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

Balance Sheet Concerns Increase
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:** Unbilled receivables grow as their quality deteriorates
- **Accounting:** Dispute with Georgia contributes to declining receivables quality
- **Accounting:** Another large contract could also impact condition of balance sheet
- **Accounting:** Tangible net worth continues to look weak
- **Governance:** Has the Company seen the light? We're not convinced.

Discussion of 3DAdvisors Findings

Accounting: Unbilled receivables grow as their quality deteriorates

Affiliated Computer Services regularly downplays the significance of its percentage of completion-related revenues, touting the fact that they amount to only 5% of total revenues. A closer look at receivables, however, reveals another story, as the percentage of the unbilled portion of A/R's has been increasing rather significantly. As of Q4, 2003, ACS's Unbilled Receivables were up to $160 million (19% of receivables) vs. just $100 million last year (13% of receivables). But there's more, much more, at issue when one looks at the quality of those Unbilled Receivables. It is a fact that 48% of '03's Unbilled Receivables ($77.7 million) are not expected to be actually billed within one year. Last year, this number was only $4.9 million, or below 5% of the Unbilled Receivables reported. At the time of the Q4 10K, this fact clearly demonstrated that an increasingly significant portion of the Company's receivables could be considered hazy.

We noted that at least one analyst with a large sell-side firm picked up on this Unbilled Receivables issue. But at the same time, we also note that most analysts maintain a “buy” rating on the Company, despite a weaker balance sheet and other behaviors that should be of profound concern to investors. (See prior ACS reports dated 8/16/02, 10/30/02, and 7/9/03.)

Accounting: Dispute with Georgia contributes to declining receivables quality

ACS’s Q1 release (October 21) contained financial details of significant problems that have emerged between the Company and the State of Georgia concerning that state’s Medicaid contract with ACS. For the first time, both parties have publicly declared the other in default of various provisions of the contract. This contract is a large one for ACS, representing about $132 million in annual revenues. More importantly, as of Q1, 2004, ACS had $84 million in Unbilled Accounts Receivable tied to this deal. Making matters even worse, as of the date of the Q1 release, the State of Georgia owed ACS $34 million in past due invoices related to the contract.

All of this has served to put a serious dent in the Company’s Q1 cash flow picture. Cash and Cash equivalents were down to just $36.4 million from their $51.2 million level at June 30, 2003 (Q4) level. Operating Cash Flow for Q1 was at $51 million. Now, it’s no secret that ACS’s first quarter Cash From Operations numbers have been seasonally slow for the past four years. This year’s Q1 number however, at $51 million, is significantly lower than the $87 million booked in Q1 of 2002, and this being a quarter where ACS booked $1 billion in revenues vs. just $882 million the prior year.

All this prompted ACS CEO Jeff Rich to exclaim, in a recent conference call, “I must say I’m very disappointed by the fact that, as of September 30, the State of Georgia owed ACS approximately $43 million of past due invoices.” He went on to state further disappointment, saying “Subsequent to quarter end, the state did pay $9 million of the past due amounts, an amount that we were frankly disappointed with…”. Later in the same conference call, Rich stated that they were “not thrilled” with their overall receivables increases, as DSO’s increased 3 days during the quarter.

It’s clear that the matter with the Georgia Medicaid contract is causing concern that had not been voiced so publicly prior to this week’s Q1 (2004) release.

Accounting: Another large contract could also impact condition of balance sheet

The Department of Education Student Loan Contract, with $172 million in annual revenues, is ACS’s largest. The deal was part of the Company’s AFSA acquisition in June of 2002. It’s a well-known fact that this contract, which runs until 2006 in its current configuration, has been put out to bid by the agency.

The progression of ACS management commentary related to this matter is disclosure behavior that we find interesting and worth monitoring closely. When Sallie Mae first contested the extension of the deal to 2006, ACS management stated, last November, that "we are confident they will remain a client". At that time, management also had voiced doubt that the contract would go out to bid. Things here didn’t look so good, however, when last February, the Company announced that the contract was indeed going out to competitive bid. The stock shed about 25% of its value on this news. With regards to this, in the subsequent conference call, the Company stated, “we continue to feel strongly about our overall position”. Currently, as the contract award process drags on, management no longer seems to have much to say about its chances of retaining the business.

This bid award, which was originally expected in September, then October, has been delayed until mid to late November. In the interim, ACS has since agreed to sell a “substantial portion” of its federal business to Lockheed Martin. The sale includes everything except the Department of Education contract. ACS goes on to explain that the Company remains very committed to the student market and consequently has decided to retain this business. We’re wondering whether, given the uncertainties surrounding the competitive bid and what appear to be the Company’s waning assurances that it will keep the contract, Lockheed Martin may not have been interested in taking the Student Loan deal off of ACS’s hands. Outside of the $172 million revenue impact, loss of this contract also carries with it significant impairment risks to the Company should this award not go ACS’s way.

The most significant contingent risk of such an event could very well be one affecting ACS’s balance sheet. The AFSA acquisition in June of 2002 (AFSA services the Department of Education Student Loan Program) cost the Company $434 million and caused Goodwill to swell by $313 million and Intangibles by $48 million. With the Company on a tightrope with regards to tangible net worth, any significant impairment of the $361 million in Goodwill and customer contract intangibles (net of any subsequent intangible amortization), related to the Department of Education business, could have a material affect on the quality of ACS’s balance sheet, and possibly related loan covenants.

Accounting: Tangible net worth continues to look very weak

As we have mentioned in prior ACS reports, the Company’s balance sheet is not in the greatest shape, and the prospect that two of its largest contracts could worsen the situation significantly is not good news. We have noted the disclosure behavior related to these two contracts above, and we also note some important accounting behavior that seems aimed at propping up a weak, and possibly weakening, balance sheet.

ACS had $3.7 billion in assets on the books at F/Y end (Sept. 30). At that time, Goodwill amounted to $1.9 billion of the number. Intangibles, which are comprised primarily of customer contracts, accounted for another $239 million of the number. This means tangible assets are in the range of $1.5 billion, not much when compared to liabilities totaling $1.3 billion.

Then there’s the trick ACS played with “Software” back in 2001. Prior to this period, the Company had carried Software as an Intangible Asset. Starting in 2001 however, Computer Software was shifted over to the tangible “Property, Equipment and Software” designation. By shifting software from intangible assets, ACS seemed to be trying to bolster up its weakening tangible net worth picture. Now, with software effectively netted in with property and equipment, it becomes impossible to determine its true valuation on ACS’s books. Suffice it to say, however, that the shifting of Software, from intangible classification to tangible, may be playing a role in preventing ACS’s tangible net worth from dropping into negative territory and is an accounting behavior we think very noteworthy.

Governance: Has the Company seen the light? We're not convinced.

On September 15 the Company put out a press release announcing the appointment of two new "independent" board members and a number of changes being made to its governance practices. The press release summarized the changes as follows: "In addition to changing the composition of the Board to a majority of outside directors, the ACS Board of Directors is implementing a variety of best-practice changes to ACS' corporate governance policies relative to board responsibilities, audit practices, and review guidelines."

The changes enumerated in the press release only hint at some of the governance and related disclosure behaviors we uncovered in our first report on ACS back in August of last year. For example, we discovered through a very obscure disclosure in a registration statement that the Company's founder was a "one-man nominating committee" for the board of directors. Other disclosures made it seem like there was a real committee with several members, as most investors would expect. The press release simply says there will be "Formation of a Nominating and Corporate Governance Committee of the Board of Directors comprised solely of outside Directors". No mention of the fact that previously the founder and single largest shareholder solely controlled who was nominated to serve on the board. We assume that the old one-man nominating committee nominated the two new "independent directors". We'll be doing some research to determine how "independent" these new directors actually are.

It also seems odd that in the wake of the Company's newfound desire to adopt "corporate governance policies using best- practice standards", the Company seems harder for the public and investors to talk to. In the past, when we called the investor relations line to ask questions, we could actually get a live person on the phone. Now when we call, a recording tells us to leave a message and to "allow 24 hours for turnaround for any questions."