3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Grand Juries, Unregistered Stock, and Insider Selling Affiliated Computer Services, Inc. (NYSE:ACS) Update

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Affiliated Computer Services, Inc. is a global company delivering comprehensive business process outsourcing and information technology (IT) outsourcing solutions, as well as system integration services. The Company operates in three business segments: commercial, federal government and state and local governments.

Summary of 3DAdvisors Findings for ACS

- **Governance:** Covering up issuance of unregistered stock to key insiders
- **Insider Trading:** Pace of selling accelerates; holdings reductions stand out
- **Accounting:** Despite management's contention, free cash flow is weakening

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Discussion of 3DAdvisors Findings

The level of regulatory scrutiny of ACS activities continues to go up, while insiders act to greatly reduce their actionable positions. We wonder how long this can continue. Some new disclosures, following on the heels of the Company's obfuscated disclosure of its fourth Grand Jury investigation in just twenty-two months, are sure to attract additional attention from the SEC, among others.

Among the newly disclosed problems is that ACS had issued over 1 million of its shares to Company executives and directors without the shares being properly registered. The timing of this disclosure, in the Company's recent Form SEC 10-K filing, is very interesting for several reasons, not the least of which is the fact that the issuance of these shares goes back to 2002. We have also uncovered what appears to be an effort by the Company to cover itself on the unregistered stock problem on August 24th, the day before it was officially notified of the latest Grand Jury investigation (which was not disclosed in a Form 8-K but was instead buried in the recent ACS Form 10-K released on September 13th) into its affairs in Florida. It seems that ACS is in scramble mode as investigations by multiple agencies and courts, including an ongoing informal investigation by the SEC, continue their course.

In the midst of all this, ACS insiders continue to significantly reduce their actionable positions to the extent that certain key executives, most notably CFO **Warren Edwards**, have monetized most of their positions. Additionally, with unbilled receivables continuing their unchecked rise, the effects on free cash flow cannot be ignored for long.

Governance: Covering up issuance of unregistered stock to key insiders

In the thinly veiled 10-K disclosure (mentioned above) ACS revealed that it had issued 1,055,968 unregistered shares between February 2002 and March 2004. The disclosure (below) was carefully worded as to imply that the shares were exempt from the registration process because they were issued to certain officers and directors and met with the requirements to qualify as a private placement:

> Between February 28, 2002 and March 31, 2004, we issued 1,055,968 shares of our Class A common stock to fifteen current or former employees or directors (collectively, the "optionees") pursuant to the exercise of options granted under our 1988 Stock Option Plan in excess of the amount originally registered with the SEC on Form S-8 filed November 17, 1994 (Registration No. 33-86426). The exercise price of the options exercised ranged from $4.00 to $10.56 per share of Class A common stock and the aggregate exercise price of the options was $9.6 million. We believe the grant of the options and the subsequent issuance of the underlying securities to the optionees was exempt from registration pursuant to Rule 506 promulgated under the Securities Act of 1933, as amended (the "Securities Act"), or pursuant to Section 4(2) of the Securities Act. Each of the optionees had access to sufficient information regarding Affiliated Computer Services, Inc. required to make an informed investment decision and had the requisite sophistication to make an investment in our securities. In addition, some of the optionees are "accredited investors" as defined in Regulation D of the Securities Act.

The above disclosure raises a host of questions, not the least of which is the question of whether or not there was really a private placement involved or was this an attempt to use the cover of a private placement for some other omission, such as a failure to register the issued shares or, more seriously, the existence of undisclosed stock option grants.

The timing of the disclosure correlates with a paper REGDEX (Reg D Exemption) filing that ACS quietly submitted to the SEC on August 24th. This filing, being in paper form, is not available on Edgar. These forms are typically filed in conjunction with Rule 506 (Securities Act of 1933) when, for certain private placements of stock to less than 35 investors, a sale of stock is considered exempt from registration. Small, private companies typically do these filings. It is clear that ACS is trying to pass the above issuance of stock, issued to insiders as a part of the Company's 1988 stock option plan, off as a private placement exempt from the registration process and they are citing two separate rules in support of their position. To us, this seems like an after-the-fact attempt to cover themselves.

First of all, if ACS really did intend to issue the shares in a private placement, the Company would have had to file the Form D fifteen days after the first issuance of shares in the "private placement". According to the ACS 10-K disclosure, this first issuance date was February 28, 2002. Their filing of this Form D on August 24^{th}, 2004 is not only extremely late, it was rather suspiciously filed the day before the Company was made aware of the latest Grand Jury investigation (see below). To us, it is a stretch to suggest it is a coincidence that this filing, having been submitted 30 months late, would have serendipitously arrived at the SEC at the very same time a new Grand Jury investigation was announced. Keep in mind, the SEC had opened its own informal investigation into Company affairs, in February of 2004, in the wake of the State of Florida's January report which resulted in a separate March 2004 Grand Jury investigation into Company customer records related to its workforce contract with the state. It would seem that this latest Grand Jury probe may be causing ACS to become more concerned that the separate SEC probe might intensify, leading it to scramble to cover some past wrongdoings.

Whatever the outcome, ACS looks exposed, on the regulatory front, with regards to the unregistered shares and its private placement claim of safe harbor. We have had extensive conversations with industry experts (on restricted securities under Rule 144) concerning this and it seems that it is very much a stretch for ACS to try this approach. Our principal contact informs us that he has never seen a company attempt to avoid the registration process in this manner for shares issued upon the exercise of options. The usual course is to file an S-8 registration. To us, and our contact, it looked more like ACS was scrambling to clean up the matter of over 1 million issued shares that had never been registered. Why they failed to register the shares is not clear, but what is clear is that over 1 million shares have been issued, through the Company's 1988 Stock Option Plan, than it had initially claimed. Granted, these shares, having been issued, have been included in subsequent EPS calculations What has our keen interest, however, is the fact that this recent ACS scramble to cover, and its correlation with the latest Grand Jury investigation, could provide some important timing clues that these recent problems, which the Company has passed off as being all-but-settled, are not only very much alive but also closer to having an effect on ACS as it seems the investigations are intensifying.

Adding fuel to this is the fact that it appears that the Company's attempts to cover for the unregistered shares has backed it into a regulatory corner: If the offering was a bona fide private placement, the insiders who received stock would have been restricted from selling the exercised-for shares for a period of one year (Rule 144). We have plenty of evidence that these insiders did not wait the year and instead, regularly executed same day sales (exercises of the options and simultaneous sale of the underlying shares) upon the exercises of their options. (See Table 1 below.)

So, it would seem that the above sales of these shares were "illegal" under Rule 144 and that ACS finds itself in a hard place here. If, in fact, it was a private placement, the subsequent sales of the securities are in violation of Rule 144. If, on the other hand, it is ruled that no private placement occurred, ACS has over 1 million unregistered shares in circulation. Both outcomes, we're certain, will be of interest to the SEC.

Table 1. Same Day Exercises and Sales by Selected ACS Insiders. Source: ACS SEC Filings.

		Exercise Date	Options Exercised	Exercise Price	Sale Date	Shares Sold
H. Hortenstine	V.P., Bus. Dev.	04/08/02	80,000	$10.56	04/08/02	80,000
W. Edwards	CFO	05/21/02	50,000	$10.56	05/21/02	50,000
M. King	Pres., COO	11/07/02*	152,000	$8.44	11/07/03	152,000
J. Rich	CEO	01/07/03**	112,100	$10.56	01/07/03	82,100

* King exercised and sold in 20 separate transactions between 11/2002 and 9/2004.
On each occasion, sold every share exercised for on the same day.

** Rich exercised and sold in 17 separate transactions between 1/7/2003 and 12/15/2003.
Sold, some or all of the shares on the day of each exercise

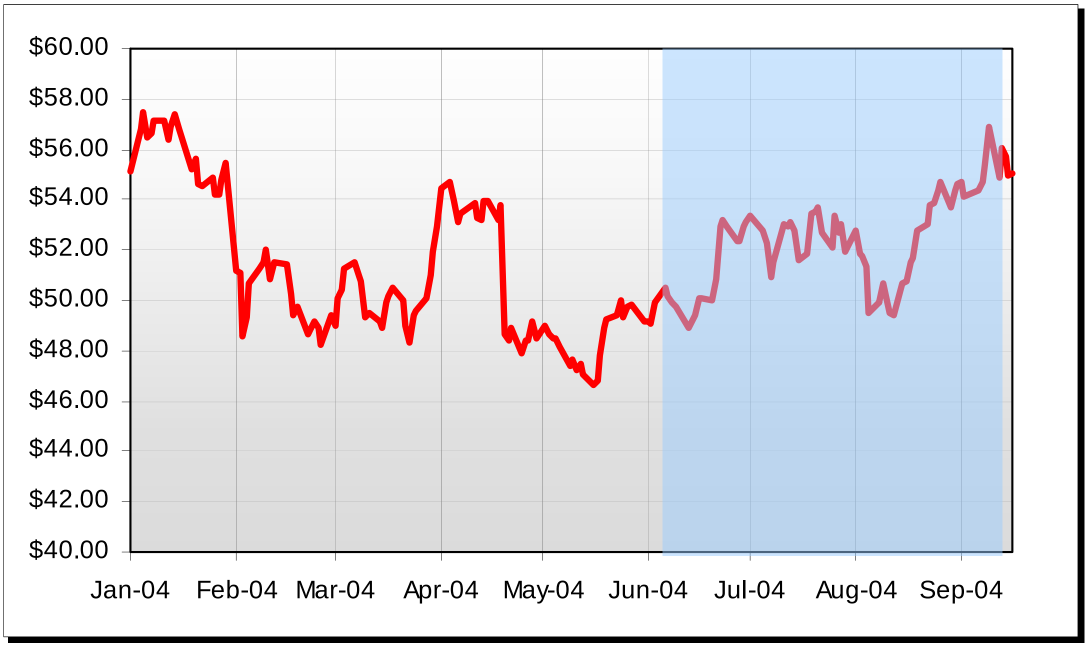
Our regulatory expert suggests it is likely that the Commission, once these violations are discovered, will fold them in with its ongoing informal investigation into the affairs of ACS. He is quite interested in how ACS was able to sell the restricted shares and wonders whether the Company had the shares issued without a legend indicating their 144 restrictions; brokers will not sell shares that are indicated as restricted. It is his feeling that the nature of these violations is egregious enough that some sort of significant enforcement action may be in order, seeking either tough penalties or even barring of certain individuals from being able to serve on a public company board in the future, should the violations prove to be intentional.

Insider Trading: Pace of selling accelerates; holdings reductions stand out

ACS is a classic example of a situation where regular insider selling, amidst the existence of 10b5-1 plans, tends to be dismissed as a regular event. We have been noting, however, that ACS insiders tend to hold few shares over time, choosing instead to maintain most of their holdings in the form of options. When their options vest, they waste little time before exercising them and clearing out the underlying shares. This behavior has been increasing in frequency in recent months as an expanding number of insiders have converged to clear out shares since early June. In addition, more of them are filing 10b5-1 plans just prior to selling their shares as three of them, including CFO **Warren Edwards**, commenced their plans just days ahead of the vesting of an option series and sold the day the options became actionable. This is always an interesting phenomenon as most Section 16 legal experts recommend that insiders, upon filing a 10b5-1 plan, wait a period of time before commencing selling in order to dispel any potential scrutiny about the timing of the inception of the plan. **Appendix A** contains the options vesting schedules for selected ACS insiders. You'll see that these individuals hold very few vested options at this point.

Since our May 2004 report, six insiders have sold 526,700 shares, between June 4^{th} and September 14^{th}, as the stock climbed from $50 to $55.96. More importantly, of the six sellers involved in the recent round, five reduced their actionable positions (common stock plus exercisable options) by an average of 75%.

Figure 1. ACS Daily Closing Price, January 2, 2004 to September 17, 2004. Blue shaded area is where insiders sold 526,700 shares. Source: Reuters and SEC Filings.



- **Jeffrey Rich (42)** – CEO, Director. As is the case with many of the recent sellers, there's been a noticeable spike in Rich's selling volume since he adopted a trading plan in August 2003. Unlike recent plan filers, who are selling as soon as they file their 10b5-1's, Rich showed more patience, waiting until April 2004 before selling his first shares. Since then, however, he's sold 350,000 shares, including 155,700 shares sold between June 4th and September 9th. With three months remaining this year, Rich's year-to-date sales are already the second heaviest since 2001, and with the trading plan in place, we expect to see this number climb. Since executing his first 10b5-1 sale in April, Rich has now **reduced his actionable position by 59%** and doesn't have any options vesting until July 2007.

- **Warren Edwards (38)** – Executive V.P., CFO. Since joining the Company in 1996, Edwards had only executed two sale transactions, the first for 50,000 shares in May 2002 at $55 and the next for the same amount in May 2003 at 10% lower prices. This year, Edwards adopted a 10b5-1 trading plan on September 3rd, exercised options and sold the underlying 50,000 shares just days later. We also noted that he exercised the entire option series on the day it vested. What's more, the selling **trimmed his holdings by 91%**, leaving him with roughly 5,000 shares of common stock, no vested options, and none set to become exercisable until July 2005. Though a 10b5-1 plan typically signals continued selling, this is impossible in Edwards' case since he has very little left to sell.

- **Lynn Blodgett (49)** – Executive V.P., Group President, Commercial Solutions. Blodgett hasn't been a focal point of our prior reports, but her recent activity definitely warrants attention. After having sold a total of 145,000 shares between 1999 and 2003, she entered into a 10b5-1 trading plan in June 2004 and her sales have since intensified. Just days after starting the plan she filed her first transaction, a 70,000-share sale on June 8th and since has executed two more sales on June 23rd and September 1st, dumping a total of 160,000 shares. The shares sold were acquired from the exercise of an option that fully vested on June 2nd and wasn't set to expire until 2009, but that didn't stop her from exercising and selling the entire block of shares, which made up a very large portion of her actionable position (common stock and exercisable options). In fact, the selling **wiped out 91% of her holdings** and only leaves her with 15,000 shares of common stock. What's more, Blodgett's common stock ownership falls short of meeting the Company's guidelines, though she still has two years to meet the requirements. It appears as if her holdings will remain at these levels for a while, as she won't have any options vesting until July 2005.

- **Harvey Braswell (58)** – Executive V.P., Group President, State Healthcare Solutions. After abstaining from selling his stock since joining the Company in 1996, Braswell initiated a pre-arranged trading plan in August 2003 and started selling under the plan in January. We've noted his selling in prior reports, but his sale of 25,000 shares on June 4th and June 7th wiped out the last remaining vested options he held (expiration: December 2008). The selling **dropped his ownership position by 58%** and leaves him with 18,324 share of common stock. The next vesting period for Braswell's options is in March 2005, when 50,000 options will become exercisable.

- **John Rexford (46)** – Executive V.P., Corporate Development. In similar fashion to Edwards' trading behavior, Rexford immediately exercised an option series that vested on September 13th and sold all 100,000 shares on September 13th and September 14th at roughly $56. Rexford's vested options holdings were comprised of this one options series, which wasn't set to expire for another five years. He does have a sizeable number of unvested options, but those won't start to become accessible until July of 2005. Following the sale, which **decreased his position by 93%**, Rexford's only actionable holdings are less than 8,000 shares tied up in retirement accounts, which is well short of his ownership targets mandated by Company-sponsored guidelines.

<u>Accounting: Despite management's contention, free cash flow is weakening</u>

We were surprised to see that not only did ACS's unbilled receivables surge to $217.3 million at F/Y end 2004 but more importantly the fact that those unbilled A/R's not expected to be billed in one year had doubled to $157.5 million (up from $77.7 million at Y/E 2003). Certainly, many eyes are on this, given the fact that now 25% of the company's A/R's are unbilled. Another interesting component of the long-term unbilled A/R's was revealed in the recent disclosure that not only is the Georgia contract responsible for a big chunk of them, as ACS has always maintained, but also that the balance are primarily related to ACS's Commercial Vehicle Operations contract in their Government segment. To us, this increasingly longer-term nature of ACS's unbilled receivables speaks to the Company's aggressive behavior of squeezing out as much up-front billing as possible out of its percentage of completion contracts.

Even in the wake of the big build-up in unbilled A/R's, ACS management continually touts its free cash flow as healthy. Indeed, the Company's presentation of cash flows in the recent Q4 conference call had a rehearsed feel to it with both CEO **Jeff Rich** and CFO **Warren Edwards** speaking to the subject of strong "Cash Flow Metrics" in duality. We found it interesting that their presentation of free cash flow double-talked around the fact that Free Cash Flow for F/Y 2004, as defined by ACS, dropped to $218.3 million vs. $291.7 million in 2003. Management is quick to pounce on the fact that the $88 million tax payment related to the gain from the sale of ACS's divested Federal Business is the culprit here and, without that payment, Free Cash Flow would have been $306.4 million, or up from 2003. **This argument aside, however, the fact stands that without that $292 million gain from the Federal Business divestiture, ACS would have been showing net income for 2004 down 22% from 2003.**

Appendix A

Option Vesting Schedules for Selected ACS Insiders

Grant Date	Shares	Price	Date Exercisable	Expiration Date	Remaining Options in Series	Unvested Options in Series	Vesting Dates of Remaining Options
Jeff Rich, CEO, Director. Common stock holdings: 92,371							
10/08/98	500,000	$11.53	10/08/03	10/08/08	150,000	0	Fully Vested
07/11/00	200,000	$16.43	07/11/05	07/11/10	200,000	200,000	07/11/05
07/23/02	400,000	$35.75	07/23/12	07/23/12	400,000	400,000	07/23/07
07/30/04	100,000	$51.90	07/30/14	07/30/14	100,000	100,000	07/30/09
Warren Edwards, EVP and CFO. Common stock holdings: 5,200							
07/11/00	30,000	$16.43	07/11/05	07/11/10	30,000	30,000	07/11/05
03/21/01	100,000	$29.52	03/21/06	03/21/11	100,000	100,000	03/21/06
07/23/02	50,000	$35.75	07/23/07	07/23/12	50,000	50,000	07/23/07
08/11/03	75,000	$44.10	08/11/08	08/11/13	75,000	75,000	08/11/08
07/30/04	50,000	$51.90	07/30/09	07/30/14	50,000	50,000	07/30/09
Lynn Blodgett, EVP, Group President, Commercial Solutions. Common stock holdings: 15,500							
07/11/00	100,000	$16.43	07/11/05	07/11/10	100,000	100,000	07/11/05
09/26/01	72,000	$38.66	09/26/06	09/26/11	72,000	72,000	09/26/06
07/23/02	75,000	$35.75	07/23/07	07/23/12	75,000	75,000	07/23/07
08/11/03	100,000	$44.10	08/11/08	08/11/13	100,000	100,000	08/11/08
07/30/04	100,000	$51.90	07/30/09	07/30/14	100,000	100,000	07/30/09
Harvey Braswell, EVP, Group President, State Healthcare Solutions. Common stock holdings: 18,752							
03/01/00	50,000	$15.65	03/01/05	03/01/10	50,000	50,000	03/01/05
07/11/00	50,000	$16.43	07/11/05	07/11/10	50,000	50,000	07/11/05
03/21/01	150,000	$29.52	03/21/06	03/21/11	150,000	150,000	03/21/06
07/23/02	50,000	$35.75	07/23/07	07/23/12	50,000	50,000	07/23/07
07/30/04	50,000	$51.90	07/30/09	07/30/14	50,000	50,000	07/30/09
John Rexford, EVP, Corporate Development. Common stock holdings: 7,359*							
07/11/00	30,000	$16.43	07/11/05	07/11/10	30,000	30,000	07/11/05
07/23/03	50,000	$35.75	07/23/07	07/23/12	50,000	50,000	07/23/07
08/11/03	50,000	$44.10	08/11/08	08/11/13	50,000	50,000	08/11/08
07/30/04	25,000	$51.90	07/30/09	07/30/14	25,000	25,000	07/30/09
Mark King, President and COO. Common stock holdings: 95,158							
05/18/98	80,000	$15.93	05/18/03	05/18/08	54,000	0	Fully Vested
10/08/98	100,000	$11.53	10/08/03	10/08/08	100,000	0	Fully Vested
09/13/99	100,000	$19.50	09/13/04	09/13/09	100,000	0	Fully Vested
07/11/00	100,000	$16.43	07/11/05	07/11/10	100,000	100,000	07/11/05
03/21/01	200,000	$29.52	03/21/06	03/21/11	200,000	200,000	03/21/06
07/23/02	200,000	$35.75	07/23/07	07/23/12	200,000	200,000	07/23/07
08/11/03	100,000	$44.10	08/11/08	08/11/13	100,000	100,000	08/11/08
07/30/04	75,000	$51.90	07/30/09	07/20/14	75,000	75,000	07/30/09

* All shares held in retirement account