

H&R BLOCK INC  
Form 10-Q/A  
March 31, 2006

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**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**FORM 10-Q/A  
Amendment No. 1**

*(Mark One)*

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended July 31, 2005**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-6089**

**H&R BLOCK**

**H&R Block, Inc.**

**(Exact name of registrant as specified in its charter)**

**MISSOURI**

**(State or other jurisdiction of  
incorporation or organization)**

**44-0607856**

**(I.R.S. Employer  
Identification No.)**

**4400 Main Street**

**Kansas City, Missouri 64111**

**(Address of principal executive offices, including zip code)**

**(816) 753-6900**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Yes  Accelerated filer Yes  Non-accelerated filer No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of the registrant's Common Stock, without par value, at the close of business on August 31, 2005 was 324,650,475 shares.

**H&R BLOCK**  
**Form 10-Q/A for the Period Ended July 31, 2005**  
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**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A ( Form 10-Q/A ) to the company's Quarterly Report on Form 10-Q for the quarterly period ended July 31, 2005, initially filed with the Securities and Exchange Commission on September 8, 2005, is being filed to reflect restatements of our consolidated balance sheets at July 31, 2005 and April 30, 2005, consolidated statements of income and comprehensive income for the three months ended July 31, 2005 and 2004, and of cash flows for the three months ended July 31, 2005 and 2004, and the notes related thereto. See detail discussion of the restatements in Item 1, note 2 to the condensed consolidated financial statements.

On February 22, 2006, the Company's management and the Audit Committee of the Board of Directors concluded to restate previously issued consolidated financial statements for the fiscal quarters ended October 31, 2005 and July 31, 2005, the fiscal years ended April 30, 2005 and 2004 and the related fiscal quarters. The Company arrived at this conclusion during the course of its closing process for the quarter ended January 31, 2006.

The restatement pertains primarily to errors in determining the Company's state effective income tax rate, including errors in identifying changes in state apportionment, expiring state net operating losses and related factors.

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CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | (in 000s, except share amounts)          |                            |
|--|--|----------------------------|
|  | Restated<br>July 31, 2005<br>(Unaudited) | Restated<br>April 30, 2005 |
| <b>ASSETS</b>  |  |                            |
| Cash and cash equivalents  | \$ 632,801                               | \$ 1,100,213               |
| Cash and cash equivalents restricted   | 416,981                                  | 516,909                    |
| Marketable securities trading  | 77,085                                   | 11,790                     |
| Receivables from customers, brokers, dealers and clearing organizations,<br>net                              | 585,214                                  | 590,226                    |
| Receivables, less allowance for doubtful accounts of \$46,752 and \$38,879                                   | 404,501                                  | 418,788                    |
| Prepaid expenses and other current assets  | 473,831                                  | 432,708                    |
| <b>Total current assets</b>  | <b>2,590,413</b>                         | <b>3,070,634</b>           |
| Residual interests in securitizations available-for-sale   | 193,207                                  | 205,936                    |
| Beneficial interest in Trusts trading  | 185,539                                  | 215,367                    |
| Mortgage servicing rights  | 188,708                                  | 166,614                    |
| Property and equipment, at cost less accumulated depreciation and<br>amortization of \$677,989 and \$658,425 | 328,684                                  | 330,150                    |
| Intangible assets, net   | 232,242                                  | 247,092                    |
| Goodwill, net  | 1,018,632                                | 1,015,947                  |
| Other assets   | 278,529                                  | 286,316                    |
| <b>Total assets</b>  | <b>\$ 5,015,954</b>                      | <b>\$ 5,538,056</b>        |

**LIABILITIES AND STOCKHOLDERS EQUITY****Liabilities:**

|  |                  |                  |
|--|------------------|------------------|
| Current portion of long-term debt                                | \$ 25,854        | \$ 25,545        |
| Accounts payable to customers, brokers and dealers               | 871,715          | 950,684          |
| Accounts payable, accrued expenses and other current liabilities | 497,215          | 564,749          |
| Accrued salaries, wages and payroll taxes                        | 161,661          | 318,644          |
| Accrued income taxes   | 372,114          | 375,174          |
| <b>Total current liabilities</b>                                 | <b>1,928,559</b> | <b>2,234,796</b> |
| Long-term debt   | 923,145          | 923,073          |
| Other noncurrent liabilities                                     | 368,028          | 430,919          |
| <b>Total liabilities</b>   | <b>3,219,732</b> | <b>3,588,788</b> |

**Stockholders equity:**

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|  |              |              |
|--|--------------|--------------|
| Common stock, no par, stated value \$.01 per share, 800,000,000 shares authorized, 435,890,796 shares issued at July 31, 2005 and April 30, 2005 | 4,359        | 4,359        |
| Additional paid-in capital   | 601,348      | 598,388      |
| Accumulated other comprehensive income   | 63,731       | 68,718       |
| Retained earnings  | 3,097,151    | 3,161,682    |
| Less cost of 106,780,588 and 104,649,850 shares of common stock in treasury  | (1,970,367)  | (1,883,879)  |
| Total stockholders' equity   | 1,796,222    | 1,949,268    |
| Total liabilities and stockholders' equity   | \$ 5,015,954 | \$ 5,538,056 |

See Notes to Condensed Consolidated Financial Statements

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**H&R BLOCK**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

|   | (Unaudited, amounts in 000s,<br>except per share amounts) |                  |
|---|---|------------------|
|   | Restated<br>2005  | Restated<br>2004 |
| Three months ended July 31,                                     |   |                  |
| <b>Revenues:</b>  |   |                  |
| Service revenues  | \$ 315,128  | \$ 248,588       |
| Other revenues:   |   |                  |
| Gains on sales of mortgage assets, net                          | 236,431   | 183,360          |
| Interest income   | 49,253  | 39,720           |
| Product and other revenues                                      | 14,181  | 14,883           |
|   | 614,993   | 486,551          |
| <b>Operating expenses:</b>                                      |   |                  |
| Cost of services  | 343,218   | 290,975          |
| Cost of other revenues  | 123,357   | 78,395           |
| Selling, general and administrative                             | 189,252   | 160,196          |
|   | 655,827   | 529,566          |
| Operating loss  | (40,834)  | (43,015)         |
| Interest expense  | 12,435  | 17,793           |
| Other income, net   | 7,400   | 2,008            |
| Loss before taxes   | (45,869)  | (58,800)         |
| Income tax benefit  | (17,875)  | (22,846)         |
| Net loss  | \$ (27,994)   | \$ (35,954)      |
| <b>Basic and diluted loss per share</b>                         | \$ (0.08)   | \$ (0.11)        |
| <b>Basic and diluted shares</b>                                 | 330,714   | 337,270          |
| <b>Dividends per share</b>                                      | \$ 0.11   | \$ 0.10          |
| <b>Comprehensive income (loss):</b>                             |   |                  |
| Net loss  | \$ (27,994)   | \$ (35,954)      |
| Change in unrealized gain on available-for-sale securities, net | (5,811)   | 21,470           |

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|  |             |             |
|--|-------------|-------------|
| Change in foreign currency translation adjustments | 824         | (330)       |
| Comprehensive income (loss)                        | \$ (32,981) | \$ (14,814) |

See Notes to Condensed Consolidated Financial Statements

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**H&R BLOCK**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | (Unaudited, amounts in 000s) |                   |
|---|------------------------------|-------------------|
|   | Restated<br>2005             | Restated<br>2004  |
| Three months ended July 31,   |                              |                   |
| <b>Cash flows from operating activities:</b>                                |                              |                   |
| Net loss  | \$ (27,994)                  | \$ (35,954)       |
| Adjustments to reconcile net loss to net cash used in operating activities: |                              |                   |
| Depreciation and amortization   | 44,085                       | 38,908            |
| Accretion of residual interests in securitizations                          | (30,777)                     | (28,677)          |
| Impairments of residual interests in securitizations                        | 12,415                       | 2,609             |
| Additions to trading securities residual interests in securitizations       | (101,002)                    |                   |
| Proceeds from net interest margin transactions, net                         | 40,371                       |                   |
| Additions to mortgage servicing rights                                      | (49,306)                     | (28,493)          |
| Amortization and impairment of mortgage servicing rights                    | 27,212                       | 18,334            |
| Net change in beneficial interest in Trusts                                 | 29,828                       | (1,433)           |
| Other, net of acquisitions  | (255,347)                    | (480,626)         |
| <b>Net cash used in operating activities</b>                                | <b>(310,515)</b>             | <b>(515,332)</b>  |
| <b>Cash flows from investing activities:</b>                                |                              |                   |
| Cash received from residual interests in securitizations                    | 24,031                       | 38,826            |
| Purchases of property and equipment, net                                    | (30,330)                     | (22,714)          |
| Payments made for business acquisitions, net of cash acquired               | (3,452)                      | (806)             |
| Other, net  | 7,935                        | 8,300             |
| <b>Net cash provided by (used in) investing activities</b>                  | <b>(1,816)</b>               | <b>23,606</b>     |
| <b>Cash flows from financing activities:</b>                                |                              |                   |
| Repayments of commercial paper  |                              | (314,836)         |
| Proceeds from issuance of commercial paper                                  |                              | 419,700           |
| Dividends paid  | (36,537)                     | (33,636)          |
| Acquisition of treasury shares  | (131,642)                    | (347,395)         |
| Proceeds from issuance of common stock                                      | 32,318                       | 12,375            |
| Other, net  | (19,220)                     | (127)             |
| <b>Net cash used in financing activities</b>                                | <b>(155,081)</b>             | <b>(263,919)</b>  |
| <b>Net decrease in cash and cash equivalents</b>                            | <b>(467,412)</b>             | <b>(755,645)</b>  |
| <b>Cash and cash equivalents at beginning of the period</b>                 | <b>1,100,213</b>             | <b>1,072,745</b>  |
| <b>Cash and cash equivalents at end of the period</b>                       | <b>\$ 632,801</b>            | <b>\$ 317,100</b> |





**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)****1. Basis of Presentation**

The condensed consolidated balance sheet as of July 31, 2005, the condensed consolidated statements of income and comprehensive income for the three months ended July 31, 2005 and 2004, and the condensed consolidated statements of cash flows for the three months ended July 31, 2005 and 2004 have been prepared by the Company, without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows at July 31, 2005 and for all periods presented have been made.

H&R Block, the Company, we, our and us are used interchangeably to refer to H&R Block, Inc. or to H&R Block, Inc. and its subsidiaries, as appropriate to the context.

Certain reclassifications have been made to prior year amounts to conform to the current year presentation. These reclassifications had no effect on our results of operations or stockholders' equity as previously reported. Adjustments related to the restatements of previously issued financial statements are detailed in note 2.

On June 8, 2005, our Board of Directors declared a two-for-one stock split of the Company's Common Stock in the form of a 100% stock distribution, effective August 22, 2005, to shareholders of record as of the close of business on August 1, 2005. All share and per share amounts in this document have been adjusted to reflect the retroactive effect of the stock split.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in our April 30, 2005 Annual Report to Shareholders on Form 10-K/A.

Operating revenues of the Tax Services and Business Services segments are seasonal in nature with peak revenues occurring in the months of January through April. Therefore, results for interim periods are not indicative of results to be expected for the full year.

We file our federal and state income tax returns on a calendar year basis. The condensed consolidated income statements reflect the effective tax rates expected to be applicable for the respective full fiscal years.

**2. Restatements of Previously Issued Financial Statements**

(A) On February 22, 2006, management and the Audit Committee of the Board of Directors concluded to restate previously issued consolidated financial statements for the fiscal quarters ended October 31, 2005 and July 31, 2005, the fiscal years ended April 30, 2005 and 2004 and the related fiscal quarters. We arrived at this conclusion during the course of our closing process for the quarter ended January 31, 2006. This restatement pertains primarily to errors in determining the Company's state effective income tax rate, including errors in identifying changes in state apportionment, expiring state net operating losses and related factors. These errors resulted in an understatement of income tax benefit (net of federal income tax benefit) of \$0.3 million and \$0.8 million for the three months ended July 31, 2005 and 2004, respectively, an overstatement of deferred income tax assets of \$1.2 million as of July 31, 2005 and April 30, 2005, and an understatement of accrued income taxes of \$25.5 million and \$25.9 million as of July 31, 2005 and April 30, 2005, respectively. The effect of the above adjustments on the condensed consolidated financial statements is set forth in 2C below.

(B) On June 7, 2005, management and the Audit Committee of the Board of Directors determined that restatement of our previously issued consolidated financial statements, including financial statements for the three months ended July 31, 2004 was appropriate as a result of the errors noted below. All amounts listed are pretax, unless otherwise noted.

§ An error in calculating the gain on sale of residual interests in fiscal year 2003. This error was corrected by deferring a portion of the gain on sale of residual interests as of the transaction date in fiscal year 2003 and recognizing revenue from the sale as interest income from accretion of residual interests in subsequent periods. Interest income from accretion increased \$3.0 million for the three months ended July 31, 2004.

This correction also decreased impairments of residual

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interests \$0.8 million and increased comprehensive income \$2.4 million for the three months ended July 31, 2004.

- § An error in the calculation of an incentive compensation accrual at our Mortgage Services segment as of April 30, 2004. This error resulted in an overstatement of compensation expense for the three months ended July 31, 2004 of \$12.1 million.
- § An error in accounting for leased properties related to rent holidays and mandatory rent escalation in our Tax Services, Mortgage Services and Investment Services segments. Rent expense was understated for the three months ended July 31, 2004 by \$0.2 million.
- § An error from the capitalization of certain branch office costs at our Investment Services segment, which should have been expensed as incurred. This error resulted in an understatement of occupancy expenses and an overstatement of depreciation expense and capital expenditures, resulting in a net understatement of operating expenses of \$0.1 million for the three months ended July 31, 2004.
- § Errors related to accounting for acquisitions at our Business Services and Investment Services segments, the largest of which was the acquisition of OLDE in fiscal year 2000. Amortization of customer relationships was understated by \$1.8 million and the provision for income taxes was overstated by approximately \$3.7 million for the three months ended July 31, 2004.

The effect of the above adjustments on the condensed consolidated financial statements is set forth in 2C below.

(C) Notes 4, 5, 7, 11, and 13 have been restated to reflect the above described adjustments.

The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated balance sheet as of July 31, 2005:

|  | (in 000s, except per share amounts)         |                               |            |
|--|---|-------------------------------|------------|
|  | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | Restated   |
| Other assets                               | \$ 279,756                                  | \$ (1,227)                    | \$ 278,529 |
| Total assets                               | 5,017,181                                   | (1,227)                       | 5,015,954  |
| Accrued income taxes                       | 346,568                                     | 25,546                        | 372,114    |
| Total current liabilities                  | 1,903,013                                   | 25,546                        | 1,928,559  |
| Total liabilities                          | 3,194,186                                   | 25,546                        | 3,219,732  |
| Retained earnings                          | 3,123,924                                   | (26,773)                      | 3,097,151  |
| Total stockholders' equity                 | 1,822,995                                   | (26,773)                      | 1,796,222  |
| Total liabilities and stockholders' equity | 5,017,181                                   | (1,227)                       | 5,015,954  |

<sup>(1)</sup> As reported in our Form 10-Q filed on September 8, 2005 for the three months ended July 31,

2005.

- (2) Adjusted to reflect the restatement described in 2A above.

The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated statement of income and comprehensive income for the three months ended July 31, 2005:

|                                  | As<br>Previously<br>Reported<br>(1) | Adjustments<br>(2) | Restated    |
|----------------------------------|-------------------------------------|--------------------|-------------|
| Income tax benefit               | \$ (17,545)                         | \$ (330)           | \$ (17,875) |
| Net loss                         | (28,324)                            | 330                | (27,994)    |
| Basic and diluted loss per share | \$ (0.09)                           | \$ 0.01            | \$ (0.08)   |
| Comprehensive income (loss)      | \$ (33,311)                         | \$ 330             | \$ (32,981) |

- (1) As reported in our Form 10-Q filed on September 8, 2005 for the three months ended July 31, 2005.

- (2) Adjusted to reflect the restatement described in 2A above.

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The following is a summary of the impact of the restatements on our condensed consolidated statement of income and comprehensive income for the three months ended July 31, 2004:

|   | As<br>Previously<br>Reported<br>(1) | Adjustments<br>(2) | As<br>Previously<br>Restated (3) | Adjustments<br>(4) | Restated   |
|---|-------------------------------------|--------------------|----------------------------------|--------------------|------------|
| Gain on sale of mortgage assets, net                    | \$ 182,534                          | \$ 826             | \$ 183,360                       | \$                 | \$ 183,360 |
| Interest income   | 36,706                              | 3,014              | 39,720                           |                    | 39,720     |
| Total revenues  | 482,711                             | 3,840              | 486,551                          |                    | 486,551    |
| Total operating expenses                                | 539,490                             | (9,924)            | 529,566                          |                    | 529,566    |
| Operating loss  | (56,779)                            | 13,764             | (43,015)                         |                    | (43,015)   |
| Loss before taxes                                       | (72,564)                            | 13,764             | (58,800)                         |                    | (58,800)   |
| Income tax benefit                                      | (28,481)                            | 6,423              | (22,058)                         | (788)              | (22,846)   |
| Net loss  | (44,083)                            | 7,341              | (36,742)                         | 788                | (35,954)   |
| Basic and diluted loss per share                        | \$ (.13)                            | \$ 0.02            | \$ (.11)                         | \$                 | \$ (.11)   |
| Change in unrealized gain on marketable securities, net | \$ 23,843                           | \$ (2,373)         | \$ 21,470                        | \$                 | \$ 21,470  |
| Comprehensive income (loss)                             | (20,570)                            | 4,968              | (15,602)                         | 788                | (14,814)   |

(1) As reported in our Form 10-Q filed on September 8, 2004 for the three months ended July 31, 2004. Amounts have been reclassified to conform to current year presentation. See discussion of reclassifications in note 1.

(2) Adjusted to reflect the restatement described in 2B above, as derived from the Company's Form 10-K/A filed on

August 5, 2005  
for the fiscal  
year ended  
April 30, 2005.

(3) As reported in  
our Form 10-Q  
filed on  
September 8,  
2005 for the  
three months  
ended July 31,  
2005.

(4) Adjusted to  
reflect the  
restatement  
described in 2A  
above.

The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated statement of cash flows for the three months ended July 31, 2005:

|                            | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | Restated    |
|----------------------------|---|-------------------------------|-------------|
| Net loss                   | \$ (28,324)                                 | \$ 330                        | \$ (27,994) |
| Other, net of acquisitions | (255,017)                                   | (330)                         | (255,347)   |

(1) As reported in  
our Form 10-Q  
filed on  
September 8,  
2005 for the  
three months  
ended July 31,  
2005.

(2) Adjusted to  
reflect the  
restatement  
described in 2A  
above.

The following is a summary of the impact of the restatements on our condensed consolidated statement of cash flows for the three months ended July 31, 2004:

(in 000s)

| As<br>Previously | As<br>Previously |
|------------------|------------------|
|------------------|------------------|

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| Three months ended July 31, 2004                    | Reported<br>(1) | Adjustments<br>(2) | Restated (3) | Adjustments<br>(4) | Restated    |
|---|-----------------|--------------------|--------------|--------------------|-------------|
| Net loss  | \$ (44,083)     | \$ 7,341           | \$ (36,742)  | \$ 788             | \$ (35,954) |
| Depreciation and amortization                       | 37,137          | 1,771              | 38,908       |                    | 38,908      |
| Accretion of residual interests in securitizations  | (25,663)        | (3,014)            | (28,677)     |                    | (28,677)    |
| Impairment of residual interests in securitizations | 3,435           | (826)              | 2,609        |                    | 2,609       |
| Other, net of acquisitions                          | (474,367)       | (5,471)            | (479,838)    | (788)              | (480,626)   |
| Net cash provided by operating activities           | (515,133)       | (199)              | (515,332)    |                    | (515,332)   |
| Purchases of property and equipment, net            | (22,913)        | 199                | (22,714)     |                    | (22,714)    |
| Net cash provided by (used in) investing activities | 23,407          | 199                | 23,606       |                    | 23,606      |

(1) As reported in our Form 10-Q filed on September 8, 2004 for the three months ended July 31, 2004. Amounts have been reclassified to conform to current year presentation. See discussion of reclassifications in note 1.

(2) Adjusted to reflect the restatement described in 2B above, as derived from the Company's Form 10-K/A filed on August 5, 2005 for the fiscal year ended April 30, 2005.

(3) As reported in our Form 10-Q filed on



September 8,  
2005 for the  
three months  
ended July 31,  
2005.

- (4) Adjusted to  
reflect the  
restatement  
described in 2A  
above.

The restatements had no impact on our cash flows from financing activities as previously reported.

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**Table of Contents****3. Earnings (Loss) Per Share**

Basic earnings (loss) per share is computed using the weighted average shares outstanding during each period. The dilutive effect of potential common shares is included in diluted earnings (loss) per share except in those periods with a loss. Diluted earnings per share excludes the impact of shares of common stock issuable upon the lapse of certain restrictions or the exercise of options to purchase 33.7 million shares and 37.0 million shares of stock for the three months ended July 31, 2005 and 2004, respectively, as the effect would be antidilutive due to the net loss recorded during the periods.

The weighted average shares outstanding for the three months ended July 31, 2005 decreased to 330.7 million from 337.3 million last year, primarily due to our purchases of treasury shares. The effect of these purchases was partially offset by the issuance of treasury shares related to our stock-based compensation plans.

During the three months ended July 31, 2005 and 2004, we issued 2.5 million shares and 1.2 million shares, respectively, of common stock pursuant to the exercise of stock options, employee stock purchases and awards of restricted shares, in accordance with our stock-based compensation plans.

During the three months ended July 31, 2005, we acquired 4.6 million shares of our common stock, of which 4.4 million shares were purchased from third parties with the remaining shares swapped or surrendered to us, at an aggregate cost of \$131.6 million. During the three months ended July 31, 2004, we acquired 14.9 million shares of our common stock, of which 14.8 million shares were purchased from third parties with the remaining shares swapped or surrendered to us, at an aggregate cost of \$347.4 million.

**4. Mortgage Banking Activities**

Activity related to available-for-sale residual interests in securitizations consists of the following:

| Three months ended July 31,                           | 2005       | (in 000s)<br>Restated<br>2004 |
|---|------------|-------------------------------|
| Balance, beginning of period                          | \$ 205,936 | \$ 210,973                    |
| Additions from net interest margin (NIM) transactions | 2,109      |                               |
| Cash received   | (24,031)   | (38,826)                      |
| Accretion   | 30,777     | 28,677                        |
| Impairments of fair value                             | (11,875)   | (2,609)                       |
| Other   | (330)      |                               |
| Changes in unrealized holding gains, net              | (9,379)    | 35,067                        |
| Balance, end of period                                | \$ 193,207 | \$ 233,282                    |

We sold \$10.8 billion and \$6.7 billion of mortgage loans in whole loan sales to warehouse trusts (Trusts) or other buyers during the three months ended July 31, 2005 and 2004, respectively, with gains totaling \$222.8 million and \$185.3 million, respectively, recorded on these sales.

Trading residual interests valued at \$101.0 million were recorded in connection with the securitizations of mortgage loans during the three months ended July 31, 2005, with net cash proceeds of \$40.4 million received in connection with NIM transactions. Total net additions to residual interests from net interest margin (NIM) transactions for the three months ended July 31, 2005 were \$2.1 million. We did not complete any securitizations or NIM transactions during the three months ended July 31, 2004.

At July 31, 2005, we had \$58.0 million in residual interests classified as trading securities. These residual interests are the result of the initial securitization of mortgage loans and are expected to be securitized in a NIM transaction during our second quarter. Trading residuals are included in marketable securities trading on the condensed consolidated balance sheet with mark-to-market adjustments and impairments included in gains on sales of mortgage

assets on the condensed consolidated income statement. Such adjustments resulted in a gain of \$3.5 million for the three months ended July 31, 2005. There were no such trading securities recorded as of April 30, 2005.

Cash flows of \$24.0 million and \$38.8 million were received from the securitization trusts for the three months ended July 31, 2005 and 2004, respectively. Cash received on residual interests is included in investing activities in the condensed consolidated statements of cash flows.

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Aggregate net unrealized gains on residual interests, which had not yet been accreted into income, totaled \$105.9 million at July 31, 2005 and \$115.4 million at April 30, 2005. These unrealized gains are recorded net of deferred taxes in other comprehensive income, and may be recognized in income in future periods either through accretion or upon further securitization or sale of the related residual interest.

Activity related to mortgage servicing rights (MSRs) consists of the following:

| Three months ended July 31,  | 2005       | (in 000s)<br>2004 |
|------------------------------|------------|-------------------|
| Balance, beginning of period | \$ 166,614 | \$ 113,821        |
| Additions                    | 49,306     | 28,493            |
| Amortization                 | (26,892)   | (18,334)          |
| Impairment                   | (320)      |                   |
| Balance, end of period       | \$ 188,708 | \$ 123,980        |

Estimated amortization of MSRs for fiscal years 2006 through 2010 is \$80.2 million, \$67.6 million, \$29.1 million, \$9.4 million and \$2.2 million, respectively.

The key weighted average assumptions we used to estimate the cash flows and values of the residual interests initially recorded during the three months ended July 31, 2005 are as follows:

| Three months ended  | July 31, 2005                  |
|---|--------------------------------|
| Estimated credit losses                                     | 2.70%                          |
| Discount rate   | 21.57%                         |
| Variable returns to third-party beneficial interest holders | LIBOR forward curve at closing |

The key weighted average assumptions we used to estimate the cash flows and values of the residual interests and MSRs at July 31, 2005 and April 30, 2005 are as follows:

|   | July 31,<br>2005                      | April 30,<br>2005 |
|---|---------------------------------------|-------------------|
| Estimated credit losses residual interests                  | 2.98%                                 | 3.03%             |
| Discount rate residual interests                            | 19.31%                                | 21.01%            |
| Discount rate MSRs  | 15.00%                                | 12.80%            |
| Variable returns to third-party beneficial interest holders | LIBOR forward curve at valuation date |                   |

We originate both adjustable and fixed rate mortgage loans. A key assumption used to estimate the cash flows and values of the residual interests is average annualized prepayment speeds. Prepayment speeds include voluntary prepayments, involuntary prepayments and scheduled principal payments. Prepayment rate assumptions are as follows:

| Prior to<br>Penalty<br>Expiration | Months Outstanding Without<br>Prepayment Penalty<br>Zero -<br>3 | Remaining<br>Life |
|-----------------------------------|---|-------------------|
|-----------------------------------|---|-------------------|

Adjustable rate mortgage loans:

|                              |     |     |     |
|------------------------------|-----|-----|-----|
| With prepayment penalties    | 30% | 70% | 43% |
| Without prepayment penalties | 36% | 53% | 41% |
| Fixed rate mortgage loans:   |     |     |     |
| With prepayment penalties    | 29% | 47% | 40% |

For fixed rate mortgages without prepayment penalties, we use an average prepayment rate of 35% over the life of the loans. Prepayment rate is projected based on actual paydown including voluntary, involuntary and scheduled principal payments.

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Expected static pool credit losses are as follows:

|                | Mortgage Loans Securitized in Fiscal Year |       |       |       |       |       |
|----------------|---|-------|-------|-------|-------|-------|
|                | Prior to<br>2002                          | 2002  | 2003  | 2004  | 2005  | 2006  |
| As of:         |   |       |       |       |       |       |
| July 31, 2005  | 4.53%                                     | 2.53% | 2.03% | 2.20% | 2.86% | 2.70% |
| April 30, 2005 | 4.52%                                     | 2.53% | 2.08% | 2.30% | 2.83% |       |
| April 30, 2004 | 4.46%                                     | 3.58% | 4.35% | 3.92% |       |       |

Static pool credit losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets.

At July 31, 2005, the sensitivities of the current fair value of the residual interests and MSRs to 10% and 20% adverse changes in the above key assumptions are as follows:

|  | Residential Mortgage Loans |                                     |                     |                    | (dollars in 000s) |
|--|----------------------------|-------------------------------------|---------------------|--------------------|-------------------|
|  | NIM<br>Residuals           | Beneficial<br>Interest<br>in Trusts | Trading<br>Residual | Servicing<br>Asset |                   |
| Carrying amount/fair value                     | \$ 193,207                 | \$ 185,539                          | \$ 57,982           | \$ 188,708         |                   |
| Weighted average remaining life (in years)     | 1.3                        | 2.3                                 | 2.0                 | 1.2                |                   |
| Prepayments (including defaults):              |                            |                                     |                     |                    |                   |
| Adverse 10% \$ impact on fair value            | \$ 458                     | \$ (9,933)                          | \$ (2,407)          | \$ (26,926)        |                   |
| Adverse 20% \$ impact on fair value            | 13,807                     | (15,078)                            | 2,540               | (44,709)           |                   |
| Credit losses:                                 |                            |                                     |                     |                    |                   |
| Adverse 10% \$ impact on fair value            | \$ (36,108)                | \$ (7,360)                          | \$ (1,743)          | Not applicable     |                   |
| Adverse 20% \$ impact on fair value            | (64,062)                   | (14,540)                            | (3,435)             | Not applicable     |                   |
| Discount rate:                                 |                            |                                     |                     |                    |                   |
| Adverse 10% \$ impact on fair value            | \$ (4,490)                 | \$ (4,629)                          | \$ (1,473)          | \$ (2,634)         |                   |
| Adverse 20% \$ impact on fair value            | (8,734)                    | (9,059)                             | (2,870)             | (5,205)            |                   |
| Variable interest rates (LIBOR forward curve): |                            |                                     |                     |                    |                   |
| Adverse 10% \$ impact on fair value            | \$ (11,240)                | \$ (40,538)                         | \$ (2,211)          | Not applicable     |                   |
| Adverse 20% \$ impact on fair value            | (23,873)                   | (81,169)                            | (4,962)             | Not applicable     |                   |

These sensitivities are hypothetical and should be used with caution. Changes in fair value based on a 10% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also in this table, the effect of a variation of a particular assumption on the fair value is calculated without changing any other assumptions. It is likely that changes in one factor may result in

changes in another, which might magnify or counteract the sensitivities.

Mortgage loans that have been securitized at July 31, 2005 and April 30, 2005, past due sixty days or more and the related credit losses incurred are presented below:

|                                       | (in 000s)   |                   |  |                   |  |                   |
|---------------------------------------|---|-------------------|--|-------------------|--|-------------------|
|                                       | Total Principal<br>Amount of Loans<br>Outstanding |                   | Principal Amount of<br>Loans 60 Days or<br>More Past Due |                   | Credit Losses<br>(net of recoveries)<br>Three months ended |                   |
|                                       | July 31,<br>2005                                  | April 30,<br>2005 | July 31,<br>2005   | April 30,<br>2005 | July 31,<br>2005   | April 30,<br>2005 |
| Securitized mortgage<br>loans         | \$ 11,140,672                                     | \$ 10,300,805     | \$ 1,058,989   | \$ 1,128,376      | \$ 23,545  | \$ 21,641         |
| Mortgage loans in<br>warehouse Trusts | 6,759,723   | 6,742,387         |  |                   |  |                   |
| Total loans                           | \$ 17,900,395                                     | \$ 17,043,192     | \$ 1,058,989   | \$ 1,128,376      | \$ 23,545  | \$ 21,641         |

**Table of Contents****5. Goodwill and Intangible Assets**

Changes in the carrying amount of goodwill for the three months ended July 31, 2005 consist of the following:

|                     | (in 000s)         |           |          |               |
|---------------------|-------------------|-----------|----------|---------------|
|                     | April 30,<br>2005 | Additions | Other    | July 31, 2005 |
| Tax Services        | \$ 360,781        | \$ 3,291  | \$ 38    | \$ 364,110    |
| Mortgage Services   | 152,467           |           |          | 152,467       |
| Business Services   | 328,745           | 81        | (725)    | 328,101       |
| Investment Services | 173,954           |           |          | 173,954       |
| Total goodwill      | \$ 1,015,947      | \$ 3,372  | \$ (687) | \$ 1,018,632  |

We test goodwill for impairment annually at the beginning of our fourth quarter, or more frequently if events occur indicating it is more likely than not the fair value of a reporting unit's net assets has been reduced below its carrying value. No such impairment or events indicating impairment were identified within any of our segments during the three months ended July 31, 2005. Our evaluation of impairment is dependent upon various assumptions, including assumptions regarding projected operating results and cash flows of reporting units. Actual results could differ materially from our projections and those differences could alter our conclusions regarding the fair value of a reporting unit and its goodwill.

Intangible assets consist of the following:

|                           | (in 000s)                   |                             |            |                             |                             |            |
|---------------------------|-----------------------------|-----------------------------|------------|-----------------------------|-----------------------------|------------|
|                           | July 31,<br>2005            |                             |            | April 30,<br>2005           |                             |            |
|                           | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net        | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net        |
| Tax Services:             |                             |                             |            |                             |                             |            |
| Customer relationships    | \$ 23,717                   | \$ (8,027)                  | \$ 15,690  | \$ 23,717                   | \$ (7,207)                  | \$ 16,510  |
| Noncompete agreements     | 17,677                      | (13,074)                    | 4,603      | 17,677                      | (11,608)                    | 6,069      |
| Business Services:        |                             |                             |            |                             |                             |            |
| Customer relationships    | 130,707                     | (71,179)                    | 59,528     | 130,585                     | (68,433)                    | 62,152     |
| Noncompete agreements     | 27,633                      | (11,876)                    | 15,757     | 27,796                      | (11,274)                    | 16,522     |
| Trade name amortizing     | 1,450                       | (1,013)                     | 437        | 1,450                       | (995)                       | 455        |
| Trade name non-amortizing | 55,637                      | (4,868)                     | 50,769     | 55,637                      | (4,868)                     | 50,769     |
| Investment Services:      |                             |                             |            |                             |                             |            |
| Customer relationships    | 293,000                     | (207,542)                   | 85,458     | 293,000                     | (198,385)                   | 94,615     |
| Total intangible assets   | \$ 549,821                  | \$ (317,579)                | \$ 232,242 | \$ 549,862                  | \$ (302,770)                | \$ 247,092 |

Amortization of intangible assets for the three months ended July 31, 2005 and 2004 was \$15.2 million and \$15.1 million, respectively. Estimated amortization of intangible assets for fiscal years 2006 through 2010 is



\$60.6 million, \$51.5 million, \$34.4 million, \$11.7 million and \$9.8 million, respectively.

## 6. Derivative Instruments

A summary of our derivative instruments as of July 31, 2005 and April 30, 2005, and gains or losses incurred during the three months ended July 31, 2005 and 2004 follows. We enter into derivative instruments to reduce risks relating to mortgage loans we originate and sell, and therefore all gains or losses are included in gains on sales of mortgage assets, net in the condensed consolidated income statements.

|                       | (in 000s)                    |            |                       |        |
|-----------------------|------------------------------|------------|-----------------------|--------|
|                       | Asset (Liability) Balance at | Balance at | Gain (Loss) in the    |        |
|                       | July 31,                     | April 30,  | Three                 |        |
|                       | 2005                         | 2005       | Months Ended July 31, |        |
|                       |                              |            | 2005                  | 2004   |
| Interest rate swaps   | \$ 19,661                    | \$ (1,325) | \$ 25,543             | \$     |
| Interest rate caps    |                              | 12,458     | 640                   |        |
| Rate-lock equivalents | (292)                        | 801        | (1,093)               | 1,484  |
| Prime short sales     | 790                          | (805)      | 996                   | (808)  |
|                       | \$ 20,159                    | \$ 11,129  | \$ 26,086             | \$ 676 |

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We generally use interest rate swaps and forward loan sale commitments to reduce interest rate risk associated with non-prime loans. We generally enter into interest rate swap arrangements related to existing loan applications with rate-lock commitments and for rate-lock commitments we expect to make in the next 30 days. Interest rate swaps represent an agreement to exchange interest rate payments, effectively converting our fixed financing costs into a floating rate. These contracts increase in value as rates rise and decrease in value as rates fall.

We generally enter into interest rate caps or swaps to mitigate interest rate risk associated with mortgage loans that will be securitized and residual interests that are classified as trading securities because they will be sold in a subsequent NIM transaction. These instruments enhance the marketability of the securitization and NIM transactions. An interest rate cap represents a right to receive cash if interest rates rise above a contractual strike rate, its value therefore increases as interest rates rise. The interest rate used in our interest rate caps is based on LIBOR.

We enter into forward loan commitments to sell our non-prime mortgage loans to manage interest rate risk. Forward loan sale commitments for non-prime loans are not considered derivative instruments and therefore cannot be recorded in our financial statements. The notional value and the contract value of the forward commitments at July 31, 2005 were \$3.9 billion. Most of our forward commitments give us the option to under- or over-deliver by five to ten percent.

We, in the normal course of business, enter into commitments with our customers to fund both non-prime and prime mortgage loans for specified periods of time at locked-in interest rates. These derivative instruments represent commitments to fund loans ( rate-lock equivalents ). The fair value of non-prime loan commitments is calculated using a binomial option model, however we do not initially record an asset for non-prime commitments to fund loans. The fair value of prime loan commitments is calculated based on the current market pricing of short sales of FNMA, FHLMC and GNMA mortgage-backed securities and the coupon rates of the eligible loans.

We sell short FNMA, FHLMC and GNMA mortgage-backed securities to reduce our risk related to our commitments to fund fixed-rate prime loans. The position on certain or all of the fixed-rate mortgage loans is closed approximately 10-15 days prior to standard Public Securities Association (PSA) settlement dates.

None of our derivative instruments qualify for hedge accounting treatment as of July 31, 2005 or April 30, 2005.

**7. Stock-Based Compensation**

Effective May 1, 2003, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), under the prospective transition method as described in Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Had compensation cost for all stock-based compensation plan grants been determined in accordance with the fair value accounting method prescribed under SFAS 123, our net loss and loss per share would have been as follows:

|  | (in 000s, except per share amounts) |                  |
|--|-------------------------------------|------------------|
|  | Restated<br>2005                    | Restated<br>2004 |
| Three months ended July 31,  |                                     |                  |
| Net loss as reported   | \$ (27,994)                         | \$ (35,954)      |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects                              | 5,765                               | 3,100            |
| Deduct: Total stock-based compensation expense determined under fair value method for all awards, net of related tax effects | (8,309)                             | (5,781)          |
| Pro forma net loss   | \$ (30,538)                         | \$ (38,635)      |
| Basic and diluted loss per share:  |                                     |                  |
| As reported  | \$ (0.08)                           | \$ (0.11)        |
| Pro forma  | (0.09)                              | (0.11)           |



**Table of Contents****8. Supplemental Cash Flow Information**

During the three months ended July 31, 2005, we paid \$35.3 million and \$13.8 million for income taxes and interest, respectively. During the three months ended July 31, 2004, we paid \$183.4 million and \$12.5 million for income taxes and interest, respectively.

The following transactions were treated as non-cash investing activities in the condensed consolidated statement of cash flows:

|                                  | (in 000s) |           |
|----------------------------------|-----------|-----------|
| Three months ended July 31,      | 2005      | 2004      |
| Residual interest mark-to-market | \$ 12,942 | \$ 53,473 |
| Additions to residual interests  | 2,109     |           |

**5. Commitments and Contingencies**

We maintain two unsecured committed lines of credit (CLOCs) for working capital, to support our commercial paper program and for general corporate purposes. The two CLOCs are from a consortium of thirty-one banks. The first \$1.0 billion CLOC is subject to annual renewal in August 2005, has a one-year term-out provision with a maturity date in August 2006. The second \$1.0 billion CLOC has a maturity date of August 2009. These lines are subject to various affirmative and negative covenants, including a minimum net worth covenant. These CLOCs were undrawn at July 31, 2005. Subsequent to July 31, 2005, the first CLOC expired and was replaced with a new \$1.0 billion CLOC, which expires in August 2010. Also subsequent to July 31, 2005, the second CLOC was extended, and now expires in August 2010.

We offer guarantees under our Peace of Mind (POM) program to tax clients whereby we will assume the cost of additional taxes attributable to tax return preparation errors for which we are responsible. We defer all revenues and direct costs associated with these guarantees, recognizing these amounts over the term of the guarantee based upon historic and actual payment of claims. Changes in the deferred revenue liability are as follows:

|  | (in 000s)  |            |
|--|------------|------------|
| Three months ended July 31,                | 2005       | 2004       |
| Balance, beginning of period               | \$ 130,762 | \$ 123,048 |
| Amounts deferred for new guarantees issued | 408        | 369        |
| Revenue recognized on previous deferrals   | (23,900)   | (22,613)   |
| Balance, end of period                     | \$ 107,270 | \$ 100,804 |

We have commitments to fund mortgage loans to customers as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments to fund loans amounted to \$4.7 billion and \$3.9 billion at July 31, 2005 and April 30, 2005, respectively. External market forces impact the probability of commitments being exercised, and therefore, total commitments outstanding do not necessarily represent future cash requirements.

We have entered into whole loan sale agreements with investors in the normal course of business, which include standard representations and warranties customary to the mortgage banking industry. Violations of these representations and warranties may require us to repurchase loans previously sold. A liability has been established related to the potential loss on repurchase of loans previously sold of \$41.8 million and \$41.2 million at July 31, 2005 and April 30, 2005, respectively, based on historical experience. Repurchased loans are normally sold in subsequent

sale transactions.

Option One Mortgage Corporation provides a guarantee up to a maximum amount equal to approximately 10% of the aggregate principal balance of mortgage loans held by the Trusts before ultimate disposition of the loans. This guarantee would be called upon in the event adequate proceeds were not available from the sale of the mortgage loans to satisfy the payment obligations of the Trusts. No losses have been sustained on this commitment since its inception. The total principal amount of Trust obligations outstanding as of July 31, 2005 and April 30, 2005 was \$6.7 billion. The fair value of mortgage loans held by the Trusts as of July 31, 2005 and April 30, 2005 was \$6.9 billion and \$6.8 billion, respectively.

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We have various contingent purchase price obligations in connection with prior acquisitions. In many cases, contingent payments to be made in connection with these acquisitions are not subject to a stated limit. We estimate the potential payments (undiscounted) total approximately \$5.9 million and \$5.1 million as of July 31, 2005 and April 30, 2005, respectively. Our estimate is based on current financial conditions. Should actual results differ materially from our assumptions, the potential payments will differ from the above estimate. Such payments, if and when paid, would be recorded as additional cost of the acquired business, generally goodwill.

We have contractual commitments to fund certain franchises requesting draws on Franchise Equity Lines of Credit (FELCs). Our commitment to fund FELCs as of July 31, 2005 and April 30, 2005 totaled \$71.6 million and \$68.9 million, respectively. We have a receivable of \$40.7 million and \$39.0 million, which represents the amounts drawn on the FELCs, as of July 31, 2005 and April 30, 2005, respectively.

We routinely enter into contracts that include embedded indemnifications that have characteristics similar to guarantees, including obligations to protect counter parties from losses arising from the following: (a) tax, legal and other risks related to the purchase or disposition of businesses; (b) penalties and interest assessed by Federal and state taxing authorities in connection with tax returns prepared for clients; (c) indemnification of our directors and officers; and (d) third-party claims relating to various arrangements in the normal course of business. Typically, there is no stated maximum payment related to these indemnifications, and the term of indemnities may vary and in many cases is limited only by the applicable statute of limitations. The likelihood of any claims being asserted against us and the ultimate liability related to any such claims, if any, is difficult to predict. While we cannot provide assurance that such claims will not be successfully asserted, we believe the fair value of these guarantees and indemnifications is not material as of July 31, 2005.

**10. Litigation Commitments and Contingencies**

We have been involved in a number of class actions and putative class action cases since 1990 regarding our RAL programs. These cases are based on a variety of legal theories and allegations. These theories and allegations include, among others, that (i) we improperly did not disclose license fees we received from RAL lending banks for RALs they make to our clients, (ii) we owe and breached a fiduciary duty to our clients and (iii) the RAL program violates laws such as state credit service organization laws and the federal Racketeer Influenced and Corrupt Organizations (RICO) Act. Although we have successfully defended many RAL cases, we incurred a pretax expense of \$43.5 million in fiscal year 2003 in connection with settling one RAL case. Several of the RAL cases are still pending and the amounts claimed in some of them are very substantial. The ultimate cost of this litigation could be substantial. We intend to continue defending the RAL cases vigorously, although there are no assurances as to their outcome.

As discussed in our Form 8-K dated May 9, 2005, we initially recorded litigation reserves of approximately \$38.0 million, after taxes, in connection with a proposed settlement of *Lynne A. Carnegie, et al. v. Household International, Inc., H&R Block, Inc., et al.*, (formerly Joel E. Zawikowski, et al. v. Beneficial National Bank, H&R Block, Inc., Block Financial Corporation, et al.). In negotiating the proposed settlement and in determining the amount of consideration we were willing to pay under the proposed settlement, we ascribed significant value to the expanded class of plaintiffs to be covered by the proposed settlement and settlement terms that reduced the likelihood of future claims being made against us regarding our RAL programs. As a result of the May 26, 2005 court ruling to deny the settlement offer, we reversed our legal reserves to amounts representing our assessment of our probable loss.

We are also parties to claims and lawsuits pertaining to our electronic tax return filing services and our POM guarantee program associated with income tax preparation services. These claims and lawsuits include actions by individual plaintiffs, as well as cases in which plaintiffs seek to represent a class of similarly situated customers. The amounts claimed in these claims and lawsuits are substantial in some instances, and the ultimate liability with respect to such litigation and claims is difficult to predict. We intend to continue defending these cases vigorously, although there are not assurances as to their outcome.

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In addition to the aforementioned types of cases, we are parties to claims and lawsuits that we consider to be ordinary, routine disputes incidental to our business (Other Claims and Lawsuits), including claims and lawsuits concerning the preparation of customers' income tax returns, the fees charged customers for various services, investment products, relationships with franchisees, contract disputes and civil actions, arbitrations, regulatory inquiries and class actions arising out of our business as a broker-dealer and as a servicer of mortgage loans. We believe we have meritorious defenses to each of the Other Claims and Lawsuits and are defending them vigorously. Although we cannot provide assurance we will ultimately prevail in each instance, we believe that amounts, if any, required to be paid in the discharge of liabilities or settlements pertaining to Other Claims and Lawsuits will not have a material adverse effect on our consolidated financial statements. Regardless of outcome, claims and litigation can adversely affect us due to defense costs, diversion of management, attention and time, and publicity related to such matters.

It is our policy to accrue for amounts related to legal matters if it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Many of the various legal proceedings are covered in whole or in part by insurance. Any receivable for insurance recoveries is recorded separately from the corresponding litigation reserve, and only if recovery is determined to be probable. Receivables for insurance recoveries at July 31, 2005 were immaterial.

**11. Segment Information**

Information concerning our operations by reportable operating segment is as follows:

|                             |              | (in 000s)    |
|-----------------------------|--------------|--------------|
|                             |              | Restated     |
| Three months ended July 31, | 2005         | 2004         |
| Revenues:                   |              |              |
| Tax Services                | \$ 57,191    | \$ 50,447    |
| Mortgage Services           | 360,438      | 271,973      |
| Business Services           | 126,846      | 109,102      |
| Investment Services         | 67,983       | 53,581       |
| Corporate                   | 2,535        | 1,448        |
|                             | \$ 614,993   | \$ 486,551   |
| Pretax income (loss):       |              |              |
| Tax Services                | \$ (144,506) | \$ (112,646) |
| Mortgage Services           | 134,468      | 109,025      |
| Business Services           | (6,765)      | (10,045)     |
| Investment Services         | (7,552)      | (20,343)     |
| Corporate                   | (21,514)     | (24,791)     |
| Loss before taxes           | \$ (45,869)  | \$ (58,800)  |

**12. New Accounting Pronouncements**

Exposure Drafts Amendments of SFAS 140

In August 2005, the Financial Accounting Standards Board (FASB) issued three exposure drafts which amend Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial

Assets and Extinguishments of Liabilities. The final standards are scheduled to be issued in the first quarter of calendar year 2006.

The first exposure draft seeks to clarify the derecognition requirements for financial assets and the initial measurement of interests related to transferred financial assets that are held by a transferor. Our current off-balance sheet warehouse facilities (the Trusts) in our Mortgage Services segment would be required to be consolidated in our financial statements based on the provisions of the exposure draft. We will continue to monitor the status of the exposure draft and consider what changes, if any, could be made to the structure of the Trusts to continue to derecognize mortgage loans transferred to the Trusts. At July 31, 2005, the Trusts held loans totaling \$6.7 billion, which we would be required to consolidate into our financial statements under the provisions of this exposure draft.

The second exposure draft would require mortgage servicing rights to be initially valued at fair value. This provision would not have a material impact to our financial statements. In addition, this



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exposure draft would permit us to choose to continue to amortize mortgage servicing rights in proportion to and over the period of estimated net servicing income, as currently required under SFAS 140, or report mortgage servicing rights at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur. We have not yet determined how we would elect to account for mortgage servicing rights under this provision or the potential impact to the financial statements.

The third exposure draft, among other things, would establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are free-standing derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. Alternatively, this exposure draft would permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Our residual interests in securitizations typically have interests in derivative instruments embedded within the securitization trusts. We have not yet determined if these embedded derivatives meet the criteria for bifurcation as outlined in the exposure draft.

**American Jobs Creation Act**

In October 2004, the American Jobs Creation Act (the Act) was signed into law. The Act introduces a one-time deduction for dividends received from the repatriation of certain foreign earnings, provided certain criteria are met. We have begun our evaluation of the effects of the Act, but do not expect to be able to complete this evaluation until additional clarifying language on key elements of the Act is issued. As of July 31, 2005, we have not provided deferred taxes on foreign earnings because we intended to indefinitely reinvest such earnings outside the United States. Whether we will ultimately take advantage of this provision depends on our review of the Act and any additional guidance provided and we are therefore currently uncertain as to the impact, if any, this matter will have on our consolidated financial statements, and are unable to estimate the amount of earnings we may repatriate.

**13. Condensed Consolidating Financial Statements**

Block Financial Corporation (BFC) is an indirect, wholly owned consolidated subsidiary of the Company. BFC is the Issuer and the Company is the Guarantor of the Senior Notes issued on October 21, 1997, April 13, 2000 and October 26, 2004. These condensed consolidating financial statements have been prepared using the equity method of accounting. Earnings of subsidiaries are, therefore, reflected in the Company's investment in subsidiaries account. The elimination entries eliminate investments in subsidiaries, related stockholder's equity and other intercompany balances and transactions.

*Condensed Consolidating Income Statements*

|                                     |                    |            |              |            | (in 000s)                    |
|-------------------------------------|--------------------|------------|--------------|------------|------------------------------|
| Three months ended                  | H&R Block,<br>Inc. | BFC        | Other        |            | Consolidated<br>H&R<br>Block |
| July 31, 2005 (Restated)            | (Guarantor)        | (Issuer)   | Subsidiaries | Elims      |                              |
| Total revenues                      | \$                 | \$ 460,640 | \$ 157,665   | \$ (3,312) | \$ 614,993                   |
| Cost of service revenues            |                    | 109,353    | 233,776      | 89         | 343,218                      |
| Cost of other revenues              |                    | 120,900    | 2,457        |            | 123,357                      |
| Selling, general and administrative |                    | 91,188     | 101,465      | (3,401)    | 189,252                      |
| Total expenses                      |                    | 321,441    | 337,698      | (3,312)    | 655,827                      |
| Operating income (loss)             |                    | 139,199    | (180,033)    |            | (40,834)                     |
| Interest expense                    |                    | 11,810     | 625          |            | 12,435                       |
| Other income, net                   | (45,869)           |            | 7,400        | 45,869     | 7,400                        |

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|                            |             |           |              |           |             |
|----------------------------|-------------|-----------|--------------|-----------|-------------|
| Income (loss) before taxes | (45,869)    | 127,389   | (173,258)    | 45,869    | (45,869)    |
| Income taxes (benefit)     | (17,875)    | 49,682    | (67,557)     | 17,875    | (17,875)    |
| Net income (loss)          | \$ (27,994) | \$ 77,707 | \$ (105,701) | \$ 27,994 | \$ (27,994) |

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| Three months ended                  | H&R Block, Inc. | BFC        | Other        |            | Consolidated |
|-------------------------------------|-----------------|------------|--------------|------------|--------------|
| July 31, 2004 (Restated)            | (Guarantor)     | (Issuer)   | Subsidiaries | Elims      | H&R Block    |
| Total revenues                      | \$              | \$ 328,603 | \$ 161,215   | \$ (3,267) | \$ 486,551   |
| Cost of services                    |                 | 93,265     | 197,664      | 46         | 290,975      |
| Cost of other revenues              |                 | 76,981     | 1,414        |            | 78,395       |
| Selling, general and administrative |                 | 72,188     | 91,321       | (3,313)    | 160,196      |
| Total expenses                      |                 | 242,434    | 290,399      | (3,267)    | 529,566      |
| Operating income (loss)             |                 | 86,169     | (129,184)    |            | (43,015)     |
| Interest expense                    |                 | 16,802     | 991          |            | 17,793       |
| Other income, net                   | (58,800)        |            | 2,008        | 58,800     | 2,008        |
| Income (loss) before taxes          | (58,800)        | 69,367     | (128,167)    | 58,800     | (58,800)     |
| Income taxes (benefit)              | (22,846)        | 27,088     | (49,934)     | 22,846     | (22,846)     |
| Net income (loss)                   | \$ (35,954)     | \$ 42,279  | \$ (78,233)  | \$ 35,954  | \$ (35,954)  |

*Condensed Consolidating Balance Sheets*

|  | H&R Block, Inc. | BFC          | Other        |                | (in 000s)<br>Consolidated |
|--|-----------------|--------------|--------------|----------------|---------------------------|
| July 31, 2005 (Restated)                             | (Guarantor)     | (Issuer)     | Subsidiaries | Elims          | H&R Block                 |
| Cash & cash equivalents                              | \$              | \$ 148,287   | \$ 484,514   | \$             | \$ 632,801                |
| Cash & cash equivalents restricted                   |                 | 403,171      | 13,810       |                | 416,981                   |
| Receivables from customers, brokers and dealers, net |                 | 585,214      |              |                | 585,214                   |
| Receivables, net                                     | 176             | 248,677      | 155,648      |                | 404,501                   |
| Intangible assets and goodwill, net                  |                 | 414,838      | 836,036      |                | 1,250,874                 |
| Investments in subsidiaries                          | 4,814,169       | 215          | 506          | (4,814,169)    | 721                       |
| Other assets   |                 | 1,458,040    | 266,660      | 162            | 1,724,862                 |
| Total assets   | \$ 4,814,345    | \$ 3,258,442 | \$ 1,757,174 | \$ (4,814,007) | \$ 5,015,954              |
| Accts. payable to customers, brokers and dealers     | \$              | \$ 871,715   | \$           | \$             | \$ 871,715                |
| Long-term debt                                       |                 | 896,799      | 26,346       |                | 923,145                   |
| Other liabilities                                    | 2               | 525,312      | 899,558      |                | 1,424,872                 |
| Net intercompany advances                            | 3,018,121       | (639,321)    | (2,378,714)  | (86)           |                           |
| Stockholders equity                                  | 1,796,222       | 1,603,937    | 3,209,984    | (4,813,921)    | 1,796,222                 |

|   |    |           |              |              |                |              |
|---|----|-----------|--------------|--------------|----------------|--------------|
| Total liabilities and stockholders equity | \$ | 4,814,345 | \$ 3,258,442 | \$ 1,757,174 | \$ (4,814,007) | \$ 5,015,954 |
|---|----|-----------|--------------|--------------|----------------|--------------|

| April 30, 2005 (Restated)                            | H&R Block, Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims        | Consolidated<br>H&R Block |              |
|--|--------------------------------|-----------------|-----------------------|--------------|---------------------------|--------------|
| Cash & cash equivalents                              | \$                             | \$ 162,983      | \$ 937,230            | \$           | \$ 1,100,213              |              |
| Cash & cash equivalents restricted                   |                                | 488,761         | 28,148                |              | 516,909                   |              |
| Receivables from customers, brokers and dealers, net |                                | 590,226         |                       |              | 590,226                   |              |
| Receivables, net                                     | 101                            | 199,990         | 218,697               |              | 418,788                   |              |
| Intangible assets and goodwill, net                  |                                | 421,036         | 842,003               |              | 1,263,039                 |              |
| Investments in subsidiaries                          | 4,851,680                      | 210             | 449                   | (4,851,680)  | 659                       |              |
| Other assets   |                                | 1,407,082       | 241,532               | (392)        | 1,648,222                 |              |
| Total assets   | \$                             | 4,851,781       | \$ 3,270,288          | \$ 2,268,059 | \$ (4,852,072)            | \$ 5,538,056 |
| Accts. payable to customers, brokers and dealers     | \$                             | \$ 950,684      | \$                    | \$           | \$ 950,684                |              |
| Long-term debt                                       |                                | 896,591         | 26,482                |              | 923,073                   |              |
| Other liabilities                                    | 2                              | 532,562         | 1,182,459             | 8            | 1,715,031                 |              |
| Net intercompany advances                            | 2,902,511                      | (641,611)       | (2,262,818)           | 1,918        |                           |              |
| Stockholders equity                                  | 1,949,268                      | 1,532,062       | 3,321,936             | (4,853,998)  | 1,949,268                 |              |
| Total liabilities and stockholders equity            | \$                             | 4,851,781       | \$ 3,270,288          | \$ 2,268,059 | \$ (4,852,072)            | \$ 5,538,056 |

**Table of Contents***Condensed Consolidating  
Statements of Cash Flows*

(in 000s)

| Three months ended<br>July 31, 2005 (Restated)          | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims     | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|-----------|---------------------------|
| Net cash provided by (used in)<br>operating activities: | \$ 15,721                         | \$ (51,974)     | \$ (274,262)          | \$        | \$ (310,515)              |
| Cash flows from investing:                              |                                   |                 |                       |           |                           |
| Cash received on residuals                              |                                   | 24,031          |                       |           | 24,031                    |
| Purchase property & equipment                           |                                   | (9,255)         | (21,075)              |           | (30,330)                  |
| Payments for business acquisitions                      |                                   | (2,994)         | (458)                 |           | (3,452)                   |
| Net intercompany advances                               | 120,140                           |                 |                       | (120,140) |                           |
| Other, net  |                                   | 330             | 7,605                 |           | 7,935                     |
| Net cash provided by (used in)<br>investing activities  | 120,140                           | 12,112          | (13,928)              | (120,140) | (1,816)                   |
| Cash flows from financing:                              |                                   |                 |                       |           |                           |
| Dividends paid  | (36,537)                          |                 |                       |           | (36,537)                  |
| Acquisition of treasury shares                          | (131,642)                         |                 |                       |           | (131,642)                 |
| Proceeds from common stock                              | 32,318                            |                 |                       |           | 32,318                    |
| Net intercompany advances                               |                                   | 14,587          | (134,727)             | 120,140   |                           |
| Other, net  |                                   | 10,579          | (29,799)              |           | (19,220)                  |
| Net cash provided by (used in)<br>financing activities  | (135,861)                         | 25,166          | (164,526)             | 120,140   | (155,081)                 |
| Net decrease in cash                                    |                                   | (14,696)        | (452,716)             |           | (467,412)                 |
| Cash beginning of period                                |                                   | 162,983         | 937,230               |           | 1,100,213                 |
| Cash end of period                                      | \$                                | \$ 148,287      | \$ 484,514            | \$        | \$ 632,801                |

| Three months ended<br>July 31, 2004 (Restated) | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims     | Consolidated<br>H&R Block |
|--|-----------------------------------|-----------------|-----------------------|-----------|---------------------------|
| Net cash used in operating<br>activities:      | \$ (8,544)                        | \$ (57,739)     | \$ (449,049)          | \$        | \$ (515,332)              |
| Cash flows from investing:                     |                                   |                 |                       |           |                           |
| Cash received on residuals                     |                                   | 38,826          |                       |           | 38,826                    |
| Purchase property & equipment                  |                                   | (6,630)         | (16,084)              |           | (22,714)                  |
| Net intercompany advances                      | 377,200                           |                 |                       | (377,200) |                           |
| Other, net                                     |                                   | 1,273           | 6,221                 |           | 7,494                     |

|   |           |            |            |           |            |
|---|-----------|------------|------------|-----------|------------|
| Net cash provided by (used in) investing activities | 377,200   | 33,469     | (9,863)    | (377,200) | 23,606     |
| Cash flows from financing:                          |           |            |            |           |            |
| Repayments of commercial paper                      |           | (314,836)  |            |           | (314,836)  |
| Proceeds from commercial paper                      |           | 419,700    |            |           | 419,700    |
| Dividends paid                                      | (33,636)  |            |            |           | (33,636)   |
| Acquisition of treasury shares                      | (347,395) |            |            |           | (347,395)  |
| Proceeds from common stock                          | 12,375    |            |            |           | 12,375     |
| Net intercompany advances                           |           | (24,361)   | (352,839)  | 377,200   |            |
| Other, net  |           |            | (127)      |           | (127)      |
| Net cash provided by (used in) financing activities | (368,656) | 80,503     | (352,966)  | 377,200   | (263,919)  |
| Net increase (decrease) in cash                     |           | 56,233     | (811,878)  |           | (755,645)  |
| Cash beginning of period                            |           | 133,188    | 939,557    |           | 1,072,745  |
| Cash end of period                                  | \$        | \$ 189,421 | \$ 127,679 | \$        | \$ 317,100 |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****RESULTS OF OPERATIONS**

H&R Block is a diversified company delivering tax services and financial advice, investment and mortgage services, and business and consulting services. For 50 years, we have been developing relationships with millions of tax clients and our strategy is to expand on these relationships. Our Tax Services segment provides income tax return preparation services, electronic filing services and other services and products related to income tax return preparation to the general public in the United States, Canada, Australia and the United Kingdom. We also offer investment services through H&R Block Financial Advisors, Inc. (HRBFA). Our Mortgage Services segment offers a full range of home mortgage services through Option One Mortgage Corporation (OOMC) and H&R Block Mortgage Corporation (HRBMC). RSM McGladrey Business Services, Inc. (RSM) is a national accounting, tax and consulting firm primarily serving mid-sized businesses.

**Our Mission**

To help our clients achieve their financial objectives  
by serving as their tax and financial partner.

Key to achieving our mission is the enhancement of client experiences through consistent delivery of valuable services and advice. Operating through multiple lines of business allows us to better meet the changing financial needs of our clients.

The accompanying Management's Discussion and Analysis of Financial Condition and Results of Operations reflects the restatements of previously issued financial statements, as discussed in note 2 to our condensed consolidated financial statements. The analysis that follows should be read in conjunction with the tables below and the condensed consolidated income statements found on page 2.

**Consolidated H&R Block, Inc. Operating Results**

(in 000s, except per share amounts)

| Three months ended July 31, | Restated<br>2005 | Restated<br>2004 |
|-----------------------------|------------------|------------------|
| Revenues:                   |                  |                  |
| Tax Services                | \$ 57,191        | \$ 50,447        |
| Mortgage Services           | 360,438          | 271,973          |
| Business Services           | 126,846          | 109,102          |
| Investment Services         | 67,983           | 53,581           |
| Corporate                   | 2,535            | 1,448            |
|                             | \$ 614,993       | \$ 486,551       |
| Pretax income (loss):       |                  |                  |
| Tax Services                | \$ (144,506)     | \$ (112,646)     |
| Mortgage Services           | 134,468          | 109,025          |
| Business Services           | (6,765)          | (10,045)         |
| Investment Services         | (7,552)          | (20,343)         |
| Corporate                   | (21,514)         | (24,791)         |
|                             | (45,869)         | (58,800)         |
| Income tax benefit          | (17,875)         | (22,846)         |
| Net loss                    | \$ (27,994)      | \$ (35,954)      |

|                                  |           |           |
|----------------------------------|-----------|-----------|
| Basic and diluted loss per share | \$ (0.08) | \$ (0.11) |
|----------------------------------|-----------|-----------|

**OVERVIEW**

A summary of our results compared to the prior year is as follows:

- § Diluted loss per share for the three months ended July 31, 2005 was \$0.08 compared to \$0.11 in the prior year.
  
- § Tax Services pretax loss totaled \$144.5 million compared to \$112.6 million in the prior year. The higher losses were primarily due to off-season costs related to offices added during fiscal year 2005, costs incurred for new offices to be opened in the coming tax season and costs associated with Small Business Resources (SBR).

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- § Mortgage Services revenues and pretax income increased \$88.5 million and \$25.4 million, respectively, compared to the prior year. These increases are due to a 59.7% increase in origination volumes, partially offset by a decline in our gross margin.
- § Business Services revenues increased \$17.7 million for the three months ended July 31, 2005, primarily due to a higher number of chargeable hours and a higher billed rate per hour in our accounting, tax and consulting business. The pretax loss improved \$3.3 million for the current quarter primarily due to revenue growth.
- § Investment Services pretax loss for the three months ended July 31, 2005 was \$7.6 million, compared to \$20.3 million and \$14.5 million in the prior year and preceding quarter, respectively. This improvement is primarily due to our actions implemented during the fourth quarter of fiscal year 2005 to reduce costs and enhance advisor performance.

**TAX SERVICES**

This segment primarily consists of our income tax preparation businesses retail, online and software.

**Tax Services Operating Results**

(in 000s)

| Three months ended July 31,         | 2005         | Restated<br>2004 |
|-------------------------------------|--------------|------------------|
| Service revenues:                   |              |                  |
| Tax preparation and related fees    | \$ 23,637    | \$ 19,044        |
| Online tax services                 | 633          | 700              |
| Other services                      | 28,334       | 24,337           |
|                                     | 52,604       | 44,081           |
| Royalties                           | 2,396        | 1,612            |
| Software sales                      | 1,193        | 1,383            |
| RAL participation fees              | 271          | 164              |
| Other                               | 727          | 3,207            |
| Total revenues                      | 57,191       | 50,447           |
| Cost of services:                   |              |                  |
| Compensation and benefits           | 40,897       | 30,684           |
| Occupancy                           | 59,313       | 50,328           |
| Depreciation                        | 10,169       | 8,978            |
| Other                               | 37,192       | 31,228           |
|                                     | 147,571      | 121,218          |
| Cost of software sales              | 2,885        | 3,167            |
| Selling, general and administrative | 51,241       | 38,708           |
| Total expenses                      | 201,697      | 163,093          |
| Pretax loss                         | \$ (144,506) | \$ (112,646)     |

**Three months ended July 31, 2005 compared to July 31, 2004**

Tax Services revenues increased \$6.7 million, or 13.4%, for the three months ended July 31, 2005 compared to the prior year.

Tax preparation and related fees increased \$4.6 million, or 24.1%, for the current quarter. This increase is primarily due to an increase in the average fee per U.S. client served, coupled with an increase in U.S. clients served in offices. The average fee per U.S. client served increased 9.1% over last year, and U.S. clients served in company-owned offices increased 5.9%. Additionally, the extension of the Canadian tax season into the month of May resulted in a \$1.7 million increase to our current quarter revenues.

Other service revenues increased \$4.0 million primarily as a result of additional revenues associated with Express IRAs and POM guarantees.

Total expenses increased \$38.6 million, or 23.7%. Cost of services for the three months ended July 31, 2005 increased \$26.4 million, or 21.7%, from the prior year. Our real estate expansion efforts have contributed to a total increase of \$7.3 million across all cost of services categories. Compensation and benefits increased \$10.2 million primarily due to an increase in the number of off-season support staff needed for our new offices, the addition of SBR costs in the current year and related payroll taxes.

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Occupancy expenses increased \$9.0 million, or 17.9%, primarily as a result of higher rent expenses, due to an 11.5% increase in company-owned offices under lease and a 6.0% increase in the average rent. Utilities and real estate taxes related to these new offices also contributed to the increase. Other cost of service expenses increased \$6.0 million primarily due to \$4.2 million of additional expenses associated with our POM program.

Selling, general and administrative expenses increased \$12.5 million over the prior year primarily due to a \$5.5 million increase in legal expenses, \$2.9 million in additional costs from corporate shared services and \$1.7 million in additional consulting expenses.

The pretax loss was \$144.5 million for the three months ended July 31, 2005 compared to a prior year loss of \$112.6 million.

Due to the seasonal nature of this segment's business, operating results for the three months ended July 31, 2005 are not comparable to the three months ended April 30, 2005 and are not indicative of the expected results for the entire fiscal year.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for the Tax Services segment is unchanged from the discussion in our April 30, 2005 Form 10-K/A.

**RAL Litigation**

We have been named as a defendant in a number of lawsuits alleging that we engaged in wrongdoing with respect to the RAL program. We believe we have strong defenses to the various RAL cases and will vigorously defend our position. Nevertheless, the amounts claimed by the plaintiffs are, in some instances, very substantial, and there can be no assurances as to the ultimate outcome of the pending RAL cases, or as to the impact of the RAL cases on our financial statements. See additional discussion of RAL Litigation in note 10 to the condensed consolidated financial statements and in Part II, Item 1, Legal Proceedings.

**Table of Contents****MORTGAGE SERVICES**

This segment is primarily engaged in the origination of non-prime mortgage loans through an independent broker network, the origination of prime and non-prime mortgage loans through a retail office network, the sale and securitization of mortgage loans and residual interests, and the servicing of non-prime loans.

**Mortgage Services Operating Statistics**

(dollars in 000s)

| Three months ended   | July 31,<br>2005 | Restated<br>July 31,<br>2004 | April 30,<br>2005 |
|--|------------------|------------------------------|-------------------|
| Volume of loans originated:                                  |                  |                              |                   |
| Wholesale (non-prime)  | \$ 9,537,227     | \$ 5,981,104                 | \$ 8,090,274      |
| Retail: Non-prime  | 950,806          | 620,126                      | 807,269           |
| Prime  | 399,596          | 215,287                      | 380,946           |
|  | \$ 10,887,629    | \$ 6,816,517                 | \$ 9,278,489      |
| Loan characteristics:  |                  |                              |                   |
| Weighted average FICO score <sup>(1)</sup>                   | 623              | 609                          | 618               |
| Weighted average interest rate for borrowers <sup>(1)</sup>  | 7.52%            | 7.21%                        | 7.45%             |
| Weighted average loan-to-value <sup>(1)</sup>                | 81.1%            | 78.0%                        | 79.6%             |
| Origination margin (% of origination volume): <sup>(2)</sup> |                  |                              |                   |
| Loan sale premium  | 2.33%            | 3.18%                        | 2.64%             |
| Residual cash flows from beneficial interest in Trusts       | 0.47%            | 0.65%                        | 0.55%             |
| Gain on derivative instruments                               | 0.24%            | 0.01%                        | 0.19%             |
| Loan sale repurchase reserves                                | (0.15%)          | (0.17%)                      | (0.08%)           |
| Retained mortgage servicing rights                           | 0.45%            | 0.42%                        | 0.46%             |
|  | 3.34%            | 4.09%                        | 3.76%             |
| Cost of acquisition  | (0.48%)          | (0.61%)                      | (0.51%)           |
| Direct origination expenses                                  | (0.57%)          | (0.75%)                      | (0.60%)           |
| Net gain on sale gross margin <sup>(3)</sup>                 | 2.29%            | 2.73%                        | 2.65%             |
| Other revenues   | %                | 0.01%                        | 0.03%             |
| Other cost of origination                                    | (1.37%)          | (1.47%)                      | (1.54%)           |
| Net margin   | 0.92%            | 1.27%                        | 1.14%             |
| Total cost of origination                                    | 1.94%            | 2.22%                        | 2.14%             |
| Total cost of origination and acquisition                    | 2.42%            | 2.83%                        | 2.65%             |
| Loan delivery:   |                  |                              |                   |
| Loan sales   | \$ 10,843,006    | \$ 6,744,056                 | \$ 9,322,150      |
| Execution price <sup>(4)</sup>                               | 2.50%            | 4.12%                        | 2.48%             |

<sup>(1)</sup> Represents non-prime

production.

- (2) See Reconciliation of Non-GAAP Financial Information on page 32.
- (3) Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.
- (4) Defined as total premium received divided by total balance of loans delivered to third-party investors or securitization vehicles (excluding mortgage servicing rights and the effect of loan origination expenses).

**Table of Contents****Mortgage Services Operating Results** (in 000s)

|                                     | July 31,<br>2005 | Restated<br>July 31,<br>2004 | April 30,<br>2005 |
|-------------------------------------|------------------|------------------------------|-------------------|
| Three months ended                  |                  |                              |                   |
| Components of gains on sales:       |                  |                              |                   |
| Gain on mortgage loans              | \$ 222,760       | \$ 185,293                   | \$ 227,633        |
| Gain on derivatives                 | 26,086           | 676                          | 18,027            |
| Gain on sales of residual interests |                  |                              | 15,396            |
| Impairment of residual interests    | (12,415)         | (2,609)                      | (5,068)           |
|                                     | 236,431          | 183,360                      | 255,988           |
| Interest income:                    |                  |                              |                   |
| Accretion residual interests        | 30,777           | 28,677                       | 41,363            |
| Other interest income               | 2,768            | 1,440                        | 3,902             |
|                                     | 33,545           | 30,117                       | 45,265            |
| Loan servicing revenue              | 90,269           | 58,166                       | 79,366            |
| Other                               | 193              | 330                          | 222               |
| Total revenues                      | 360,438          | 271,973                      | 380,841           |
| Cost of services                    | 64,392           | 49,861                       | 61,590            |
| Cost of other revenues:             |                  |                              |                   |
| Compensation and benefits           | 80,283           | 45,906                       | 74,777            |
| Occupancy                           | 12,629           | 8,009                        | 10,868            |
| Other                               | 22,878           | 18,280                       | 20,729            |
|                                     | 115,790          | 72,195                       | 106,374           |
| Selling, general and administrative | 45,788           | 40,892                       | 49,764            |
| Total expenses                      | 225,970          | 162,948                      | 217,728           |
| Pretax income                       | \$ 134,468       | \$ 109,025                   | \$ 163,113        |

**Three months ended July 31, 2005 compared to July 31, 2004**

Mortgage Services revenues increased \$88.5 million, or 32.5%, for the three months ended July 31, 2005 compared to the prior year. Revenues increased as a result of increased origination volumes, servicing revenue and gains on derivatives.

The following table summarizes the key drivers of gains on sales of mortgage loans:

|                             | (dollars in 000s) |      |
|-----------------------------|-------------------|------|
| Three months ended July 31, | 2005              | 2004 |
|                             |                   |      |

|  |               |              |
|--|---------------|--------------|
| Application process:   |               |              |
| Total number of applications   | 109,929       | 74,492       |
| Number of sales associates <sup>(1)</sup>                              | 3,692         | 3,117        |
| Closing ratio <sup>(2)</sup>   | 60.1%         | 59.0%        |
| Originations:  |               |              |
| Total number of originations   | 66,041        | 43,926       |
| Weighted average interest rate for borrowers (WAC)                     | 7.52%         | 7.21%        |
| Average loan size  | \$ 165        | \$ 155       |
| Total originations   | \$ 10,887,629 | \$ 6,816,517 |
| Non-prime origination ratio  | 96.3%         | 96.8%        |
| Direct origination and acquisition expenses, net Revenue (loan value): | \$ 114,224    | \$ 92,489    |
| Net gain on sale gross margin <sup>(3)</sup>                           | 2.29%         | 2.73%        |

(1) Includes all direct sales and back office sales support associates.

(2) Percentage of loans funded divided by total applications in the period.

(3) Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.

Gains on sales of mortgage loans increased \$37.5 million, primarily as a result of increased origination volume, partially offset by a decline in our gross margin. Originations increased 59.7% over the prior year, due to increased productivity of our account executives and support staff, new product introductions, increased applications and a higher closing ratio. Market interest rates, based on the two-year swap, increased from an average of 3.03% last year to 4.06% in the current quarter. However, our WAC increased only 31 basis points, up to 7.52% from 7.21% in the prior year. Because

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our WAC was not more aligned with market rates, our gross margin declined 44 basis points, to 2.29% from 2.73% last year. To mitigate the risk of short-term changes in market interest rates, we use interest rate swaps and forward loan sale commitments. During the current quarter, we recorded a net \$26.1 million in gains, compared to \$0.7 million in the prior year, related to our various derivative instruments. See note 6 to the condensed consolidated financial statements. We also recorded a \$4.0 million favorable mark-to-market adjustment for our residual interests classified as trading securities during the current quarter.

During the first quarter of fiscal year 2006, our residual interests performed better than expected in our internal valuation models, with lower credit losses than originally modeled, partially offset by higher interest rates. We recorded favorable pretax mark-to-market adjustments, which increased the fair value of our residual interests \$16.0 million during the quarter. These adjustments were recorded, net of write-downs of \$3.0 million and deferred taxes of \$4.9 million, in other comprehensive income and will be accreted into income throughout the remaining life of those residual interests. Offsetting these write-ups were impairments of \$12.4 million, which were recorded in gains on sales of mortgage assets. Future changes in interest rates or other assumptions, based on market conditions or actual loan pool performance, could cause additional adjustments to the fair value of the residual interests and could cause changes to the accretion of these residual interests in future periods. Favorable mark-to-market adjustments on low original value residuals will generally not be accreted into revenues until the residual interest begins to cash flow.

The following table summarizes the key drivers of loan servicing revenues:

|                              | (dollars in 000s) |               |
|------------------------------|-------------------|---------------|
| Three months ended July 31,  | 2005              | 2004          |
| Average servicing portfolio: |                   |               |
| With related MSR             | \$ 49,635,474     | \$ 37,524,221 |
| Without related MSR          | 20,070,745        | 10,012,639    |
|                              | \$ 69,706,219     | \$ 47,536,860 |
| Number of loans serviced     | 451,310           | 344,659       |
| Average delinquency rate     | 4.28%             | 5.01%         |
| Weighted average FICO score  | 619               | 612           |
| Value of MSR                 | \$ 188,708        | \$ 123,980    |

Loan servicing revenues increased \$32.1 million, or 55.2%, compared to the prior year. The increase reflects a higher loan servicing portfolio. The average servicing portfolio for the three months ended July 31, 2005 increased \$22.2 billion, or 46.6%, to \$69.7 billion.

Total expenses for the three months ended July 31, 2005, increased \$63.0 million, or 38.7%, over the prior year. Cost of services increased \$14.5 million as a result of a higher average servicing portfolio during the current quarter. Cost of other revenues increased \$43.6 million, primarily due to \$34.4 million in increased compensation and benefits as a result of an 18.4% increase in sales associates, coupled with related increases in payroll taxes and origination-based incentives. Occupancy expenses increased \$4.6 million, or 57.7%, primarily as a result of a 13.0% increase in branch offices. Other expenses increased \$4.6 million primarily as a result of \$2.3 million in additional costs for our annual sales meeting, coupled with increases in consulting and outsourced services.

Selling, general and administrative expenses increased \$4.9 million due to \$7.6 million in additional retail marketing costs, partially offset by a \$2.1 million decrease in consulting expenses.

Pretax income increased \$25.4 million to \$134.5 million for the three months ended July 31, 2005.

**Three months ended July 31, 2005 compared to April 30, 2005**

Mortgage Services revenues decreased \$20.4 million, or 5.4%, for the three months ended July 31, 2005, compared to the fourth quarter of fiscal year 2005. Revenues decreased primarily due to a \$15.4 million gain on sale of previously securitized residual interests recorded in the fourth quarter.





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The following table summarizes the key drivers of gains on sales of mortgage loans:

(dollars in 000s)

| Three months ended                                 | July 31, 2005 | April 30,<br>2005 |
|--|---------------|-------------------|
| Application process:                               |               |                   |
| Total number of applications                       | 109,929       | 103,202           |
| Number of sales associates <sup>(1)</sup>          | 3,692         | 3,526             |
| Closing ratio <sup>(2)</sup>                       | 60.1%         | 57.0%             |
| Originations:                                      |               |                   |
| Total number of originations                       | 66,041        | 58,777            |
| Weighted average interest rate for borrowers (WAC) | 7.52%         | 7.45%             |
| Average loan size                                  | \$ 165        | \$ 158            |
| Total originations                                 | \$ 10,887,629 | \$ 9,278,489      |
| Non-prime origination ratio                        | 96.3%         | 95.9%             |
| Direct origination and acquisition expenses, net   | \$ 114,224    | \$ 103,123        |
| Revenue (loan value):                              |               |                   |
| Net gain on sale gross margin <sup>(3)</sup>       | 2.29%         | 2.65%             |

(1) Includes all direct sales and back office sales support associates.

(2) Percentage of loans funded divided by total applications in the period.

(3) Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.

Gains on sales of mortgage loans decreased \$4.9 million primarily as a result of increased price competition and poorer execution in the secondary market. Market interest rates have increased to 4.06% from 3.96% in the preceding quarter. However, our WAC increased 7 basis points, from 7.45% to 7.52%. To mitigate the risk of short-term changes in market interest rates, we use interest rate swaps and forward loan sale commitments. Primarily as a result of interest rate changes, during the current quarter, we recorded a net \$26.1 million in gains, compared to \$18.0 million in the fourth quarter, related to our various derivative instruments. Loan origination volumes increased 17.3% from the fourth quarter primarily due to increased productivity of our account executives and support staff. We also recorded a \$4.0 million favorable mark-to-market adjustment for our residual interests classified as trading securities during the current quarter.

Impairments of residual interests in securitizations of \$12.4 million were recognized during the first quarter, compared to \$5.1 million in the fourth quarter of fiscal year 2005. This was primarily due to a decline in value of older residuals based on loan performance.

The following table summarizes the key drivers of loan servicing revenues:

|                              | (dollars in 000s) |                |
|------------------------------|-------------------|----------------|
| Three months ended           | July 31, 2005     | April 30, 2005 |
| Average servicing portfolio: |                   |                |
| With related MSR             | \$ 49,635,474     | \$ 45,493,695  |
| Without related MSR          | 20,070,745        | 17,540,643     |
|                              | \$ 69,706,219     | \$ 63,034,338  |
| Number of loans serviced     | 451,310           | 435,290        |
| Average delinquency rate     | 4.28%             | 4.43%          |
| Weighted average FICO score  | 619               | 624            |
| Value of MSR                 | \$ 188,708        | \$ 166,614     |

Loan servicing revenues increased \$10.9 million, or 13.7%, compared to the fourth quarter. The increase reflects a higher loan servicing portfolio. The average servicing portfolio for the three months ended July 31, 2005 increased \$6.7 billion, or 10.6%.

Total expenses increased \$8.2 million compared to the fourth quarter. Cost of other revenues increased \$9.4 million, primarily due to \$5.5 million in increased compensation and benefits as a result of a 4.7% increase in sales associates, coupled with related increases in payroll taxes and origination-based incentives. Other expenses increased \$2.1 million for the current quarter, primarily due to \$3.5 million in additional costs for our annual sales meeting, partially offset by a \$2.0 million decrease in consulting expenses.

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Selling, general and administrative expenses decreased \$4.0 million due to a decline of \$3.9 million in incentive compensation resulting from lower profitability.

Pretax income decreased \$28.6 million, or 17.6%, for the three months ended July 31, 2005 compared to the preceding quarter.

**Fiscal 2006 outlook**

We continue to expect loan origination growth will exceed 20 percent over the previous year, however, we now expect our margins will continue to decline in the second quarter. We believe margins in the 90 to 115 basis point range are achievable for the third and fourth quarters, but expect full year margins will likely be at the low end or below the 90 to 115 basis point range.

**BUSINESS SERVICES**

This segment offers middle-market companies accounting, tax and consulting services, wealth management, retirement resources, payroll and benefits services, corporate finance and financial process outsourcing.

**Business Services Operating Statistics**

| Three months ended July 31,     | 2005      | 2004      |
|---------------------------------|-----------|-----------|
| Accounting, tax and consulting: |           |           |
| Chargeable hours                | 597,202   | 537,035   |
| Chargeable hours per person     | 270       | 269       |
| Net billed rate per hour        | \$ 134    | \$ 126    |
| Average margin per person       | \$ 17,321 | \$ 16,327 |

**Business Services Operating Results**

(in 000s)

| Three months ended July 31,               | 2005      | Restated<br>2004 |
|---|-----------|------------------|
| Service revenues:                         |           |                  |
| Accounting, tax and consulting            | \$ 83,828 | \$ 74,551        |
| Capital markets                           | 15,472    | 15,780           |
| Payroll, benefits and retirement services | 8,277     | 4,671            |
| Other services                            | 9,882     | 5,759            |
|   | 117,459   | 100,761          |
| Other                                     | 9,387     | 8,341            |
| Total revenues                            | 126,846   | 109,102          |
| Cost of services:                         |           |                  |
| Compensation and benefits                 | 71,647    | 64,103           |
| Occupancy                                 | 8,163     | 4,531            |
| Other                                     | 10,810    | 11,806           |
|   | 90,620    | 80,440           |
| Selling, general and administrative       | 42,991    | 38,707           |

|                |            |             |
|----------------|------------|-------------|
| Total expenses | 133,611    | 119,147     |
| Pretax loss    | \$ (6,765) | \$ (10,045) |

**Three months ended July 31, 2005 compared to July 31, 2004**

Business Services revenues for the three months ended July 31, 2005 increased \$17.7 million, or 16.3%, from the prior year. This increase was primarily due to a \$9.3 million increase in accounting, tax and consulting revenues resulting from an 11.2% increase in chargeable hours and a 6.3% increase in the net billed rate per hour. The increase in chargeable hours is primarily due to favorable market conditions for all of our core services and strong demand for consulting and risk management services.

Payroll, benefits and retirement services revenues increased \$3.6 million, or 77.2%, primarily due to acquisitions completed during the third and fourth quarters of fiscal year 2005. Other service revenues increased \$4.1 million as a result of growth in wealth management services and acquisitions completed in the fourth quarter of fiscal year 2005 in our financial process outsourcing business.

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Total expenses increased \$14.5 million, or 12.1%, for the three months ended July 31, 2005 compared to the prior year. Cost of services increased \$10.2 million, primarily due to a \$7.5 million increase in compensation and benefits. Acquisitions completed in the third and fourth quarters of fiscal year 2005 and increases in the number of personnel and the average wage per employee, which is being driven by marketplace competition for professional staff, were the primary drivers for this increase. Occupancy expenses increased \$3.6 million, or 80.2%, due primarily to acquisitions completed in the third and fourth quarters of fiscal year 2005.

Selling, general and administrative expenses increased \$4.3 million primarily due to additional costs associated with our business development initiatives and acquisitions completed in the third and fourth quarters of fiscal year 2005.

The pretax loss for the three months ended July 31, 2005 was \$6.8 million compared to \$10.0 million in the prior year.

Due to the seasonal nature of this segment's business, operating results for the three months ended July 31, 2005 are not comparable to the three months ended April 30, 2005 and are not indicative of the expected results for the entire fiscal year.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for our Business Services segment is consistent with the discussion in our April 30, 2005 Form 10-K/A, except for the announcement to acquire American Express Tax and Business Services. On August 1, 2005 we announced a definitive agreement to acquire the American Express Tax & Business Services division. This acquisition is expected to close by the end of September, with operating results of the acquired business reported in this segment beginning October 1. Our early indication is that this acquisition will be accretive by two cents per diluted share in fiscal year 2006, after expected integration costs.

**INVESTMENT SERVICES**

This segment is primarily engaged in offering advice-based brokerage services and investment planning. Our integration of investment advice and new service offerings are allowing us to shift our focus from a transaction-based client relationship to a more advice-based focus.

**Investment Services Operating Statistics**

| Three months ended                                       | July 31,<br>2005 | July 31,<br>2004 | April 30,<br>2005 |
|--|------------------|------------------|-------------------|
| Customer trades <sup>(1)</sup>                           | 226,378          | 205,948          | 241,327           |
| Customer daily average trades                            | 3,593            | 3,269            | 3,892             |
| Average revenue per trade <sup>(2)</sup>                 | \$ 126.71        | \$ 119.71        | \$ 127.73         |
| Customer accounts: <sup>(3)</sup>                        |                  |                  |                   |
| Traditional brokerage                                    | 431,046          | 454,147          | 431,749           |
| Express IRAs   | 379,432          | 337,583          | 380,539           |
|  | 810,478          | 791,730          | 812,288           |
| Ending balance of assets under administration (billions) | \$ 30.0          | \$ 26.6          | \$ 27.8           |
| Average assets per traditional brokerage account         | \$ 68,870        | \$ 58,132        | \$ 63,755         |
| Average margin balances (millions)                       | \$ 573           | \$ 598           | \$ 603            |
| Average customer payable balances (millions)             | \$ 841           | \$ 1,012         | \$ 936            |
| Number of advisors                                       | 985              | 997              | 1,010             |

Included in the numbers above are the following relating to fee-based accounts:

|  |            |            |            |
|--|------------|------------|------------|
| Customer household accounts                              | 7,985      | 7,688      | 7,668      |
| Average revenue per account                              | \$ 2,235   | \$ 1,848   | \$ 2,841   |
| Ending balance of assets under administration (millions) | \$ 2,126   | \$ 1,547   | \$ 1,975   |
| Average assets per active account                        | \$ 266,222 | \$ 201,198 | \$ 260,238 |

(1) Includes only trades on which revenues are earned ( revenue trades ). Revenues are earned on both transactional and annuitized trades.

(2) Calculated as total trade revenues divided by revenue trades.

(3) Includes only accounts with a positive balance.

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| <b>Investment Services</b>          | <b>Operating Results</b> |                              |                   | (in 000s) |
|-------------------------------------|--------------------------|------------------------------|-------------------|-----------|
| Three months ended                  | July 31,<br>2005         | Restated<br>July 31,<br>2004 | April 30,<br>2005 |           |
| Service revenue:                    |                          |                              |                   |           |
| Transactional revenue               | \$ 22,835                | \$ 19,952                    | \$ 23,922         |           |
| Annuitized revenue                  | 22,271                   | 18,533                       | 23,272            |           |
| Production revenue                  | 45,106                   | 38,485                       | 47,194            |           |
| Other service revenue               | 8,207                    | 6,262                        | 9,417             |           |
|                                     | 53,313                   | 44,747                       | 56,611            |           |
| Margin interest revenue             | 14,093                   | 8,760                        | 12,925            |           |
| Less: interest expense              | (1,254)                  | (299)                        | (1,184)           |           |
| Net interest revenue                | 12,839                   | 8,461                        | 11,741            |           |
| Other                               | 577                      | 74                           | 262               |           |
| Total revenues <sup>(1)</sup>       | 66,729                   | 53,282                       | 68,614            |           |
| Cost of services:                   |                          |                              |                   |           |
| Compensation and benefits           | 30,535                   | 28,848                       | 31,644            |           |
| Occupancy                           | 5,165                    | 5,789                        | 5,668             |           |
| Depreciation                        | 1,034                    | 1,064                        | 1,015             |           |
| Other                               | 3,901                    | 3,755                        | 3,655             |           |
|                                     | 40,635                   | 39,456                       | 41,982            |           |
| Selling, general and administrative | 33,646                   | 34,169                       | 41,120            |           |
| Total expenses                      | 74,281                   | 73,625                       | 83,102            |           |
| Pretax loss                         | \$ (7,552)               | \$ (20,343)                  | \$ (14,488)       |           |

(1) Total revenues,  
less interest  
expense.

**Three months ended July 31, 2005 compared to July 31, 2004**

Investment Services revenues, net of interest expense, for the three months ended July 31, 2005 increased \$13.4 million, or 25.2%, over the prior year.

Production revenue increased \$6.6 million, or 17.2%, over the prior year. Transactional revenue, which is based on individual securities transactions, increased \$2.9 million, or 14.4%, from the prior year due primarily to a 4.7% increase in transactional trading volume and a 10.6% increase in average revenue per transactional trade. Annuitized revenue, which is based on sales of mutual funds, insurance, fee based products and unit investment trusts, increased



\$3.7 million, or 20.2%, due to increased sales of mutual funds and annuities. Annualized productivity averaged approximately \$180,000 per advisor during the current quarter compared to \$155,000 per advisor in the prior year. Increased productivity was primarily due to minimum production standards we put into place during the fourth quarter of fiscal year 2005 which caused an increase in production per advisor across all advisor classes, with 164 advisors increasing their production. These standards also resulted in 74 low-producing advisors leaving the company and we expect this trend to continue throughout the remainder of the fiscal year.

Margin interest revenue increased \$5.3 million, or 60.9%, from the prior year, as a result of higher interest rates earned.

Total expenses increased \$0.7 million, or 0.9%. Cost of services increased \$1.2 million, or 3.0%, primarily as a result of \$1.7 million of additional compensation and benefits. This increase is primarily due to higher production revenues, partially offset by cost containment measures implemented in the fourth quarter of fiscal year 2005.

The pretax loss for Investment Services for the first quarter of fiscal year 2006 was \$7.6 million compared to the prior year loss of \$20.3 million.

**Three months ended July 31, 2005 compared to April 30, 2005**

Investment Services revenues, net of interest expense, for the three months ended July 31, 2005 decreased \$1.9 million, or 2.7% compared to the preceding quarter.

Production revenue decreased \$2.1 million, or 4.4%, over the preceding quarter. Transactional revenue decreased \$1.1 million, or 4.5%, compared to the preceding quarter, primarily due to lower

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underwriting commissions. Annuitized revenues declined \$1.0 million, or 4.3%, due to the timing in recognition of certain fee-based revenues.

Margin interest revenue increased \$1.2 million, or 9.0%, from the preceding quarter, which is primarily a result of higher interest rates earned, partially offset by lower margin balances.

Total expenses decreased \$8.8 million, or 10.6%. Cost of services decreased \$1.3 million, or 3.2%, principally due to a \$1.1 million decline in compensation and benefits, primarily resulting from lower production revenues.

Selling, general and administrative expenses decreased \$7.5 million, or 18.2%, primarily due to fourth quarter severance expenses, gains on the disposition of certain assets during the first quarter, reduced back-office headcount relating to cost containment efforts and a decline in legal expenses. These decreases were partially offset by increased bonuses associated with improved performance.

The pretax loss for the Investment Services segment was \$7.6 million, compared to a loss of \$14.5 million in the fourth quarter of fiscal year 2005.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for our Investment Services segment is unchanged from the discussion in our April 30, 2005 Form 10-K/A.

**CORPORATE**

This segment consists primarily of corporate support departments, which provide services to our operating segments. These support departments consist of marketing, information technology, facilities, human resources, executive, legal, finance, government relations and corporate communications. Support department costs are generally allocated to our operating segments. Our captive insurance and franchise financing subsidiaries are also included within this segment, as was our small business initiatives subsidiary in the first half of fiscal year 2005.

**Corporate Operating Results**

(in 000s)

|                               | 2005     | Restated<br>2004 |
|-------------------------------|----------|------------------|
| Three months ended July 31,   |          |                  |
| Operating revenues            | \$ 5,006 | \$ 4,433         |
| Eliminations                  | (2,471)  | (2,985)          |
| Total revenues                | 2,535    | 1,448            |
| Corporate expenses:           |          |                  |
| Interest expense              | 13,794   | 16,224           |
| Other                         | 17,462   | 11,166           |
|                               | 31,256   | 27,390           |
| Shared services:              |          |                  |
| Information technology        | 26,452   | 25,178           |
| Marketing                     | 4,441    | 3,571            |
| Finance                       | 11,795   | 8,807            |
| Other                         | 20,889   | 20,229           |
|                               | 63,577   | 57,785           |
| Allocation of shared services | (63,629) | (57,804)         |

|                   |             |             |
|-------------------|-------------|-------------|
| Other income, net | 7,155       | 1,132       |
| Pretax loss       | \$ (21,514) | \$ (24,791) |

**Three months ended July 31, 2005 compared to July 31, 2004**

Corporate expenses increased \$3.9 million primarily due an increase of \$1.7 million in losses at our captive insurance subsidiary, \$1.5 million in additional consulting, accounting and auditing expenses related to the restatement of our previously issued financial statements and \$2.1 million in increased costs from finance shared services. These increases were partially offset by a decline of \$2.4 million in interest expense.

Finance department expenses increased \$3.0 million, primarily due to \$2.3 million of additional consulting expenses and increases in compensation expenses.

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Other income increased \$6.0 million primarily as a result of a \$3.4 million gain recognized on the sale of an investment.

The pretax loss was \$21.5 million, compared with last year's first quarter loss of \$24.8 million.

Due to the nature of this segment, the three months ended July 31, 2005 are not comparable to the three months ended April 30, 2005 and are not indicative of the expected results for the entire fiscal year.

**FINANCIAL CONDITION**

These comments should be read in conjunction with the condensed consolidated balance sheets and condensed consolidated statements of cash flows found on pages 1 and 3, respectively.

**CAPITAL RESOURCES & LIQUIDITY BY SEGMENT**

Our sources of capital include cash from operations, issuances of common stock and debt. We use capital primarily to fund working capital requirements, pay dividends, repurchase our shares and acquire businesses.

**Cash From Operations.** Cash used in operations totaled \$310.5 million and \$515.3 million for the three months ended July 31, 2005 and 2004, respectively. The decrease in cash used in operating activities is primarily due to a decline in income tax payments. Income tax payments totaled \$35.3 million during the current year, a decrease of \$148.1 million from the prior year. A change in a tax accounting method in the prior year resulted in the acceleration of taxable income within our Mortgage Services segment.

**Issuance of Common Stock.** We issue shares of common stock, in accordance with our stock-based compensation plans, out of treasury shares. Proceeds from the issuance of common stock totaled \$32.3 million and \$12.4 million for the three months ended July 31, 2005 and 2004, respectively.

**Dividends.** Dividends paid totaled \$36.5 million and \$33.6 million for the three months ended July 31, 2005 and 2004, respectively. On June 8, 2005, our Board of Directors declared a two-for-one stock split of the Company's Common Stock in the form of a 100% stock distribution, effective August 22, 2005, to shareholders of record as of the close of business on August 1, 2005. All share and per share amounts in this document have been adjusted to reflect the retroactive effect of the stock split.

**Share Repurchases.** On June 9, 2004, our Board of Directors approved an authorization to repurchase 15 million shares. During the three months ended July 31, 2005, we repurchased 2.2 million (pre-split) shares pursuant to these authorizations at an aggregate price of \$126.1 million or an average price of \$56.78 per share (pre-split). There are 12.9 million shares remaining under this authorization at July 31, 2005. We plan to continue to purchase shares on the open market in accordance with these authorizations, subject to various factors including the price of the stock, the availability of excess cash, our ability to maintain liquidity and financial flexibility, securities laws restrictions, targeted capital levels and other investment opportunities available.

**Restricted Cash.** We hold certain cash balances that are restricted as to use. Cash and cash equivalents restricted totaled \$417.0 million at July 31, 2005 compared to \$516.9 million at April 30, 2005. Investment Services held \$388.0 million of this total segregated in a special reserve account for the exclusive benefit of customers. Restricted cash of \$13.8 million at July 31, 2005 held by Business Services is related to funds held to pay payroll taxes on behalf of its customers. Restricted cash held by Mortgage Services totaled \$15.2 million and is held for outstanding commitments to fund mortgage loans.

**Segment Cash Flows.** A condensed consolidating statement of cash flows by segment for the three months ended July 31, 2005 follows. Generally, interest is not charged on intercompany activities between segments.

(in 000s)

|                                | Tax<br>Services | Mortgage<br>Services | Business<br>Services | Investment<br>Services | Corporate   | Consolidated<br>H&R Block |
|--------------------------------|-----------------|----------------------|----------------------|------------------------|-------------|---------------------------|
| Cash provided by (used<br>in): |                 |                      |                      |                        |             |                           |
| Operations                     | \$ (224,218)    | \$ (43,189)          | \$ 21,995            | \$ (11,274)            | \$ (53,829) | \$ (310,515)              |

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|                  |          |        |          |        |           |           |
|------------------|----------|--------|----------|--------|-----------|-----------|
| Investing        | (5,573)  | 16,006 | (7,821)  | 3,410  | (7,838)   | (1,816)   |
| Financing        | (26,486) |        | (2,497)  | 10,579 | (136,677) | (155,081) |
| Net intercompany | 250,383  | 48,749 | (11,263) | 1,386  | (289,255) |           |

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Net intercompany activities are excluded from investing and financing activities within the segment cash flows. We believe that by excluding intercompany activities, the cash flows by segment more clearly depicts the cash generated and used by each segment. Had intercompany activities been included, those segments in a net lending situation would have been included in investing activities, and those in a net borrowing situation would have been included in financing activities.

**Tax Services.** Tax Services has historically been our largest provider of annual operating cash flows. The seasonal nature of Tax Services generally results in a large positive operating cash flow in the fourth quarter. Tax Services used \$224.2 million in its current three-month operations to cover off-season costs and working capital requirements. This segment also used \$26.5 million in financing activities, primarily related to book overdrafts.

**Mortgage Services.** This segment primarily generates cash as a result of the sale and securitization of mortgage loans and residual interests, and as its residual interests begin to cash flow. Mortgage Services used \$43.2 million in cash from operating activities primarily due to \$58.0 million in trading residuals held at July 31, 2005 that had not yet been securitized in a NIM transaction. Cash flows from investing activities consist of \$24.0 million in cash receipts on residual interests, partially offset by \$8.3 million in capital expenditures.

Gains on sales. Gains on sales of mortgage assets totaled \$236.4 million, with the cash received primarily recorded as operating activities. The percentage of cash proceeds we receive from our capital market transactions, which are included within the gains on sales of mortgage assets, is reconciled below. The decline in the percentage of cash proceeds is due to the \$58.0 million in trading residuals recorded at July 31, 2005, which we expect to securitize in a NIM transaction during our second quarter.

|  | (in 000s)  |                  |
|--|------------|------------------|
| Three months ended July 31,                                    | 2005       | Restated<br>2004 |
| Cash proceeds:   |            |                  |
| Whole loans sold by the Trusts                                 | \$ 154,802 | \$ 218,064       |
| Residual cash flows from beneficial interest in Trusts         | 58,790     | 40,378           |
| Loans securitized  | 60,382     |                  |
| Derivative instruments   | 6,194      |                  |
|  | 280,168    | 258,442          |
| Non-cash:  |            |                  |
| Retained mortgage servicing rights                             | 49,306     | 28,493           |
| Additions to balance sheet <sup>(1)</sup>                      | 60,091     |                  |
|  | 109,397    | 28,493           |
| Portion of gain on sale related to capital market transactions | 389,565    | 286,935          |
| Other items included in gain on sale:                          |            |                  |
| Changes in beneficial interest in Trusts                       | (29,534)   | 2,598            |
| Impairments to fair value of residual interests                | (12,415)   | (2,609)          |
| Net change in fair value of derivative instruments             | 19,892     | 676              |
| Direct origination and acquisition expenses, net               | (114,224)  | (92,489)         |
| Loan sale repurchase reserves                                  | (16,853)   | (11,751)         |

|  |            |            |
|--|------------|------------|
|  | (153,134)  | (103,575)  |
| Reported gains on sales of mortgage assets   | \$ 236,431 | \$ 183,360 |
| Percent of gain on sale related to capital market transactions received as cash <sup>(2)</sup> | 72%        | 90%        |

(1) Includes residual interests and interest rate caps.

(2) Cash proceeds divided by portion of gain on sale related to capital market transactions.

Warehouse Funding. To finance our prime originations, we utilize an on-balance sheet warehouse facility with capacity up to \$25 million. This annual facility bears interest at one-month LIBOR plus 140 to 200 basis points. As of July 31, 2005 and April 30, 2005 the balance outstanding under this facility was \$10.3 million and \$4.4 million, respectively.

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To fund our non-prime originations, we utilize six off-balance sheet warehouse Trusts. The facilities used by the Trusts had a total capacity of \$10.0 billion as of July 31, 2005. Amounts drawn on the facilities by the Trusts totaled \$6.7 billion at July 31, 2005. See additional discussion below in Off-Balance Sheet Financing Arrangements.

We believe the sources of liquidity available to the Mortgage Services segment are sufficient for its needs.

**Business Services.** Business Services funding requirements are largely related to receivables for completed work and work in process. We provide funding sufficient to cover their working capital needs. This segment provided \$22.0 million in operating cash flows during the first three months of the year. Business Services used \$7.8 million in investing activities related to acquisitions and capital expenditures.

**Investment Services.** Investment Services, through HRBFA, is subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers.

At July 31, 2005, HRBFA's net capital of \$119.8 million, which was 19.1% of aggregate debit items, exceeded its minimum required net capital of \$12.5 million by \$107.3 million.

In the first three months of fiscal year 2005, Investment Services used \$11.3 million in its operating activities primarily due to working capital requirements, including the timing of cash deposits that are restricted for the benefit of customers. Cash provided by financing activities consists primarily of financing of book overdrafts.

Liquidity needs relating to client trading and margin-borrowing activities are met primarily through cash balances in client brokerage accounts and working capital. We believe these sources of funds will continue to be the primary sources of liquidity for Investment Services. Stock loans have historically been used as a secondary source of funding and could be used in the future, if warranted.

Pledged securities at July 31, 2005 totaled \$55.5 million, an excess of \$5.3 million over the margin requirement. Pledged securities at the end of fiscal year 2005 totaled \$44.6 million, an excess of \$7.9 million over the margin requirement.

We believe the funding sources for Investment Services are stable. Liquidity risk within this segment is primarily limited to maintaining sufficient capital levels to obtain securities lending liquidity to support margin borrowing by customers.

### **OFF-BALANCE SHEET FINANCING ARRANGEMENTS**

Substantially all non-prime mortgage loans we originate are sold daily to the Trusts. The Trusts purchase the loans from us utilizing six warehouse facilities that were arranged by us, bear interest at one-month LIBOR plus 45 to 400 basis points and expire on various dates during the year. In July 2005, the warehouse facilities were increased from \$9.0 billion to \$10.0 billion.

In August 2005, the FASB issued three exposure drafts which amend Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. See discussion in note 12 to the condensed consolidated financial statements.

There have been no other material changes in our off-balance sheet financing arrangements from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

### **COMMERCIAL PAPER ISSUANCE**

We maintain two unsecured CLOCs, for working capital, to support our commercial paper program and for general corporate purposes. Subsequent to July 31, 2005, the first CLOC expired and was replaced with a new \$1.0 billion CLOC, which expires in August 2010. Also subsequent to July 31, 2005, the second CLOC was extended, and now expires in August 2010.

There have been no other material changes in our commercial paper program from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

### **CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

There have been no material changes in our contractual obligations and commercial commitments from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.



**Table of Contents****REGULATORY ENVIRONMENT**

There have been no material changes in our regulatory environment from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**FORWARD-LOOKING INFORMATION**

In this report, and from time to time throughout the year, we share our expectations for our future performance. These forward-looking statements are based upon current information, expectations, estimates and projections regarding the Company, the industries and markets in which we operate, and our assumptions and beliefs at that time. These statements speak only as of the date on which they are made, are not guarantees of future performance, and involve certain risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results could materially differ from what is expressed, implied or forecast in these forward-looking statements. Words such as believe, will, plan, expect, intend, estimate, approximate, and similar expressions may identify such forward-looking statements.

There have been no material changes in our risk factors from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**RECONCILIATION OF NON-GAAP FINANCIAL INFORMATION**

We report our financial results in accordance with generally accepted accounting principles (GAAP). However, we believe certain non-GAAP performance measures and ratios used in managing the business may provide additional meaningful comparisons between current year results and prior periods, by excluding certain items that do not represent results from our basic operations. Reconciliations to GAAP financial measures are provided below. These non-GAAP financial measures should be viewed in addition to, not as an alternative for, our reported GAAP results.

**Origination Margin**

(dollars in 000s)

| Three months ended                                 | July 31, 2005 | Restated<br>July 31,<br>2004 | April 30,<br>2005 |
|--|---------------|------------------------------|-------------------|
| Total expenses                                     | \$ 225,970    | \$ 162,948                   | \$ 217,728        |
| Add: Expenses netted against gain on sale revenues | 114,222       | 92,489                       | 103,123           |
| Less:  |               |                              |                   |
| Cost of services                                   | 64,392        | 49,861                       | 61,590            |
| Cost of acquisition                                | 52,306        | 41,700                       | 47,428            |
| Allocated support departments                      | 5,831         | 5,346                        | 5,768             |
| Other  | 6,255         | 7,200                        | 7,528             |
|  | \$ 211,408    | \$ 151,330                   | \$ 198,537        |
| Divided by origination volume                      | \$ 10,887,629 | \$ 6,816,517                 | \$ 9,278,489      |
| Total cost of origination                          | 1.94%         | 2.22%                        | 2.14%             |

**ITEM 4. CONTROLS AND PROCEDURES****EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

We have established disclosure controls and procedures (Disclosure Controls) to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls were designed to provide reasonable assurance that the controls and procedures would meet their objectives. Our management, including the Chief Executive Officer and Chief Financial

Officer, does not expect that our Disclosure Controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the designed control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of

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the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusions of two or more people, or by management override of the control. Because of the inherent limitations in a cost-effective, maturing control system, misstatements due to error or fraud may occur and not be detected.

As of the end of the period covered by this Form 10-Q/A, we evaluated the effectiveness of the design and operation of our Disclosure Controls. The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, and included consideration of the material weakness initially disclosed in our Annual Report on Form 10-K/A for the year ended April 30, 2005. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our Disclosure Controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q/A because of the material weakness described below.

As disclosed initially in our Annual Report on Form 10-K/A for the year ended April 30, 2005, management identified a material weakness in our accounting for income taxes. Specifically, the Company did not maintain sufficient resources in the corporate tax function to accurately identify, evaluate and report, in a timely manner, non-routine and complex transactions. In addition, the Company had not completed the requisite historical analysis and related reconciliations to ensure tax balances were appropriately stated prior to the completion of the Company's April 30, 2005 internal control activities.

In February 2006, as a result of the ongoing controls and procedural work to remediate the material weakness in the Company's internal controls over accounting for income taxes as of April 30, 2005, management discovered additional income tax errors which required the restatement of prior periods. In preparation for its revised 10-Q/A filing, management reviewed this disclosure and continues to believe it accurately describes the nature of the internal control deficiencies that contributed to the material weakness as of April 30, 2005.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

In order to remediate the aforementioned material weakness, management completed the requisite historical analysis including creation of the necessary tax basis balance sheets and current and deferred reconciliations required and related internal control testing to ensure propriety of all tax related financial statement account balances as of the Form 10-K/A filing date. The Company believes it established appropriate controls and procedures and created appropriate tax account analysis and support subsequent to April 30, 2005.

In addition to implementing management's action plan addressing items from the comprehensive evaluation, we will continue to monitor the improvements in the controls over accounting for income taxes to ensure remediation of the material weakness.

Other than the changes outlined above, there were no changes that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 6. EXHIBITS**

- 10.1 Sale and Servicing Agreement dated as of June 1, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2005-6 and Wells Fargo Bank, N.A., filed as Exhibit 10.1 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.2 Note Purchase Agreement dated as of June 1, 2005 among Option One Loan Warehouse Corporation, Option One Owner Trust 2005-6 and Lehman Brothers Bank, filed as Exhibit 10.2 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.

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- 10.3 Indenture dated as of June 1, 2005 between Option One Owner Trust 2005-6 and Wells Fargo Bank, N.A., filed as Exhibit 10.3 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.4 Amendment Number 1 to Second Amended and Restated Sale and Servicing Agreement dated March 8, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2001-2 and Wells Fargo Bank, N.A., filed as Exhibit 10.4 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.5 Amendment Number Five to Amended and Restated Note Purchase Agreement dated November 25, 2003 among Option One Loan Warehouse Corporation, Option One Owner Trust 2001-2 and Bank of America, N.A., filed as Exhibit 10.5 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.6 Amendment Number One to Second Amended and Restated Sale and Servicing Agreement dated as of April 29, 2005 among Option One Owner Trust 2001-1A, Option One Loan Warehouse Corporation, Option One Mortgage Corporation and Wells Fargo Bank N.A., filed as Exhibit 10.6 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.7 Amendment Number One to Second Amended and Restated Sale and Servicing Agreement dated as of April 29, 2005 among Option One Owner Trust 2001-1B, Option One Loan Warehouse Corporation, Option One Mortgage Corporation and Wells Fargo Bank N.A., filed as Exhibit 10.7 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 10.8 Description of Executive Officer Cash Compensation, filed as Exhibit 10.8 to the Company's quarterly report on Form 10-Q for the quarter ended July 31, 2005, file number 1-6089, is incorporated by reference.
- 31.1 Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by Chief Executive Officer furnished pursuant to 18 U.S.C. 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification by Chief Financial Officer furnished pursuant to 18 U.S.C. 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**H&R BLOCK, INC.**

Mark A. Ernst  
Chairman of the Board, President  
and Chief Executive Officer  
March 31, 2006

William L. Trubeck  
Executive Vice President and  
Chief Financial Officer  
March 31, 2006

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