AFFILIATED COMPUTER SERVICES INC
Form 10-Q
February 14, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

(Mark One)

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

For the quarterly period ended December 31, 2001

OR

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

For the period from __________ to __________

Commission file number 0-24787

AFFILIATED COMPUTER SERVICES, INC.
(Exact name of registrant as specified in its charter)

Delaware	51-0310342
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2828 North Haskell, Dallas, Texas	75204
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (214) 841-6111

NOT APPLICABLE
(Former name, former address and former fiscal year, if changed since last report.)

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 X No ___

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

TITLE OF EACH CLASS	NUMBER OF SHARES OUTSTANDING AS OF FEBRUARY 8, 2002
Class A Common Stock, $.01 par value	56,939,056
Class B Common Stock, $.01 par value	3,299,686

60,238,742

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	DECEMBER 31, 2001 (UNAUDITED)	JUNE 30, 2001 (AUDITED)

ASSETS		
Current assets:		
Cash and cash equivalents	$ 44,174	$ 242,458
Accounts receivable, net	623,121	472,042
Inventory	12,576	8,591
Prepaid expenses and other current assets	89,993	77,572
Deferred taxes	6,707	8,952
Total current assets	776,571	809,615
Property, equipment and software, net	343,506	237,563
Intangibles, net	163,763	97,160
Goodwill, net	1,422,008	697,760
Long-term investments and other assets	53,402	49,589
Total assets	$ 2,759,250	$ 1,891,687
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 48,176	$ 40,265
Accrued compensation and benefits	82,839	82,043
Other accrued liabilities	209,591	126,875
Income taxes payable	15,922	7,742
Short-term debt	9,550	3,362
Current portion of unearned revenue	36,398	20,765
Total current liabilities	402,476	281,052
Convertible notes	546,927	546,927
Long-term debt	308	102,386
Deferred taxes	74,241	55,601
Other long-term liabilities	17,689	20,206
Total liabilities	1,041,641	1,006,172
Stockholders' equity:		
Class A common stock	569	473
Class B common stock	33	33
Additional paid-in capital	1,083,585	350,767
Retained earnings	633,390	534,374
Accumulated other comprehensive income (net of tax)	32	(132)
Total stockholders' equity	1,717,609	885,515
Total liabilities and stockholders' equity	$ 2,759,250	$ 1,891,687

See notes to consolidated financial statements.

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended December 31,		Six Month Decemb
	2001	2000	2001
Revenues	$ 750,427	$ 500,882	$ 1,405,446
Expenses:			
Wages and benefits	327,417	212,442	624,290
Services and supplies	224,707	151,477	397,578
Rent, lease and maintenance	65,980	52,683	138,860
Depreciation and amortization	27,499	22,576	51,914
Other operating expenses	7,403	4,977	13,841
Total operating expenses	653,006	444,155	1,226,483
Operating income	97,421	56,727	178,963
Interest expense	7,583	4,839	20,182
Other non-operating (income) expense, net	942	(991)	(374)
Pretax profit	88,896	52,879	159,155
Income tax expense	33,336	20,887	59,682
Net income	$ 55,560	$ 31,992	$ 99,473
Earnings per common share:			
Basic	$ .94	$ .64	$ 1.81
Diluted	$ .84	$ .59	$ 1.62
Shares used in computing earnings per common share:			
Basic	59,286	49,811	55,038
Diluted	70,346	56,881	66,009

See notes to consolidated financial statements.

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

	SIX MONTHS DECEMBER
	2001
Cash flows from operating activities:	
Net income	$ 99,473
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	51,914
Gain on sale of investment	--
Other	836
Changes in assets and liabilities, net of effects from acquisitions:	
Increase in accounts receivable	(42,443)
Increase in inventory	(3,606)
Increase in prepaid expenses and other current assets	(660)
Change in deferred taxes	20,745
Increase in other long-term assets	(1,069)
Increase (decrease) in accounts payable	6,952
Decrease in accrued compensation and benefits	(23,858)
Increase in other accrued liabilities	25,065
Change in income taxes payable	17,869
Decrease in unearned revenue	(2,393)
Increase (decrease) in other long-term liabilities	(615)
Total adjustments	48,737
Net cash provided by operating activities	148,210
Cash flows from investing activities:	
Purchases of property, equipment and software, net of sales	(78,550)
Payments for acquisitions, net of cash acquired	(878,809)
Proceeds from divestitures, net of transaction costs	(3,401)
Purchase of investments	--
Proceeds from sale of investment	--
Additions to other intangible assets	(8,523)
Additions to notes receivable	(2,823)
Proceeds received on notes receivable	2,395
Net cash provided (used) by investing activities	(969,711)
Cash flows from financing activities:	
Proceeds from issuance of debt, net of issuance costs	810,360
Repayments of debt	(911,468)
Proceeds from equity offering	715,392
Proceeds from stock options exercised	9,733
Other	(800)

Net cash provided (used) by financing activities	623,217
Net decrease in cash and cash equivalents	(198,284)
Cash and cash equivalents at beginning of period	242,458
Cash and cash equivalents at end of period	$ 44,174

See notes to consolidated financial statements.

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AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Affiliated Computer Services, Inc. and its majority-owned subsidiaries. All material intercompany profits, transactions and balances have been eliminated. We are a Fortune 1000 company comprised of approximately 30,000 full-time equivalent employees in 29 countries providing business process and technology outsourcing solutions to world-class commercial and government clients.

The financial information presented should be read in conjunction with our consolidated financial statements for the year ended June 30, 2001. The foregoing unaudited consolidated financial statements reflect all adjustments (all of which are of a normal recurring nature) which are, in the opinion of management, necessary for a fair presentation of the results of the interim periods. The results for the interim periods are not necessarily indicative of results to be expected for the year.

All share and per share information is presented without giving effect to the two-for-one stock split of our Class A and Class B common shares declared on January 22, 2002, payable on February 22, 2002 to shareholders of record as of February 15, 2002 (see Note 13 for further discussion).

2. EQUITY OFFERING

On October 10, 2001, we completed our offering of 9.2 million shares of our Class A common stock. The shares were issued at $81.00 per share. Net proceeds of $714.5 million (net of underwriters' fees and other costs) were used to repay the $550 million 18-month interim credit facility incurred to fund the Lockheed Martin IMS Corporation ("IMS") acquisition and a portion of the amount outstanding under our revolving credit facility.

3. ACQUISITIONS

In August 2001, we acquired 100% of the stock of IMS, a wholly owned subsidiary of Lockheed Martin Corporation for approximately $825 million. The acquisition was funded from a $550 million 18-month interim credit

facility, borrowings from our existing revolving credit facility, and existing cash on hand. IMS' results have been included in our consolidated financial statements from the effective date of the acquisition, August 1, 2001. IMS provides business process outsourcing services to more than 230 state and local government agencies in 45 U.S. states, the District of Columbia, Canada, Australia, and Europe. IMS specializes in child support enforcement, welfare and workforce services, child care management, electronic toll collection, and other intelligent transportation services involving the trucking industry, photo enforcement of red-light and speeding violations, parking management, and information technology outsourcing. We believe the acquisition of IMS solidifies ACS as a leader in technology based outsourcing solutions to state and local government agencies.

The acquisition was accounted for under the purchase method of accounting with assets acquired of $935.2 million and liabilities assumed of $110.2 million. The purchase price was allocated to assets acquired and liabilities assumed based on the estimated fair value at July 31, 2001, subject to finalization of third party valuation, as follows (in thousands):

Current Assets	$120,604
Property, equipment and software	58,804
Other long-term assets	2,826
Intangible assets	64,501
Goodwill	688,512
Total assets acquired	935,247
Current liabilities	110,247
Total liabilities assumed	110,247
Net assets acquired	$825,000

The total amount of goodwill is expected to be fully deductible for tax purposes. Software of $41.5 million is included in property, equipment and software and has an anticipated useful life ranging from 2 to 10 years. The $64.5 million acquired intangible assets is attributable to customer contracts with an aggregate anticipated useful life of approximately 11 years.

3. ACQUISITIONS (CONTINUED)

Pro forma Financial Information

The following unaudited pro forma information presents a summary of our consolidated results of operations as if the IMS acquisition had occurred at the beginning of the periods presented and are not necessarily

indicative of future results or actual results that would have been achieved had the acquisition occurred at the beginning of the periods presented (in thousands, except per share amounts).

	For the three months ended December 31,		For the six months ended December 31,	
	2001	2000	2001	2000
Revenue	$ 750,427	$ 659,292	$ 1,457,099	$ 1,296,45
Net income	55,560	41,346	101,467	75,44
Earnings per common share:				
Basic	$ .94	$ .83	$ 1.84	$ 1.5
Diluted	$ .84	$ .75	$ 1.65	$ 1.3

4. NEW ACCOUNTING STANDARDS

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, ("SFAS 141") "Business Combinations" and No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as assets apart from goodwill. SFAS 142 requires that ratable amortization of goodwill be replaced with periodic tests of the goodwill's impairment and that intangible assets other than goodwill be amortized over their useful lives. SFAS 141 is effective for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. We adopted the provisions of SFAS 141 and SFAS 142 effective July 1, 2001.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Standards No. 144, ("SFAS 144") "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 retains the fundamental provisions of existing generally accepted accounting principles with respect to the recognition and measurement of long-lived asset impairment contained in Statement of Financial Accounting Standards No. 121 ("SFAS 121") "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." However, SFAS No. 144 provides new guidance intended to address certain significant implementation issues associated with SFAS 121, including expanded guidance with respect to appropriate cash flows to be used to determine whether recognition of any long-lived asset impairment is required, and if required, how to measure the amount of the impairment. SFAS 144 also requires that any net assets to be disposed of by sale be reported at the lower of carrying value or fair market value less cost to sell, and expands the reporting of discontinued operations to include any component of an entity with operations and cash flows that can be clearly distinguished from the rest of the entity. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. We do not believe SFAS 144 will have a material impact on our future earnings and financial position.

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

5. GOODWILL AND OTHER INTANGIBLE ASSETS - ADOPTION OF SFAS 142

The following table reflects the effect of SFAS 142 on net income and earnings per share as if SFAS 142 had been in effect for all periods presented:

	FOR THE THREE MONTHS ENDED DECEMBER 31,		FOR THE D
	2001	2000	2001
	(in thousands except per share amounts)		(in thousan
Net income	$ 55,560	$ 31,992	$ 99,4
Add back goodwill amortization, net of related tax benefit ($809 and $1,760 respectively)	--	5,297	
Adjusted net income	$ 55,560	$ 37,289	$ 99,4
Basic earnings per share:			
Reported net income	$ .94	$ .64	$ 1.
Add back goodwill amortization (net of tax benefit)	--	.11	
Adjusted net income	$ .94	$ .75	$ 1.
Diluted earnings per share:			
Reported net income	$ .84	$ .59	$ 1.
Add back goodwill amortization (net of tax benefit)	--	.09	
Adjusted net income	$ .84	$ .68	$ 1.

6. DERIVATIVES AND HEDGING ACTIVITIES

In order to manage interest costs and exposure to changing interest rates, we held two interest rate hedges, designated as cash flow hedges, which were initiated in December 1998. Both interest rate hedges expired in December 2001. Each hedge was structured such that we paid a fixed rate of interest of 4.54%, and received a floating rate of interest based on one month LIBOR. The notional amount of the two hedges totaled $100 million and the fair market value of the two hedges at December 31, 2001 and June 30, 2001 was $0 and ($355,000), respectively. The fair value of each interest rate hedge reflected termination cash value. The fair value of the interest rate

hedges, net of $0 and $139,000 tax benefit, respectively, was reflected in "Accumulated other comprehensive income (net of tax)."

In order to manage the volatility of the value of our marketable security investment of $1.1 million, we entered into a no-cost collar agreement in June 2001 which matures in March 2002. The collar, a fair value hedge, is structured so that all fluctuations in the price of the marketable security above or below 100% or 102.5% of its value on the date the collar was entered into are hedged. As of December 31, 2001 and June 30, 2001, the collar had fair market values of $11,000 and $27,000, respectively.

7. COMPREHENSIVE INCOME

We have adopted Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income." The objective of SFAS 130 is to report a measure of all changes in equity of an enterprise that result from transactions and other economic events of the period other than transactions with owners. Comprehensive income is the total of net income and other non-owner charges in equity.

The components of comprehensive income are as follow (in the thousands):

	THREE MONTHS ENDED DECEMBER 31,		SIX MONTHS E DECEMBER	
	2001	2000	2001	
Net income	$ 55,560	$ 31,992	$ 99,473	$
Change in fair value of derivatives (net of tax effect of $159, ($460), $158 and $507 respectively)	249	(703)	164	
Comprehensive income	$ 55,809	$ 31,289	$ 99,637	$

8. GOODWILL

The changes in the carrying amount of goodwill for the quarter ended December 31, 2001 are as follow (in thousands):

	COMMERCIAL	FEDERAL GOVERNMENT	TOTAL

Balance as of September 30, 2001	$ 1,265,696	$ 122,873	$ 1,388,569
Goodwill activity			
During the quarter	33,439	--	33,439
Balance as of December 31, 2001	$ 1,299,135	$ 122,873	$ 1,422,008

The goodwill activity in the commercial segment is primarily the result of the refinement of the third-party valuation of the assets acquired in the IMS acquisition during the current quarter.

9. INTANGIBLE ASSETS

	AS OF DECEMBER 31, 2001 (IN THOUSANDS)	
	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION
Amortized intangible assets:		
Customer contract related intangibles	$ 151,914	$ (43,190)
All other	6,865	(2,626)
Total	$ 158,779	$ (45,816)
Unamortized intangible asset:		
Title plant	$ 50,800	
Total	$ 50,800	

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

8. INTANGIBLE ASSETS (CONTINUED)

Aggregate amortization expense:	
For the quarter ended December 31, 2001	$ 5,643
Estimated amortization expense:	
For the year ended June 30, 2002	$ 21,503
For the year ended June 30, 2003	$ 18,913
For the year ended June 30, 2004	$ 15,497
For the year ended June 30, 2005	$ 12,591
For the year ended June 30, 2006	$ 11,348

Customer contract related intangibles are amortized over a weighted average of approximately 8 years. All other intangibles are amortized over a weighted average of 14 years.

10. EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standard No. 128, "Earnings per Share," the following table (in thousands except per share amounts) sets forth the computation of basic and diluted earnings per share before giving effect to the two-for-one stock split payable on February 22, 2002 (see Note 13):

	THREE MONTHS ENDED DECEMBER 31,		
	2001	2000	
Numerator:			
Numerator for earnings per share (basic)			
Income available to common stockholders	$ 55,560	$ 31,992	$
Effect of dilutive securities:			
Interest on 4% convertible debt, net of tax	1,548	1,540	
Interest on 3.5% convertible debt, net of tax	2,066	--	
Numerator for earnings per share assuming Dilution - income available to common stockholders	$ 59,174	$ 33,532	$
Denominator:			
Weighted average shares outstanding (basic)	59,286	49,811	
Effect of dilutive securities:			
4% convertible debt	5,390	5,392	
3.5% convertible debt	3,650	--	
Stock options	2,020	1,678	
Total potential common shares	11,060	7,070	
Denominator for earnings per share assuming dilution	70,346	56,881	
Earnings per common share (basic)	$ .94	$ .64	$
Earnings per common share assuming dilution	$ .84	$ .59	$

11. NON-RECURRING ITEMS

In the first quarter of fiscal 2001, we recorded a $12.8 million gain in "Other non-operating (income) expense, net" related to the sale of a non-strategic minority investment in ACS Merchant Services, Inc.

In the first quarter of fiscal 2001, we recorded a $10.4 million charge in connection with the termination of certain hardware leases and disaster recovery contracts, which is included in "Rent, lease and maintenance" expense. In addition, we recorded a $2.1 million charge for non-recurring litigation costs and the writedown of property held-for-sale to market value to "Other operating expenses."

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

12. SEGMENT INFORMATION

Based on the criteria set forth in Statement of Financial Accounting Standard No. 131, "Disclosure about Segments of an Enterprise and Related Information," we have two reportable segments: commercial and federal government. Certain reclassifications have been made to the segment disclosure as the result of changes to our reporting structure. The following is a summary of certain financial information by reportable segment (in thousands):

Quarter Ended December 31, 2001	Commercial	Federal Government	Corporate	Consol
Revenue	$ 559,286	$ 191,141	$ --	$ 7
Operating expense	446,820	170,671	8,016	6
EBITDA(a)	112,466	20,470	(8,016)	1
Depreciation & amortization expense	22,308	4,662	529	
Goodwill amortization	--	--	--	
Operating income	$ 90,158	$ 15,808	$ (8,545)	$

Quarter Ended December 31, 2000	Commercial	Federal Government	Corporate	Con
Revenue	$ 314,728(b)	$ 186,154	$ --	$
Operating expense	249,426	168,000	4,153	
EBITDA(a)	65,302	18,154	(4,153)	
Depreciation & amortization expense	13,419	2,660	391	
Goodwill amortization	4,858	1,248	--	
Operating income	$ 47,025	$ 14,246	$ (4,544)	$

Six Months Ended December 31, 2001

	Commercial	Federal Government	Corporate	Consol
Revenue	$1,024,129	$ 381,317	$ --	$ 1,
Operating expense	819,695	342,197	12,677	1,
EBITDA(a)	204,434	39,120	(12,677)	
Depreciation & amortization expense	42,442	8,459	1,013	
Goodwill amortization	--	--	--	
Operating income	$ 161,992	$ 30,661	$ (13,690)	$

Six Months Ended December 31, 2000

	Commercial	Federal Government	Corporate	Con
Revenue	$ 615,743(b)	$ 363,765	$ --	$
Operating expense	500,869(c)	328,417	7,654	
EBITDA(a)	114,874	35,348	(7,654)	
Depreciation & amortization expense	25,672	5,469	712	
Goodwill amortization	9,486	2,329	--	
Operating income	$ 79,716	$ 27,550	$ (8,366)	$

(a) EBITDA consist of earnings before interest income, interest expense, other non-operating income and expense, income taxes, depreciation and amortization. EBITDA is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as an alternative to net income as an indicator of a company's performance or to cash flows from operating activities as a measure of liquidity.

(b) Includes revenue of $4.3 million for the quarter ended December 31, 2000 and $16.2 million for the six months ended December 31, 2000 related to the divestitures announced in June 2000.

(c) Operating expense includes $12.5 million of non-recurring charges related to hardware lease buyouts and disaster recovery contracts, legal fees and a writedown of property held-for sale to market value (see Note 11).

AFFILIATED COMPUTER SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

13. SUBSEQUENT EVENTS

On January 22, 2002, we announced that our Board of Directors approved a two-for-one stock split of our outstanding Class A Common Stock and Class B Common Stock to be implemented in the form of a 100% stock dividend ("Stock Split"). Each holder of record of our Class A Common Stock and Class B Common Stock as of the close of business on February 15, 2002 will receive one additional share of such stock held by them at that time. We will issue the additional shares resulting from the Stock Split on February 22, 2002. In connection with the Stock Split, the number of shares of Class A Common Stock reserved for issuance or subject to outstanding options granted under our employee stock option or other benefit plans, as well as the number of shares reserved for issuance under our 4% Convertible Subordinated Notes due March 15, 2005 and 3.5% Convertible Subordinated Notes due February 15, 2006, will be proportionately increased in accordance with the terms of such options, plans and other instruments.

The following table (in thousands except per share amounts) sets forth the pro forma computation of basic and diluted earnings per share as if the two-for-one stock split payable on February 22, 2002 had been effective for all periods presented:

	THREE MONTHS ENDED DECEMBER 31,		SIX MON DECEM
	2001	2000	2001
Net Income	$ 55,560	$ 31,992	$ 99,473
Weighted average shares outstanding (basic)	118,572	99,622	110,076
Weighted average shares outstanding (diluted)	140,692	113,762	132,018
Earnings per common share (basic)	$ .47	$ .32	$ .90
Earnings per common share assuming dilution	$ .42	$ .29	$ .81

On February 12, 2002, we announced that our Board of Directors had approved the redemption of our 4% Convertible Subordinated Notes due March 15, 2005 (the "Notes"). As of February 12, 2002, the outstanding principal amount of the Notes was $229.9 million. The redemption will occur on March 15, 2002, for holders of record on that date at a redemption price equal to 101.71% of the principal amount of Notes held. Holders of the Notes may elect to convert the Notes to our Class A Common Stock on or before the day prior to redemption. The conversion rate is 23.4432 shares of Class A Common Stock for each $1,000 principal amount of the Notes (equivalent to a conversion price of $42.66 per share of Class A Common Stock before giving effect to our previously announced two-for-one stock split, to be implemented in the form of a stock dividend payable on February 22, 2002 to stockholders of record as of the close of business on February 15, 2002). In accordance with

the terms of the Notes, we will be required to make payment for fractional shares in cash, based on the closing price of our stock on the date of conversion, and all accrued interest due through the date of conversion. The notice is irrevocable.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts, included in this MD&A regarding our financial position, business strategy and plans and objectives of our management for future operations are forward-looking statements. While management has based any forward looking statements contained herein on its current expectations, the information on which such expectations were based may change. These forward-looking statements rely on a number of assumptions concerning future events and are subject to a number of risks, uncertainties and other factors, many of which are outside of our control, that could cause actual results to materially differ from such statements. Such events include, but are not necessarily limited to: (i) uncertainties caused by terrorist attacks on September 11, 2001 and the threat of other attacks, acts of war or other related events that may disrupt the markets in which we operate, our customers, our operations and our profitability; (ii) the loss of business from significant customers; (iii) the impairment of our capital investments as the result of the deterioration of the financial condition of our customers in whom we have made a significant capital investment; (iv) the competition in the information technology industry and the impact of such competition on pricing, revenues and margins; (v) difficulty or inability to execute our acquisition strategy; (vi) timing and magnitude of technological advances; (vii) loss of significant vendor(s) resulting in increased expense or inability to serve our customers; (viii) provisions in our contracts permitting termination for convenience, permitting termination of or subjecting us to penalties under certain contracts, if specified service levels are not maintained, and/or permitting audits of our pricing and compliance; (ix) changes in federal, state or local government requirements imposing additional burdens and subjecting us to additional expenditures and increased compliance risk; and (x) the cost of attracting and retaining highly skilled personnel. These risks and uncertainties and other risks and uncertainties are discussed in more detail in the "Risk Factors" section of our Prospectus Supplement dated October 3, 2001, which has been filed with the Securities and Exchange Commission. In addition, we operate in a highly and rapidly changing environment and new risks may arise. Accordingly, investors should not place any reliance on forward looking statements as a prediction of actual results. We undertake no obligation to update any forward looking statements.

SIGNIFICANT DEVELOPMENTS

SIX MONTHS ENDED DECEMBER 31, 2001

On October 10, 2001, we completed our offering of 9.2 million shares of our Class A common stock. The shares were issued at $81.00 per share. Net proceeds of $714.5 million (net of underwriters' fees and other costs) were used to repay the $550 million 18-month interim credit facility incurred to fund the IMS acquisition and a portion of the amount outstanding under our revolving credit facility.

In August 2001, we acquired IMS, a wholly-owned subsidiary of Lockheed Martin Corporation. IMS, with its principal offices located in Washington D.C. and approximately 4,800 employees primarily throughout the United States, provides services to state and local government agencies in health and human services, transportation, public safety and child support. The transaction, valued at $825 million plus related transaction costs, was funded initially through a combination of a $550 million, 18-month interim credit facility, borrowings on our existing credit facility and existing cash on hand. IMS' operating results are included in our financial statements from the effective date of the acquisition, August 1, 2001.

Also in August 2001, we acquired the business process outsourcing services unit of National Processing Company ("NPC"). NPC provides healthcare claims processing, credit card application processing and airline lift ticket processing. As part of the transaction, we acquired all of NPC's offshore operations in Jamaica, the Dominican Republic, Barbados and a majority of NPC's Mexican operations. The transaction value was $43 million plus related transaction costs. NPC's operating results are included in our financial statements from the effective date of the acquisition, August 1, 2001.

On January 22, 2002, we announced that our Board of Directors approved a two-for-one stock split of our outstanding Class A Common Stock and Class B Common Stock to be implemented in the form of a 100% stock dividend ("Stock Split"). Each holder of record of our Class A Common Stock and Class B Common Stock as of the close of business on February 15, 2002 will receive one additional share of such stock held by them at that time. We will issue the additional shares resulting from the Stock Split on February 22, 2002. In connection with the Stock Split, the number of shares of Class A Common Stock reserved for issuance or subject to outstanding options granted under our employee stock option or other benefit plans, as well as the number of shares reserved for issuance under our 4% Convertible Subordinated Notes due March 15, 2005 and 3.5% Convertible Subordinated Notes due February 15, 2006, will be proportionately increased in accordance with the terms of such options, plans and other instruments.

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On February 12, 2002, we announced that our Board of Directors had approved the redemption of our 4% Convertible Subordinated Notes due March 15, 2005 (the "Notes"). As of February 12, 2002, the outstanding principal amount of the Notes was $229.9 million. The redemption will occur on March 15, 2002, for holders of record on that date at a redemption price equal to 101.71% of the principal amount of Notes held. Holders of the Notes may elect to convert the Notes to our Class A Common Stock on or before the day prior to redemption. The conversion rate is 23.4432 shares of Class A Common Stock for each $1,000 principal amount of the Notes (equivalent to a conversion price of $42.66 per share of Class A Common Stock before giving effect to our previously announced two-for-one stock split, to be implemented in the form of a stock dividend payable on February 22, 2002 to stockholders of record as of the close of business on February 15, 2002). In accordance with the terms of the Notes, we will be required to make payment for fractional shares in cash, based on the closing price of our stock on the date of conversion, and all accrued interest due through the date of conversion. The notice is irrevocable.

SIX MONTHS ENDED DECEMBER 31, 2000

During the first quarter of fiscal 2001, we recorded a $12.8 million gain in "Other non-operating (income) expense, net" associated with the sale of a certain non-strategic minority investment in ACS Merchant Services, Inc. In addition, we recorded non-recurring charges totaling $12.5 million related to the termination of certain computer equipment leases and consolidation of disaster recovery contracts ($10.4 million recorded in "Rent, lease and maintenance") and litigation expense and the writedown of a facility held-for-sale to market value ($2.1 million recorded in "Other operating expenses").

RESULTS OF OPERATIONS

The following table sets forth certain items from our consolidated statements of income as a percentage of revenues:

	THREE MONTHS ENDED DECEMBER 31,		SIX MONTHS ENDED DECEMBER 31,	
	2001	2000	2001	200
Revenues	100%	100%	100%	
Expenses:				
Wages and benefits	43.6	42.4	44.4	
Services and supplies	29.9	30.3	28.3	
Rent, lease and maintenance	8.8	10.5	9.9	
Depreciation and amortization	3.7	4.5	3.7	
Other operating expenses	1.0	1.0	1.0	
Total operating expenses	87.0	88.7	87.3	
Operating income	13.0	11.3	12.7	
Interest expense	1.0	1.0	1.4	
Other non-operating income, net	0.1	(0.2)	(0.0)	
Pretax profit	11.9	10.5	11.3	
Income tax expense	4.5	4.1	4.2	
Net income	7.4%	6.4%	7.1%	

COMPARISON OF THE QUARTER ENDED DECEMBER 31, 2001 TO THE QUARTER ENDED DECEMBER 31, 2000

Revenues increased to $750.4 million, or 50%, in the second quarter of fiscal year 2002 from $500.9 million in the second quarter of fiscal year 2001. Included in the revenues for the second quarter fiscal 2001 was $4.3 million related to business units which were divested in fiscal 2001. Internal revenue growth was 12% and revenue growth from acquisitions was 38%, primarily due to the IMS and NPC acquisitions in the first quarter of fiscal year 2002. Excluding revenues from the divested units, our commercial revenues increased $248.9 million, or 80%, to $559.3 million in the second quarter of fiscal 2002, of which 63% related to acquisitions completed in the last twelve months and 17% due primarily to strong revenue increases in our business process outsourcing and state healthcare businesses. Our federal government revenues increased 3%, or $5.0 million, to $191.1 million.

After adjusting for the application of SFAS 142 (see Note 5), our operating income increased to $97.4 million, or 55%, in the second quarter of fiscal year 2002 as compared to $62.8 million for the second quarter of fiscal year 2001, primarily due to the full quarter impact of the IMS and NPC acquisitions in the first quarter of fiscal year 2002, as well as the internal growth discussed above.

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After adjusting for the application of SFAS 142 (see Note 5), our operating margins increased slightly to 13.0% from 12.5% in the second quarter of fiscal 2001. Wages and benefits increased 1.2%, rent, lease and maintenance decreased 1.7%, and services and supplies decreased 0.4% as a percentage of revenue due to our increased focus in business process outsourcing, which has a larger component of salaries and wages and a lower component of rent, lease and maintenance than traditional technology outsourcing. When adjusting for SFAS 142, depreciation and amortization increased 0.4% as a percentage of revenue primarily due to capital expenditures and additions to intangible assets from acquisition related activity.

Interest expense increased $2.7 million from $4.8 million in the second quarter of fiscal year 2001 to $7.6 million in the second quarter of fiscal year 2002. The increase was primarily due to interest expense incurred on the 3.5% Convertible Subordinated Notes which were issued in February 2001 and the interim credit facility which funded the IMS acquisition.

Other non-operating expense in fiscal year 2002 consisted primarily of a loss of $1.0 million on a long-term investment, which we received in the December 1998 acquisition of BRC Holdings, Inc., recorded in the second quarter of fiscal year 2002. The other non-operating income in fiscal year 2001 primarily consisted of a gain on a note receivable recorded in the second quarter of fiscal 2001.

Our effective tax rate of approximately 37.5% in the second quarter of fiscal 2002 exceeded the federal statutory rate of 35% due primarily to the net effect of state income taxes. Our effective tax rate decreased 2.0% from 39.5% for the second quarter of fiscal year 2001 due to the application of SFAS 142 (see Note 5).

COMPARISON OF THE SIX MONTHS ENDED DECEMBER 31, 2001 TO THE SIX MONTHS ENDED DECEMBER 31, 2000

Revenues increased to $1.4 billion, or 46%, for the six months ended December 31, 2001 as compared to the same period last year when excluding the fiscal year 2001 revenues from divested units of $16.2 million. Internal growth was 11% and growth through acquisitions was 35%. Our commercial revenues increased $424.5 million, or 72%, to $1.0 billion when excluding revenues from our divested units, with 15% internal growth and 57% from acquisitions. Internal growth was due to growth in our state healthcare, state and local governments and business process outsourcing businesses. Our federal government revenues increased 5% to $381.3 million for the six months ended December 31, 2001 as a result of continued growth in our defense and education contracts.

After adjusting for the application of SFAS 142 (see Note 5), our operating income increased to $179.0 million, or 62%, for the six months ended December 31, 2002 as compared to $110.7 million for the same period last year, primarily due to the impact of the first quarter fiscal year 2002 acquisitions of IMS and

NPC, as well as the internal growth discussed above.

Operating margins increased 0.1% to 12.7% for the six months ended December 31, 2001 after adjusting for the application of SFAS 142 (see Note 5) and the non-recurring items recorded in the first quarter of fiscal year 2001 (see Note 11). Excluding these items, wages and benefits increased 0.6%, rent, lease and maintenance decreased 0.8%, and services and supplies decreased 0.4% as a percentage of revenue due to our increased focus in business process outsourcing which has a larger component of salaries and wages and a lower component of rent, lease and maintenance than traditional technology outsourcing. Depreciation and amortization increased 0.4% as a percentage of revenue when adjusting for SFAS 142 due to capital expenditures and additions to intangible assets during the last year.

Interest expense increased $10.3 million from $9.9 million to $20.2 million for the six months ended December 31, 2001 compared to the six months ended December 31, 2000. The increase was due to interest expense on the 3.5% Convertible Subordinated Notes which were issued in February 2001 and the interim credit facility which funded the IMS acquisition.

Other non-operating expense in fiscal year 2002 consisted primarily of a loss of $1.0 million on a long-term investment, which we received in the December 1998 acquisition of BRC Holdings, Inc. recorded in the second quarter of fiscal year 2002. Other non-operating income in fiscal year 2001 consisted of a non-recurring gain on sale of an investment (see Note 11) and a gain on a note receivable.

Our effective tax rate of approximately 37.5% in the first six months of fiscal 2002 exceeded the federal statutory rate of 35% due primarily to the net effect of state income taxes. Our effective tax rate decreased 2.0% from 39.5% for the six months ended December 31, 2001 due to the application of SFAS 142 (see Note 5).

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2001, we had cash and cash equivalents of $44.2 million compared to $242.5 million at June 30, 2001. Included in these cash balances was $5.0 million and $4.9 million, respectively as of December 31, 2001 and June 30, 2001, of restricted cash held on behalf of our governmental customers. Working capital decreased to $374.1 million at December 31, 2001 from $528.6 million at June 30, 2001 due to cash paid for the IMS and NPC acquisitions during the first quarter of $225 million and $43 million, respectively, offset by proceeds from the second quarter fiscal 2002 equity offering, net of repayments of outstanding balances on our revolving credit facility and interim credit facility.

Excluding the $50.0 million in taxes related to our divestiture activity and $10.4 million of non-recurring items in fiscal year 2001, cash provided by operating activities increased to $148.2 million for the six months ended December 31, 2001, as compared to $67.8 million in the same period last year. The increase in operating cash flow is primarily due to increased net income and our continued focus on our working capital requirements, including improvement in our days sales outstanding on our accounts receivable. Cash used in investing activities was $969.7 million, primarily due to the IMS and NPC acquisitions during the first quarter of fiscal year 2002. Cash provided by financing activities was $623.2 million due to proceeds received from the equity offering

(see Note 2) offset by net repayments of our credit facilities.

On October 10, 2001, we completed our offering of 9.2 million shares of our Class A common stock. The shares were issued at $81.00 per share. Net proceeds of $714.5 million (net of underwriters' fees and other costs) were used to repay the $550 million 18-month interim credit facility incurred to fund the IMS acquisition and a portion of the amount outstanding under our revolving credit facility.

At December 31, 2001, we had $434.4 million available on our $450 million revolving credit facility and outstanding letters of credit of $15.6 million. In January 2002, we issued an additional $89 million of letters of credit to secure our performance on our Georgia Healthcare Partnership contract. These letters of credit reduce the availability of our revolving credit facility.

Due to the terrorist attacks on September 11, 2001 and the Enron Corporation bankruptcy, the surety bond market has substantially changed, resulting in reduced availability of bonds and increased premiums. Some of our state and local government contracts require either a bond or a letter of credit and future requests for proposal may require a surety bond or letter of credit. Notwithstanding the existing condition of the surety bond market, management believes that it has sufficient liquidity from its cash flow and under its revolving credit facility to meet ongoing business needs and to respond to future requests for proposals from state and local governments.

On January 22, 2002, we announced that our Board of Directors approved a two-for-one stock split of our outstanding Class A Common Stock and Class B Common Stock to be implemented in the form of a 100% stock dividend ("Stock Split"). Each holder of record of our Class A Common Stock and Class B Common Stock as of the close of business on February 15, 2002 will receive one additional share of such stock held by them at that time. We will issue the additional shares resulting from the Stock Split on February 22, 2002. In connection with the Stock Split, the number of shares of Class A Common Stock reserved for issuance or subject to outstanding options granted under our employee stock option or other benefit plans, as well as the number of shares reserved for issuance under our 4% Convertible Subordinated Notes due March 15, 2005 and 3.5% Convertible Subordinated Notes due February 15, 2006, will be proportionately increased in accordance with the terms of such options, plans and other instruments.

On February 12, 2002, we announced that our Board of Directors had approved the redemption of our 4% Convertible Subordinated Notes due March 15, 2005 (the "Notes"). As of February 12, 2002, the outstanding principal amount of the Notes was $229.9 million. The redemption will occur on March 15, 2002, for holders of record on that date at a redemption price equal to 101.71% of the principal amount of Notes held. Holders of the Notes may elect to convert the Notes to our Class A Common Stock on or before the day prior to redemption. The conversion rate is 23.4432 shares of Class A Common Stock for each $1,000 principal amount of the Notes (equivalent to a conversion price of $42.66 per share of Class A Common Stock before giving effect to our previously announced two-for-one stock split, to be implemented in the form of a stock dividend payable on February 22, 2002 to stockholders of record as of the close of business on February 15, 2002). In accordance with the terms of the Notes, we will be required to make payment for fractional shares in cash, based on the closing price of our stock on the date of conversion, and all accrued interest due through the date of conversion. The notice is irrevocable.

Management believes that available cash and cash equivalents, together with cash generated from operations and available borrowings under our credit facility, will provide adequate funds for our anticipated internal growth needs, including capital expenditures. Our management also believes that cash provided by operations will be sufficient to satisfy all existing debt obligations as they

become due. However, we intend to continue our growth through acquisitions and from time to time to engage in discussions with potential acquisition candidates, which could require significant commitments of capital. In order to pursue such opportunities we may be required to incur debt or to issue additional potentially dilutive securities in the future. No assurance can be given as to our future acquisitions and expansion opportunities and how such opportunities will be financed.

NEW ACCOUNTING STANDARDS

On July 1, 2001, we adopted Statements Financial Accounting Standards No. 141, "Business Combinations," and No. 142 "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as assets apart from goodwill. SFAS 142 requires that ratable amortization of goodwill be replaced with periodic tests of the goodwill's impairment and that intangible assets other than goodwill be amortized over their useful lives. SFAS 141 is effective for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Standards No. 144, ("SFAS 144") "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 retains the fundamental provisions of existing generally accepted accounting principles with respect to the recognition and measurement of long-lived asset impairment contained in Statement of Financial Accounting Standards No. 121 ("SFAS 121") "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." However, SFAS No. 144 provides new guidance intended to address certain significant implementation issues associated with SFAS 121, including expanded guidance with respect to appropriate cash flows to be used to determine whether recognition of any long-lived asset impairment is required, and if required, how to measure the amount of the impairment. SFAS 144 also requires that any net assets to be disposed of by sale be reported at the lower of carrying value or fair market value less cost to sell, and expands the reporting of discontinued operations to include any component of an entity with operations and cash flows that can be clearly distinguished from the rest of the entity. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. We do not believe SFAS 144 will have a material impact on our future earnings and financial position.

PART II

ITEM 1. LEGAL PROCEEDINGS

On December 16, 1998, a state district court in Houston, Texas entered final judgment against us in a lawsuit brought by twenty-one former employees of

Gibraltar Savings Association and/or First Texas Savings Association (collectively, "GSA/FTSA"). The GSA/FTSA employees alleged that they were entitled to the value of 401,541 shares of our stock pursuant to options issued to the GSA/FTSA employees in 1988 in connection with a former technology outsourcing services agreement between GSA/FTSA and us. The judgment against us was for approximately $17 million, which includes attorneys' fees and pre-judgment interest, but excludes additional attorneys' fees of approximately $850,000 and post-judgement interest at the statutorily mandated rate, which could be awarded in the event the plaintiffs are successful upon appeal and final judgment. We continue to believe that we have a meritorious defense to all or a substantial portion of the plaintiffs' claims, and accordingly, have not accrued any amount on our balance sheet related to the lawsuit. We filed our appeal of the judgment on March 15, 1999 and a brief in support of such appeal has been filed. We plan to vigorously pursue the appeal. The plaintiffs also have filed a notice of appeal. A hearing for oral arguments on the parties' appeals occurred on September 20, 2001. Should the proceedings not be favorably resolved on appeal, we would be subject to a material charge. The court of appeals has given no indication of when it will issue its decision.

In addition to the foregoing, we are subject to certain other legal proceedings, claims and disputes which arise in the ordinary course of our business. Although we cannot predict the outcomes of these legal proceedings, we do not believe these actions, in the aggregate, will have a material adverse effect on our financial position, results of operations or liquidity.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On October 10, 2001, we completed our offering of 9.2 million shares of our Class A common stock. The shares were issued at $81.00 per share. Net proceeds of $714.5 million (net of underwriters' fees and other costs) were used to repay the $550 million 18-month interim credit facility we obtained in connection with the IMS acquisition and a portion of the amount outstanding under our revolving credit facility.

On January 22, 2002, we announced that our Board of Directors approved a two-for-one stock split of our outstanding Class A Common Stock and Class B Common Stock to be implemented in the form of a 100% stock dividend ("Stock Split"). Each holder of record of our Class A Common Stock and Class B Common Stock as of the close of business on February 15, 2002 will receive one additional share of such stock held by them at that time. We will issue the additional shares resulting from the Stock Split on February 22, 2002. In connection with the Stock Split, the number of shares of Class A Common Stock reserved for issuance or subject to outstanding options granted under our employee stock option or other benefit plans, as well as the number of shares reserved for issuance under our 4% Convertible Subordinated Notes due March 15, 2005 and 3.5% Convertible Subordinated Notes due February 15, 2006, will be proportionately increased in accordance with the terms of such options, plans and other instruments.

On February 12, 2002, we announced that our Board of Directors had approved the redemption of our 4% Convertible Subordinated Notes due March 15, 2005 (the "Notes"). As of February 12, 2002, the outstanding principal amount of the Notes was $229.9 million. The redemption will occur on March 15, 2002, for holders of record on that date at a redemption price equal to 101.71% of the principal amount of Notes held. Holders of the Notes may elect to convert the Notes to our Class A Common Stock on or before the day prior to redemption. The conversion rate is 23.4432 shares of Class A Common Stock for each $1,000 principal amount of the Notes (equivalent to a conversion price of $42.66 per share of Class A Common Stock before giving effect to our previously announced two-for-one stock split, to be implemented in the form of a stock dividend payable on February 22, 2002 to stockholders of record as of the close of business on February 15,

2002). In accordance with the terms of the Notes, we will be required to make payment for fractional shares in cash, based on the closing price of our stock on the date of conversion, and all accrued interest due through the date of conversion. The notice is irrevocable.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a.) Exhibits
None.

b.) Reports on Form 8-K
None.

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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 on the 14th day of February, 2002.

AFFILIATED COMPUTER SERVICES, INC.

By: /s/ Warren D. Edwards

Warren D. Edwards
Executive Vice President and
Chief Financial Officer

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