

H&R BLOCK INC
Form 10-Q
December 13, 2007

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

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended October 31, 2007
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 1-6089

H&R Block, Inc.
(Exact name of registrant as specified in its charter)

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

44-0607856
**(I.R.S. Employer
Identification No.)**

One H&R Block Way
Kansas City, Missouri 64105
(Address of principal executive offices, including zip code)

(816) 854-3000
(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

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

Yes No

The number of shares outstanding of the registrant's Common Stock, without par value, at the close of business on November 30, 2007 was 325,034,129 shares.

Form 10-Q for the Period Ended October 31, 2007

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Amendment Number Nine to the Second Amended and Restated Sale and Servicing Agreement

Kiosk License Agreement

Omnibus Amendment

Amendment Number Three to the Second Amended and Restated Sale and Servicing Agreement

Amendment Number Two to the Amended and Restated Note Purchase Agreement

Receivables Purchase Agreement

Indenture

Note Purchase Agreement

Amendment Number Ten to the Amended and Restated Note Purchase Agreement

Omnibus Amendment

Advances, Pledge and Security Agreement

Amendment Number One to the Indenture

Certification of CEO Pursuant to Section 302

Certification of CFO Pursuant to Section 302

Certification of CEO Pursuant to Section 906

Certification of CFO Pursuant to Section 906

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CONDENSED CONSOLIDATED BALANCE SHEETS (amounts in 000s, except share and per share amounts)

	October 31, 2007	April 30, 2007
	(Unaudited)	
ASSETS		
Cash and cash equivalents	\$ 386,915	\$ 921,838
Cash and cash equivalents restricted	237,176	332,646
Receivables from customers, brokers, dealers and clearing organizations, less allowance for doubtful accounts of \$2,345 and \$2,292	414,557	410,522
Receivables, less allowance for doubtful accounts of \$109,266 and \$99,259	486,802	556,255
Prepaid expenses and other current assets	219,562	208,564
Assets of discontinued operations, held for sale	2,236,021	1,746,959
 Total current assets	 3,981,033	 4,176,784
Mortgage loans held for investment, less allowance for loan losses of \$15,492 and \$3,448	1,082,301	1,358,222
Property and equipment, at cost less accumulated depreciation and amortization of \$648,766 and \$647,151	383,930	379,066
Intangible assets, net	161,199	181,413
Goodwill	1,007,695	993,919
Other assets	490,613	454,646
 Total assets	 \$ 7,106,771	 \$ 7,544,050
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Commercial paper and other short-term borrowings	\$ 500,000	\$ 1,567,082
Customer banking deposits	886,533	1,129,263
Accounts payable to customers, brokers and dealers	568,122	633,189
Accounts payable, accrued expenses and other current liabilities	400,738	519,372
Accrued salaries, wages and payroll taxes	123,424	307,854
Accrued income taxes	22,647	439,472
Current portion of long-term debt	11,480	9,304
Liabilities of discontinued operations, held for sale	1,363,207	615,373
 Total current liabilities	 3,876,151	 5,220,909
Long-term debt	2,144,012	519,807
Other noncurrent liabilities	542,328	388,835
 Total liabilities	 6,562,491	 6,129,551

Stockholders equity:

Common stock, no par, stated value \$.01 per share, 800,000,000 shares authorized, 435,890,796 shares issued at October 31, 2007 and April 30, 2007	4,359	4,359
Additional paid-in capital	678,407	676,766
Accumulated other comprehensive income (loss)	1,131	(1,320)
Retained earnings	1,981,378	2,886,440
Less cost of 111,009,460 and 112,671,610 shares of common stock in treasury	(2,120,995)	(2,151,746)
Total stockholders equity	544,280	1,414,499
Total liabilities and stockholders equity	\$ 7,106,771	\$ 7,544,050

See Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF
INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS) (unaudited, amounts in 000s,
except per share amounts)

	Three Months Ended		Six Months Ended	
	October 31,		October 31,	
	2007	2006	2007	2006
Revenues:				
Service revenues	\$ 373,817	\$ 347,942	\$ 695,480	\$ 650,738
Other revenues:				
Interest income	39,599	29,975	81,437	55,685
Product and other revenues	21,408	18,166	39,116	32,430
	434,824	396,083	816,033	738,853
Operating expenses:				
Cost of services	428,733	399,254	812,133	762,779
Cost of other revenues	58,806	25,573	102,335	43,780
Selling, general and administrative	180,876	162,972	326,700	312,043
	668,415	587,799	1,241,168	1,118,602
Operating loss	(233,591)	(191,716)	(425,135)	(379,749)
Interest expense	(652)	(12,091)	(1,247)	(24,226)
Other income, net	10,507	5,188	19,066	11,382
Loss from continuing operations before tax benefit	(223,736)	(198,619)	(407,316)	(392,593)
Income tax benefit	(87,631)	(77,622)	(161,388)	(153,757)
Net loss from continuing operations	(136,105)	(120,997)	(245,928)	(238,836)
Net loss from discontinued operations	(366,166)	(35,463)	(558,923)	(49,001)
Net loss	\$ (502,271)	\$ (156,460)	\$ (804,851)	\$ (287,837)
Basic and diluted loss per share:				
Net loss from continuing operations	\$ (0.42)	\$ (0.38)	\$ (0.76)	\$ (0.74)
Net loss from discontinued operations	(1.13)	(0.11)	(1.72)	(0.15)
Net loss	\$ (1.55)	\$ (0.49)	\$ (2.48)	\$ (0.89)
Basic and diluted shares	324,694	321,742	324,279	322,706
Dividends per share	\$ 0.143	\$ 0.135	\$ 0.28	\$ 0.26

Comprehensive income (loss):

Net loss	\$ (502,271)	\$ (156,460)	\$ (804,851)	\$ (287,837)
Change in unrealized gain on available-for-sale securities, net	1,626	1,667	1,163	(844)
Change in foreign currency translation adjustments	(3,023)	(329)	1,288	489
Comprehensive loss	\$ (503,668)	\$ (155,122)	\$ (802,400)	\$ (288,192)

See Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS			(unaudited, amounts in 000s)
Six Months Ended October 31,	2007	2006	
Cash flows from operating activities:			
Net loss	\$ (804,851)	\$ (287,837)	
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	75,246	71,964	
Stock-based compensation expense	17,550	17,262	
Changes in assets and liabilities of discontinued operations	243,306	(189,494)	
Other, net of business acquisitions	(473,376)	(783,866)	
Net cash used in operating activities	(942,125)	(1,171,971)	
Cash flows from investing activities:			
Mortgage loans originated or purchased for investment, net	76,889	(278,003)	
Purchases of property and equipment, net	(48,480)	(80,440)	
Payments made for business acquisitions, net of cash acquired	(21,037)	(12,670)	
Net cash provided by (used in) investing activities of discontinued operations	9,596	(8,864)	
Other, net	5,763	(29,274)	
Net cash provided by (used in) investing activities	22,731	(409,251)	
Cash flows from financing activities:			
Repayments of commercial paper	(5,125,279)	(2,295,573)	
Proceeds from issuance of commercial paper	4,133,197	3,336,002	
Repayments of line of credit borrowings	(1,005,000)	-	
Proceeds from line of credit borrowings	2,555,000	-	
Customer deposits, net	(243,030)	595,769	
Dividends paid	(90,495)	(84,225)	
Purchase of treasury shares	-	(180,897)	
Proceeds from exercise of stock options	13,434	10,640	
Net cash provided by (used in) financing activities of discontinued operations	200,812	(100)	
Other, net	(54,168)	(71,520)	
Net cash provided by financing activities	384,471	1,310,096	
Net decrease in cash and cash equivalents	(534,923)	(271,126)	
Cash and cash equivalents at beginning of the period	921,838	673,827	
Cash and cash equivalents at end of the period	\$ 386,915	\$ 402,701	
Supplementary cash flow data:			
Income taxes paid, net of refunds received of \$71,724 and \$1,468	\$ (52,360)	\$ 313,016	

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Interest paid on borrowings	73,998	39,683
Interest paid on deposits	28,039	9,892

See Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY(unaudited, amounts in 000s,
except per share amounts)

	Common Stock		Convertible Preferred Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	
	Shares	Amount	Shares	Amount				Shares	Amount
2006	435,891	\$ 4,359	-	\$ -	\$ 653,053	\$ 21,948	\$ 3,492,059	(107,378)	\$ (2,023,6
	-	-	-	-	-	-	(287,837)	-	-
Gain	-	-	-	-	-	489	-	-	-
ized	-	-	-	-	-	(844)	-	-	-
-sale	-	-	-	-	-	-	-	-	-
ation	-	-	-	-	21,955	-	-	-	-
	-	-	-	-	(1,495)	-	-	726	13,8
	-	-	-	-	(15,160)	-	-	778	14,7
	-	-	-	-	513	-	-	258	4,9
	-	-	-	-	54	-	-	21	3
ry	-	-	-	-	-	-	-	(8,380)	(186,5
\$0.26	-	-	-	-	-	-	(84,225)	-	-
31,	435,891	\$ 4,359	-	\$ -	\$ 658,920	\$ 21,593	\$ 3,119,997	(113,975)	\$ (2,176,2
2007	435,891	\$ 4,359	-	\$ -	\$ 676,766	\$ (1,320)	\$ 2,886,440	(112,672)	\$ (2,151,7
as	-	-	-	-	-	-	(9,716)	-	-
48	-	-	-	-	-	-	(804,851)	-	-
Gain	-	-	-	-	-	1,288	-	-	-
ized	-	-	-	-	-	1,163	-	-	-
-sale	-	-	-	-	-	-	-	-	-
ation	-	-	-	-	20,750	-	-	-	-
	-	-	-	-	(5,105)	-	-	940	17,9
	-	-	-	-	(14,439)	-	-	742	14,1

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	-	-	-	-	400	-	-	218	4,1
	-	-	-	-	35	-	-	8	1
ry	-	-	-	-	-	-	-	(245)	(5,6
\$0.28	-	-	-	-	-	-	(90,495)	-	
31,	435,891	\$ 4,359	-	\$ -	678,407	\$ 1,131	\$ 1,981,378	(111,009)	\$ (2,120,9

See Notes to Condensed Consolidated Financial Statements

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

The condensed consolidated balance sheet as of October 31, 2007, the condensed consolidated statements of income and comprehensive income for the three and six months ended October 31, 2007 and 2006, the condensed consolidated statements of cash flows for the six months ended October 31, 2007 and 2006, and the condensed consolidated statement of stockholders' equity for the six months ended October 31, 2007 and 2006 have been prepared by the Company, without audit. In the opinion of management, all adjustments, which include only normal recurring adjustments, necessary to present fairly the financial position, results of operations, cash flows and changes in stockholders' equity at October 31, 2007 and for all periods presented have been made. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

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

Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in our April 30, 2007 Annual Report to Shareholders on Form 10-K.

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

Discontinued Operations Recent Developments

On April 19, 2007, we entered into an agreement to sell Option One Mortgage Corporation (OOMC) to Cerberus Capital Management (Cerberus). In conjunction with this plan, we also announced we would terminate the operations of H&R Block Mortgage Corporation (HRBMC), a wholly-owned subsidiary of OOMC.

On December 4, 2007, we agreed to terminate the agreement with Cerberus in light of the changing business environment for OOMC, as mutually acceptable alternatives for restructuring the original agreement could not be reached. We also announced that we would immediately terminate all remaining origination activities and pursue the sale of OOMC's loan servicing activities. OOMC had existing loan applications in its pipeline of \$69.4 million in gross loan principal amount at October 31, 2007. We believe that only approximately \$20 million to \$30 million of these loans will ultimately be funded, at which time our mortgage origination activities will cease. We believe a majority of these loans will be eligible for sale to Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

Termination of the mortgage lending activities of OOMC is expected to result in a pretax restructuring charge of \$74.8 million. The restructuring charge covers expected severance and lease termination costs, write-off of property, plant and equipment and related shutdown costs. Of the total restructuring charge, \$34.9 million was incurred in our second quarter ending October 31, 2007, with the remainder to be incurred primarily in our third quarter ending January 31, 2008. This charge, combined with the restructuring activities previously announced, brings our total restructuring charges for the three and six months ended October 31, 2007 to \$61.0 million and \$77.1 million, respectively.

Following the termination of its loan origination activities, OOMC will continue to carry out its servicing activities and collect servicing revenues as it does today. Because of the cessation of new originations, the volume of mortgage loans serviced will gradually decline as the aggregate principal amount of existing loans being serviced declines without replacement. The majority of servicing activities are carried out with respect to loans owned by third parties.

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We have estimated the fair values of the servicing business and other assets, which resulted in an additional asset impairment for the second quarter ending October 31, 2007 of \$123.0 million, bringing our total impairment recorded in discontinued operations to \$146.2 million for the six months ended October 31, 2007.

During fiscal year 2007, we also committed to a plan to sell two smaller lines of business and completed the wind-down of one other line of business, all of which were previously reported in our Business Services segment. One of these businesses was sold during the six months ended October 31, 2007. Additionally, during fiscal year 2007, we completed the wind-down of our tax operations in the United Kingdom, which were previously reported in Tax Services. As of October 31, 2007, these businesses are presented as discontinued operations and the assets and liabilities of the businesses being sold are presented as held-for-sale in the condensed consolidated financial statements. All periods presented have been reclassified to reflect our discontinued operations.

2. Earnings (Loss) Per Share

Basic and diluted loss per share is computed using the weighted average shares outstanding during each period. The dilutive effect of potential common shares is included in diluted earnings per share except in those periods with a loss from continuing operations. Diluted earnings per share excludes the impact of shares of common stock issuable upon the lapse of certain restrictions or the exercise of options to purchase 30.2 million shares and 30.7 million shares for the three and six months ended October 31, 2007, respectively, and 32.5 million shares for the three and six months ended October 31, 2006, as the effect would be antidilutive due to the net loss from continuing operations during each period.

The weighted average shares outstanding for the three and six months ended October 31, 2007 increased to 324.7 million and 324.3 million, respectively, from 321.7 million and 322.7 million for the three and six months ended October 31, 2006, respectively, primarily due the issuance of treasury shares related to our stock-based compensation plans.

During the six months ended October 31, 2007 and 2006, we issued 1.9 million and 1.8 million shares of common stock, respectively, pursuant to the exercise of stock options, employee stock purchases and awards of nonvested shares, in accordance with our stock-based compensation plans.

During the six months ended October 31, 2007, we acquired 0.2 million shares of our common stock, which represent shares swapped or surrendered to us in connection with the vesting of nonvested shares and the exercise of stock options, at an aggregate cost of \$5.7 million. During the six months ended October 31, 2006, we acquired 8.4 million shares of our common stock, of which 8.1 million shares were purchased from third parties with the remaining shares swapped or surrendered to us, at an aggregate cost of \$186.6 million.

During the six months ended October 31, 2007, we granted 5.0 million stock options and 0.9 million nonvested shares and units in accordance with our stock-based compensation plans. The weighted average fair value of options granted was \$4.53 for manager and director options and \$3.07 for options granted to our seasonal associates. At October 31, 2007, the total unrecognized compensation cost for options and nonvested shares and units was \$26.2 million and \$49.4 million, respectively.

3. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill of continuing operations for the six months ended October 31, 2007 consist of the following:

(in 000s)

	April 30, 2007	Additions	Other	October 31, 2007
Tax Services	\$ 415,077	\$ 13,334	\$ 7,519	\$ 435,930
Business Services	404,888	356	(7,433)	397,811
	173,954	-	-	173,954

Consumer Financial
Services

Total	\$	993,919	\$	13,690	\$	86	\$	1,007,695
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We test goodwill for impairment annually at the beginning of our fourth quarter, or more frequently if events occur indicating it is more likely than not the fair value of a reporting unit's net assets has been

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reduced below its carrying value. No impairments of goodwill were identified within any of our operating segments during the six months ended October 31, 2007.

Intangible assets of continuing operations consist of the following:

	October 31, 2007			April 30, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
(in 000s)						
Tax Services:						
Customer relationships	\$ 45,123	\$ (19,453)	\$ 25,670	\$ 39,347	\$ (14,654)	\$ 24,693
Noncompete agreements	22,979	(19,344)	3,635	21,237	(18,279)	2,958
Purchased technology	12,500	(1,305)	11,195	12,500	-	12,500
Trade name	1,025	(67)	958	1,025	-	1,025
Business Services:						
Customer relationships	144,143	(94,464)	49,679	142,315	(90,900)	51,415
Noncompete agreements	32,266	(16,309)	15,957	31,352	(15,524)	15,828
Trade name amortizing	3,290	(3,006)	284	3,290	(2,430)	860
Trade name non-amortizing	55,637	(4,868)	50,769	55,637	(4,868)	50,769
Consumer Financial Services:						
Customer relationships	293,000	(289,948)	3,052	293,000	(271,635)	21,365
Total intangible assets	\$ 609,963	\$ (448,764)	\$ 161,199	\$ 599,703	\$ (418,290)	\$ 181,413

Amortization of intangible assets of continuing operations for the three and six months ended October 31, 2007 was \$15.0 million and \$30.5 million, respectively. Amortization of intangible assets of continuing operations for the three and six months ended October 31, 2006 was \$13.9 million and \$28.6 million, respectively. Estimated amortization of intangible assets for fiscal years 2008 through 2012 is \$45.7 million, \$22.0 million, \$19.4 million, \$17.6 million and \$14.9 million, respectively.

4. Borrowings

H&R Block Bank (HRB Bank) is a member of the Federal Home Loan Bank (FHLB) of Des Moines, which extends credit to member banks based on eligible collateral. At October 31, 2007, HRB Bank had FHLB advance capacity of \$428.9 million, and there was \$104.0 million outstanding on this facility. Mortgage loans held for investment of \$1.1 billion were pledged as collateral on these advances.

At October 31, 2007, we maintained \$2.0 billion in revolving credit facilities to support commercial paper issuance and for general corporate purposes. These unsecured committed lines of credit (CLOCs), and outstanding borrowings thereunder, have a maturity date of August 2010 and an annual facility fee in a range of six to fifteen basis points per annum, based on our credit ratings. Negative market conditions during our second fiscal quarter and recent credit rating downgrades continued to negatively impact the availability of commercial paper. As a result, during the current quarter we repaid our commercial paper borrowings with proceeds from the CLOCs, and had no outstanding commercial paper as of October 31, 2007. We had a combined \$1.6 billion outstanding under our \$2.0 billion in

available CLOCs as of October 31, 2007. These borrowings are included in long-term debt on our condensed consolidated balance sheet due to their contractual maturity date. The CLOCs, among other things, require we maintain at least \$650.0 million of Adjusted Net Worth, as defined in the agreement, on the last day of any fiscal quarter. On November 19, 2007, effective October 31, 2007, the CLOCs were amended to, among other things, require \$450.0 million of Adjusted Net Worth, for the fiscal quarters ending October 31, 2007 and January 31, 2008. Before the end of the second quarter, we initiated efforts to seek an amendment to the Minimum Net Worth Requirement (i) in light of the possibility that we might not have met the Minimum Net Worth Requirement for the fiscal quarter ended October 31, 2007, (ii) to obtain flexibility for purposes of negotiating a sale of OOMC, and (iii) in light of the possibility that, without the amendment, we would not be in compliance with the Minimum Net Worth Covenant as of January 31, 2008 without taking steps to raise additional capital. When financial results for the six months ended October 31, 2007 were finalized, we determined that we had an Adjusted Net Worth of \$544.3 million at October 31, 2007, primarily due to operating losses of our discontinued operations. Subsequent to October 31, 2007, we drew additional funds on the CLOCs to bring total borrowings to \$1.8 billion as of the date of this filing.

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In April 2007, we obtained a \$500.0 million credit facility to provide funding for the \$500.0 million of 8 1/2% Senior Notes which were due April 16, 2007. This facility matures on December 20, 2007. The facility was fully drawn at closing and is subject to various covenants that are similar to our primary CLOCs. We expect to refinance this facility when it matures.

5. Income Taxes

In June 2006, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) was issued. The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The interpretation prescribes a recognition threshold and measurement attribute criteria for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

We adopted the provisions of FIN 48 on May 1, 2007 and, as a result, recognized a \$9.7 million decrease to retained earnings as of May 1, 2007. Total unrecognized tax benefits as of May 1, 2007 were \$133.3 million, of which \$89.0 million, on a gross basis, were tax positions that, if recognized, would impact the effective tax rate. Net unrecognized tax benefits that would impact the effective tax rate totaled \$50.0 million as of May 1, 2007.

We recognize interest and, if applicable, penalties related to unrecognized tax benefits as a component of income tax expense. As of May 1, 2007 we accrued \$36.6 million for the potential payment of interest and penalties. Interest was estimated by applying the applicable statutory rate of interest of each of the jurisdictions identified on uncertain tax positions.

In the second quarter, we accrued an additional \$2.4 million of interest & penalties related to our uncertain tax positions. As of October 31, 2007 we had unrecognized tax benefits of \$130.8 million. The primary change during the quarter was related to the expiration of statutes of limitations for various jurisdictions during the quarter. We have classified the liability for unrecognized tax benefits, including corresponding accrued interest, as long-term at October 31, 2007, which is included in other noncurrent liabilities on the condensed consolidated balance sheet. Amounts that we expect to pay within the next twelve months have been included in accounts payable, accrued expenses and other current liabilities on the condensed consolidated balance sheet.

Based upon the expiration of statutes of limitations, payments of tax and other factors in several jurisdictions, we believe it is reasonably possible that the total amount of previously unrecognized tax benefits may decrease by approximately \$8 million to \$9 million within twelve months of October 31, 2007.

We file a consolidated federal tax return in the United States and income tax returns in various state and foreign jurisdictions. We are no longer subject to U.S. federal income tax audits for years before 1999. The U.S. federal audit for years 1999 through 2003 is in its final stages. The Internal Revenue Service (IRS) has commenced an audit for the years 2004 and 2005. With respect to our Canadian operations, audits for tax years 1996 through 2001 have been completed and are in the final stages, and tax years 2002 and 2003 are currently under audit. With respect to state and local jurisdictions, with limited exceptions, H&R Block, Inc. and its subsidiaries are no longer subject to income tax audits for years before 1999.

6. Regulatory Requirements**Registered Broker-Dealer**

H&R Block Financial Advisors, Inc. (HRBFA) is subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers. At October 31, 2007, HRBFA's net capital of \$91.2 million, which was 20.0% of aggregate debit items, exceeded its minimum required net capital of \$9.1 million by \$82.0 million. During the three months ended October 31, 2007, HRBFA paid a dividend of \$37.5 million to Block Financial Corporation (BFC), its direct corporate parent.

The fair value of pledged securities at October 31, 2007 totaled \$57.9 million, an excess of \$6.0 million over the margin requirement.

Table of Contents**Banking**

HRB Bank and the Company are subject to various regulatory capital guidelines and requirements administered by federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on HRB Bank and the consolidated financial statements. All savings associations are subject to the capital adequacy guidelines and the regulatory framework for prompt corrective action. HRB Bank must meet specific capital guidelines that involve quantitative measures of HRB Bank's assets, liabilities and certain off-balance sheet items, as calculated under regulatory accounting practices. HRB Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. HRB Bank files its regulatory Thrift Financial Report (TFR) on a calendar quarter basis.

Quantitative measures established by regulation to ensure capital adequacy require HRB Bank to maintain minimum amounts and ratios of tangible equity, total risk-based capital and Tier 1 capital, as set forth in the table below. In addition to these minimum ratio requirements, HRB Bank is required to continually maintain a 12.0% minimum leverage ratio as a condition of its charter-approval order through fiscal year 2009. This condition was extended through fiscal year 2012 as a result of a Supervisory Directive issued on May 29, 2007. See further discussion of the Supervisory Directive below. As of October 31, 2007, HRB Bank's leverage ratio was 14.8%.

As of September 30, 2007, our most recent TFR filing with the Office of Thrift Supervision (OTS), HRB Bank was a well capitalized institution under the prompt corrective action provisions of the Federal Deposit Insurance Corporation (FDIC). The five capital categories are: (1) well capitalized (total risk-based capital ratio of 10%, Tier 1 Risk-based capital ratio of 6% and leverage ratio of 5%); (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; and (5) critically undercapitalized. There are no conditions or events since September 30, 2007 that management believes have changed HRB Bank's category.

The following table sets forth HRB Bank's regulatory capital requirements at September 30, 2007, as calculated in the most recently filed TFR:

(dollars in 000s)

	Actual		For Capital Adequacy		To Be Well	
	Amount	Ratio	Purposes	Ratio	Capitalized	
			Amount		Under Prompt	
					Corrective Action	
					Provisions	
					Amount	Ratio
Total risk-based capital ratio ⁽¹⁾	\$ 186,851	28.5%	\$ 52,519	8.0%	\$ 65,649	10.0%
Tier 1 risk-based capital ratio ⁽²⁾	\$ 178,638	27.2%	n/a	n/a	\$ 39,389	6.0%
Tier 1 capital ratio (leverage) ⁽³⁾	\$ 178,638	14.6%	\$ 147,074	12.0%	\$ 61,281	5.0%
Tangible equity ratio ⁽⁴⁾	\$ 178,638	14.6%	\$ 18,384	1.5%	n/a	n/a

(1) Total risk-based capital divided by risk-weighted assets.

(2) Tier 1 (core) capital less deduction for low-level recourse and residual interest divided by risk-weighted assets.

(3) Tier 1 (core) capital divided by adjusted total assets.

(4) Tangible capital divided by tangible assets.

In conjunction with H&R Block, Inc.'s application with the OTS for HRB Bank, H&R Block, Inc. made commitments as part of our charter approval order (Master Commitment) which included, but were not limited to: (1) H&R Block, Inc. to maintain a three percent minimum ratio of adjusted tangible capital to adjusted total assets, as defined by the OTS; (2) maintain all HRB Bank capital within HRB Bank in accordance with the submitted three-year business plan; and (3) follow federal regulations surrounding intercompany transactions and approvals. H&R Block, Inc. fell below the three percent minimum ratio at April 30, 2007. We notified the OTS of our failure to meet this requirement, and on May 29, 2007, the OTS issued a Supervisory Directive. We submitted a revised capital plan to the OTS on July 19, 2007, in which we expected to meet the three percent minimum ratio at April 30, 2008. The OTS accepted our revised capital plan.

The Supervisory Directive included additional conditions that we will be required to meet in addition to the Master Commitment. The significant additional conditions included in the Supervisory Directive are as

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follows: (1) requires HRB Bank to extend its compliance with a minimum 12.0% leverage ratio through fiscal year 2012; (2) requires H&R Block, Inc. to comply with the Master Commitment at all times, except for the projected capital levels and compliance with the three percent minimum ratio, as provided in the fiscal year 2008 and 2009 capital adequacy projections presented to the OTS on July 19, 2007; (3) institutes reporting requirements to the OTS quarterly and monthly by the Board of Directors and management, respectively; and (4) requires HRB Bank's Board of Directors to have an independent chairperson and at least the same number of outside directors as inside directors. Operating losses of our discontinued operations for the first six months of fiscal year 2008 were higher than projected in our revised capital plan that was submitted to the OTS in July 2007. As a result, our capital levels are lower than those projections. H&R Block, Inc. continued to be below the three percent minimum ratio during our second quarter, and had adjusted tangible capital of negative \$644.4 million, and a requirement of \$177.5 million to be in compliance at October 31, 2007.

In November 2007, the OTS directed us to submit a new revised capital plan no later than January 15, 2008. At this time, we do not expect to be in compliance with the three percent minimum ratio at April 30, 2008. We do not expect to be in a position to repurchase treasury shares until sometime after fiscal year 2009. Achievement of the capital plan depends on future events and circumstances, the outcome of which cannot be assured. If we are not in a position to cure deficiencies and if operating results continue to be below our plan, a resulting failure could impair our ability to repurchase shares of our common stock, acquire businesses or pay dividends.

Failure to meet the conditions under the Master Commitment and the Supervisory Directive, including capital levels of H&R Block, Inc., could result in the OTS taking further regulatory actions, such as a supervisory agreement, cease-and-desist orders and civil monetary penalties. The OTS could also require us to sell assets, which could negatively impact our financial statements. At this time, the financial impact, if any, of additional regulatory actions cannot be determined.

7. Commitments and Contingencies

Changes in the deferred revenue liability related to our Peace of Mind (POM) program, the current portion of which is included in accounts payable, accrued expenses and other current liabilities and the long-term portion of which is included in other noncurrent liabilities in the condensed consolidated balance sheets, are as follows:

	(in 000s)	
Six Months Ended October 31,	2007	2006
Balance, beginning of period	\$ 142,173	\$ 141,684
Amounts deferred for new guarantees issued	1,067	1,178
Revenue recognized on previous deferrals	(46,388)	(48,694)
Balance, end of period	\$ 96,852	\$ 94,168

The following table summarizes certain of our other contractual obligations and commitments:

	(in 000s)	
As of	October 31, 2007	April 30, 2007
Commitment to fund Franchise		

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Equity Lines of Credit	\$	81,484	\$	79,628
Media advertising purchase obligation		37,749		37,749
Contingent business acquisition obligations		30,376		19,891

On November 1, 2006 we entered into an agreement to purchase \$57.2 million in media advertising between November 1, 2006 and June 30, 2009. We expect to make payments totaling \$20.6 million and \$17.2 million during fiscal years 2008 and 2009, respectively.

We routinely enter into contracts that include embedded indemnifications that have characteristics similar to guarantees, including obligations to protect counterparties from losses arising from the following: (a) tax, legal and other risks related to the purchase or disposition of businesses; (b) penalties and interest assessed by Federal and state taxing authorities in connection with tax returns prepared for clients; (c) litigation involving our directors and officers; and (d) third-party claims relating to various arrangements in the normal course of business. Typically, there is no stated maximum payment related to

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these indemnifications, and the term of indemnities may vary and in many cases is limited only by the applicable statute of limitations. The likelihood of any claims being asserted against us and the ultimate liability related to any such claims, if any, is difficult to predict. While we cannot provide assurance that such claims will not be successfully asserted, we believe the fair value of these guarantees and indemnifications is not material as of October 31, 2007.

8. Litigation and Related Contingencies**RAL Litigation**

We have been named as a defendant in numerous lawsuits throughout the country regarding our refund anticipation loan programs (collectively, RAL Cases). The RAL Cases have involved a variety of legal theories asserted by plaintiffs. These theories include allegations that, among other things, disclosures in the RAL applications were inadequate, misleading and untimely; the RAL interest rates were usurious and unconscionable; we did not disclose that we would receive part of the finance charges paid by the customer for such loans; untrue, misleading or deceptive statements in marketing RALs; breach of state laws on credit service organizations; breach of contract, unjust enrichment, unfair and deceptive acts or practices; violations of the federal Racketeer Influenced and Corrupt Organizations Act; violations of the federal Fair Debt Collection Practices Act and unfair competition regarding debt collection activities; and that we owe, and breached, a fiduciary duty to our customers in connection with the RAL program.

The amounts claimed in the RAL Cases have been very substantial in some instances. We have successfully defended against numerous RAL Cases, some of which were dismissed on our motions for dismissal or summary judgment, and others were dismissed voluntarily by the plaintiffs after denial of class certification. Other cases have been settled, with one settlement resulting in a pretax expense of \$43.5 million in fiscal year 2003 (the Texas RAL Settlement) and other settlements resulting in a combined pretax expense in fiscal year 2006 of \$70.2 million (the 2006 Settlements). We believe we have meritorious defenses to the remaining RAL Cases and we intend to defend them vigorously. There can be no assurances, however, as to the outcome of the pending RAL Cases individually or in the aggregate. Likewise, there can be no assurances regarding the impact of the RAL Cases on our financial statements. There were no significant developments regarding the RAL Cases during the fiscal quarter ended October 31, 2007.

Peace of Mind Litigation.

We are defendants in lawsuits regarding our Peace of Mind (POM) program (the POM Cases). The POM Cases are described below.

Lorie J. Marshall, et al. v. H&R Block Tax Services, Inc., et al., Civil Action 2003L000004, in the Circuit Court of Madison County, Illinois, is a class action case filed on January 18, 2002, that was granted class certification on August 27, 2003. Plaintiffs' claims consist of five counts relating to the POM program under which the applicable tax return preparation subsidiary assumes liability for additional tax assessments attributable to tax return preparation error. The plaintiffs allege that the sale of POM guarantees constitutes (i) statutory fraud by selling insurance without a license, (ii) an unfair trade practice, by omission and by cramming (i.e., charging customers for the guarantee even though they did not request it or want it), and (iii) a breach of fiduciary duty. In August 2003, the court certified the plaintiff classes consisting of all persons who from January 1, 1997 to final judgment (i) were charged a separate fee for POM by H&R Block or a defendant H&R Block class member; (ii) reside in certain class states and were charged a separate fee for POM by H&R Block or a defendant H&R Block class member not licensed to sell insurance; and (iii) had an unsolicited charge for POM posted to their bills by H&R Block or a defendant H&R Block class member. Persons who received the POM guarantee through an H&R Block Premium office and persons who reside in Alabama are excluded from the plaintiff class. The court also certified a defendant class consisting of any entity with names that include H&R Block or HRB, or are otherwise affiliated or associated with H&R Block Tax Services, Inc., and that sold or sells the POM product. The trial court subsequently denied the defendants' motion to certify class certification issues for interlocutory appeal. Discovery is proceeding. No trial date has been set.

There is one other putative class action pending against us in Texas that involves the POM guarantee. This case is being tried before the same judge that presided over the Texas RAL Settlement, involves the

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same plaintiffs attorneys that are involved in the Marshall litigation in Illinois, and contains similar allegations. No class has been certified in this case.

We believe the claims in the POM actions are without merit, and we intend to defend them vigorously. The amounts claimed in the POM actions are substantial, however, and there can be no assurances as to the outcome of these pending actions individually or in the aggregate. Likewise, there can be no assurances regarding the impact of these actions on our consolidated financial statements.

Electronic Filing Litigation

We are a defendant to a class action filed on August 30, 2002 and entitled *Erin M. McNulty and Brian J. Erzar v. H&R Block, Inc., et al.*, Case No. 02-CIV-4654 in the Court of Common Pleas of Lackawanna County, Pennsylvania, in which the plaintiffs allege that the defendants deceptively portray electronic filing fees as a necessary and required component of standard tax preparation services and do not inform tax preparation clients that they may (i) file tax returns free of charge by mailing the returns, (ii) electronically file tax returns from personal computers either free of charge or at significantly lower fees and (iii) be eligible to electronically file tax returns free of charge via telephone. The plaintiffs seek unspecified damages and disgorgement of all electronic filing, tax preparation and related fees collected during the applicable class period. Class certification was granted in this case on September 5, 2007. We believe the claims in this case are without merit, and we intend to defend them vigorously, but there can be no assurances as to its outcome.

Express IRA Litigation

On March 15, 2006, the New York Attorney General filed a lawsuit in the Supreme Court of the State of New York, County of New York (Index No. 06/401110) entitled *The People of New York v. H&R Block, Inc. and H&R Block Financial Advisors, Inc.* The complaint alleged fraudulent business practices, deceptive acts and practices, common law fraud and breach of fiduciary duty with respect to the Express IRA product and sought equitable relief, disgorgement of profits, damages and restitution, civil penalties and punitive damages. On July 12, 2007, the Supreme Court of the State of New York issued a ruling that dismissed all defendants other than H&R Block Financial Advisors, Inc. and the claims of common law fraud. We intend to defend this case vigorously, but there are no assurances as to its outcome.

In addition to the New York Attorney General action, a number of civil actions were filed against us concerning the Express IRA matter, the first of which was filed on March 17, 2006. Except for two cases pending in state court, all of the civil actions have been consolidated by the panel for Multi-District Litigation into a single action styled *In re H&R Block, Inc. Express IRA Marketing Litigation* in the United States District Court for the Western District of Missouri. We intend to defend these cases vigorously, but there are no assurances as to their outcome.

Securities Litigation

On April 6, 2007, a putative class action styled *In re H&R Block Securities Litigation* was filed against the Company and certain of its officers in the United States District Court for the Western District of Missouri. The complaint alleged, among other things, deceptive, material and misleading financial statements, failure to prepare financial statements in accordance with generally accepted accounting principles and concealment of the potential for lawsuits stemming from the allegedly fraudulent nature of the Company's operations. The complaint sought unspecified damages and equitable relief. On October 5, 2007, the court dismissed the complaint and granted the plaintiffs leave to re-file the portion of the complaint pertaining to the Company's financial statements. On November 19, 2007, the plaintiffs re-filed the complaint, alleging, among other things, deceptive, material and misleading financial statements and failure to prepare financial statements in accordance with generally accepted accounting principles. We intend to defend this litigation vigorously, but there are no assurances as to its outcome.

HRBFA Litigation

As reported previously, the NASD brought charges against HRBFA regarding the sale by HRBFA of Enron debentures in 2001. The hearing for this matter was concluded in August 2007, and post-hearing briefs were submitted

in October 2007. We intend to defend the NASD charges vigorously, although there can be no assurances regarding the outcome and resolution of the matter.

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RSM McGladrey Litigation

As part of an industry-wide review, the IRS is investigating tax-planning strategies that certain RSM McGladrey (RSM) clients utilized during fiscal years 2000 through 2003. Specifically, the IRS is examining these strategies to determine whether RSM complied with tax shelter reporting and listing regulations and whether such strategies were abusive as defined by the IRS. The IRS has indicated that it will assess a fine against RSM for RSM's alleged failure to comply with the tax shelter reporting and listing regulations. RSM is in discussions with the IRS regarding this penalty, which we believe will not have a material adverse effect on RSM's operations or on our conso