AFFILIATED COMPUTER SERVICES INC
Form 10-Q
May 15, 2001

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

(Mark One)

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

For the quarterly period ended March 31, 2001

OR

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

For the period from __________ to __________

Commission file number 0-24787

AFFILIATED COMPUTER SERVICES, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 51-0310342 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 2828 North Haskell, Dallas, Texas | 75204 |
| (Address of principal executive offices) | (Zip Code) |

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

Not Applicable
(Former name, former address and former fiscal year, if changed since last report.)

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

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

| TITLE OF EACH CLASS | NUMBER OF SHARES OUTSTANDING AS OF APRIL 10, 2001 |
|---|---|

| | |
|---|---|
| Class A Common Stock, $.01 par value | 46,957,148 |
| Class B Common Stock, $.01 par value | 3,299,686 |
| | 50,256,834 |

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

| | MARCH 31, 2001 (UNAUDITED) | JUNE 30, 2000 (AUDITED) |
|---|---|---|

| | | |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 276,214 | $ 44,521 |
| Accounts receivable, net | 456,307 | 399,853 |
| Receivable from divestitures | -- | 180,335 |
| Inventory | 8,540 | 7,324 |
| Prepaid expenses and other current assets | 58,233 | 71,290 |
| Net assets held for sale | -- | 43,362 |
| Deferred taxes | 9,283 | 25,189 |
| Total current assets | 808,577 | 771,874 |
| Property, equipment and software, net | 226,799 | 194,034 |
| Goodwill and other intangibles, net | 729,610 | 650,263 |
| Long-term investments and other assets | 47,145 | 40,275 |
| Total assets | $ 1,812,131 | $ 1,656,446 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 28,788 | $ 47,901 |
| Accrued compensation and benefits | 66,191 | 69,208 |
| Other accrued liabilities | 128,432 | 156,720 |
| Income taxes payable | 12,974 | 60,671 |
| Short-term debt | 2,990 | 2,877 |
| Current portion of unearned revenue | 20,487 | 20,865 |
| Total current liabilities | 259,862 | 358,242 |
| Convertible notes | 546,990 | 230,000 |
| Long-term debt | 103,389 | 295,619 |
| Deferred taxes | 49,902 | 35,316 |
| Other long-term liabilities | 22,964 | 25,892 |
| Total liabilities | 983,107 | 945,069 |
| Stockholders' equity: | | |
| Class A common stock | 468 | 463 |
| Class B common stock | 33 | 33 |
| Additional paid-in capital | 330,866 | 321,525 |
| Retained earnings | 497,655 | 400,200 |
| Accumulated other comprehensive income (net of tax) | 23 | -- |
| | (21) | (10,844) |
| Total stockholders' equity | 829,024 | 711,377 |
| Total liabilities and stockholders' equity | $ 1,812,131 | $ 1,656,446 |

See notes to consolidated financial statements.

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | THREE MONTHS ENDED MARCH 31, | | NINE MONTHS EN[DED] MARCH 31, | |
|---|---|---|---|---|
| | 2001 | 2000 | 2001 | |
| Revenues | $ 533,574 | $ 510,439 | $ 1,513,082 | $ |
| Expenses: | | | | |
| Wages and benefits | 232,220 | 222,635 | 660,851 | |
| Services and supplies | 157,796 | 155,933 | 438,778 | |
| Rent, lease and maintenance | 53,621 | 52,807 | 169,010 | |
| Depreciation and amortization | 24,586 | 23,286 | 68,254 | |
| Other operating expenses | 3,584 | 5,774 | 15,522 | |
| Total operating expenses | 471,807 | 460,435 | 1,352,415 | |
| Operating income | 61,767 | 50,004 | 160,667 | |
| Interest expense | 6,375 | 6,192 | 16,250 | |
| Other non-operating income, net | (2,301) | (2,818) | (16,659) | |
| Pretax profit | 57,693 | 46,630 | 161,076 | |
| Income tax expense | 22,500 | 18,794 | 63,336 | |
| Net income | $ 35,193 | $ 27,836 | $ 97,740 | $ |
| Earnings per common share: | | | | |
| Basic | $ .70 | $ .57 | $ 1.97 | $ |
| Diluted | $ .64 | $ .53 | $ 1.80 | $ |
| Shares used in computing earnings per common share: | | | | |
| Basic | 49,964 | 49,139 | 49,736 | |
| Diluted | 58,673 | 55,658 | 57,245 | |

See notes to consolidated financial statements.

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

| | NINE MONTH MARCH |
|---|---|
| | 2001 |
| Cash flows from operating activities: | |
| Net income | $ 97,740 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | |
| Depreciation and amortization | 68,254 |
| Gain on sale of investment | (12,785) |
| Gain on collection of note receivable | (1,713) |
| Other | 239 |
| Changes in assets and liabilities, net of effects from acquisitions: | |
| Decrease in ATM cash | -- |
| Increase in accounts receivable | (52,729) |
| Increase in inventory | (1,109) |
| (Increase) decrease in prepaid expenses and other current assets | 7,972 |
| Change in deferred taxes | 31,175 |
| (Increase) decrease in other long-term assets | 2,186 |
| Decrease in accounts payable | (21,322) |
| Decrease in accrued compensation and benefits | (2,662) |
| Decrease in other accrued liabilities | (9,962) |
| Increase (decrease) in income taxes payable | (37,815) |
| Increase (decrease) in unearned revenue | (5,476) |
| Increase in other long-term liabilities | 713 |
| Total adjustments | (35,034) |
| Net cash provided by operating activities | 62,706 |
| Cash flows from investing activities: | |
| Purchases of property, equipment and software, net of sales | (68,740) |
| Payments for acquisitions, net of cash acquired | (87,047) |
| Proceeds from divestitures, net of transaction costs | 206,235 |
| Purchase of investments | (500) |
| Proceeds from sale of investment | 17,100 |
| Additions to other intangible assets | (20,743) |
| Additions to notes receivable | (3,229) |
| Proceeds received on notes receivable | 8,913 |
| Other | -- |
| Net cash provided by (used in) investing activities | 51,989 |
| Cash flows from financing activities: | |
| Proceeds from issuance of debt, net of issuance costs | 674,983 |

| | |
|---|---|
| Repayments of debt | (566,089) |
| Proceeds from stock options exercised | 8,400 |
| Net repayment of ATM debt | -- |
| Other, net | (296) |
| Net cash provided by financing activities | 116,998 |
| Net increase (decrease) in cash and cash equivalents | 231,693 |
| Cash and cash equivalents at beginning of period | 44,521 |
| Cash and cash equivalents at end of period | $ 276,214 |

See notes to consolidated financial statements.





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

1. BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Affiliated Computer Services, Inc. and its majority-owned subsidiaries. All material intercompany profits, transactions and balances have been eliminated. We are a Fortune 1000 Company based in Dallas, Texas with operations primarily in North America, as well as Central America, Africa, South America, Europe and the Middle East. We provide business process and technology outsourcing to world class commercial and government clients.

The financial information presented should be read in conjunction with our consolidated financial statements for the year ended June 30, 2000. The foregoing unaudited consolidated financial statements reflect all adjustments (all of which are of a normal recurring nature) which are, in the opinion of management, necessary for a fair presentation of the results of the interim periods. The results for the interim periods are not necessarily indicative of results to be expected for the year. Certain financial statement items from the prior year have been reclassified to conform with current presentation.

2. CONVERTIBLE DEBT OFFERING

On February 21, 2001, we completed the sale of a new issue of $300 million of 3.5% Convertible Subordinated Notes due February 15, 2006 (the "Notes"). The sale of an additional $17 million aggregate Notes pursuant to an overallotment option was completed on March 22, 2001. The Notes are convertible into our Class A common stock at a conversion rate of 11.5117 shares of Class A common stock for each $1,000 principal amount of Notes (equivalent to a conversion price of $86.87 per share of Class A common stock), subject to adjustments in certain events. Interest on the Notes is payable semi-annually on February 15 and August 15 of each year commencing on August 15, 2001. The Notes may be redeemed at our option on or after February 18, 2004, in whole or in part, at the redemption prices set forth in the Notes.

3. HEDGING ACTIVITIES AND COMPREHENSIVE INCOME

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivatives and Hedging Activities". The statement requires us to record all derivatives on the balance sheet at fair value. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of the derivatives are either recognized in earnings or are recognized in other comprehensive income until the hedged item is recognized in earnings. As of March 31, 2001, the fair market value of our interest rate hedge was $37,000 and was recorded in other current assets.

Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income" establishes standards for reporting and display of comprehensive income and its components in the 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.

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

| | THREE MONTHS ENDED MARCH 31, | | NINE MONTHS MARCH 3 | |
|---|---|---|---|---|
| | 2001 | 2000 | 2001 | |
| Net income | $ 35,193 | $ 27,836 | $ 97,740 | $ |
| Change in fair value of derivatives (net of tax effect of ($492) and $15, respectively) | (754) | -- | 23 | |
| Comprehensive income | $ 34,439 | $ 27,836 | $ 97,763 | $ |





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

4. EARNINGS PER SHARE

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

| | THREE MONTHS ENDED MARCH 31, | | NINE MO MA |
|---|---|---|---|
| | 2001 | 2000 | 2001 |

| | | | |
|---|---|---|---|
| Numerator: | | | |
| Numerator for earnings per share (basic) - Income available to common stockholders | $ 35,193 | $ 27,836 | $ 97,740 |
| Effect of dilutive securities: | | | |
| Interest on convertible debt | 2,374 | 1,538 | 5,449 |
| Numerator for earnings per share assuming Dilution - income available to common stockholders | $ 37,567 | $ 29,374 | $103,189 |
| Denominator: | | | |
| Weighted average shares outstanding (basic) | 49,964 | 49,139 | 49,736 |
| Effect of dilutive securities: | | | |
| Convertible debt | 6,915 | 5,392 | 5,892 |
| Stock options | 1,794 | 1,127 | 1,617 |
| Total potential common shares | 8,709 | 6,519 | 7,509 |
| Denominator for earnings per share assuming Dilution | 58,673 | 55,658 | 57,245 |
| Earnings per common share (basic) | $ .70 | $ .57 | $ 1.97 |
| Earnings per common share assuming dilution | $ .64 | $ .53 | $ 1.80 |

5. NON-RECURRING ITEMS

In the first quarter of fiscal 2001, we recorded a $12.8 million gain in other non-operating income related to the sale of a non-strategic minority investment in ACS Merchant Services, Inc. Also during the quarter, we recorded a $10.4 million charge in connection with the termination of certain hardware leases and disaster recovery contracts (reflected in rent, lease and maintenance expense) and a $2.1 million charge for non-recurring litigation costs and the writedown of property held-for-sale (reflected in other operating expense).

In the second quarter of fiscal 2000, we recorded $3.0 million of accelerated expenses in connection with the consolidation of certain business process outsourcing operations. These expenses included approximately $2.6 million related to duplicate software and production facilities (reflected in rent, lease and maintenance expense), $0.2 million of unamortized leasehold improvements and write off of excess equipment (reflected in depreciation and amortization expense) and $0.2 million for severance payments for reductions in staff (reflected in wages and benefits expense).

In January 1999, we sold a business unit of an acquired company to CyberPlus Corporation ("Cyberplus"). As part of the consideration, we received a $3.2 million promissory note due March 2000 and 2.1 million warrants to purchase CyberPlus common stock. Given the financial uncertainty surrounding CyberPlus, the note receivable was fully reserved. In the second quarter of fiscal 2000, CyberPlus obtained financing and repaid $3.0 million on the promissory note, resulting in a $3.0 million gain (reflected in other non-operating income).

6. ACCUMULATED DEPRECIATION AND AMORTIZATION

Property, equipment and software are stated net of accumulated depreciation of $202.1 million and $165.6 million at March 31, 2001 and June 30, 2000, respectively. Additionally, goodwill and other intangibles are stated net of accumulated amortization of $105.6 million and $80.3 million at March 31, 2001 and June 30, 2000, respectively.





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

7. ACQUISITIONS

During December 2000, we acquired Business Resources Corporation, ("BRC"), a subsidiary of Tyler Technologies, Inc. for approximately $70 million in cash, which was funded by our existing credit facility. The acquisition was accounted for under the purchase method of accounting with assets acquired of $76.2 million and liabilities assumed of $6.2 million. BRC's results have been included in our consolidated financial statements from the effective date of the acquisition. BRC is a provider of outsourced records management, document workflow, imaging systems and services to state and local governments. BRC also provides real estate title plant services to title companies.

8. SEGMENT INFORMATION

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

QUARTER ENDED MARCH 31, 2001

| | COMMERCIAL | FEDERAL GOVERNMENT | CORPORATE | CONSOLID |
|---|---|---|---|---|
| Revenue | $343,427 | $190,147 | $ -- | $533,5 |
| Operating expense | 272,347 | 170,627 | 4,247 | 447,2 |
| EBITDA(b) | 71,080 | 19,520 | (4,247) | 86,3 |
| Depreciation & amortization expense excluding goodwill amortization | 15,020 | 2,871 | 483 | 18,3 |
| Goodwill amortization | 5,019 | 1,193 | -- | 6,2 |
| Operating income (loss) | $ 51,041 | $ 15,456 | ($ 4,730) | $ 61,7 |

QUARTER ENDED MARCH 31, 2000

| | COMMERCIAL | FEDERAL GOVERNMENT | CORPORATE | CONSOLIDA |
|---|---|---|---|---|
| Revenue | $351,739(a) | $158,700 | $ -- | $510,4 |
| Operating expense | 287,647 | 145,244 | 4,258 | 437,1 |
| EBITDA(b) | 64,092 | 13,456 | (4,258) | 73,2 |
| Depreciation & amortization expense excluding goodwill amortization | 14,818 | 2,275 | 286 | 17,3 |
| Goodwill amortization | 5,311 | 596 | -- | 5,9 |
| Operating income (loss) | $ 43,963 | $ 10,585 | ($ 4,544) | $ 50,0 |

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(a) Revenue includes $74.7 million for the three months ended March 2000 related to the divestitures announced in June 2000.

(b) EBITDA consist of earnings before interest income, interest expense, other non-operating income and expense, income taxes, depreciation and amortization. EBITDA is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as an alternative to net income as an indicator of a company's performance or to cash flows from operating activities as a measure of liquidity.



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

8. SEGMENT INFORMATION (CONTINUED)

NINE MONTHS ENDED MARCH 31, 2001

| | COMMERCIAL | FEDERAL GOVERNMENT | CORPORATE | C |
|---|---|---|---|---|
| Revenue | $ 959,170(a) | $ 553,912 | $ -- | |
| Operating expense | 773,215(b) | 499,045 | 11,901 | |

| | | | | |
|---|---|---|---|---|
| EBITDA(c) | 185,955 | 54,867 | (11,901) | |
| Depreciation & amortization expense excluding goodwill amortization | 40,692 | 8,353 | 1,196 | |
| Goodwill amortization | 14,505 | 3,508 | -- | |
| Operating income (loss) | $ 130,758 | $ 43,006 | ($ 13,097) | |

NINE MONTHS ENDED MARCH 31, 2000

| | COMMERCIAL | FEDERAL GOVERNMENT | CORPORATE | C |
|---|---|---|---|---|
| Revenue | $ 982,122(a) | $ 452,011 | $ -- | |
| Operating expense | 808,298(d) | 410,778 | 10,121 | |
| EBITDA(c) | 173,824 | 41,233 | (10,121) | |
| Depreciation & amortization expense excluding goodwill amortization | 40,406 | 6,591 | 829 | |
| Goodwill amortization | 14,225 | 1,794 | -- | |
| Operating income (loss) | $ 119,193 | $ 32,848 | ($ 10,950) | |

(a) Revenue includes $7.5 million and $229.0 million for the nine months ended March 31, 2001 and 2000, related to the divestitures announced in June 2000.

(b) Operating expense includes $12.5 million of non-recurring charges related to hardware lease buyouts and disaster recovery contracts, legal fees and a writedown of property held-for-sale to market value (see Note 5).

(c) EBITDA consist of earnings before interest income, interest expense, other non-operating income and expense, income taxes, depreciation and amortization. EBITDA is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as an alternative to net income as an indicator of a company's performance or to cash flows from operating activities as a measure of liquidity.

(d) Operating expense for the nine months ended March 31, 2000 included $3.0 million of accelerated expenses in connection with the consolidation of certain business process outsourcing operations (see Note 5).

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts, included in this MD&A regarding our financial position, business strategy and plans and objectives of our management for future operations are forward-looking statements. These forward-looking statements rely on a number of assumptions concerning future events and are subject to a number of uncertainties and other factors, many of which are outside of our control, that could cause actual results to materially differ from such statements. While we believe that the assumptions concerning future events are reasonable, we caution that there are inherent difficulties in predicting certain important factors, especially the timing and magnitude of technological advances; the performance of recently acquired businesses; the prospects for future acquisitions; the possibility that a current customer could be acquired or otherwise be affected by a future event that would diminish its information technology requirements; the competition in the information technology industry and the impact of such competition on pricing, revenues and margins; the degree to which business entities continue to outsource information technology and business processes; uncertainties surrounding budget reductions or changes in funding priorities or existing government programs; and the cost of attracting and retaining highly skilled personnel.

SIGNIFICANT DEVELOPMENTS

During the fourth quarter of fiscal 2000, we entered into a formal plan to divest certain business units consisting of our ATM processing business and our commercial staffing business due to the fact that these businesses were no longer strategic to our long-term goal of providing information technology and business process outsourcing services. By October 31, 2000, we had completed the sale of and received the proceeds from these divestitures. During the first quarter of fiscal 2001, we recorded a $12.8 million gain in other non-operating income associated with the sale of a non-strategic minority investment in ACS Merchant Services, Inc.

RESULTS OF OPERATIONS

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

| | THREE MONTHS ENDED MARCH 31, | | NINE MONTHS ENDED MARCH 31, | |
|---|---|---|---|---|
| | 2001 | 2000 | 2001 | 2000 |
| Revenues | 100% | 100% | 100% | 100% |
| Expenses: | | | | |
| Wages and benefits | 43.5 | 43.6 | 43.7 | 43.3 |
| Services and supplies | 29.6 | 30.5 | 29.0 | 30.6 |
| Rent, lease and maintenance | 10.0 | 10.4 | 11.2 | 10.7 |
| Depreciation and amortization | 4.6 | 4.6 | 4.5 | 4.5 |
| Other operating expenses | 0.7 | 1.1 | 1.0 | 1.0 |

| | | | | |
|---|---|---|---|---|
| Total operating expenses | 88.4 | 90.2 | 89.4 | 90.1 |
| Operating income | 11.6 | 9.8 | 10.6 | 9.9 |
| Interest expense | 1.2 | 1.2 | 1.1 | 1.2 |
| Other non-operating income, net | (0.4) | (0.6) | (1.1) | (0.6) |
| Pretax profit | 10.8 | 9.2 | 10.6 | 9.3 |
| Income tax expense | 4.2 | 3.7 | 4.2 | 3.7 |
| Net income | 6.6% | 5.5% | 6.4% | 5.6% |





COMPARISON OF THE QUARTER ENDED MARCH 31, 2001 TO THE QUARTER ENDED MARCH 31, 2000

Excluding the third quarter fiscal year 2000 revenue related to the divested units of $74.7 million, revenues increased 22% from $435.7 million to $533.6 million for the third quarter of fiscal 2001. More than two-thirds of the revenue increase, or 15%, was derived from internal growth. Excluding the revenues from the divested units, revenues from our commercial segment increased $66.4 million, or 24%. Internal revenue growth of 20% in the commercial segment was primarily due to growth in new and existing business process outsourcing, technology outsourcing contracts and state Medicaid and Welfare benefit program management contracts. Revenues from our federal government segment increased $31.4 million, or 20%, over the prior year quarter. This growth was comprised of 5% internal growth and 15% from the Intellisource acquisition in the fourth quarter of fiscal 2000.

Operating income increased $11.8 million, or 24% to $61.8 million in the third quarter of fiscal 2001 as compared to the third quarter of fiscal 2000. Operating margins increased to 11.6% in the third quarter of fiscal 2001 from 9.8 % in the third quarter of fiscal 2000 as a result of the divestitures program that was completed in the first quarter of fiscal year 2001. Services and supplies as a percentage of revenue decreased from 30.5% in the third quarter of fiscal year 2000 to 29.6% in the third quarter of fiscal 2001 due to the divestiture of the ATM processing business, which had a large component of interchange fees paid to ATM distributors.

Our effective tax rate of approximately 39.0% in the third quarter of fiscal 2001 exceeded the federal statutory rate of 35%, due primarily to the amortization of certain acquisition-related costs that are non-deductible for tax purposes, plus the net effect of state income taxes.

COMPARISON OF THE NINE MONTHS ENDED MARCH 31, 2001 TO THE NINE MONTHS ENDED MARCH 31, 2000

Excluding revenues related to the divested units ($7.5 million and $229.0 million for the nine months ended March 31, 2001 and 2000 respectively), revenue increased $300.5 million, or 25% over the prior year from $1.21 billion to $1.51 billion. Revenues from our commercial segment increased, excluding the divested units, $198.6 million, or 26% as a result of new customer contracts in state Medicaid and Welfare benefit program management and growth from new and existing business process outsourcing and technology outsourcing contracts. Revenues in our federal government segment increased $101.9 million, or 23%, primarily as a result of the acquisition of Intellisource in the fourth quarter of fiscal year 2000 and growth in tasks performed under Department of Education contracts.

Excluding the $12.5 million and $3.0 million in non-recurring charges in the first nine months of fiscal years 2001 and 2000, respectively (see Note 5), operating margins increased 1.4% from 10.0% to 11.4% in fiscal 2001 as a result of the completed divestiture program completed in the first quarter of fiscal year 2001. Wages and benefits as a percentage of revenue increased from 43.3% to 43.7% as a result of the divestitures, which had a smaller component of wages and benefit expense, and our continued focus on delivering business process outsourcing services, which has a larger component of wages and benefits. Services and supplies as a percentage of revenue decreased from 30.6% to 29.0% as a result of the divestiture of the ATM processing business, which had a large component of interchange fees paid to ATM distributors. After adjusting for the non-recurring charges of $10.4 million in fiscal 2001 and $2.6 million in fiscal 2000, rent, lease and maintenance expense remained relatively constant.

Other non-operating income includes non-recurring gains of $12.8 million and $3.0 million in the nine months ended March 31, 2001 and 2000, respectively (see Note 5). Excluding these gains, other non-operating income decreased as a percentage of revenue from 0.4% to 0.3% primarily due to income earned on the excess cash from the issuance of the February 2001 Convertible Subordinated Notes.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2001, we had cash and cash equivalents totaling $276.2 million compared to $44.5 million at June 30, 2000. Included in the cash balances at March 31, 2001 and June 30, 2000 were $5.6 million and $22.3 million, respectively, of restricted cash held on behalf of governmental customers. Working capital increased to $548.7 million at March 31, 2001 from $413.7 million at June 30, 2000 due primarily to the collection of proceeds from divestitures and the February 2001 convertible notes (see Note 2) offset by the subsequent paydown of long-term debt. We had approximately $341 million available under our credit facility as of March 31, 2001.

Cash flow from operations was $62.7 million for the nine months ended March 31, 2001. However, during the first quarter of fiscal 2001, we paid approximately $49.7 million in income taxes related to the net gain from our divestiture activity and approximately $10.4 million of non-recurring lease termination charges, which are included in cash flows from operations. After adjusting for these items, our net cash provided by operating activities would have been approximately $122.8 million for the nine months ended March 31, 2001. Cash flow from investing activities was $52.0 million primarily due to the collection of proceeds from divestitures offset by the acquisition of BRC in the second quarter of fiscal 2001 (see Note 7). Net cash provided by financing activities was $117.0 million, which was the result of proceeds from issuances of debt, including the February 2001 Convertible Subordinated Notes offering, less paydowns of our credit facility.





We hold two interest rate hedges initiated in December 1998 and expiring in December 2001. Each hedge is structured such that we pay a fixed rate of interest of 4.54% and receive a floating rate of interest based on one month LIBOR. The notional amount of the two hedges totals $100,000,000 and the fair market value of the two hedges at March 31, 2001 was approximately $37,000, which is recorded in other current assets (see Note 3). The fair value of each interest rate hedge reflects termination cash value.

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

NEW ACCOUNTING STANDARDS

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements". SAB 101 provides guidance on the recognition, presentation and disclosure of revenue in financial statements and requires adoption no later than the fourth quarter of fiscal 2001. We do not believe the adoption of SAB 101 will have a material impact on our future earnings and financial position.

## PART II

ITEM 1. LEGAL PROCEEDINGS

On December 16, 1998, a state district court in Houston, Texas entered final judgment against us in a lawsuit brought by twenty-one former employees of Gibraltar Savings Association and/or First Texas Savings Association (collectively, "GSA/FTSA"). The GSA/FTSA employees alleged that they were entitled to the value of 401,541 shares of our stock pursuant to options issued to the GSA/FTSA employees in 1988 in connection with a former data processing services agreement between GSA/FTSA and us. The judgment against us was for approximately $17,000,000, which includes attorneys' fees and pre-judgment interest, but excludes additional attorneys' fees of approximately $850,000 which could be awarded in the event the plaintiffs are successful upon appeal and final judgment. We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs' claims. We filed our appeal of the judgment on March 15, 1999 and are vigorously pursuing the appeal. The plaintiffs also filed a notice of appeal and are pursuing their appeal. Should the proceedings not be favorably resolved on appeal, we would be subject to a material charge.

Government contracts are subject to review and audit by various governmental authorities in the normal course of our business. Cost audits have been completed through fiscal 1998 for a majority of the federal government business operations. In management's opinion, any such reviews and the results of cost audits for subsequent fiscal years will not have a material effect on our financial position or results of operations.

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

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On February 21, 2001, we completed the sale of a new issue of $300 million aggregate principal amount with the option to purchase an additional $50 million aggregate principal amount ("Overallotment Option") of 3.5% Convertible Subordinate Notes due February 15, 2006 (the "Notes"). The sale of an additional $17 million aggregate Notes pursuant to the Overallotment Option was completed on March 22, 2001. The Notes are convertible into Class A common stock at a conversion rate of 11.5117 shares of class A common stock for each $1,000 principal amount of Notes (equivalent to a conversion price of $86.87 per share of Class A common stock), subject to adjustments in certain events. The Notes were sold to Goldman, Sachs & Co. and Bear Stearns & Co. (collectively, the "Purchasers") in a unregistered private placement. The discount to the Purchasers was 2.5% of the $317 million principal amount of the Notes purchased (or an aggregated amount of $7.9 million). We used $65 million of the proceeds from the Notes to pay down our credit facility and we intend to use the remainder for working capital and general corporate purposes, which may include acquisitions.



ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a.) Exhibits.

4.1 Indenture, dated as of February 21, 2001, between Affiliated Computer Service, Inc and U.S. Trust Company of Texas, N.A. relating to the Notes (filed as exhibit 4.1 to the Company's Registration Statement and is incorporated herein by reference).

4.2 Registration Rights Agreement between Affiliated Computer Services, Inc. and Goldman, Sachs, and Co. as representative of the several Purchasers named therein (filed as Exhibit 4.4 to the Company's Form S-3 on March 30, 2001 and incorporated herein by reference).

b.) Reports on Form 8-K.

1. On March 8, 2001, the Company filed a Current Report on Form 8-K announcing executive management changes.

2. On April 4, 2001, the Company filed a Current Report on Form 8-K reporting the sale of a new issue of $317 million aggregate principal amount of 3.5% Convertible Subordinate Notes due February 15, 2006.



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 15th day of May 2001.

AFFILIATED COMPUTER SERVICES, INC.

By: /s/ Warren D. Edwards
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Warren D. Edwards
Executive Vice President and

Chief Financial Officer