# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d)**
**of the Securities Exchange Act of 1934**

**For the quarterly period ended December 31, 2006**

**Commission File Number: 1-12997**

# MAXIMUS, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Virginia**<br>(State or other jurisdiction of incorporation or organization) | **54-1000588**<br>(I.R.S. Employer Identification No.) |
| **11419 Sunset Hills Road**<br>**Reston, Virginia**<br>(Address of principal executive offices) | **20190**<br>(Zip Code) |

**(703) 251-8500**
(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 ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of January 31, 2007, there were 21,713,802 shares of the registrant's common stock (no par value) outstanding.

**MAXIMUS, Inc.**

**Quarterly Report on Form 10-Q**
**For the Quarter Ended December 31, 2006**

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*Throughout this Quarterly Report on Form 10-Q, the terms "we," "us," "our" and "MAXIMUS" refer to MAXIMUS, Inc. and its subsidiaries.*



## PART I. FINANCIAL INFORMATION

### Item 1. Condensed Consolidated Financial Statements.

**MAXIMUS, Inc.**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(Dollars in thousands)**

| | September 30, 2006 (Note 1) | December 31, 2006 (unaudited) |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 39,545 | $ 21,964 |
| Marketable securities | 117,315 | 141,811 |
| Restricted cash | 1,512 | 312 |
| Accounts receivable — billed, net of reserves of $5,830 and $16,816 | 153,399 | 126,912 |
| Accounts receivable — unbilled | 47,728 | 39,949 |
| Income taxes receivable | 9,003 | 11,018 |
| Deferred income taxes | 6,844 | 10,690 |
| Prepaid expenses and other current assets | 8,334 | 8,498 |
| Total current assets | 383,680 | 361,154 |
| | | |
| Property and equipment, at cost | 71,078 | 72,558 |
| Less accumulated depreciation and amortization | (37,649) | (39,631) |
| Property and equipment, net | 33,429 | 32,927 |
| Capitalized software | 57,260 | 57,351 |
| Less accumulated amortization | (23,335) | (25,655) |
| Capitalized software, net | 33,925 | 31,696 |
| Deferred contract costs, net | 11,165 | 9,758 |
| Goodwill | 86,688 | 86,019 |
| Intangible assets, net | 5,720 | 4,892 |
| Other assets, net | 3,894 | 2,967 |
| Total assets | $ 558,501 | $ 529,413 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 54,484 | $ 44,350 |
| Accrued compensation and benefits | 24,426 | 22,172 |
| Deferred revenue | 54,414 | 48,264 |
| Current portion of capital lease obligations | 1,690 | 1,707 |
| Other accrued liabilities | 1,600 | 1,122 |
| Total current liabilities | 136,614 | 117,615 |
| Capital lease obligations, less current portion | 2,044 | 1,643 |
| Deferred income taxes | 14,944 | 13,692 |
| Total liabilities | 153,602 | 132,950 |
| | | |
| Shareholders' equity: | | |
| Common stock, no par value; 60,000,000 shares authorized; 21,544,964 and 21,652,730 shares issued and outstanding at September 30, 2006 and December 31, 2006, at stated amount, respectively | 156,349 | 159,250 |
| Accumulated other comprehensive income (loss) | (916) | 300 |
| Retained earnings | 249,466 | 236,913 |
| Total shareholders' equity | 404,899 | 396,463 |
| Total liabilities and shareholders' equity | $ 558,501 | $ 529,413 |

*See notes to unaudited condensed consolidated financial statements.*



**MAXIMUS, Inc.**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
**(Dollars in thousands, except per share data)**
**(Unaudited)**

| | Three Months Ended December 31, 2005 | Three Months Ended December 31, 2006 |
|---|---|---|
| Revenue | $ 162,726 | $ 161,138 |
| Cost of revenue | 117,980 | 140,860 |
| Gross profit | 44,746 | 20,278 |
| Selling, general and administrative expenses | 31,564 | 34,653 |
| Legal expense (Note 12) | 500 | 3,000 |
| Income (loss) from operations | 12,682 | (17,375) |
| Interest and other income, net | 2,038 | 477 |
| Gain on sale of business (Note 13) | — | 684 |
| Income (loss) before income taxes | 14,720 | (16,214) |
| Provision (benefit) for income taxes | 5,814 | (5,819) |
| Net income (loss) | $ 8,906 | $ (10,395) |
| Earnings (loss) per share (Note 6): | | |
| Basic | $ 0.42 | $ (0.48) |
| Diluted | $ 0.41 | $ (0.48) |
| Dividends per share | $ 0.10 | $ 0.10 |
| Weighted average shares outstanding: | | |
| Basic | 21,432 | 21,590 |
| Diluted | 21,908 | 21,590 |

*See notes to unaudited condensed consolidated financial statements.*



**MAXIMUS, Inc.**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Dollars in thousands)**
**(Unaudited)**

| | Three Months Ended December 31, 2005 | Three Months Ended December 31, 2006 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income (loss) | $ 8,906 | $ (10,395) |
| | | |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 2,202 | 2,284 |
| Amortization | 1,942 | 2,769 |
| Deferred income taxes | (130) | (5,098) |
| Non-cash equity based compensation | 1,333 | 1,020 |
| Gain on sale of business | — | (684) |
| | | |
| Change in assets and liabilities, net of effects from divestiture: | | |
| Accounts receivable - billed | 897 | 26,486 |
| Accounts receivable - unbilled | (3,421) | 6,734 |
| Prepaid expenses and other current assets | (192) | (151) |
| Deferred contract costs | (7,073) | 1,407 |
| Other assets | (707) | 2,065 |
| Accounts payable | 2,548 | (9,641) |
| Accrued compensation and benefits | (5,457) | (2,254) |
| Deferred revenue | 5,417 | (5,745) |
| Income taxes | (62) | (2,015) |
| Other liabilities | (1,127) | 844 |
| Net cash provided by operating activities | 5,076 | 7,626 |

| | | |
|---|---|---|
| **Cash flows from investing activities:** | | |
| Proceeds from sale of business, net of transaction costs | — | 2,171 |
| Purchases of property and equipment | (3,651) | (1,918) |
| Capitalized software costs | (1,880) | (304) |
| Increase in marketable securities | (16,525) | (24,496) |
| Net cash used in investing activities | (22,056) | (24,547) |
| **Cash flows from financing activities:** | | |
| Employee stock transactions | 1,532 | 1,526 |
| Repurchases of common stock | (4,315) | — |
| Payments on capital lease obligations | (370) | (384) |
| Tax benefit due to option exercises and restricted stock units vesting | (87) | 357 |
| Cash dividends paid | (2,146) | (2,159) |
| Net cash used in financing activities | (5,386) | (660) |
| Net decrease in cash and cash equivalents | (22,366) | (17,581) |
| Cash and cash equivalents, beginning of period | 59,073 | 39,545 |
| Cash and cash equivalents, end of period | $ 36,707 | $ 21,964 |

*See notes to unaudited condensed consolidated financial statements.*



**MAXIMUS, Inc.**
**Notes to Unaudited Condensed Consolidated Financial Statements**
**For the Three Months Ended December 31, 2006 and 2005**

*In these Notes to Unaudited Condensed Consolidated Financial Statements, the terms the "Company", "MAXIMUS", "we", or "our" refer to MAXIMUS, Inc. and its subsidiaries.*

**1. Organization and Basis of Presentation**

*General*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months ended December 31, 2006 are not necessarily indicative of the results that may be expected for the full fiscal year. The balance sheet at September 30, 2006 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In addition to the Company's wholly owned subsidiaries, the financial statements as of and for the three months ended December 31, 2006 and 2005, and as of September 30, 2006, include a majority (55%) owned international subsidiary.

These financial statements should be read in conjunction with the audited financial statements and the notes thereto at September 30, 2006 and 2005 and for each of the three years in the period ended September 30, 2006, included in the Company's Annual Report on Form 10-K for the year ended September 30, 2006 (File No. 1-12997) filed with the Securities and Exchange Commission on December 13, 2006.

*Income Taxes*

During the three months ended December 31, 2006, our historical effective income tax rate was impacted by approximately 4 percentage points as a result of recording a $0.7 million valuation allowance on certain deferred tax assets related to a foreign subsidiary's net operating losses recorded at September 30, 2006 that were considered more-likely-than-not to be realized at that time. As a result of events occurring during the first fiscal quarter of 2007 impacting the subsidiary's operating results for that period, the need for a valuation allowance was re-evaluated and it was determined that it was no longer more-likely-than-not that the net operating losses that existed at September 30, 2006 would be realized.

*Legal Expense*

Legal expense consists of costs, net of reimbursed insurance claims, related to significant legal settlements and non-routine legal matters, including future probable legal costs estimated to be incurred in connection with those matters. Legal expenses incurred in the ordinary course of business are included in selling, general and administrative expense.



*Stock-Based Compensation*

The Company's Board of Directors established stock option plans during 1997 pursuant to which the Company may grant non-qualified stock options to officers, employees and directors of the Company. Such plans also provide for stock awards and direct purchases of the Company's common stock. At December 31, 2006, the Board of Directors had reserved 8.1 million shares of common stock for issuance under the Company's stock option plans. At December 31, 2006, approximately 2.0 million shares remained available for grants under the Company's stock option plans.

Stock options are granted at exercise prices equal to the fair market value of the Company's common stock at the date of grant. Stock options generally vest ratably over a period of four years and, beginning in fiscal 2005, expire six years after date of grant. Options issued prior to fiscal 2005 expire ten years after date of grant. Compensation expense recognized related to stock options was $0.9 million and $1.0 million for the three months ended December 31, 2005 and 2006, respectively.

The Company also issues Restricted Stock Units (RSUs) to certain executive officers and employees under its 1997 Equity Incentive Plan ("Plan"). Generally, these RSUs vest ratably over six years with full vesting upon the sixth anniversary of the date of grant, provided, however, that the vesting will accelerate if the Company meets certain earnings targets determined by the Board of Directors. The fair value of the RSUs, based on the Company's stock price at the grant date, is expensed over the vesting period. Compensation expense recognized related to RSUs was $0.4 million for the three months ended December 31, 2005. During the three months ended December 31, 2006, the Company increased its estimate of RSU forfeitures based upon historical data, which had the result of reducing compensation expense by $0.8 million to less than $0.1 million in the first quarter of fiscal 2007.

**2. Comprehensive Income (Loss)**

Comprehensive income (loss) includes net income (loss), plus changes in the net unrealized gains (losses) on investments, net of taxes, and changes in cumulative foreign currency translation adjustments. The components of comprehensive income (loss) for the three months ended December 31, 2005 and 2006 are as follows:

| (in thousands) | Three months Ended December 31, 2005 | Three months Ended December 31, 2006 |
|---|---|---|
| Net income (loss) | $ 8,906 | $ (10,395) |
| Foreign currency translation adjustments | (649) | 1,216 |
| Unrealized investment gains (losses) | (7) | — |
| Reclassification adjustment for gains realized in net income, net of tax effect of $93 | (143) | — |
| Comprehensive income (loss) | $ 8,107 | $ (9,179) |

**3. Deferred Contract Costs**

Deferred contract costs consist of contractually recoverable direct set-up costs relating to long-term service contracts in progress. These costs include direct and incremental costs incurred prior to the commencement of the Company providing contracted services to our customers. These costs totaled $26.3 million and $26.2 million at September 30, 2006 and December 31, 2006, respectively, of which $7.6 million consisted of leased equipment. Deferred contract costs are expensed ratably as services are provided under the contracts. Accumulated amortization of deferred contract costs was $15.1 million and $16.4 million at September 30, 2006 and December 31, 2006, respectively.



**4. Goodwill and Intangible Assets**

The changes in the carrying amount of goodwill, by each of the Company's business segments, for the three months ended December 31, 2006 are as follows (in thousands):

| | Consulting | Systems | Operations | Total |
|---|---|---|---|---|
| Balance as of September 30, 2006 | $ 10,902 | $ 42,154 | $ 33,632 | $ 86,688 |
| Goodwill activity during period | — | — | (669) | (669) |
| Balance as of December 31, 2006 | $ 10,902 | $ 42,154 | $ 32,963 | $ 86,019 |

During the quarter ended December 31, 2006, the Company sold its Corrections Services business and allocated $0.7 million of goodwill to the sale transaction.

The following table sets forth the components of intangible assets (in thousands):

| | As of September 30, 2006 | | | As of December 31, 2006 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated amortization | Intangible assets, net | Cost | Accumulated amortization | Intangible assets, net |
| Non-competition agreements | $ 3,475 | $ 3,288 | $ 187 | $ 3,275 | $ 3,177 | $ 98 |
| Technology-based intangibles | 4,870 | 2,532 | 2,338 | 4,870 | 2,755 | 2,115 |
| Customer contracts and relationships | 7,475 | 4,280 | 3,195 | 6,475 | 3,796 | 2,679 |
| Total | $ 15,820 | $ 10,100 | $ 5,720 | $ 14,620 | $ 9,728 | $ 4,892 |

Intangible assets from acquisitions are amortized over five to ten years. The weighted-average amortization period for intangible assets is approximately six years. Intangible amortization expense was $0.5 million for each of the three months ended December 31, 2005 and 2006, respectively. The estimated amortization expense for the years ending September 30, 2007, 2008, 2009, 2010, 2011 and 2012 is $1.7 million, $1.5 million, $1.1 million, $0.4 million, $0.4 million, and $0.2 million, respectively.

**5. Commitments and Contingencies**

*Litigation*

The Company is involved in various legal proceedings, including contract and employment claims, in the ordinary course of its business. The matters reported on below involve significant pending or potential claims against us.

(a) In October 2004, MAXIMUS received a subpoena from the Criminal Division of the U.S. Department of Justice acting through the U.S. Attorney's Office for the District of Columbia. The subpoena requested records pertaining to the Company's work for the District of Columbia, primarily relating to the preparation and submission of federal Medicaid reimbursement claims on behalf of the District. The U.S. Attorney's Office is investigating issues pertaining to compliance with the federal laws governing Medicaid claims. We have fully cooperated with the U.S. Attorney's Office in producing documents in response to the subpoena and making employees available for interviews, and we have conducted an internal review of this matter through independent outside legal counsel.

Attorneys from the Criminal Division have expressed their view that the Company either willfully or recklessly submitted inaccurate claims to the federal government on behalf of the District of Columbia. MAXIMUS disputes that view. Nevertheless, the Criminal Division attorneys have referred the Company to attorneys from the Civil Division to determine if a civil resolution of the matter is possible. Those discussions are ongoing.



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Based on the probable legal costs of the internal review, we recorded a charge of $0.5 million in connection with this matter in the quarter ended December 31, 2005. We are unable to quantify the probability of criminal or civil prosecution or the probability or magnitude of any other expenditure, fine, penalty, or settlement amount we may incur in connection with this matter at this time.

(b) In June 2005, MAXIMUS received a subpoena pursuant to the Illinois Whistleblower Reward and Protection Act from the Office of the Attorney General of Illinois in connection with a purported whistleblower investigation of potential false claims. The subpoena requested records pertaining to the Company's work for agencies of the Executive Branch of Illinois State Government. Discussions with the Attorney General's office have indicated that MAXIMUS was one of nine contractors that received such subpoenas and that the investigation is primarily focused at this time on the procurement and contracting activities of the Illinois Department of Central Management Services. Although there can be no assurance of a favorable outcome and we are unable to quantify the probability or magnitude of any expenditures we may incur in connection with this matter, the Company does not believe that this matter will have a material adverse effect on its financial condition or results of operations, and the Company has not accrued for any loss related to this matter.

(c) In December 2006, Emergis, Inc. filed a demand for arbitration against MAXIMUS and certain of its wholly-owned subsidiary companies in British Columbia, Canada. Emergis was a subcontractor to MAXIMUS BC Health, Inc. and MAXIMUS BC Health Benefit Operations, Inc. in support of their contract with the British Columbia Ministry of Health. The subcontract required Emergis to provide a system for the adjudication, processing and payment of health care claims for the Province and had a total value of approximately $32.0 million Canadian ($27.2 million U.S.). Because Emergis failed to meet product development and delivery requirements under the subcontract, MAXIMUS declared Emergis in default and ultimately terminated the subcontract in September 2006. In its demand for arbitration, Emergis challenges the basis of the termination, alleges that the subcontract remains in force and seeks payment of damages including the amounts that it would have received under the subcontract. MAXIMUS believes that termination was justified and that, in any event, damages would be limited to the contractual limitation of liability, which is less than $2.0 million Canadian ($1.7 million U.S.). MAXIMUS is currently preparing its response and counterclaims to the arbitration demand.

(d) In December 2006, the Ontario Ministry of Community and Social Services sent a notice to Themis Program Management and Consulting Limited ("Themis") purporting to terminate for default the Ministry's contract with Themis. Themis is a Canadian subsidiary of MAXIMUS that had contracted with the Ministry to provide software and services in support of the Ministry's child support case management system. The Ministry alleges that Themis failed to meet certain requirements under the contract pertaining to deliverables, services and timeliness. Themis believes that it fulfilled its contractual obligations and that any remaining open tasks are due to the non-cooperation of the Ministry. No legal actions have been filed, but the Ministry has asserted damages exceeding $30.0 million Canadian ($25.5 million U.S.) in correspondence. Themis disputes that damages claim and believes that any damages of the Ministry would be capped at the $5.0 million Canadian ($4.3 million U.S.) limitation of liability set forth in the contract. MAXIMUS co-signed the contract as a guarantor of the obligations of Themis.

(e) In January 2007, MAXIMUS delivered to Accenture LLP a written formal demand for arbitration to resolve disputes relating to the Company's role as a subcontractor in support of Accenture's prime contract with the Texas Health and Human Services Commission ("HHSC") for the Integrated Eligibility and Enrollment Services program (the "Program"). The Company's claims include (i) Accenture's attempt to misappropriate the Company's intellectual property, (ii) Accenture's failure to deliver required technology under the subcontract, (iii) Accenture's unilateral negotiation of issues with HHSC having a direct effect on the Company, (iv) Accenture's unfounded assertions that the Company had breached its obligations with respect to the Children's Health Insurance Program ("CHIP") operations under the subcontract, and (v) Accenture's imposition of excessive and unsubstantiated cover costs on the Company arising out of the amendment to the subcontract entered into in June 2006. MAXIMUS seeks to recover its damages which it believes exceed $100 million. Accenture submitted a response disputing MAXIMUS' claims and asserting a counterclaim that MAXIMUS has breached the subcontract. Accenture seeks unspecified damages which it has stated could be hundreds of millions of dollars. The subcontract incorporates the terms and conditions of the prime contract which contains a limitation of liability of $250.0 million.



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Also in January 2007, Accenture delivered to the Company a letter purporting to declare the Company in default of its obligations under the subcontract. The Accenture letter states that Accenture plans to exercise step-in rights with respect to certain management and supervisory services currently provided by the Company for the CHIP operations. The letter also states that Accenture intends to partially terminate the subcontract as of February 5, 2007 with respect to the Company's obligations regarding CHIP services. The letter includes a proposed turnover plan for transitioning the CHIP services from the Company to Accenture. Accenture has alleged that the Company owes damages relating to the CHIP operations of at least $45.0 million plus $30.0 million in indemnification for amounts that Accenture agreed to pay to HHSC.

The Company believes that its positions are meritorious and that Accenture's positions are without merit, including Accenture's unjustified issuance of a default notice with respect to the CHIP operations. Based on the future probable legal costs associated with the arbitration, the Company recorded a charge of $3.0 million during the quarter ended December 31, 2006. The Company will continue to aggressively pursue its rights and remedies against Accenture to resolve the current dispute. The Company cannot predict the outcome of the arbitration proceedings or any settlement negotiations or the impact they may have on the Company's operating results or financial condition.

*Credit Facilities and Performance Bonds*

In June 2003, in connection with a long-term contract, the Company issued a standby letter of credit in an initial amount of up to $20.0 million, which amount was reduced to $10.0 million on April 1, 2005. The letter of credit, which expires on March 31, 2009, may be called by the customer in the event the Company defaults under the terms of the contract. In March 2006, in connection with another long-term contract, the Company issued a standby letter of credit in the amount of $4.0 million. The letter of credit, which expires on September 30, 2008, may be called by the customer in the event the Company defaults under the terms of the contract. Both letters of credit, as amended by the Company and its lender on December 20, 2006, contain financial covenants that establish minimum levels of tangible net worth, earnings before interest, tax, depreciation and amortization (EBITDA), cash balances and a maximum level of losses on the Texas Integrated Eligibility project. The Company was in compliance with all covenants as of December 31, 2006.

At December 31, 2006, the Company had performance bond commitments totaling $96.6 million.

*Lease Obligations*

On July 15, 2003, the Company entered into a capital lease financing arrangement with a financial institution, whereby the Company acquired assets pursuant to an equipment lease agreement. Rental payments for assets leased are payable over a 60-month period at an interest rate of 4.05% commencing in January 2004. On March 29, 2004, the Company entered into a supplemental capital lease financing arrangement with the same financial institution whereby the Company acquired additional assets pursuant to an equipment lease agreement. Rental payments for assets leased under the supplemental arrangement are payable over a 57-month period at an interest rate of 3.61% commencing in April 2004. Capital lease obligations of $3.7 million and $3.4 million were outstanding related to these lease arrangements for new equipment at September 30, 2006 and December 31, 2006, respectively.



**6. Earnings (Loss) Per Share**

The following table sets forth the components of basic and diluted earnings (loss) per share (in thousands):

| | Three Months Ended December 31, | |
|---|---|---|
| | 2005 | 2006 |
| Numerator: | | |
| Net income (loss) | $ 8,906 | $ (10,395) |
| Denominator: | | |
| Basic weighted average shares outstanding | 21,432 | 21,590 |
| Effect of dilutive securities: | | |
| Employee stock options and unvested restricted stock awards | 476 | — |
| Denominator for diluted earnings (loss) per share | 21,908 | 21,590 |

In computing diluted loss per share for the three months ended December 31, 2006, employee stock options and unvested restricted stock units aggregating 206,000 were excluded from the computation of diluted loss per share as a result of their antidilutive effect.

**7. Stock Repurchase Program**

Under resolutions adopted in May 2000, July 2002, and March 2003, the Board of Directors has authorized the repurchase, at management's discretion, of up to an aggregate of $90.0 million of the Company's common stock. In addition, in June 2002, the Board of Directors authorized the use of option exercise proceeds for the repurchase of the Company's common stock. During the three months ended December 31, 2006, the Company did not repurchase any shares. At December 31, 2006, $27.7 million remained authorized for future stock repurchases under the program.

**8. Segment Information**

The following table provides certain financial information for each of the Company's business segments (in thousands):

| | Three Months Ended December 31, | |
|---|---|---|
| | 2005 | 2006 |
| Revenue: | | |
| Consulting | $ 23,635 | $ 24,656 |
| Systems | 36,290 | 34,541 |
| Operations | 102,801 | 101,941 |
| Total | $ 162,726 | $ 161,138 |
| Income (loss) from operations: | | |
| Consulting | $ 2,536 | $ 2,815 |
| Systems | 3,887 | (1,597) |
| Operations | 6,068 | (16,044) |
| Consolidating adjustments | 691 | 451 |
| Legal expense | (500) | (3,000) |
| Total | $ 12,682 | $ (17,375) |



**9. Recent Accounting Pronouncements**

On July 13, 2006, the Financial Accounting Standards Board issued Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, which is effective in fiscal years beginning after December 15, 2006, which is the Company's 2008 fiscal year. The purpose of FIN 48 is to clarify and set forth consistent rules for accounting for uncertain tax positions in accordance with FAS 109, Accounting for Income Taxes. The cumulative effect of initially applying the provisions of this interpretation are required to be reported separately as an adjustment to the opening balance of retained earnings in the year of adoption. We are in the process of reviewing and evaluating FIN 48, and therefore the ultimate impact of its adoption is not yet known.

**10. Subsequent Events**

On January 5, 2007, the Company's Board of Directors declared a quarterly cash dividend of $0.10 for each share of the Company's common stock outstanding. The dividend is payable on February 28, 2007, to shareholders of record on February 15, 2007. Based on the current number of shares outstanding, the payment will be $2.2

million.

**11. Texas Integrated Eligibility Project**

During the three months ended December 31, 2006, the Texas Integrated Eligibility project adversely impacted our results by $27.0 million, which included a pre-tax operating loss of $11.9 million; a provision of $12.1 million for outstanding receivables; and a provision of $3.0 million for future probable legal expenses related to the ongoing arbitration process with Accenture. Under this project, we serve as a subcontractor to Accenture as part of the Texas Access Alliance which provides services under the Texas Health and Human Services Commissions' Integrated Eligibility Program. We were awarded the five-year, $370 million subcontract in June 2005. See "Note 5. Commitments and Contingencies" above and "Special Considerations and Risk Factors" in Exhibit 99.1 for additional information.

**12. Legal Expense**

During the quarter ended December 31, 2006, the Company recorded a provision of $3.0 million for future probable legal costs in connection with its formal demand for arbitration to resolve disputes relating to the Company's role as a subcontractor to Accenture on the Texas Integrated Eligibility project. In addition, during the quarter ended December 31, 2005, the Company recorded a charge of $0.5 million in connection with the Company's work for the District of Columbia, primarily relating to the preparation and submission of federal Medicaid reimbursement claims on behalf of the District. See "Note 5. Commitments and Contingencies" above and "Special Considerations and Risk Factors" in Exhibit 99.1 for additional information.

**13. Sales of Business**

On October 5, 2006, the Company sold its Corrections Services business for proceeds of $2.2 million, net of transaction costs of $0.8 million, and recognized a pre-tax gain on the sale of $0.7 million. During the fiscal year ended September 30, 2006, this business had revenue of $9.1 million and generated an operating loss of approximately $0.6 million.



**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*The following discussion and analysis of financial condition and results of operations is provided to enhance the understanding of, and should be read in conjunction with, our Consolidated Financial Statements and related Notes included both herein and in our Annual Report on Form 10-K for the year ended September 30, 2006, filed with the Securities and Exchange Commission on December 13, 2006.*

**Forward Looking Statements**

From time to time, we may make forward-looking statements that are not historical facts, including statements about our confidence and strategies and our expectations about revenue, results of operations, profitability, current and future contracts, market opportunities, market demand or acceptance of our products and services. Any statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact may be forward-looking statements. The words "could," "estimate," "future," "intend," "may," "opportunity," "potential," "project," "will," "believes," "anticipates," "plans," "expect" and similar expressions are intended to identify forward-looking statements. These statements may involve risks and uncertainties that could cause our actual results to differ materially from those indicated by such forward-looking statements. These risks are detailed in Exhibit 99.1 to this Quarterly Report on Form 10-Q and incorporated herein by reference.

**Business Overview**

We are a leading provider of consulting, systems solutions and operations program management primarily to government. Since our inception, we have been at the forefront of innovation in meeting our mission of "Helping Government Serve the People®." We use our expertise, experience and advanced information technology to make government operations more efficient while improving the quality of services provided to program beneficiaries. We operate primarily in the United States, and we have had contracts with government agencies in all 50 states, Canada, Australia, Israel, and the United Kingdom. We have been profitable every year since we were founded in 1975. For the fiscal year ended September 30, 2006, we had revenue of $700.9 million and net income of $2.5 million. For the three months ended December 31, 2006, we had revenue of $161.1 million and net loss of $10.4 million.



**Results of Operations**

*Consolidated*

The following table sets forth, for the periods indicated, selected statements of income data:

| (dollars in thousands, except per share data) | Three months ended December 31, 2005 | 2006 |
|---|---|---|
| Revenue | $ 162,726 | $ 161,138 |
| Gross profit | $ 44,746 | $ 20,278 |
| Legal expense | $ 500 | $ 3,000 |
| Income (loss) from operations | $ 12,682 | $ (17,375) |
| Operating margin (loss) percentage | 7.8% | (10.8)% |
| Selling, general and administrative expense | $ 31,564 | $ 34,653 |
| Selling, general and administrative expense as a percentage of revenue | 19.4% | 21.5% |
| Net income (loss) | $ 8,906 | $ (10,395) |

| | | |
|---|---|---|
| **Earnings (loss) per share:** | | |
| Basic | $ 0.42 | $ (0.48) |
| Diluted | $ 0.41 | $ (0.48) |

Revenue for the three months ended December 31, 2006 was $161.1 million, compared to $162.7 million for the same period in fiscal 2006. Revenue was reduced in the first fiscal quarter of 2007 by approximately $15.7 million as a result of provisions recorded on the Texas Integrated Eligibility and Ontario Child Support systems implementation projects**.**

Loss from operations for the three months ended December 31, 2006 was $17.4 million, compared to income from operations of $12.7 million for the same period in fiscal 2006. The decrease in income from operations of $30.1 million is primarily attributable to (1) a $11.9 million operating loss on the Texas Integrated Eligibility project, (2) a $12.1 million provision for receivables on the Texas Integrated Eligibility project, (3) a $3.0 million provision for future probable legal expense related to the ongoing arbitration with Accenture, and (4) a $4.0 million operating loss on the Ontario Child Support systems implementation project where the Company is no longer performing work.

Selling, general and administrative expense (SG&A) consists of costs related to general management, marketing and administration. These costs include salaries, benefits, bid and proposal efforts, travel, recruiting, continuing education, employee training, non-chargeable labor costs, facilities costs, printing, reproduction, communications, equipment depreciation, intangible amortization, and legal expenses incurred in the ordinary course of business. SG&A as a percentage of revenue for the three months ended December 31, 2006 was 21.5 %, compared to 19.4% for the same period in fiscal 2006. The increase in SG&A as a percentage of revenue is primarily attributable to the reductions in revenue of approximately $15.7 million in the quarter as a result of provisions recorded on the Texas Integrated Eligibility and Ontario Child Support systems implementation projects.

Also included in SG&A was $1.0 million and $1.3 million of non-cash, equity-based compensation related to stock options and restricted stock units (RSUs) for the three months ended December 31, 2006 and 2005, respectively. During the three months ended December 31, 2006, the Company increased its estimate of RSU forfeitures based upon historical data, which had the result of reducing RSU compensation expense by $0.8 million.



Provision (benefit) for income taxes for the three months ended December 31, 2006 was (35.9)% of income (loss) before income taxes, compared to 39.5% for the same period in fiscal 2006. During the three months ended December 31, 2006, our historical effective income tax rate was impacted by approximately 4 percentage points as a result of recording a $0.7 million valuation allowance on certain deferred tax assets related to a foreign subsidiary's net operating losses recorded at September 30, 2006 that were considered more-likely-than-not to be realized at that time. As a result of events occurring during the first fiscal quarter of 2007 impacting the subsidiary's operating results for that period, the need for a valuation allowance was re-evaluated and it was determined that it was no longer more-likely-than-not that the net operating losses that existed at September 30, 2006 would be realized.

Net loss for the three months ended December 31, 2006 was $10.4 million, or $0.48 per diluted share, compared with net income of $8.9 million, or $0.41 per diluted share, for the same period in fiscal 2006. The decrease in net income of $19.3 million is primarily attributable to the aforementioned reasons listed above that also reduced the Company's operating income.

*Consulting Segment*

| (dollars in thousands) | Three months ended December 31, 2005 | Three months ended December 31, 2006 |
|---|---|---|
| Revenue | $ 23,635 | $ 24,656 |
| Gross profit | 10,196 | 10,907 |
| Operating income | 2,536 | 2,815 |
| Operating margin percentage | 10.7% | 11.4% |

The Consulting Segment is comprised of financial services (which includes child welfare, cost services, and revenue maximization), educational services (school-based claiming), technical services, and Unison (airport consulting services). Revenue increased 4.3% for the three months ended December 31, 2006, compared to the same period in fiscal 2006, resulting from growth in the technical services division. Operating margin percentage increased to 11.4% for the three months ended December 31, 2006 from 10.7% in the same period in fiscal 2006. The increase in revenue and operating margin percentage compared to the same period last year is primarily attributable to margin expansion in the technical services, financial services and Unison divisions, which offset reduced income in the educational services division where volumes were lower on a large claiming project.

*Systems Segment*

| (dollars in thousands) | Three months ended December 31, 2005 | Three months ended December 31, 2006 |
|---|---|---|
| Revenue | $ 36,290 | $ 34,541 |
| Gross profit | 13,870 | 8,551 |
| Operating income (loss) | 3,887 | (1,597) |
| Operating margin (loss) percentage | 10.7% | (4.6)% |

The Systems Segment develops and implements both third party and proprietary software in five divisions: justice solutions, asset solutions, educational systems, security solutions, and enterprise resource planning (ERP) solutions. Revenue decreased 4.8% for the three months ended December 31, 2006, compared to the same period in fiscal 2006. The decrease in revenue is primarily due to lower revenue in justice solutions which benefited from more license revenue in the first quarter of last year compared to the first quarter of fiscal 2007. Loss from operations for the three months ended December 31, 2006 was $1.6 million, compared to income from operations of $3.9 million for the same period in fiscal 2006. The decrease in income from operations of $5.5 million is primarily attributable to (1) lower license revenue, and (2) losses in educational systems.

*Operations Segment*

| (dollars in thousands) | Three months ended December 31, 2005 | 2006 |
|---|---|---|
| Revenue | $ 102,801 | $ 101,941 |
| Gross profit | 20,680 | 820 |
| Operating income (loss) | 6,068 | (16,044) |
| Operating margin (loss) percentage | 5.9% | (15.7)% |

The Operations Segment includes health services, human services, and federal outsourcing and operations work. Revenue decreased 0.8% for the three months ended December 31, 2006, compared to the same period in fiscal 2006. Loss from operations for the three months ended December 31, 2006 was $16.0 million, compared to income from operations of $6.1 million for the same period in fiscal 2006. The decrease in income from operations of $22.1 million is primarily attributable to (1) a $11.9 million operating loss on the Texas Integrated Eligibility project, (2) a $12.1 million provision for receivables on the Texas Integrated Eligibility project, and (3) a $4.0 million operating loss on the Ontario Child Support systems implementation project where the Company is no longer performing work, offset by improved performance in health services and the British Columbia Health Operations project.

**Interest and Other Income, Net**

| (dollars in thousands) | Three months ended December 31, 2005 | 2006 |
|---|---|---|
| Interest and other income, net | $ 2,038 | $ 477 |
| Percentage of revenue | 1.3% | 0.3% |

Interest and other income for the three months ended December 31, 2006 was $0.5 million, compared to $2.0 million for the same period in fiscal 2006. The decrease in interest and other income of $1.5 million is primarily attributable to a weakening of the Canadian dollar which resulted in $0.8 million of unrealized, non-cash foreign currency losses on loans to our Canadian subsidiaries in the first quarter of fiscal 2007, compared to $0.6 million of unrealized, non-cash foreign currency gains for the same period in fiscal 2006.



**Liquidity and Capital Resources**

| (dollars in thousands) | Three months ended December 31, 2005 | 2006 |
|---|---|---|
| Net cash provided by (used in): | | |
| Operating activities | $ 5,076 | $ 7,626 |
| Investing activities | (22,056) | (24,547) |
| Financing activities | (5,386) | (660) |
| Net decrease in cash and cash equivalents | $ (22,366) | $ (17,581) |

Cash provided by operating activities for the three months ended December 31, 2006 was $7.6 million, compared to $5.1 million for the same period in fiscal 2006. Cash provided by operating activities for the three months ended December 31, 2006 consisted of net loss of $10.4 million and non-cash items aggregating $0.3 million, plus cash provided by working capital changes of $14.2 million, plus cash provided by decreases in deferred contract costs of $1.4 million and other assets of $2.1 million. Non-cash items consisted of depreciation and amortization of $5.1 million and non-cash equity based compensation of $1.0 million, offset by deferred income taxes of $5.1 million and gain on sale of business of $0.7 million. Cash provided by working capital changes reflected decreases in accounts receivable-billed of $26.5 million and accounts receivable-unbilled of $6.7 million, and an increase in other liabilities of $0.8 million, offset by decreases in accounts payable of $9.6 million, accrued compensation and benefits of $2.3 million, deferred revenue of $5.7 million and income taxes of $2.0 million, and an increase in prepaid expenses of $0.2 million.

Cash provided by operating activities for the three months ended December 31, 2005 consisted of net income of $8.9 million and non-cash items aggregating $5.3 million, less cash used by working capital changes of $1.3 million, less cash provided by increases in deferred contract costs of $7.1 million and other assets of $0.7 million. Non-cash items consisted of depreciation and amortization of $4.1 million and non-cash equity-based compensation of $1.3 million, offset by deferred income taxes of $0.1 million. Cash used by working capital changes reflected decreases in accrued compensation and benefits of $5.4 million and other liabilities of $1.1 million, and increases in accounts receivable-unbilled of $3.4 million and prepaid expenses of $0.2 million, offset by increases in deferred revenue of $5.4 million and accounts payable of $2.5 million, and a decrease in accounts receivable-billed of $0.9 million.

Cash used in investing activities for the three months ended December 31, 2006 was $24.5 million, compared to $22.1 million for the same period in fiscal 2006. Cash used in investing activities for the three months ended December 31, 2006 consisted of purchases of marketable securities of $24.5 million, purchases of property and equipment of $1.9 million, expenditures for capitalized software costs of $0.3 million, offset by proceeds from the sale of business of $2.2 million. Cash used in investing activities for the three months ended December 31, 2005 consisted of purchases of marketable securities of $16.5 million, purchases of property and equipment of $3.7 million, and expenditures for capitalized software costs of $1.9 million.

Cash used in financing activities for the three months ended December 31, 2006 was $0.7 million, compared to $5.4 million for the same period in fiscal 2006. Cash used in financing activities for the three months ended December 31, 2006 consisted of dividends paid of $2.2 million and principal payments on capital leases of $0.4 million, offset by employee stock sales of $1.5 million and equity-based tax benefits of $0.4 million. Cash used in financing activities for the three months ended December 31, 2005 consisted of common stock repurchases of $4.3 million, dividends paid of $2.1 million and principal payments on capital leases of $0.4 million, offset by employee stock sales of $1.5 million.

Under resolutions adopted in May 2000, July 2002, and March 2003, the Board of Directors has authorized the repurchase, at management's discretion, of up to an aggregate of $90.0 million of our common stock. In addition, in June 2002, the Board of Directors authorized the use of option exercise proceeds for the repurchase of our common stock. During the three months ended December 31, 2006, we did not repurchase any shares. At December 31, 2006, $27.7 million remained available for future stock repurchases under the program.

Our working capital at December 31, 2006 was $243.5 million. At December 31, 2006, we had cash, cash equivalents, and marketable securities of $163.8 million and no debt, except for lease obligations. Management believes this liquidity and financial position will allow us to continue our stock repurchase program (depending on the price of the Company's common stock), to pursue selective acquisitions, and to consider the continuation of dividends on a quarterly basis. Restricted cash represents amounts collected on behalf of certain customers and its use is restricted to the purposes specified under our contracts with these customers.

Under the provisions of certain long-term contracts, we may incur certain reimbursable transition period costs. During the transition period, these expenditures resulted in the use of our cash and in our entering into lease financing arrangements for a portion of the costs. Reimbursement of these costs may occur in the set-up phase or over the contract operating period. Related revenue may also be deferred during the set-up phase. As of December 31, 2006, $9.8 million in net costs had been incurred and reported as deferred contract costs on our December 31, 2006 consolidated balance sheet.

In June 2003, in connection with a long-term contract, the Company issued a standby letter of credit in an initial amount of up to $20.0 million, which amount was reduced to $10.0 million on April 1, 2005. The letter of credit, which expires on March 31, 2009, may be called by the customer in the event the Company defaults under the terms of the contract. In March 2006, in connection with another long-term contract, the Company issued a standby letter of credit in the amount of $4.0 million. The letter of credit, which expires on September 30, 2008, may be called by the customer in the event the Company defaults under the terms of the contract. Both letters of credit, as amended by the Company and its lender on December 20, 2006, contain financial covenants that establish minimum levels of tangible net worth, earnings before interest, tax, depreciation and amortization (EBITDA), cash balances and a maximum level of losses on the Texas Integrated Eligibility project. The Company was in compliance with all covenants as of December 31, 2006.

In July 2003, we entered into a capital lease financing arrangement with a financial institution whereby we acquired assets pursuant to an equipment lease agreement. Rental payments for assets leased are payable over a 60-month period at an interest rate of 4.05% commencing in January 2004. In March 2004, we entered into a supplemental capital lease financing arrangement with the same financial institution whereby we acquired additional assets pursuant to an equipment lease agreement. Rental payments for assets leased under the supplemental arrangement are payable over a 57-month period at an interest rate of 3.61% commencing in April 2004. At December 31, 2006, capital lease obligations of $3.4 million were outstanding related to these lease arrangements for new equipment.

At December 31, 2006, we classified accounts receivable of $2.2 million, net of a $0.6 million discount, as long-term receivables and reported them within the other assets category on our consolidated balance sheet. These receivables have extended payment terms and collection is expected to exceed one-year.

On January 5, 2007, the Company's Board of Directors declared a quarterly cash dividend of $0.10 for each share of the Company's common stock outstanding. The dividend is payable on February 28, 2007, to shareholders of record on February 15, 2007. Based on the current number of shares outstanding, the payment will be $2.2 million.

We believe that we will have sufficient resources to meet our currently anticipated capital expenditures and working capital requirements for at least the next twelve months.



**Critical Accounting Policies and Estimates**

Our discussion and analysis of financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities and the reported amounts of revenue and expenses. On an ongoing basis, we evaluate our estimates including those related to revenue recognition and cost estimation on certain contracts, the realizability of goodwill, and amounts related to income taxes, certain accrued liabilities and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from those estimates.

We believe that we do not have significant off-balance-sheet risk or exposure to liabilities that are not recorded or disclosed in our financial statements. While we have significant operating lease commitments for office space, those commitments are generally tied to the period of performance under related contracts. Additionally, although on certain contracts we are bound by performance bond commitments and standby letters of credit, we have not had any defaults resulting in draws on performance bonds. Also, we do not speculate in derivative transactions.

We believe the following critical accounting policies affect the significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue Recognition*. In fiscal 2006, approximately 77% of our total revenue was derived from state and local government agencies; 7% from federal government agencies; 11% from foreign customers; and 5% from other sources, such as commercial customers. Revenue is generated from contracts with various pricing arrangements, including: (1) fixed-price; (2) performance-based criteria; (3) costs incurred plus a negotiated fee ("cost-plus"); and (4) time and materials. Also, some contracts contain "not-to-exceed" provisions. Of the contracts with "not-to-exceed" provisions, to the extent we estimate we will exceed the contractual limits, we treat these contracts as fixed price. For fiscal 2006, revenue from fixed-price contracts was approximately 41% of total revenue; revenue from performance-based contracts was approximately 35% of total revenue; revenue from cost-plus contracts was approximately 15% of total revenue; and revenue from time and materials contracts was approximately 9% of total revenue. A majority of the contracts with state and local government agencies have been fixed-price and performance-based, and our contracts with the federal government generally have been cost-plus. Fixed-price and performance-based contracts generally offer higher margins but typically involve more risk than cost-plus or time and materials reimbursement contracts.

We recognize revenue on fixed-priced contracts when earned, as services are provided. For certain fixed-price contracts, primarily systems design, development and implementation, we recognize revenue based on costs incurred using estimates of total expected contract revenue and costs to be incurred in accordance with the provisions of AICPA Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts ("SOP 81-1"). The cumulative impact of any revisions in estimated revenue and costs is recognized in the period in which the facts that give rise to the revision become known. For other fixed-price contracts, revenue is recognized on a straight-line basis unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern. With fixed-price contracts, we are subject to the risk of potential cost overruns. For fixed-price contracts accounted for under SOP 81-1, provisions for estimated losses on incomplete contracts are provided in full in the period in which such losses become known. Costs related to contracts may be incurred in periods prior to recognizing revenue. These costs are generally expensed.

However, certain direct and incremental set-up costs may be deferred until services are provided and revenue begins to be recognized, when such costs are recoverable from a contractual arrangement. Set-up costs are costs related to activities that enable us to provide contractual services to a client. The timing of expense recognition may result in irregular profit margins.



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We recognize revenue on performance-based contracts as such revenue becomes fixed or determinable, which generally occurs when amounts are billable to customers. For certain contracts, this may result in revenue being recognized in irregular increments.

Revenue on cost-plus contracts is recognized based on costs incurred plus an estimate of the negotiated fee earned. Revenue on time and materials contracts is recognized based on hours worked and expenses incurred.

Our most significant expense is cost of revenue, which consists primarily of project-related costs such as employee salaries and benefits, subcontractors, computer equipment and travel expenses. Our management uses its judgment and experience to estimate cost of revenue expected on projects. Our management's ability to accurately predict personnel requirements, salaries and other costs as well as to effectively manage a project or achieve certain levels of performance can have a significant impact on the gross margins related to our fixed-price, performance-based and time and materials contracts. If actual costs are higher than our management's estimates, profitability may be adversely affected. Service cost variability has little impact on cost-plus arrangements because allowable costs are reimbursed by the customer.

We also license software under license agreements. Software revenue is recognized in accordance with AICPA Statement of Position 97-2, Software Revenue Recognition ("SOP 97-2"), as amended by Statement of Position 98-9, Modification of SOP 97-2, With Respect to Certain Transactions ("SOP 98-9"). Software license revenue is recognized when a customer enters into a non-cancelable license agreement, the software product has been delivered, there are no uncertainties surrounding product acceptance, there are no significant future performance obligations, the license fees are fixed or determinable and collection of the license fee is considered probable. Amounts received in advance of meeting these criteria are deferred. As required by SOP 98-9, the Company determines the value of the software component of its multiple-element arrangements using the residual method as vendor specific objective evidence ("VSOE") of fair value exists for the undelivered elements such as the support and maintenance agreements and related implementation and training services, but not for all delivered elements such as the software itself. The residual method requires revenue to be allocated to the undelivered elements based on the fair value of such elements, as indicated by VSOE. VSOE is based on the price charged when the element is sold separately. Maintenance and post-contract customer support revenue are recognized ratably over the term of the related agreements, which in most cases is one year. Revenue from software-related consulting services under time and material contracts and for training is recognized as services are performed. Revenue from other software-related contract services requiring significant modification or customization of software is recognized under the percentage-of-completion method.

EITF 00-21, Revenue Arrangements with Multiple Deliverables, requires contracts with multiple deliverables to be divided into separate units of accounting if certain criteria are met. We apply the guidance therein and recognize revenue on multiple deliverables as separate units of accounting if the criteria are met.

*Impairment of Goodwill.* We adhere to the Financial Accounting Standards Board's Statements of Financial Accounting Standards No. 141, Business Combinations ("FAS 141"), and No. 142, Goodwill and Other Intangible Assets ("FAS 142"). Under these rules, goodwill is not amortized but is subject to annual impairment tests in accordance with FAS 141 and FAS 142. Goodwill is tested on an annual basis, or more frequently as impairment indicators arise. Annual impairment tests involve the use of estimates related to the fair market values of our reporting units with which goodwill is associated. Losses, if any, resulting from annual impairment tests will be reflected in operating income in our income statement**.**

*Capitalized Software Development Costs*. Software development costs are capitalized in accordance with FAS No. 86, Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed. We capitalize both purchased software that is ready for resale and costs incurred internally for software development projects from the time technological feasibility is established. Capitalized software development costs are reported at the lower of unamortized cost or estimated net realizable value. Upon the general release of the software to customers, capitalized software development costs for the products are amortized over the greater of the ratio of gross revenues to expected total revenues of the product or on the straight-line method of amortization over the estimated economic life of the product, which ranges from three to five years. The establishment of technological feasibility and the ongoing assessment for recoverability of capitalized development costs require considerable judgment by management including, but not limited to, technological feasibility, anticipated future gross revenues, estimated economic life, and changes in software and hardware technologies. Any changes to these estimates could impact the amount of amortization expense and the amount recognized as capitalized software development costs in the consolidated balance sheet.



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*Allowance for Doubtful Account*s. We maintain an allowance for doubtful accounts at an amount we estimate to be sufficient to cover the risk of collecting less than full payment on our receivables. On a regular basis we re-evaluate our client receivables, especially receivables that are past due, and reassess our allowance for doubtful accounts based on specific client collection issues. If our clients were to express dissatisfaction with the services we have provided, additional allowances may be required.

*Deferred Contract Costs*. Deferred contract costs consist of contractually recoverable direct set-up costs relating to long-term service contracts in progress. These costs include direct and incremental costs incurred prior to the commencement of our providing service to enable us to provide the contracted services to our customer. Such costs are expensed over the period services are provided under the long-term service contract. We review deferred contract costs for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Our review is based on our projection of the undiscounted future operating cash flows of the related customer project. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amount, we recognize a non-cash impairment charge to reduce the carrying amount to equal projected future discounted cash flows.

*Contingencies.* From time to time, we are involved in legal proceedings, including contract and employment claims, in the ordinary course of business. We assess the likelihood of any adverse judgments or outcomes to these contingencies as well as potential ranges of probable losses and establish reserves accordingly. The amount of reserves required may change in future periods due to new developments in each matter or changes in approach to a matter such as a change in settlement strategy.

*Legal Expense*. Legal expense consists of costs, net of reimbursed insurance claims, related to significant legal settlements and non-routine legal matters, including future probable legal costs estimated to be incurred in connection with those matters. Legal expenses incurred in the ordinary course of business are included in selling, general and administrative expense.

*Stock-Based Compensation.* Effective October 1, 2005, the Company adopted the provisions of SFAS No. 123(R), Share-Based Payment, using the modified-prospective-transition method.

*Income Taxes.* To record income tax expense, we are required to estimate our income taxes in each of the jurisdictions in which we operate. In addition, income tax expense at interim reporting dates requires us to estimate our expected effective tax rate for the entire year. This process involves estimating our actual current tax liability together with assessing temporary differences that result in deferred tax assets and liabilities and expected future tax rates. Circumstances that could cause our estimates of income tax expense to change include: the impact of information that subsequently becomes available as we prepare our tax returns; changes in the geographic mix of our business; the actual level of pre-tax income; changes in tax rules, regulations and rates; and changes mandated as a result of audits by taxing authorities.

We may also establish tax reserves when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are subject to challenge and that we may not fully succeed. We adjust these reserves in light of changing facts, such as the progress of a tax audit, new case law, or expiration of a statute of limitations. We have deferred tax assets due to net operating loss carryforwards in our Canadian subsidiaries, the utilization of which is not assured and is dependent on generating sufficient taxable income in the future. These net operating loss carryforwards may be used to offset taxable income in future periods, reducing the amount of taxes we might otherwise be required to pay. A valuation allowance is recognized if, based on the weight of available evidence, it is more-likely-than-not that some portion, or all, of the deferred tax asset will not be realized. In the event that actual circumstances differ from management's estimates, or to the extent that these estimates are adjusted in the future, any changes to the valuation allowance could be material.



**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We believe that our exposure to market risk related to the effect of changes in interest rates, foreign currency exchange rates, commodity prices and other market risks with regard to instruments entered into for trading or for other purposes is immaterial.

**Item 4. Controls and Procedures.**

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our principal executive officer and principal financial officer concluded that these disclosure controls and procedures were effective and designed to ensure that the information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the requisite time periods.

(b) Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) identified in connection with the evaluation of our internal control that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

The Company is involved in various legal proceedings, including contract and employment claims, in the ordinary course of its business. The matters reported on below involve significant pending or potential claims against us.

(a) In October 2004, MAXIMUS received a subpoena from the Criminal Division of the U.S. Department of Justice acting through the U.S. Attorney's Office for the District of Columbia. The subpoena requested records pertaining to the Company's work for the District of Columbia, primarily relating to the preparation and submission of federal Medicaid reimbursement claims on behalf of the District. The U.S. Attorney's Office is investigating issues pertaining to compliance with the federal laws governing Medicaid claims. We have fully cooperated with the U.S. Attorney's Office in producing documents in response to the subpoena and making employees available for interviews, and we have conducted an internal review of this matter through independent outside legal counsel.

Attorneys from the Criminal Division have expressed their view that the Company either willfully or recklessly submitted inaccurate claims to the federal government on behalf of the District of Columbia. MAXIMUS disputes that view. Nevertheless, the Criminal Division attorneys have referred the Company to attorneys from the Civil Division to determine if a civil resolution of the matter is possible. Those discussions are ongoing.



Based on the probable legal costs of the internal review, we recorded a charge of $0.5 million in connection with this matter in the quarter ended December 31, 2005. We are unable to quantify the probability of criminal or civil prosecution or the probability or magnitude of any other expenditure, fine, penalty, or settlement amount we may incur in connection with this matter at this time.

(b) In June 2005, MAXIMUS received a subpoena pursuant to the Illinois Whistleblower Reward and Protection Act from the Office of the Attorney General of Illinois in connection with a purported whistleblower investigation of potential false claims. The subpoena requested records pertaining to the Company's work for agencies of the Executive Branch of Illinois State Government. Discussions with the Attorney General's office have indicated that MAXIMUS was one of nine contractors that received such subpoenas and that the investigation is primarily focused at this time on the procurement and contracting activities of the Illinois Department of Central Management Services. Although there can be no assurance of a favorable outcome and we are unable to quantify the probability or magnitude of any expenditures we may incur in connection with this matter, the Company does not believe that this matter will have a material adverse effect on its financial condition or results of operations, and the Company has not accrued for any loss related to this matter.

(c) In December 2006, Emergis, Inc. filed a demand for arbitration against MAXIMUS and certain of its wholly-owned subsidiary companies in British Columbia, Canada. Emergis was a subcontractor to MAXIMUS BC Health, Inc. and MAXIMUS BC Health Benefit Operations, Inc. in support of their contract with the British Columbia Ministry of Health. The subcontract required Emergis to provide a system for the adjudication, processing and payment of health care claims for the Province and had a total value of approximately $32.0 million Canadian ($27.2 million U.S.). Because Emergis failed to meet product development and delivery requirements under the subcontract, MAXIMUS declared Emergis in default and ultimately terminated the subcontract in September 2006. In its demand for arbitration, Emergis challenges the basis of the termination, alleges that the subcontract remains in force and seeks payment of damages including the amounts that it would have received under the subcontract. MAXIMUS believes that termination was justified and that, in any event, damages would be limited to the contractual limitation of liability, which is less than $2.0 million Canadian ($1.7 million U.S.). MAXIMUS is currently preparing its response and counterclaims to the arbitration demand.

(d) In December 2006, the Ontario Ministry of Community and Social Services sent a notice to Themis Program Management and Consulting Limited ("Themis") purporting to terminate for default the Ministry's contract with Themis. Themis is a Canadian subsidiary of MAXIMUS that had contracted with the Ministry to provide software and services in support of the Ministry's child support case management system. The Ministry alleges that Themis failed to meet certain requirements under the contract pertaining to deliverables, services and timeliness. Themis believes that it fulfilled its contractual obligations and that any remaining open tasks are due to the non-cooperation of the Ministry. No legal actions have been filed, but the Ministry has asserted damages exceeding $30.0 million Canadian ($25.5 million U.S.) in correspondence. Themis disputes that damages claim and believes that any damages of the Ministry would be capped at the $5.0 million Canadian ($4.3 million U.S.) limitation of liability set forth in the contract. MAXIMUS co-signed the contract as a guarantor of the obligations of Themis.

(e) In January 2007, MAXIMUS delivered to Accenture LLP a written formal demand for arbitration to resolve disputes relating to the Company's role as a subcontractor in support of Accenture's prime contract with the Texas Health and Human Services Commission ("HHSC") for the Integrated Eligibility and Enrollment Services program (the "Program"). The Company's claims include (i) Accenture's attempt to misappropriate the Company's intellectual property, (ii) Accenture's failure to deliver required technology under the subcontract, (iii) Accenture's unilateral negotiation of issues with HHSC having a direct effect on the Company, (iv) Accenture's unfounded assertions that the Company had breached its obligations with respect to the Children's Health Insurance Program ("CHIP") operations under the subcontract, and (v) Accenture's imposition of excessive and unsubstantiated cover costs on the Company arising out of the amendment to the subcontract entered into in June 2006. MAXIMUS seeks to recover its damages which it believes exceed $100 million. Accenture submitted a response disputing MAXIMUS' claims and asserting a counterclaim that MAXIMUS has breached the subcontract. Accenture seeks unspecified damages which it has stated could be hundreds of millions of dollars. The subcontract incorporates the terms and conditions of the prime contract which contains a limitation of liability of $250.0 million.



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Also in January 2007, Accenture delivered to the Company a letter purporting to declare the Company in default of its obligations under the subcontract. The Accenture letter states that Accenture plans to exercise step-in rights with respect to certain management and supervisory services currently provided by the Company for the CHIP operations. The letter also states that Accenture intends to partially terminate the subcontract as of February 5, 2007 with respect to the Company's obligations regarding CHIP services. The letter includes a proposed turnover plan for transitioning the CHIP services from the Company to Accenture. Accenture has alleged that the Company owes damages relating to the CHIP operations of at least $45.0 million plus $30.0 million in indemnification for amounts that Accenture agreed to pay to HHSC.

The Company believes that its positions are meritorious and that Accenture's positions are without merit, including Accenture's unjustified issuance of a default notice with respect to the CHIP operations. Based on the future probable legal costs associated with the arbitration, the Company recorded a charge of $3.0 million during the quarter ended December 31, 2006. The Company will continue to aggressively pursue its rights and remedies against Accenture to resolve the current dispute. The Company cannot predict the outcome of the arbitration proceedings or any settlement negotiations or the impact they may have on the Company's operating results or financial condition.

**Item 1A. Risk Factors.**

Our operations are subject to many risks that could adversely affect our future financial condition and performance and, therefore, the market value of our securities. See Exhibit 99.1 of this Quarterly Report on Form 10-Q under the caption "Special Considerations and Risk Factors" for information on risks and uncertainties that could affect our future financial condition and performance. The information in Exhibit 99.1 is incorporated by reference into this Item 1A.



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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

(c) The following table sets forth the information required regarding repurchases of common stock that we made during the three months ended December 31, 2006:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans (1) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan (in thousands) |
|---|---|---|---|---|
| Oct. 1, 2006 — Oct. 31, 2006 | — | — | — | $ 26,223 |
| Nov. 1, 2006 — Nov. 30, 2006 | — | — | — | $ 26,340 |
| Dec. 1, 2006 —Dec. 31, 2006 | — | — | — | $ 27,724 |
| Total | — | — | — | |

(1) Under resolutions adopted and publicly announced on May 12, 2000, July 10, 2002, and April 2, 2003, our Board of Directors has authorized the repurchase, at management's discretion, of up to an aggregate of $90.0 million of common stock under our 1997 Equity Incentive Plan. In addition, in June 2002, the Board of Directors authorized the use of option exercise proceeds for the repurchase of our common stock.

**Item 6. Exhibits.**

The Exhibits filed as part of this Quarterly Report on Form 10-Q are listed on the Exhibit Index immediately preceding the Exhibits. The Exhibit Index is incorporated herein by reference.



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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.

MAXIMUS, INC.

| | | |
|---|---|---|
| Date: February 8, 2007 | By: | /s/ David N. Walker<br>David N. Walker<br>Chief Financial Officer<br>(On behalf of the registrant and as Principal Financial and Accounting Officer) |



**EXHIBIT INDEX**

| Exhibit No. | Description |
|---|---|
| 31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Section 906 Principal Executive Officer Certification. |
| 32.2 | Section 906 Principal Financial Officer Certification. |
| 99.1 | Special Considerations and Risk Factors. |

**EXHIBIT 31.1**

**Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Richard A. Montoni, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of MAXIMUS, Inc. for the period ended December 31, 2006;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

    c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: February 8, 2007

/s/ Richard A. Montoni
Richard A. Montoni
Chief Executive Officer

**EXHIBIT 31.2**

**Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, David N. Walker, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of MAXIMUS, Inc. for the period ended December 31, 2006;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: February 8, 2007

/s/ David N. Walker
David N. Walker
Chief Financial Officer

**EXHIBIT 32.1**

**Section 906 CEO Certification**

I, Richard A. Montoni, Chief Executive Officer of MAXIMUS, Inc. ("the Company"), do hereby certify, under the standards set forth in and solely for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Quarterly Report on Form 10-Q of the Company for the period ended December 31, 2006 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78m or 78o(d)) and

2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 8, 2007

/s/ Richard A. Montoni
Richard A. Montoni
Chief Executive Officer

**EXHIBIT 32.2**

**Section 906 CFO Certification**

I, David N. Walker, Chief Financial Officer of MAXIMUS, Inc. ("the Company"), do hereby certify, under the standards set forth in and solely for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Quarterly Report on Form 10-Q of the Company for the period ended December 31, 2006 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78m or 78o(d)) and

2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 8, 2007

/s/ David N. Walker
David N. Walker
Chief Financial Officer

## Special Considerations and Risk Factors

From time to time, we may make forward-looking public statements, such as statements concerning our then-expected future revenue or earnings or concerning projected plans, performance or contract procurement, as well as other estimates relating to future operations. Forward-looking statements may be in reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in press releases or in informal statements made with the approval of an authorized executive officer. The words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project," "believe," "could," "intend," "may," "opportunity," "plan," "potential" or similar terms and expressions are intended to identify "forward-looking statements" within the meaning of Section 21E of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995.

We wish to caution you not to place undue reliance on these forward-looking statements that speak only as of the date on which they are made. In addition, we wish to advise you that the factors listed below, as well as other factors we have not currently identified, could affect our financial or other performance and could cause our actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods or events in any current statement.

We will not undertake and we specifically decline any obligation to publicly release revisions to these forward-looking statements to reflect either a circumstance after the date of the statements or the occurrence of events that may cause us to re-evaluate our forward-looking statements.

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act, we are hereby filing the following cautionary statements identifying important factors that could cause our actual results to differ materially from those projected in forward-looking statements made by us or on our behalf:

**If we fail to satisfy our contractual obligations or meet performance standards, our contracts may be terminated and we may incur significant costs or liabilities, including liquidated damages and penalties, which could adversely impact our operating results, financial condition and our ability to compete for future contracts.**

Our contracts may be terminated for our failure to satisfy our contractual obligations or to meet performance standards and often require us to indemnify customers. In addition, some of our contracts contain substantial liquidated damages provisions and financial penalties related to performance failures. Although we have liability insurance, the policy coverage and limits may not be adequate to provide protection against all potential liabilities. Further, for certain contracts, we have posted significant performance bonds or issued letters of credit to secure our indemnification and other obligations. If a claim is made against a performance bond or letter of credit, we would be required to reimburse the issuer for the amount of the claim. Consequently, as a result of the above matters, we may incur significant costs or liabilities, including penalties, which could adversely impact our operating results, financial condition and our ability to compete for future contracts.

The company serves as a subcontractor to Accenture LLP in support of Accenture's prime contract with the Texas Health and Human Services Commission ("HHSC") for the Integrated Eligibility and Enrollment Services program. In January 2007, Accenture delivered a letter purporting to declare the Company in default of its obligations under that subcontract. The letter states that Accenture plans to exercise step-in rights with respect to certain management and supervisory services currently provided by the Company for the Children's Health Insurance Program ("CHIP") operations. The letter also states that Accenture intends to partially terminate the subcontract as of February 5, 2007 with respect to the Company's obligations regarding CHIP integrated eligibility services. The letter includes a proposed turnover plan for transitioning the CHIP services from the Company to Accenture. Accenture has alleged that the Company owes damages relating to the CHIP operations of at least $45 million plus $30 million in indemnification for amounts that Accenture agreed to pay to HHSC.

These issues are the subject of an arbitration proceeding the Company has initiated against Accenture alleging, among other things, that Accenture breached the subcontract and that the CHIP termination was unjustified. Accenture has disputed MAXIMUS' claims and asserted that MAXIMUS breached the subcontract. The Company cannot predict the outcome of that proceeding. The Company has incurred very substantial losses on this project. An adverse decision in the arbitration could adversely our operating results, financial condition and ability to compete for future projects.

**We may be subject to fines, penalties and other sanctions if we fail to comply with federal, state and local laws governing our business.**

Our business lines operate within a variety of complex regulatory schemes, including but not limited to the Federal Acquisition Regulation (FAR), Cost Accounting Standards, the Truth in Negotiations Act, the Fair Debt Collection Practices Act (and analogous state laws), as well as the regulations governing Medicaid and Medicare. If a government audit uncovers improper or illegal activities by us or we otherwise determine that these activities have occurred, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeitures of profits, suspension of payments, fines and suspension or disqualification from doing business with the government. Any adverse determination could adversely impact our ability to bid in response to RFPs in one or more jurisdictions. Further, as a government contractor subject to the types of regulatory schemes described above, we are subject to an increased risk of investigations, criminal prosecution, civil fraud, whistleblower lawsuits and other legal actions and liabilities to which private sector companies are not, the result of which could have a material adverse effect on our operations.

**We are subject to review and audit by federal, state and local governments at their sole discretionand, if any improprieties are found, we may be required to refund revenue we have received, or forego anticipated revenue, which could have a material adverse impact on our revenues and our ability to bidin response to RFPs.**

As a provider of services to government agencies, we are subject to periodic audits and other reviews by federal, state and local governments of our costs and performance, accounting and general business practices relating to our contracts with those government agencies. As part of that process, the government agency reviews our performance on the contract, our pricing practices, our cost structure and our compliance with applicable laws, regulations and standards. Based on the results of these audits, government agencies may demand refunds or adjust our contract-related costs and fees, including internal costs and expense allocation. Although adjustments arising from government audits and reviews have not had a material adverse effect on our results of operations in the past, there can be no assurance that future audits and reviews would not have such effects.

**If we fail to accurately estimate the factors upon which we base our contract pricing, we may generate less profit than expected or incur losses on those contracts.**

We derived approximately 41% of our fiscal 2006 revenue from fixed-price contracts and approximately 35% of our fiscal 2006 revenue from performance-based contracts. For fixed-price contracts, we receive our fee based on services provided. Those services might include operating a Medicaid enrollment center pursuant to specified standards, designing and implementing computer systems or applications, or delivering a planning document under a consulting arrangement. For performance-based contracts, we receive our fee on a per-transaction basis. These contracts include, for example, child support enforcement contracts, in which we often receive a fee based on the amount of child support collected. To earn a profit on these contracts, we must accurately estimate costs involved and assess the probability of completing individual transactions within the contracted time period. If our estimates prove to be inaccurate, we may not achieve the level of profit we expected or we may incur a net loss on a contract. Although we believe that we have recorded adequate provisions in our financial statements for losses on our fixed-price and cost-plus contracts, as required under U.S. generally accepted accounting principles, we cannot assure you that our contract loss provisions will be adequate to cover all actual future losses.

**Adverse judgments or settlements in legal disputes could harm our financial condition and operating results.**

We are subject to a variety of litigation or other claims and suits that arise from time to time in the ordinary course of our business such as contract and employment claims and lawsuits involving compliance with laws governing debt collections and child support enforcement. Adverse judgments or settlements in some or all of these legal disputes may result in significant monetary damages or injunctive relief against us. In addition, the litigation and other claims described in our periodic report are subject to inherent uncertainties and management's view of these matters may change in the future. Those uncertainties include, but are not limited to, costs of litigation, unpredictable court or jury decisions, and the differing laws and attitudes regarding damage awards among the states and countries in which we operate.

**We may incur significant costs before receiving related contract payments that could result in increasing the use of cash and accounts receivable.**

When we are awarded a contract, we may incur significant expenses before we receive contract payments, if any. These expenses may include leasing office space, purchasing office equipment and hiring personnel. In other situations, contract terms provide for billing upon achievement of specified project milestones. As a result, in these situations, we are required to expend significant sums of money before receiving related contract payments. In addition, payments due to us from government agencies may be delayed due to billing cycles or as a result of failures to approve governmental budgets in a timely manner. These factors could impact us by increasing the use of cash and accounts receivable. Moreover, these impacts could be exacerbated if we fail to either invoice the government agency or collect our fee in a timely manner.

**We obtain most of our business through competitive bidding in response to government RFPs. We may not be awarded contracts through this process on the same level in the future as in the past, and contracts we are awarded may not be profitable.**

Substantially all of our customers are government agencies. To market our services to government customers, we are often required to respond to government RFPs which may result in contract awards on a competitive basis. To do so effectively, we must estimate accurately our cost structure for servicing a proposed contract, the time required to establish operations and likely terms of the proposals submitted by competitors. We must also assemble and submit a large volume of information within a RFP's rigid timetable. Our ability to respond successfully to RFPs will greatly impact our business. There is no assurance that we will continue to obtain contracts in response to government RFPs and our proposals may not result in profitable contracts. In addition, competitors may protest contracts awarded to us through the RFP process which may cause the award to be delayed or overturned or may require the customer to reinitiate the RFP process.

**Government entities have in the past and may in the future terminate their contracts with us earlier than we expect, which may result in revenue shortfalls.**

Many of our government contracts contain base periods of one or more years, as well as option periods covering more than half of the contract's potential duration. Government agencies do not have to exercise these option periods, and they may elect not to exercise them for budgetary, performance, or any other reason. Our contracts also typically contain provisions permitting a government customer to terminate the contract on short notice, with or without cause. Termination without cause provisions generally allow the government to terminate a contract at any time, and enable us to recover only our costs incurred or committed, and settlement expenses and profit, if any, on the work completed prior to termination. The unexpected termination of significant contracts could result in significant revenue shortfalls. If revenue shortfalls occur and are not offset by corresponding reductions in expenses, our business could be adversely affected. We cannot anticipate if, when or to what extent a customer might terminate its contracts with us.



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**If we are unable to manage our growth, our profitability will be adversely affected.**

Sustaining our growth places significant demands on our management as well as on our administrative, operational and financial resources. For us to continue to manage our growth, we must continue to improve our operational, financial and management information systems and expand, motivate and manage our workforce. If our growth comes at the expense of providing quality service and generating reasonable profits, our ability to successfully bid for contracts and our profitability will be adversely affected.

**We rely on key contracts with state and local governments for a significant portion of our sales. A substantial reduction in those contracts would materially adversely affect our operating results.**

In fiscal 2006, approximately 77% of our total revenue was derived from contracts with state and local government agencies. Any significant disruption or deterioration in our relationship with state and local governments and a corresponding reduction in these contracts would significantly reduce our revenues and could substantially harm our business.

**Government unions may oppose outsourcing of government programs to outside vendors such as us, which could limit our market opportunities and could impact us adversely. In addition, our unionized workers could disrupt our operations.**

Our success depends in part on our ability to win profitable contracts to administer and manage health and human services programs traditionally administered by government employees. Many government employees, however, belong to labor unions with considerable financial resources and lobbying networks. Unions have in the past applied, and are likely to continue to apply, political pressure on legislators and other officials seeking to outsource government programs. Union opposition to these programs may result in fewer opportunities for us to service government agencies and/or longer and more complex procurements.

We do operate outsourcing programs using unionized employees in Canada. We have experienced opposition from the union which does not favor the outsourcing of government programs. As a result, we have received negative press coverage as the union continues to oppose our program operations. Such press coverage and union opposition may have an adverse affect on the willingness of government agencies to outsource such projects as well as certain contracts that are operated within a unionized environment. Our unionized workers could also declare a strike which could adversely affect our performance and financial results.

**We may be precluded from bidding and performing certain work due to other work we currently perform.**

Various laws and regulations prohibit companies from performing work for government agencies that might be viewed as an actual or apparent conflict of interest. These laws may limit our ability to pursue and perform certain types of work. For example, some of our Consulting Segment divisions assist government agencies in developing requests for proposals (RFPs) for various government programs. In those situations, the divisions involved in operating such programs would likely be precluded from bidding on those RFPs. Similarly, rules governing the independence of enrollment brokers could prevent us from providing services to other organizations such as health plans.

**We may lose executive officers and senior managers on whom we rely to generate business and execute projects successfully.**

The ability of our executive officers and our senior managers to generate business and execute projects successfully is important to our success. While we have employment agreements with some of our executive officers, those agreements do not prevent them from terminating their employment with us. The loss of an executive officer or senior manager could impair our ability to secure and manage engagements, which could harm our business, prospects, financial condition and results of operations.

**Inaccurate, misleading or negative media coverage could adversely affect our reputation and our ability to bid for government contracts.**

Because of the public nature of many of our business lines, the media frequently focus their attention on our contracts with government agencies. If the media coverage is negative, it could influence government officials to slow the pace of outsourcing government services, which could reduce the number of RFPs. The media also focus their attention on the activities of political consultants engaged by us, and we may be tainted by adverse media coverage about their activities, even when those activities are unrelated to our business. Moreover, inaccurate, misleading or negative media coverage about us could harm our reputation and, accordingly, our ability to bid for and win government contracts.

**We may be unable to attract and retain sufficient qualified personnel to sustain our business.**

Our delivery of services is labor-intensive. When we are awarded a government contract, we must quickly hire project leaders and case management personnel. The additional staff also creates a concurrent demand for increased administrative personnel. Our success requires that we attract, develop, motivate and retain:

- experienced and innovative executive officers;
- senior managers who have successfully managed or designed government services programs; and
- information technology professionals who have designed or implemented complex information technology projects.

Innovative, experienced and technically proficient individuals are in great demand and are likely to remain a limited resource. There can be no assurance that we will be able to continue to attract and retain desirable executive officers and senior managers. Our inability to hire sufficient personnel on a timely basis or the loss of significant numbers of executive officers and senior managers could adversely affect our business.

**If we fail to establish and maintain important relationships with government entities and agencies, our ability to successfully bid for RFPs may be adversely affected.**

To facilitate our ability to prepare bids in response to RFPs, we rely in part on establishing and maintaining relationships with officials of various government entities and agencies. These relationships enable us to provide informal input and advice to the government entities and agencies prior to the development of an RFP. We also engage marketing consultants, including lobbyists, to establish and maintain relationships with elected officials and appointed members of government agencies. The effectiveness of these consultants may be reduced or eliminated if a significant political change occurs. In that circumstance, we may be unable to successfully manage our relationships with government entities and agencies and with elected officials and appointees. Any failure to maintain positive relationships with government entities and agencies may adversely affect our ability to bid successfully in response to RFPs.

**The federal government may refuse to grant consents and/or waivers necessary to permit private entities, such as us, to perform certain elements of government programs.**

Under current law, in order to privatize certain functions of government programs, the federal government must grant a consent and/or waiver to the petitioning state or local agency. If the federal government does not grant a necessary consent or waiver, the state or local agency will be unable to outsource that function to a private entity, such as us. This situation could eliminate a contracting opportunity or reduce the value of an existing contract.



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**Our business could be adversely affected by future legislative or government budgetary and spending changes.**

The market for our services depends largely on federal and state legislative programs and the budgetary capability to support programs, including the continuance of existing programs. These programs can be modified or amended at any time by acts of federal and state governments.

Moreover, part of our growth strategy includes aggressively pursuing new opportunities and continuing to serve existing programs scheduled for re-bid, which are or may be created by federal and state initiatives, principally in the area of health services, human services and child welfare.

State budgets were adversely impacted by a general economic slowdown in fiscal 2003, creating state budget deficits, which trend, although to a lesser extent, continued into fiscal 2004 and 2005. All but one state must operate under a balanced budget. There are a number of alternatives to states in managing a possible budget deficit, including:

- Accessing previously set aside or “rainy day” funds;
- Increasing taxes;
- Elimination or reduction in services;
- Cost containment and savings;
- Pursuit of additional federal assistance; and
- Developing additional sources of revenue, such as the legalization of gaming.

While we believe that the demand for our services remains substantial, state budget deficits could adversely impact our existing and anticipated business as well as our future financial performance.

Also, changes in federal initiatives or in the level of federal spending due to budgetary or deficit considerations may have a significant impact on our future financial performance. For example, increased or changed spending on defense, security or anti-terrorism threats may impact the level of demand for our services. Many state programs, such as Medicaid, are federally mandated and fully or partially funded by the federal government. Changes, such as program eligibility, benefits, or the level of federal funding may impact the demand for our services. Certain changes may present new opportunities to us and other changes may reduce the level of demand for services provided by us, which could materially adversely impact our future financial performance.

**If we do not successfully integrate the businesses that we acquire, our results of operations could be adversely affected.**

Business combinations involve a number of factors that affect operations, including:

- diversion of management's attention;
- loss of key personnel;
- entry into unfamiliar markets;
- assumption of unanticipated legal or financial liabilities;
- becoming significantly leveraged as a result of incurring debt to finance an acquisition;
- unanticipated operating, accounting or management difficulties in connection with the acquired entities;
- impairment of acquired intangible assets, including goodwill; and
- dilution to our earnings per share.



Businesses we acquire may not achieve the revenue and earnings we anticipated. Customer dissatisfaction or performance problems with an acquired firm could materially and adversely affect our reputation as a whole. As a result, we may be unable to profitably manage businesses that we have acquired or that we may acquire or we may fail to integrate them successfully without incurring substantial expenses, delays or other problems that could materially negatively impact our business and results of operations.

**Federal government officials may discourage state and local governmental entities from engaging us, which may result in a decline in revenue.**

To avoid higher than anticipated demands for federal funds, federal government officials occasionally discourage state and local authorities from engaging private consultants to advise them on obtaining federal funding reimbursements. If state and local officials are dissuaded from engaging us for revenue maximization services, we will not receive contracts for, or revenue from, those services.

**We may rely on subcontractors and partners to provide clients with a single-source solution.**

From time to time, we may engage subcontractors, teaming partners or other third parties to provide our customers with a single-source solution. While we believe that we perform appropriate due diligence on our subcontractors and teaming partners, we cannot guarantee that those parties will comply with the terms set forth in their agreements. We may have disputes with our subcontractors, teaming partners or other third parties arising from the quality and timeliness of the subcontractor's work, customer concerns about the subcontractor or other matters. Subcontractor performance deficiencies could result in a customer terminating our contract for default. We may be exposed to liability, and we and our clients may be adversely affected if a subcontractor or teaming partner failed to meet its contractual obligations.

**We face competition from a variety of organizations, many of which have substantially greater financial resources than we do; we may be unable to compete successfully with these organizations.**

Our Consulting Segment typically competes for consulting contracts with large consulting firms such as Accenture Ltd., as well as smaller niche players, such as Public Consulting Group.

Our Systems Segment competes for system products sales and system service contracts with a large number of competitors, including Unisys Corporation, SAP America, Inc., Oracle Corporation, BearingPoint, Inc., Accenture Ltd., Deloitte & Touche LLP, Northrop Grumman Corporation, and Electronic Data Systems Corporation.

Our Operations Segment competes for program management contracts with the following:

- government services divisions of large organizations such as Affiliated Computer Services, Inc., Electronic Data Systems Corporation, and International Business Machines Corporation;
- specialized service providers; and
- local non-profit organizations such as the United Way of America, Goodwill Industries and Catholic Charities, USA.

Many of these companies are national and international in scope, are larger than us and have greater financial resources, name recognition and larger technical staffs. Substantial resources could enable certain competitors to initiate severe price cuts or take other measures in an effort to gain market share. In addition, we may be unable to compete for the limited number of large contracts because we may not be able to meet an RFP's requirement to obtain and post a large cash performance bond. Also, in some geographic areas, we face competition from smaller consulting firms with established reputations and political relationships. There can be no assurance that we will be able to compete successfully against our existing or any new competitors.



**A number of factors may cause our cash flows and results of operations to vary from quarter to quarter.**

Factors which may cause our cash flows and results of operations to vary from quarter to quarter include:

- the terms and progress of contracts;

- the levels of revenue earned and profitability of fixed-price and performance-based contracts;
- expenses related to certain contracts which may be incurred in periods prior to revenue being recognized;
- the commencement, completion or termination of contracts during any particular quarter;
- the schedules of government agencies for awarding contracts;
- the term of awarded contracts; and
- potential acquisitions.

Changes in the volume of activity and the number of contracts commenced, completed or terminated during any quarter may cause significant variations in our cash flows and results of operations because a large amount of our expenses are fixed.

**Our Articles of Incorporation and bylaws include provisions that may have anti-takeover effects.**

Our Articles of Incorporation and bylaws include provisions that may delay, deter or prevent a takeover attempt that shareholders might consider desirable. For example, our Articles of Incorporation provide that our directors are to be divided into three classes and elected to serve staggered three-year terms. This structure could impede or discourage an attempt to obtain control of us by preventing stockholders from replacing the entire board in a single proxy contest, making it more difficult for a third party to take control of us without the consent of our Board of Directors. Our Articles of Incorporation further provide that our shareholders may not take any action in writing without a meeting. This prohibition could impede or discourage an attempt to obtain control of us by requiring that any corporate actions initiated by shareholders be adopted only at properly called shareholder meetings.