H&R BLOCK INC
Form 10-Q
September 06, 2007

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 31, 2007

OR

o **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	**44-0607856**
(State or other jurisdiction of incorporation or organization)	(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 þ No o

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 þ Accelerated filer o Non-accelerated filer o

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

The number of shares outstanding of the registrant s Common Stock, without par value, at the close of business on August 31, 2007 was 324,632,718 shares.

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

	July 31, 2007 (Unaudited)	April 30, 2007
ASSETS		
Cash and cash equivalents	$ 437,671	$ 921,838
Cash and cash equivalents restricted	287,789	332,646
Receivables from customers, brokers, dealers and clearing organizations, less allowance for doubtful accounts of $2,314 and $2,292	404,420	410,522
Receivables, less allowance for doubtful accounts of $95,530 and $99,259	423,450	556,255
Prepaid expenses and other current assets	224,834	208,564
Current assets of discontinued operations, held for sale	1,110,427	1,024,467
Total current assets	2,888,591	3,454,292
Mortgage loans held for investment, less allowance for loan losses of $4,585 and $3,448	1,241,281	1,358,222
Property and equipment, at cost less accumulated depreciation and amortization of $656,335 and $647,151	372,235	379,066
Intangible assets, net	173,799	181,413
Goodwill	1,006,278	993,919
Other assets	484,081	454,646
Noncurrent assets of discontinued operations, held for sale	701,805	722,492
Total assets	$ 6,868,070	$ 7,544,050
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Commercial paper and other short-term borrowings	$ 1,651,237	$ 1,567,082
Customer banking deposits	1,039,238	1,129,263
Accounts payable to customers, brokers and dealers	615,858	633,189
Accounts payable, accrued expenses and other current liabilities	398,864	519,372
Accrued salaries, wages and payroll taxes	131,274	307,854
Accrued income taxes	113,739	439,472
Current portion of long-term debt	9,371	9,304
Current liabilities of discontinued operations, held for sale	750,782	615,373
Total current liabilities	4,710,363	5,220,909
Long-term debt	519,803	519,807
Other noncurrent liabilities	556,542	388,835
Total liabilities	5,786,708	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 July 31, 2007 and April 30, 2007	4,359	4,359
Additional paid-in capital	671,647	676,766
Accumulated other comprehensive income (loss)	2,528	(1,320)
Retained earnings	2,530,207	2,886,440
Less cost of 111,344,662 and 112,671,610 shares of common stock in treasury	(2,127,379)	(2,151,746)
Total stockholders equity	1,081,362	1,414,499
Total liabilities and stockholders equity	$ 6,868,070	$ 7,544,050

See Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(unaudited, amounts in 000s, except per share amounts)

Three months ended July 31,	2007	2006
Revenues:		
Service revenues	$ 321,663	$ 302,796
Other revenues:		
Interest income	41,838	25,710
Product and other revenues	17,708	14,264
	381,209	342,770
Operating expenses:		
Cost of services	383,400	363,525
Cost of other revenues	43,529	18,207
Selling, general and administrative	145,824	149,071
	572,753	530,803
Operating loss	(191,544)	(188,033)
Interest expense	(595)	(12,135)
Other income, net	8,559	6,194
Loss from continuing operations before tax benefit	(183,580)	(193,974)
Income tax benefit	(73,757)	(76,135)
Net loss from continuing operations	(109,823)	(117,839)
Loss from discontinued operations, net of tax	(192,757)	(13,538)
Net loss	$ (302,580)	(131,377)
Basic and diluted loss per share:		
Net loss from continuing operations	$ (0.34)	$ (0.36)
Net loss from discontinued operations	(0.59)	(0.05)
Net loss	$ (0.93)	$ (0.41)
Basic and diluted shares	323,864	323,671
Dividends per share	$ 0.14	$ 0.13

Comprehensive income (loss):		
Net loss	$ (302,580)	$ (131,377)
Change in unrealized gain on available-for-sale securities, net	(463)	(2,511)
Change in foreign currency translation adjustments	4,311	818
Comprehensive loss	$ (298,732)	$ (133,070)

See Notes to Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited, amounts in 000s)

Three months ended July 31,	2007	2006
Cash flows from operating activities:		
Net loss	$ (302,580)	$ (131,377)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	37,075	34,627
Stock-based compensation expense	7,398	8,179
Changes in assets and liabilities of discontinued operations	115,486	175,207
Other, net of business acquisitions	(289,562)	(562,695)
Net cash used in operating activities	(432,183)	(476,059)
Cash flows from investing activities:		
Mortgage loans originated or purchased for investment, net	111,164	(135,161)
Purchases of property and equipment, net	(14,497)	(34,358)
Payments made for business acquisitions, net of cash acquired	(20,887)	(4,627)
Net cash provided by (used in) investing activities of discontinued operations	3,068	(3,871)
Other, net	6,699	1,774
Net cash provided by (used in) investing activities	85,547	(176,243)
Cash flows from financing activities:		
Repayments of commercial paper	(3,463,719)	(1,034,210)
Proceeds from issuance of commercial paper	3,622,874	1,223,566
Repayments of lines of credit borrowings	(560,000)	
Proceeds from lines of credit borrowings	485,000	
Customer deposits, net	(90,378)	404,030
Dividends paid	(43,937)	(40,485)
Purchase of treasury shares		(180,897)
Proceeds from exercise of stock options	9,788	6,791
Net cash used in financing activities of discontinued operations	(47,535)	(100)
Other, net	(49,624)	(53,549)
Net cash provided by (used in) financing activities	(137,531)	325,146
Net decrease in cash and cash equivalents	(484,167)	(327,156)
Cash and cash equivalents at beginning of the period	921,838	673,827
Cash and cash equivalents at end of the period	$ 437,671	$ 346,671
Supplementary cash flow data:		
Income taxes paid	$ 9,653	$ 190,378
Interest paid on borrowings	27,833	15,504

Interest paid on deposits	15,792	3,198

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	Accumulated Other Comprehensive Income (Loss)	Retained	Treasury Stock		Total
	Shares	Amount	Shares	Amount	Capital		Earnings	Shares	Amount	Equity
Balances at April 30, 2006	435,891	$ 4,359		$	$ 653,053	$ 21,948	$ 3,492,059	(107,378)	$ (2,023,620)	$ 2,147,799
Net loss							(131,377)			(131,377)
Unrealized translation gain						818				818
Change in net unrealized gain on available-for-sale securities						(2,511)				(2,511)
Stock-based compensation					10,514					10,514
Shares issued for:										
Option exercises					(746)			461	8,756	8,010
Nonvested shares					(13,997)			719	13,687	(310)
ESPP					627			253	4,823	5,450
Acquisition of treasury shares								(8,370)	(186,339)	(186,339)
Cash dividends paid $0.13 per share							(40,485)			(40,485)
Balances at July 31, 2006	435,891	$ 4,359		$	$ 649,451	$ 20,255	$ 3,320,197	(114,315)	$ (2,182,693)	$ 1,811,569
Balances at April 30, 2007	435,891	$ 4,359		$	$ 676,766	$ (1,320)	$ 2,886,440	(112,672)	$ (2,151,746)	$ 1,414,499
Remeasurement of uncertain tax positions upon adoption of FIN 48							(9,716)			(9,716)
Net loss							(302,580)			(302,580)
Unrealized translation gain						4,311				4,311
Change in net unrealized gain						(463)				(463)

on available-for-sale securities									
Stock-based compensation				9,226					9,226
Shares issued for:									
Option exercises				(1,431)			668	12,758	11,327
Nonvested shares				(13,349)			663	12,669	(680)
ESPP				400			218	4,161	4,561
Acquisitions				35			8	151	186
Acquisition of treasury shares							(230)	(5,372)	(5,372)
Cash dividends paid $0.14 per share						(43,937)			(43,937)
Balances at July 31, 2007	435,891	$ 4,359	$	$ 671,647	$ 2,528	$ 2,530,207	(111,345)	$ (2,127,379)	$ 1,081,362

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 July 31, 2007, the condensed consolidated statements of income and comprehensive income for the three months ended July 31, 2007 and 2006, the condensed consolidated statements of cash flows for the three months ended July 31, 2007 and 2006, and the condensed consolidated statement of stockholders equity for the three months ended July 31, 2007 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 July 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 B Inc. and its subsidiaries, as appropriate to the context.

Certain reclassifications have been made to prior year amounts to conform to the current year presentation. These reclassifications had no effect on our results of operations or stockholders equity as previously reported.

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). 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. 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 three months ended July 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 July 31, 2007, we continued to meet the criteria requiring us to present the related financial results of these businesses as discontinued operations and the assets and liabilities of the business being sold as held-for-sale in the condensed consolidated financial statements. All periods presented have been reclassified to reflect our discontinued operations.

The non-prime residential mortgage loan market has been adversely affected by a weakening housing market and increasing rates of delinquencies and defaults. Warehouse lenders have required significant margin calls from non-prime residential mortgage loan originators, including OOMC, due to declining values of non-prime residential mortgage loans and increasing levels of loans held for sale by lenders for longer periods of time due to softening secondary market conditions.

We have been significantly and negatively impacted by the events and conditions impacting the broader non-prime residential mortgage loan market. The softening secondary market conditions expose us to margin calls to cover declining values in loans held for sale. In addition, warehouse lenders have discretion over the sale of loans in the secondary market, which may result in losses on sales due to forced sales in depressed market conditions. These exposures are also influenced by loans being held for longer periods of time.

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The declining mortgage market conditions continued in August 2007 and were compounded by illiquidity in the secondary market. In early August 2007, OOMC began only underwriting loan originations to the standards established by Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). These new underwriting guidelines should enhance the overall credit quality of loans offered for sale, but will significantly reduce origination volume. We expect our loan originations will slow to a rate of about $200 million per month beginning in September 2007. Reductions in loan origination volumes and an increasing frequency of selling loans without retaining servicing rights may adversely impact our loan servicing business. OOMC announced reductions in its mortgage lending workforce and retail facilities in August 2007. The cost of these restructuring activities is estimated at $16 million to $20 million, which will be primarily reflected in the consolidated income statement for the quarter ended October 31, 2007. It is possible that OOMC may need to commit to additional restructuring activities. If current market conditions fail to improve, we believe there could be further impairments to our residual interests, beneficial interests in Trusts, and loans held for sale in our second quarter, potentially in the range of $150 to $200 million pretax. The actual amount of the second quarter impairment will ultimately depend primarily on market conditions at the end of the second quarter.

While we have taken steps to respond to the rapid and substantial decline in the non-prime residential mortgage loan market, there can be no assurances that such steps will be adequate in the event the non-prime residential loan market experiences additional or sustained market declines. If conditions in the mortgage industry continue to decline, our future operating losses from discontinued operations would continue to be negatively impacted.

We continue to expect to complete the sale of OOMC pursuant to the April 2007 agreement by December 31, 2007. However, we are not currently in compliance with certain closing conditions required by this agreement and do not believe we will be able to regain compliance with such closing conditions or maintain compliance through the anticipated closing date. We are currently in discussions with Cerberus Capital Management to have such conditions either waived or modified. We are also conducting ongoing discussion regarding potentially modifying the agreement, which may include only selling the servicing platform, although we currently believe it is unlikely that the existing agreement will ultimately be changed. Therefore, it is our intention to consummate the transaction under the existing agreement on or before December 31, 2007. If the sale is not consummated, then we would divest the servicing platform and either divest or wind-down the origination business. There are no assurances that the current agreement will be modified or that the transaction will close. Our condensed consolidated financial statements as of July 31, 2007 include an impairment charge which reflects our best estimate of the valuation of OOMC based on the terms of the existing agreement. See additional discussion in note 11. If the agreement is modified, we may incur additional impairment losses, which could be significant, beyond those that are provided in our financial statements. However, we are currently unable to estimate the amount of such additional impairment, if any, until the terms of a modified agreement are determined.

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 31.3 million shares and 32.9 million shares for the three months ended July 31, 2007 and 2006, respectively, 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 months ended July 31, 2007 increased to 323.9 million from 323.7 million at July 31, 2006, primarily due the issuance of treasury shares related to our stock-based compensation plans.

During the three months ended July 31, 2007 and 2006, we issued 1.6 million and 1.4 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 three months ended July 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 $5.4 million. During the three months ended July 31, 2006, we

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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 $186.3 million.

During the three months ended July 31, 2007, we granted 4.9 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 $4.54 for manager and director options and $3.07 for seasonal options. At July 31, 2007, the total unrecognized compensation cost for options and nonvested shares and units was $27.5 million and $52.2 million, respectively.

3. Goodwill and Intangible Assets

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