

APAC CUSTOMER SERVICE INC
Form 10-Q
November 03, 2004

PRELIMINARY DRAFT 10-28-04

**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 September 26, 2004

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 0-26786

APAC Customer Services, Inc.

(Exact name of registrant as specified in its charter)

Illinois
(State or other jurisdiction
of incorporation or organization)

36-2777140
(I.R.S. Employer
Identification No.)

Six Parkway North, Deerfield, Illinois 60015
(Address of Principal Executive Offices, Zip Code)

Registrant's telephone number, including area code: **(847) 374-4980**

Indicate by check mark whether 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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Exchange Act).

Yes No

There were 49,454,654 common shares, \$0.01 par value per share, outstanding as of November 3, 2004.

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Part I. Financial Information

Item 1. Consolidated Condensed Financial Statements

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Consolidated Condensed Balance Sheets

(Unaudited)

(In thousands)

| | September 26, 2004 | December 28, 2003 |
|---|-----------------------|----------------------|
| <u>Assets</u> | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 10,621 | \$ 11,428 |
| Accounts receivable, net | 38,201 | 46,896 |
| Other current assets | 8,217 | 9,218 |
| Total current assets | 57,039 | 67,542 |
| Property and equipment, net | 22,010 | 24,147 |
| Goodwill | 23,876 | 23,876 |
| Other intangible assets, net | 13,275 | 15,035 |
| Deferred taxes | 3,111 | 3,072 |
| Other assets | 630 | 921 |
| Total assets | \$ 119,941 | \$ 134,593 |
| <u>Liabilities and Shareholders' Equity</u> | | |
| Current liabilities: | | |
| Current maturities of long-term debt | \$ 413 | \$ 389 |
| Accounts payable | 2,570 | 4,046 |
| Accrued payroll and related items | 15,440 | 18,367 |
| Income taxes payable | 13,282 | 17,952 |
| Other accrued liabilities | 10,771 | 11,107 |
| Total current liabilities | 42,476 | 51,861 |
| Long-term debt, less current maturities | | 313 |
| Other liabilities | 1,462 | 1,689 |
| Commitments and contingencies | | |
| Shareholders' equity | | |
| Common shares, \$0.01 par value; 200,000,000 shares authorized; 49,695,699 shares issued at September 26, 2004, and December 28, 2003 | 497 | 497 |
| Additional paid-in capital | 99,598 | 99,620 |
| Accumulated deficit | (23,108) | (18,413) |
| Accumulated other comprehensive loss | (137) | (82) |
| Treasury shares: 241,045 and 254,107 shares, respectively, at cost | (847) | (892) |
| Total shareholders' equity | 76,003 | 80,730 |
| Total liabilities and shareholders' equity | \$ 119,941 | \$ 134,593 |

See notes to consolidated condensed financial statements

APAC Customer Services, Inc. and Subsidiaries

Consolidated Condensed Statements of Operations

(Unaudited)

(In thousands, except per share data)

| | Thirteen Weeks Ended | | Thirty-Nine Weeks Ended | |
|---|-----------------------|-----------------------|-------------------------|-----------------------|
| | September 26, 2004 | September 28, 2003 | September 26, 2004 | September 28, 2003 |
| Net revenue | \$ 64,626 | \$ 79,658 | \$ 204,036 | \$ 247,939 |
| Operating expenses: | | | | |
| Cost of services | 58,060 | 65,338 | 176,686 | 201,411 |
| Selling, general and administrative expenses | 9,967 | 12,124 | 30,468 | 38,039 |
| Restructuring and other charges | 159 | 1,800 | 2,009 | 1,800 |
| Asset impairment charges | | 108 | 2,234 | 108 |
| Total operating expenses | 68,186 | 79,370 | 211,397 | 241,358 |
| Operating income (loss) | (3,560) | 288 | (7,361) | 6,581 |
| Interest expense, net | 115 | 226 | 212 | 885 |
| Income (loss) before income taxes | (3,675) | 62 | (7,573) | 5,696 |
| Provision (benefit) for income taxes | (1,397) | (228) | (2,878) | 1,912 |
| Net income (loss) | \$ (2,278) | \$ 290 | \$ (4,695) | \$ 3,784 |
| Net income (loss) per share: | | | | |
| Basic | \$ (0.05) | \$ 0.01 | \$ (0.10) | \$ 0.08 |
| Diluted | \$ (0.05) | \$ 0.01 | \$ (0.10) | \$ 0.08 |
| Weighted average number of shares outstanding: | | | | |
| Basic | 49,455 | 49,442 | 49,452 | 49,434 |
| Diluted | 49,455 | 49,475 | 49,452 | 49,465 |

See notes to consolidated condensed financial statements.

APAC Customer Services, Inc. and Subsidiaries

Consolidated Condensed Statements of Cash Flows

(Unaudited)

(In thousands)

| | Thirty-Nine Weeks Ended | |
|---|-------------------------|-----------------------|
| | September 26, 2004 | September 28, 2003 |
| Operating activities: | | |
| Net income (loss) | \$ (4,695) | \$ 3,784 |
| Depreciation and amortization | 8,127 | 9,153 |
| Non-cash restructuring charges | 279 | |
| Asset impairment charges | 2,200 | 108 |
| Deferred income taxes | 758 | 130 |
| Change in operating assets and liabilities | (565) | 3,517 |
| Net cash provided by operating activities | 6,104 | 16,692 |
| Investing activities: | | |
| Purchases of property and equipment, net | (6,646) | (5,571) |
| Net cash used by investing activities | (6,646) | (5,571) |
| Financing activities: | | |
| Payments on long-term debt | (289) | (488) |
| Repayments under revolving credit facility, net | | (15,500) |
| Stock and warrant transactions | 24 | 46 |
| Net cash used by financing activities | (265) | (15,942) |
| Net change in cash and cash equivalents | (807) | (4,821) |
| Cash and cash equivalents: | | |
| Beginning balance | 11,428 | 14,530 |
| Ending balance | \$ 10,621 | \$ 9,709 |

See notes to consolidated condensed financial statements

APAC Customer Services, Inc. and Subsidiaries

Notes to Consolidated Condensed Financial Statements

(Unaudited)

(Dollars in thousands, except as otherwise indicated)

1. Basis of Presentation

The accompanying unaudited consolidated condensed financial statements of APAC Customer Services, Inc. and its subsidiaries (collectively, the Company) have been prepared in accordance with generally accepted accounting principles 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 accruals) considered necessary for a fair presentation have been included. Operating results for the thirteen and thirty-nine week periods ended September 26, 2004, are not necessarily indicative of the results that may be expected for the fiscal year ending January 2, 2005. The balance sheet at December 28, 2003, 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. For additional information, refer to the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 28, 2003.

2. Other Accrued Liabilities

The components of other accrued liabilities included in the consolidated condensed balance sheets are as follows:

| | September 26, 2004 | December 28, 2003 |
|-------------------------------|-----------------------|----------------------|
| Accrued worker's compensation | \$ 3,149 | \$ 3,097 |
| Accrued professional fees | 1,405 | 795 |
| Restructuring charges | 743 | 2,706 |
| Accrued relocation | 708 | 607 |
| Accrued property tax | 603 | 741 |
| Accrued telecommunications | 513 | 573 |
| Other | 3,650 | 2,588 |
| Total | \$ 10,771 | \$ 11,107 |

3. Intangible Assets

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The identifiable intangible assets of the Company represent acquired customer relationships with a gross carrying value of \$28,493 and accumulated amortization of \$15,218 and \$13,458 as of September 26, 2004, and December 28, 2003, respectively. Under the provisions of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS No. 142), identifiable intangible assets with finite lives are amortized. The customer relationship intangible assets are amortized on a straight-line basis over the expected period of benefit of 12 years. Total amortization expense related to intangible assets as of September 26, 2004, and September 28, 2003, was \$587 per quarter and \$1,760 year to date. Annual amortization expense is expected to be \$2.3 million for fiscal 2004 through 2009 and \$1.0 million in fiscal 2010.

Under SFAS No. 142, the Company is required to test all existing goodwill and intangible assets for impairment at least annually. The Company's policy is to test goodwill for impairment as of the end of the fiscal year.

4. Accounting for Stock-Based Compensation

For stock-based employee compensation plans, the Company has elected to use the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). In accordance with APB No. 25, no compensation expense is recognized for stock options issued to employees when the option price equals or exceeds the fair market value of the Company's common shares at the date of grant. Stock-based compensation expense for non-employees is recognized in accordance with Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation (SFAS No. 123).

The following table illustrates the effect on net income and earnings per share if the Company had adopted the fair value recognition provisions of SFAS No. 123.

| | Thirteen Weeks Ended | | Thirty-Nine Weeks Ended | |
|---|-----------------------|-----------------------|-------------------------|-----------------------|
| | September 26, 2004 | September 28, 2003 | September 26, 2004 | September 28, 2003 |
| Net income (loss) as reported | \$ (2,278) | \$ 290 | \$ (4,695) | \$ 3,784 |
| Less-compensation expense on stock options, net of income tax benefit | (306) | (881) | (1,051) | (2,310) |
| Net income (loss) pro forma | \$ (2,584) | \$ (591) | \$ (5,746) | \$ 1,474 |
| Earnings (loss) per share - basic | | | | |
| As reported | \$ (0.05) | \$ 0.01 | \$ (0.10) | \$ 0.08 |
| Pro forma | \$ (0.05) | \$ (0.01) | \$ (0.12) | \$ 0.03 |
| Earnings (loss) per share - diluted | | | | |
| As reported | \$ (0.05) | \$ 0.01 | \$ (0.10) | \$ 0.08 |
| Pro forma | \$ (0.05) | \$ (0.01) | \$ (0.12) | \$ 0.03 |

In order to calculate the pro forma information set forth above, the fair value of each option is estimated on the date of grant based on the Black-Scholes option-pricing model. Assumptions include no dividend yield, risk-free interest rates ranging from 4% to 7%, expected volatility ranging between 45% and 90%, and an expected life ranging from 7 years to 10 years.

5. Comprehensive Income (Loss) and Accumulated Other Comprehensive Income (Loss)

Comprehensive income (loss) is as follows:

| | Thirteen Weeks Ended | | Thirty-Nine Weeks Ended | |
|-------------------------------------|-----------------------|-----------------------|-------------------------|-----------------------|
| | September 26, 2004 | September 28, 2003 | September 26, 2004 | September 28, 2003 |
| Net income (loss) | \$ (2,278) | \$ 290 | \$ (4,695) | \$ 3,784 |
| Foreign currency translation (loss) | (8) | (62) | (55) | (62) |
| Total comprehensive income (loss) | \$ (2,286) | \$ 228 | \$ (4,750) | \$ 3,722 |

The foreign currency translation losses in the first nine months of fiscal 2004 and 2003 relate to the impact of a change in exchange rates on net assets located outside of the United States.

6. Legal Proceedings

The Company is a party to an arbitration proceeding with Apogee Enterprises, Inc. and Harmon Glass Solutions, which is described in the Company's Quarterly Report on Form 10-Q for the first quarter of fiscal 2004.

The Company is also subject to occasional lawsuits, governmental investigations and claims arising out of the normal conduct of its business. Management does not believe the outcome of any such pending claims will have a material adverse impact on the Company's consolidated financial position, annual results of operations or liquidity. Although the Company does not believe that any of these proceedings will result in a material adverse effect, no assurance to that effect can be given.

7. Long Term Debt

On December 20, 2002, the Company entered into an Amended and Restated Credit Agreement (Credit Agreement) replacing the previous Amended and Restated Credit Facility. Under the terms of the Credit Agreement, the Company has a revolving credit facility, which expires in December 2005. The facility initially provided \$65.0 million of total credit availability which was gradually reduced to \$57.5 million as of September 26, 2004.

On October 26, 2004, the Credit Agreement was amended, reducing the size of the revolver to \$50 million. Under terms of the amendment, availability will vary monthly based on the level of eligible receivables at the end of the preceding month. If the amendment had been in place during the third quarter, the Company would have had between \$29 million and \$33 million of availability.

The Credit Agreement is secured principally by a grant of a security interest in all personal property and fixtures of the Company. Under the terms of the Credit Agreement, the Company is also required to maintain certain financial covenants which limit the Company's ability to incur additional indebtedness, repurchase outstanding common shares, create liens, acquire, sell or dispose of certain assets, engage in certain mergers and acquisitions and make certain restricted payments.

Borrowings under the Credit Agreement incur a floating interest rate usually based on the LIBOR index rate, although the Company has the option of using an alternate base rate defined in the agreement. In addition, the Company pays a commitment fee on the unused portion of the revolving facility as well as quarterly fees on the outstanding letters of credit.

8. Restructuring and Other Charges/Asset Impairment Charges

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The Company recorded \$2.1 million of restructuring charges in the first nine months of fiscal 2004 related to the closure of three Customer Interaction Centers, the transition of one center to a client and the elimination of certain administrative and support positions. These charges included severance costs of \$1.6 million resulting from the elimination of 37 administrative and support positions and \$0.5 million for the write down of property and lease termination and other costs. Cash charges totaling \$1.2 million relating to the restructuring have been paid through September 26, 2004. The remaining \$0.7 million of cash charges, primarily related to severance costs, are payable over the next two years. The Company also recorded \$2.2 million of asset impairment charges during the first nine months of fiscal 2004 relating to the write-off of unutilized software and telecommunications equipment.

Restructuring and other charges also include the reversal of \$0.1 million of prior year charges, which were not utilized.

Following is a summary of the fiscal 2004 year-to-date activity in the reserves established in connection with the Company's restructuring initiatives:

| | Balance 12/28/03 | Charges/ (Reversals) | 2004 Asset Write-down | Cash Payments | Balance 9/26/04 |
|--------------------------------------|---------------------|-------------------------|-----------------------------|------------------|--------------------|
| 2002 | | | | | |
| Employee severance costs | \$ 112 | \$ (42) | \$ | \$ (70) | \$ |
| Lease obligations and other | 1,261 | 33 | | (1,252) | 42 |
| 2003 | | | | | |
| Employee severance costs | 1,295 | (122) | | (810) | 363 |
| Write down of property and equipment | 48 | 24 | (72) | | |
| Lease obligations and other | 337 | (24) | | (303) | 10 |
| 2004 | | | | | |
| Employee severance costs | | 1,571 | | (1,068) | 503 |
| Write down of property and equipment | | 218 | (218) | | |
| Lease obligations and other | | 351 | | (173) | 178 |
| Total | \$ 3,053 | 2,009 | (290) | (3,676) | 1,096 |

9. Income Taxes

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The Company accounts for income taxes using the asset and liability approach. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Valuation allowances are recorded when management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized in the future. The Company records a reserve for tax contingencies until management believes it is probable that the deductions giving rise to these contingencies will not be successfully challenged. The Company's effective income tax rate is 38.0% and 34.0% for the nine months ended September 26, 2004, and September 28, 2003, respectively.

Item 2. Management's Discussion and Analysis of

Financial Condition and Results of Operations

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The Company is a leading provider of customer interaction solutions for market leaders in the communications, financial services, insurance, health care, logistics, publishing and travel and hospitality industries. To help its clients better manage their customer relationships, APAC Customer Services develops and delivers customer care and customer acquisition programs. The Company operates and manages approximately 6,600 workstations in 24 Customer Interaction Centers. The Customer Interaction Centers are managed centrally through the application of telecommunications and computer technology to promote the consistent delivery of quality service. The Company consists of a single operating segment that offers customer interaction solutions to its clients.

The following discussion of the Company's results of operations and liquidity and capital resources should be read in conjunction with the Consolidated Condensed Financial Statements of the Company and related notes thereto appearing elsewhere in this report.

Results of Operations

The following table sets forth the Consolidated Condensed Statements of Operations data as a percent of net revenue for the thirteen and thirty-nine week periods ended September 26, 2004, and September 28, 2003, respectively.

| | Thirteen Weeks Ended | | Thirty-Nine Weeks Ended | |
|--|-----------------------|-----------------------|-------------------------|-----------------------|
| | September 26, 2004 | September 28, 2003 | September 26, 2004 | September 28, 2003 |
| Net revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Operating expenses: | | | | |
| Cost of services | 89.8 | 82.0 | 86.6 | 81.2 |
| Selling, general and administrative expenses | 15.5 | 15.2 | 14.9 | 15.3 |
| Restructuring and other charges | .2 | 2.3 | 1.0 | .7 |
| Asset impairment charges | | .1 | 1.1 | .1 |
| Total operating expenses | 105.5 | 99.6 | 103.6 | 97.3 |
| Operating income (loss) | (5.5) | .4 | (3.6) | 2.7 |
| Interest expense, net | .2 | .3 | .1 | .4 |
| Income (loss) before income taxes | (5.7) | .1 | (3.7) | 2.3 |
| Provision (benefit) for income taxes | (2.2) | (.3) | (1.4) | .8 |
| Net income (loss) | (3.5)% | .4% | (2.3)% | 1.5% |

Comparison of Results of Operations for the thirteen weeks ended September 26, 2004, and September 28, 2003

Net revenue decreased 18.9% to \$64.6 million in the third quarter of fiscal 2004 from \$79.7 million in the same period of fiscal 2003, a decrease of \$15.1 million. The revenue decline from the third quarter of fiscal 2003 is attributable to the decision by Comcast, a major client of the Company, to bring certain marketing programs in-house, softness in the mortgage servicing business and reduced customer acquisition volumes related to the cutback in marketing programs by several telecommunications clients.

Cost of services decreased \$7.2 million in the third quarter of fiscal 2004, or 11.1%, to \$58.1 million from \$65.3 million in the same period of fiscal 2003. Approximately 69% of the decrease in cost of services resulted from lower direct costs associated with the decline in revenue, while the remaining reduction related to savings associated with center closings. These reductions were partially offset by higher wages, overhead costs, and operational improvement initiatives. As a percent of revenue, cost of services increased to 89.8% in the third quarter of fiscal 2004 from 82.0% in the third quarter of fiscal 2003, principally due to the effect of lower capacity utilization, higher labor costs, operational improvement initiatives and softening prices in certain client programs.

Selling, general and administrative expenses decreased to \$10.0 million in the third quarter of fiscal 2004 from \$12.1 million in the same period of fiscal 2003, a decrease of \$2.1 million or 17.8%. Expenses declined from the prior year primarily due to lower employee related expenses resulting from headcount reductions and reduced incentive expense. As a percent of net revenue, selling, general and administrative expenses were 15.5% in the third quarter of fiscal 2004 versus 15.2% in the same period of fiscal 2003.

The Company recorded \$0.2 million of restructuring charges in the third quarter of fiscal 2004 related to the closure of one Customer Interaction Center. These charges will be paid during the fourth quarter of fiscal 2004.

During the third quarter of fiscal 2003, the Company recorded restructuring charges of \$1.8 million related to severance costs due to the elimination of 121 administrative, support and call center positions. The Company also recorded \$0.1 million of asset impairment charges related to the write-off of computer hardware.

The Company generated a net loss of \$2.3 million in the third quarter of fiscal 2004 compared to \$0.3 million of net income for the same period of fiscal 2003. The decrease is primarily due to the lower revenue and gross profit margins, partially offset by a reduction in selling, general and administrative expenses and restructuring charges, as previously discussed.

Net interest expense for the third quarter of fiscal 2004 decreased \$0.1 million from the same period of fiscal 2003. This decrease reflects the pay down of substantially all debt in fiscal 2003.

The Company recorded a \$1.4 million tax benefit for the third quarter of fiscal 2004 related to the pre-tax loss from operations, versus \$0.2 million of tax benefit in the prior year period. The benefits recorded in the third quarter of fiscal 2003 were due to the effect of a change in the year to date estimated effective tax rate resulting from the impact of tax credits on lower income.

Comparison of Results of Operations for the thirty-nine weeks ended September 26, 2004, and September 28, 2003

Net revenue decreased 17.7% to \$204.0 million in the first nine months of fiscal 2004 from \$247.9 million in the same period of fiscal 2003, a decrease of \$43.9 million. The revenue decline from fiscal 2003 is attributable to the decision by Comcast, a major client of the Company, to bring certain marketing programs in-house, reduced customer acquisition volumes related to the impact of the rollout of the national Do Not Call registry on October 1, 2003, and softness in the credit card acquisition and mortgage servicing business.

Cost of services decreased \$24.7 million in the first nine months of fiscal 2004, or 12.3%, to \$176.7 million from \$201.4 million in the same period of fiscal 2003. Approximately 75% of the decrease in cost of services resulted from lower direct costs associated with the decline in revenue, while the remaining reduction related to cutbacks in overhead spending, including savings associated with center closings. These reductions were partially offset by higher wages and operational improvement initiatives. As a percent of revenue, cost of services increased to 86.6% in the first nine months of fiscal 2004 from 81.2% in the same period of fiscal 2003 principally due to the effect of lower capacity utilization, higher labor costs, operational improvement initiatives and softening prices in certain client programs.

Selling, general and administrative expenses decreased to \$30.5 million in the first nine months of fiscal 2004 from \$38.0 million in the same period of fiscal 2003, a decrease of \$7.5 million or 19.9%. Expenses declined from the prior year primarily due to lower salary expense resulting from headcount reductions and reduced incentive expense and overhead spending. As a percent of net revenue, selling, general and administrative expenses were 14.9% in the first nine months of fiscal 2004 versus 15.3% in the same period of fiscal 2003.

The Company recorded \$2.1 million of restructuring charges in the first nine months of fiscal 2004 related to the closure of three Customer Interaction Centers, the transition of one center to a client and the elimination of certain administrative and support positions. These charges included severance costs of \$1.6 million resulting from the elimination of 37 administrative and support positions, and \$0.5 million for the write down of property and lease termination and other costs. Cash charges totaling \$1.2 million relating to the restructuring have been paid through September 26, 2004. The remaining \$0.7 million of cash charges, primarily related to severance costs, are payable over the next two years. The Company also recorded \$2.2 million of asset impairment charges during the first nine months of fiscal 2004 relating to the write-off of unutilized software and telecommunications equipment.

Restructuring and other charges in fiscal 2004 also include the reversal of \$0.1 million of prior year charges, which were not utilized.

Restructuring charges for the first nine months of fiscal 2003 relate to the charges recorded in the third quarter as previously discussed.

The Company generated a net loss of \$4.7 million in the first nine months of fiscal 2004 compared to \$3.8 million of net income for the same period of fiscal 2003. The decrease is primarily due to the lower revenue and gross profit margins, and \$2.2 million of asset impairment charges in the first nine months of fiscal 2004, partially offset by a reduction of selling, general and administrative expenses, as previously discussed.

Net interest expense for the first nine months of fiscal 2004 decreased \$0.7 million from the same period of fiscal 2003. This decrease reflects the pay down of substantially all debt in fiscal 2003 and the receipt of \$0.2 million of other investment income in fiscal 2004.

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The Company's effective income tax rate is 38.0% for the first nine months of fiscal 2004, versus 34.0% in the prior year period. The lower tax rate for fiscal 2003 was primarily due to the effect of tax credits on taxable income in fiscal 2003.

Critical Accounting Policies and Estimates

The preparation of the Company's financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company believes its estimates and assumptions are reasonable; however, actual results and the timing of the recognition of such amounts could differ from those estimates. The Company has identified the following critical accounting policies and estimates utilized by management in the preparation of the Company's financial statements: revenue recognition, accounting for long-lived assets, allowance for doubtful accounts, accounting for employee benefits and income taxes. Any deviation from these policies or estimates could have a material impact on the financial statements of the Company.

Revenue recognition

The Company recognizes customer services revenue as services are performed for our clients. Client contracts generally require that clients be billed for the Company's services on the basis of time spent by Company representatives providing services. The Company's services are also occasionally priced on a pay-for-performance basis, pursuant to which the Company typically receives fees that are a combination of base-rate plus fee per sale. The Company is often subject to performance standards, such as sales per hour, average handle time, occupancy rate and abandonment rate. The Company's performance against such standards may provide bonus opportunities or conversely may subject the Company to penalties, which are recognized as earned or incurred.

Accounting for long-lived assets

The Company's long-lived assets consist primarily of property and equipment, capitalized software and intangible assets. In addition to the original cost of these assets, their recorded value is impacted by a number of policy elections made by the Company, including estimated useful lives and salvage values. In addition, any decision by the Company to reduce capacity by closing Customer Interaction Centers or to abandon software may result in a write-off of the net book value of these affected assets. In accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company records impairment charges on long-lived assets used in operations when events and circumstances indicate that the assets may be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets. In this circumstance, the impairment charge is determined based upon the amount the net book value of the assets exceeds their fair market value. In making these determinations, the Company utilizes certain assumptions, including, but not limited to, the estimated fair market value of the assets, which are based on additional assumptions such as asset utilization, length of time the asset will be used in the Company's operations and estimated salvage values.

Under SFAS No. 142, the Company is required to test all existing goodwill and intangible assets for impairment at least annually. The Company's policy is to test goodwill for impairment as of the end of the fiscal year.

Allowance for doubtful accounts

The Company records an allowance for doubtful accounts based on a quarterly assessment of the probable estimated losses in trade accounts receivable. This estimate is based on specific allowances for identified problem receivables and an additional allowance for estimated losses on

all other receivables based on their age and the Company's collection history.

Accounting for employee benefits

The Company records an accrued liability for group health and workers compensation claims based on an estimate of claims incurred, but not reported, as well as asserted claims at the end of the period. This estimate is derived from an analysis performed by actuaries hired by the Company who have expertise in this area. Although these estimates are generally reliable, changes in the employee mix and unforeseen events could result in an adjustment to these estimates.

The balances of these accounts at September 26, 2004, and September 28, 2003, were:

| | (in thousands) | | | |
|------------------------|----------------|-------|------|-------|
| | 2004 | | 2003 | |
| Group Health Insurance | \$ | 2,665 | \$ | 3,831 |
| Workers Compensation | | 3,149 | | 3,293 |

Income taxes

The Company accounts for income taxes using the asset and liability approach. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Valuation allowances are recorded when management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized in the future. The Company records a reserve for tax contingencies until management believes it is probable that the deductions giving rise to these contingencies will not be successfully challenged.

Liquidity and Capital Resources

The following table sets forth consolidated statements of cash flow data for the Company for the thirty-nine week periods ended September 26, 2004, and September 28, 2003, respectively.

| | 2004 | | 2003 | |
|---|----------------|---------|------|----------|
| | (In thousands) | | | |
| Net cash provided by operating activities | \$ | 6,104 | \$ | 16,692 |
| Net cash used by investing activities | | (6,646) | | (5,571) |
| Net cash used by financing activities | | (265) | | (15,942) |
| Net decrease in cash | \$ | (807) | \$ | (4,821) |

Cash from operating activities decreased \$10.6 million versus the first nine months of fiscal 2003, primarily due to lower operating margins, a decrease in accrued liabilities and income taxes payable, \$1.2 million of payments related to restructuring charges and lower depreciation and amortization.

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Net cash used by investing activities was \$6.6 million in the first nine months of fiscal 2004 primarily due to expenditures related to the buildout of additional seats in the Company's call center in the Philippines and computer hardware and software upgrades. Capital expenditures of \$5.6 million in the first nine months of fiscal 2003 were primarily related to the initial buildout of the facility in the Philippines and equipment upgrades.

Net cash used by financing activities primarily related to the repayment of capital lease payments in fiscal 2003 and 2004 and \$15.5 million of bank debt in 2003.

On October 26, 2004, the Credit Agreement was amended, reducing the size of the revolver from \$56.3 million to \$50 million. Under terms of the amendment, availability will vary monthly based on the level of eligible receivables at the

end of the preceding month. If the amendment had been in place during the third quarter, the Company would have had between \$29 million and \$33 million of availability.

In 2003, the Company received an \$11.6 million cash tax refund as a result of carrying back against prior years' taxable income a \$48.1 million loss reported on its 2002 tax return, which is subject to audit. This loss resulted from the Company taking a \$59.9 million deduction to write-off, for tax purposes, its remaining investment in ITI Holdings, Inc. (for book purposes the Company recorded appropriate impairment charges related to ITI in previous fiscal years). The total combined liquidity benefit to the Company from this deduction is expected to be \$20.9 million, which includes the \$11.6 million cash tax refund, \$3.3 million of cash tax savings related to the 2002 tax year and the release of \$6.0 million of tax credits generated and utilized in prior years to be used in current and future periods. The potential income statement benefit of this deduction will not be recognized and the associated income tax liability eliminated until the Company believes it is probable the deduction will not be successfully challenged.

The Company expects that its cash balances, cash flows from future operations and available borrowings under its Credit Agreement will be sufficient to meet normal operating needs, fund any planned capital expenditures and repay debt obligations payable during fiscal 2004. However, a significant change in operating cash flow could impact the Company's ability to meet its cash requirement needs and comply with covenants of its Credit Agreement.

Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements. This Report on Form 10-Q and other documents that the Company files with the SEC contain forward-looking statements that reflect the Company's current views with respect to future events and financial performance. These forward-looking statements are subject to certain risks and uncertainties, which could cause future results to differ materially from historical results or those anticipated. The words believe, expect, anticipate, intend, estimate, would, could, should, and other expressions which indicate future events and trends identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. If no date is provided, such statements speak only as of the date of this Report on Form 10-Q. Except as required under the Federal securities laws and rules and regulations of the SEC, the Company undertakes no obligation to publicly update or revise any forward-looking statements in connection with new information or future events or otherwise. Factors that could cause future results to differ materially from historical results or those anticipated include, but are not limited to, reliance by the Company on a small number of principal clients for a substantial proportion of its total revenue; possible changes in or events affecting the business of the Company's clients, including changes in customers' interest in, and use of, clients' products and services; fluctuations in quarterly results of operations due to timing of clients' initiation and termination of large programs; risks in conducting business internationally; changes in competitive conditions affecting the Company's industry; the ability of the Company's clients to terminate contracts with the Company on a relatively short notice; changes in the availability and cost of qualified employees; variations in the performance of the Company's automated systems and other technological factors; changes in government regulations affecting the teleservices and telecommunications industries; and competition from other outside providers of customer interaction solutions and in-house customer interaction operations.

See the Company's filings with the SEC for further discussion of the risks and uncertainties associated with the Company's business, in particular, the discussion under the caption Information Regarding Forward-Looking Statements in Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2003.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Historically, the Company has been exposed to the impact of U.S. interest rate changes directly related to its normal operating and funding activities. From time to time, the Company has entered into derivatives in order to minimize these risks, but not for trading purposes. The Company does not have any derivative agreements at this time.

The Company prepared a sensitivity analysis of its average debt for the quarter ended September 26, 2004, assuming a one-percentage point adverse change in interest rates. Holding all other variables constant, the hypothetical adverse change would not significantly increase interest expense. The sensitivity analysis assumes no changes in the Company's financial structure.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

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The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Internal Control Over Financial Reporting

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There have not been changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The Company is a party to an arbitration proceeding with Apogee Enterprises, Inc. and Harmon Glass Solutions, which is described in the Company's Quarterly Report on Form 10-Q for the first quarter of fiscal 2004.

The Company is also subject to occasional lawsuits, governmental investigations and claims arising out of the normal conduct of its business. Management does not believe the outcome of any such pending claims will have a material adverse impact on the Company's consolidated financial position, annual results of operations or liquidity. Although the Company does not believe that any of these proceedings will result in a material adverse effect, no assurance to that effect can be given.

Item 6. Exhibits

(a) The exhibits required by Item 601 of Regulation S-K are listed in the Exhibit Index attached hereto.

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.

APAC Customer Services, Inc.

Date: November 3, 2004

By: /s/ Marc T. Tanenberg
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer
and duly authorized officer)

Date: November 3, 2004

By: /s/ Kenneth R. Batko
Vice President and Controller
(Principal Accounting Officer
and duly authorized officer)

Exhibit Index

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| Exhibit Number | Description |
|----------------|--|
| 3.1 | Articles of Incorporation of APAC Customer Services, Inc. are incorporated by reference to APAC Customer Services, Inc. s Quarterly Report on Form 10-Q for the Quarter ended October 3, 1999. |
| 3.2 | Amended and Restated Bylaws of APAC Customer Services, Inc. as amended through April 30, 2000, incorporated by reference to APAC Customer Services, Inc. s Quarterly Report on Form 10-Q for the Quarter ended April 2, 2000. |
| 3.3 | Certificate of Amendment of the Amended and Restated Bylaws of APAC Customer Services, Inc. as amended March 10, 2004, incorporated by reference to APAC Customer Services, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 28, 2004. |
| 10.1 | Amendment to the Amended and Restated Credit Agreement dated October 26, 2004, incorporated by reference to APAC Customer Services, Inc. s Current Report on Form 8-K, dated October 27, 2004. |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |