Consolidated Communications Holdings, Inc.
Form 10-Q
November 07, 2008

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

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended September 30, 2008

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Transition Period from __________ to __________

Commission File Number 000-51446

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**02-0636095**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

121 South 17th Street
Mattoon, Illinois 61938-3987
(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (217) 235-3311

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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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

The number of shares of the registrant s common stock, $.01 par value, outstanding as of November 3, 2008 was 29,508,873.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

Consolidated Communications Holdings, Inc.
Condensed Consolidated Statements of Income
(Amounts in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenues	$ 103,824	$ 80,320	$ 315,682	$ 244,244
Operating expenses:				
Cost of services and products (exclusive of depreciation and amortization shown separately below)	37,778	27,698	107,749	79,115
Selling, general and administrative expenses	26,162	21,800	81,217	66,395
Depreciation and amortization	22,841	16,350	68,062	49,585
Income from operations	17,043	14,472	58,654	49,149
Other income (expense):				
Interest income	41	253	329	694
Interest expense	(13,637)	(12,118)	(47,963)	(35,420)
Investment income	5,918	1,987	15,125	5,041
Minority interest	(145)	(251)	(550)	(541)
Loss on extinguishment of debt			(9,224)	
Other, net	13	10	(101)	286
Income before income taxes	9,233	4,353	16,270	19,209
Income tax expense	4,262	2,012	7,410	6,756
Net income	$ 4,971	$ 2,341	$ 8,860	$ 12,453
Net income per common share Basic and Diluted	$ 0.17	$ 0.09	$ 0.30	$ 0.48
Cash dividends declared per common share	$ 0.39	$ 0.39	$ 1.16	$ 1.16

See accompanying notes

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Consolidated Communications Holdings, Inc.
Condensed Consolidated Balance Sheets
(Amounts in thousands, except share and per share amounts)

	September 30, 2008 (unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,435	$ 34,341
Accounts receivable, net of allowance of $1,895 and $2,440, respectively	46,325	44,001
Inventories	7,094	6,364
Deferred income taxes	4,632	4,551
Prepaid expenses and other current assets	11,797	10,358
Total current assets	82,283	99,615
Property, plant and equipment, net	396,438	411,647
Intangibles and other assets:		
Investments	94,935	94,142
Goodwill	527,913	526,439
Customer lists, net	129,788	146,411
Tradenames	14,291	14,291
Deferred financing costs and other assets	8,432	12,046
Total assets	$ 1,254,080	$ 1,304,591
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of capital lease obligations	$ 906	$ 1,010
Current portion of pension and postretirement benefit obligations	2,895	8,765
Accounts payable	10,721	17,386
Advance billings and customer deposits	19,728	18,167
Dividends payable	11,366	11,361
Accrued expenses	23,595	28,254
Total current liabilities	69,211	84,943
Capital lease obligations less current portion	581	1,636
Long-term debt	880,000	890,000
Deferred income taxes	98,488	97,289
Pension and postretirement benefit obligations	57,397	56,729
Other liabilities	14,479	14,306
Total liabilities	1,120,156	1,144,903

Minority interest		4,872		4,322
Stockholders equity				
Common stock, $0.01 par value, 100,000,000 shares authorized, 29,511,519 and 29,440,587 issued and outstanding, respectively		295		294
Additional paid in capital		279,568		278,175
Accumulated deficit		(142,852)		(117,452)
Accumulated other comprehensive loss		(7,959)		(5,651)
Total stockholders equity		129,052		155,366
Total liabilities and stockholders equity	$	1,254,080	$	1,304,591

See accompanying notes

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Consolidated Communications Holdings, Inc.
Consolidated Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

	Nine Months Ended September 30, 2008	2007
OPERATING ACTIVITIES		
Net income	$ 8,860	$ 12,453
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	68,062	49,585
Provision for bad debt losses	3,350	3,194
Loss on extinguishment of debt	9,224	
Deferred income tax	(2,961)	(4,114)
Partnership income	(7,650)	(1,667)
Non-cash stock compensation	1,402	2,942
Minority interest in net income of subsidiary	550	541
Amortization of deferred financing costs	1,119	2,507
Changes in operating assets and liabilities:		
Accounts receivable	(5,674)	(5,865)
Inventories	(730)	(359)
Other assets	4,612	(400)
Accounts payable	(6,665)	(3,874)
Accrued expenses and other liabilities	(6,853)	(2,164)
Net cash provided by operating activities	66,646	52,779
INVESTING ACTIVITIES		
Proceeds from sale of investments		10,625
Securities purchased		(10,625)
Capital expenditures	(37,131)	(24,648)
Net cash used in investing activities	(37,131)	(24,648)
FINANCING ACTIVITIES		
Proceeds from issuance of stock		12
Proceeds from long-term obligations	120,000	
Payments made on long-term obligations	(136,337)	
Payment of deferred financing costs	(240)	(320)
Payment of capital lease obligation	(750)	
Purchase and retirement of common stock	(8)	
Dividends on common stock	(34,086)	(30,140)
Net cash used in financing activities	(51,421)	(30,448)
Net decrease in cash and cash equivalents	(21,906)	(2,317)
Cash and cash equivalents at beginning of period	34,341	26,672

Cash and cash equivalents at end of period	$ 12,435	$ 24,355

See accompanying notes

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Consolidated Communications Holdings, Inc.
Condensed Consolidated Statement of Changes in Stockholders Equity
Nine Months Ended September 30, 2008
(Amounts in thousands, except share amounts)
(Unaudited)

	Common Stock		Additional Paid in	Accumulated	Accumulated Other Comprehensive	
	Shares	**Amount**	**Capital**	**Deficit**	**Loss**	**Total**
Balance, January 1, 2008	**29,440,587**	**$ 294**	**$ 278,175**	**$ (117,452)**	**$ (5,651)**	**$ 155,366**
Effects of accounting change regarding postretirement plan measurement dates pursuant to SFAS No. 158:						
Service cost, interest cost, and expected return on plan assets for October 1, 2007 through December 31, 2007, net of ($88) of tax				(154)		(154)
Amortization of prior service cost and net loss for October 1, 2007 through December 31, 2007, net of ($9) of tax				(15)	15	
				(169)	15	(154)
Balance, January 1, 2008 as adjusted	**29,440,587**	**294**	**278,175**	**(117,621)**	**(5,636)**	**155,212**
Net income				8,860		8,860
Dividends on common stock				(34,091)		(34,091)
Shares issued under employee plan, net of forfeitures	71,467					
Non-cash stock compensation		1	1,401			1,402
Purchase and retirement of common stock	(535)		(8)			(8)
Prior service cost and net loss, net of ($169) of tax					(295)	(295)
Change in fair value of cash flow hedges, net of ($1,164) of tax					(2,028)	(2,028)
Balance, September 30, 2008	**29,511,519**	**$ 295**	**$ 279,568**	**$ (142,852)**	**$ (7,959)**	**$ 129,052**

See accompanying notes

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three and nine months ended September 30, 2008 and 2007
(Dollars in thousands, except share and per share amounts)

1. Description of Business

Consolidated Communications Holdings, Inc. and its wholly owned subsidiaries (the Company) operate under the name Consolidated Communications. The Company is an established rural local exchange company (RLEC) providing communications services to residential and business customers in Illinois, Texas and Pennsylvania. With approximately 270,352 local access lines, 74,762 Competitive Local Exchange Carrier (CLEC) access line equivalents, 89,129 digital subscriber lines (DSL) and 15,454 digital television subscribers, the Company offers a wide range of telecommunications services, including local and long distance service, Voice Over Internet Protocol (VOIP) calling, custom calling features, private line services, dial-up and high-speed Internet access, digital TV, carrier access services, network capacity services over our regional fiber optic network, directory publishing and CLEC calling services. The Company also operates a number of complementary businesses, including telemarketing and order fulfillment; telephone services to county jails and state prisons; equipment sales; operator services; and mobile services.

2. Presentation of Interim Financial Statements

These unaudited interim condensed consolidated financial statements include the accounts of Consolidated Communications Holdings, Inc. and its wholly owned subsidiaries and subsidiaries in which it has a controlling financial interest. All material intercompany balances and transactions have been eliminated in consolidation. These interim statements have been prepared in accordance with Securities and Exchange Commission (SEC) guidelines and do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. These interim financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair presentation of its financial position and results of operations for the interim periods. All such adjustments are of a normal recurring nature. Interim results are not necessarily indicative of the results that may be expected for the entire year. These interim financial statements should be read in conjunction with the financial statements and related notes for the year ended December 31, 2007, which were included in our annual report on Form 10-K previously filed with the SEC.

3. Recent Accounting Pronouncements

In June 2008, the Financial Accounting Standards Board, or the FASB, issued FASB Staff Position (FSP) No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities.* This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. Early application of this FSP is prohibited. The Company does not expect any material financial statement impact on future results of operations and financial condition.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (SFAS No. 161), *Disclosure about Derivative Instruments and Hedging Activities an Amendment of FASB Statement No. 133.* SFAS No. 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. SFAS No. 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, have been applied, and the impact that hedges have on an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early adoption encouraged. The Company currently provides information about its hedging activities and use of derivatives in its quarterly and annual filings with the SEC, including many of the disclosure requirements contained within SFAS No. 161. The Company is currently evaluating the impact, if any, of adopting SFAS No. 161 on the Company s disclosures. SFAS No. 161 will have no impact on the Company s future results of operations and financial condition.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160 (SFAS No. 160), *Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51.* SFAS No. 160 clarifies that a noncontrolling interest in a consolidated subsidiary should be reported as equity in the consolidated financial statements. It also requires consolidated net income to include the amounts attributable to both the parent and the noncontrolling interest. The Company is required to adopt SFAS No. 160 on January 1, 2009 and is currently evaluating the impact of adopting SFAS No. 160 on its future results of operations and financial condition.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007) (SFAS No. 141 (R)), *Business Combinations.* SFAS No. 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any non-controlling interest at their fair values as of the acquisition date. SFAS No. 141(R) also requires, among other things, that acquisition-related costs be recognized separately from the acquisition. The Company is required to adopt SFAS No. 141(R) effective January 1, 2009. SFAS No. 141(R) will generally impact acquisitions made after the date of adoption.

4. Marketable Securities

In the second quarter of 2007, the Company acquired $10,625 of investments in auction rate securities which were considered available-for-sale under SFAS No. 115. These securities were sold in the third quarter of 2007 with no gain or loss to the Company.

5. Acquisition

On December 31, 2007, the Company acquired all of the capital stock of North Pittsburgh Systems, Inc. (North Pittsburgh). By acquiring all of the capital stock of North Pittsburgh, the Company acquired an RLEC that serves portions of Allegheny, Armstrong, Butler and Westmoreland Counties in western Pennsylvania; a CLEC company that serves small to mid-sized business customers in Pittsburgh and its surrounding suburbs as well as in Butler County; an Internet Service Provider that furnishes broadband services in western Pennsylvania; and minority interests in three cellular partnerships and one competitive access provider. The results of operations for North Pittsburgh are included in the Company s telephone operations segment for December 31, 2007 and thereafter.

The Company accounted for the North Pittsburgh acquisition using the purchase method of accounting. Accordingly, the financial statements reflect the allocation of the total purchase price to the net tangible and intangible assets acquired based on their respective fair values. At the time of the acquisition, 80% of the shares of North Pittsburgh converted into the right to receive $25.00 per share in cash and each of the remaining shares of North Pittsburgh common stock converted into the right to receive 1.1061947 shares of common stock of the Company, or 3,318,480 shares of stock valued at $74,398, net of issuance fees. The total purchase price, including acquisition costs and net of $32,902 of cash acquired, is being allocated according to the following table which summarizes the preliminary, estimated fair values of the North Pittsburgh assets acquired and liabilities assumed:

Current assets	$	17,729
Property, plant and equipment		116,308
Customer list		49,000
Goodwill		215,863
Investments and other assets		53,360
Liabilities assumed		(105,349)
Net purchase price	$	346,911

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Because of the proximity of this transaction to year-end, the values of certain assets and liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Adjustments of $1,474 were made to goodwill during the period ended September 30, 2008. The adjustments consist of $333 in additional acquisition costs incurred, a $333 adjustment to the capital lease liability and $808 for income tax liability adjustments.

The aggregate purchase price was determined through a negotiated bid and was influenced by the Company s assessment of the value of the overall North Pittsburgh business. The significant goodwill value reflects the Company s view that the North Pittsburgh business can generate strong cash flow, and sales and earnings following the acquisition. All of the goodwill recorded as part of this acquisition was allocated to the telephone operations segment.

In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets,* the $215,863 in goodwill recorded as part of the North Pittsburgh acquisition is not being amortized, but will be tested for impairment at least annually. The customer list is being amortized over its estimated useful life of 5 years. The goodwill and other intangibles associated with this acquisition did not qualify under the Internal Revenue Code as deductible for tax purposes.

Because the acquisition occurred on December 31, 2007, the Company s results of operations for the three and nine months ended September 30, 2007 do not include North Pittsburgh. Unaudited pro forma results of operations data for the three and nine months ended September 30, 2007 as if the acquisition had occurred at the beginning of the period presented are as follows:

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Total revenues	$ 103,971	$ 316,632
Income from operations	$ 14,540	$ 45,749
Net income	$ 1,539	$ 6,682
Income per share basic	$ 0.05	$ 0.23
Income per share diluted	$ 0.05	$ 0.23

6. Goodwill and Customer Lists

The following table summarizes the carrying value of goodwill by segment:

	September 30, 2008	December 31, 2007
Telephone Operations	$ 520,729	$ 519,255
Other Operations	7,184	7,184
	$ 527,913	$ 526,439

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The Company s customer lists consist of an established core base of customers that subscribe to its services. The carrying amount of customer lists is as follows:

	September 30, 2008	December 31, 2007
Gross carrying amount	$ 205,648	$ 205,648
Less: accumulated amortization	(75,860)	(59,237)
Net carrying amount	$ 129,788	$ 146,411

The aggregate amortization expense associated with customer lists was $5,540 and $3,209 for the three months ended September 30, 2008 and 2007, respectively and was $16,623 and $9,651 for the nine months ended September 30, 2008 and 2007, respectively. Customer lists are being amortized on a straight-line basis using a weighted average life of approximately 10 years.

7. Summarized Financial Information for Significant Investments

In connection with the North Pittsburgh Acquisition, the Company acquired a 23.67% ownership of Pennsylvania RSA 6(II) wireless limited partnership (the RSA 6(II)). The principal activity of the RSA 6(II) is providing cellular service to territories that overlap the majority of the markets served by the Company s North Pittsburgh wireline operations. The Company accounts for this investment on the equity basis. Unaudited summarized income statement information for the RSA 6(II) was as follows:

	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2008
Total revenues	$ 27,639	$ 79,569
Income from operations	$ 5,673	$ 16,886
Income before income taxes	$ 5,699	$ 17,038
Net income	$ 5,699	$ 17,038

8. Pension Costs and Other Postretirement Benefits

The Company has several tax-qualified defined benefit pension plans covering substantially all of its hourly employees and certain salaried employees. The plans provide retirement benefits based on years of service and earnings. The pension plans are generally noncontributory. The Company s funding policy is to contribute amounts sufficient to meet the minimum funding requirements as set forth in employee benefit and tax laws. The Company also has a qualified supplemental pension plan (Restoration Plan) covering certain former North Pittsburgh employees. The Restoration Plan restores benefits that are precluded under the pension plan by Internal Revenue Service limits on compensation and benefits applicable to qualified pension plans and by the exclusion of bonus compensation from the pension plan s definition of earnings.

The Company currently provides other postretirement benefits (Other Benefits) consisting of health care and life insurance benefits for certain groups of retired employees. Retirees share in the cost of health care benefits. Retiree contributions for health care benefits are adjusted periodically based upon either collective bargaining agreements for former hourly employees or as total costs of the program change for former salaried employees. The Company s funding policy for retiree health benefits is generally to pay covered expenses as they are incurred. Postretirement life insurance benefits are fully insured.

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The following tables present the components of net periodic benefit cost:

	Pension Benefits		Other Benefits	
	2008	2007	2008	2007
Three months ended September 30,				
Service cost	$ 498	$ 672	$ 170	$ 119
Interest cost	2,837	3,204	552	294
Expected return on plan assets	(3,008)	(3,540)		
Other, net	4	(62)	(184)	65
Net periodic benefit cost	$ 331	$ 274	$ 538	$ 478
Nine months ended September 30,				
Service cost	$ 1,590	$ 1,362	$ 675	$ 558
Interest cost	8,449	5,544	1,815	1,064
Expected return on plan assets	(9,518)	(6,007)		
Other, net	14	19	(478)	(430)
Net periodic benefit cost	$ 535	$ 918	$ 2,012	$ 1,192

For the three months ending September 30, 2008 and 2007, the Company contributed $96 and $4,164 to its tax-qualified pension plans, respectively. For the nine months ended September 30, 2008 and 2007, the Company contributed $215 and $4,760 to these pension plans, respectively. No further contributions are expected for 2008. Contributions to the Restoration Plan are made on a pay-as-you go basis, with total contributions of $5,873 having been made during the nine months ended September 30, 2008.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158 (SFAS No. 158), *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.* SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. The Company was required to adopt the recognition provisions of SFAS No. 158 effective December 31, 2006; however, the requirement to measure plan assets and benefit obligations as of the date of the Company s fiscal year end is required to be effective as of December 31, 2008. Upon combining the Texas and Illinois pension plans on December 31, 2007, the Company adopted the measurement date provisions of SFAS No. 158 effective January 1, 2008 for pension and postretirement plans with measurement dates other than December 31. The impact of the adoption of the measurement date provisions resulted in an increase to opening accumulated deficit on January 1, 2008 of $169 net of tax of $97.

9. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2008	December 31, 2007
Senior Secured Credit Facility		
Revolving loan	$	$
Term loan	880,000	760,000
Obligations under capital lease	1,487	2,646
Senior notes		130,000
	881,487	892,646
Less: current portion	(906)	(1,010)
	$ 880,581	$ 891,636

In connection with the acquisition of North Pittsburgh on December 31, 2007, the Company, through its wholly-owned subsidiaries, entered into a credit agreement with various financial institutions, which provides for borrowings of up to $950,000 consisting of a $760,000 term loan facility, a $50,000 revolving credit facility, which was fully available as of September 30, 2008, and a $140,000 delayed draw term loan facility (DDTL). The DDTL s sole purpose was for the funding of the redemption of the Company s outstanding senior notes plus any associated fees or redemption premium. As described below, the Company borrowed $120,000 under the DDTL on April 1, 2008, at which time the commitment for the remaining $20,000 that was originally available under the DDTL expired. Other borrowings under the credit facility were used to retire the Company s previous $464,000 credit facility and to fund the acquisition of North Pittsburgh. Borrowings under the credit facility are the Company s senior, secured obligations that are secured by substantially all of the assets of the Company and its subsidiaries with the exception of Illinois Consolidated Telephone Company. The term loan and DDTL have no interim principal maturities and thus mature in full on December 31, 2014. The revolving credit facility matures on December 31, 2013.

At the Company s election, all borrowings under the credit facilities bear interest at a rate equal to an applicable margin plus either a base rate or LIBOR. The applicable margin for the term loan is fixed at 2.50% for LIBOR based borrowings and 1.50% for alternative base rate loans. The applicable margin for the revolving credit facility is based upon the Company s total leverage ratio. As of September 30, 2008, the applicable margin for interest rates was 2.50% on LIBOR based revolving credit facility borrowings and the applicable margin for alternative base rate loans was 1.50% per year for the revolving credit facility. At September 30, 2008 and 2007, the weighted average rate of interest on the Company s credit facilities, including the effect of interest rate swaps and the applicable margin, was 6.91% and 6.33% per annum, respectively. Interest is payable at least quarterly.

The credit agreement contains various provisions and covenants, which include, among other items, restrictions on the ability to pay dividends, incur additional indebtedness, and issue capital stock, as well as limitations on future capital expenditures. The Company has also agreed to maintain certain financial ratios, including interest coverage and total net leverage ratios, all as defined in the credit agreement. As of September 30, 2008, the Company was in compliance with the credit agreement covenants.

On April 1, 2008, the Company redeemed all of the outstanding senior notes. The total amount of the redemption was $136,337 including a call premium of $6,337. The senior note redemption and payment of accrued interest through the redemption date was funded using $120,000 of borrowings on the DDTL together with cash on hand. The Company recognized a loss on extinguishment of debt of $9,224 related to the redemption premium and the write-off of unamortized deferred financing costs.

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10. Derivative Instruments

The Company maintains interest rate swap agreements that are accounted for as cash flow hedges and effectively convert a portion of its floating-rate debt to a fixed-rate basis, thus reducing the impact of interest rate changes on future interest expense. As of September 30, 2008 the Company had $790.0 million of notional amount floating to fixed interest rate swap agreements. Approximately 89.8% of the floating rate term loans were fixed as of September 30, 2008. The swaps expire at various times from December 31, 2008 through March 31, 2013. The swaps are designated as cash flow hedges of our expected future interest payments. Under the swap agreements, the Company receives 3-month LIBOR based interest payments from the swap counterparties and pays a fixed rate. In addition, in September 2008 the Company added $790,000 of basis swaps under which it pays 3-month LIBOR based payments less a fixed percentage to the basis swap counterparties and receives 1-month LIBOR. Upon entering into the swaps the Company began utilizing 1-month LIBOR resets on its credit facility. The effect of the swap portfolio is to fix the cash interest payments on the floating portion of $790,000 million of debt at a rate of 4.49%.

The fair value of the Company s derivative instruments, comprised solely of its interest rate swaps and basis swaps, amounted to liabilities of $13,556 and $12,769 at September 30, 2008 and December 31, 2007, respectively. The fair value is included in Other Liabilities in the accompanying Balance Sheets. The change in the fair value of derivative instruments, net of related tax effect, is recorded in Other Comprehensive Loss. The Company recognized comprehensive loss of $2,150 and $5,372 during the three months ended September 30, 2008 and 2007, respectively and $2,028 and $3,519 for the nine months ended September 30, 2008 and 2007, respectively.

In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings during the same period in which the hedged item affects earnings. The change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings. To further reduce potential future income statement impacts from hedge ineffectiveness, the Company dedesignated its interest rate contracts and redesignated them as of September 4, 2008, contemporaneously with entering into the basis swaps. Included in the interest expense for the three and nine months ended September 30, 2008 was a non-cash credit of $2,406 for the ineffective portion of the Company s cash flow hedges.

11. Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements.* SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company has adopted the provisions of SFAS No. 157 as of January 1, 2008, for financial instruments that are required to be measured at fair value on a recurring basis. Although the adoption of SFAS No. 157 did not materially impact the results of operations or financial condition, the Company is now required to provide additional disclosures as part of its financial statements.

SFAS No. 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of September 30, 2008, the Company s derivative instruments related to interest rate swap agreements are required to be measured at fair value on a recurring basis. The fair values of the interest rate swaps are determined using an internal valuation model which relies on the expected LIBOR based yield curve and estimates of counterparty and the Company s non performance risk as the most significant inputs. Certain material inputs to the valuations are not directly observable and cannot be corroborated by observable market data. The Company has categorized these interest rate derivatives as Level 3.

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The Company s net liabilities measured at fair value on a recurring basis subject to disclosure requirements of SFAS No. 157 at September 30, 2008 were as follows:

		Fair Value Measurements at Reporting Date Using		
Description	September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest Rate Derivatives	$ 13,556	$	$	$ 13,556

The following table presents the Company s net liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined in SFAS No. 157 at September 30, 2008:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Interest Rate Derivatives
Balance at December 31, 2007	$ 12,769
Total gains or losses (realized/unrealized)	
Unrealized gain included in earnings	(2,406)
Unrealized loss included in other comprehensive loss from basis swap	184
Unrealized loss included in other comprehensive income	3,009
Balance at September 30, 2008	$ 13,556
The amount of total gain for the period included in earnings for the period as a component of interest expense	$ 2,406

12. Restricted Share Plan

The following table summarizes restricted stock activity:

Restricted shares outstanding, December 31, 2007	129,302
Shares granted	71,467
Shares vested	(4,500)
Shares forfeited or retired	
Restricted shares outstanding, September 30, 2008	196,269

The Company recognized non-cash compensation expense associated with the restricted shares totaling $542 and $1,236 for the three months ended September 30, 2008 and 2007, respectively and $1,402 and $2,942 for the nine months ended September 30, 2008 and 2007, respectively. The shares granted in the nine months ended September 30, 2008 includes 14,750 restricted shares granted to certain key employees and directors as well as 56,717 performance based restricted shares. The performance based restricted shares were granted to key employees based upon the Company achieving certain financial and operating targets for 2007 based on a sliding scale. In March 2008, a target of 64,447 performance based restricted shares was approved for issuance in the first quarter of 2009 based upon meeting operational and financial goals in 2008. The non-cash compensation expense is included in Selling, general and administrative expenses in the accompanying statements of income.

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13. Contingencies

On October 23, 2006, Verizon Pennsylvania, Inc., along with a number of its affiliated companies, filed a formal complaint with the Pennsylvania Public Utility Commission (PAPUC) claiming that the Company s Pennsylvania CLEC s intrastate switched access rates are in violation of Pennsylvania statute. The provision that Verizon cites in its complaint was enacted as part of Act 183 of 2004 and requires CLEC rates to be no higher than the corresponding incumbent s rates unless the CLEC can demonstrate that the higher access rates are cost justified. Verizon s original claim requested a refund of $480 from access billings through August 2006. In a letter dated January 30, 2007, Verizon notified the Company s Pennsylvania CLEC that it was revising its complaint to reflect a more current alleged over-billing calculation which resulted in a revised claim of $1,346 through December 2006, which claim includes amounts from certain affiliates that had not been included in the original calculation. The Company believes that its CLEC s switched access rates are permissible, and is in the process of vigorously opposing this complaint. In an Initial Decision dated December 5, 2007, the presiding administrative law judge (ALJ) recommended that the PAPUC sustain Verizon s complaint. As relief, the ALJ directed that the Company s Pennsylvania CLEC reduce its access rates down to those of the underlying incumbent exchange carrier and provide a refund to Verizon in an amount equal to the amount of access charges collected in excess of the new rate since November 30, 2004, the date Act 183 became effective. The Company filed exceptions to the full PAPUC and the Chairman agreed in part in August 2008 and requested that Verizon and the Company go to mediation to resolve the issue. The Company and Verizon have until November 29, 2008 to complete the mediation.

In the event the Company is not successful in this proceeding, the Pennsylvania CLEC s operations could be materially adversely impacted by not only the refund sought by Verizon but more importantly by the prospective decreases in access revenues resulting from the change in its intrastate access rates, which would apply to all carriers on a non-discriminatory basis. The Company preliminarily estimates that the decrease in our annual revenues would be approximately $1,200 on a static basis (meaning keeping access minutes of use constant) if Verizon prevails completely in its complaint. In addition, other interexchange carriers could file similar claims for refunds. The Company has estimated its potential liability to Verizon and other interexchange carriers to be $3,000 and has recorded a liability that is included in Other Liabilities in the accompanying consolidated Balance Sheets. The Company believes that the amount accrued is adequate to cover its potential liabilities.

14. Income Taxes

The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of Financial Accounting Standards Board Statement No. 109* (FIN 48), effective January 1, 2007, with no impact on its results of operations or financial condition. During the nine months ended September 30, 2008, there was a net decrease of $290 to the balance of unrecognized tax benefits reported at December 31, 2007. This net decrease includes a decrease of $562 due to the expiration of federal and state statutes of limitations and an increase of $272 related to the 2007 income tax filings. As of September 30, 2008 and December 31, 2007, the amount of unrecognized tax benefits was $5,740 and $6,030, respectively. The total amount of unrecognized benefits that, if recognized, would affect the effective tax rate is $0. No additional changes in unrecognized tax benefits are expected in the remainder of 2008. The tax benefit attributable to $236 of the decrease in unrecognizable tax benefits resulted in a reduction to the Company s effective tax rate. An additional decrease of $326 and an increase of $272 in unrecognized tax benefits had no effect on the effective tax rate.

The Company is continuing its practice of recognizing interest and penalties related to income tax matters in interest expense and general and administrative expense, respectively. Upon adoption of FIN 48 the Company had no accrual balance for interest and penalties. For the quarter ended September 30, 2008, the Company had accrued $538 of interest and penalties of which $234 was recorded during the nine months ended Sept 30, 2008 and $91 was recorded during the nine months ended September 30, 2007. The only periods subject to examination for the Company s federal return are the 2005 through 2007 tax years. The periods subject to examination for the Company s state returns are years 2004 through 2007. The Company is currently under examination by both federal and state tax authorities. The Company does not expect that any settlement or payment that may result from the audits will have a material effect on the Company s results of operations or cash flows. The Company does not anticipate that the total unrecognized tax benefits will significantly change due to the settlement of audits and the expiration of statute of limitations in the next twelve months. There were no material changes to any of these amounts during the third quarter of 2008.

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The Company s effective tax rate was 45.5% and 35.2%, for the nine months ended September 30, 2008 and 2007, respectively. The effective tax rate differs from the federal and state statutory rates primarily due to non-deductible expenses.

The Company s effective tax rate was 46.2% and 46.2%, for the three months ended September 30, 2008 and 2007, respectively. The effective tax rate differs from the federal and state statutory rates primarily due to non-deductible expenses.

During the third quarter of 2008, the Company completed and filed 2007 tax returns for Consolidated Communications Holdings, Inc. and Subsidiaries and North Pittsburgh Systems, Inc. and Subsidiaries. The Company recognized approximately $200 of tax benefit to adjust its provision to match the returns.

During the third quarter of 2007, the Company completed and filed its 2006 tax return, filed amended returns for 2005, and recognized approximately $40 of additional net taxes to adjust its provision to match the returns. During the second quarter of 2007, the State of Texas amended the tax legislation enacted during the second quarter of 2006. The most significant impact of this amendment on the Company was the revision to the temporary credit on taxable margin. This new legislation resulted in a reduction of the Company s net deferred tax liabilities and a corresponding credit to its tax provision of approximately $1,728. Exclusive of these adjustments, the effective tax rate would have been approximately 45% and 44% for the three and nine months ended September 30, 2007, respectively.

15. Net Income per Common Share

The following table sets forth the computation of net income per common share:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Basic:				
Net income	$ 4,971	$ 2,341	$ 8,860	$ 12,453
Weighted average number of common shares outstanding	29,315,250	25,758,289	29,315,005	25,757,746
Net income per common share	$ 0.17	$ 0.09	$ 0.30	$ 0.48
Diluted:				
Net income	$ 4,971	$ 2,341	$ 8,860	$ 12,453
Weighted average number of common shares outstanding	29,529,487	26,144,943	29,519,578	26,102,020
Net income per common share	$ 0.17	$ 0.09	$ 0.30	$ 0.48

Non-vested shares issued pursuant to the Restricted Share Plan (see Note 12) were considered outstanding for the computation of diluted net income per share as the recipients are entitled to dividends and voting rights.

In accordance with SFAS No. 128, *Earnings per Share,* 17,968 contingent performance based shares were included in the weighted average diluted shares based on the Company s results through the nine months ended September 30, 2008.

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16. Comprehensive Income

The following table presents the components of comprehensive income:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net income	$ 4,971	$ 2,341	$ 8,860	$ 12,453
Other comprehensive income (loss):				
Prior service cost and net loss, net of tax	(115)		(295)	
Change in fair value of cash flow hedges, net of tax	(2,150)	(5,372)	(2,028)	(3,519)
Total comprehensive income	$ 2,706	$ (3,031)	$ 6,537	$ 8,934

17. Business Segments

The Company is viewed and managed as two separate, but highly integrated, reportable business segments, Telephone Operations and Other Operations. Telephone Operations consists of a wide range of telecommunications services, including local and long distance service, VOIP service, custom calling features, private line services, dial-up and high speed Internet access, digital TV, carrier access services, network capacity services over our regional fiber optic network, and directory publishing. The Company also operates a number of complementary businesses that comprise Other Operations, including telemarketing and order fulfillment, telephone services to county jails and state prisons, equipment sales, operator services, and mobile services. Management evaluates the performance of these business segments based upon revenue, gross margins, and net operating income.

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Operating revenues				
Telephone Operations	$ 94,323	$ 70,052	$ 284,934	$ 213,570
Other Operations	9,501	10,268	30,748	30,674
Total	$ 103,824	$ 80,320	$ 315,682	$ 244,244
Operating income (loss)				
Telephone Operations	$ 17,204	$ 15,267	$ 58,804	$ 51,505
Other Operations	(161)	(795)	(150)	(2,356)
Total	17,043	14,472	58,654	49,149
Interest income	41	253	329	694
Interest expense	(13,637)	(12,118)	(47,963)	(35,420)
Investment income	5,918	1,987	15,125	5,041
Minority interest	(145)	(251)	(550)	(541)
Loss on extinguishment of debt			(9,224)	
Other, net	13	10	(101)	286
Income before income taxes	$ 9,233	$ 4,353	$ 16,270	$ 19,209

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

We present below Management s Discussion and Analysis of Financial Condition and Results of Operations of Consolidated Communications Holdings, Inc. and its subsidiaries on a consolidated basis. The following discussion should be read in conjunction with our historical financial statements and related notes contained elsewhere in this Report.

Consolidated Communications or the Company refers to Consolidated Communications Holdings, Inc. alone or with its wholly owned subsidiaries, as the context requires. When this report uses the words we, our, or us, they refer to the Company and its subsidiaries.

Forward-Looking Statements

Any statements contained in this Report that are not statements of historical fact, including statements about our beliefs and expectations, are forward-looking statements and should be evaluated as such. The words anticipates , believes , expects , intends , plans , estimates , targets , projects , should , may , will and similar words intended to identify forward-looking statements. These forward-looking statements are contained throughout this Report, including, but not limited to, statements found in this Part I Item 2 - Management s Discussion and Analysis of Financial Condition and Results of Operations , Part I - Item 3 Quantitative and Qualitative Disclosures about Market Risk and Part II Item 1 Legal Proceedings . Such forward-looking statements reflect, among other things, our current expectations, plans, strategies, and anticipated financial results and involve a number of known and unknown risks, uncertainties, and factors that may cause our actual results to differ materially from those expressed or implied by these forward-looking statements, including but not limited to:

- various risks to stockholders of not receiving dividends and risks to our ability to pursue growth opportunities if we continue to pay dividends according to our current dividend policy;
- various risks to the price and volatility of our common stock;
- our substantial amount of debt and our ability to incur additional debt in the future;
- our need for a significant amount of cash to service and repay our debt and to pay dividends on our common stock;
- restrictions contained in our debt agreements that limit the discretion of our management in operating our business;
- the ability to refinance our existing debt as necessary;
- rapid development and introduction of new technologies and intense competition in the telecommunications industry;
- risks associated with our possible pursuit of future acquisitions;
- the integration of the Company and North Pittsburgh;
- the length and severity of weakened economic conditions in our service areas in Illinois, Texas and Pennsylvania;
- adverse changes in the value of assets or obligations associated with our employee benefit plans;
- system failures;
- loss of large customers or government contracts;

risks associated with the rights-of-way for our network;

disruptions in our relationship with third party vendors;

loss of key management personnel and the inability to attract and retain highly qualified management and personnel in the future;

changes in the extensive governmental legislation and regulations governing telecommunications providers, the provision of telecommunications services and access charges and subsidies, which are a material part of our revenues;

telecommunications carriers disputing and/or avoiding their obligations to pay network access charges for use of our network;

high costs of regulatory compliance;

the competitive impact of legislation and regulatory changes in the telecommunications industry;

liability and compliance costs regarding environmental regulations; and

the additional risk factors outlined in Part II Other Information Item 1A Risk Factors herein and in Part I Item 1A Risk Factors incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, and the other documents that we file with the SEC from time to time that could cause our actual results to differ from our current expectations and from the forward-looking statements discussed in this Report.

Many of these risks are beyond our ability to control or predict. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained throughout this Report. Because of these risks, uncertainties, and assumptions, you should not place undue reliance on these forward-looking statements. Furthermore, forward-looking statements speak only as of the date they are made. Except as required under the federal securities laws or the rules and regulations of the SEC, we do not undertake any obligation to update or review any forward-looking information, whether as a result of new information, future events or otherwise.

Overview

We are an established rural local exchange company that provides communications services to residential and business customers in Illinois, Texas and Pennsylvania. Our main sources of revenues are our local telephone businesses which offer an array of services, including local dial tone, Voice Over Internet Protocol (VOIP) service, custom calling features, private line services, long distance, dial-up and high-speed Internet access, which we refer to as Digital Subscriber Line or DSL, inside wiring service and maintenance, carrier access, billing and collection services, telephone directory publishing, Internet Protocol digital video service, which we refer to as IPTV, wholesale transport services on a fiber optic network in Texas and Competitive Local Exchange Carrier (CLEC) services in close proximity to our primary service territory in Pennsylvania. We also operate a number of complementary businesses, which offer telephone services to county jails and state prisons, operator services, equipment sales and telemarketing and order fulfillment services.

Acquisition of North Pittsburgh and New Credit Facility

On December 31, 2007, we completed our acquisition of North Pittsburgh Systems, Inc., pursuant to an Agreement and Plan of Merger, dated as of July 1, 2007. At the effective time of the Merger, 80% of the shares of North Pittsburgh common stock converted into the right to receive $25.00 in cash, without interest, per share, for an approximate total of $300.1 million in cash, and each of the remaining shares of North Pittsburgh common stock converted into the right to receive 1.1061947 shares of our common stock or an approximate total of 3.32 million shares of our common stock. The total purchase price, including fees, was $346.9 million, net of cash acquired.

In connection with the acquisition, we entered into a new credit facility that provides for:

a $50.0 million revolving credit facility that is currently undrawn;

a $760.0 million term loan, the proceeds of which were drawn at closing of the acquisition; and a delayed draw term loan (DDTL) in the amount of up to $140.0 million which was available to us until May 1, 2008, a portion of the proceeds of which were used for the purpose of redeeming our $130.0 million of outstanding senior notes along with the payment of any accrued interest and fees, as described below under Redemption of Senior Notes.

Proceeds from the term loan along with cash on hand were used to:

pay off our previous credit facility of $464.0 million plus accrued interest;

fund the cash portion of the acquisition; and

pay fees and expenses related to the acquisition and new financing.

Redemption of Senior Notes

On April 1, 2008, we redeemed all of our outstanding senior notes. The total amount of the redemption was $136.3 million including a call premium of $6.3 million. The senior note redemption and the payment of accrued interest through the redemption date was funded using $120.0 million of borrowings on the DDTL together with cash on hand. In the second quarter of 2008, we recognized a charge of $9.2 million related to the redemption premium and the write-off of unamortized deferred financing costs in connection with the redemption.

Factors Affecting Results of Operations

Revenues

Telephone Operations and Other Operations. To date, our revenues have been derived primarily from the sale of voice and data communications services to residential and business customers in our rural telephone companies service areas. We do not anticipate significant growth in revenues in our Telephone Operations segment due to its primarily rural service area, except through acquisitions such as that of North Pittsburgh, but we do expect relatively consistent cash flow from year-to-year due to stable customer demand, limited competition in the majority of our territories and a generally supportive regulatory environment.

Local Access Lines and Bundled Services. Local access lines are an important element of our business. An access line is the telephone line connecting a person s home or business to the public switched telephone network. The monthly recurring revenue we generate from end users, the amount of traffic on our network and related access charges generated from other carriers, the amount of federal and state subsidies we receive and most other revenue streams are directly related to the number of local access lines in service. We had 270,352 and 286,186 local access lines in service as of September 30, 2008 and December 31, 2007, and 227,186 at September 30, 2007, prior to our acquisition of North Pittsburgh.

Many rural telephone companies have experienced a loss of local access lines due to challenging economic conditions, increased competition from wireless providers, competitive local exchange carriers and, in some cases, cable television operators. We have not been immune to these conditions. Both Suddenlink and Comcast, cable competitors in Texas, have launched a competing voice product in the second quarter, which caused a spike in our line loss for the quarter. In our estimation, cable companies are now virtually 100% launched covering 85% of our territory.

We also lost local access lines due both to the disconnection of second telephone lines by our residential customers in connection with their substituting DSL or cable modem service for dial-up Internet access and to substituting wireless service for wireline service. As of September 30, 2008 and December 31, 2007 we had 9,273 and 10,685 second lines, respectively, and we had 7,146 second lines as of September 30, 2007, prior to our acquisition of North Pittsburgh. The disconnection of second lines represented 9.1% and 10.9% of our residential line loss in the periods ending September 30, 2008 and September 30, 2007, respectively. We expect to continue to experience modest erosion in access lines.

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We have mitigated the decline in local access lines with increased average revenue per access line by focusing on the following:

- aggressively promoting DSL service, including selling DSL as a stand-alone service;
- bundling value-adding services, such as DSL or IPTV, with a combination of local service, custom calling features, voicemail and Internet access;
- maintaining excellent customer service standards, particularly as we introduce new services to existing customers; and
- keeping a strong local presence in the communities we serve.

We have implemented a number of initiatives to gain new local access lines and retain existing local access lines by enhancing the attractiveness of the bundle with new service offerings, including unlimited long distance, and promotional offers like discounted second lines. With the launch of IPTV, we are marketing our triple play bundle, which includes local telephone service, DSL and IPTV. As of September 30, 2008, IPTV was available to approximately 130,000 homes in our markets. Our IPTV subscriber base has grown from 11,063 as of September 30, 2007 to 15,454 as of September 30, 2008. We launched IPTV in our Pennsylvania markets in April 2008. In addition to our access line and video initiatives, we intend to continue to integrate best practices across our Illinois, Texas and Pennsylvania regions.

Additionally, we continue to look for ways to enhance current products and introduce new services to ensure that we remain competitive and continue to meet our customers needs. These initiatives include offering:

- hosted VOIP, which was launched in certain Texas markets in 2005 to meet the needs of small to medium sized business customers who want robust function without having to purchase a traditional key or PBX phone system;
- VOIP service for residential customers, which is being offered both as a growth opportunity and as an alternative to the traditional phone line for customers who are considering a switch to a cable competitor;
- DSL service which has been made available to users who do not have our access line. This expands our customer base and creates additional revenue generating opportunities;
- a DSL tier with speeds up to 10 Mbps is now being offered for those customers desiring greater Internet speed; and
- High definition video service and digital video recorders in all of our IPTV markets.

These efforts may act to mitigate the financial impact of any access line loss we may experience.

Because of our promotional efforts and through the acquisition of North Pittsburgh, the number of DSL subscribers we serve grew substantially. We had 89,129, 81,337 and 62,546 DSL lines in service as of September 30, 2008, December 31, 2007 and September 30, 2007, respectively. Currently over 95% of our rural telephone companies local access lines are DSL capable.

We have also utilized service bundles, which included combinations of local service, custom calling features, voicemail and Internet access as a revenue generation tool and a customer retention tool in our Illinois and Texas markets. Our service bundles totaled 43,902, 45,971 and 45,911 at September 30, 2008, December 31, 2007 and September 30, 2007, respectively. We intend to implement a similar bundling strategy in the North Pittsburgh market as well.

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Our plan is to continue to execute our customer retention program by delivering excellent customer service and improving the value of our bundle with DSL and IPTV. However, if these actions fail to mitigate access line loss, or we experience a higher degree of access line loss than we currently expect, it could have an adverse impact on our revenues and earnings.
The following sets forth several key metrics as of the end of the periods presented:

	September 30, 2008	**December 31, 2007 (1)**	**September 30, 2007**
Local access lines in service:			
Residential	167,581	183,070	149,735
Business	102,771	103,116	77,451
Total local access lines	270,352	286,186	227,186
IPTV subscribers	15,454	12,241	11,063
ILEC DSL subscribers	89,129	81,337	62,546
	104,583	93,578	73,609
VOIP subscribers	5,739	2,465	
CLEC Access Line Equivalents (2)	74,762	70,063	
Total connections	455,436	452,292	300,795
Long distance lines (3)	166,652	166,599	151,320
Dial-up subscribers	5,442	6,783	8,858

(1) In connection with the acquisition of North Pittsburgh, we acquired 36,411 residential access lines, 25,988 business access lines, 14,713 DSL subscribers, 87 VOIP subscribers, 70,063 CLEC access line equivalents and 18,223 long distance lines.

(2) CLEC access line equivalents

represent a combination of voice services and data circuits. The calculations represent a conversion of data circuits to an access line basis. Equivalents are calculated by converting data circuits (basic rate interface, primary rate interface, DSL, DS-1, DS-3 and Ethernet) and SONET-based (optical) services (OC-3 and OC-48) to the equivalent of an access line.

(3) Reflects the inclusion of long distance service provided as part of our VOIP offering while excluding CLEC long distance subscribers.

As of December 31, 2007 and for the nine months ended September 30, 2008, our operating statistics include metrics and results associated with our acquisition of North Pittsburgh. In addition, we are now including VOIP lines and CLEC access line equivalents in its total connection count and reflecting T-1 voice grade equivalents in its access line count for the Pennsylvania RLEC, which is consistent with our methodology in Illinois and Texas and with industry norms.

Network Access and Subsidy Revenues. A significant portion of our revenues come from network access charges paid by long distance and other carriers for originating or terminating calls within our service areas. The amount of network access charge revenues we receive is based on rates set or approved by federal and state regulatory commissions and are subject to change at any time.

We also derive significant revenues from Universal Service Fund subsidy payments. These payments are designed to assist rural telephone companies in providing telecommunication services to customers in areas with low customer density since switching and other facilities server fewer customers and loops are typically longer and more expensive to maintain than in more densely populated areas. Like access charges, subsidies are regulated by federal and state regulatory commissions.

Changes in regulations regarding network access and subsidy revenues could have an adverse affect on our financial results. See Part II Other Information Item 1A Risk Factors herein.

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Expenses

Our primary operating expenses consist of cost of services, selling, general and administrative expenses and depreciation and amortization expenses.

Cost of Services and Products

Our cost of services includes the following:

- operating expenses relating to plant costs, including those related to the network and general support costs, central office switching and transmission costs and cable and wire facilities;
- general plant costs, such as testing, provisioning, network, administration, power and engineering; and
- the cost of transport and termination of long distance and private lines outside our rural telephone companies service area.

We have agreements with carriers to provide long distance transport and termination services. These agreements contain various commitments and expire at various times. We believe we will meet all of our commitments in these agreements and believe we will be able to procure services for future periods. We are currently procuring services for future periods, and at this time, the costs and related terms under which we will purchase long distance transport and termination services have not been determined. We do not expect, however, any material adverse affects from any changes in any new service contract.

Selling, General and Administrative Expenses

Selling, general and administrative expenses include the following:

- selling and marketing expenses;
- expenses associated with customer care;
- billing and other operating support systems; and
- corporate expenses, including professional service fees, and non-cash stock compensation.

Our Telephone Operations segment incurs selling, marketing and customer care expenses from its customer service centers and commissioned sales representatives. Our customer service centers are the primary sales channels for residential and business customers with one or two phone lines, whereas commissioned sales representatives provide customized solutions to larger business customers. In addition, we use customer retail centers for various communication needs, including new telephone, Internet and IPTV purchases in Illinois and Texas.

Each of our Other Operations businesses primarily use an independent sales and marketing team comprised of dedicated field sales account managers, management teams and service representatives to execute our sales and marketing strategy.

We have operating support and back office systems that are used to enter, schedule, provision and track customer orders, test services and interface with trouble management, inventory, billing, collections and customer care service systems for the local access lines in our operations. We have migrated most key business processes of our Illinois and Texas operations onto single, company-wide systems and platforms. Our objective is to improve profitability by reducing individual company costs through centralization, standardization and sharing of best practices. We successfully completed the integration of our Illinois and Texas billing systems in the third quarter of 2007. Upon closing of the acquisition we were able to immediately convert the North Pittsburgh accounting and payroll functions to our existing systems and began integrating many other functions to our systems. For the nine months ended September 30, 2008 and September 30, 2007 we spent $3.2 million and $0.7 million, respectively, on integration and restructuring expenses (which included projects to integrate our support and back office systems).

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Depreciation and Amortization Expenses

We recognize depreciation expenses for our regulated telephone plant using rates and lives approved by the Illinois Commerce Commission, the Public Utility Commission of Texas and the Pennsylvania Public Utility Commission. The provision for depreciation on nonregulated property and equipment is recorded using the straight-line method based upon the following useful lives:

	Years
Buildings	15-35
Network and outside plant facilities	5-30
Furniture, fixtures and equipment	3-17
Capital leases	11

Amortization expenses are recognized primarily for our intangible assets considered to have finite useful lives on a straight-line basis based on the pattern over which we believe we will derive value from our customer lists. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets that have indefinite useful lives are not amortized but rather are tested at least annually for impairment. Because trade names have been determined to have indefinite lives, they are not amortized. Customer relationships are amortized over their useful life, at a weighted average life of approximately 10 years.

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The following summarizes our revenues and operating expenses on a consolidated basis for the three months ended September 30, 2008 and September 30, 2007:

	Three Months Ended September 30,			
	2008		2007	
	$ (millions)	% of Total Revenues	$ (millions)	% of Total Revenues
Revenues				
Telephone Operations				
Local calling services	$ 26.0	25.0%	$ 20.5	25.5%
Network access services	23.4	22.5	17.1	21.3
Subsidies	13.8	13.3	10.1	12.6
Long distance services	5.8	5.6	3.6	4.5
Data and internet services	16.5	15.9	9.9	12.3
Other services	8.9	8.6	8.9	11.1
Total Telephone Operations	94.4	90.9	70.1	87.3
Other Operations	9.4	9.1	10.2	12.7
Total operating revenues	103.8	100.0	80.3	100.0
Expenses				
Operating expenses				
Telephone Operations	54.6	52.5	39.0	48.6
Other Operations	9.3	9.0	10.5	13.1
Depreciation and amortization	22.9	22.1	16.4	20.4
Total operating expenses	86.8	83.6	65.9	82.1
Income from operations	17.0	16.4	14.4	17.9
Interest expense, net	(13.6)	(13.1)	(11.8)	(14.6)
Other income, net	5.9	5.7	1.8	2.2
Income tax expense	(4.3)	(4.2)	(2.1)	(2.6)
Net income	$ 5.0	4.8%	$ 2.3	2.9%

Segments

In accordance with the reporting requirement of SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, we have two reportable business segments, Telephone Operations and Other Operations. The results of operations for North Pittsburgh are included in the Telephone Operations segment for the periods following its acquisition on December 31, 2007. The results of operations discussed below reflect our consolidated results.

Results of Operations

For the Three Months Ended September 30, 2008 Compared to September 30, 2007

Revenues

Our revenues increased by 29.3% or $23.5 million, to $103.8 million for the three months ended September 30, 2008, from $80.3 million for the three months ended September 30, 2007. Our discussion and analysis of the components of the variance follows:

Telephone Operations Revenues

Local calling services revenues increased by 26.8%, or $5.5 million, to $26.0 million for the three months ended September 30, 2008 compared to $20.5 million for the same period in 2007. The increase is primarily due to $6.9 million of incremental local calling revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, local calling revenue decreased by $1.4 million primarily due to a decline in local access lines as previously discussed under Factors Affecting Results of Operations.

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Network access services revenues increased by 36.8%, or $6.3 million, to $23.4 million for the three months ended September 30, 2008 compared to $17.1 million for the same period in 2007. The increase is primarily due to $7.1 million of incremental network access revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, network access revenue decreased by $0.8 million. The decrease in revenue is primarily the result of decreasing minutes of use.

Subsidies revenues increased by 36.6%, or $3.7 million, to $13.8 million for the three months ended September 30, 2008 compared to $10.1 million for the same period in 2007. The increase is primarily due to $2.1 million of incremental subsidy revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, subsidy revenue increased by $1.6 million. The increase is primarily due to the impact of refunding out of period settlements in our interstate common line support fund during the third quarter of 2007.

Long distance services revenues increased by 61.1%, or $2.2 million, to $5.8 million for the three months ended September 30, 2008 compared to $3.6 million for the same period in 2007. The increase is primarily due to $2.8 million of incremental long distance revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, long distance revenue decreased by $0.6 million as a result of a decline in billable minutes.

Data and Internet revenues increased by 66.7%, or $6.6 million, to $16.5 million for the three months ended September 30, 2008 compared to $9.9 million for the same period in 2007. The increase is primarily due to $4.4 million of incremental Data and Internet revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, Data and Internet revenues increased by $2.2 million primarily due to an increase in DSL and IPTV subscribers.

Other services revenues was $8.9 million for both the three months ended September 30, 2008 and the three months ended September 30, 2007. The acquisition of North Pittsburgh resulted in $0.5 million of incremental other services revenue. Without the effect of North Pittsburgh, other service revenues decreased by $0.5 million primarily due to a decrease in revenue from inside wiring projects.

Other Operations Revenue

Other Operations revenues decreased by 7.8%, or $0.8 million, to $9.4 million for the three months ended September 30, 2008 compared to $10.2 million for the same period in 2007. Decreased call attempts resulted in a decline of $0.2 million in Operator Services Revenues. Also contributing to the revenue decline was a decrease of $0.3 million in sales of equipment to our business clients. In addition, as a result of extending its contract to supply calling services to prisons in the State of Illinois in exchange for pricing concessions, our Prison Systems business recognized a decrease of $0.1 million in revenues.

Operating Expenses

Our operating expenses increased by 31.7%, or $20.9 million, to $86.8 million for the three months ended September 30, 2008 compared to $65.9 million for the same period 2007. Our discussion and analysis of the components of the variance follows:

Telephone Operations Operating Expense

Operating expenses for Telephone Operations increased by 40.0%, or $15.6 million, to $54.6 million for the three months ended September 30, 2008 compared to $39.0 million for the same period in 2007. The increase is primarily due to an additional $14.2 million of incremental telephone operations operating expenses as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, telephone operations operating expenses increased by $1.4 million primarily due to $1.2 million of additional costs incurred due to the recovery from Hurricane Ike, which hit our Texas markets before moving through our other markets, causing severe power outages in both Texas and Pennsylvania. The remaining increase is attributable to increased fleet costs and increased costs for professional and contract labor fees.

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Other Operations Operating Expenses

Operating expenses for Other Operations decreased by 11.4%, or $1.2 million, to $9.3 million for the three months ended September 30, 2008 compared to $10.5 million for the same period in 2007. The decrease is directly related to the decrease in revenues for the various businesses. In addition, salary and benefit reductions that began on January 1, 2008 in our Operator Services business contributed to an additional decrease in costs for the business.

Depreciation and Amortization

Depreciation and amortization expenses increased by 39.6%, or $6.5 million, to $22.9 million for the three months ended September 30, 2008 compared to $16.4 million for the same period in 2007. The increase is primarily the result of the acquisition of North Pittsburgh. In connection with the acquisition, we acquired property, plant and equipment valued at $116.3 million which caused an increase in depreciation expense. In addition, we allocated $49.0 million of the purchase price to customer lists which are being amortized over five years.

Non-Operating Income

Interest Expense, Net

Interest expense, net of interest income, increased by 15.3%, or $1.8 million, to $13.6 million for the three months ended September 30, 2008 compared to $11.8 million for the same period in 2007. The increase is primarily due to an increase of $296.0 million in our long-term debt as a result of the acquisition of North Pittsburgh. The increase in interest expense resulting from the acquisition was partially offset by the redemption of our senior notes. On April 1, 2008 we redeemed $130.0 million of senior notes paying 9.75% interest by borrowing $120.0 million at a rate of approximately 7.0% and using cash on hand. In addition, during the third quarter of 2008 we entered into $790.0 million of basis swaps as described in Note 10 to the financial statements. The recognition of ineffectiveness on our interest rate swaps created a non-cash benefit of $2.4 million to interest expense

Other Income (Expense)

Other income, net increased by 227.8%, or $4.1 million, to $5.9 million for the three months ended September 30, 2008 compared to other income, net of $1.8 million for the same period in 2007. As part of the acquisition of North Pittsburgh, we acquired interests in three additional cellular partnerships, which contributed $3.7 million of income during the period. Our other partnership investments experienced a slight decrease in income for the three months ended September 30, 2008 compared to the same period in 2007.

Income Taxes

Our provision for income taxes was $4.3 million in 2008 compared to $2.1 million in 2007. Our effective tax rate was 46.2% for the three months ended September 30, 2008 compared to 46.2% for the three months ended September 30, 2007. During the third quarter of 2008, the Company completed and filed 2007 tax returns for Consolidated Communications Holdings, Inc. and subsidiaries and North Pittsburgh Systems, Inc. and subsidiaries. The Company recognized approximately $0.2 million of tax benefit to adjust its provision to match the returns. Exclusive of adjustments, our effective tax rate would have been approximately 48.3% for the three months ended September 30, 2008 compared to 45% for the three months ended September 30, 2007.

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For the Nine Months Ended September 30, 2008 Compared to September 30, 2007

The following summarizes our revenues and operating expenses on a consolidated basis for the nine months ended September 30, 2008 and September 30, 2007:

	Nine Months Ended September 30,			
	2008		2007	
	$ (millions)	% of Total Revenues	$ (millions)	% of Total Revenues
Revenues				
Telephone Operations				
Local calling services	$ 79.5	25.2%	$ 62.8	25.7%
Network access services	72.5	23.0	52.9	21.7
Subsidies	41.0	13.0	32.8	13.5
Long distance services	18.3	5.8	10.8	4.4
Data and internet services	46.1	14.6	27.6	11.3
Other services	27.6	8.7	26.7	10.9
Total Telephone Operations	285.0	90.3	213.6	87.5
Other Operations	30.7	9.7	30.6	12.5
Total operating revenues	315.7	100.0	244.2	100.0
Expenses				
Operating expenses				
Telephone Operations	159.1	50.4	114.3	46.8
Other Operations	29.9	9.5	31.2	12.8
Depreciation and amortization	68.1	21.6	49.6	20.3
Total operating expenses	257.1	81.5	195.1	79.9
Income from operations	58.6	18.5	49.1	20.1
Interest expense, net	(47.6)	(15.1)	(34.7)	(14.2)
Other income, net	5.3	1.7	4.8	2.0
Income tax benefit expense	(7.4)	(2.3)	(6.8)	(2.8)
Net income	$ 8.9	2.8%	$ 12.4	5.1%

Revenues

Our revenues increased by 29.3%, or $71.5 million, to $315.7 million for the nine months ended September 30, 2008, from $244.2 million for the nine months ended September 30, 2007. Our discussion and analysis of the components of the variance follows:

Telephone Operations Revenues

Local calling services revenues increased by 26.6%, or $16.7 million, to $79.5 million for the nine months ended September 30, 2008 compared to $62.8 million for the same period in 2007. The increase is primarily due to $20.8 million of incremental local calling revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, local calling revenue decreased by $4.1 million primarily due to a decline in local access lines as previously discussed under Factors Affecting Results of Operations.

Network access services revenues increased by 37.1%, or $19.6 million, to $72.5 million for the nine months ended September 30, 2008 compared to $52.9 million for the same period in 2007. The increase is primarily due to $22.3 million of incremental network access revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, network access revenue decreased by $2.7 million. In 2007 we recognized $0.7 million of non-recurring revenue as a result of the favorable settlement of an outstanding billing claim. The remainder of the decrease in revenue is a result of decreasing minutes of use.

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Subsidies revenues increased by 25.0%, or $8.2 million, to $41.0 million for the nine months ended September 30, 2008 compared to $32.8 million for the same period in 2007. The increase is primarily due to $5.9 million of incremental subsidy revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, subsidy revenue increased by $2.3 million primarily due to the impact of out of period settlements in our interstate common line support fund in 2007 as described above.

Long distance services revenues increased by 69.4%, or $7.5 million, to $18.3 million for the nine months ended September 30, 2008 compared to $10.8 million for the same period in 2007. The increase is primarily due to $8.7 million of incremental long distance revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, long distance revenue decreased by $1.2 million as a result of a decline in billable minutes.

Data and Internet revenues increased by 67.0%, or $18.5 million, to $46.1 million for the nine months ended September 30, 2008 compared to $27.6 million for the same period in 2007. The increase is primarily due to $12.4 million of incremental Data and Internet revenue as a result of the acquisition of North Pittsburgh. Without the effect of North Pittsburgh, Data and Internet revenues increased by $6.1 million due to an increase in DSL and IPTV subscribers.

Other services revenues increased by 3.4%, or $0.9 million, to $27.6 million for the nine months ended September 30, 2008 compared to $26.7 million for the same period in 2007. The acquisition of North Pittsburgh resulted in $1.7 million of incremental other services revenue. Without the effect of North Pittsburgh, other service revenues decreased by $0.8 million due to the recognition of $0.1 million of revenue from the settlement of a billing dispute in 2007 and a decrease of $0.7 million in inside wiring revenue in 2008.

Other Operations Revenue

Other Operations revenues increased by 0.3%, or $0.1 million, to $30.7 million for the nine months ended September 30, 2008 compared to $30.6 million for the same period in 2007. In 2007 our telemarketing business expanded its call volume capacity. As a result of the expansion, revenue for the nine months ended September 30, 2008 increased by $1.5 million compared to the same period in 2007. Offsetting the increases was a decline of $0.8 million in our operator services business as a result of decreased call attempts and lower revenues from prison systems calling and mobile and paging services.

Operating Expenses

Our operating expenses increased by 31.8%, or $62.0 million, to $257.1 million for the nine months ended September 30, 2008 compared to $195.1 million for the same period in 2007. Our discussion and analysis of the components of the variance follows:

Telephone Operations Operating Expense

Operating expenses for Telephone Operations increased by 39.2%, or $44.8 million, to $159.1 million for the nine months ended September 30, 2008 compared to $114.3 million for the same period in 2007. The increase is primarily due to an additional $43.2 million of incremental telephone operations operating expenses as a result of the acquisition of North Pittsburgh as well as $1.2 million of costs incurred during the recovery from Hurricane Ike, which hit our Texas markets before moving through our other markets, causing severe power outages in both Texas and Pennsylvania.

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Other Operations Operating Expenses

Operating expenses for Other Operations decreased by 4.2%, or $1.3 million, to $29.9 million for the nine months ended September 30, 2008 compared to $31.2 million for the same period in 2007. As a result of the added call volume for our telemarketing business, operating expense increased by $1.1 million. In addition, higher cost of sales and increased general and administrative expenses caused an increase of $0.3 million in expenses for our prison system business. A decrease of $1.6 million primarily related to salaries and benefits reductions in our operator services business partially offset these expenses, while our business systems and mobile services businesses also reduced costs in 2008.

Depreciation and Amortization

Depreciation and amortization expenses increased by 37.3%, or $18.5 million, to $68.1 million for the nine months ended September 30, 2008 compared to $49.6 million for the same period in 2007. The increase is primarily the result of the acquisition of North Pittsburgh. In connection with the acquisition, we acquired property, plant and equipment valued at $116.3 million which caused an increase in depreciation expense. In addition, we allocated $49.0 million of the purchase price to customer lists which are being amortized over five years.

Non-Operating Income (Expense)

Interest Expense, Net

Interest expense, net of interest income, increased by 37.2%, or $12.9 million, to $47.6 million for the nine months ended September 30, 2008 compared to $34.7 million for the same period in 2007. The increase is primarily due to an increase of $296.0 million in our long-term debt as a result of the acquisition of North Pittsburgh. The increase in interest expense resulting from the acquisition was partially offset by the redemption of our senior notes. On April 1, 2008 we redeemed $130.0 million of senior notes paying 9.75% interest by borrowing $120.0 million at a rate of approximately 7.0% and using cash on hand. In addition, during the third quarter of 2008 we entered into $790.0 million of basis swaps as described in Note 10 to the financial statements. The recognition of ineffectiveness on our interest rate swaps created a non-cash benefit of $2.4 million to interest expense.

Other Income

Other income, net increased by 10.4%, or $0.5 million, to $5.3 million for the nine months ended September 30, 2008 compared to $4.8 million for the same period in 2007. In connection with the redemption of our senior notes, we recognized a loss on extinguishment of debt of $9.2 million, which included a redemption premium of $6.3 million and the write off of unamortized deferred financing costs of $2.9 million. Offsetting this loss was $9.1 million of income recognized from three additional cellular partnerships acquired as part of the acquisition of North Pittsburgh as well as additional earnings from our previously existing partnership investments.

Income Taxes

Our provision for income taxes was $7.4 million in 2008 compared to $6.8 million in 2007. Our effective tax rate was 45.5% for the nine months ended September 30, 2008 compared to 35.2% for the nine months ended September 30, 2007. During the third quarter of 2008, the Company completed and filed 2007 tax returns for Consolidated Communications Holdings, Inc. and subsidiaries and North Pittsburgh Systems, Inc. and subsidiaries. The Company recognized approximately $0.2 million of tax benefit to adjust its provision to match the returns. During the second quarter of 2007, the State of Texas amended the tax legislation enacted during the second quarter of 2006. The most significant impact of this amendment for us was the revision to the temporary credit on taxable margin. This new legislation resulted in a reduction of our net deferred tax liabilities and a corresponding credit to our tax provision of approximately $1.7 million. Exclusive of adjustments, our effective tax rate would have been approximately 46.8% for the nine months ended September 30, 2008 compared to 44.0% for the nine months ended September 30, 2007.

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Liquidity and Capital Resources

General

Historically, our operating requirements have been funded from cash flow generated from our business and borrowings under our credit facilities. As of September 30, 2008, we had $881.5 million of debt, including capital leases. Our $50.0 million revolving line of credit, however, remains unused. On April 1, 2008 we redeemed our $130.0 million of outstanding senior notes. The redemption, including the payment of the redemption premium of $6.3 million, accrued interest through the redemption date and the associated fees, was funded using $120.0 million of proceeds from our DDTL facility and cash on hand. In the second quarter of 2008, we recognized a loss on redemption of the senior notes of $9.2 million, which included the redemption premium and the write off of unamortized deferred financing costs associated with the senior notes.

We expect that our future operating requirements will continue to be funded from cash flow generated from our business and borrowings under our revolving credit facility. As a general matter, we expect that our liquidity needs in 2008 will arise primarily from: (i) expected dividend payments of $45.6 million, reflecting quarterly dividends at an annual rate of $1.5495 per share; (ii) interest payments on our indebtedness of $65.0 million to $65.5 million; (iii) capital expenditures not to exceed $48.0 million; (iv) cash income tax payments of $13.0 million to $14.0 million; and (v) certain other costs. Among other expected uses of cash in 2009 and beyond are contributions to our pension plans. As of the most recent actuarial measurement, we were approximately 90% funded on our pension plans. However, due to the challenges facing the economy and the recent negative returns in the capital markets, we anticipate that our funding obligations will increase in 2009. At the present time, we have not quantified the future funding obligations. These expected liquidity needs are presented in a format which is consistent with our prior disclosures and are a component of our total expenses as summarized above under Factors Affecting Results of Operations Expenses. In addition, we may use cash and incur additional debt to fund selective acquisitions. However, our ability to use cash may be limited by our other expected uses of cash, including our dividend policy, and our ability to incur additional debt will be limited by our existing and future debt agreements.

We believe that cash flow from operating activities, together with our existing cash and borrowings available under our revolving credit facility, will be sufficient for approximately the next twelve months to fund our currently anticipated uses of cash. After that, our ability to fund these expected uses of cash and to comply with the financial covenants under our debt agreements will depend on the results of future operations, performance and cash flow. Our ability to do so will be subject to prevailing economic conditions and to financial, business, regulatory, legislative and other factors, many of which are beyond our control.

We may be unable to access the cash flow of our subsidiaries since certain of our subsidiaries are parties to credit or other borrowing agreements that restrict the payment of dividends or making intercompany loans and investments, and those subsidiaries are likely to continue to be subject to such restrictions and prohibitions for the foreseeable future. In addition, future agreements that our subsidiaries may enter into governing the terms of indebtedness may restrict our subsidiaries ability to pay dividends or advance cash in any other manner to us.

To the extent that our business plans or projections change or prove to be inaccurate, we may require additional financing or require financing sooner than we currently anticipate. Sources of additional financing may include commercial bank borrowings, other strategic debt financing, sales of nonstrategic assets, vendor financing or the private or public sales of equity and debt securities. We cannot assure you that we will be able to generate sufficient cash flow from operations in the future, that anticipated revenue growth will be realized, or that future borrowings or equity issuances will be available in amounts sufficient to provide adequate sources of cash to fund our expected uses of cash. Failure to obtain adequate financing, if necessary, could require us to significantly reduce our operations or level of capital expenditures which could have a material adverse effect on our financial condition and the results of operations.

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In recent months liquidity in the capital markets has become scarce and in many cases commercial banks have been reluctant to lend money. As discussed below, our term loan has been fully funded at a fixed spread above LIBOR and we have $50.0 million available under our revolving credit facility. Based on our discussion with banks participating in the bank group, we expect that the funds will be available under the revolving credit facility if necessary. For further discussion see Part II Other Information Item 1A Risk Factors herein.

The following table summarizes our sources and uses of cash for the periods presented:

	Nine Months Ended September 30, 2008	2007
	(In millions)	
Net Cash Provided by (Used for):		
Operating activities	$ 66.6	$ 52.8
Investing activities	(37.1)	(24.6)
Financing activities	(51.4)	(30.4)

Operating Activities

Net income adjusted for non-cash charges is our primary source of operating cash. For the nine months ended September 30, 2008, net income adjusted for non-cash charges generated $81.9 million of operating cash. During the period we paid $9.2 million for federal and state income taxes, while our tax expense was $7.4 million for the period. Changes in components of working capital, primarily accrued expenses, accounts receivable and accounts payable, in the ordinary course of business accounted for the remainder of the cash flows from operations.

For the nine months ended September 30, 2007, net income adjusted for non-cash charges generated $65.4 million of operating cash. Two primary uses of the operating cash were cash income tax payments of $11.0 million and pension plan contributions of $4.8 million. We elected to contribute approximately $2.3 million in excess of our required minimum contribution to the pension plan in order to reduce future contribution obligations. Partially offsetting these payments is an increase in accrued interest of $2.7 million based on the timing of interest payments on our term debt and senior notes.

Investing Activities

Cash used in investing activities has traditionally been for capital expenditures and acquisitions. For the nine months ending September 30, 2008, we used $37.1 million for capital expenditures, which is an increase of $12.5 million for the same period in 2007. The increase is due to increased incremental spending as a result of the acquisition of North Pittsburgh. Because our networks, including the North Pittsburgh network, are modern and have been well maintained, we do not believe we will substantially increase capital spending beyond current levels in the future. Any such increase would likely occur as a result of a planned growth or expansion, if at all. We expect our capital expenditures for 2008 will be no greater than $48.0 million, which will be used primarily to maintain and upgrade our network, central offices and other facilities and information technology for operating support and other systems. In addition to our capital investments made in the first nine months of 2007, we also invested $10.6 million in marketable securities in order to maximize the returns on our excess cash. These securities were subsequently sold in the third quarter of 2007.

Financing Activities

During the nine months ended September 30, 2008, we borrowed $120.0 million under our Delayed Draw Term Loan and used the proceeds along with cash on hand to retire $130.0 million of our outstanding senior notes and to pay a redemption premium of $6.3 million. In addition we paid $34.1 million of cash to our common stockholders in accordance with the dividend policy adopted by our board of directors. For the same period in 2007 we paid $30.1 million in dividends. The increase is due to the issuance of approximately 3.32 million shares of stock in connection with the North Pittsburgh acquisition. For the year we expect to pay approximately $45.6 million in dividends. We also paid $0.2 million of deferred financing fees in connection with finalizing our new credit facility, while $0.8 million was used to pay obligations under capital leases for the nine months ended September 30, 2008. In the same period during 2007 we paid $0.3 million in deferred financing costs to amend our previous credit facility.

Debt

The following table summarizes our indebtedness as of September 30, 2008:

Debt and Capital Leases as of September 30, 2008
(In Millions)

	Balance	Maturity Date	Rate (1)
Capital lease	$ 1.5	July 1, 2011	7.40%
Revolving credit facility		December 31, 2013	LIBOR + 2.50%
Term loan	880.0	December 31, 2014	LIBOR + 2.50%

(1) As of September 30, 2008, the 1-month LIBOR rate in effect on our borrowings was 3.71%.

Credit Facilities

Borrowings under our credit facilities are our senior, secured obligations that are secured by substantially all of the assets of the borrowers (Consolidated Communications, Inc., Consolidated Communications Acquisition Texas, Inc. and North Pittsburgh Systems, Inc.) and the guarantors (the Company and each of the existing subsidiaries of Consolidated Communications, Inc., Consolidated Communications Ventures, and North Pittsburgh Systems, Inc. other than ICTC, and certain future subsidiaries). The credit agreement contains customary affirmative covenants, which require us and our subsidiaries to furnish specified financial information to the lenders, comply with applicable laws, maintain our properties and assets and maintain insurance on our properties, among others, and contains customary negative covenants which restrict our and our subsidiaries ability to incur additional debt and issue capital stock, create liens, repay other debt, sell assets, make investments, loans, guarantees or advances, pay dividends, repurchase equity interests or make other restricted payments, engage in affiliate transactions, make capital expenditures, engage in mergers, acquisitions or consolidations, enter into sale-leaseback transactions, amend specified documents, enter into agreements that restrict dividends from subsidiaries and change the business we conduct. In addition, the credit agreement requires us to comply with specified financial ratios that are summarized below under Covenant Compliance .

As of September 30, 2008, we had no borrowings under the revolving credit facility. Borrowings under our credit facilities bear interest at a rate equal to an applicable margin plus, at the borrowers election, either a base rate or LIBOR. As of September 30, 2008, the applicable margin for interest rates was 2.50% per year for the LIBOR based term loan and the revolving credit facility. The applicable margin for alternative base rate loans was 1.50% per year for the term loan and the revolving credit facility. At September 30, 2008, the weighted average interest rate, including swaps, on our credit facilities was 6.91% per annum.

On April 1, 2008 we redeemed all of our outstanding senior notes in part utilizing $120.0 million of borrowings under the DDTL. The ability to utilize the delayed draw term loan for additional borrowings expired on May 1, 2008. The relevant terms of the DDTL are the same as our term loan.

Derivative Instruments

As of September 30, 2008, we had $790.0 million of notional amount floating to fixed interest rate swap agreements. Approximately 89.8% of our floating rate term loans were fixed as of September 30, 2008. The swaps expire at various times from December 31, 2008 through March 31, 2013. Under the swap agreements, we receive 3-month LIBOR based interest payments from the swap counterparties and pay a fixed rate. In addition, in September 2008 we added $790.0 million of basis swaps under which we pay 3-month LIBOR based payments less a fixed percentage to the basis swap counterparties and receive 1-month LIBOR. Upon entering into the swaps we began utilizing 1-month LIBOR resets on our credit facility. The swaps are in place to hedge the change in overall cash flows related to our term loan, the driver of which is changes in the underlying variable interest rate. Because of our liquidity needs discussed above under Liquidity and Capital Resources - General, we seek to have between 75% and 85% of our variable rate debt fixed in order to provide a level of certainty to our cash flow streams. The maturity dates are laddered in order to minimize any potential exposure to unfavorable rates upon expiration of a given swap. The current effect of the swap portfolio is to fix our cash interest payments on the floating portion of $790.0 million of debt at a rate of 4.49%.

Covenant Compliance

In general our credit agreement restricts our ability to pay dividends to the amount of our Available Cash accumulated after October 1, 2005, plus $23.7 million and minus the aggregate amount of dividends paid after July 27, 2005. Available Cash for any period is defined in our credit facility as Consolidated EBITDA (a) minus, to the extent not deducted in the determination of Consolidated EBITDA, (i) non-cash dividend income for such period; (ii) consolidated interest expense for such period net of amortization of debt issuance costs incurred (A) in connection with or prior to the consummation of the acquisition of North Pittsburgh or (B) in connection with the redemption of our senior notes; (iii) capital expenditures from internally generated funds; (iv) cash income taxes for such period; (v) scheduled principal payments of Indebtedness, if any; (vi) voluntary repayments of indebtedness, mandatory prepayments of term loans and net increases in outstanding revolving loans during such period; (vii) the cash costs of any extraordinary or unusual losses or charges; and (viii) all cash payments made on account of losses or charges expensed prior to such period (b) plus, to the extent not included in Consolidated EBITDA, (i) cash interest income; (ii) the cash amount realized in respect of extraordinary or unusual gains; and (iii) net decreases in revolving loans. Based on the results of operations from October 1, 2005 through September 30, 2008, we would have been able to pay a dividend of $74.7 million under the credit facility covenant. After giving effect to the dividend of $11.4 million which was declared in August 2008 and paid on November 1, 2008, we could pay a dividend of $63.3 million under the credit facility covenant.

Under our credit agreement, if our total net leverage ratio (as such term is defined in the credit agreement), as of the end of any fiscal quarter, is greater than 5.25:1.00, until December 31, 2008 and 5.10:1.00 thereafter, we will be required to suspend dividends on our common stock unless otherwise permitted by an exception for dividends that may be paid from the portion of proceeds of any sale of equity not used to make mandatory prepayments of loans and not used to fund acquisitions, capital expenditures or make other investments. During any dividend suspension period, we will be required to repay debt in an amount equal to 50.0% of any increase in available cash (as such term is defined in our credit agreement) during such dividend suspension period, among other things. In addition, we will not be permitted to pay dividends if an event of default under the credit agreement has occurred and is continuing. Among other things, it will be an event of default if our interest coverage ratio as of the end of any fiscal quarter is below 2.25:1.00. As of September 30, 2008, our total net leverage ratio was 4.59:1.00 and our interest coverage ratio was 2.80:1.00.

The description of the covenants above and of our credit agreement generally in this Report are summaries only. They do not contain a full description, including definitions, of the provisions summarized. As such, these summaries are qualified in their entirety by these documents, which are filed as exhibits to our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Dividends

The cash required to fund dividend payments is in addition to our other expected cash needs, both of which we expect to be funded with cash flows from operations. In addition, we expect we will have sufficient availability under our revolving credit facility to fund dividend payments in addition to any expected fluctuations in working capital and other cash needs, although we do not intend to borrow under this facility to pay dividends.

We believe that our dividend policy will limit, but not preclude, our ability to grow. If we continue paying dividends at the level currently anticipated under our dividend policy, we may not retain a sufficient amount of cash, and may need to seek refinancing, to fund a material expansion of our business, including any significant acquisitions or to pursue growth opportunities requiring capital expenditures significantly beyond our current expectations. In addition, because we expect a significant portion of cash available will be distributed to holders of common stock under our dividend policy, our ability to pursue any material expansion of our business will depend more than it otherwise would on our ability to obtain third-party financing.

Surety Bonds

In the ordinary course of business, we enter into surety, performance, and similar bonds. As of September 30, 2008, we had approximately $2.0 million of these bonds outstanding.

Recent Accounting Pronouncements

In June 2008, the Financial Accounting Standards Board, (FASB), issued FASB Staff Position (FSP) No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities.* This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. Early application of this FSP is prohibited. We do not expect any material financial statement impact on future results of operations and financial condition.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (SFAS No. 161), *Disclosure about Derivative Instruments and Hedging Activities an Amendment of FASB Statement No. 133.* SFAS No. 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. SFAS No. 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, have been applied, and the impact that hedges have on an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early adoption encouraged. We currently provide information about our hedging activities and use of derivatives in our quarterly and annual filings with the SEC, including many of the disclosure requirements contained within SFAS No. 161. We are currently evaluating the impact, if any, of adopting SFAS No. 161 on our disclosures. SFAS No. 161 will have no impact on our future results of operations and financial condition.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160 (SFAS No. 160), *Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51.* SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in a consolidated entity that should be reported as equity in the consolidated financial statements. It also requires consolidated net income to include the amounts attributable to both the parent and the noncontrolling interest. We are required to adopt SFAS No. 160 on January 1, 2009 and are currently evaluating the impact of adopting SFAS No. 160 on our future results of operations and financial condition.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007) (SFAS No. 141(R)), *Business Combinations.* SFAS No. 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any non-controlling interest at their fair values as of the acquisition date. SFAS No. 141(R) also requires, among other things, that acquisition-related costs be recognized separately from the acquisition. We are required to adopt SFAS No. 141(R) effective January 1, 2009. SFAS No. 141(R) will generally impact acquisitions made after the date of adoption.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk from changes in interest rates on our long-term debt obligations. We estimate our market risk using sensitivity analysis. Market risk is defined as the potential change in the fair market value of a fixed-rate long-term debt obligation due to hypothetical adverse change in interest rates and the potential change in interest expense on variable rate long-term debt obligations due to a change in market interest rates. The fair value on long-term debt obligations is determined based on discounted cash flow analysis, using the rates and the maturities of these obligations compared to terms and rates currently available in long-term debt markets. The potential change in interest expense is determined by calculating the effect of the hypothetical rate increase on the portion of variable rate debt that is not hedged through the interest rate swap agreements described below and assumes no changes in our capital structure. As of September 30, 2008, approximately 89.8% of our long-term debt obligations were variable rate obligations subject to interest rate swap agreements and approximately 10.2% were variable rate obligations not subject to interest rate swap agreements.

As of September 30, 2008, we had $880.0 million of debt outstanding under our credit facilities. Our exposure to fluctuations in interest rates was limited by interest rate swap agreements that effectively converted a portion of our variable rate debt to a fixed-rate basis, thus reducing the impact of interest rate changes on future interest expenses. On September 30, 2008, we had interest rate swap agreements covering $790.0 million of aggregate principal amount of our variable rate debt at fixed LIBOR rates ranging from 3.87% to 5.51% and expiring on various dates from December 31, 2008 through March 31, 2013. In addition, we had $790.0 million of basis swap agreements under which we make 3-month LIBOR payments less a percentage ranging from 5.4 to 15.0 basis points and receive 1-month LIBOR. As of September 30, 2008, we had $90.0 million of variable rate debt not covered by interest rate swap agreements. If market interest rates averaged 1.0% higher than the average rates that prevailed from January 1, 2008 through September 30, 2008, interest expense would have increased by approximately $0.7 million for the period. As of September 30, 2008, the fair value of interest rate swap agreements amounted to a liability of $8.6 million, net of taxes.

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Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2008. Based upon that evaluation and subject to the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures provided reasonable assurance that the disclosure controls and procedures are effective to accomplish their objectives. No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) occurred during our fiscal quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On April 15, 2008, Salsgiver Inc., a Pennsylvania-based telecommunications company, and certain of its affiliates filed a lawsuit against us and our subsidiaries North Pittsburgh Telephone Company and North Pittsburgh Systems Inc. in the Court of Common Pleas of Allegheny County, Pennsylvania, alleging that we have prevented Salsgiver from connecting its fiber optic cables to North Pittsburgh s utility poles. Salsgiver seeks compensatory and punitive damages as the result of alleged lost projected profits, damage to its business reputation, and other costs. It claims to have sustained losses of approximately $125 million, but does not request a specific dollar amount in damages. We believe that these claims are without merit and, regardless of the merit of the claims, the damages are completely unfounded. We intend to defend against these claims vigorously. In the third quarter we filed preliminary objections and responses to Salsgivers s complaint; however, the court ruled against our preliminary objections. On November 3, we responded to Salsgiver s amended complaint and filed a counter claim for trespass due to attaching to our poles without an authorized agreement and in an unsafe manner.

In addition, we currently are, and from time to time may be, subject to additional claims arising in the ordinary course of business. We are not currently subject to any such claims that we believe could reasonably be expected to have a material adverse effect on our results of operations or financial condition.

Item 1A. Risk Factors

The current volatility in economic conditions and the financial markets may adversely affect our industry, business and financial performance.

The second half of 2008 has witnessed unprecedented disruptions in financial markets, including volatility in asset values and constraints on the availability of credit. In addition, the U.S. economy slowed significantly in the third quarter, reflecting these disruptions and other factors. The impact, if any, that these developments might have on the Company and its business is uncertain and cannot be estimated at this time. Item 1A (Risk Factors) of the Company s 2007 Annual Report on Form 10-K discusses some of the principal risks inherent in the Company s business, including the availability of and ability to generate cash to pay dividends, the amount of debt outstanding and the Company s ability to service and refinance it, and the effect of economic conditions in our service territories on access line loss and revenues. The current economic and financial market conditions have accentuated each of these risks and magnified their potential effect on the Company and disruptions in the financial markets have affected the availability and costs of credit generally and could adversely affect the Company s ability to obtain additional credit or refinance existing losses.

Adverse changes in the value of assets or obligations associated with the Company s employee benefit plans could adversely affect the Company s results.

The current economic environment could negatively impact the fair value of pension assets, which could increase future funding requirements of the Company s pension plans and adversely impact the Company s liquidity.

Proposed Access and Universal Service Reforms could have an adverse impact on the Company s revenues.

The FCC is required to address the ISP remand order by November 5, 2008 to the U.S. Court of Appeals. In conjunction with the requirement, FCC Chairman Martin had proposed to incorporate comprehensive intercarrier compensation and universal service reform. The FCC has circulated an order internally and was scheduled to vote on it at the November 4, 2008 open meeting. The remaining Commissioners requested that the vote be delayed by one month and the draft Notice of Proposed Rule Making be submitted for public comment prior to a vote. Any comprehensive reform could have an adverse impact on the Company s network access revenue, but it is unclear at this time what the direction, timing of, and how comprehensive, any reform might be.

Item 6. Exhibits

See the Exhibit Index following the signature page 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.

	Consolidated Communications Holdings, Inc. (Registrant)
Date: November 7, 2008	By: /s/ Robert J. Currey
	Robert J. Currey President and Chief Executive Officer (Principal Executive Officer)
Date: November 7, 2008	By: /s/ Steven L. Childers
	Steven L. Childers Chief Financial Officer (Principal Financial Officer and Chief Accounting Officer)

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EXHIBIT INDEX

Exhibit Number	Description
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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>Liquidity and Capital Resources

Cash Flows

During fiscal year 2007, we generated approximately $738.4 million in cash flows provided by operating activities compared to $638.7 million in fiscal year 2006. Significant items affecting our fiscal years 2007 and 2006 cash flows provided by operating activities are discussed below.

	Fiscal year ended June 30, 2007	2006
Cash paid for interest on outstanding debt, which was higher in fiscal year 2007 primarily due to our share repurchase program	$ (169.6)	$ (56.3)
Cash paid for final settlement of the Mellon Financial Corporate (Mellon) transition services agreement (a)		(85.8)
Cash paid for incentive compensation to employees of the Acquired HR Business (a)		(26.3)
Cash received for interest income	8.0	3.4
Cash paid for legal fees and other costs related to the investigations into our stock option grant practices, derivative lawsuits related to our stock option grant practices and the potential sale of the company as discussed above	(30.3)	
Cash paid on tax, interest and penalties related to our stock option grant practices as discussed above	(35.0)	
	$ (226.9)	$ (165.0)

(a) During fiscal year 2006, we paid approximately $85.8 million related to the final settlement of the Mellon transition services agreement. Under the transition services agreement, Mellon provided certain accounting, treasury and payroll services for an interim period while we integrated the Acquired HR Business. As part of these services, Mellon was also paying certain operational costs on our behalf, such as employee related expenses and accounts payable. This agreement and the related timing of payments to Mellon had a favorable impact on our net cash provided by operating activities and free cash flow (defined below) in fiscal year 2005 of $75.9 million and a negative impact on our net cash provided by operating activities and free cash flow in fiscal year 2006 of $85.8 million when the Acquired HR Business was fully integrated. During fiscal year 2006, we also paid approximately $26.3 million to employees of the Acquired HR Business related to incentive compensation that was earned prior to the date that we acquired the business.

Our fiscal year 2007 cash flows provided by operating activities were also impacted by collections of accounts receivable, offset by timing of collections of unearned revenue, as well as payments for hardware and software maintenance during the fiscal year 2007.

Fiscal year 2006 cash flows provided by operating activities were also impacted by an increase in accounts receivables related to signed new business and timing of collections related to other accounts receivable and payments of approximately $5.2 million related to the departure of Jeffrey A. Rich, our former Chief Executive Officer. These decreases were offset by lower annual incentive compensation payments and timing of payments to vendors.

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.

For fiscal years 2007 and 2006, excess tax benefits from stock-based compensation awards of $3.8 million and $14.3 million, respectively, were reflected as an outflow in cash flows from operating activities and an inflow in cash flows from financing activities in the Consolidated Statements of Cash Flows, resulting in a net impact of zero on cash. During fiscal year 2005, income tax benefits from the exercise of stock options of $20.1 million were reflected as an inflow in cash flows from operating activities in the Consolidated Statements of Cash Flows. However, had SFAS 123(R) been in effect for fiscal year 2005, the portion of those income tax benefits that would have been characterized as excess tax benefits in the Consolidated Statements of Cash Flows would have been $14.1 million and would have decreased cash flows from operating activities and increased cash flows from financing activities accordingly.

During fiscal year 2005, we generated approximately $739.3 million in cash flows provided by operating activities. As discussed above, fiscal year 2005 cash flows provided by operating activities includes a temporary benefit of $75.9 million related to the transition services agreement with Mellon. Fiscal year 2005 cash flows provided by operating activities were negatively impacted by the payment of approximately $19.3 million related to the settlement of the interest rate hedges associated with the issuance of the Senior Notes (please see *Derivative instruments and hedging activities* below), the payment of a legal settlement of $10 million and the payment of the settlement on a client contract of $10 million, both of which were accrued during fiscal year 2004, as well as the timing of payments related to software used in our information technology services business, transfer agent fees related to our unclaimed property business and other contract related costs, offset by increased net income and increased collections on our accounts receivable balances.

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):

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Net cash provided by operating activities	$ 738,378	$ 638,710	$ 739,348
Purchases of property, equipment and software, net	(316,843)	(394,467)	(253,231)
Additions to other intangible assets	(43,187)	(35,831)	(35,518)
Free cash flow	$ 378,348	$ 208,412	$ 450,599

Our capital expenditures, defined as purchases of property, equipment and software, net, and additions to other intangible assets, were approximately $360.0 million, or 6.2% of total revenues, $430.3 million, or 8% of total revenues, and $288.7 million, or 6.6% of total revenues, for fiscal years 2007, 2006 and 2005, respectively. Historically, the capital intensity of our business has ranged between 5 to 7%. During fiscal year 2006, the overall capital intensity of our business was 8% due to approximately $60 million of investments for the following: investments related to integrating the Acquired HR Business 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.

During fiscal years 2007, 2006 and 2005, cash used in investing activities was $529.0 million, $651.8 million and $922 million, respectively. We used $182.7 million in fiscal year 2007 for acquisitions, including Systech, Primax, Albion and CDR. We used $250.3 million for acquisitions during fiscal year 2006, primarily for the purchase of Transport Revenue, LiveBridge and Intellinex. During fiscal year 2006, we received proceeds from the 2006 Divestitures of $67.7 million. We used $626.9 million for acquisitions during fiscal year 2005, primarily for the purchase of the Acquired HR Business, Superior and BlueStar.

During fiscal year 2007, approximately $2.9 million was used in financing activities. Such financing activities included $696.7 million net borrowings of debt and the repurchase of shares of $730.7 million. During fiscal year 2006, approximately $51.2 million was provided by financing activities. Such financing activities included

$813.2 million net borrowings of debt, proceeds from employee stock transactions of $103.1 million, excess tax benefits on stock option exercises of $14.3 million, offset by the purchase of shares in our tender offer of $476 million and our share repurchase programs of $385.1 million, as well as the settlement of stock options with Jeffrey A. Rich, our former Chief Executive Officer, of $18.4 million. During fiscal year 2005, approximately $168.4 million was provided by financing activities. Such financing activities included $496.1 million net proceeds from the issuance of the Senior Notes, offset by repurchases of approximately 4.9 million shares of our common stock pursuant to our share repurchase programs for approximately $250.8 million and net repayments of debt primarily under our credit facilities of $143.7 million.

We entered into capital lease agreements of an aggregate of $47.8 million, $24.3 million and $2.3 million for the purchase of equipment during fiscal years 2007, 2006 and 2005, respectively.

Credit Facilities

On March 20, 2006, we and certain of our subsidiaries entered into a Credit Agreement (the Credit Agreement) with Citicorp USA, Inc., as Administrative Agent (Citicorp), Citigroup Global Markets Inc., as Sole Lead Arranger and Book Runner, and with Morgan Stanley Bank, SunTrust Bank, Bank of Tokyo-Mitsubishi UFJ, Ltd., Wachovia Bank National Association, Bank of America, N.A., Bear Stearns Corporate Lending and Wells Fargo Bank, N.A., as Co-Syndication Agents, and various other lenders and issuers (the Credit Facility). The Credit Facility provides for a senior secured term loan facility of $1.8 billion, with the ability to increase it by up to $2 billion (as of June 30, 2007), under certain circumstances (the Term Loan Facility) and a senior secured revolving credit facility of $1 billion with the ability to increase it by up to $750 million (the Revolving Facility), each of which is described more fully below. At the closing of the Credit Facility, we and certain of our subsidiaries jointly borrowed approximately $800 million under the Term Loan Facility and approximately $93 million under the Revolving Facility. We used the proceeds of the Term Loan Facility to (i) refinance approximately $278 million in outstanding indebtedness under our 5-Year Competitive Advance and Revolving Credit Facility Agreement dated as of October 27, 2004 (the Prior Facility), (ii) finance the purchase of shares of our Class A common stock tendered in the Company s Dutch Auction tender which expired March 17, 2006 (as extended) and (iii) for the payment of transaction costs, fees and expenses related to the Credit Facility and Dutch Auction. As a result of the refinancing of the Prior Facility, we wrote off approximately $4.1 million in debt issue costs, which was included in other non-operating income, net. A portion of the proceeds of the Revolving Facility were used to refinance approximately $73 million in outstanding indebtedness under the Prior Facility. The remainder of the proceeds of the Revolving Facility were used for working capital purposes and to fund our share repurchase programs. In addition, approximately $114 million of letters of credit were issued under the Credit Facility to replace letters of credit outstanding under the Prior Facility. The Prior Facility was terminated on March 20, 2006.

On July 6, 2006, we amended our Term Loan Facility. We 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. The borrowing rate under the Term Loan Facility as of August 20, 2007 was 7.33%. 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 and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility.

Amounts borrowed under the Term Loan Facility mature on March 20, 2013, and will amortize in quarterly installments in an aggregate annual amount equal to 1% of the aggregate principal amount of the loans advanced, with the balance payable on the final maturity date. Amounts borrowed under the Term Loan Facility may also be repaid at any time at our discretion. Interest on the outstanding balances under the Term Loan Facility is payable, at our option, at a rate equal to the Applicable Margin (as defined in the Credit Facility) plus the fluctuating Base Rate (as defined in the Credit Facility), or at the Applicable Margin plus the current LIBOR (as defined in the Credit Facility). The borrowing rate on the Term Loan Facility at June 30, 2007 was 7.32%.

Proceeds borrowed under the Revolving Facility will be used as needed for general corporate purposes and to fund our share repurchase programs. Amounts under the Revolving Facility are available on a revolving basis until the maturity date of March 20, 2012. The Revolving Facility allows for borrowings up to the full amount of the revolver in either U.S. Dollars or Euros. Up to the U.S. dollar equivalent of $200 million may be borrowed in other currencies, including Sterling, Canadian Dollars, Australian Dollars, Yen, Francs, Krones and New Zealand Dollars. Portions of the Revolving Facility are available for issuances of up to the U.S. dollar equivalent of $700 million of letters of credit and for borrowings of up to the U.S. dollar equivalent of $150 million of swing loans. Interest on outstanding balances under the Revolving Facility is payable, at our option, at a rate equal to the Applicable Margin plus the fluctuating Base Rate, or at the Applicable Margin plus the current LIBOR for the applicable currency. The borrowing rate under the Revolving Facility at June 30, 2007 ranges from 3.87% to 5.37%, depending upon the currency of the outstanding borrowings.

The Credit Facility includes an uncommitted accordion feature of up to $750 million in the aggregate allowing for future incremental borrowings under the Revolving Facility, which may be used for general corporate purposes. The Credit Facility also includes an additional uncommitted accordion feature of up to $2 billion (as of June 30, 2007) allowing for future incremental borrowings under the Term Loan Facility which may be used to fund additional purchases of our equity securities or for extinguishment of our Senior Notes. The Term Loan Facility accordion expires on March 20, 2009.

Obligations under the Credit Facility are guaranteed by us and substantially all of our domestic subsidiaries and certain of our foreign subsidiaries (but only to the extent such guarantees would not result in materially adverse tax consequences). In addition, Credit Facility obligations are secured under certain pledge agreements by (i) a first priority perfected pledge of all notes owned by us and the guarantors and the capital stock of substantially all of our domestic subsidiaries and certain of our foreign subsidiaries (subject to certain exceptions, including to the extent the pledge would give rise to additional SEC reporting requirements for our subsidiaries or result in materially adverse tax consequences), and (ii) a first priority perfected security interest in all other assets owned by us and the guarantors, subject to customary exceptions. As required under the indentures governing our outstanding Senior Notes, we have granted equal and ratable liens in favor of the holders of the Senior Notes in all assets discussed above, other than the accounts receivable of the Company and our subsidiaries.

Among other fees, we pay a commitment fee (payable quarterly) based on the amount of unused commitments under the Revolving Facility (not including the uncommitted accordion feature discussed above). The commitment fee payable at June 30, 2007 was 0.375% of the unused commitment. We also pay fees with respect to any letters of credit issued under the Credit Facility. Letter of credit fees at June 30, 2007 were 1.35% of the currently issued and outstanding letters of credit.

The Credit Facility contains customary covenants, including but not limited to, restrictions on our ability, and in certain instances, our subsidiaries ability, to incur liens, merge or dissolve, make certain restricted payments, or sell or transfer assets. The Credit Facility also limits the Company s and our subsidiaries ability to incur additional indebtedness. In addition, based upon the total amount advanced under the Term Loan Facility at June 30, 2007, we may not permit our consolidated total leverage ratio to exceed 4.00 to 1.00, nor permit our consolidated senior leverage ratio to exceed 3.00 to 1.00, nor permit our consolidated interest coverage ratio to be less than 4.50 to 1.0 during specified periods.

Upon the occurrence of certain events of default, our obligations under the Credit Facility may be accelerated and the lending commitments under the Credit Facility terminated. Such events of default include, but are not limited to, payment default to lenders, material inaccuracies of representations and warranties, covenant defaults, material payment defaults with respect to indebtedness or guaranty obligations, voluntary and involuntary bankruptcy proceedings, material money judgments, material ERISA events, or change of control of the Company. As of June 30, 2007, we were in compliance with the covenants of our Credit Facility, as amended, as described further below.

Draws made under our credit facilities are made to fund cash acquisitions, share repurchases and for general working capital requirements. During the fiscal year ended June 30, 2007, the balance outstanding under our credit facilities for borrowings ranged from $1.1 billion to $2.1 billion. At June 30, 2007, we had approximately $834.7 million available under our Revolving Credit Facility after giving effect to outstanding indebtedness of $52.1 million and $113.2 million of outstanding letters of credit that secure certain contractual performance and other obligations and which reduced the availability of our Revolving Facility. At June 30, 2007, we had $1.8 billion outstanding under our Credit Facility, of which $1.8 billion is reflected in long-term debt and $18 million is reflected in current portion of long-term debt, and approximately $1.8 billion of which bore interest at 7.32% and $52.1 million bore interest from 3.87% to 5.37%. Please see *Derivatives and Hedging Activities* below for a discussion of an interest rate swap agreement related to interest rates on our Credit Facility.

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 were 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 SEC 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 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.

Senior Notes

On June 6, 2005, we completed a public offering of $250 million aggregate principal amount of 4.70% Senior Notes due June 1, 2010 and $250 million aggregate principal amount of 5.20% Senior Notes due June 1, 2015. Interest on the Senior Notes is payable semiannually. The net proceeds from the offering of approximately $496 million, after deducting underwriting discounts, commissions and expenses, were used to repay a portion of the outstanding balance of our Prior Facility. We may redeem some or all of the Senior Notes at any time prior to maturity, which may include prepayment penalties determined according to pre-established criteria.

The Senior Notes contain customary covenants including, but not limited to, restrictions on our ability, and the ability of our subsidiaries, to create or incur secured indebtedness, merge or consolidate with another person, or enter into certain sale and leaseback transactions.

Upon the occurrence of certain events of default, the principal of, and all accrued and unpaid interest on, the Senior Notes may be declared due and payable by the trustee, The Bank of New York Trust Company, N.A. (the Trustee), or the holders of at least 25% in principal amount of the outstanding Senior Notes. Such events of default include, but are not limited to, payment default, covenant defaults, material payment defaults (other than under the Senior Notes) and voluntary or involuntary bankruptcy proceedings. As of June 30, 2007, we were in compliance with the covenants of our 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 Trustee advising us that we were in default of our covenants. 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 purported default set forth in the September 22, 2006 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, 2006 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 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 January 8, 2007, the Court entered an order substituting Wilmington Trust Company for the Trustee. 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.

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

In the event the claim of default against us made by certain holders of the Senior Notes is upheld in a court of law and we are required to pay off the Senior Notes, it is most likely that we would utilize 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.

On December 19, 2006, we entered into an Instrument of Resignation, Appointment and Acceptance with The Bank of New York Trust Company, N.A. and Wilmington Trust Company, whereby The Bank of New York Trust Company, N.A. resigned as trustee, as well as other offices or agencies, with respect to the Senior Notes, and was replaced by Wilmington Trust Company.

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 $13.8 million ($8.6 million, net of income tax), unamortized deferred financing costs of $2.6 million ($1.7 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 June 30, 2007 may be adjusted and reported as interest expense in our Consolidated Statements 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 June 30, 2007, outstanding surety bonds of $524 million and $90.9 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $22.3 million of letters of credit and $1.8 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. On March 7, 2007, Standard & Poor s raised our credit rating to BB, reflecting the filing of our Annual Report on Form 10-K for the year ended June 30, 2006 and our Quarterly Report for the quarter ended September 30, 2006. On March 20, 2007, following the announcement that ACS founder Darwin Deason and private equity fund Cerberus have proposed to buy the Company, all three agencies have placed ACS on review for potential downgrade. 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.

Derivatives 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 June 30, 2007 and 2006, the notional amount of these agreements totaled 312 million pesos (approximately $27.9 million) and 217.5 million pesos (approximately $19.5 million), respectively. These agreements 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 June 30, 2007, the unrealized gain on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was $0.6 million ($0.4 million, net of income tax), and the fair market value of $0.6 million is reflected in other current assets. As of June 30, 2006, the unrealized loss on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was $0.5 million ($0.3 million, net of income tax) and the fair market value $0.5 million was reflected in other current liabilities.

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 U. S. dollar revenues. These agreements do not qualify for hedge accounting under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). As a result, we recorded a gain on hedging instruments of approximately $1.7 million ($1.1 million, net of income tax) for the year ended June 30, 2006 in other non-operating income, net in our Consolidated Statements of Income. The gain on hedging instruments was not material for the year ended June 30, 2007. As of June 30, 2007 and 2006, the notional amount of these agreements totaled 25.2 million Euros (approximately $33.9 million) and 31.2 million Euros (approximately $39.1 million), respectively, and are set to expire at various times over the next four years. A liability was recorded for the related fair value of approximately $4.3 million and $4.1 million as of June 30, 2007 and 2006, respectively.

In order to hedge the variability of future interest payments related to our Senior Notes issuance, we entered into forward interest rate agreements in April 2005. The agreements were designated as cash flow hedges of forecasted interest payments in anticipation of the issuance of the Senior Notes. The notional amount of the agreements totaled $500 million and the agreements were terminated in June 2005 upon issuance of the Senior Notes. The settlement of the forward interest rate agreements of $19 million ($12 million, net of income tax) was recorded in accumulated other comprehensive income (loss), net, and 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. During fiscal years 2007, 2006 and 2005, we amortized approximately $2.5 million, $2.5 million and $0.2 million, respectively, to interest expense. The amount of gain or loss related to hedge ineffectiveness was not material.

In March 2007, we entered into a five-year amortizing interest rate swap agreement. As of June 30, 2007, the notional amount of the agreement totaled $700 million. The agreement is designated as a cash flow hedge of forecasted interest payments on up to $700 million of outstanding floating rate debt under our Credit Facility. The interest rate swap is structured such that we pay a fixed rate of interest of 4.897%, and receive a floating rate of interest based on one month LIBOR. The fair value of the agreement of $8.1 million at June 30, 2007 reflects termination cash value. The unrealized gain of $8.1 million ($5.3 million, net of income tax), is reflected in accumulated other comprehensive income (loss), net at June 30, 2007. As of June 30, 2007, the fair market value of $8.1 million was reflected in other assets.

Share Repurchase Programs

Prior to the Tender Offer, our Board of Directors authorized three share repurchase programs totaling $1.75 billion of our Class A common stock. On September 2, 2003, we announced that our Board of Directors authorized a share repurchase program of up to $500 million of our Class A common stock; on April 29, 2004, we announced that our Board of Directors authorized a new, incremental share repurchase program of up to $750 million of our Class A common stock; and on October 20, 2005, we announced that our Board of Directors authorized an incremental share repurchase program of up to $500 million of our Class A common stock. These share repurchase plans were terminated on January 25, 2006 by our Board of Directors in contemplation of our Tender Offer, which was announced January 26, 2006 and expired March 17, 2006. The programs, which were open-ended, allowed us to repurchase our shares on the open market from time to time in accordance with SEC rules and regulations, including shares that could be purchased pursuant to SEC Rule 10b5-1. The number of shares purchased and the timing of purchases was based on the level of cash and debt balances, general business conditions and other factors, including alternative investment opportunities, and purchases under these plans were funded from various sources, including, but not limited to, cash on hand, cash flow from operations, and borrowings under our credit facilities. Under our previously authorized share repurchase programs, we had repurchased approximately 2.2 million and 4.9 million shares, respectively, at a total cost of approximately $115.8 million and $250.8 million, respectively during fiscal years 2006 and 2005. We reissued approximately 0.3 million shares and 0.6 million shares, respectively, for proceeds of approximately $17.9 million and $28.5 million, respectively, to fund contributions to our employee stock purchase plan and 401(k) plan during fiscal years 2006 and 2005, respectively. In fiscal year 2007, we reissued approximately 57,000 shares for proceeds totaling approximately $2.8 million to fund contributions to our employee stock purchase plan.

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 June 30, 2007, we had repurchased approximately 19.9 million shares under the June 2006 authorization at an average cost of approximately $50.30 per share (approximately $1 billion) all of which have been retired. A total of 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 authorization as of the date of this filing. If any additional repurchases are made, such repurchases would be funded from borrowings under our Credit Facility.

Stock Option Repricing

As discussed in Note 21 to our Consolidated Financial Statements, 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 amendment of the affected stock options and income tax related impacts have required and may continue to require the use of cash.

Through June 30, 2007, we recorded approximately $33.4 million of additional income taxes, estimated penalties and interest, net of the reversal discussed below, related to disallowed Section 162(m) executive compensation deductions resulting from revised measurement dates. At this time, we cannot predict when these Section 162(m) issues will be resolved; however, during the third quarter of fiscal year 2007, we paid approximately $35 million of estimated income taxes, penalties and interest related to Section 162(m) issues in order to reduce future interest that would accrue on the amounts of estimated taxes, penalties and interest. This payment is reflected in cash flows from operating activities at June 30, 2007. During fiscal year 2007, we reversed approximately $6 million of accrued income taxes, penalties and interest associated with Section 162(m) issues attributable to factors unrelated to revised measurement dates as we believe an accrual for these amounts is no longer required.

In December 2006, we amended the exercise price of outstanding stock options of certain current executive officers, other executive officers and former executive officers in order to re-price all or a portion of the respective option grant to the correct accounting measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. We will pay cash payments in the aggregate amount of $2.4 million in accordance with the terms of the amendment, which will be paid in the third quarter of fiscal year 2008 from cash flows from operating activities. Of the $2.4 million cash payment, approximately $0.5 million was expensed in fiscal year 2007, and the balance was charged to Additional Paid-in Capital. If options are exercised, such exercise prices to be paid by option holders is expected to offset the related amounts of the cash payments related to those exercised options; however, the timing of any such exercises cannot be determined.

On June 18, 2007, we initiated a tender offer to amend certain options (the Eligible Options) to purchase an aggregate of 1,703,650 shares (as amended) of our Class A common stock in order to re-price all or a portion of the respective option grant to the correct accounting measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. The Eligible Options included options that (i) were granted under our 1997 Stock Incentive Plan, as amended; (ii) had exercise prices per share that were less, or may have been less, than the fair market value per share of ACS on the revised measurement dates for such options, as determined by us for accounting and tax purposes; (iii) were unexercised and unvested, either in whole or in part, as of January 1, 2005; (iv) were outstanding as of the expiration time of this tender offer; and (v) were held by individuals who (x) were employed by the Company through the expiration time of this tender offer (other than any executive officer or director) and (y) are subject to income taxation in the United States. Eligible participants could elect to (i) amend Eligible Options to increase the exercise price per share to the fair market value of the Company s Class A common stock on the respective option s measurement date and (ii) receive a cash payment equal to the difference between the new exercise price per share of each amended option and the original exercise price per share of such amended option, multiplied by the number of unexercised shares of the Company s Class A common stock subject to such amended option. This payment will be made on or before the eligible option holder s first regular payroll date in January 2008.

The tender offer expired on July 17, 2007. Pursuant to the offer, we accepted for amendment options to purchase 1,696,650 shares of our Class A common stock, which represented 99.6% of the shares of our Class A common stock subject to all Eligible Options. We will pay cash payments in the aggregate amount of $4.0 million in accordance with the terms of the tender offer, which will be paid in the third quarter of fiscal year 2008 from cash flows from operating activities. Of the $4.0 million cash payment, we anticipate that approximately $1.3 million will be expensed, and the balance will be charged to Additional Paid-in Capital in the first quarter of fiscal year 2008. If options are exercised, such exercise prices to be paid by option holders is expected to offset the related amounts of the cash payments related to those exercised options; however, the timing of any such exercises cannot be determined.

In July 2007, we notified former employees with vested, unexercised and outstanding options which had exercise prices per share that were less, or may have been less, than the fair market value per share of ACS on the revised measurement dates for such options, as determined by us for accounting and tax purposes, that we will pay them the additional 20% income tax imposed by Section 409A based on the excess, if any, of the fair market value of our Class A common stock (up to $62 per share) on the date a triggering event occurs or condition exists that under Section 409A results in the excess being recognized and reported as income on the former employee s W-2 and the exercise price of the affected option (reduced by any gain that had become subject to tax in a prior year because of an earlier triggering event). We anticipate that these income tax reimbursements will be up to approximately $1.9 million based on the current fair market value of our Class A common stock on the exercise date and will be paid from cash flows from operating activities as the triggering event occurs for each option holder, beginning in the third quarter of fiscal year 2008. In the first quarter of fiscal year 2008, we will accrue the estimated charge related to these income tax reimbursements based on the current fair market value of our Class A common stock and adjust the accrual each quarter until the options are exercised.

Other

At June 30, 2007, we had cash and cash equivalents of $307.3 million compared to $100.8 million at June 30, 2006. Our working capital (defined as current assets less current liabilities) increased $135.5 million to $839.7 million at June 30, 2007 from $704.2 million at June 30, 2006. Our current ratio (defined as total current assets divided by total current liabilities) was 1.9 at both June 30, 2007 and 2006. 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 54% and 40% at June 30, 2007 and 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. Should interest rates continue to rise, our interest expense could increase, possibly significantly, and impact our results of operations and cash flows. We believe that our expected cash flow provided by operating activities, and anticipated access to the unused portion of our 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.

Related Party Transactions

Please see Management s Discussion and Analysis of Financial Condition and Results of Operations - *Potential Sale of the Company* above for a discussion of the proposal received from our Chairman, Darwin Deason, and Cerberus to acquire all of the outstanding shares of the Company.

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

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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. In the first quarter of fiscal year 2003, we purchased $1 million in prepaid charter flights at favorable rates from DDH. In the second quarter of fiscal year 2007, we were notified by DDH of their intent to wind down operations; therefore, we recorded a charge of $0.6 million related to the unused prepaid charter flights. We made no payments to DDH during fiscal years 2007, 2006 and 2005. Previously, we reported that we anticipated that the administrative services we are providing to DDH would cease prior to June 30, 2007 as a result of the wind down of the DDH operations. Because of continuing activities related to the wind down of operations, the administrative services we are providing to DDH will continue until the wind down is complete.

During fiscal years 2007, 2006 and 2005, we purchased approximately $5.8 million, $8.8 million and $9.0 million, respectively, of office products and printing services from Prestige Business Solutions, Inc., a supplier owned by the daughter-in-law of our Chairman, Darwin Deason. These products and services were purchased on a competitive bid basis in substantially all cases. We believe this relationship has allowed us to obtain these products and services at quality levels and costs more favorable than would have been available through alternative market sources.

In connection with the departure of Jeffrey A. Rich (please see Note 23 to our Consolidated Financial Statements), our former Chief Executive Officer, 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 approximately $63 thousand related to this agreement through June 30, 2006. 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. No payments were made during fiscal year 2007 related to this agreement.

Disclosures about Contractual Obligations and Commercial Commitments as of June 30, 2007 (in thousands):

		Payments Due by Period			
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Long-term debt (1)	$1,832,009	$ 19,651	$ 36,067	$ 88,177	$1,688,114
Senior Notes, net of unamortized discount (1)	499,449		249,950		249,499
Capital lease obligations (1)	57,853	27,388	29,100	1,365	
Operating leases (2)	1,127,317	337,537	518,758	205,271	65,751
Purchase obligations (3) (4)	30,107	16,797	13,310		
Total Contractual Cash Obligations	$3,546,735	$401,373	$847,185	$294,813	$2,003,364

		Amount of Commitment Expiration per Period			
Other Commercial Commitments	**Total Amounts Committed**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Standby letters of credit	$113,205	$113,205	$	$	$
Surety Bonds	525,836	445,113	52,726	26,135	1,862
Total Commercial Commitments	$639,041	$558,318	$52,726	$26,135	$1,862

(1) Excludes accrued interest of $8.9 million at June 30, 2007.

(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 2012, which are included in operating leases in the table.

(3) We have 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.

(4) We entered into a two year agreement with Rich Capital LLC, an M&A advisory firm owned by Jeffrey A. Rich, our former Chief Executive Officer,

to provide us with advisory services in connection with potential acquisition candidates. This contractual obligation is included in the table above. 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.

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We expect to contribute approximately $14.5 million to our pension plans in fiscal year 2008. Minimum pension funding requirements are not included in the table above as such amounts are zero for our pension plans as of June 30, 2007. Please see Critical Accounting Policies and Note 13 to our Consolidated Financial Statements 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 June 30, 2007, outstanding surety bonds of $524 million and $90.9 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $22.3 million of letters of credit and $1.8 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 certain contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During fiscal years 2007, 2006 and 2005, we made contingent consideration payments of $25.4 million, $9.8 million and $17 million, respectively, related to acquisitions completed in prior years. As of June 30, 2007, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities is approximately $90.6 million, of which $21 million has been earned as of June 30, 2007. The $21 million was accrued as of June 30, 2007 and is expected to be paid during the first half of fiscal year 2008. Any such payments primarily result in a corresponding increase in goodwill.

We indemnified Lockheed Martin Corporation against certain specified claims from certain pre-sale litigation, investigations, government audits and other issues related to the majority of the federal business sold 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 June 30, 2007, other accrued liabilities include a reserve for these claims in an amount we believe to be adequate at this time. As discussed in Note 21 to the Consolidated Financial Statements, we 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 June 30, 2007, we serviced a FFEL portfolio of approximately 2.2 million loans with an outstanding principal balance of approximately $32.5 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 June 30, 2007 and 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 that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. We base our estimates on historical experience and on various other assumptions or conditions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates under different assumptions or conditions.

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

Revenue Recognition

A significant portion of our revenue is recognized based on objective criteria that do not require significant estimates or uncertainties. For example, transaction volumes and time and material and cost reimbursable arrangements are based on specific, objective criteria under the contracts. Accordingly, revenues recognized under these methods do not require the use of significant estimates that are susceptible to change. Revenue recognized using the percentage-of-completion accounting method does require the use of estimates and judgment as discussed below.

Our policy follows the guidance from SEC Staff Accounting Bulletin 104 Revenue Recognition (SAB 104), unless the transaction is within the scope of other specific authoritative guidance. SAB 104 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements 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 fee is fixed or determinable, and collectibility is reasonably assured.

During fiscal year 2007, approximately 74% of our revenue was recognized based on transaction volumes, approximately 9% was fixed fee based, wherein our revenue is earned as we fulfill our performance obligations under the arrangement, approximately 5% was related to cost reimbursable contracts, approximately 5% 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 probable and reasonably estimable revenue using the percentage of services completed, on a current cumulative cost to estimated total cost basis, using a reasonably consistent profit margin over the period. Due to the longer term nature of these projects, developing the estimates of costs often requires 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. 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 but does not stipulate the revenue recognition methodology that should be applied to these separate elements. In certain instances where revenue cannot be allocated to a contract element delivered earlier than other elements, costs of delivery are deferred and recognized as the subsequent elements are delivered. Costs deferred cannot exceed the relative fair value of the related element. We adopted the provisions of EITF 00-21 on a prospective basis for transactions entered into or modified 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 on a straight-line basis over the period between the initiation of the ongoing services through the end of the contract term.

Cost of revenues

We present cost of revenues in our Consolidated Statements of Income based on the nature of the costs incurred. Substantially all these costs are incurred in the provision of services to our 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 SFAS No. 5, Accounting for Contingencies (SFAS 5). SFAS 5 requires that we record an estimated loss from a claim or loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business.

Our contracts with clients typically span several years. We continuously review and reassess our estimates of contract profitability. If our estimates indicate that a contract loss will occur, a loss accrual is recorded in the Consolidated Financial Statements in the period it is first identified. 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 long-term contracts and to perform the transition and setup activities necessary to enable us to perform under the terms of the arrangement. We capitalize certain incremental direct costs which are related to the contract origination or transition, implementation and setup activities and amortize them over the term of the arrangement. From time to time, we also provide certain inducements to 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. In addition to our annual impairment testing, we continually evaluate whether events and circumstances have occurred that indicate the balance of goodwill or intangible assets may not be recoverable. In evaluating goodwill for impairment, we compare the estimated fair value of the reporting unit to its underlying book value. In evaluating intangible assets for impairment, we compare the estimated fair value of the intangible asset to its underlying book value. Such evaluation is significantly impacted by estimates and assumptions of future revenues, costs and expenses and other factors. If an event occurs which would cause us to revise our estimates and assumptions used in analyzing the value of our goodwill or other intangible assets, such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

Valuation of property, equipment and software

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

Stock-Based Compensation

We adopted SFAS 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 stock-based payment arrangements based on the fair value of the stock-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 (please see Note 21 to our Consolidated Financial Statements) will be recognized as wages and benefits in the Consolidated Statements of Income on a straight-line basis over the remaining vesting period. For stock-based payment arrangements granted subsequent to July 1,

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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 and the vesting and contractual terms of the respective option.

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

Expected dividend yield.

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

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

Pension and post-employment benefits

SFAS No. 87, Employers Accounting for Pensions (SFAS 87), establishes standards for reporting and accounting for pension benefits provided to employees. On June 30, 2007, we adopted SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106, and 132R (SFAS 158). This Statement requires recognition of the funded status of a defined benefit plan in the statement of financial position as an asset or liability if the plan is overfunded or underfunded, respectively. Changes in the funded status of a plan are required to be recognized in the year in which the changes occur, and reported in comprehensive income as a separate component of stockholders equity. Further, certain gains and losses that were not previously recognized in the financial statements are required to be reported in comprehensive income, and certain disclosure requirements were changed. SFAS No. 158 also requires the measurement date of the plan s funded status to be the same as the company s fiscal year end. There was no change to our June 30 measurement date as a result of the adoption of SFAS 158. Adoption of SFAS 158 resulted in an increase to accumulated other comprehensive income (loss), net of approximately $2.4 million, net of $1.0 million deferred income tax.

Assumptions for calculating benefit obligations and net periodic benefit cost

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

	June 30, 2007		June 30, 2006	
	Pension Plans	**Other Benefit Plan**	**Pension Plans**	**Other Benefit Plan**
Non-U.S. Plans				
Discount rate	5.20% - 5.67%	5.60%	5.00% - 5.75%	5.75%
Rate of increase in compensation levels	4.25% - 4.80%	N/A	4.25% - 4.40%	N/A
U.S. Plan				

Discount rate	6.40%	N/A	6.50%	N/A
Rate of increase in compensation levels	3.40%	N/A	3.50%	N/A

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

	Fiscal year ended June 30, 2007		Fiscal year ended June 30, 2006		Fiscal year ended June 30, 2005	
	Pension Plans	**Other Benefit Plan**	**Pension Plans**	**Other Benefit Plan**	**Pension Plans**	**Other Benefit Plan**
Non-U.S. Plans						
Discount rate	5.20% - 5.67%	5.60%	5.00% - 5.75%	5.75%	5.25% - 5.75%	5.75%
Long-term rate of return on assets	6.50% - 7.00%	N/A	7.00% - 7.50%	N/A	7.00% - 7.50%	N/A
Rate of increase in compensation levels	4.25% - 4.60%	N/A	4.25% - 4.40%	N/A	4.25% - 4.40%	N/A
U.S. Plan						
Discount rate	6.50%	N/A	5.75%	N/A	N/A	N/A
Long-term rate of return on assets	8.00%	N/A	N/A	N/A	N/A	N/A
Rate of increase in compensation levels	3.50%	N/A	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):

	Fiscal year ended June 30, 2007		Fiscal year ended June 30, 2006	
	Plus .25%	**Less .25%**	**Plus .25%**	**Less .25%**
Non-U.S. Plans				
Effect on pension benefit obligation	$(5,786)	$5,841	$(5,055)	$5,155
Effect on service and interest cost	$ (485)	$ 488	$ (432)	$ 450
U.S. Plan				
Effect on pension benefit obligation	$ (316)	$ 336	$ (164)	$ 174
Effect on service and interest cost	$ (145)	$ 153	$ (104)	$ 110

We estimate the long-term rate of return on UK, Canadian and US plan assets will be 6.5%, 7% and 8%, respectively, based on the long-term target asset allocation. 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 35% Canadian provincial and corporate bonds, 30% larger capitalization Canadian stocks, 30% 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.

The U.S. pension plan s target asset allocation is 30% large capitalization U.S. equities, 5% small capitalization U.S. equities, 25% developed market non-U.S. equities, 30% long duration U.S. Treasury bonds and 10% in alternative investments. The asset allocation was set considering asset class expected returns and volatility relative to the duration of the liabilities of the pension plan. The asset allocation is reviewed annually in accordance with the Investment Policy Statement. The assets are held in a separate pension trust account at a custodian bank. External registered investment advisors manage the assets in active and passive strategies that are well diversified, investment grade, liquid and unleveraged.

SFAS 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, a 7.8% 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):

	Fiscal year ended June 30, 2007		**Fiscal year ended June 30, 2006**	
	Plus 1%	Less 1%	Plus 1%	Less 1%
Effect on pension benefit obligation	$34	$(31)	$30	$(27)
Effect on service and interest cost	$ 5	$ (4)	$ 4	$ (4)

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

Please see Note 28 to our Consolidated Financial Statements for a discussion of recent accounting pronouncements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk resulting from changes in interest rates, changes in market value of financial instruments caused by changes in interest rates, foreign currency exchange rates and fair market value of our investments. Sensitivity analysis is one technique available to measure the impact that changes in these rates could have on our results of operations or financial position. The following analysis provides an indication of our sensitivity to changes in interest rates and foreign currency exchange rates as of June 30, 2007.

Interest Rates

During fiscal year 2006, we entered into a new credit agreement (please see Note 12 to our Consolidated Financial Statements for more discussion). These new facilities are variable rate instruments and are subject to market risk resulting 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 interest rates had increased by 10% at June 30, 2007, and our June 30, 2007 Credit Facility debt had been outstanding for the entire fiscal year, net of $700 million under our five-year amortizing interest rate swap agreement discussed below, our results of operations would have decreased approximately $8.2 million ($5.3 million, net of income tax).

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In March 2007, we entered into a five-year amortizing interest rate swap agreement. At June 30, 2007, the notional amount of the agreement was $700 million. The agreement is designated as a cash flow hedge of forecasted interest payments on up to $700 million of outstanding floating rate debt under our Credit Facility. The interest rate swap is structured such that we pay a fixed interest rate of 4.897%, and receive a floating interest rate based on one month LIBOR. Risk can be estimated by measuring the impact of a near-term adverse movement of 10% in short-term market interest rates. As of June 30, 2007, the fair value of the agreement is approximately $8.1 million and reflects the termination cash value. If interest rates were 10% lower at June 30, 2007, the fair value of the interest rate swap agreement would be a liability of approximately $2.5 million. Changes in the fair value of our interest rate swap agreement would not affect our results of operations or cash flows unless terminated prior to maturity.

We entered into fixed rate Senior Notes during fiscal year 2005. The Senior Notes are 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 market interest rates. The fair value of the Senior Notes as of June 30, 2007 and 2006 was $459.4 million and $448 million, respectively, based on quoted market prices. If these rates were 10% higher or lower at June 30, 2007, the fair value of the Senior Notes would be approximately $445.6 million and $473.9 million, respectively. Changes in the fair value of our fixed rate Senior Notes would not impact our results of operations or cash flows, unless redeemed prior to maturity.

Foreign Currency

We conduct business in the U. S. and in foreign countries and are exposed to foreign currency risk from changes in the value of underlying assets and liabilities of our non-U. S. denominated foreign investments and foreign currency transactions. Risk can be estimated by measuring the impact of a near-term adverse movement of 10% in foreign currency rates against the U.S. dollar. If these rates were 10% higher or lower at June 30, 2007, there would have been no material adverse impact on our results of operations or financial position.

We hedge the variability of a portion of our anticipated future Mexican Peso cash flows through foreign exchange forward agreements. We use sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our foreign exchange forward agreements. The foreign exchange risk is computed based on the market value of the forward agreements as affected by changes in the corresponding foreign exchange rates. The sensitivity analysis represents the hypothetical changes in the value of the foreign exchange forward agreements and does not reflect the offsetting gain or loss on the underlying exposure. Fluctuations in the fair value of the foreign exchange forward agreements are recorded in accumulated other comprehensive income (loss), net. As of June 30, 2007, a 10% adverse movement in the foreign currency exchange rate with all other variables held constant would have resulted in a decrease in the fair value of our foreign exchange forward agreements of $3.2 million. Changes in the fair value of these foreign exchange forward agreements would not impact our results of operations or cash flows, unless terminated prior to maturity.

As discussed in Note 20 to our Consolidated Financial Statements, we hedge our Transport Revenue s French operation s Euro foreign exchange exposure related to its Canadian dollar and U.S. dollar revenues. We use sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our foreign exchange forward agreements. The foreign exchange risk is computed based on the market value of the forward agreements as affected by changes in the corresponding foreign exchange rates. The sensitivity analysis represents the hypothetical changes in the value of the foreign exchange forward agreements and does not reflect the offsetting gain or loss on the underlying exposure. As of June 30, 2007, a 10% adverse movement in the foreign currency exchange rate with all other variables held constant would have resulted in a decrease in the fair value of our foreign exchange forward agreements of approximately $3.5 million. Changes in the fair value of our foreign exchange forward agreements would be recorded in our Consolidated Statements of Income.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Affiliated Computer Services, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in stockholders equity and cash flows present fairly, in all material respects, the financial position of Affiliated Computer Services, Inc. and its subsidiaries at June 30, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2007 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Notes 1 and 2 to the consolidated financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share Based Payment, as of July 1, 2005.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management s Report on Internal Control over Financial Reporting, management has excluded Primax Recoveries, Inc. (Primax) and Systech Integrators, Inc. (Systech) from its assessment of internal control over financial reporting as of June 30, 2007 because they were acquired by the Company in purchase business combinations during fiscal year 2007. We have also excluded Primax and Systech from our audit of internal control over financial reporting. Primax and Systech are wholly-owned subsidiaries whose total assets and total revenues represent 2.3% and 1.6%, respectively, of the related consolidated financial statement amounts as of and for the year ended June 30, 2007.

PricewaterhouseCoopers LLP
Dallas, TX
August 29, 2007

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands)

	June 30, 2007	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 307,286	$ 100,837
Accounts receivable, net	1,257,108	1,231,846
Income taxes receivable	13,268	8,090
Prepaid expenses and other current assets	232,872	188,490
Total current assets	1,810,534	1,529,263
Property, equipment and software, net	897,319	870,020
Goodwill	2,612,368	2,456,654
Other intangibles, net	481,378	475,701
Other assets	180,830	170,799
Total assets	$ 5,982,429	$ 5,502,437
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 97,951	$ 104,473
Accrued compensation and benefits	246,742	172,853
Other accrued liabilities	400,238	354,632
Deferred taxes	14,418	18,047
Current portion of long-term debt	47,039	23,074
Current portion of unearned revenue	164,484	152,026
Total current liabilities	970,872	825,105
Senior Notes, net of unamortized discount	499,449	499,368
Other long-term debt	1,842,823	1,114,664
Deferred taxes	367,565	331,433
Other long-term liabilities	235,552	275,649
Total liabilities	3,916,261	3,046,219
Commitments and contingencies (Please see Notes 12, 21 and 29)		
Stockholders equity:		
Class A common stock, $.01 par value, 500,000 shares authorized, 113,960 and 129,848 shares issued, respectively	1,139	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	1,642,900	1,799,778
Accumulated other comprehensive income (loss), net	15,916	(10,943)
Retained earnings	1,462,115	1,836,850
Treasury stock at cost, 21,002 and 23,289 shares, respectively	(1,055,968)	(1,170,832)
Total stockholders equity	2,066,168	2,456,218
Total liabilities and stockholders equity	$ 5,982,429	$ 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
(In thousands except per share amounts)

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Revenues	$ 5,772,479	$ 5,353,661	$ 4,351,159
Operating expenses:			
Cost of revenues:			
Wages and benefits	2,748,717	2,568,042	1,874,044
Services and supplies	1,262,435	1,168,540	1,046,341
Rent, lease and maintenance	701,620	646,474	503,132
Depreciation and amortization	346,199	289,852	232,779
Software impairment charge	76,407		
Other	33,440	39,629	23,687
Cost of revenues	5,168,818	4,712,537	3,679,983
Gain on sale of business		(32,907)	
Other operating expenses	66,706	56,747	23,692
Total operating expenses	5,235,524	4,736,377	3,703,675
Operating income	536,955	617,284	647,484
Interest expense	182,665	68,367	20,186
Other non-operating income, net	(29,123)	(9,396)	(5,186)
Pretax profit	383,413	558,313	632,484
Income tax expense	130,323	199,507	222,915
Net income	$ 253,090	$ 358,806	$ 409,569
Earnings per share:			
Basic	$ 2.53	$ 2.91	$ 3.21
Diluted	$ 2.49	$ 2.87	$ 3.14
Shares used in computing earnings per share:			
Basic	100,181	123,197	127,560

Diluted	101,572	125,027	130,556

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 CHANGES IN STOCKHOLDERS EQUITY
(In thousands)

	Common Stock Class A		Common Stock Class B		Additional Paid-in	Retained	Accumulated Other Comprehensive Income (Loss),	Treasury Stock		
	Shares	**Amount**	**Shares**	**Amount**	**Capital**	**Earnings**	**Net**	**Shares Held**	**Amount**	**Total**
Balance at June 30, 2004	135,981	$ 1,360	6,600	$ 66	$ 1,750,159	$ 1,560,067	$ (3,381)	(14,900)	$ (738,593)	$ 2,569,678
Comprehensive income:										
Foreign currency translation gains							4,260			4,260
Interest rate hedges, net of income tax							(11,789)			(11,789)
Net income						409,569				409,569
Total comprehensive income										402,040
Share repurchases								(4,922)	(250,793)	(250,793)
Stock-based compensation expense					6,061					6,061
Tax benefit on stock option exercises					18,587					18,587
Employee stock transactions and related tax benefits	1,905	19			37,667			567	28,453	66,139
Balance at June 30, 2005	137,886	1,379	6,600	66	1,812,474	1,969,636	(10,910)	(19,255)	(960,933)	2,811,712
Comprehensive income:										
Foreign currency translation							(1,305)			(1,305)

losses										
Foreign currency hedges, net of income tax							(316)			(316)
Interest rate hedges, net of income tax							1,588			1,588
Net income						358,806				358,806
Total comprehensive income										358,773
Share repurchases								(7,611)	(385,116)	(385,116)
Shares purchased in Tender Offer								(7,365)	(475,993)	(475,993)
Retired shares	(10,585)	(106)			(141,592)	(491,592)		10,585	633,290	
Stock-based compensation expense					33,589					33,589
Tax benefit on stock option exercises					25,772					25,772
Employee stock transactions and related tax benefits	2,547	26			69,535			357	17,920	87,481
Balance at June 30, 2006	129,848	1,299	6,600	66	1,799,778	1,836,850	(10,943)	(23,289)	(1,170,832)	2,456,218
Comprehensive income:										
Foreign currency translation gains							16,955			16,955
Foreign currency hedges, net of income tax							693			693
Interest rate hedges, net of income tax							6,837			6,837
Net income						253,090				253,090
Total comprehensive										277,575

income										
Share repurchases								(14,429)	(730,688)	(730,688)
Retired shares	(16,659)	(167)			(214,712)	(627,825)		16,659	842,704	
Stock-based compensation expense					27,968					27,968
Tax benefit on stock option exercises					7,203					7,203
Employee stock transactions and related tax benefits	771	7			22,663			57	2,848	25,518
Adjustment to initially apply SFAS 158, net of income tax							2,374			2,374
Balance at June 30, 2007	113,960	$ 1,139	6,600	$ 66	$ 1,642,900	$ 1,462,115	$ 15,916	(21,002)	$ (1,055,968)	$ 2,066,168

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
(In thousands)

	Fiscal year ended June 30, 2007	2006	2005
Cash flows from operating activities:			
Net income	$ 253,090	$ 358,806	$ 409,569
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	346,199	289,852	232,779
Contract inducement amortization	14,634	15,332	14,309
Provision for uncollectible accounts receivable	(290)	8,462	763
Deferred financing fee amortization	6,292	2,850	1,436
Provision for default loan liability	(218)	(1,144)	(188)
Software impairment charge	76,407		
Other asset impairments	1,351	19,132	
Gain on sale of business units	(2,459)	(32,907)	(70)
Gain on long-term investments	(19,345)	(6,787)	(2,967)
Deferred income tax expense	19,626	84,701	84,817
Excess tax benefits on stock-based compensation	(3,763)	(14,318)	
Stock-based compensation expense	28,491	35,035	6,061
Tax benefit of stock options			20,059
Loss on early extinguishment of long-term debt		4,104	
Settlement of interest rate hedges			(19,267)
Other non-cash activities	3,384	3,790	225
Changes in assets and liabilities, net of effects from acquisitions:			
Accounts receivable	10,882	(112,601)	(21,945)
Prepaid expenses and other current assets	(42,023)	(34,379)	(16,540)
Other assets	(2,085)	16,090	3,234
Accounts payable	(11,349)	25,943	(11,483)
Accrued compensation and benefits	63,233	(3,676)	(5,362)
Other accrued liabilities	12,493	(132,238)	2,414
Income taxes receivable/payable	4,312	18,093	(8,277)
Other long-term liabilities	(29,085)	(920)	15,913
Unearned revenue	8,601	95,490	33,868
Total adjustments	485,288	279,904	329,779
Net cash provided by operating activities	738,378	638,710	739,348
Cash flows from investing activities:			
Purchases of property, equipment and software, net	(316,843)	(394,467)	(253,231)
Additions to other intangible assets	(43,187)	(35,831)	(35,518)
Payments for acquisitions, net of cash acquired	(182,724)	(250,317)	(626,858)
Proceeds from divestitures, net of transaction costs		67,665	87
Intangibles acquired in subcontractor termination		(16,530)	
Purchases of investments	(6,532)	(25,462)	(8,607)

Proceeds from sale of investments	20,283	3,167	1,713
Proceeds from notes receivable			425
Net cash used in investing activities	(529,003)	(651,775)	(921,989)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt, net	1,847,719	3,681,205	2,790,016
Payments of long-term debt	(1,150,972)	(2,867,995)	(2,437,635)
Purchase of treasury shares	(730,689)	(385,116)	(250,793)
Excess tax benefits on stock-based compensation	3,763	14,318	
Proceeds from stock options exercised	24,523	83,190	36,596
Proceeds from issuance of treasury shares	2,923	19,927	30,243
Purchase of shares in Tender Offer		(475,959)	
Stock option settlement with Jeffrey A. Rich, former Chief Executive Officer		(18,353)	
Other, net	(193)		
Net cash provided by (used in) financing activities	(2,926)	51,217	168,427
Net increase (decrease) in cash and cash equivalents	206,449	38,152	(14,214)
Cash and cash equivalents at beginning of year	100,837	62,685	76,899
Cash and cash equivalents at end of year	$ 307,286	$ 100,837	$ 62,685

Please see supplemental cash flow information in Notes 4, 6, 12, and 14

The accompanying Notes are an integral part of these Consolidated Financial Statements.

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

1. BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business and basis of presentation

We are a Fortune 500 and S&P 500 company with approximately 60,000 employees providing business process outsourcing and information technology services to commercial and government clients. We were incorporated in Delaware on June 8, 1988 and our corporate headquarters is located in Dallas, Texas. Our clients have time-critical, transaction-intensive business and information processing needs, and we typically service these needs through long-term contracts.

The Consolidated Financial Statements are comprised of our accounts and the accounts of our controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated. Investments in business entities in which we do not have control, but have the ability to exercise significant influence over operating and financial policies are accounted for by the equity method. Other investments are accounted for by the cost method. Our fiscal year ends on June 30. The accompanying Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States that require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, the reported amount of revenues and expenses during the reporting period, as well as the accompanying notes. These estimates are based on information available to us. Actual results could differ from these estimates.

Certain prior period amounts have been reclassified to conform to current year presentation.

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.

Cash and cash equivalents

Cash and cash equivalents consist primarily of cash, short-term investments in commercial paper, and money market investments that have an initial maturity of three months or less. Cash equivalents are valued at cost, which approximates market.

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.

Property, equipment and software, net

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which for equipment ranges primarily from 3 to 12 years and for buildings and improvements up to 40 years. Leasehold improvements are depreciated over the shorter of the term of the lease or the estimated useful life.

In accordance with Statement of Position 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1), certain costs related to the development or purchase of internal-use software are capitalized and amortized over the estimated useful life of the software. Costs incurred for upgrades and enhancements, which will not result in additional functionality, are expensed as incurred. During fiscal years 2007, 2006 and 2005, we capitalized approximately $65.1 million, $104.7 million and $57.4 million, respectively, in software costs under SOP 98-1, which are being amortized over expected useful lives, which range from 3 to 10 years. These capitalized amounts include internal costs of approximately $35.7 million, $39.2 million and $15.9 million and external costs of approximately $29.4 million, $65.5 million and $41.5 million for fiscal years 2007, 2006 and 2005, respectively. These costs were incurred primarily in the development of our proprietary software used in connection with our long-term client relationships. The amortization of our internal use software is included in the amortization of computer software in our depreciation and amortization expense as reflected in Note 8.

During fiscal year 2007, we recorded a non-cash impairment charge for in-process capitalized software related to our Department of Education contract of approximately $76.4 million (please see Note 22 for further discussion), which included $12.7 million capitalized in fiscal year 2007, and which is included in the total amounts capitalized under SOP 98-1 above.

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

In accordance with Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (SFAS 86), certain costs related to the development of software to be sold to our clients are capitalized upon reaching technological feasibility and amortized over the estimated useful life of the software. During fiscal years 2007, 2006 and 2005, we capitalized approximately $27.6 million, $31.6 million and $10.1 million, respectively, in software costs under SFAS 86, which are being amortized over expected useful lives, which range from 3 to 10 years. These capitalized amounts include internal costs of approximately $0.5 million, $6.1 million and $8.6 million and external costs of approximately $27.1 million, $25.5 million and $1.5 million for fiscal years 2007, 2006 and 2005, respectively. The amortization of software costs under SFAS 86 is included in the amortization of computer software in our depreciation and amortization expense as reflected in Note 8.

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

Goodwill and other intangible assets

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

Other intangible assets consist primarily of acquired customer-related intangibles, and contract and migration costs related to new business activity, both of which are recorded at cost and amortized using the straight-line method over the contract terms. In connection with our revenue arrangements, we incur costs to originate long-term contracts and to perform the transition and setup activities necessary to enable us to perform under the terms of the arrangement. We capitalize certain incremental direct costs which are related to the contract origination or transition, implementation and setup activities and amortize them over the term of the arrangement. From time to time, we also provide certain inducements to clients in the form of various arrangements, including contractual credits, which are capitalized and amortized as a reduction of revenue over the term of the contract. The amortization period of customer-related intangible assets ranges from 1 to 17 years, with a weighted average of approximately 10 years. The amortization period for all other intangible assets, excluding title plants and tradenames with indefinite useful lives, ranges from 1 to 20 years, with a weighted average of 6 years. For the acquisitions in all periods presented except one immaterial acquisition in our Government segment during fiscal year 2007, we obtained a third-party valuation of the intangible assets from Value Incorporated. The determination of the value of other intangible assets requires us to make estimates and assumptions about future business trends and growth. In addition to our annual impairment testing, we continually evaluate whether events and circumstances have occurred that indicate the balance of intangible assets may not be recoverable. In evaluating impairment, we compare the estimated fair value of the intangible asset to its underlying book value. Such evaluation is significantly impacted by estimates and assumptions of future revenues, costs and expenses and other factors. If an event occurs which would cause us to revise our estimates and assumptions used in analyzing the value of our other intangible assets, such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

Other assets

Other assets primarily consist of long-term receivables, long-term investments related to our deferred compensation plans (please see Note 10), long-term investments accounted for using the cost and equity methods, long-term deposits and deferred debt issuance costs. It is our policy to periodically review the net realizable value of our long-term receivables and investments through an assessment of the recoverability of the carrying amount of each receivable and investment. For the investments related to our deferred compensation plans, we carry the assets at their fair value, with changes in fair value included in our results of operations. Each investment is reviewed to determine if events or changes in circumstances have occurred which indicate that the recoverability of the carrying amount may be uncertain. In the event that an investment is found to be carried at an amount in excess of its recoverable amount, the asset would be adjusted for impairment to a level commensurate with the

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

recoverable amount of the underlying asset. Deferred debt issuance costs are amortized using the straight-line method over the life of the related debt, which approximates the effective interest method.

Derivative Instruments

We may, from time to time, enter into derivative financial instruments to manage exposure to certain risks, including interest rate risk and foreign currency exchange rate risk. We may hedge material cash flow exposures using forward and/or option contracts. These instruments are generally short-term in nature, with maturities of one year or less. Our derivative instruments are accounted for in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). As such, the change in the fair value of our derivative financial instruments are recorded at fair value in the Consolidated Balance Sheets and are reclassified to the same Consolidated Statements of Income category as the hedged item in the period in which the hedged transaction occurs. In addition, we classify payments received or paid related to cash flow and fair value hedges in the same category of the Consolidated Statements of Cash Flows as the item being hedged.

As part of the Transport Revenue acquisition (defined below), we acquired foreign exchange forward agreements that hedge our French operation s Euro foreign exchange exposure related to its Canadian dollar and U. S. dollar revenues. These agreements do not qualify for hedge accounting under SFAS 133. As such, the changes in fair value are recognized in other non-operating income, net in the Consolidated Statements of Income.

Revenue recognition

A significant portion of our revenue is recognized based on objective criteria that do not require significant estimates or uncertainties. For example, transaction volumes and time and material and cost reimbursable arrangements are based on specific, objective criteria under the contracts. Accordingly, revenues recognized under these methods do not require the use of significant estimates that are susceptible to change. Revenue recognized using the percentage-of-completion accounting method does require the use of estimates and judgment as discussed below.

Our policy follows the guidance from SEC Staff Accounting Bulletin 104 Revenue Recognition (SAB 104), unless the transaction is within the scope of other specific authoritative guidance. SAB 104 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements and updates Staff Accounting Bulletin Topic 13 to be consistent with Emerging Issues Task Force (EITF) 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 fee is fixed or determinable, and collectibility is reasonably assured.

During fiscal year 2007, approximately 74% of our revenue was recognized based on transaction volumes, approximately 9% was fixed fee based, wherein our revenue is earned as we fulfill our performance obligations under the arrangement, approximately 5% was related to cost reimbursable contracts, approximately 5% 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

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

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 probable and reasonably estimable revenue using the percentage of services completed, on a current cumulative cost to estimated total cost basis, using a reasonably consistent profit margin over the period. Due to the longer term nature of these projects, developing the estimates of costs often requires 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. 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 but does not stipulate the revenue recognition methodology that should be applied to these separate elements. In certain instances where revenue cannot be allocated to a contract element delivered earlier than other elements, costs of delivery are deferred and recognized as the subsequent elements are delivered. Costs deferred cannot exceed the relative fair value of the related element. We adopted the provisions of EITF 00-21 on a prospective basis for transactions entered into or modified 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 on a straight-line basis over the period between the initiation of the ongoing services through the end of the contract term.

Contingencies

We account for claims and contingencies in accordance with SFAS No. 5, Accounting for Contingencies (SFAS 5). SFAS 5 requires that we record an estimated loss from a claim or loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business.

Our contracts with clients typically span several years. We continuously review and reassess our estimates of contract profitability. If our estimates indicate that a contract loss will occur, a loss accrual is recorded in the Consolidated Financial Statements in the period it is first identified. 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.

Income taxes

The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing the timing and amounts of deductible and taxable items. We establish reserves when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be challenged and that we may not succeed. We adjust these reserves in light of changing facts and circumstances. Our provision for income taxes includes the impact of these reserve changes. In the event that there is a significant unusual or 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. Please see Note 14 for a discussion of income taxes.

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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Sales taxes

Sales taxes collected from customers are excluded from revenues. The obligation is included in accounts payable until the taxes are remitted to the appropriate taxing authorities.

Earnings per share

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the combination of dilutive common share equivalents and the weighted average number of common shares outstanding during the period. Please see Note 18 for the computation of earnings per share.

Stock-based compensation

Please see Note 21 for information concerning our internal investigation into our stock option grant practices during the period from 1994 through 2005.

We adopted SFAS 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 stock-based payment arrangements based on the fair value of the stock-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 will be recognized as wages and benefits in the Consolidated Statements of Income on a straight-line basis over the remaining vesting period. For stock-based payment arrangements 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 and the vesting and contractual terms of the respective option.

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

Expected dividend yield.

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

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

Pensions and other post-employment benefits

SFAS No. 87, Employers Accounting for Pensions (SFAS 87), establishes standards for reporting and accounting for pension benefits provided to employees. On June 30, 2007, we adopted SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106, and 132R (SFAS 158). This Statement requires recognition of the funded status of a defined benefit plan in the statement of financial position as an asset or liability if the plan is overfunded or underfunded, respectively. Changes in the funded status of a plan are required to be recognized in the year in which the changes occur, and reported in comprehensive income as a separate component of stockholders equity. Further, certain gains and losses that were not previously recognized in the financial statements are required to be reported in comprehensive income, and certain disclosure requirements were changed. SFAS 158 also requires the measurement date of the plan s funded status to be the same as the company s fiscal year end. There was no change to our June 30 measurement date as a result of the adoption of SFAS 158. Adoption of SFAS 158 resulted in an increase to accumulated other comprehensive income (loss), net of approximately $2.4 million, net of $1.0 million deferred income tax.

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Following is the incremental impact of applying SFAS 158 on individual line items in the consolidated balance sheet at June 30, 2007 (in millions):

	Before Application of SFAS 158	Adjustments	After Application of SFAS 158
Other assets	$ 182,508	$ (1,678)	$ 180,830
Total Assets	5,984,107	(1,678)	5,982,429
Accrued compensation and benefits	245,382	1,360	246,742
Total current liabilities	969,512	1,360	970,872
Deferred taxes	366,585	980	367,565
Other long-term liabilities	241,944	(6,392)	235,552
Total liabilities	3,920,313	(4,052)	3,916,261
Accumulated other comprehensive income (loss), net	13,542	2,374	15,916
Total stockholders equity	2,063,794	2,374	2,066,168
Total liabilities and stockholders equity	5,984,107	(1,678)	5,982,429

In addition to these pension plans, we also assumed a post-employment medical plan for Canadian Acquired HR Business (defined in Note 4) employees and retirees. The amount of health care benefits is limited to lifetime maximum and age limitations as described in the plan.

For further discussion of our pensions and other post-employment plans, please see Note 13.

2. STOCK-BASED COMPENSATION PLANS

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123(R). SFAS 123(R) requires the company to measure all employee stock-based compensation awards using a fair value method and recognize compensation cost in our financial statements. We adopted SFAS 123(R) on a prospective basis beginning July 1, 2005 for stock-based compensation awards granted after that date and for unvested awards outstanding at that date using the modified prospective application method. We recognize the fair value of stock-based compensation awards as wages and benefits in the Consolidated Statements of Income on a straight-line basis over the vesting period.

Prior to July 1, 2005, we followed Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees in accounting for our stock-based compensation plans. Had compensation cost for our stock-based compensation plans been determined based on the fair value at the grant date under those plans consistent with the fair value method of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), our net income and earnings per share would have been reduced to the pro forma amounts indicated below (in thousands, except per share amounts):

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		Fiscal year ended June 30, 2005
Net income	$	409,569
Add: Recorded employee compensation cost of stock-based compensation plans, net of income tax of $2,195		3,866
Less: Pro forma employee compensation cost of stock-based compensation plans, net of income tax of $14,705		(26,124)
Pro forma	$	387,311
Basic earnings per share		
As reported	$	3.21
Pro forma	$	3.04
Diluted earnings per share		
As reported	$	3.14
Pro forma	$	2.99

The fair value of each option grant was estimated at the date of grant using a separate Black-Scholes option pricing calculation for each grant. As discussed above, prior to the adoption of SFAS 123(R), we determined the fair value of grants for disclosure of pro forma stock-based compensation costs in accordance with SFAS 123. We used the following weighted-average assumptions to determine the fair value of grants:

		Fiscal year ended June 30, 2005
Expected volatility		24.58%
Expected term		4.77 years
Risk-free interest rate		3.91%
Expected dividend yield		0%
Weighted average fair value of options granted	$	14.22

The adoption of SFAS 123(R) in the first quarter of fiscal year 2006 resulted in prospective changes in our accounting for stock-based compensation awards including recording stock-based compensation expense and the related deferred income tax benefit on a prospective basis and reflecting the excess tax benefits from the exercise of stock-based compensation awards in cash flows from financing activities.

The adoption of SFAS 123(R) resulted in the recognition of compensation expense of $28 million ($17.8 million, net of deferred income tax benefits) and $35 million ($22.9 million, net of deferred income tax benefits), $0.18 and $0.19 per basic share or $0.18 and $0.18 per diluted share, in wages and benefits in the Consolidated Statements of Income for the fiscal years ended June 30, 2007 and 2006, respectively. In accordance with the modified prospective application method of SFAS 123(R), prior period amounts have not been restated to reflect the recognition of stock-based compensation costs as determined under SFAS 123. The total compensation cost related to non-vested awards not yet recognized at June 30, 2007 was approximately $68.1 million, which is expected to be recognized over a weighted average of 3.5 years.

In periods ending prior to July 1, 2005, the income tax benefits from the exercise of stock options were classified as net cash provided by operating activities pursuant to EITF Issue No. 00-15 Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. However, for periods ending after July 1, 2005, pursuant to SFAS 123(R), the income tax benefits exceeding the recorded deferred income tax benefit and any pre-adoption as-if deferred income tax benefit from stock-based compensation awards (the excess tax benefits) are required to be reported in net cash provided by financing activities. For the years ended June 30, 2007 and 2006, excess tax benefits from stock-based compensation awards of $3.8 million and $14.3 million, respectively, were reflected as an outflow in cash flows from operating activities and an inflow in

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cash flows from financing activities in the Consolidated Statements of Cash Flows, resulting in a net impact of zero on cash. In fiscal year 2005, income tax benefits from the exercise of stock options of $20.1 million were reflected as an inflow in cash flows from operating activities in the Consolidated Statements of Cash Flows.

On June 7, 2007, our stockholders approved the 2007 Equity Incentive Plan (the 2007 Equity Plan). This plan is intended to replace our 1997 Stock Incentive Plan (the 1997 Stock Plan). Under the 2007 Equity Plan we have reserved 15 million shares of Class A common stock for issuance to key employees at exercise prices determined by the Board of Directors or designated committee thereof. Under our 1997 Stock Plan, we originally reserved approximately 7.4 million shares of Class A common stock for issuance to key employees at exercise prices determined by the Board of Directors or designated committee thereof. In May 2000, February 2001, October 2001, July 2003, February 2005 and July 2005, the Board of Directors approved the additional allotment of approximately 1.7 million, 1.6 million, 4.1 million, 3.8 million, 2.7 million and 0.8 million shares, respectively, to the 1997 Stock Plan in accordance with the terms and conditions of the 1997 Stock Plan authorized by our shareholders pursuant to our November 14, 1997 Proxy Statement. Options granted under the 1997 Stock Plan to our current employees cannot exceed 12.8% of our issued and outstanding shares, and consequently, any share repurchases (as discussed in Note 16) reduce the number of options to purchase shares that we may grant under the 1997 Stock Plan. As of June 7, 2007, the 1997 Stock Plan has been discontinued for new grants and as a result, 1,521,736 unissued shares will expire as of December 31, 2007. Our 1988 Stock Option Plan (the 1988 Plan), which originally reserved 12 million shares of Class A common stock for issuance, was discontinued for new grants during fiscal year 1998 and terminated (except for the exercise of then existing option grants as of September 1997) and subsequently, 3.2 million unissued shares expired. Generally, the options under each plan vest in varying increments over a five-year period become exercisable as they vest (please see discussion of the February 2, 2005 amendment below) and expire ten years from the date of grant. As of June 30, 2007, we had approximately 14,643,000 shares available for issuance under the 2007 Equity Plan.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes valuation model utilizing the assumptions noted below. The expected volatility of our stock price is based on historical monthly volatility over the expected term based on daily closing stock prices. The expected term of the option is based on historical employee stock option exercise behavior, and the vesting term of the respective award and the contractual term of the respective options. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. 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. The weighted-average fair value of options granted was $13.44 for the year ended June 30, 2007.

The following weighted-average assumptions were used to determine the fair value of grants.

	Fiscal year ended June 30,	
	2007	**2006**
Expected volatility	21.10%	22.20%
Expected term	4.25 years	4.21 years
Risk-free interest rate	4.74%	3.49%
Expected dividend yield	0%	0%

In order to conform our stock option program with standard market practice, on February 2, 2005, our Board of Directors approved an amendment to stock options previously granted that did not become exercisable until five years from the date of grant to provide that such options become exercisable on the day they vest. Options granted under both our 1997 Stock Plan and our 1988 Plan generally vest in varying increments over a five year period. It is expected that future option grants will contain matching vesting and exercise schedules, which we believe will result in a lower expected term. This amendment does not amend or affect the vesting schedule, exercise price, quantity of options granted, shares into which such options are exercisable or life of any award under any outstanding option grant. Therefore, no compensation expense was recorded related to this amendment; however, the expected term of the options decreased due to this amendment.

The total intrinsic value of options exercised during the years ended June 30, 2007, 2006 and 2005 was $20.2 million, $66.2 million and $66.5 million, respectively, resulting in income tax benefits of $7.3 million, $23.9 million and $20.1 million, respectively. In addition, we also recorded income tax benefits of $6.7 million in the first quarter of fiscal year 2006 related to the purchase of vested options from former Chief Executive Officer Jeffrey A. Rich (please see Note 23 for further discussion).

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Of the total income tax benefit of $7.3 million and $30.6 million for the year ended June 30, 2007 and 2006, respectively, $3.8 million and $14.3 million, respectively, is reflected as excess tax benefits in net cash provided by financing activities in the Consolidated Statements of Cash Flows.

Option activity for the year ended June 30, 2007 is summarized as follows:

	Options	Weighted Average Exercise Price (1)	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding as of June 30, 2006	11,638,410	$42.30		
Granted	3,288,500	50.78		
Exercised	(770,550)	31.83		
Forfeited (2)	(1,533,800)	49.63		
Expired				
Outstanding as of June 30, 2007	12,622,560	$44.88	6.73	$150,355
Vested and exercisable at June 30, 2007	5,516,600	$38.45	5.00	$100,764

(1) Weighted average exercise price of outstanding options, warrants, and rights of $44.88 per share is prior to the repricing of certain options that occurred in the first quarter of fiscal year 2008, as discussed in Notes 21 and 29.

(2) Includes 355,000 stock options terminated due to the departure of our executive officers during

fiscal year 2007. Please see Note 23 for further discussion of the departure of our executive officers.

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.

We follow the transition method described in SFAS 123(R) for calculating the excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R) (the APIC Pool). Tax deficiencies arise when actual tax benefits we realize upon the exercise of stock options are less than the recorded tax benefit. In November 2005, the FASB issued FASB Staff Position FAS 123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards (FSP FAS 123(R)-3), which provides an alternative one-time transition election for calculating the APIC Pool. We have elected not to utilize the one-time transition election provided in FSP FAS 123(R)-3 and will instead follow the method described in SFAS 123(R).

Employee Stock Purchase Plan

Under our 1995 Employee Stock Purchase Plan (ESPP), a maximum of 4 million shares of Class A common stock can be issued to substantially all full-time employees who elect to participate. In October 2002, the Board of Directors approved an amendment to the ESPP to increase the number of shares that can be issued under the plan from 2 million to 4 million. Through payroll deductions, eligible participants may purchase our stock at a 5% discount to market value. Prior to December 31, 2005, eligible participants were able to purchase our stock at a 15% discount to market value. The stock is either purchased by the ESPP in the open market or issued from our treasury account, or a combination of both. Our contributions for the years ended June 30, 2007 and 2005, which were charged to additional paid-in capital, were approximately $0.3 million and $1 million, respectively. During fiscal year 2006 we expensed $1.4 million related to our ESPP and funded this liability through the issuance of treasury shares, resulting in a credit to additional paid-in-capital of $1.3 million. No expense was recorded in fiscal years 2007 and 2005 related to our ESPP. During fiscal years 2007, 2006 and 2005, in addition to stock purchased by the ESPP in the open market, we issued approximately 57,000, 227,000 and 446,000 treasury shares, respectively, to fund the issuance into the ESPP.

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3. POTENTIAL SALE OF THE COMPANY

On March 20, 2007, we received a proposal from Darwin Deason, our Chairman, and Cerberus Capital Management, L.P. (Cerberus), on behalf of certain funds and accounts managed by it or its affiliates to acquire all of the outstanding shares of the Company for $59.25 per share in cash, other than certain shares and options held by Mr. Deason and members of our management team. On April 21, 2007, we received a revised proposal from Mr. Deason and Cerberus to acquire, for a cash purchase price of $62 per share, all of the outstanding shares of our common stock, other than certain shares and options held by Mr. Deason and members of our management team that would be rolled into equity securities of the acquiring entity in connection with the proposed transaction.

Our Board of Directors has appointed a special committee of independent directors (the Special Committee) to evaluate our strategic alternatives, including the proposal from Mr. Deason and Cerberus, and expects to make a recommendation to the Board of Directors following its consideration of all strategic alternatives, including the proposal and all others received, in due course. The Special Committee has engaged its own legal counsel and financial advisors to assist in its review.

On June 10, 2007, we announced that we entered into a Waiver Agreement dated June 10, 2007 with Darwin Deason and Cerberus to suspend the Exclusivity Agreement between Mr. Deason and Cerberus so that the Company, under the direction of the Special Committee of independent directors, can conduct a process to consider the sale of the Company that it considers to be in the best interests of the Company and its stockholders.

We recognized approximately $4 million in legal and other costs related to this potential transaction and $1.9 million related to shareholder derivative lawsuits related to this potential transaction in fiscal year 2007.

Please see Note 29 for discussion of subsequent events.

4. BUSINESS COMBINATIONS

During fiscal years 2007, 2006 and 2005, we acquired several businesses in the information technology services and business process outsourcing industries. Our recent acquisition activity is summarized as follows (excluding contingent consideration and transaction costs):

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Purchase consideration (in thousands):			
Net cash paid	$ 164,330	$ 225,024	$ 620,382
Amounts due to seller	5,931	4,638	28,254
Liabilities assumed	40,588	119,984	254,174
Fair value of assets acquired (including intangibles)	$ 210,849	$ 349,646	$ 902,810

Fiscal Year 2007 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). During fiscal year 2007, we accrued $10 million of contingent consideration which was earned during the year and is expected to be paid in the first half of fiscal year 2008. 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 $73.8 million and assumed liabilities of $23.8 million. We recorded $29.6 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 approximately 11 years. This acquisition expanded our healthcare payor offering to include subrogation and overpayment recovery services to help our 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

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and custom application development and maintenance. The transaction was valued at approximately $63.8 million plus related transaction costs excluding 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 (defined below). We acquired assets of $75.3 million and assumed liabilities of $11.5 million. We recorded $54.2 million in goodwill, which is not 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 approximately 4 years. This acquisition enhanced 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.

In April 2007, we acquired CDR Associates, LLC (CDR), a leading provider of credit balance audit recovery and software services to healthcare payors, providers and state Medicaid agencies. The transaction was valued at approximately $27.2 million plus related transaction costs excluding contingent consideration of up to $15 million based upon future financial performance. The transaction was funded with a combination of cash on hand and borrowings under our Credit Facility (defined below). We acquired assets of $32 million and assumed liabilities of $4.8 million. We recorded $22.2 million in goodwill, which is deductible for income tax purposes, and intangible assets of $4.9 million. The $4.9 million of intangible assets is attributable to customer relationships and non-compete agreements with weighted average useful lives of approximately 7 years. The acquisition expands our service mix in the healthcare payor and provider markets and provides a platform to bridge the gap between the payor and provider communities. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, April 3, 2007.

In April 2007, we acquired certain assets of Albion, Inc. (Albion), a company specializing in integrated eligibility software solutions. The transaction was valued at approximately $30.9 million plus related transaction costs. The transaction was funded with a combination of cash on hand and borrowings under our Credit Facility. We acquired assets of $36.5 million and assumed liabilities of $5.6 million. We recorded $5.2 million in goodwill, which is deductible for income tax purposes, and intangible assets of $1.8 million. The $1.8 million of intangible assets is attributable to customer relationships and non-compete agreements with weighted average useful lives of approximately 3 years. The acquisition enables us to address key health and human services challenges facing state and local government clients, including: expensive legacy systems; a need for cost effectiveness; and a client-centered approach to service delivery. The acquired proprietary @Vantage software addresses these clients challenges while meeting federal financial support requirements for a commercial, off-the-shelf (COTS) solution. The operating results of the acquired business are included in our financial statements in the Government segment from the effective date of the acquisition, April 25, 2007.

We completed two other small acquisitions in fiscal year 2007, one in our Government segment and one in our Commercial 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.

Fiscal year 2006 acquisitions

In May 2006, we completed the acquisition of Intellinex, LLC (Intellinex), an Ernst & Young LLP enterprise specializing in integrated learning solutions. The transaction was valued at approximately $75.6 million plus related transaction costs and was funded from cash on hand. The purchase price was allocated to assets acquired and liabilities assumed based on the estimated fair value as of the date of acquisition. We acquired assets of $88.4 million and assumed liabilities of $12.8 million. We recorded goodwill of $56.6 million, which is deductible for income tax purposes and intangible assets of $19.1 million. The $19.1 million of intangible assets is attributable to customer relationships with a useful life of approximately 10 years. We believe this acquisition provides us with a global technology platform that we can leverage to deliver learning services to existing and potential clients, key management talent in the learning BPO market, expanded content development and delivery capabilities and a broader presence in the rapidly growing learning BPO market. This acquisition should also allow us to better compete on multi-scope human resources BPO opportunities that include a learning component. We will also leverage this acquisition to develop and implement learning content and programs for our employees. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, June 1, 2006.

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In December 2005, we completed the acquisition of the Transport Revenue division of Ascom AG (Transport Revenue), a Switzerland based communications company. Transport Revenue consists of three business units, fare collection, airport parking solutions and toll collection, with office locations across nine countries. The transaction was valued at approximately $100.5 million plus related transaction costs and was funded from borrowings under our Prior Facility (as defined in Note 12). We also paid a net working capital settlement of approximately $13.6 million which was funded from cash on hand and borrowings under our Credit Facility (as defined in Note 12). The purchase price was allocated to assets acquired and liabilities assumed based on the estimated fair value as of the date of acquisition. We acquired assets of $213 million and assumed liabilities of $98.9 million. We recorded goodwill of $72.7 million, approximately 42% of which is deductible for income tax purposes, and intangible assets of $1.3 million. The $1.3 million of intangible assets is attributable to customer relationships, non-compete agreements and patents with weighted average useful lives of approximately 8 years. This acquisition launched us into the international transportation services industry and expanded our portfolio in the transit and parking payment markets and adds toll collection customers to our existing customer base. The operating results of the acquired business are included in our financial statements in the Government segment from the effective date of the acquisition, December 1, 2005.

In July 2005, we completed the acquisition of LiveBridge, Inc. (LiveBridge), a customer care service provider primarily serving the financial and telecommunications industries. The transaction was valued at approximately $32 million plus a working capital adjustment of $2.5 million, excluding contingent consideration of up to $32 million based upon future financial performance, and was funded from cash on hand and borrowings under our Prior Facility. During fiscal year 2007, we paid $18.1 million of contingent consideration which was earned during the year. The purchase price was allocated to assets acquired and liabilities assumed based on the estimated fair value as of the date of acquisition. We acquired assets of $60.1 million and assumed liabilities of $7.5 million. We recorded goodwill of $29.6 million, 80% of which is deductible for income tax purposes, and intangible assets of $12.9 million. The $12.9 million of intangible assets is attributable to customer relationships and non-compete agreements with weighted average useful lives of approximately 6 years. This acquisition expanded our customer care service offerings in the finance and telecommunications industries and extended our global capabilities and operations by adding operational centers in Canada, India and Argentina. 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 1, 2005.

We completed two other small acquisitions during fiscal year 2006, one in our Commercial segment and one 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.

Fiscal year 2005 acquisitions

During fiscal year 2005, we completed six acquisitions, the most significant of which was the acquisition of the human resources (HR) consulting and outsourcing businesses of Mellon Financial Corporation (the Acquired HR Business) in May 2005. The Acquired HR Business provides consulting services, benefit plan administration services, and multi-scope HR outsourcing services. The transaction was valued at approximately $405 million, plus related transaction costs and was initially funded from borrowings under our Prior Facility. In fiscal year 2006, we paid a net working capital settlement of $19.6 million which was funded from cash on hand and borrowings under our Prior Facility. 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 $596.1 million and assumed liabilities of $171.5 million. We recorded $211.2 million in goodwill, of which 76% is deductible for income tax purposes, and intangible assets of $166.7 million. The $166.7 million of intangible assets is attributable to customer relationships, non-compete agreements and an indefinite lived tradename. The customer relationships and non-compete agreements have useful lives of 3 to 17 years with a weighted average anticipated useful life of approximately 15 years. This acquisition made us a stronger competitor in the end-to-end human resources marketplace and strengthened our position as a global provider of business process outsourcing services. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, May 1, 2005. Please refer to Note 5 for discussion of the integration of the Acquired HR Business.

In January 2005, we completed the acquisition of Superior Consultant Holdings Corporation (Superior), acquiring all of the issued and outstanding shares of Superior through a cash tender offer, which was completed on January 25, 2005, and subsequent short-form merger, at a purchase price of $8.50 per share. Superior provides information technology consulting and

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business process outsourcing services and solutions to the healthcare industry. The transaction was valued at approximately $122.2 million (including payment of approximately $106 million for issued and outstanding shares, options, and warrants and additional amounts for debentures and other payments) plus related transaction costs and was funded from borrowings under our Prior Facility. 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 $152.6 million and assumed liabilities of $30.4 million. We recorded $62.2 million in goodwill, which is not deductible for income tax purposes, and intangible assets of $16.8 million. The $16.8 million of intangible assets is attributable to customer relationships and non-compete agreements with useful lives of 5 years. This acquisition expanded our provider healthcare subject matter expertise, as well as provided experience with major hospital information systems and additional healthcare management talent. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, January 25, 2005.

In August 2004, we acquired BlueStar Solutions, Inc. (BlueStar), an information technology outsourcer specializing in applications management of packaged enterprise resource planning and messaging services. The transaction was valued at approximately $73.5 million, plus related transaction costs. The transaction value includes $6.4 million attributable to the 9.2% minority interest we held in BlueStar prior to the acquisition; therefore, the net purchase price was approximately $67.1 million. Of this amount, approximately $61 million was paid to former BlueStar shareholders by June 30, 2005 and was funded from borrowings under our credit facilities and cash on hand. The remaining purchase price of $6 million was paid in the first quarter of fiscal year 2006. 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 $97.8 million and assumed liabilities of $30.7 million. We recorded goodwill of $34.4 million, which is not deductible for income tax purposes, and intangible assets of $11.6 million. The $11.6 million of intangible assets is attributable to customer relationships with a useful life of seven years. The acquisition of BlueStar improved our existing information technology services with the addition of applications management and messaging services. The operating results of the acquired business are included in our financial statements in the Commercial segment from the effective date of the acquisition, August 26, 2004.

In July 2004, we acquired Heritage Information Systems, Inc. (Heritage). Heritage provides clinical management and pharmacy cost containment solutions to 14 state Medicaid programs, over a dozen national commercial insurers and Blue Cross Blue Shield licensees and some of the largest employer groups in the country. The transaction was valued at approximately $23.1 million plus related transaction costs, excluding contingent consideration of up to $17 million maximum based upon future financial performance, and was funded from borrowings under our then existing credit facility and cash on hand. During fiscal year 2005, we accrued $6 million of contingent consideration, which was earned during the year and paid in fiscal year 2006. During fiscal year 2007, we accrued $11 million of contingent consideration, which was earned during the year and is expected to be paid in the first quarter of fiscal year 2008. 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 $43.6 million and assumed liabilities of $3.5 million. We recorded $31.3 million in goodwill, which is deductible for income tax purposes, and intangible assets of $2.4 million. The $2.4 million of intangible assets is attributable to customer relationships and non-compete agreements with useful lives of five years. This acquisition enhanced our clinical management and cost containment service offerings. The operating results of the acquired business are included in our financial statements in the Government segment from the effective date of the acquisition, July 1, 2004.

We completed two other small acquisitions in our Government segment during the fiscal year 2005.

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

Contingent consideration

We are obligated to make certain contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During fiscal years 2007, 2006 and 2005, we made contingent consideration payments of $25.4 million, $9.8 million and $17 million, respectively, related to acquisitions completed in prior years. As of June 30, 2007, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities is approximately $90.6 million of which $21 million has been earned as of June 30, 2007. The $21 million was accrued as of June 30, 2007 and is expected to be paid during the first half of fiscal year 2008. Any such payments primarily result in a corresponding increase in goodwill.

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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. As of June 30, 2007, approximately 2,500 employees have been 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 would be migrated to lower cost markets.

In our Commercial segment, we began an assessment of the cost structure of our global production model, particularly our offshore processing activities. We identified offshore locations in which our labor costs were no longer competitive or where the volume of work processed by the site no longer justifies retaining the location, including one of our Mexican facilities. In connection with this assessment, we recorded restructuring charges for involuntary termination of employees related to the closure of those duplicative facilities or locations of $6.5 million and $5.5 million for the years ended June 30, 2007 and 2006, respectively, which is reflected in wages and benefits in our Consolidated Statements of Income, and $2.4 million and $4.7 million for the years ended June 30, 2007 and 2006, respectively, for impairments of duplicative technology equipment and facility costs, facility shutdown and other costs, which are reflected as part of total operating expenses in our Consolidated Statements of Income. We plan to further penetrate offshore labor markets. We expect these activities will consolidate our global production activities and enhance our competitive position.

In our Government segment, we began an assessment of our competitive position, evaluated our market strategies and the technology used to support certain of our service offerings. We began to implement operating practices that we utilize in our Commercial segment, including leveraging our proprietary workflow technology and implementing activity based compensation, which is expected to reduce our operating costs and enhance our competitive position. In connection with these activities, we recorded restructuring charges for involuntary termination of employees of $0.7 million and $1 million for the years ended June 30, 2007 and 2006, respectively, which is reflected in wages and benefits in our Consolidated Statements of Income. In fiscal year 2007, we recorded $0.5 million of costs related to the consolidation of solution development groups within the Government segment, which is reflected in total operating expenses in our Consolidated Statements of Income. In fiscal year 2006, we recorded $1.6 million for asset impairment and other charges, principally for duplicative software as a result of recent acquisition activity, which is reflected in total operating expenses in our Consolidated Statements of Income. As discussed in Note 6, we completed the WWS Divestiture, which allows us to focus on our technology-enabled business process outsourcing and information technology service offerings.

The following table summarizes the activity for the accrual for involuntary termination of employees for the year ended June 30, 2007 and 2006 (in thousands) exclusive of the Acquired HR Business:

	Fiscal year ending June 30,	
	2007	**2006**
Beginning balance	$ 899	$
Accruals	7,185	6,500
Payments	(7,191)	(5,601)
Ending balance	$ 893	$ 899

The June 30, 2007 accrual for involuntary termination of employees is expected to be paid primarily in fiscal year 2008 from cash flows from operating activities.

We substantially completed the integration of the Acquired HR Business in the fourth quarter of fiscal year 2006. 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 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. The following table summaries the activity for the accrual for involuntary termination of employees for the years ended June 30, 2007, 2006 and 2005 (in thousands):

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	Fiscal year ending June 30,		
	2007	2006	2005
Beginning balance	$ 3,521	$ 20,495	$
Accrual recorded at acquisition			22,264
Excess accrual credited to goodwill	(1,678)	(3,116)	
Payments	(1,441)	(13,858)	(1,769)
Ending balance	$ 402	$ 3,521	$ 20,495

The remaining accrual is expected to be paid out in the first quarter of fiscal year 2008 from cash flows from operating activities.

In our Corporate segment, we determined that the costs related to the ownership of a corporate aircraft outweighed the benefits to the Company. During fiscal year 2006, we sold our corporate aircraft for approximately $3.4 million, net of transaction costs. These proceeds are reflected in cash flows from investing activities in purchases of property, equipment and software, net in our Consolidated Statements of Cash Flows. We recorded an asset impairment charge of $4.7 million in the year ended June 30, 2006 related to the sale of our corporate aircraft, which is reflected in other operating expenses in our Consolidated Statements of Income.

6. DIVESTITURES

Sale of Government welfare-to-workforce services business

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 $2.5 million ($1.5 million, net of income tax) and $33.5 million ($20.1 million, net of income tax) during fiscal years 2007 and 2006, respectively, upon the assignment of customer contracts to Arbor. The after tax proceeds from the divestiture were primarily used for general corporate purposes.

Revenues from the WWS Divestiture were $0.9 million, $104.2 million and $218 million for fiscal years 2007, 2006 and 2005, respectively. Operating (loss) income from the WWS Divestiture, excluding the gain on sale, was ($0.6 million), $6.4 million and $11.5 million for fiscal years 2007, 2006 and 2005, respectively. Fiscal year 2006 operating loss included the following: a provision for estimated litigation settlement related to the WWS Divestiture; and a provision for uncollectible accounts receivable due to a change in our estimate of collectibility of the retained outstanding receivables. Total provisions recorded in fiscal year 2006 were $3.3 million ($2.1 million, net of income tax).

In the fourth quarter of fiscal year 2006, we completed the sale of a subsidiary related to operations of the WWS Divestiture and recorded a loss on the sale of approximately $0.6 million ($1.0 million, net of income tax) and related charges of $0.2 million ($0.1 million, net of income tax).

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

At June 30, 2006, we classified as assets held for sale certain customer contracts related to the WWS Divestiture whose transfer to Arbor was not complete as of June 30, 2006. The transfers of these remaining contracts to Arbor were completed in the second quarter of fiscal year 2007 upon receipt of customer consents. The following table sets forth the assets held for sale included in prepaid expenses and other current assets in our Consolidated Balance Sheets as of June 30, 2006 (in thousands):

Assets held for sale	
Intangible assets related to the WWS Divestiture, net	$ 634
Goodwill related to the WWS Divestiture	1,096
Total assets held for sale	$ 1,730

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7. ACCOUNTS RECEIVABLE

The components of accounts receivable are as follows (in thousands):

	June 30, 2007	June 30, 2006
Amounts Billed or Billable:		
Commercial	$ 526,584	$ 534,569
Government	399,271	419,905
	925,855	954,474
Unbilled Amounts	336,326	287,819
Total accounts receivable	1,262,181	1,242,293
Allowance for doubtful accounts	(5,073)	(10,447)
	$ 1,257,108	$ 1,231,846

Unbilled amounts include amounts associated with percentage of completion accounting, and other earned revenues not currently billable due to contractual provisions. The unbilled amounts at June 30, 2007 and 2006 include approximately $129.6 million and $157.2 million, respectively, which is not expected to be billed and collected within one year. These amounts are primarily related to our Commercial Vehicle Operations contract, our Transport Revenue contracts, our contract with the Georgia Department of Health and Human Services, and the 2007 acquisition of Albion in our Government segment. Billings are based on reaching contract milestones or other contractual terms. Amounts to be invoiced in the subsequent month for current services provided are included in billable, and at June 30, 2007 and 2006 include approximately $406.1 million and $367.9 million, respectively, for services which have been rendered and will be billed in the normal course of business in the succeeding months.

Changes in the allowance for doubtful accounts were as follows (in thousands):

	Fiscal year ended June 30, 2007	2006	2005
Balance at beginning of period	$ 10,447	$ 5,399	$ 4,756
Provision for uncollectible accounts receivable	(290)	8,462	763
Losses sustained, net of recoveries and other	(5,084)	(3,414)	(120)
Balance at end of period	$ 5,073	$ 10,447	$ 5,399

During fiscal year 2006, we recorded a provision related to our assessment of risk related to the bankruptcies of certain airline clients of $3 million, a provision for a receivable retained in connection with the sale of the majority of the federal business in November 2003 of $2.4 million, and a provision for uncollectible accounts receivable due to a change in our estimate of collectibility of the retained outstanding receivables in connection with the WWS Divestiture of $1.3 million.

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

8. PROPERTY, EQUIPMENT AND SOFTWARE

Property, equipment and software consist of the following (in thousands):

	June 30, 2007	June 30, 2006
Land	$ 20,177	$ 20,167
Buildings and improvements	177,453	155,503
Computer equipment	901,493	743,516
Computer software	742,271	645,242
Furniture and fixtures	107,556	97,803
	1,948,950	1,662,231
Accumulated depreciation and amortization	(1,051,631)	(792,211)
	$ 897,319	$ 870,020

Depreciation expense on property and equipment was approximately $212.2 million, $182.8 million and $149 million for the fiscal years ended June 30, 2007, 2006 and 2005, respectively. Amortization of computer software was approximately $69 million, $51 million and $40.4 million in fiscal years 2007, 2006 and 2005, respectively.

During fiscal year 2007, we recorded a non-cash impairment charge to in-process capitalized software related to our Department of Education contract of approximately $76.4 million (please see Note 22 for further discussion).

9. GOODWILL AND OTHER INTANGIBLE ASSETS

The changes in the carrying amount of goodwill for the years ended June 30, 2007 and 2006 are as follow (in thousands):

	Commercial	Government	Total
Balance as of June 30, 2005	$ 1,217,727	$ 1,116,928	$ 2,334,655
Acquisition activity during the year	64,506	73,823	138,329
Divestiture activity during the year		(16,656)	(16,656)
Held for sale as of June 30, 2006		(1,096)	(1,096)
Foreign currency translation adjustments	(180)	1,602	1,422
Balance as of June 30, 2006	1,282,053	1,174,601	2,456,654
Acquisition activity during the year	127,624	19,461	147,085
Foreign currency translation adjustments	5,638	2,991	8,629
Balance as of June 30, 2007	$ 1,415,315	$ 1,197,053	$ 2,612,368

Fiscal years 2007 and 2006 activity is primarily related to acquisitions and divestitures completed during the periods (please see Notes 4 and 6). Approximately $2.1 billion, or 78.7%, of the original gross amount of goodwill recorded is deductible for income tax purposes.

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The following table reflects the balances of our other intangible assets (in thousands):

	June 30, 2007		2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible assets:				
Acquired customer-related intangibles	$ 419,853	$ (147,872)	$ 384,738	$ (104,901)
Customer contract costs	247,840	(101,217)	222,268	(90,326)
All other	17,248	(9,362)	15,147	(6,113)
Total	$ 684,941	$ (258,451)	$ 622,153	$ (201,340)
Non-amortizable intangible assets:				
Title plant	$ 51,045		$ 51,045	
Tradename	3,843		3,843	
	$ 54,888		$ 54,888	
Aggregate amortization:				
For the year ended June 30, 2007				$ 79,597
For the year ended June 30, 2006				71,353
For the year ended June 30, 2005				57,721
Estimated amortization for the years ended June 30,				
2008				85,643
2009				74,612
2010				62,828
2011				52,841
2012				36,363

Amortization includes amounts charged to amortization expense for customer contract costs and other intangibles, other than contract inducements. Amortization of contract inducements of $14.6 million, $15.3 million and $14.3 million for fiscal years 2007, 2006 and 2005, respectively, is recorded as a reduction to related contract revenue. Amortization for fiscal years 2007, 2006 and 2005 includes approximately $42.4 million, $37.4 million and $27.7 million, respectively, related to acquired customer-related intangible assets. Amortization expense includes approximately $22.6 million, $18.7 million and $15.7 million for customer-related and all other intangibles for fiscal years 2007, 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 10 years. The amortization period for all other intangible assets, including trademarks, ranges from 1 to 20 years, with a weighted average of 6 years.

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10. OTHER ASSETS

The following summaries our other assets as of June 30, 2007 and 2006 (in thousands):

	June 30, 2007	June 30, 2006
Long-term investments related to our deferred compensation plans (please see Note 13)	$ 80,253	$ 64,383
Long-term investments accounted for using the cost method and equity method	21,443	31,289
Deferred debt issuance costs	28,099	31,242
Other assets	51,035	43,885
Total	$180,830	$170,799

During fiscal year 2007, we sold our minority interests in a professional services company, which was accounted for under the equity method, for approximately $19 million. We recorded a gain on the sale of our minority interests of approximately $8.2 million ($5.3 million, net of income tax) in other non-operating (income) expense, net.

11. OTHER ACCRUED LIABILITIES

The following summarizes other accrued liabilities at June 30, 2007 and 2006 (in thousands):

	June 30, 2007	June 30, 2006
Accrued payments to vendors and contract related accruals	$ 228,250	$ 223,841
Software and equipment lease and maintenance	57,283	42,824
Accruals related to acquisitions and divestitures	46,455	29,247
Other	68,250	58,720
Total	$ 400,238	$ 354,632

The increase in accruals related to acquisitions and divestitures is primarily the fiscal year 2007 accrual for contingent consideration payments earned as of June 30, 2007. These accruals are expected to be paid in the first half of fiscal year 2008.

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12. LONG- TERM DEBT

A summary of long-term debt follows (in thousands):

	June 30, 2007	June 30, 2006
Term Loan Facility due in March 2013	$ 1,778,000	$ 796,000
Revolving Facility due in March 2012	52,102	310,336
4.70% Senior Notes due in June 2010, net of unamortized discount	249,950	249,933
5.20% Senior Notes due in June 2015, net of unamortized discount	249,499	249,435
Capitalized lease obligations at various interest rates, payable through 2010	57,853	29,677
Other notes payable through 2015	1,907	1,725
	2,389,311	1,637,106
Less current portion	(47,039)	(23,074)
	$ 2,342,272	$ 1,614,032

Maturities of long-term debt at June 30, 2007 are as follows (in thousands):

Year ending June 30,	
2008	$ 47,039
2009	40,156
2010	274,961
2011	18,900
2012	70,642
Thereafter	1,937,613
Total	$ 2,389,311

Credit Agreement

On March 20, 2006, we and certain of our subsidiaries entered into a Credit Agreement (the Credit Agreement) with Citicorp USA, Inc., as Administrative Agent (Citicorp), Citigroup Global Markets Inc., as Sole Lead Arranger and Book Runner, and with Morgan Stanley Bank, SunTrust Bank, Bank of Tokyo-Mitsubishi UFJ, Ltd., Wachovia Bank National Association, Bank of America, N.A., Bear Stearns Corporate Lending and Wells Fargo Bank, N.A., as Co-Syndication Agents, and various other lenders and issuers (the Credit Facility). The Credit Facility provides for a senior secured term loan facility of $1.8 billion, with the ability to increase it by up to $2 billion (as of June 30, 2007), under certain circumstances (the Term Loan Facility) and a senior secured revolving credit facility of $1 billion with the ability to increase it by up to $750 million (the Revolving Facility), each of which is described more fully below. At the closing of the Credit Facility, we and certain of our subsidiaries jointly borrowed approximately $800 million under the Term Loan Facility and approximately $93 million under the Revolving Facility. We used the proceeds of the Term Loan Facility to (i) refinance approximately $278 million in outstanding indebtedness under our 5-Year Competitive Advance and Revolving Credit Facility Agreement dated as of October 27, 2004 (the Prior Facility), (ii) finance the purchase of shares of our Class A common stock tendered in the Company s Dutch Auction tender which expired March 17, 2006 (as extended) and (iii) for the payment of transaction costs, fees and expenses related to the Credit Facility and Dutch Auction. As a result of the refinancing of the Prior Facility, we wrote off approximately $4.1 million in debt issue costs, which was included in other non-operating income, net. A portion of the proceeds of the Revolving Facility were used to refinance approximately $73 million in outstanding indebtedness under the Prior Facility. The remainder of the proceeds of the Revolving Facility were used for working capital purposes and to fund our share repurchase programs. In addition, approximately $114 million of letters of credit were issued under the Credit Facility to replace letters of credit outstanding under the Prior Facility. The Prior Facility was terminated on March 20, 2006.

On July 6, 2006, we amended our Term Loan Facility. We 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 and for the payment of transaction costs, fees and expenses related to the increase in the Term Loan Facility.

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Amounts borrowed under the Term Loan Facility mature on March 20, 2013, and will amortize in quarterly installments in an aggregate annual amount equal to 1% of the aggregate principal amount of the loans advanced, with the balance payable on the final maturity date. Amounts borrowed under the Term Loan Facility may also be repaid at any time at our discretion. Interest on the outstanding balances under the Term Loan Facility is payable, at our option, at a rate equal to the Applicable Margin (as defined in the Credit Facility) plus the fluctuating Base Rate (as defined in the Credit Facility), or at the Applicable Margin plus the current LIBOR (as defined in the Credit Facility). The borrowing rate on the Term Loan Facility at June 30, 2007 was 7.32%.

Proceeds borrowed under the Revolving Facility will be used as needed for general corporate purposes and to fund share repurchase programs. Amounts under the Revolving Facility are available on a revolving basis until the maturity date of March 20, 2012. The Revolving Facility allows for borrowings up to the full amount of the revolver in either U.S. Dollars or Euros. Up to the U.S. dollar equivalent of $200 million may be borrowed in other currencies, including Sterling, Canadian Dollars, Australian Dollars, Yen, Francs, Krones and New Zealand Dollars. Portions of the Revolving Facility are available for issuances of up to the U.S. dollar equivalent of $700 million of letters of credit and for borrowings of up to the U.S. dollar equivalent of $150 million of swing loans. Interest on outstanding balances under the Revolving Facility is payable, at our option, at a rate equal to the Applicable Margin plus the fluctuating Base Rate, or at the Applicable Margin plus the current LIBOR for the applicable currency. The borrowing rate under the Revolving Facility at June 30, 2007 ranges from 3.87% to 5.37%, depending upon the currency of the outstanding borrowings.

The Credit Facility includes an uncommitted accordion feature of up to $750 million in the aggregate allowing for future incremental borrowings under the Revolving Facility, which may be used for general corporate purposes. The Credit Facility also includes an additional uncommitted accordion feature of up to $2 billion (as of June 30, 2007) allowing for future incremental borrowings under the Term Loan Facility which may be used to fund additional purchases of our equity securities or for extinguishment of our Senior Notes (defined below). The Term Loan Facility accordion expires on March 20, 2009.

Obligations under the Credit Facility are guaranteed by us and substantially all of our domestic subsidiaries and certain of our foreign subsidiaries (but only to the extent such guarantees would not result in materially adverse tax consequences). In addition, Credit Facility obligations are secured under certain pledge agreements by (i) a first priority perfected pledge of all notes owned by us and the guarantors and the capital stock of substantially all of our domestic subsidiaries and certain of our foreign subsidiaries (subject to certain exceptions, including to the extent the pledge would give rise to additional SEC reporting requirements for our subsidiaries or result in materially adverse tax consequences), and (ii) a first priority perfected security interest in all other assets owned by us and the guarantors, subject to customary exceptions. As required under the indentures governing our outstanding Senior Notes, we have granted equal and ratable liens in favor of the holders of the Senior Notes in all assets discussed above, other than the accounts receivable of the Company and our subsidiaries.

Among other fees, we pay a commitment fee (payable quarterly) based on the amount of unused commitments under the Revolving Facility (not including the uncommitted accordion feature discussed above). The commitment fee payable at June 30, 2007 was 0.375% of the unused commitment. We also pay fees with respect to any letters of credit issued under the Credit Facility. Letter of credit fees at June 30, 2007 were 1.35% of the currently issued and outstanding letters of credit.

The Credit Facility contains customary covenants, including but not limited to, restrictions on our ability, and in certain instances, our subsidiaries ability, to incur liens, merge or dissolve, make certain restricted payments, or sell or transfer assets. The Credit Facility also limits the Company s and our subsidiaries ability to incur additional indebtedness. In addition, based upon the total amount advanced under the Term Loan Facility at June 30, 2007, we may not permit our consolidated total leverage ratio to exceed 4.00 to 1.00, nor permit our consolidated senior leverage ratio to exceed 3.00 to 1.00, nor permit our consolidated interest coverage ratio to be less than 4.50 to 1.0 during specified periods.

Upon the occurrence of certain events of default, our obligations under the Credit Facility may be accelerated and the lending commitments under the Credit Facility terminated. Such events of default include, but are not limited to, payment default to lenders, material inaccuracies of representations and warranties, covenant defaults, material payment defaults with respect to indebtedness or guaranty obligations, voluntary and involuntary bankruptcy proceedings, material money judgments, material ERISA events, or change of control of the Company. As of June 30, 2007, we were in compliance with the covenants of our Credit Facility, as amended.

At June 30, 2007, we had approximately $834.7 million available on our Revolving Facility after giving effect to outstanding indebtedness of $52.1 million and $113.2 million of outstanding letters of credit that secure certain contractual performance and other obligations and which reduce the availability of our Revolving Facility. At June 30, 2007, we had $1.8 billion outstanding

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under our Credit Facility, of which $1.8 billion is reflected in long-term debt and $18 million is reflected in current portion of long-term debt, and approximately $1.8 billion of which bore interest at 7.32% and $52.1 million bore interest from 3.87% to 5.37%. Please see Note 20 for a discussion of an interest rate swap agreement related to interest rates on our Credit Facility.

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 were 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 SEC 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 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.

Senior Notes

On June 6, 2005, we completed a public offering of $250 million aggregate principal amount of 4.70% Senior Notes due June 1, 2010 and $250 million aggregate principal amount of 5.20% Senior Notes due June 1, 2015 (collectively, the Senior Notes). Interest on the Senior Notes is payable semiannually. The net proceeds from the offering of approximately $496 million, after deducting underwriting discounts, commissions and expenses, were used to repay a portion of the outstanding balance of our Prior Facility. We may redeem some or all of the Senior Notes at any time prior to maturity, which may include prepayment penalties determined according to pre-established criteria. Please see Note 20 for a discussion of the forward interest rate hedges related to the issuance of the Senior Notes.

The Senior Notes contain customary covenants, including but not limited to, restrictions on our ability, and the ability of our subsidiaries, to create or incur secured indebtedness, merge or consolidate with another person, or enter into certain sale and leaseback transactions.

Upon the occurrence of certain events of default, the principal of, and all accrued and unpaid interest on, the Senior Notes may be declared due and payable by the trustee, The Bank of New York Trust Company, N.A. (the Trustee), or the holders of at least 25% in principal amount of the outstanding Senior Notes. Such events of default include, but are not limited to, payment default,

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covenant defaults, material payment defaults (other than under the Senior Notes) and voluntary or involuntary bankruptcy proceedings. As of June 30, 2007, we were in compliance with the covenants of our 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 Trustee advising us that we were in default of our covenants. 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 purported default set forth in the September 22, 2006 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, 2006 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 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 January 8, 2007, the Court entered an order substituting Wilmington Trust Company for the Trustee. 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.

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

In the event the claim of default against us made by certain holders of the Senior Notes is upheld in a court of law and we are required to pay off the Senior Notes, it is most likely that we would utilize 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.

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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.

On December 19, 2006, we entered into an Instrument of Resignation, Appointment and Acceptance with The Bank of New York Trust Company, N.A. and Wilmington Trust Company, whereby The Bank of New York Trust Company, N.A. resigned as trustee, as well as other offices or agencies, with respect to the Senior Notes, and was replaced by Wilmington Trust Company.

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 $13.8 million ($8.6 million, net of income tax), unamortized deferred financing costs of $2.6 million ($1.7 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 June 30, 2007 may be adjusted and reported as interest expense in our Consolidated Statement of Income in the period of refinancing or demand.

Other

We entered into capital lease agreements of an aggregate of $47.8 million, $24.3 million and $2.3 million for the purchase of equipment during fiscal years 2007, 2006 and 2005, respectively.

Interest

Cash payments for interest on borrowings for the years ended June 30, 2007, 2006 and 2005 were approximately $169.6 million, $56.3 million and $13.1 million, respectively. In addition, in fiscal year 2007 we paid $7.4 million of interest related to the Section 162(m) deduction disallowance discussed in Note 21. The increase in cash payments for interest during fiscal year 2007 was primarily due to higher borrowings on our Term Credit Facility and waiver fees related to the credit facility amendment. Accrued interest was $8.9 million and $11 million at June 30, 2007 and 2006, respectively.

13. PENSION AND OTHER POST-EMPLOYMENT PLANS

SFAS 87 establishes standards for reporting and accounting for pension benefits provided to employees. On June 30, 2007, we adopted SFAS 158. This Statement requires recognition of the funded status of a defined benefit plan in the statement of financial position as an asset or liability if the plan is overfunded or underfunded, respectively. Changes in the funded status of a plan are required to be recognized in the year in which the changes occur, and reported in comprehensive income as a separate component of stockholders equity. Further, certain gains and losses that were not previously recognized in the financial statements are required to be reported in comprehensive income, and certain disclosure requirements were changed. SFAS 158 also requires the measurement date of the plan s funded status to be the same as the company s fiscal year end. There was no change to our June 30 measurement date as a result of the adoption of SFAS 158. Adoption of SFAS 158 resulted in an increase to accumulated other comprehensive income (loss), net of approximately $2.4 million, net of $1.0 million deferred income tax.

In connection with the acquisition of the Acquired HR Business, we assumed pension plans for the Acquired HR Business employees located in Canada and the United Kingdom (UK). The Canadian Acquired HR Business has both a funded basic pension plan and an unfunded excess pension plan. The UK pension scheme is a funded plan. These defined benefit plans provide benefits for participating employees based on years of service and average compensation for a specified period before retirement. We 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 from the effective date of the acquisition, May 1, 2005.

In addition to these pension plans, we also 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 includes both a funded plan and unfunded plan. We established June 30 as our measurement date for this defined benefit 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 of $2 million 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.

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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.

Benefit obligations

The following table provides a reconciliation of the changes in the defined benefit plans benefit obligations (in thousands):

	June 30,					
	2007			2006		
	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan
Reconciliation of benefit obligation:						
Obligation at beginning of period	$ 98,537	$ 3,731	$ 266	$ 89,728	$	$ 376
Service cost	5,841	3,395	13	5,195	2,266	21
Interest cost	5,662	251	15	4,725	68	21
Plan amendments	300	(2)		72	2,024	
Actuarial (gain) loss	(3,408)	225	14	(2,256)	(627)	(169)
Foreign currency exchange rate changes	8,831		(1)	3,492		30
Benefit payments	(3,529)			(2,419)		(13)
Obligation at end of period	$ 112,234	$ 7,600	$ 307	$ 98,537	$ 3,731	$ 266

Costs (income) of plans

The following table provides the components of net periodic benefit cost and other amounts recognized in other comprehensive income (in thousands):

	Fiscal year ended June 30,								
	2007			2006			2005		
	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan
Components of net periodic benefit cost:									
Defined benefit plans:									
Service cost	$ 5,841	$ 3,395	$ 13	$ 5,195	$ 2,266	$ 21	$ 751	$	$ 3
Interest cost	5,662	251	15	4,725	68	21	739		3
Expected return on assets	(5,465)	(111)		(4,952)			(536)		
Recognized net actuarial gain		(11)							
Amortization of prior service costs		217			128				

Net periodic benefit cost for defined benefit plans	$ 6,038	$ 3,741	$ 28	$ 4,968	$ 2,462	$ 42	$ 954	$	$ 6
Other changes in plan assets and benefit obligations recognized in other comprehensive income									
Total recognized in net periodic benefit cost and other comprehensive income	$ 6,038	$ 3,741	$ 28	$ 4,968	$ 2,462	$ 42	$ 954	$	$ 6

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Approximately $0.2 million of prior service cost for the defined benefit pension plans that will be amortized from accumulated other comprehensive income (loss), net into net periodic benefit cost in fiscal year 2008.

Plan assets

The following table provides a reconciliation of the changes in the fair value of plan assets (in thousands):

	Fiscal year ended June 30,					
	2007			2006		
	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan	Non-U.S. Pension Plans	U.S. Pension Plan	Other Benefit Plan
Reconciliation of fair value of plan assets:						
Fair value of plan assets at beginning of period	$ 77,704	$ 1	$	$ 68,195	$	$
Actual return on plan assets	8,784	59		5,093		
Amendments	300			72		
Foreign currency exchange rate changes	7,613			2,204		
Employer contributions	7,137	6,742		4,559	1	
Benefit payments	(3,529)			(2,419)		
Fair value of plan assets at end of period	$ 98,009	$ 6,802	$	$ 77,704	$ 1	$

We made contributions to the pension plans of approximately $13.9 million and $4.6 million in fiscal years 2007 and 2006, respectively. As of June 30, 2007, we have no minimum pension funding requirement.

The following table provides the weighted-average asset allocation of all pension plan assets, by asset category:

	Fiscal year ended June 30,	
	2007	2006
Mutual fund equity securities	52%	62%
Mutual fund debt securities	35%	30%
Mutual fund real estate	7%	7%
Other	6%	1%
Total	100%	100%

There are no holdings in shares or debt issued by us included in the pension plan assets.

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Funded status of defined benefit pension plans

The following table provides a statement of funded status (in thousands):

	June 30,			
	2007		2006	
	Funded Plans	Unfunded Plan	Funded Plans	Unfunded Plan
Non-U.S. Plans				
Accumulated benefit obligation (ABO)	$79,103	$11,070	$68,318	$10,673
Projected benefit obligation (PBO)	99,921	12,313	86,689	11,848
Fair value of assets	98,009		77,704	
U.S. Plan				
Accumulated benefit obligation (ABO)	$ 5,865	$ 145	$	$ 2,926
Projected benefit obligation (PBO)	7,392	208		3,731
Fair value of assets	6,802			1

	June 30,			
	2007		2006	
	Pension Plans	Other Benefit Plan	Pension Plans	Other Benefit Plan
Non-U.S. Plans				
Funded status	$ (14,225)	$ (307)	$ (20,833)	$ (266)
Unrecognized (gain) loss	(4,358)	(135)	2,424	(152)
Net amount recognized	$ (18,583)	$ (442)	$ (18,409)	$ (418)
U.S. Plan				
Funded status	$ (798)	$	$ (3,730)	$
Unrecognized prior service cost	1,678		1,896	
Unrecognized (gain) loss	(338)		(627)	
Net amount recognized	$ 542	$	$ (2,461)	$

The following table reflects amounts recognized in the statement of financial position (in thousands):

	June 30,			
	2007		2006	
	Pension Plans	Other Benefit Plan	Pension Plans	Other Benefit Plan
Non-U.S. Plans				
Accrued benefit liability short term	$ (1,333)	$ (18)	$	$
Accrued benefit liability long term	(12,892)	(289)	(18,409)	(418)
Accumulated other comprehensive (income) loss, net	(4,358)	(135)		

Net amount recognized	$	(18,583)	$	(442)	$	(18,409)	$	(418)
U.S. Plan								
Accrued benefit liability short term	$	(9)	$		$		$	
Accrued benefit liability long term		(789)				(2,925)	$	
Intangible asset						464		
Accumulated other comprehensive (income) loss, net		1,340						
Net amount recognized	$	542	$		$	(2,461)	$	

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The following table is a summary of amounts in accumulated other comprehensive (income) loss, net as of June 30, 2007 upon adoption of SFAS 158 (in thousands):

	June 30, 2007	
	Pension Plans	Other Benefit Plan
Non-U.S. Plans		
Net actuarial gain	$ (4,358)	$ (135)
	$ (4,358)	$ (135)
U.S. Plan		
Net actuarial gain	$ (338)	$
Unrecognized prior service cost	1,678	
	$ 1,340	$

Accumulated other comprehensive income (loss), net as of June 30, 2007 also includes a net actuarial gain related to our German pension plan of $0.2 million, which is not included in the tables above.

As of the measurement date, June 30, 2007, the fair value of plan assets exceeded the accumulated benefit obligation for the UK pension scheme, the Canadian basic pension plan and the U.S. Plan. The UK pension scheme, the Canadian basic plan and the U.S. plan are underfunded on a PBO basis as of June 30, 2007.

<u>Assumptions for calculating benefit obligations and net periodic benefit cost</u>

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

	June 30,			
	2007		2006	
	Pension Plans	Other Benefit Plan	Pension Plans	Other Benefit Plan
Non-U.S. Plans				
Discount rate	5.20% - 5.67%	5.60%	5.00% - 5.75%	5.75%
Rate of increase in compensation levels	4.25% - 4.80%	N/A	4.25% - 4.40%	N/A
U.S. Plan				
Discount rate	6.40%	N/A	6.50%	N/A
Rate of increase in compensation levels	3.40%	N/A	3.50%	N/A

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

	Fiscal year ended June 30, 2007		Fiscal year ended June 30, 2006		Fiscal year ended June 30, 2005	
	Pension Plans	Other Benefit Plan	Pension Plans	Other Benefit Plan	Pension Plans	Other Benefit Plan
Non-U.S. Plans						
Discount rate	5.20% - 5.67%	5.60%	5.00% - 5.75%	5.75%	5.25% - 5.75%	5.75%
Long-term rate of return on assets	6.50% - 7.00%	N/A	7.00% - 7.50%	N/A	7.00% - 7.50%	N/A
Rate of increase in compensation levels	4.25% - 4.60%	N/A	4.25% - 4.40%	N/A	4.25% - 4.40%	N/A
U.S. Plan						
Discount rate	6.50%	N/A	5.75%	N/A	N/A	N/A
Long-term rate of return on assets	8.00%	N/A	N/A	N/A	N/A	N/A
Rate of increase in compensation levels	3.50%	N/A	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):

	Fiscal year ended June 30, 2007		Fiscal year ended June 30, 2006	
	Plus .25%	Less .25%	Plus .25%	Less .25%
Non-U.S. Plans				
Effect on pension benefit obligation	$(5,786)	$5,841	$(5,055)	$5,155
Effect on service and interest cost	$ (485)	$ 488	$ (432)	$ 450
U.S. Plan				
Effect on pension benefit obligation	$ (316)	$ 336	$ (164)	$ 174
Effect on service and interest cost	$ (145)	$ 153	$ (104)	$ 110

We estimate the long-term rate of return on UK, Canadian and U.S. plan assets will be 6.5%, 7% and 8%, respectively, based on the long-term target asset allocation. 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 35% Canadian provincial and corporate bonds, 30% larger capitalization Canadian stocks, 30% 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.

The U.S. pension plan s target asset allocation is 30% large capitalization U.S. equities, 5% small capitalization U.S. equities, 25% developed market non-U.S. equities, 30% long duration U.S. Treasury bonds and 10% in alternative investments. The asset allocation was set considering asset class expected returns and volatility relative to the duration of the liabilities of the pension plan.

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The asset allocation is reviewed annually in accordance with the Investment Policy Statement. The assets are held in a separate pension trust account at a custodian bank. External registered investment advisors manage the assets in active and passive strategies that are well diversified, investment grade, liquid and unleveraged.

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, a 7.8% 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):

	Fiscal year ended June 30, 2007		Fiscal year ended June 30, 2006	
	Plus 1%	**Less 1%**	**Plus 1%**	**Less 1%**
Effect on pension benefit obligation	$34	$(31)	$30	$(27)
Effect on service and interest cost	$ 5	$ (4)	$ 4	$ (4)

Expected Cash Flows

We expect to contribute approximately $14.5 million to our pension plans in fiscal year 2008.

The following table summarizes the estimated benefit payments, which include amounts to be earned by active plan employees through expected future service for all pension plans over the next ten years as of June 30, 2007 (in thousands):

	Pension Plans		
	Non-U.S. Plans	**U.S. Plan**	**Other Benefit Plan**
2008	$ 3,314	$ 75	$19
2009	3,431	108	20
2010	3,307	182	19
2011	3,552	309	14
2012	3,507	466	13
2013-2017	23,957	5,374	63

Supplemental executive retirement plan

In December 1998, we entered into a Supplemental Executive Retirement Agreement with Mr. Deason, which was amended in August 2003 to conform the normal retirement date specified therein to our fiscal year end next succeeding the termination of the Employment Agreement between Mr. Deason and us. The normal retirement date under the Supplemental Executive Retirement Agreement was subsequently amended in June 2005 to conform to the termination date of the Employment Agreement with the exception of the determination of any amount deferred in taxable years prior to January 1, 2005 for purposes of applying the provisions of the American Jobs Creation Act of 2004 and the regulations and interpretive guidance published pursuant thereto (the AJCA). Pursuant to the Supplemental Executive Retirement Agreement, which was reviewed and approved by the Board of Directors, Mr. Deason will receive a benefit upon the occurrence of certain events equal to an actuarially calculated amount based on a percentage of his average monthly compensation determined by his monthly compensation during the highest thirty-six consecutive calendar months from among the 120 consecutive calendar months ending on the earlier of his termination of employment or his normal retirement date. The amount of this benefit payable by us will be offset by the value of particular options granted to Mr. Deason (including 150,000 shares covered by options granted in October 1998 with an exercise price of $11.53 per share and 300,000 shares granted in August 2003 with an exercise price of $44.10). To the extent that we determine that our estimated actuarial liability under the Supplemental

Executive Retirement Agreement exceeds the in the money value of such options, such deficiency would be reflected in our results of operations as of the date of such determination. In the event that the value of the options granted to Mr. Deason exceeds the benefit, such excess benefit would accrue to Mr. Deason and we would have no further obligation under the Supplemental Executive Retirement Agreement. The percentage applied to the average monthly compensation is 56% for benefit determinations made on or any time after May 18, 2005. The events triggering the benefit are retirement, total and permanent disability, death, resignation, and change in control or termination for any reason other

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than cause. The benefit will be paid in a lump sum or, at the election of Mr. Deason, in monthly installments over a period not to exceed ten years. We estimate that our obligation with respect to Mr. Deason under the Supplemental Executive Retirement Agreement was approximately $9.1 million at June 30, 2007. The value (the excess of the market price over the option exercise price) of the options at June 30, 2007 was $10.6 million. If the payment is caused by a change in control and at such time Mr. Deason would be subject to an excise tax under the Code with respect to the benefit, the amount of the benefit will be grossed-up to offset this tax.

Deferred compensation plans

We offer a deferred compensation plan to employees who meet specified compensation criteria. The assets and liabilities of this plan are included in our Consolidated Financial Statements. Approximately 1,100 employees participate in the plan. Participants may elect to defer a specified percentage of base salary and incentive compensation annually. The assets of the plan as of June 30, 2007 and 2006 were $58.9 million and $51 million, respectively, and were included in cash and other assets in our Consolidated Balance Sheets. The liabilities of the plan, representing participants account balances, were $53.8 million and $41.8 million at June 30, 2007 and 2006, respectively, and were included in other long-term liabilities in our Consolidated Balance Sheets.

In connection with the acquisition of the Acquired HR Business, we assumed a deferred compensation plan for certain Acquired HR Business employees. This plan is closed to new contributions. The assets and liabilities of this plan were included in our Consolidated Financial Statements as of the date of acquisition. Approximately 100 employees participate in the plan. The assets of the plan as of June 30, 2007 and 2006 were $28.9 million and $25.4 million, respectively, and were included in other assets in our Consolidated Balance Sheets. The liabilities of the plan, representing participants account balances, were $29.5 million and $29 million at June 30, 2007 and 2006, respectively, and were included in other long-term liabilities in our Consolidated Balance Sheets.

Other contributory plans

We have contributory retirement and savings plans, which cover substantially all employees and allow for discretionary matching contributions by us as determined by our Board of Directors. Contributions made by us to certain plans during the years ended June 30, 2007, 2006, and 2005 were approximately $13.3 million, $15 million and $13.4 million, respectively.

14. INCOME TAXES

Income tax expense (benefit) is comprised of the following (in thousands):

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Current:			
U.S. federal	$ 79,953	$ 92,090	$ 116,334
State	12,134	11,508	18,170
Foreign	18,610	11,208	3,594
Total current expense	110,697	114,806	138,098
Deferred:			
U.S. federal	17,588	75,168	76,051
State	5,070	10,010	8,555
Foreign	(3,032)	(477)	211
Total deferred expense	19,626	84,701	84,817
Total income tax expense	$ 130,323	$ 199,507	$ 222,915

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Deferred tax assets (liabilities) consist of the following (in thousands):

	June 30, 2007	June 30, 2006
Deferred tax assets:		
Accrued expenses not yet deductible for tax purposes	$ 39,815	$ 50,454
Unearned revenue	36,266	22,548
Tax credits and loss carryforwards	56,677	57,361
Stock-based compensation	25,529	16,515
Divestiture-related accruals	4,617	4,845
Forward agreements	2,124	6,321
Other		872
Subtotal	165,028	158,916
Deferred tax assets valuation allowance	(17,184)	(14,594)
Total deferred tax assets	147,844	144,322
Deferred tax liabilities:		
Goodwill amortization	(334,065)	(280,830)
Depreciation and amortization	(123,722)	(135,908)
Unbilled revenue	(41,634)	(41,835)
Prepaid and receivables	(27,403)	(35,229)
Other	(3,003)	
Total deferred tax liabilities	(529,827)	(493,802)
Net deferred tax liabilities	$ (381,983)	$ (349,480)

At June 30, 2007, we had available unused domestic net operating loss carryforwards (NOLs), net of Internal Revenue Code Section 382 limitations, of approximately $98.7 million which will expire over various periods from 2010 through 2024. We also had foreign net operating loss carryforwards of approximately $9.3 million, all of which have indefinite lives. The change in tax credits and loss carryforwards from June 30, 2006 to June 30, 2007 is primarily due to current year usage of net operating losses. A valuation allowance of $17.2 million and $14.6 million was recorded at June 30, 2007 and June 30, 2006, respectively, against deferred tax assets associated with net operating losses and tax credit carryforwards for which realization of any future benefit is uncertain due to taxable income limitations. We routinely evaluate all deferred tax assets to determine the likelihood of their realization.

The depreciation and amortization related deferred tax liabilities changed during the years ended June 30, 2007 and 2006 predominantly due to current tax deductions for acquired intangibles and depreciation. Generally, since the adoption of SFAS No. 142, Goodwill and Other Intangibles, eliminates the book goodwill amortization, the difference between the cumulative book and tax bases of goodwill will continue to change as current tax deductions are realized. As of June 30, 2007 and June 30, 2006, the amount of deductible goodwill was approximately $2.1 billion and $2.0 billion, respectively.

Income tax expense varies from the amount computed by applying the statutory federal income tax rate to income before income taxes as follows (in thousands):

	Fiscal year ended June 30, 2007	2006	2005

Statutory U.S. federal income tax	$ 134,194	$ 195,410	$ 221,369
State income taxes, net	12,188	13,505	19,396
Section 162(m) disallowance	(4,610)		870
Basis difference on sales of subsidiaries		(449)	(9,594)
Research and development tax credits	(385)		(4,674)
Foreign benefits	(6,287)	(5,259)	(2,734)
Other	(4,777)	(3,700)	(1,718)
Total income tax expense	$ 130,323	$ 199,507	$ 222,915

The effective tax rate for fiscal years 2007, 2006 and 2005 were 34.0%, 35.7%, and 35.2%, respectively.
Cumulative undistributed earnings of non-U.S. subsidiaries for which U.S. taxes have not been provided are included in consolidated retained earnings in the amount of approximately $118.6 million, $70.9 million and $36.5 million as of June 30,

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2007, 2006, and 2005, respectively. These earnings are intended to be permanently reinvested outside the U.S. If future events necessitate that these earnings should be repatriated to the U.S., an additional tax provision and related liability may be required. If such earnings were distributed, U.S. income taxes would be partially reduced by available credits for taxes paid to the jurisdictions in which the income was earned.

Federal, state and foreign income tax payments, net of refunds during the years ended June 30, 2007, 2006, and 2005 were approximately $106.7 million, $102.2 million, and $118.9 million, respectively.

15. OTHER LONG-TERM LIABILITIES

The following summarizes other long-term liabilities at June 30, 2007 and 2006 (in thousands):

	June 30,	
	2007	**2006**
Deferred compensation, pension and other post-retirement obligations	$ 97,974	$ 95,911
Unearned revenue	89,759	95,870
Income taxes payable and estimated penalties and interest on income tax underpayment deficiencies resulting from certain disallowed Section 162(m) executive compensation deductions	3,201	37,842
Other	44,618	46,026
Total	$ 235,552	$ 275,649

During fiscal year 2007, we paid approximately $35 million of estimated income taxes, penalties and interest related to Section 162(m) issues in order to reduce future interest that would accrue on the amounts of estimated taxes, penalties and interest. This payment is reflected in cash flows from operating activities at June 30, 2007. During fiscal year 2007, we reversed approximately $6 million of accrued income taxes, penalties and interest associated with Section 162(m) issues attributable to factors unrelated to revised measurement dates as we believe an accrual for these amounts is no longer required. Please see Note 21 for further discussion.

16. COMMON STOCK

Our Class A common stock trades publicly on the New York Stock Exchange (symbol ACS) and is entitled to one vote per share. Our Class B common stock is entitled to ten votes per share. Class B shares are convertible, at the holder s option, into Class A shares, but until converted carry significant transfer restrictions.

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 June 30, 2007, we had repurchased approximately 19.9 million shares under the June 2006 authorization at an average cost of approximately $50.30 per share (approximately $1 billion) all of which have been retired. A total of 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 authorization as of the date of this filing. If any additional repurchases are made, such repurchases would be funded from borrowings under our Credit Facility.

Prior to the Tender Offer (defined in Note 17), our Board of Directors authorized three share repurchase programs totaling $1.75 billion of our Class A common stock. On September 2, 2003, we announced that our Board of Directors authorized a share repurchase program of up to $500 million of our Class A common stock; on April 29, 2004, we announced that our Board of Directors authorized a new, incremental share repurchase program of up to $750 million of our Class A common stock, and on October 20, 2005, we announced that our Board of Directors authorized an incremental share repurchase program of up to $500

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million of our Class A common stock. These share repurchase plans were terminated on January 25, 2006 by our Board of Directors in contemplation of our Tender Offer, which was announced January 26, 2006 and expired March 17, 2006. The programs, which were open-ended, allowed us to repurchase our shares on the open market from time to time in accordance with SEC rules and regulations, including shares that could be purchased pursuant to SEC Rule 10b5-1. The number of shares purchased and the timing of purchases was based on the level of cash and debt balances, general business conditions and other factors, including alternative investment opportunities, and purchases under these plans were funded from various sources, including, but not limited to, cash on hand, cash flow from operations, and borrowings under our credit facilities. Under our previously authorized share repurchase programs during fiscal years 2006 and 2005, we had repurchased approximately 2.2 million and 4.9 million shares, respectively, at a total cost of approximately $115.8 million and $250.8 million, respectively. We reissued approximately 0.3 million and 0.6 million shares, respectively, for proceeds of approximately $17.9 million and $28.5 million, respectively, to fund contributions to our employee stock purchase plan and 401(k) plan during fiscal years 2006 and 2005, respectively. In fiscal year 2007, we reissued approximately 57,000 treasury shares for proceeds totaling approximately $2.8 million to fund contributions to our employee stock purchase plan.

Stock options grants

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 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 as discussed below.

Because of the ongoing stock option investigation (please see Note 21 to our Consolidated Financial Statements), we were unable to timely file our Annual Report on Form 10-K for the fiscal year ended June 30, 2006 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 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 granted 692,000 shares 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.

Please see Note 29 for a discussion of our July 2007 stock option grant to certain executive officers.

Stock option repricing

Please see Notes 21 and 29 for a discussion of the December 2006 repricing of certain outstanding stock options, our tender offer to amend certain options and results of the tender offer, as well as our offer to former employees.

In June 2007, our stockholders approved the 2007 Equity Incentive Plan. Please see Note 2 for further discussion of the 2007 Equity Incentive Plan.

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17. TENDER OFFER

On January 26, 2006, we announced that our Board of Directors authorized a modified Dutch Auction tender offer to purchase up to 55.5 million shares of our Class A common stock at a price per share not less than $56 and not greater than $63 (the Tender Offer). The Tender Offer commenced on February 9, 2006, and expired on March 17, 2006 (as extended), and was funded with proceeds from the Term Loan Facility. Our directors and executive officers, including our Chairman, Darwin Deason, did not tender shares pursuant to the Tender Offer. The number of shares purchased in the Tender Offer was 7,365,110 shares of Class A common stock at an average price of $63 per share plus transaction costs, for an aggregate purchase amount of $475.9 million. All of the shares purchased in the Tender Offer were retired as of June 30, 2006.

Voting Rights of Our Chairman

In connection with the Tender Offer, Mr. Deason entered into a Voting Agreement with the Company dated February 9, 2006 (the Voting Agreement) in which he agreed to limit his ability to cause the additional voting power he would hold as a result of the Tender Offer to affect the outcome of any matter submitted to the vote of the stockholders of the Company after consummation of the Tender Offer. Mr. Deason agreed that to the extent his voting power immediately after the Tender Offer increased above the percentage amount of his voting power immediately prior to the Tender Offer, Mr. Deason would cause the shares representing such additional voting power (the Excess Voting Power) to appear, not appear, vote or not vote at any meeting or pursuant to any consent solicitation in the same manner, and in proportion to, the votes or actions of all stockholders including Mr. Deason whose Class A and Class B shares shall, solely for the purpose of proportionality, be counted on a one for one vote basis (even though the Class B shares have ten votes per share).

As the result of the purchase of approximately 7.4 million shares of Class A common stock in the Tender Offer, Mr. Deason s percentage increase in voting power above the percentage amount of his voting power immediately prior to the Tender Offer was approximately 1.5%.

The Voting Agreement will have no effect on shares representing the approximately 36.7% voting power of the Company held by Mr. Deason prior to the Tender Offer, which Mr. Deason will continue to have the right to vote in his sole discretion, or on any increase in his voting percentage as a result of any share repurchases by the Company. The Voting Agreement also does not apply to any Class A shares that Mr. Deason may acquire after the Tender Offer through his exercise of stock options, open market purchases or in any future transaction that we may undertake (including any increase in voting power related to any Company share repurchase program). Other than as expressly set forth in the Voting Agreement, Mr. Deason continues to have the power to exercise all rights attached to the shares he owns, including the right to dispose of his shares and the right to receive any distributions thereon.

The Voting Agreement will terminate on the earliest of (i) the mutual agreement of the Company (authorized by not less than a majority of the vote of the then independent and disinterested directors) and Mr. Deason, (ii) the date on which Mr. Deason ceases to hold any Excess Voting Power, as calculated in the Voting Agreement, or (iii) the date on which all Class B shares are converted into Class A shares.

Mr. Deason and a special committee of the Board of Directors, consisting of independent directors, have not reached an agreement regarding the fair compensation to be paid to Mr. Deason for entering into the Voting Agreement. However, whether or not Mr. Deason and our special committee are able to reach agreement on compensation to be paid to Mr. Deason, the Voting Agreement will remain in effect.

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18. EARNINGS PER SHARE

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

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Numerator:			
Numerator for earnings per share -			
Net Income	$ 253,090	$ 358,806	$ 409,569
Denominator:			
Weighted average shares outstanding (basic)	100,181	123,197	127,560
Effect of dilutive securities:			
Stock options	1,391	1,830	2,996
Total potential common shares	1,391	1,830	2,996
Denominator for earnings per share assuming dilution	101,572	125,027	130,556
Earnings per share (basic)	$ 2.53	$ 2.91	$ 3.21
Earnings per share assuming dilution	$ 2.49	$ 2.87	$ 3.14

Additional dilution from assumed exercises of stock options is dependent upon several factors, including the market price of our common stock. During fiscal year 2007, 2006 and 2005, options to purchase approximately 6,019,000, 5,136,000, and 1,075,000 shares of common stock, 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 benefits 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).

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19. COMPREHENSIVE INCOME

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

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

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Net income	$ 253,090	$ 358,806	$ 409,569
Other comprehensive income (loss):			
Foreign currency translation adjustment	16,955	(1,305)	4,260
Unrealized gains (losses) on foreign exchange forward agreements (net of income tax of $958 and ($193), respectively)	693	(316)	
Unrealized loss on forward interest rate agreements (net of income tax of $7,150)			(11,899)
Amortization of unrealized loss on forward interest rate agreements (net of income tax of $958, $956 and $66)	1,586	1,588	110
Unrealized gain on interest rate swap agreement (net of income tax of $2,819)	5,251		
Comprehensive income	$ 277,575	$ 358,773	$ 402,040

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

	June 30,	
	2007	**2006**
Foreign currency gains (losses)	$ 16,529	$ (426)
Unrealized gains (losses) on foreign exchange forward agreements (net of income tax of $226 and ($193), respectively)	377	(316)
Unrealized loss on forward interest rate agreements (net of income tax of $5,170 and $6,128, respectively)	(8,615)	(10,201)
Unrealized gain on interest rate swap agreement (net of income tax of $2,819)	5,251	
Adjustment to initially apply SFAS 158 (net of income tax of $980)	2,374	
Total	$ 15,916	$ (10,943)

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20. FINANCIAL INSTRUMENTS

Long-term Debt

As of June 30, 2007 and 2006, the fair values of our Senior Notes approximated $459.4 million and $448 million, respectively, based on quoted market prices.

As of June 30, 2007 and 2006, the fair values of balances outstanding under our Credit Facility and Prior Facility approximated the related carrying values.

Derivatives and hedging instruments

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 June 30, 2007 and 2006, the notional amount of these agreements totaled 312 million pesos (approximately $27.9 million) and 217.5 million pesos (approximately $19.5 million), respectively. These agreements 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 June 30, 2007, the unrealized gain on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was $0.6 million ($0.4 million, net of income tax), and the fair market value of $0.6 million is reflected in other current assets. As of June 30, 2006, the unrealized loss on these foreign exchange forward agreements, reflected in accumulated other comprehensive income (loss), net, was $0.5 million ($0.3 million, net of income tax) and the fair market value of $0.5 million was reflected in other current liabilities.

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 U.S. dollar revenues. These agreements do not qualify for hedge accounting under SFAS 133. As a result, we recorded a gain on hedging instruments of approximately $1.7 million ($1.1 million, net of income tax) for the year ended June 30, 2006 in other non-operating income, net in our Consolidated Statements of Income. The gain on hedging instruments was not material in fiscal year 2007. As of June 30, 2007 and 2006, the notional amount of these agreements totaled 25.2 million Euros (approximately $33.9 million) and 31.2 million Euros (approximately $39.1 million), respectively, and are set to expire at various times over the next four years. A liability was recorded for the related fair value of approximately $4.3 million and $4.1 million as of June 30, 2007 and 2006, respectively.

In order to hedge the variability of future interest payments related to our Senior Notes issuance, we entered into forward interest rate agreements in April 2005. The agreements were designated as cash flow hedges of forecasted interest payments in anticipation of the issuance of the Senior Notes. The notional amount of the agreements totaled $500 million and the agreements were terminated in June 2005 upon issuance of the Senior Notes. The settlement of the forward interest rate agreements of $19 million ($12 million, net of income tax) was recorded in accumulated other comprehensive income (loss), net, and 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. During fiscal years 2007, 2006 and 2005, we amortized approximately $2.5 million, $2.5 million and $0.2 million, respectively, to interest expense. The amount of gain or loss related to hedge ineffectiveness was not material.

In March 2007, we entered into a five-year amortizing interest rate swap agreement. As of June 30, 2007, the notional amount of the agreement totaled $700 million. The agreement is designated as a cash flow hedge of forecasted interest payments on up to $700 million outstanding floating rate debt under our Credit Facility. The interest rate swap is structured such that we pay a fixed rate of interest of 4.897%, and receive a floating rate of interest based on one month LIBOR. The fair value of the agreement of $8.1 million at June 30, 2007 reflects termination cash value. The unrealized gain of $8.1 million ($5.3 million, net of income tax), was reflected in accumulated other comprehensive income (loss), net. As of June 30, 2007, the fair market value of $8.1 million is reflected in other assets.

Investments

As of June 30, 2007 and 2006, as part of our deferred compensation plan, we held investments in insurance policies with a fair market value of $51.3 million and $39 million, respectively and mutual funds with a fair market value of

$28.9 million and $25.4 million, respectively. Please see Note 13 for more information on the deferred compensation plans. We recorded gains on these investments of $9.6 million, $3.2 million and $3.1 million for fiscal years 2007, 2006 and 2005, respectively.

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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 SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities and are reflected in other assets in our Consolidated Balance Sheet at June 30, 2007.

21. COMMITMENTS AND CONTINGENCIES

We have various non-cancelable operating lease agreements for information technology equipment, software and facilities. Our facilities leases have varying terms through 2018. 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 2012. Lease expense for information technology equipment, software and facilities was approximately $374.2 million, $339.6 million and $258.9 million for the years ended June 30, 2007, 2006 and 2005, respectively. A summary of these commitments at June 30, 2007 is as follows (in thousands):

Year ending June 30,	
2008	$ 337,537
2009	282,312
2010	236,446
2011	150,262
2012	55,009
Thereafter	65,751
	$ 1,127,317

We have various contractual agreements to purchase telecommunications services. These agreements provide for minimum annual spending commitments, and have varying terms through fiscal year 2010. We estimate future payments related to these agreements will be $16.4 million, $12.9 million, and $0.4 million in fiscal years 2008, 2009, and 2010, respectively.

In June 2006, we entered into an agreement with Rich Capital LLC, an M&A advisory firm owned by our former Chief Executive Officer, Jeffrey A. Rich. The agreement is for two years during which time we will pay a total of $0.5 million for services. We have paid approximately $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.

Regulatory Agency Investigations Relating to Stock Option Grant Practices

On March 3, 2006, we received notice from the Securities and Exchange Commission that it was conducting an investigation into certain stock option grants made by us from October 1998 through March 2005. On June 7, 2006 and on June 16, 2006, we received requests from the SEC for information on all of our stock option grants since 1994. We have been providing supplemental information to the SEC on a voluntary basis following the initial SEC requests. Subsequent to May 10, 2007, the date of our last quarterly filing with the Commission, the Company has learned that the SEC obtained a formal order of investigation in this matter in August 2006. We are continuing to cooperate with the SEC s 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).

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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 have been 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 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 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

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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 our 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. Please see Note 23 for a discussion of the terms of their separation.

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, which have 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 a number of changes to our internal controls, including:

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- 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 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 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 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 recognized compensation expense in accordance with 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, determined that the cumulative non-cash stock-based compensation expense adjustment and related income tax effects was material. Our decision to restate our financial statements was based on the facts obtained by management and the special committee. We determined that the cumulative, pre-tax, non-cash stock-based compensation expense resulting from revised measurement dates was approximately $51.2 million during the period from our initial public offering in 1994 through June 30, 2006. The corrections relate to options covering approximately 19.4 million shares. Previously reported total revenues were not impacted by our restatement. The impact of the restatement on each year of our previously issued financial statements is more fully disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

Related income tax effects included deferred income tax benefits on the compensation expense, and additional income tax liabilities and estimated penalties and interest related to the application of Internal Revenue Code Section 162(m) and related Treasury Regulations (Section 162(m)) to stock-based executive compensation previously deducted, that was no longer deductible as a result of revised measurement dates of certain stock option grants. We also included in our restatements additional income tax liabilities and estimated penalties and interest, with adjustments to additional paid-in capital and income tax expense, related to certain cash and stock-based executive compensation deductions previously taken under Section 162(m), which we believed may be non-deductible as a result of information that has been obtained by us in connection with our internal investigation, due to factors unrelated to revised measurement dates. Through June 30, 2007, we recorded approximately $33.4 million of additional income taxes, estimated penalties and interest related to disallowed Section 162(m) executive compensation deductions resulting from revised measurement dates. At this time, we cannot predict when these Section 162(m) issues will be resolved; however, during fiscal year 2007, we paid approximately $35 million of estimated income taxes, penalties and interest related to Section 162(m) issues in order to reduce future interest that would accrue on the amounts of estimated taxes, penalties and interest. This payment is reflected in cash flows from operating activities at June 30, 2007. During fiscal year 2007, we reversed approximately $6 million of accrued income taxes, penalties and interest associated with

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Section 162(m) issues attributable to factors unrelated to revised measurement dates, which is reflected in the total amount recorded above, as we believe an accrual for these amounts is no longer required.

In December 2006, we amended the exercise price of outstanding stock options of certain current executive officers, other executive officers and former executive officers were amended in order to re-price all or a portion of the respective option grant to the correct accounting measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. We will pay cash payments in the aggregate amount of $2.4 million in accordance with the terms of the amendment, which will be paid in the third quarter of fiscal year 2008 from cash flows from operating activities. Of the $2.4 million cash payment, approximately $0.5 million was expensed in fiscal year 2007, and the balance was charged to Additional Paid-in Capital.

On June 18, 2007, we initiated a tender offer to amend certain options (the Eligible Options) to purchase an aggregate of 1,703,650 shares (as amended) of our Class A common stock in order to re-price all or a portion of the respective option grant to the correct accounting measurement date to avoid adverse tax consequences to individual option holders under Section 409A of the Internal Revenue Code. The Eligible Options included options that (i) were granted under our 1997 Stock Incentive Plan, as amended; (ii) had exercise prices per share that were less, or may have been less, than the fair market value per share of ACS on the revised measurement dates for such options, as determined by us for accounting and tax purposes; (iii) were unexercised and unvested, either in whole or in part, as of January 1, 2005; (iv) were outstanding as of the expiration time of this tender offer; and (v) were held by individuals who (x) were employed by the Company through the expiration time of this tender offer (other than any executive officer or director) and (y) are subject to income taxation in the United States. Eligible participants could elect to (i) amend Eligible Options to increase the exercise price per share to the fair market value of the Company s Class A common stock on the respective option s measurement date and (ii) receive a cash payment equal to the difference between the new exercise price per share of each amended option and the original exercise price per share of such amended option, multiplied by the number of unexercised shares of the Company s Class A common stock subject to such amended option. This payment will be made on or before the eligible option holder s first regular payroll date in January 2008. Please see Note 29 for a discussion of the results of the tender offer, as well as our offer to former employees.

Lawsuits Related to Stock Option Grant Practices

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

Dallas County TX State District Court

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

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

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

The Huntsinger, Oury, and Anchorage lawsuits were consolidated into one case on June 5, 2006, under the caption In Re Affiliated Computer Services, Inc. Derivative Litigation in the District Court of Dallas County, Texas, 193rd

Judicial District (the Texas State Derivative Action). On March 26, 2007, plaintiffs filed a Third Amended Consolidated Complaint, which added causes of action related to the announced buy-out transaction as well. On May 1, 2007, ACS and the individual defendants filed a Special Exceptions Motion, on the grounds that plaintiffs buy-out claims were not yet ripe for adjudication, and that plaintiffs cannot bring both direct and derivative claims in a single lawsuit. The court has not yet scheduled a hearing

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date on our Special Exceptions Motion, which seeks to dismiss the buy-out claims.

Court of Chancery for the State of Delaware

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

On August 15, 2006, plaintiff filed a First Amended Complaint. The First Amended Complaint added Lynn R. Blodgett, David W. Black, Henry Hortenstine, Peter A. Bracken, William L. Deckelman, Jr., Warren Edwards, John M. Brophy, John Rexford, Dennis McCuistion, J. Livingston Kosberg and Clifford M. Kendall. On April 5, 2007, plaintiff Brandin filed a Motion for Summary Judgment against Darwin Deason, Jeffrey Rich and Mark King. Each of the parties has filed their respective briefs and a hearing date on the Motion for Summary Judgment has been scheduled for October 30, 2007.

United States District Court for the Northern District of Texas

Alaska Electrical Fund, derivatively on behalf of Affiliated Computer Services Inc. v. Jeffrey Rich; Joseph O Neill; Frank A. Rossi; Darwin Deason; Mark King; Lynn Blodgett; J. Livingston Kosberg; Dennis McCuistion; Warren Edwards; John Rexford and John M. Brophy, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, in the United States District Court for the 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 McCuistion; Warren Edwards; John Rexford and John M. Brophy, Defendants, and Affiliated Computer Services, Inc., Nominal Defendant, in the United States District Court for the 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 on August 1, 2006, under the caption In Re Affiliated Computer Services Federal Derivative Litigation, in the United States District Court for the Northern District of Texas, Master File No 3:06-CV-1110-M (the Texas Federal Derivative Action). On April 5, 2007, the plaintiffs filed a Second Amended Complaint, adding causes of action related to the announced buy-out transaction as well. On June 4, 2007, ACS and the individual defendants filed a Motion to Dismiss the Second Amended Complaint, on the grounds that the buy-out claims were not yet ripe for adjudication. On August 1, 2007, the federal judge dismissed the buy-out related causes of action, and dismissed the Section 16(b) claims against Jeff Rich and Mark King, (which had formerly been filed in the Delaware U.S. District Court as the Strauss case, and had been transferred to this court in June, 2007). The federal judge also dismissed the SEC Rule 10(b)5 cause of action against William L. Deckelman, Jr., based on plaintiffs failure to state a claim against Mr. Deckelman. Defendant David Black was also dismissed from this case by the plaintiffs.

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

United States District Court of Texas for the 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, in the United States District Court for the 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

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A. Rich, Mark A. King, Darwin Deason, Joseph P. O Neill and J. Livingston Kosberg, United States District Court for the Northern District of Texas, Dallas Division, Case No. 306-CV-02379-M.

On February 12, 2007, the Simeon case and the Burke case were consolidated into one case, under the caption, In re Affiliated Computer Systems [sic] ERISA Litigation, Master File No. 3:06-CV-1592-M. Plaintiffs in the consolidated action filed a Consolidated Amended Class Action Complaint on March 21, 2007. The Consolidated Amended Class Action Complaint added Lynn Blodgett, Dennis McCuistion, Warren Edwards, John Rexford, and John M. Brophy as defendants. On April 6, 2007, the Court issued an order staying this case for 180 days, or until either party requests that the stay be lifted, whichever occurs first, (i.e., by October 6, 2007). If the stay is lifted, ACS will have thirty (30) days to answer or otherwise respond to the Consolidated Complaint.

All of 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.

Litigation arising from buy-out offer

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

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

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

Mark Levy v. Darwin Deason, Lynn Blodgett, John Rexford, Joseph P. O Neill, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Civil Action No. 2816-VCL, filed on March 21, 2007.

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

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

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

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

On May 4, 2007, each of the six Delaware buy-out cases was consolidated into one case, pending in the Delaware Chancery Court, entitled In Re Affiliated Computer Services, Inc. Shareholder Litigation, Civil Action No. 2821-VCL. A Consolidated Complaint has not yet been filed by the plaintiffs.

In the Texas State Court, two stand-alone buy-out cases were filed, as follows:

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Steamship Trade Association/International Longshoreman s Association Pension Fund v Affiliated Computer Services, Inc., Darwin Deason, Lynn Blodgett, John Rexford, Joseph P. O Neill, Gerardo I. Lopez, Frank A. Rossi, J. Livingston Kosberg, Dennis McCuistion, Robert B. Holland, and Cereberus [sic] Capital Management, L.P., Cause No. 07-02691 in the District Court of Dallas County, Texas, 44th Judicial District, filed on March 22, 2007.

The City of Birmingham, Alabama Retirement and Relief System v. Darwin Deason, Robert B. Holland, III, J. Livingston Kosberg, Frank A. Rossi, Joseph P. O Neill, Lynn R. Blodgett, John H. Rexford, Dennis McCuistion, Affiliated Computer Services, Inc., and Cerberus Capital Management, L.P., Cause No. 07-02768 in the District Court of Dallas, Texas, 160th Judicial District, filed on March 28, 2007.

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

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

In the Texas Federal Court Consolidated stock option derivative case, on April 5, 2007, the plaintiffs filed a Second Amended Complaint, adding causes of action related to the announced buy-out transaction as well, and adding as defendants, Clifford Kendall, David Black, Henry Hortenstine, Peter A. Bracken, William Deckelman, Jr., PriceWaterhouseCoopers LLP, and Cerberus Capital Management LP. Like the Third Amended Petition in the Texas State Court Derivative Action, the Second Amended Complaint in the Texas Federal Court Derivative Action challenged both the process through which the Proposal was generated, and the substance of the Proposal. On June 4, 2007, ACS and the individual defendants filed a Motion to Dismiss the Second Amended Complaint, on the grounds that the buy-out claims were not yet ripe for adjudication, i.e., no claim related to the Proposal can properly be the subject of litigation, because the Proposal has not been accepted or recommended by either the Company or by the Special Committee formed to evaluate the Proposal and strategic alternatives to the Proposal. On August 1, 2007, the federal judge dismissed the buy-out related causes of action. The federal judge also dismissed the SEC Rule 10(b)5 cause of action against defendant William Deckelman, Jr., based on plaintiff s failure to state a claim against Mr. Deckelman. Defendant David Black was also dismissed from this case by the plaintiffs.

The Proposal has not been recommended or accepted by ACS, or by the Special Committee formed to evaluate the Proposal and strategic alternatives to the Proposal. Accordingly, we do not believe that the claims raised in the cases related to the Proposal state a live controversy, nor have any merit, and we intend to vigorously defend those claims in each lawsuit.

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 12 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 two Edmonton police officers. The two officers were separately charged for violation of this law. The alleged violation relates to the subsidiary s contract with the City of Edmonton for red-light camera photo-enforcement

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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 $2.3 million, $2.3 million and $2 million (U.S. dollars) in fiscal years 2007, 2006 and 2005, respectively. A renewal contract had been awarded to our subsidiary in 2004 on a sole source basis, but this 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. On June 8, 2007, the Alberta government withdrew the original charges against the two police officers, and informed the court it would proceed against them on the lesser charge of breach of public trust and fraud on the government. On June 27, 2007, the Alberta government also withdrew the original charge against our subsidiary, and informed the court that it would proceed against our subsidiary on the lesser charge of aiding and abetting a breach of public trust and fraud on the government. On August 8, 2007, the Alberta government dismissed all charges against one of the police officers. A preliminary hearing on this matter has been scheduled for September 10, 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 $45.2 million, $45.6 million and $43.5 million for fiscal years 2007, 2006 and 2005, respectively, representing approximately 0.8%, 0.9% and 1% of our revenues for fiscal years 2007, 2006 and 2005, 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, 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.

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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 0.4% and 0.9% of our revenues for fiscal years 2006 and 2005, respectively. We had no revenue related to this contract in fiscal year 2007. In March 2004, we filed our response to the OIG report. The principal workforce policy organization for the State of Florida, which oversees and monitors the administration of the State s workforce policy and the programs carried out by AWI and the regional workforce boards, is Workforce Florida, Inc. (WFI). On May 20, 2004, the Board of Directors of WFI held a public meeting at which the Board 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 related to a workforce contract in Pinellas County, Florida, for the period from January 1999 to the contract s expiration in March 2001, which was prior to our acquisition of this business from Lockheed Martin Corporation in August 2001. Further, we settled a civil lawsuit with Pinellas County in December 2003, with respect to claims related to the services rendered to Pinellas County by Lockheed Martin Corporation prior to our acquisition of ACS SLS (those claims having been transferred with ACS SLS as part of the acquisition), and the settlement resulted in Pinellas County paying ACS SLS an additional $600,000. We are continuing to cooperate with the DOJ and DOL in connection with their investigations. At this stage of these investigations, we are unable to express an opinion as to their likely outcome. It is not possible at this time to reasonably estimate the possible loss or range of loss, if any. During the second quarter of fiscal year 2006, we completed the divestiture of substantially all of our welfare-to-workforce business (please see Note 6 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 would not intervene in the Complaint. The court then entered an order to unseal the Complaint and, we were subsequently served with the Complaint. The allegations in this Complaint arise from the workforce contract in Pinellas County, Florida, that is the subject of the grand jury document subpoena issued by the U.S. District Court for the Middle District of Florida in connection with an inquiry being conducted by the DOJ and 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 June 30, 2007, outstanding surety bonds of $524 million and $90.9 million of our outstanding letters of credit secure our performance of contractual obligations with our clients. Approximately $22.3 million of letters of credit and $1.8 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.

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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 SFAS 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 certain contingent payments to former shareholders of acquired entities upon satisfaction of certain contractual criteria in conjunction with certain acquisitions. During fiscal years 2007, 2006 and 2005, we made contingent consideration payments of $25.4 million, $9.8 million and $17 million, respectively, related to acquisitions completed in prior years. As of June 30, 2007, the maximum aggregate amount of the outstanding contingent obligations to former shareholders of acquired entities is approximately $90.6 million of which $21 million has been earned as of June 30, 2007. The $21 million was accrued as of June 30, 2007 and is expected to be paid during the first half of fiscal year 2008. Any such payments primarily result in a corresponding increase in goodwill.

We 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 June 30, 2007, 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 June 30, 2007, we serviced a FFEL portfolio of approximately 2.2 million loans with an outstanding principal balance of approximately $32.5 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 June 30, 2007, 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 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 was 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 also requested 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. During the fourth quarter of fiscal year 2006, we recorded a charge of approximately $4.0 million, of which $3.9 million was charged to revenue, related to our assessment of realization of amounts previously recognized for the North Carolina MMIS contract.

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On March 22, 2007, we settled all issues with DHHS. Pursuant to the settlement, DHHS rescinded its June 6, 2006 notice of intent to terminate the NCMMIS contract and its July 14, 2006 notice of termination and the parties agreed to a mutual termination of the contract. We agreed, as part of the settlement, to license to DHHS certain work product we produced in connection with the NCMMIS contract and DHHS has agreed to pay us the aggregate amount of $10.5 million in four installments beginning on or before March 31, 2007 and ending on or before June 30, 2008. We recognized $3.4 million in revenue in the third quarter of fiscal year 2007 related to this settlement. In addition, we have entered into several new contracts, with terms of two years, to provide new services to DHHS and will be compensated based on achieving certain levels of cost savings.

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.

22. CONTRACT WITH THE DEPARTMENT OF EDUCATION

We have provided loan servicing for the Department of Education s (the Department) 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 student loan processing services for the Department, allowing the Department to increase loan servicing 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. 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. Annual revenues from this contract represent approximately 4% of our fiscal year 2007 revenues.

In May 2007, we and the Department agreed to cease development of certain software contemplated under the CSB contract. At that time, we had implemented approximately $39 million of internally developed software into the current production system. As a result of the decision to cease development, we recorded a non-cash impairment charge of approximately $76.4 million (approximately $48.3 million, net of income tax) related to in-process capitalized development costs.

23. 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 provided, among other things, that Mr. King 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. In accordance with the King Agreement, the exercise price of Mr. King s vested stock options were increased to an amount equal to the fair market value of the stock on the correct accounting measurement date as determined 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 were 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 was reduced during the transition period and Mr. King was not eligible to participate in our bonus plans, and 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 provided, among other things, that Mr. Edwards 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

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
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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. In accordance with the Edwards Agreement the exercise price of Mr. Edwards vested stock options were increased to an amount equal to the fair market value of the stock on the correct accounting measurement date as determined 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 was reduced during the transition period and Mr. Edwards was not eligible to participate in our bonus plans, and 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 then 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.

In the first quarter of fiscal year 2006, we accrued $5.4 million ($3.4 million, net of income taxes) of compensation expense (recorded in wages and benefits in our Consolidated Statements of Income) related to the Agreement with Mr. Rich. In addition, the purchase of Mr. Rich s unexercised vested stock options for approximately $18.4 million ($11.7 million, net of income taxes) was recorded as a reduction of additional paid-in capital. We made payments of approximately $23.6 million related to this Agreement in fiscal year 2006.

In connection with the departure of Mr. Rich, 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 to his M&A advisory firm 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. No payments were made related to this agreement in fiscal year 2007.

24. RELATED PARTY TRANSACTIONS

Please see Note 3 for a discussion of the proposal received from our Chairman, Darwin Deason, and Cerberus to acquire all of the outstanding shares of the Company.

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. In the first quarter of fiscal year 2003, we purchased $1 million in prepaid charter flights at favorable rates from DDH. In the second quarter of fiscal year 2007, we were notified by DDH of their intent to wind down operations; therefore, we recorded a charge of $0.6 million related to the unused prepaid charter flights. We made no payments to DDH during fiscal years 2007, 2006 and 2005. Previously, we reported that we anticipated that the administrative services we are providing to DDH would cease prior to June 30, 2007 as a result of the wind down of the DDH operations. Because of continuing activities

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related to the wind down of operations, the administrative services we are providing to DDH will continue until the wind down is complete.

During fiscal years 2007, 2006 and 2005, we purchased approximately $5.8 million, $8.8 million and $9.0 million, respectively, of office products and printing services from Prestige Business Solutions, Inc., a supplier owned by the daughter-in-law of our Chairman, Darwin Deason. These products and services were purchased on a competitive bid basis in substantially all cases. We believe this relationship has allowed us to obtain these products and services at quality levels and costs more favorable than would have been available through alternative market sources.

As discussed in Note 23 and in connection with the departure of Jeffrey A. Rich, our former Chief Executive Officer, 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 approximately $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. No payments were made related to this agreement in fiscal year 2007.

25. SEGMENT INFORMATION

We are organized into Commercial and Government segments due to the different operating environments of each segment, caused by different types of clients, differing economic characteristics, and the nature of regulatory environments. In the Commercial segment, we provide business process outsourcing, information technology services, systems integration services and consulting services to clients including healthcare providers and payors, pharmaceutical and other manufacturers, retailers, wholesale distributors, utilities, entertainment companies, higher education institutions, financial institutions, insurance and transportation companies. In the Government segment, we provide business process outsourcing, information technology services and systems integration services to state and local governments. Our Government segment also includes our relationship with the Department of Education.

Approximately 93%, 95% and 97% of our consolidated revenues for fiscal years 2007, 2006 and 2005, respectively, were derived from domestic clients. Our relationship with the Department of Education is our largest contract and represents approximately 4%, 4% and 5% of consolidated revenues for fiscal years 2007, 2006 and 2005, respectively. Other than the Department of Education, no single customer exceeded 5% of our revenues.

The accounting policies of each segment are the same as those described in the summary of significant accounting policies (please see Note 1).

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The following tables reflect the results of the segments consistent with our management system (in thousands):

	Commercial	Government	Corporate (c)	Consolidated
Fiscal year 2007				
Revenues (a)	$ 3,436,501	$ 2,335,978	$	$ 5,772,479
Operating expenses (excluding impairment charge and depreciation and amortization)	2,842,147	1,822,404	148,367	4,812,918
Software impairment charge		76,407		76,407
Depreciation and amortization expense	250,760	93,951	1,488	346,199
Operating income (loss)	$ 343,594	$ 343,216	$ (149,855)	$ 536,955
Total assets	$ 3,187,763	$ 2,588,033	$ 206,633	$ 5,982,429
Capital expenditures, net	$ 205,744	$ 109,390	$ 1,709	$ 316,843
Fiscal year 2006				
Revenues (a)	$ 3,167,630	$ 2,186,031	$	$ 5,353,661
Operating expenses (excluding gain on sale of business and depreciation and amortization)	2,657,353	1,708,548	113,531	4,479,432
Gain on sale of business		(32,907)		(32,907)
Depreciation and amortization expense	195,621	92,671	1,560	289,852
Operating income (loss)	$ 314,656	$ 417,719	$ (115,091)	$ 617,284
Total assets	$ 2,940,693	$ 2,529,021	$ 32,723	$ 5,502,437
Capital expenditures, net (b)	$ 250,531	$ 145,999	$ (2,063)	$ 394,467
Fiscal year 2005				
Revenues (a)	$ 2,175,087	$ 2,176,072	$	$ 4,351,159
Operating expenses (excluding depreciation and amortization)	1,727,358	1,682,001	61,537	3,470,896
Depreciation and amortization expense	145,859	85,016	1,904	232,779
Operating income (loss)	$ 301,870	$ 409,055	$ (63,441)	$ 647,484
Total assets	$ 2,608,617	$ 2,160,297	$ 81,924	$ 4,850,838
Capital expenditures, net	$ 149,406	$ 102,560	$ 1,265	$ 253,231

(a)

Revenues in our Government segment for fiscal years 2007, 2006 and 2005 include revenues from operations divested through June 30, 2007 of \$0.9 million, \$104.5 million and \$218.6 million, respectively.

(b) Fiscal year 2006 corporate capital expenditures, net includes proceeds of \$3.4 million related to the sale of the corporate aircraft.

(c) Corporate segment operating expenses include \$28.5 million (\$18.2 million, net of income tax), \$35 million (\$22.9 million, net of income tax) and \$6.1 million (\$3.9 million, net of income tax) of stock-based compensation expense in fiscal years 2007, 2006 and 2005, respectively.

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26. REVENUES BY SERVICE LINE

Our revenues by service line over the past three years are shown in the following table (in thousands):

	Fiscal year ended June 30,		
	2007	**2006**	**2005**
Business process outsourcing (1)	$ 4,322,164	$ 3,996,558	$ 3,237,981
Information technology services	1,013,801	971,832	858,639
Systems integration services (2)	436,514	385,271	254,539
Total	$ 5,772,479	$ 5,353,661	$ 4,351,159

(1) Includes $0.9 million, $104.2 million and $218 million of revenues for fiscal years 2007, 2006 and 2005, respectively, from operations divested through June 30, 2007.

(2) Includes $0.3 million and $0.6 million of revenues for fiscal years 2006 and 2005, respectively, from operations divested through June 30, 2007.

27. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share amounts)

Fiscal Year 2007	**June 30, 2007**	**March 31, 2007**	**December 31, 2006**	**September 30, 2006**
Revenues	$ 1,519,734	$ 1,440,546	$ 1,426,761	$ 1,385,438
Operating income	$ 83,178	$ 162,591	$ 150,328	$ 140,858
Net income	$ 37,574	$ 82,059	$ 72,074	$ 61,383

Earnings per share basic	$ 0.38	$ 0.83	$ 0.73	$ 0.59
Weighted average shares outstanding	99,378	98,945	98,914	103,452
Earnings per share diluted	$ 0.37	$ 0.82	$ 0.72	$ 0.59
Weighted average shares outstanding diluted	101,039	100,300	100,152	104,761

Fiscal Year 2006	**June 30, 2006**	**March 31, 2006**	**December 31, 2005**	**September 30, 2005**
Revenues	$1,380,702	$1,314,455	$1,347,587	$1,310,917
Operating income	$ 149,798	$ 137,867	$ 175,422	$ 154,197
Net income	$ 86,061	$ 77,000	$ 102,370	$ 93,375
Earnings per share basic	$ 0.73	$ 0.62	$ 0.82	$ 0.74
Weighted average shares outstanding	118,131	124,347	124,849	125,429
Earnings per share diluted	$ 0.72	$ 0.61	$ 0.81	$ 0.73
Weighted average shares outstanding diluted	119,484	126,381	126,926	127,286

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28. NEW ACCOUNTING PRONOUNCEMENTS

On June 30, 2007, we adopted SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106, and 132R (SFAS 158). This Statement requires recognition of the funded status of a defined benefit plan in the statement of financial position as an asset or liability if the plan is overfunded or underfunded, respectively. Changes in the funded status of a plan are required to be recognized in the year in which the changes occur, and reported in comprehensive income as a separate component of stockholders equity. Further, certain gains and losses that were not previously recognized in the financial statements are required to be reported in comprehensive income, and certain disclosure requirements were changed. SFAS 158 also requires the measurement date of the plan s funded status to be the same as the company s fiscal year end. There was no change to our June 30 measurement date as a result of the adoption of SFAS 158. Adoption of SFAS 158 resulted in an increase to accumulated other comprehensive income (loss), net of approximately $2.4 million, net of $1.0 million deferred income tax.

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 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 did not 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. The provisions of FIN 48 must be adopted by the Company as of July 1, 2007 and reported in the financial statements for the period ended September 30, 2007. Consequently, we are currently assessing the impact of FIN 48 and have not yet determined the impact this interpretation will have on our consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 , (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 provides entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective as of the beginning of an entity s fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of FASB Statement No. 157, Fair Value

Measurements . We have not yet determined the impact, if any, that SFAS 159 will have on our financial position or results of operations.

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29. SUBSEQUENT EVENTS

Stock option repricing

As discussed in Note 21, on June 18, 2007, we initiated a tender offer to amend certain options to purchase an aggregate of 1,703,650 shares (as amended) of our Class A common stock. The tender offer expired on July 17, 2007. Pursuant to the offer, we accepted for amendment options to purchase 1,696,650 shares of our Class A common stock, which represented 99.6% of the shares of our Class A common stock subject to all Eligible Options. We will pay cash payments in the aggregate amount of $4.0 million in accordance with the terms of the tender offer, which will be paid in the third quarter of fiscal year 2008 from cash flows from operating activities. Of the $4.0 million cash payment, we anticipate that approximately $1.3 million will be expensed and the balance will be charged to Additional Paid-in Capital in the first quarter of fiscal year 2008.

In July 2007, we notified former employees with vested, unexercised and outstanding options which had exercise prices per share that were less, or may have been less, than the fair market value per share of ACS on the revised measurement dates for such options, as determined by us for accounting and tax purposes, that we will pay them the additional 20% income tax imposed by Section 409A based on the excess, if any, of the fair market value of our Class A common stock (up to $62 per share) on the date a triggering event occurs or condition exists that under Section 409A results in the excess being recognized and reported as income on the former employee s W-2 and the exercise price of the affected option (reduced by any gain that had become subject to tax in a prior year because of an earlier triggering event). We anticipate that these income tax reimbursements will be up to approximately $1.9 million based on the current fair market value of our Class A common stock on the exercise date and will be paid from cash flows from operating activities as the triggering event occurs for each option holder, beginning in the third quarter of fiscal year 2008. In the first quarter of fiscal year 2008, we will accrue the estimated charge related to these income tax reimbursements based on the current fair market value of our Class A common stock and adjust the accrual each quarter until the options are exercised.

Potential sale of the Company

On August 10, 2007, we announced the suspension of the Exclusivity Agreement between Darwin Deason and Cerberus expired at 11:59 p.m. on August 9, 2007. The Exclusivity Agreement is now in effect and is scheduled to expire on November 14, 2007.

However, in light of the current conditions of the credit markets, the Special Committee is in discussions with Cerberus and Mr. Deason regarding an extension of the suspension of the Exclusivity Agreement. In addition, the Special Committee is continuing to have discussions with respect to strategic alternatives. There can be no assurance of any particular outcome.

Stock option grants

During the December 9, 2006 Compensation Committee meeting, it was recognized that the grants made to Mr. Blodgett and Mr. Rexford were for a number of shares that were less than the number of shares that would have been normally granted to a new CEO and new CFO because of the limited number of options remaining available under the 1997 Stock Incentive Plan. The Compensation Committee noted that it should consider a future grant to supplement the number of options made in the earlier grant so that the aggregate number of shares granted to Mr. Blodgett and Mr. Rexford would be equal to the number that would normally be granted to a new CEO and new CFO. To accomplish this purpose, at a meeting on July 2, 2007, the Committee approved option grants (the Grants) to Lynn Blodgett to purchase 60,000 shares of the Company s Class A Common Stock under the 2007 Equity Incentive Plan and to John Rexford to purchase 25,000 shares of the Company s Class A Common Stock under the 2007 Equity Incentive Plan, subject to the waiver of the Stock Option Grant Policy by the Board of Directors, which occurred on July 9, 2007 and on which date the Grants became effective.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. 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, have 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 June 30, 2007. Based on such evaluation, our principal executive officer and principal financial officer have concluded that such disclosure controls and procedures were operating effectively as of June 30, 2007.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As discussed in Note 4 to the Consolidated Financial Statements, in July 2006 we acquired Primax Recoveries, Inc. (Primax). We have excluded the Primax business from the scope of our assessment of our internal control over financial reporting as of June 30, 2007. The Primax business total revenues and total assets represent 0.8% and 1%, respectively of the related consolidated financial statement amounts as of and for the year ended June 30, 2007.

Also as discussed in Note 4 to the Consolidated Financial Statements, in October 2006, we completed the acquisition of Systech Integrators, Inc. (Systech). We have excluded the Systech business from the scope of our assessment of our internal control over financial reporting as of June 30, 2007. The Systech business total revenues and total assets represent 0.8% and 1.3%, respectively of the related consolidated financial statement amounts as of and for the year ended June 30, 2007.

Management has evaluated the effectiveness of our internal control over financial reporting as of June 30, 2007 using the criteria set forth in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission . Based on this evaluation, management has concluded that, as of June 30, 2007, our internal control over financial reporting was effective.

The effectiveness of our internal control over financial reporting as of June 30, 2007, has been audited by PricewaterhouseCoopers LLP, the independent registered public accounting firm who also audited our consolidated financial statements. Their report appears under Item 8.

Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) of the Securities Exchange Act of 1934) during the quarter ending June 30, 2007 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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PART III

Pursuant to Instruction G(3) to Form 10-K, the information required in **Items 10 through 14** is incorporated by reference from our definitive proxy statement, which is incorporated herein by reference.

PART IV

ITEM 15. FINANCIAL STATEMENTS AND EXHIBITS

(a) Financial Statements

The following Consolidated Financial Statements of Affiliated Computer Services, Inc. and Subsidiaries are included in Part II, Item 8:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets
Consolidated Statements of Income
Consolidated Statements of Changes in Stockholders Equity
Consolidated Statements of Cash Flows
Notes to our Consolidated Financial Statements

(b) Exhibits

Reference is made to the Index to Exhibits beginning on page 123 for a list of all exhibits filed as part of this report.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, we have duly caused this Report to be signed on our behalf by the undersigned thereunto duly authorized representative.

Affiliated Computer Services, Inc.

Date: August 29, 2007

By: /s/ John H. Rexford

John H. Rexford
Executive Vice President and
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 29th day of August 2007.

Signature	Title
/s/ Darwin Deason (Darwin Deason)	Director, Chairman of the Board
/s/ Lynn R. Blodgett (Lynn R. Blodgett)	Director, President and Chief Executive Officer
/s/ John H. Rexford (John H. Rexford)	Director, Executive Vice President and Chief Financial Officer
/s/ Laura Rossi (Laura Rossi)	Senior Vice President, Corporate Controller and Interim Chief Accounting Officer
/s/ J. Livingston Kosberg (J. Livingston Kosberg)	Director
/s/ Joseph P. O Neill (Joseph P. O Neill)	Director
/s/ Frank A. Rossi (Frank A. Rossi)	Director
/s/ Dennis McCuistion (Dennis McCuistion)	Director

/s/ Robert B. Holland, III	Director
(Robert B. Holland, III)	

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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)).
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).
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

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
	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	Amended Stock Option Plan of the Company (filed as Exhibit 10.1 to Amendment No. 1 to our Registration Statement on Form S-1, filed July 15, 1994, File No. 33-79394 and incorporated herein by reference).
10.2	1997 Stock Incentive Plan of the Company (filed as Appendix D to our Joint Proxy Statement on Schedule 14A, filed November 14, 1997 and incorporated herein by reference).
10.3	Amendment No.1 to Affiliated Computer Services, Inc. 1997 Stock Incentive Plan, dated as of October 28, 2004 (filed as Exhibit 4.6 to our Registration Statement on Form S-8, filed December 6, 2005 and incorporated herein by reference).
10.4	2007 Equity Incentive Plan of the Company (filed as Appendix C to our Proxy Statement on Schedule 14A, filed April 30, 2007 and incorporated herein by reference).
10.5	Form of Directors Indemnification Agreement (filed as Exhibit 10.20 to Amendment No. 3 to our Registration Statement on Form S-1, filed August 23, 1994, File No. 33-79394 and incorporated herein by reference).
10.6	Form of Severance Agreement, each dated as of March 1, 2004 except as otherwise noted, by and between Affiliated Computer Services, Inc. and each of Mark A. King, Warren D. Edwards, Lynn Blodgett, Harvey Braswell (September 14, 2004), John Brophy, William L. Deckelman, Jr. and Ann Vezina (May 25, 2006) (filed as Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed May 17, 2004 and incorporated herein by reference).
10.7	Form of Amendment No. 1 to Severance Agreement, each dated as of February 2, 2005, by and between Affiliated Computer Services, Inc. and each of Mark A. King, Warren D. Edwards, Lynn Blodgett, Harvey Braswell, John Brophy and William L. Deckelman, Jr. (filed as Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed February 8, 2005 and incorporated herein by reference).
10.8	Severance Agreement, dated as of February 2, 2005, by and between Affiliated Computer Services, Inc. and John Rexford (filed as Exhibit 10.2 to our Quarterly Report on Form 10-Q, filed February 8, 2005 and incorporated herein by reference).

10.9	Amendment No. 2 to Severance Agreement, dated as of April 30, 2007, by and between Affiliated Computer Services, Inc. and John H. Rexford (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed May 2, 2007 and incorporated herein by reference).
10.10	Severance Agreement, dated as of June 13, 2005, by and between Affiliated Computer Services, Inc. and Tom Burlin (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed June 16, 2005 and incorporated herein by reference).
10.11	Supplemental Executive Retirement Agreement, dated as of December 15, 1998, by and between Affiliated Computer Services, Inc. and Darwin Deason (filed as Exhibit 10.13 to our Annual Report on Form 10-K, filed September 29, 1999 and incorporated herein by reference).
10.12	Amendment to Supplemental Executive Retirement Agreement, dated as of November 13, 2003, by and between Affiliated Computer Services, Inc. and Darwin Deason (filed as Exhibit 10.1 to our Quarterly Report on Form 10-Q, filed February 17, 2004 and incorporated herein by reference).

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
10.13	Amendment No. 2 to Supplemental Executive Retirement Agreement, dated as of June 30, 2005, by and between Affiliated Computer Services, Inc. and Darwin Deason (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed July 1, 2005 and incorporated herein by reference).
10.14	Employment Agreement, dated February 16, 1999 between the Company and Darwin Deason (filed as Exhibit 10(iii)(A) to our Quarterly Report on Form 10-Q, filed May 17, 1999 and incorporated herein by reference).
10.15	Affiliated Computer Services, Inc. 401(k) Supplemental Plan, effective as of July 1, 2000, as amended (filed as Exhibit 10.15 to our Annual Report on Form 10-K, filed September 13, 2004 and incorporated herein by reference).
10.16	Five Year Competitive Advance and Revolving Credit Facility Agreement, dated as of October 27, 2004, by and among Affiliated Computer Services, Inc., other Borrowers from time to time party thereto, the Lender Parties from time to time party thereto, JPMorgan Chase Bank, as Administrative Agent, Wells Fargo Bank, National Association, as Syndication Agent, and others (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed October 29, 2004 and incorporated herein by reference).
10.17	Guaranty, dated as of October 27, 2004, by Affiliated Computer Services, Inc. for the benefit of JPMorgan Chase Bank, as Administrative Agent for the benefit of the Lender Parties (filed as Exhibit 10.2 to our Current Report on Form 8-K, filed October 29, 2004 and incorporated herein by reference).
10.18	Affiliated Computer Services, Inc. Executive Benefit Plan, effective as of January 1, 2002, as amended (filed as Exhibit 10.15 to our Annual Report on Form 10-K, filed September 13, 2005 and incorporated herein by reference).
10.19	Summary of Independent Director Compensation (filed as Item 1.01 of our Current Report on Form 8-K, filed August 29, 2005 and incorporated herein by reference).
10.20	Form of Stock Option Agreement (filed as Exhibit 10.17 to our Annual Report on Form 10-K, filed September 13, 2005 and incorporated herein by reference).
10.21	Form of Stock Option Agreement (UK grant) (filed as Exhibit 10.18 to our Annual Report on Form 10-K, filed September 13, 2005 and incorporated herein by reference).
10.22	Named Executive Officer Compensation (filed as Item 1.01 of our Current Report on Form 8-K, filed September 14, 2005 and incorporated herein by reference).
10.23	Named Executive Officer Compensation (filed as Item 1.01 of our Current Report on Form 8-K, filed October 3, 2005 and incorporated herein by reference).
10.24	Agreement, dated as of September 30, 2005, between Affiliated Computer Services, Inc. and Jeffrey A. Rich (filed as Exhibit 10.1 to our Current Report on Form 8-K, filed October 3, 2005 and

incorporated herein by reference).

10.25	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).
10.26	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 10.24 to our Annual Report on Form 10-K, filed January 23, 2007 and incorporated herein by reference).
10.27	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).
10.28	Amendment No. 3, Consent and Waiver to Credit Agreement, by and among Affiliated Computer Services,

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
	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).
10.29	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).
10.30	Pledge and Security Agreement, dated March 20, 2006, by and among Affiliated Computer Services and certain of its subsidiaries, and Citicorp USA, Inc., as Administrative Agent (filed as Exhibit 10.2 to our Current Report on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.31	Deed of Assignment, dated March 20, 2006, by and among the companies listed on Schedule thereto, as Assignors, and Citicorp USA, Inc., as Security Agent (filed as Exhibit 10.3 to our Current Report on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.32	Assignment of Receivables, dated March 20, 2006, by and among the entities listed in Schedule 1 thereto, as Assignors, and Citicorp USA, Inc. as Security Agent (filed as Exhibit 10.4 to our Current Report on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.33	Agreement and Deed of the Creation of a First Ranking Right of Pledge of Shares in Affiliated Computer Services International B.V., dated March 20, 2006 (filed as Exhibit 10.5 on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.34	Agreement and Deed of the Creation of a First Ranking Right of Pledge of Receivables of Affiliated Computer Services International B.V., dated March 20, 2006 (filed as Exhibit 10.6 to our Current Report on Form 8-K, filed March 21, 2006 and incorporated herein by reference).
10.35	Form of Stock Option Agreement (Switzerland, Canton of Fribourg) (filed as Exhibit 10.8 to our Quarterly Report on Form 10-Q, filed May 15, 2006 and incorporated herein by reference).
10.36	Form of Stock Option Agreement (Switzerland, Cantons of Aargau, Basel-Landschaft, Bern & Zurich) (filed as Exhibit 10.9 to our Quarterly Report on Form 10-Q, filed May 15, 2006 and incorporated herein by reference).
10.37	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).
10.38	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).
10.39	Affirmation of Liens and Guaranties, dated as of July 6, 2006, by and among Affiliated Computer Services, Inc. and certain of its subsidiaries, and Citicorp USA, Inc., as Administrative Agent (filed

	as Exhibit 10.2 to our Current Report on Form 8-K, filed July 7, 2006 and incorporated herein by reference).
10.40	Confirmation Deed, dated as of July 6, 2006, by and among the entities listed on the Schedule thereto and Citicorp USA, Inc., as Security Agent (filed as Exhibit 10.3 to our Current Report on Form 8-K, filed July 7, 2006 and incorporated herein by reference).
10.41	Engagement Letter between Rich Capital, LLC and Affiliated Computer Services, Inc. dated June 9, 2006 (filed as Exhibit 10.1 on Form 8-K, filed June 12, 2006 and incorporated herein by reference).
10.42	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).
10.43	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).
10.44	Exclusivity Agreement dated as of March 20, 2007 between Darwin Deason and Cerberus Capital Management, L.P. (filed as Exhibit 99.3 to our Current Report on Form 8-K, filed June 11, 2007 and

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
	incorporated herein by reference).
10.45	Waiver Agreement dated as of June 10, 2007 between Affiliated Computer Services, Inc., Darwin Deason and Cerberus Capital Management, L.P. (filed as Exhibit 99.2 to our Current Report on Form 8-K, filed June 11, 2007 and incorporated herein by reference).
21.1*	Subsidiaries of the Company.
23.1*	Consent of PricewaterhouseCoopers LLP.
23.2*	Consent of Value Incorporated.
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.
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.