3D ADVISORS

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

The One Man Nominating Committee
Affiliated Computer Services, Inc. (NYSE:ACS)

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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:** The one man nominating committee
- **Governance:** Multiple related-party transactions involving family members
- **Accounting:** Goodwill accounting and related issues
- **Accounting:** Reclassifying software assets

Discussion of 3DAdvisors Findings

Governance: The one-man nominating committee

The founder of ACS, Darwin Deason, who is still the company's single largest shareholder, is a One Man Nominating Committee for the board of directors. This disclosure is buried in a recent S-8 registration statement dealing with the Company Stock Option Plans. It is the only time the information below is ever disclosed:

> "Mr. Deason serves as the one-person nominations committee to our Board of Directors and thus recommends management's slate of directors to be proposed by the Board to our shareholders".

This is in contrast to the disclosure in the Proxy, which makes it appear that there is a true committee with multiple members:

> "The Nominating Committee, which was formed in March 1999 and on which Mr. Deason serves, has the responsibility of considering, evaluating and recommending to the Board the slate of director nominees. Recommendations as to nominees will be considered by the Nominating Committee. Such recommendations can be submitted to the Nominating Committee by directing

them to ACS' executive offices at 2828 North Haskell Avenue, Dallas, Texas 75204, to the attention of Darwin Deason."

Through this structure, Mr. Deason has sole control over who is nominated to serve on the board of directors. We are also concerned with the lack of clear disclosure on this important governance issue.

Governance: Multiple related party transactions involving board and family members

Over the past few years there have been a long line of Related Party Transactions between the ACS, and its founder and chairman, Darwin Deason, his sons, or entities controlled by them. Here is some interesting detail of a current Related Party situation:

Deason and ACS combined own 50% (Deason owns 44%, ACS owns 6%) of a corporate airplane brokerage firm called **DDH Aviation Inc**. DDH has a $47 million line of credit where Deason and ACS are guarantors. Deason is also Chairman of the Board of DDH. In August of '01, ACS bought a Challenger 600 aircraft from DDS for $8.5 million, which included refurbishment of the interior and exterior of the aircraft. The disclosure does not state that the consideration paid for the aircraft represented going market prices. The above is what ACS discloses. Below are other details, related to the ACS aircraft purchase from DDH, which round out the picture:

In early '01 DDH had bought a total of eight Challenger 600 aircraft from the Canadian Government for a total purchase price of $30 million (not disclosed in any ACS or related SEC filings), or $3.75 million per plane. A website published by The Canadian Air Force maintenance team, who was in charge of the Challenger fleet, says that the planes were released to DDH in March of '01. The website goes on to explain that, for the entire fleet, only three new engines had to be installed prior to delivery and that the planes reached their destinations and passed inspections.

We called around to other aircraft brokers familiar with Challenger 600 jets and found out that the going market price for the plane (with upgraded interior and exterior) should be in the high $6 million to low $7 million range. When we mentioned to one dealer the fact that ACS had paid $8.5 million, he registered surprise until, that is, we told him ACS had bought the plane.

DDH is just one example of interest-conflicting dealings. There are many more:

Precept Business Services - This entity was spun-off from ACS back in '94. The companies had a reciprocal services agreement where Precept would sell business forms and supplies, and provide other services, to ACS. ACS in turn, would provide office space and certain administrative services to Precept. Such services and products were "believed to approximate fair market value". (Note how the "Fair Market Value" designation is absent from the above aircraft purchase transaction with DDH).

Dawson Deason was a director and retained voting control of Precept after the spin-off. Douglas Deason, Deason's son, was President and COO of Precept, receiving a salary of $500,000. Precept was also one of the original equity partners in DDH

Aviation (above). Precept declared bankruptcy during ACS's 2001 fiscal year. Both Deasons resigned their respective positions before the bankruptcy filing. Not disclosed in the ACS filings is the fact that Precept, prior it's Chapter 11 filing, had entered into the following transactions with Deason:

In a private placement, Precept decreased its ownership percentage in Building and Construction projects (Builders). Precept-related documents go on to say that although the offering was directed to "other shareholders", Darwin Deason acquired the entire deal nonetheless. The deal decreased Precept's stake from 90.5% to 1.8% of the total stock in Builders. There was no disclosure of the price paid by Deason.

Another Precept-owned entity was referred to as "Holdings". One of the Holdings properties was a ranch property, located in Bells, Texas (Bells Property). Precept sold the Bells Property to D3 Holdings, Inc., which is controlled by none other than Darwin Deason and his son, Douglas (who was Precept's President and COO at the time) for $1.2 million. Precept then entered into a five-year lease for "a more limited use of the Bells Property" for $9,000/mo, thus allowing D3 Holdings to recoup half of the purchase price, but its unclear what “more limited use” means.

The Precept-owned Holdings also agreed to sell to Darwin Deason, another property, in Palm Desert California for $1.025 million in cash. Along with this deal, Precept sold, to Deason, its 49% interest in the privately held company (CCC&D) that operated a restaurant on the Palm Desert property Deason had acquired.

The Precept-owned Holdings entity was also the owner (though a separate entity called Lone Star Jockey Club Ltd.) of a luxury box at Lone Star Park, a racing facility in Grand Prairie Texas. Holdings sold this interest to another Darwin-controlled entity, D3 Investments, for $92,500. Precept then leased the box back from D3 for five years at $1,000/mo.

These Precept-Related transactions, with Deason, hardly seem arms-length. It is interesting how, after spinning Precept off from ACS, Deason was able to personally buy back a number of assets from the entity (Precept) prior to its eventual Chapter 11 filing (our guess is that they did so at bargain prices). We bring these dealings up because they provide important insight into the behavior of Dawson Deason.

Some of the older (1998 vintage) related-party transactions below reinforce the pattern of what appear to be self-serving behavior and murky disclosure at the expense of ACS shareholders:

Microresponse Inc. was a company owned by another Darwin Deason son, David. David was also President and a director of the company. During F/Y '98, ACS purchased $200,000 in personal computers from Microresponse "at what the company believes were market rates".

Enviro-Kleen, L.P. Darwin Deason and Douglas Deason were among the principal owners of Enviro-Kleen, which provides commercial janitorial services. ACS utilized Enviro-Kleen services at its Dallas headquarters, on a month-to-month basis, for $30,000/mo. It is not clear if, and when, these services may have been terminated.

Since they do not show up in current financials, we are assuming that they no longer exist.

Accounting: Goodwill accounting and related issues

To put the discussion of ACS assets in perspective, it's best to start with the fact that intangible assets (including goodwill) total 58% of the Company's total assets. If you take the $2 billion in shareholders' equity and reduce it by the $1.62 billion in intangible assets, the Company has just under $400 million in tangible net worth. Total debt is almost that much. When you consider that software assets sit in "Property, Equipment and Software" and receivables are at $658 million, the overall picture is that of a balance sheet that brings tears to your eyes.

By far, the largest component of the non-goodwill intangible assets consists of customer contracts acquired through acquisitions. It is interesting that ACS has shifted its amortization schedules associated with some of these contracts. It seems that, in these cases, the lengths of related amortization periods have become longer than indicated in the past. In the '00 and '01 10K, the company indicated that these customer contracts were amortized "using the straight-line method over the contract terms, which range from three to ten years". The company does not break out amortization schedules related to customer contracts acquired through acquisitions.

The company's Q1 - '02 10Q, however, provided evidence that, at the very least, the customer contracts picked up from the Lockheed Martin IMS Corp. acquisition were being amortized at the longer end of the scale. "The $64.7 million acquired intangible assets is attributable to customer contracts with an aggregate anticipated useful life of approximately 8 years." In Q2, however, the language associated with those contracts acquired from Lockheed changed: "The $64.5 million acquired intangible assets is attributable to customer contracts with an aggregate anticipated useful life of approximately 11 years." It's pretty clear that, starting in Q2 of F/Y '02, they stretched out the amortization period for those Lockheed customer contracts by three years, well beyond the 3 - 10 years they had been indicating was their practice in prior years. It would seem that they are keeping their amortization charges lower by pushing the envelope on the length of amortization periods.

Certainly, the numbers related to this particular instance are not material. These however, are only what become readily evident, given the limited related detail provided for in the financial statements. Given the existence of the one instance, we wouldn't want to bet that others do not exist. If so, it could be a contributing factor for ACS's high level of intangible assets as the company may have been under-amortizing these items in many of their acquisitions. At the very least, this behavior provides evidence that the Company is not beyond managing its numbers.

Accounting: Reclassifying Software "Assets"

In the past, ACS had always included "Software" in the Intangible section of Assets along with Goodwill and Other Intangible Assets. This is the way EDS does it and is consistent with most approaches in the industry. In Q2 of F/Y '01, however, ACS changed the way it classified "Software". In that quarter ACS began the practice of pulling "Software" out of the traditional "Intangible" section and lumping it in with "Property and Equipment." Consequently, in Q2 of '01 "Goodwill, Software and Other Intangibles" became "Goodwill and Other Intangibles" and "Property and Other Equipment" became "Property, Equipment and Software". These new designations continue in effect today.

What this means is that the already-horrible Tangible Net Worth calculations are even worse than originally thought. The company is not forthright with providing detail on just how much of the current $395 million "Property, Equipment and Software" asset is represented by "Software". In the Lockheed Martin IMS acquisition (the only one where they provide allocation detail) $41.5 million of the purchase price was allocated to "Software". To us, it seems that the only reason for the move was to get that huge intangible asset number down in an effort to improve perceptions of tangible net worth, possibly with the intent of keeping financing options open and another example of a behavior that leaves us concerned.