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

Timing of 10b5-1 Plan by Key Insider Very Revealing
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:** Is the new North Carolina contract going to be another problem?
- **Insider Trading:** Insider in charge of key contracts uses 10b5-1 to drop holdings
- **Accounting:** Conference call transcript contains several curious disclosures

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Discussion of 3DAdvisors Findings

Accounting: Is the new North Carolina contract going to be another problem?

One of the few bright spots in ACS' Q3 earnings release, the $171 million North Carolina Medicaid replacement contract, is now under fire. We had noted that, in the ACS Q3 conference call, a number of analysts had expressed concern that the contract was won by underbidding the competition by at least $80 million, or over 30%. Since the contract called for the implementation of a new system, and with the bid coming in so low, the question of profitability, at least in terms of ACS' usual business model, was immediately raised. ACS' answer was interesting to us at the time because it implied that since they had implemented a system for a similar-sized state in the recent past, all they had to do is customize a system they had already built. The problem with that logic, as we saw it, was that this other system was the one built for the State of Georgia, a problem-riddled contract that has caused the Company much unwanted publicity and financial stress. The Georgia contract was plagued by not only significant disputes regarding Phase I of the contracted work but also the cancellation of Phase II (see our ACS report dated 10/24/03).

In addition to reliance on the ill-fated Georgia work, other possible problems with the North Carolina contract may have been hinted at this weekend, as it was announced late Friday (April 30th) that not one, but two competitors that had bid on the contract, EDS and Unisys, have filed protests seeking to overturn the state's decision to award the contract to ACS. The "foul" claims are rather broad in scope:

- ACS' proposed system design doesn't comply with mandatory requirements for both the solicitation and North Carolina's statewide technical architecture.
- The state's evaluators recognized that many aspects of ACS' offering were "weak" and did not comply with the RFP.
- Industry experts have rated some features of ACS' solution as inferior.
- The location of ACS' integrated test facility and maintenance and modification staff doesn't meet the solicitation's geographic requirements.
- The perceived price advantage is largely illusory, given, in part, that the ACS proposal was based on a noncompliant design.
- Six out of ten key managers who will run the N.C. system lack required experience and many of the functions would be handled out of state in violation of state rules.

Defending the ACS cause in all this is **Harvey Braswell**, Group President of Government Services.

Braswell has fairly deep North Carolina roots, having been born and raised there; he is also on the board of North Carolina's Electronics and Information Technologies Association. He, among others, is quick to point out that protests of contract awards in cases such as this are not uncommon, which is true. However, given the circumstances surrounding this contract and the fact that ***two*** very well known and large competitors are protesting the award, this problem is not so easily dismissed.

Braswell's comments, regarding this case, are interesting in that he readily admits that the Company plans to utilize much of the technology developed under the troubled Georgia contract in order to fulfill the North Carolina deal. Braswell is also the point person on the Georgia contract. Unfortunately, Braswell's trading behavior shows considerably less confidence in the North Carolina or Georgia contracts than do his positive statements.

<u>Insider Trading: Insider in charge of key contracts uses 10b5-1 to drop holdings</u>

Starting in early January, Harvey Braswell (above), after filing a 10b5-1 trading plan, began selling his ACS shares in earnest. Starting with a 75,000-share sale in January, he has followed up with 25,000 share sales per month during February, March and April. The sales have lowered his holdings by about 63% and can easily go undetected by those who tend to ignore 10b5-1 selling as an ordinary event.

It would seem that Braswell plans to reduce his holdings further, based on his current selling pattern. Making his actions more interesting is the fact that Braswell has been with the Company since 1996 and, until now, has never sold a share. Also, the filing of his 10b5-1 plan, and subsequent selling coincided with the call-writing spree of

Chairman **Darwin Deason**, who managed to write July 60 calls on 425,000 shares between late December and early January of 2004. At the time, he was responsible for most of the open interest in the series (see *Insider Research Bulletin*, 1/12/04).

Braswell's recent 25,000-share sale occurred just before the problematic Q3 release. No doubt Braswell would respond to any questions regarding his timing by pointing to the fact that he had a 10b5-1 in place. Interestingly enough, another ACS insider also has a 10b5-1 that provides convenient cover for his selling, even in front of an earnings release. We are referring here to President and COO, **Mark King** who also sold, like Braswell, before the Q3 release (in King's case, it was the day before) at $55 per share. King only sold 5,000 shares and, it should be stated, has been doing so regularly. We mention this, however, because it is an example of how a 10b5-1 can provide camouflage for insiders who are looking to lighten up.

Just this morning, another significant sale by a key insider hit the EDGAR system. Selling just after the Q3 earnings announcement, and subsequent nearly 10% drop in the stock, was CEO **Jeffrey Rich**, who sold 150,000 shares on April 30th at prices in the $49 range. Rich had filed a 10b5-1 in October of 2003, but had sold only once since, a 48,100-share sale in December of 2003, right about the time Darwin Deason had begun writing calls. This current sale by Rich, however, is his largest-ever by far and has reduced his holdings by 24%.

So now we have two key insiders selling at an unprecedented pace, and dramatically reducing holdings, during the same time span that the Chairman was writing calls. At the same time, additional important contract problems have surfaced, along with the other questions that are being raised in the wake of the Company's most recent quarterly report.

Accounting: Conference call transcript contains several curious disclosures

Street reaction to Affiliated Computer Services' latest (Q3) earnings release and conference call was swift and tough. Lowered company guidance (blamed primarily on a weak acquisition pipeline), combined with higher than expected capital expenditures, persistently high DSO's (76 days), concerns about the Florida work force contracts and the continued workout of the Georgia Medicaid contract dispute had some investors head for the exits. The day after the earnings release, the shares dropped 9.5% (from the prior day's close at $53.80 to $48.69), a $700 million haircut in market cap for ACS.

Our clients know we have been monitoring ACS executive behavior for quite some time. Each quarterly review has become more interesting as the problems facing the Company have broadened. Our immediate observation of the Company's April 21 conference call was that management fell far short of exuding the confidence it had been exhibiting in prior quarters. Perhaps the most glaring comment was that of Company CEO, **Jeffrey Rich** when asked if investors should read anything into the fact that ACS was removing non-closed acquisitions from its guidance picture (bolding is ours for emphasis):

> "Our sales pipeline can be lumpy and acquisitions are even worse. So we thought we would just make it easier to just forecast the core

> operations and the acquisitions that we have already made. We're still going to need to do acquisitions in this industry to continue to be consolidator and we'll continue to do that. **The fact that the current pipeline is, you know, fairly average and mediocre, mean, that's not abnormal. As soon as the pipe line gets active and you start working a lot of deals and then you close a couple, lose a couple, then you wake up and you got a weak pipeline and then you go build the pipeline and then you're back in business again**."
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> Source: ACS conference call transcript from 4/21/04 provided by CCBN StreetEvents.

Given the Company's reliance on acquisitions to maintain high growth rates, we found this comment very curious. Combine this with what seems to be persistent contract problems and its no wonder investors have gotten cold feet.

There were a number of other dubious comments made during the call. One relates to Q1's higher-than-expected capital expenditures. Management explained this as being related to the capital requirements of the Department of Education contract, ACS' largest contract that had recently been "won" after a testy re-bid process forced by a competitor. From the same conference call transcript:

> "Just given the size of the total contract value and the fact that the vast majority of the capital spending on this contract will occur within the first 12 to 18 months of the contract, it did slightly skew our quarterly metrics this quarter."

It seems to us that this should have been seen on the horizon, and have been included in the Company's capex forecast.

We also noted that, for the first conference call in a year, nowhere was there an indication as to the status of those Georgia related unbilled receivables that stood at $84 million at the end of Q2 with just $12 million expected to be billed during calendar 2004 (see our ACS report dated 10/24/03). This was the first time, in four quarters, where some mention as to the status of the Georgia unbilled receivables has not been made. We would venture to say that if some large improvement of this situation had occurred, ACS would have been talking about it, especially given the tough quarter it found itself reporting on.

ACS made repeated references, in the Q3 conference call, to its problems in Florida where the inspector general has launched an investigation over "errors and possible irregularities" in a $7 million contract with the state labor department. Implying that most of the situation is behind them, the Company stressed that it has terminated three employees in the Miami (Dade County) operation and that it was "currently in settlement discussions with Miami (Dade County) to resolve any amounts which we might owe them due to our employees' conduct." Settlement or not, there are continuing related investigations here by both the Justice Department and the SEC.

The Florida situation seems eerily reminiscent to a similar event in New York State where, just this past January, ACS' most senior New York operations officer had been convicted by a jury of multiple counts of conspiracy and mail fraud for his participation in a scheme to defraud numerous ACS clients of $3.8 million by fraudulently inflating customer invoices. The events leading to his conviction had occurred between 1997 and 2000. According to trial evidence, the individual, **James Donnell**, was responsible for falsely inflating ACS' revenues and, based on those false revenues, he enhanced his yearly bonuses.