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

More Aggressive Accounting and Contract Difficulties Affiliated Computer Services, Inc. (NYSE:ACS) Update

March 2, 2005

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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:** Treatment of "contract inducements" effectively inflates revenue
- **Accounting:** Problems with North Carolina contract appear far from over
- **Accounting:** Even in small deals, the Company seems to find trouble
- **Governance:** Change in options plans inure to the benefit of insiders
- **Insider Trading:** After heavy selling last summer, the calm before the storm?

Discussion of 3DAdvisors Findings

As Affiliated Computer Services continues its struggle with flattening internal growth in its local government segment, evidence keeps surfacing of just how competitive this market has become for the Company. On February 28th the news broke that ACS had lost its bid to process welfare eligibility claims for the State of Texas to Accenture, Ltd. (NYSE:ACN). The contract was worth about $25 million per year. Also adding to the Company's competitive woes was the loss of the Wisconsin Medicaid deal to archrival Electronic Data Systems Corp. (NYSE:EDS), a contract that would have been worth about $190 million over a seven year period.

The loss of these new sales comes at a time when ACS is battling to save its North Carolina Medicaid contract, a deal which it had apparently been awarded until EDS cried foul and filed a protest with the state. Though Company management has maintained its confidence that the EDS protest would not be upheld, recent developments strongly hint that this just may not be the case (see below).

And the North Carolina Medicaid protest is not the only area where the ACS contract procurement process has come under the microscope recently. A recent case in Solano County, California, reared its head as well when that county's technology contract, long-held by ACS, came under scrutiny when that county's technology manager alleged the county has corrupt ties to ACS. It would seem that the Company can't catch a break with new deals or old deals, large and small.

Combined with these elements, we have also uncovered significant evidence that points to additional aggressive accounting behavior by ACS with regards to the way it handles its "Contract Inducements" to customers, which on the surface look like ordinary contract discounts, but their accounting treatment is anything but ordinary.

In the midst of these developments, we also note how ACS has just made a significant move to accelerate the exercisable dates of its options for Company executives, even though the selling has been ominously slow save for some large sales by **Darwin Deason**, the Company's founder, back in December.

Accounting: Treatment of "contract inducements" has effect of inflating revenue

In 2002, ACS began disclosing the term "Contract Inducements" in its notes to financial statements. It is interesting to note that, in the entire Edgar universe, ACS is the only company to use this term. Making this matter much more significant, however, is the fact that ACS amortizes these, not as expenses, but as reductions to the related contract revenues. What appears to be happening here is that ACS books receivables on a gross revenue basis (that is, pre-Contract Inducement). It then amortizes the "Contract Inducement" discount over the life of the contract. This, in effect, would inflate, at the very least, revenues in the earlier years of a contract since the Inducement is being amortized (as a reduction of revenue) over life of the contract.

We have uncovered a document, marked "ACS Confidential", that is an example of the way the Company treats these Inducements in a proposal to the Texas Department of Human Services drafted back in 2000 (see Exhibit 1 below).

Making this more interesting is the fact that the above proposal was dated April of 2000, prior to any mention of Contract Inducements in any ACS financials. It is clear that these Contract Inducements have been on the rise in the past three years. In 2002, ACS amortized $0.9 million of them. The total jumped to $7.3 million in 2003, then jumped again to $11 million in F/Y 2004. So far into F/Y 2005, the Company has amortized $6.2 million of these during through Q2 ending December 31st.

These Contract Inducements appear to come into play in the infamous Georgia contract as well. To this point, we call your attention to an item in the prepared text section of the Q4 conference call transcript. In it, COO **Mark King**, discusses Georgia-related unbilled receivables after the settlement of the Company's contract dispute with the state: **"The remaining unbilled receivable of $104 million will be reduced over the life of the contract and actual monthly billings to the State will be greater than the revenue recognized by ACS"**. It appears as if the possibility exists that, through the recording of unbilled receivables, the Company has not only recognized revenue prior to its being billed to customers but also, after settling the Georgia matter, they have had to amortize the portion of unbilled receivables attributable to "contract inducements" by reducing revenue over some period of time.

Exhibit 1. Page from ACS Pricing Proposal to the Texas Depart. of Human Services. Source: www.dhs.state.tx.us/providers/LoneStar/Downloads/ACSPricingSheets%20.pdf

AFFILIATED COMPUTER SERVICES, INC.
Texas Department of Human Services EBT2 Proposal
Pricing Response

Retailer Management - Option A

Price Breakdown Worksheet
for Implementation Period (4/00 - 2/01)

Item / Activity	Fixed Fee	Industry Standard Unit (a)	Price per Unit	Volume	Total Charges
Point of Sale Equipment Rental / Lease	$ 1,490,042				$ 1,490,042
Travel	$ 12,278				$ 12,278
Merchant Point of Sale Training	$ 20,463				$ 20,463
Help Desk Support	$ 191,157				$ 191,157
Help Desk Software Downloads	$ 4,781				$ 4,781
Start-up Costs	$ -				$ -
Contract Inducement Credit (b)					$ (341,857)
Totals	$ 1,718,721				$ 1,376,864

(a) See attached assumptions for definitions of Industry Standard Units.
(b) Contract Inducement Credit reflects amount reduced from billing during implementation phase to meet TDHS budget.

ACS Confidential

So it appears quite possible that the practice is to record the annual gross amount of its contract revenues, before Contract Inducements, charge receivables with the same gross amount and then amortize the Contract Inducements through reducing unbilled receivables with an offsetting charge to revenues, over the life of the contract. In effect, the Company is recognizing revenues that it never intends to collect, which is aggressive revenue accounting, to say the least.

<u>Accounting: Problems with North Carolina contract appear far from over</u>

ACS steadfastly maintains that it will hold on to its North Carolina contract, even after the administrative law judge (North Carolina) announced his non-binding recommendation that the state uphold EDS's protest to the Medicaid contract previously awarded to ACS. Even after this development, COO **Mark King** goes so far to state that "we do not believe we have any financial exposure at this time" with regards to the situation. We would beg to differ on this as the judge, Fred G. Morrison Jr., cited in his recommendation a number of issues. Here are a few:

1. Compliance with Statewide Technical Architecture (STA) was a mandatory requirement of the RFP that ACS and EDS bid on. In a draft report, evaluating the technical architecture of the ACS proposal, the State's own reviewers found that "the following application systems do not satisfy the STA architecture standard". The report then goes on to cite three components of the ACS solution that didn't meet the standard.

2. In the event that oral presentations to the State were held the presentations are supposed to be tape recorded. The State failed to record both the ACS and the EDS oral presentations.

3. The Proposal evaluation plan developed by the State required that if oral presentations were conducted, a written report be made substantiating what had occurred at such proceedings. No written reports were created at either the ACS or the EDS oral presentations.

4. The Recommendation for Award, which incorporated the findings of the technical architecture reviewers, concluded that the EDS proposal had "the essential characteristics" of the required design, "without exception". In contrast, the report found that only the "core solution" of the ACS proposal, met requirements.

It certainly looks as if a re-bid is in the cards, with respect to the North Carolina contract. EDS steadfastly charges that the ACS system is not compliant with the technical architecture required by the State. EDS also maintains that ACS was able to come in at $80 million lower than its own bid because ACS proposed to install a system that is "strikingly similar" to the very system the State was trying to replace. What's more, ACS claims that it will be using technologies from its Medicaid project in Georgia, were the Company has had such well-publicized problems.

It would seem that, given a re-bid, ACS will have a hard time coming in at the low end, as it did in the first effort, once incorporating the necessary changes to make its proposal truly compliant with North Carolina's Statewide Technical Architecture (as EDS has apparently done).

Accounting: Even in small deals, the Company seems to find trouble

An obscure allegation involving ACS shows its contract problems are not unique to big deals. The Company's contract with Solano County, California, has been held by ACS since 1989 and has not been put out to bid since. This contract was hastily re-negotiated (without going to bid) after a lawsuit was filed against the county and ACS by the county's former top technology manager who alleged the county has corrupt ties to ACS that could have resulted in as much as $30 million in fraudulent billings.

This case caused county supervisors to suggest that a grand jury or an outside expert look into the county's relationship with ACS. It is quite interesting that, within one week, ACS and Solano County renegotiated their agreement, cutting about $300,000 from the contract price. Not much money, you may say, but possibly enough to get the heat off both the county and ACS, at least for the time being. Though the dollar amounts may be small relative to ACS total revenue, it suggests the Company's contract problems are not limited to competitive losses for new deals or large deals already won.

Governance: Change in options plan inures to the benefit of insiders

We have been aware of the fact that, prior to this year, ACS has required its executives to hold their vested options for a period of five years before exercising them. This rare constraint was actually one of the few elements of the Company's compensation practices that seemed in the interests of shareholders as it encouraged executives to stay around until their options could be exercised. This practice went out the window in February though. Early in the month, the ACS board approved an amendment "to stock options previously granted" to allow the options to be immediately exercisable, once vested. The argument for the change was to bring the Company more in line with industry standard practices. While that would be hard to argue with, we find the behavior interesting nonetheless for its timing when you consider the extent of sales and holdings reductions over the past 18 months combined with the persistent contract problems and evidence of multiple accounting issues.

Insider Trading: After heavy selling last summer, the calm before the storm?

Insider selling, brisk when the shares traded in the $60 range, has slowed since the shares have been flirting with breaking below $50 once again. In our update report on 09/20/04 we reported on the significant sales and holdings reductions that had taken place between early June and mid-September as the shares trended upward in the mid-$50s. We noted in particular the trading behavior of CFO **Warren Edwards**, CEO **Jeffrey Rich**, and EVP **Lynn Blodgett**, who sold off 91%, 59% and 91%, respectively, of their actionable positions (common stock plus exercisable options).

Even though the pace of selling has slowed since the fall, we did, however, find the selling late in the year by **Darwin Deason** to be particularly interesting. He unloaded over 605,000 shares at prices in the $60 range. Unlike last December though, when he wrote options on 425,000 shares, his recent sales, which occurred between November 26th and December 7th, did not give him much time for tax planning, causing us to wonder why he didn't wait until the New Year before selling. The calls he wrote in December of 2003 (July 60's) expired out of the money and he effectively put off the attendant gains until July of 2004. Since then, selling of ACS shares by its insiders has been slow.

One could interpret the recent lack of selling as insiders waiting for higher prices before selling anew, and with the new options rules it is probably a fair assumption that they could be waiting for a bounce before cashing out of the newly-available options. There is a flip-side to this, however. If something truly negative were just around the corner, it is unlikely that they would be selling in front of the news.