Plan for Employees in France (filed as Exhibit 10.35 to our Annual Report on Form 10-K, filed January 23, 2007 and incorporated herein by reference).
10.7	

	Form of Stock Option Agreement (France) (filed as Exhibit 10.36 to our Annual Report on Form 10-K, filed January 23, 2007, and incorporated herein by reference).
10.8	Separation Agreement dated as of November 26, 2006 between Affiliated Computer Services, Inc. and Mark A. King (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed November 27, 2006 and incorporated herein by reference).
10.9	Separation Agreement dated as of November 26, 2006 between Affiliated Computer Services, Inc. and Warren D. Edwards (filed as Exhibit 10.2 to our Current Report on Form 8-K, filed November 27, 2006 and incorporated herein by reference).
31.1*	Certification of Chief Executive Officer of Affiliated Computer Services, Inc. pursuant to Rule 13a-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer of Affiliated Computer Services, Inc. pursuant to Rule 13a-14(a) promulgated under the Securities Exchange Act of 1934, as amended.

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
32.1*	Certification of Chief Executive Officer of Affiliated Computer Services, Inc. pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended and Section 1350 of Chapter 63 of Title 18 of the United States Code. Pursuant to Item 601(b)(32)(ii) of Regulation S-K, this Exhibit is furnished to the SEC and shall not be deemed to be filed.
32.2*	Certification of Chief Financial Officer of Affiliated Computer Services, Inc. pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended and Section 1350 of Chapter 63 of Title 18 of the United States Code. Pursuant to, Item 601(b)(32)(ii) of Regulation S-K this Exhibit is furnished to the SEC and shall not be deemed to be filed.

* Filed herewith.

Management contract or compensatory plan or arrangement.

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