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

Accounting Concerns, and Governance Issues Linger 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

- **Accounting:** Observations from Q1 conference call
- **Governance:** Who's in charge (and responsible)?
- **Accounting:** Our review of the '02 10-K and '03 Q1 10-Q
- **Accounting:** Looming impairment risks

Discussion of 3DAdvisors Findings

Accounting: Observations from the Q1 conference call

From our perspective, the ACS Q1 Conference Call was remarkable for what was not discussed rather than for what was discussed. There was no mention at all regarding one of our principal concerns, namely, the continuing deterioration of tangible net worth and the effort by the Company to mask this problem by reclassifying items on its balance sheet (see 3DA report dated August 16, 2002). In fact, during the call, CEO Jeffery Rich repeatedly stated how "our balance sheet is in great shape", which he also stated during the prior quarter's conference call.

The Company did, however, make what seemed to be a contradictory statement about an issue we are interested in. In one statement, ACS management was saying how the Company stayed away from low margin business, and wasn't afraid to walk away from the Procter & Gamble deal (a bid lost after much time had been invested) or Medicaid contracts (they lost out on California and Texas bids). They also said that investors should not worry about lower quarter to quarter booking comparisons of Q1 '02 to Q1 '01 since the Georgia Medicaid deal in Q1 of '01 had "pumped up their numbers for that '01 (earlier) period".

An interesting question was posed. Since they lost out to aggressive pricing in the California Medicaid contract, could this be a sign of things to come? The answer was not particularly direct but they appeared to be saying something that sounded basically like an admission that they will have to accept lower margins in order to get Medicaid deals downstream. We found it very interesting that, after rallying on the morning of the release, ACS shares had given up most of their gains by the end of the day.

Governance: Who's in charge (and responsible):

All this said it still stands that this is a very unusual organization. Darwin Deason, the individual who controls the Company, has removed himself from certain responsibilities such as signing off on company financials yet he continues to be the highest-compensated individual in the company, with a total package worth over $2.1 million in '01. Deason, as Chairman of the Board, is not even an operating officer, a fact that makes his 2003 performance-based incentive compensation of $1.84 million even more curious. After all, Jeffery Rich (CEO) only received $1.57 million in '01 comp and is looking forward to '03 performance-based comp of $1.5 million in '03.

Accounting: Our reviews of the '02 10K and Q1 '03 10Q:

In reviewing the ACS 10K, practically line-for-line and the subsequent Q1 '03 release, we have some interesting observations:

The first we would like to discuss is the condition of the Surety Bond market and how this is affecting Affiliated Computer Services. I'm sure you are aware of the problems facing this market. Enron served as some sort of epiphany as many of the burned firms are refusing to pay energy-related guarantees. The Enron situation was even cited as a reason for K-mart's Chapter 11 filing. K-Mart had blamed "the evaporation of the Surety Market" as a primary factor forcing its filing.

Starting with the '02 "K", ACS began to mention the Surety Market for the first time. In the filing, the Company included two separate references to the situation, each time citing the problems in the Surety Bond market. Here's the first mention:

"Certain of our state and local government contracts require we execute surety bonds or letters of credit to ensure that the project is administered and completed as provided for in the contract. Prior to September 11 and the well-documented bankruptcies of several large companies (e.g. Enron, Kmart, and WorldCom), surety bonds were obtainable on relatively favorable terms at minimal pricing. In late 2001, the market for surety bonds changed dramatically with capacity tightening and prices increasing. The long-term outlook of the surety market, while improving, remains unclear. As of June 30, 2002, we have outstanding surety bonds and letters of credit of $316.6 million and $100.9 million, respectively, to secure our performance of contractual obligations with our clients."

The second disclosure, in the same "K", provided some more detail concerning how ACS was also using its Credit Facilities to substitute for Surety Bonds in order to keep their margins, under State and Local contracts, under control:

"In certain situations, we have found it more economical to satisfy our obligations under certain state and local contracts with letters of credit under our revolving credit facility. The long-term outlook of the surety market, while improving, remains unclear. We may not have enough capacity under our revolving credit facility to continue doing this in the future, and therefore, profitability under our existing contracts may deteriorate, and we may not be able to bid on state and local contracts in the future."

State and Local governments represent 45% of ACS's revenues as of Q1 '03 (up from 41% at the end of Q4 '02). ACS does not provide detail as to how much of their credit facilities they have utilized in this manner. What we have been able to cull out, from an earlier loan agreement, is that they had only $209 million in Surety Bonds outstanding as of Fiscal Y/E '01 (June 30). By June 30, '02 this number had risen to $316 million, with an additional $100 million in letters of credit being used for these purposes. We have not found a reference, in earlier ACS filings, to issuing letters of credit under the revolving credit facility.

With the large addition to revenues (especially from State and Local Governments) in '02, many due to acquisitions, it would be interesting to see how much this use of credit facilities for this purpose helped to keep related margins under control. In the above referenced conference call, ACS had said that Booking Margins for Q1 '03 were below average because they don't rely on percentage of completion accounting (which they claim, over and over again, are less than 5% of revenues). But that has always been the case, so why the margin shrinkage now? It would be interesting if this Surety situation may, in fact, have something to do with it.

Accounting: Looming impairment risks could have material consequences

All this has caused us to look into the newly completed $875 million Credit Facility, which was entered into in Sept of '02. There are some interesting coverage issues (read: Covenant Disclosures) that we are currently reviewing. These issues relate to the large amount of intangibles on the books, especially intangibles related to recent large acquisitions. It seems that ACS could be a case where a significant impairment write-off (either Goodwill or Purchased Intangible) could put the company's recent loan covenants (related to Credit Facilities) in jeopardy. Up to now, impairment write-offs have been basically shrugged off as one-time events. Clearly, an impairment write-off that could threaten loan covenants would be viewed much differently.

Our review of the Company's credit facilities (of which there are two) centered on covenant disclosures. Although ACS is not required to retain a level of Tangible Net Worth, the new $875 million facility requires it to maintain a net worth of $1.572 billion plus 75% of the Company's cumulative net income commencing with the Sept. 30, '02 quarter. As of the recent "K", net worth (at $2.096 billion) was just $534 million above the limit; an amount that one impairment charge could easily generate. Perhaps this is why the shares almost broke down on the news that Sallie Mae's protest of the three-year extension of ACS's contract with the Dept. of Education had been sustained and that, after a comment period, the contract may go out to competitive bid.

ACS has $3.4 billion in assets on the books. Goodwill totals $1.85 billion of this number. Intangibles, which are comprised primarily of customer contracts, account for another $234 million. Then there's software. Property and Equipment, on the books at $395 million, is 64% Software and Computer Equipment. Recent acquisitions (in '02) contributed significantly to these totals: The IMS Deal ($825 million) added $704 million to Goodwill, $64 million to intangible assets and $51 million to Property, and Equipment. The AFSA acquisition (AFSA services the Student Loan Program), costing $434 million, added $313 million to Goodwill, $48 million to intangible assets and $37 million to Property and Equipment. This puts ACS's Intangible and "soft" asset (Software and Computer equipment) at approximately $2.337 billion. And even though the company hypes the fact that Percentage of Completion represents less than 5% of revenues, it is a fact that unbilled receivables have nearly doubled since F/Y end '01 and were on the books at $108 million at Q1 '03 (according to the conference call).

As we had mentioned in earlier notes, Customer Contracts (the main component of Intangible Assets) under the IMF and ASTA acquisitions are being amortized over an 11-year period (the company had extended this period over earlier estimates). The non-compete covenants, under the ASTA acquisition, are being amortized for 5 years. We feel that relying on continuing customer relationships and assigning such extended periods of amortization increases the impairment risk.

About 45% of ACS's revenues come from State and Local Governments. About 57% of ACS's Goodwill is related to State and Local Governments business. This percentage is growing. Of the $1.149 billion in Goodwill added to ACS's balance sheet in '02, 64% was related to State and Local Governments. With so many State and Local Governments operating with deficits, and with so many of them having trouble passing next year's budgets, it's hard to ignore the rather significant impairment and revenue risks that exist in this sector. Indeed, ACS management blamed the recent two-day DSO expansion to the State and Local sector. Clearly, the surfacing Dept. of Education risk took concerns to the federal level as well.

It was probably no fluke that the shares tanked when the news broke about ACS possibly losing a three-year extension on the Dept. of Education Student Loan Contract. At $161 million in revenues, this is their biggest client. It may not, however, be the revenue risk that loomed as the big problem but rather the impairment potential, and its related effect on the company's debt covenants that could be the culprit. The company has added new language, in its recent "K", related to impairment risk in both Goodwill and Intangible Assets. If you combine the inherent risk in the nature of the Company's business and the obvious risk of impairment that exists, it would seem that a lot of things have to work correctly for ACS to not have major issues surface.