

COGNIZANT TECHNOLOGY SOLUTIONS CORP
Form 10-Q
August 09, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2006

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 0-24429

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

13-3728359
(I.R.S. Employer
Identification No.)

500 Glenpointe Centre West, Teaneck, New Jersey
(Address of Principal Executive Offices)

07666
(Zip Code)

Registrant's telephone number, including area code (201) 801-0233

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No:

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's class of common stock, as of August 1, 2006:

Class	Number of Shares
Class A Common Stock, par value \$.01 per share	140,900,833

Table of Contents

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1. <u>Condensed Consolidated Financial Statements (Unaudited)</u>	1
<u>Condensed Consolidated Statements of Operations and Comprehensive Income (Unaudited) for the Three Months Ended June 30, 2006 and 2005 and for the Six Months Ended June 30, 2006 and 2005</u>	2
<u>Condensed Consolidated Statements of Financial Position (Unaudited) as of June 30, 2006 and December 31, 2005</u>	3
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the Six Months Ended June 30, 2006 and 2005</u>	4
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	24
<u>PART II. OTHER INFORMATION</u>	
Item 1A. <u>Risk Factors</u>	25
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	34
Item 6. <u>Exhibits</u>	36
<u>SIGNATURES</u>	37

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

(Unaudited)

1

Table of Contents

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

(Unaudited)

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	\$ 336,836	\$ 211,711	\$ 622,315	\$ 393,392
Operating expenses:				
Cost of revenues (exclusive of depreciation and amortization expense shown separately below)	188,320	117,768	346,908	215,762
Selling, general and administrative expenses	80,044	46,126	146,749	87,536
Depreciation and amortization expense	7,801	5,449	14,831	10,539
Income from operations	60,671	42,368	113,827	79,555
Other income (expense), net:				
Interest income	3,853	2,061	7,290	3,901
Other income (expense) net	1,508	(595)	1,467	(719)
Total other income (expense), net	5,361	1,466	8,757	3,182
Income before provision for income taxes	66,032	43,834	122,584	82,737
Provision for income taxes	10,961	7,802	20,349	14,727
Net income	\$ 55,071	\$ 36,032	\$ 102,235	\$ 68,010
Basic earnings per share	\$ 0.39	\$ 0.27	\$ 0.73	\$ 0.50
Diluted earnings per share	\$ 0.37	\$ 0.25	\$ 0.68	\$ 0.47
Weighted average number of common shares outstanding Basic	140,542	135,687	140,103	135,086
Dilutive effect of shares issuable as of period-end under stock option plans	9,951	10,867	9,821	11,101
Weighted average number of common shares outstanding Diluted	150,493	146,554	149,924	146,187
Comprehensive income:				
Net income	\$ 55,071	\$ 36,032	\$ 102,235	\$ 68,010
Foreign currency translation adjustments	4,218	(3,528)	4,940	(5,109)
Total comprehensive income	\$ 59,289	\$ 32,504	\$ 107,175	\$ 62,901

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Unaudited)

(in thousands, except par values)

	June 30,	December 31,
	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 203,105	\$ 196,938
Short-term investments	265,095	227,063
Trade accounts receivable, net of allowance of \$2,962 and \$2,325, respectively	227,985	153,971
Unbilled accounts receivable	38,274	22,725
Deferred income tax assets, net	50,833	42,752
Other current assets	26,298	19,974
Total current assets	811,590	663,423
Property and equipment, net of accumulated depreciation of \$78,506 and \$64,736, respectively	179,277	146,982
Goodwill	18,430	18,223
Other intangible assets, net	15,414	16,277
Deferred income tax assets, net	10,779	17,247
Other assets	10,576	7,741
Total assets	\$ 1,046,066	\$ 869,893
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 24,871	\$ 16,420
Accrued expenses and other current liabilities	144,449	137,375
Total current liabilities	169,320	153,795
Other noncurrent liabilities	2,553	1,953
Total liabilities	171,873	155,748
Commitments and Contingencies (See Note 7)		
Stockholders equity:		
Preferred stock, \$.10 par value, 15,000 shares authorized, none issued		
Class A common stock, \$.01 par value, 500,000 and 325,000 shares authorized, 140,886 and 139,346 shares issued and outstanding, at June 30, 2006 and December 31, 2005, respectively	1,409	1,393
Additional paid-in-capital	346,006	293,149
Retained earnings	519,717	417,482
Accumulated other comprehensive income	7,061	2,121
Total stockholders equity	874,193	714,145
Total liabilities and stockholders equity	\$ 1,046,066	\$ 869,893

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	For the Six Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 102,235	\$ 68,010
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,831	10,539
Provision for doubtful accounts	847	716
Deferred income taxes	(1,613)	(11,484)
Stock-based compensation expense	14,371	
Tax benefit related to stock option exercises	1,067	21,025
Changes in assets and liabilities:		
Trade accounts receivable	(74,209)	(43,141)
Other current assets	(21,028)	(10,762)
Other assets	(2,742)	(577)
Accounts payable	6,973	695
Accrued and other liabilities	6,940	(4,360)
Net cash provided by operating activities	47,672	30,661
Cash flows from investing activities:		
Purchases of property and equipment	(44,989)	(22,352)
Purchases of short-term investments	(186,899)	(108,548)
Proceeds from maturity or sale of short-term investments	148,867	75,881
Acquisition, net of cash acquired		(15,290)
Net cash used in investing activities	(83,021)	(70,309)
Cash flows from financing activities:		
Proceeds from issued shares	22,872	23,011
Excess tax benefit on stock option exercises	14,563	
Cash flows provided by financing activities	37,435	23,011
Effect of currency translation on cash and cash equivalents	4,081	(2,536)
Increase (decrease) in cash and cash equivalents	6,167	(19,173)
Cash and cash equivalents, beginning of year	196,938	199,296
Cash and cash equivalents, end of period	\$ 203,105	\$ 180,123

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(dollar amounts in thousands)

Note 1 Interim Condensed Consolidated Financial Statements

The accompanying unaudited condensed consolidated financial statements included herein have been prepared by Cognizant Technology Solutions Corporation (Cognizant or the Company) in accordance with generally accepted accounting principles in the United States of America and Article 10 of Regulation S-X under the Securities and Exchange Act of 1934, as amended, and should be read in conjunction with the Company's consolidated financial statements (and notes thereto) included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of the Company's management, all adjustments considered necessary for a fair presentation of the accompanying unaudited condensed consolidated financial statements have been included, and all adjustments are of a normal and recurring nature. Operating results for the interim periods are not necessarily indicative of results that may be expected to occur for the entire year. Certain reclassifications have been made to prior year numbers to conform to the current year presentation.

Note 2 Revenue Recognition

The Company's services are entered into on either a time-and-materials or fixed-price basis. Revenues related to time-and-material contracts are recognized as the service is performed. Revenues related to fixed-price contracts that provide for highly complex information technology application development services are recognized as the service is performed using the percentage of completion method of accounting, under which the total value of revenue is recognized on the basis of the percentage that each contract's cost to date bears to the total estimated cost (cost to cost method). Revenues related to fixed-priced contracts that provide solely for application maintenance services are recognized on a straight-line basis or as services are rendered or transactions processed in accordance with contractual terms. Expenses are recorded as incurred over the contract period. Volume discounts, if any, are recorded as a reduction of revenue over the contract period as services are provided.

For contracts with multiple deliverables, the Company evaluates at the inception of each new contract all deliverables in an arrangement to determine whether they represent separate units of accounting. For arrangements with multiple units of accounting, primarily fixed-price contracts that provide both application maintenance and application development services and certain application maintenance contracts, arrangement consideration is allocated among the units of accounting, where separable, based on their relative fair values and revenue is recognized for each unit of accounting based on the Company's revenue recognition policy described above.

Fixed-price contracts are cancelable subject to a specified notice period. All services provided by the Company through the date of cancellation are due and payable under the contract terms. The Company issues invoices related to fixed-price contracts based upon achievement of milestones during a project or other contractual terms. Differences between the timing of billings, based upon contract milestones or other contractual terms, and the recognition of revenue, based upon the percentage-of-completion method of accounting, are recognized as either unbilled or deferred revenue. Estimates of certain fixed-price contracts are subject to adjustment as a project progresses to reflect changes in expected completion costs. The cumulative impact of any revision in estimates is reflected in the financial reporting period in which the change in estimate becomes known and any anticipated losses on contracts are recognized immediately. Warranty provisions generally exist under such contracts for a period of ninety days past contract completion and costs related to such provisions are accrued at the time the related revenues are recorded.

Revenues related to services performed without a signed agreement or work order are not recognized until there is evidence of an arrangement, such as when agreements or work orders are signed or payment is received; however, the cost related to the performance of such work is recognized in the period the services are rendered.

For all services, revenue is recognized when, and if, evidence of an arrangement is obtained and the other criteria to support revenue recognition are met, including the price is fixed or determinable, services have been rendered and collectibility is assured.

The Company accounts for reimbursement of out-of-pocket expenses as revenues.

Note 3 Capital Stock

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

On June 13, 2006, the Company's stockholders approved amendments to: (1) the Restated Certificate of Incorporation to increase the maximum number of authorized shares of the Company's capital stock, all classes, from 340,000,000 shares,

Table of Contents

consisting of (i) 325,000,000 shares of Class A common stock, and (ii) 15,000,000 shares of preferred stock, to 515,000,000 shares, consisting of (x) 500,000,000 shares of Class A common stock, and (y) 15,000,000 shares of preferred stock and (2) the 1999 Incentive Compensation Plan, as amended (the Incentive Plan) and the Key Employees Stock Option Plan, as amended (the Key Employees Plan) to (i) increase the maximum number of shares of Class A common stock reserved for issuance under the Incentive Plan from 37,500,000 to 38,261,580 shares and thereby reserve an additional 761,580 shares of Class A common stock for issuance and (ii) decrease the maximum number of shares of Class A common stock reserved for issuance under the Key Employees Plan by 761,580 from 8,385,000 to 7,623,420 shares.

As a result of the aforementioned amendments to the Incentive Plan and Key Employees Plan, the total number of shares available for issuance under the Company's stock-based compensation plans remains unchanged and there are no more shares available for future grants under the Key Employees Plan.

Note 4 Stock-Based Compensation Plans

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123R, Share-Based Payment, utilizing the modified prospective method. SFAS No. 123R requires the recognition of stock-based compensation expense in the consolidated financial statements for awards of equity instruments to employees and non-employee directors based on the grant-date fair value of those awards. Under the modified prospective method, the provisions of SFAS No. 123R apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), shall be recognized in net income in the periods after the date of adoption. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flow and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under the prior accounting rules.

Prior to the adoption of SFAS No. 123R, the Company followed the intrinsic value method to account for its employee stock option plans and employee stock purchase plan in accordance with the recognition and measurement principles of Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees and Related Interpretations (APB No. 25), as allowed by SFAS No. 123 and as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure . Accordingly, no stock-based employee compensation cost was recognized, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant and, with respect to the employee stock purchase plan, the discount did not exceed fifteen percent. In accordance with the transitional provisions of SFAS 123R, operating results for 2005 have not been restated. The Company historically reported pro forma results under the disclosure-only provisions of SFAS No. 123.

The Company has three stock option plans (Option Plans):

The Incentive Plan provides for grants up to 38,261,580 shares to eligible employees and non-employee directors. All options granted under the Incentive Plan are exercisable into one (1) share of the Company's Class A common stock, have a life of ten years, vest proportionally over four years, unless specified otherwise, and have an exercise price equal to the fair market value of the common stock on the date of grant. Stock-based compensation expense for Incentive Plan grants is recognized on a straight-line basis over the requisite service period.

The Key Employees Plan provides for the grant of up to 7,623,420 stock options (each option exercisable into one (1) share of the Company's Class A common stock) to eligible employees. Options granted under this plan may not be granted at an exercise price less than the fair market value of the underlying shares on the date of grant. These options have a life of ten years, vest proportionally over four years and have an exercise price equal to the fair market value of the common stock on the grant date. Stock-based compensation expense for Key Employees Plan grants is recognized on a straight-line basis over the requisite service period. Effective June 13, 2006, there are no shares available for future grant and as such no further grants will be made under the Key Employees Plan.

The Non-Employee Directors Stock Option Plan (the Non-Employee Directors Plan) provides for the grant of up to 858,000 stock options (each option exercisable into one (1) share of the Company's Class A common stock) to eligible directors. Options granted under this plan may not be granted at an exercise price less than fair market value of the underlying shares on the date of grant. These options have a life of ten years, vest proportionally over two years and have an exercise price equal to the fair market value of the

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

common stock on the grant date. Stock-based compensation expense for Non-Employee Directors' Plan grants is recognized on a straight-line basis over the requisite service period.

In addition to the Option Plans, the Company maintains the 2004 Employee Stock Purchase Plan (the "Purchase Plan") that provides for the issuance of up to 3,000,000 shares of Class A common stock to eligible employees. The Purchase Plan provides for eligible employees to purchase whole shares of Class A common stock at a price of 90% of the lesser of: (a) the

Table of Contents

fair market value of a share of Class A common stock on the first date of the purchase period or (b) the fair market value of a share of Class A common stock on the last date of the purchase period. Stock-based compensation expense for the Purchase Plan is recognized over the vesting period of three months on a straight-line basis.

The Company currently utilizes authorized, available shares to satisfy stock option exercises under its Option Plans and issuances under its Purchase Plan. During the three and six months ended June 30, 2006, stock-based compensation expense and related income tax benefits reflected in the Company's operating results were \$6,769 and \$14,371, respectively, and \$1,380 and \$2,689, respectively. The allocation of stock-based compensation expense between cost of revenues and selling, general and administrative expenses was as follows:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of revenues	\$ 3,332	\$ 6,479
Selling, general and administrative expenses	3,437	7,892
Total stock-based compensation expense	\$ 6,769	\$ 14,371

The effect of adopting SFAS No. 123R on selected reported items as compared to amounts that would have been reported under APB No. 25, including changes to the geographic mix of taxable income attributed to the adoption of SFAS No. 123R resulting in decreased tax benefits of \$538 and \$714 as compared to our reported results for the three and six months ended June 30, 2006, is presented in the following table:

	For the Three Months Ended June 30, 2006 (Decrease)/Increase	For the Six Months Ended June 30, 2006 (Decrease)/Increase
Income before provision for income taxes	\$ (6,769)	\$ (14,371)
Net income	\$ (5,927)	\$ (12,396)
Net cash used in operating activities	\$ (5,483)	\$ (14,563)
Net cash provided by financing activities	\$ 5,483	\$ 14,563
Basic earnings per share	\$ (0.04)	\$ (0.09)
Diluted earnings per share	\$ (0.04)	\$ (0.09)

A summary of changes in the Option Plans for the six months ended June 30, 2006 is as follows:

	Number of Options	Weighted Average Price (in dollars)	Weighted Average Remaining Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	15,557,055	\$ 13.29		
Granted	1,136,550	\$ 56.30		
Exercised	(1,342,157)	\$ 9.79		
Cancelled	(205,033)	\$ 25.64		
Expired	(2,100)	\$ 33.85		
Outstanding at June 30, 2006	15,144,315	\$ 16.66	6.41	\$ 767,961
Exercisable at June 30, 2006	9,513,858	\$ 9.29	5.47	\$ 552,595

As of June 30, 2006, the total remaining unrecognized stock-based compensation cost related to non-vested stock options expected to vest amounted to \$47,219, which will be amortized over the weighted-average remaining requisite service period of 1.91 years. At June 30, 2006, the

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

Company has 2,334,698 and 2,198,495 shares available for future stock option grants and issuances under the Option Plans and Purchase Plan, respectively.

Table of Contents

Other information pertaining to option activity during the three and six months ended June 30, 2006 and 2005 was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Total fair value of options vested	\$ 6,461	\$ 3,903	\$ 21,414	\$ 11,741
Total intrinsic value of options exercised	\$ 22,757	\$ 45,652	\$ 65,511	\$ 80,743

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for periods ended June 30, 2005:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	\$ 36,032	\$ 68,010
Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects		
Deduct: Total stock-based employee compensation determined using the fair value-based method for all awards, net of related tax effects	(4,406)	(9,530)
Pro Forma net earnings	\$ 31,626	\$ 58,480
Earning per share:		
Basic-as reported	\$ 0.27	\$ 0.50
Basic-pro forma	\$ 0.23	\$ 0.43
Diluted-as reported	\$ 0.25	\$ 0.47
Diluted-pro forma	\$ 0.22	\$ 0.40

The fair value of each stock option was estimated on the date of grant using a Black-Scholes option-pricing model. For the three and six months ended June 30, 2006, expected volatility was calculated using implied market volatilities. In addition, the expected term, which represents the period of time, measured from the grant date, that vested options are expected to be outstanding, was derived by incorporating exercise and post-vest termination assumptions, based on historical data, in a Monte Carlo simulation model. For the three and six months ended June 30, 2005, expected volatility was based on historical volatility of the Company's Class A common stock and the expected term was based on historical employee exercise behavior. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant. The Black-Scholes model also incorporates forfeiture assumptions based on an analysis of historical data. The Company does not pay dividends.

The fair values of option grants, including the Purchase Plan, were estimated at the date of grant with the following assumptions:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Dividend yield	0%	0%	0%	0%
Weighted average volatility factor:				
Option Plans	34.80%	45.19%	35.55%	45.20%
Purchase Plan	32.03%	45.95%	33.17%	45.99%
Weighted average expected life (in years):				
Option Plans	5.19	4.0	5.21	4.0
Purchase Plan	0.25	0.25	0.25	0.25
Weighted average risk-free interest rate:				
Option Plans	5.06%	3.75%	4.80%	3.70%
Purchase Plan	4.80%	2.53%	4.42%	2.42%
Weighted average fair value:				
Option Plans	\$ 23.73	\$ 16.93	\$ 22.63	\$ 16.41

Purchase Plan	\$ 10.03	\$ 8.90	\$ 9.33	\$ 8.47
---------------	----------	---------	---------	---------

Table of Contents

During the three and six months ended June 30, 2006, the Company issued 92,340 and 197,370 shares of Class A common stock, respectively, under the Purchase Plan with a total vested fair value of approximately \$926 and \$1,841, respectively.

Note 5 Short-term Investments

The following is a summary of short-term investments:

	June 30, 2006	December 31, 2005
Auction rate securities	\$ 260,325	\$ 219,425
Other	4,770	7,638
Total short-term investments	\$ 265,095	\$ 227,063

The carrying value of our short-term investments approximated fair value as of June 30, 2006 and December 31, 2005. Realized gains or losses, if any, on these investments were insignificant for the periods presented.

Note 6 Income Taxes

Our Indian subsidiary, Cognizant India, is an export-oriented company, which, under the Indian Income Tax Act of 1961, is entitled to claim tax holidays for a period of ten consecutive years for each Software Technology Park (STP) with respect to export profits for each STP. Substantially all of the earnings of Cognizant India are attributable to export profits. The majority of the Company's STPs in India are currently entitled to a 100% exemption from Indian income tax. Under current law, these tax holidays will be completely phased out by March 2009. On March 31, 2006, the tax holiday expired for a second STP. The incremental Indian taxes related to the taxable STPs have been incorporated into the Company's effective income tax rate for 2006. The effective tax rate of 17.8% for the three and six months ended June 30, 2005 decreased to 16.6% for the three and six months ended June 30, 2006 primarily due to the Company's overall growth, which resulted in a greater percentage of Cognizant India's revenue falling under the income tax holiday. The principal difference between the effective income tax rates for the 2006 and 2005 periods and the United States federal statutory rate is the effect of the tax holiday in India.

Note 7 Commitments and Contingencies

In February 2006, the Company expanded its plans to construct additional fully-owned development centers to now include over 1,700,000 square feet as compared to previous plans, announced in October 2004, to add 900,000 square feet of space. The 1,700,000 square feet of facilities will be located in Chennai, Pune, Kolkata, Hyderabad and Bangalore, India. The total construction expenditure related to this expanded program is estimated to be approximately \$140,000, an increase of approximately \$64,000 when compared to the expansion program announced in October 2004. As of June 30, 2006, the Company has entered into fixed capital commitments of approximately \$87,000 related to this India development center expansion program, of which approximately \$77,000 has been spent to date.

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the outcome of such claims and legal actions, if decided adversely, is not expected to have a material adverse effect on the Company's quarterly or annual results of operations, cash flows, or consolidated financial position. Additionally, many of the Company's engagements involve projects that are critical to the operations of its customers' businesses and provide benefits that are difficult to quantify. Any failure in a customer's computer system could result in a claim for substantial damages against the Company, regardless of the Company's responsibility for such failure. Although the Company attempts to contractually limit its liability for damages arising from negligent acts, errors, mistakes, or omissions in rendering its software development and maintenance services, there can be no assurance that the limitations of liability set forth in its contracts will be enforceable in all instances or will otherwise protect the Company from liability for damages. Although the Company has general liability insurance coverage, including coverage for errors or omissions, there can be no assurance that such coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. The successful assertion of one or more large claims against the Company that exceed available insurance coverage or changes in the Company's insurance policies, including premium increases or the imposition of large deductible or co-insurance requirements, could have a material adverse effect on the Company's business, results of operations, cash flows and financial condition.

In connection with the split-off of the Company from IMS Health Incorporated (IMS Health) on February 13, 2003, the Company entered into a Distribution Agreement, dated January 7, 2003, with IMS Health (the Distribution Agreement), that provides, among other things, that IMS Health and the Company will comply with, and not take any action during the relevant time period that is inconsistent with, the representations

made to and relied upon by McDermott, Will & Emery in

Table of Contents

connection with rendering its opinion regarding the U.S. federal income tax consequences of the exchange offer. In addition, pursuant to the Distribution Agreement, the Company indemnified IMS Health for any tax liability to which they may be subject as a result of the exchange offer but only to the extent that such tax liability resulted solely from a breach in the representations the Company made to and were relied upon by McDermott, Will & Emery in connection with rendering its opinion regarding the U.S. federal income tax consequences of the exchange offer. If the Company breaches any of its representations in connection with the Distribution Agreement, the related indemnification liability could be material to the Company's results of operations, financial position and cash flows.

Note 8 Segment Information

The Company's reportable segments are: Financial Services, which includes customers providing banking / transaction processing, capital markets and insurance services; Healthcare, which includes healthcare providers and payers as well as life sciences customers; Manufacturing / Retail / Logistics, which includes manufacturers, retailers, travel and other hospitality customers, as well as customers providing logistics services; and Other, which is an aggregation of industry segments which, individually, are less than 10% of consolidated revenues and segment operating profit. The Other reportable segment includes media, information services, telecommunications and high technology operating segments. The Company's sales managers, account executives, account managers and project teams are aligned in accordance with the specific industries they serve.

The Company's chief operating decision maker evaluates the Company's performance and allocates resources based on segment revenues and operating profit. Segment operating profit is defined as income from operations before unallocated costs. Expenses included in segment operating profit consist principally of direct selling and delivery costs as well as a per seat charge for use of the Company's development centers. Certain expenses, such as general and administrative, and a portion of depreciation and amortization, are not specifically allocated to specific segments as management does not believe it is practical to allocate such costs to individual segments because they are not directly attributable to any specific segment. Further, stock-based compensation expense is not allocated to individual segments in internal management reports used by the chief operating decision maker. Accordingly, these expenses are separately disclosed as unallocated and adjusted only against the total income from operations of the Company. Additionally, management has determined that it is not practical to allocate identifiable assets, by segment, since such assets are used interchangeably among the segments.

Revenues from external customers and segment operating profit, before unallocated expenses, for the Financial Services, Healthcare, Manufacturing / Retail / Logistics, and Other reportable segments for the three and six months ended June 30, 2006 and 2005 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
Financial services	\$ 162,597	\$ 103,912	\$ 298,442	\$ 193,626
Healthcare	73,392	39,736	135,897	75,011
Manufacturing / retail / logistics	52,242	37,993	97,237	73,928
Other	48,605	30,070	90,739	50,827
Total revenue	\$ 336,836	\$ 211,711	\$ 622,315	\$ 393,392
Segment Operating Profit:				
Financial services	\$ 58,878	\$ 33,830	\$ 108,512	\$ 65,162
Healthcare	28,859	15,612	55,713	29,689
Manufacturing / retail / logistics	17,994	10,672	34,060	22,646
Other	15,758	10,198	31,293	17,821
Total segment operating profit	121,489	70,312	229,578	135,318
Less: unallocated costs ⁽¹⁾	60,818	27,944	115,751	55,667
Less: other ⁽²⁾				96
Income from operations	\$ 60,671	\$ 42,368	\$ 113,827	\$ 79,555

-
- (1) Includes \$6,769 and \$14,371 of stock-based compensation expense for the three and six months ended June 30, 2006. Results for 2005 do not include such expense.
 - (2) Represents costs related to the wind-down of the Company's development facility in Limerick, Ireland. The costs associated with the closure of this facility have been disclosed separately since these costs were not allocated to a reportable segment in management's internal reporting. During the quarter ended June 30, 2005, the Company recorded additional expenses of \$96 and made payments of approximately \$600 primarily for severance and retention bonuses. All costs have been paid as of December 31, 2005.

Table of Contents*Geographic Area Information*

Revenue and long-lived assets, by geographic area, are as follows

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues⁽¹⁾				
North America ⁽²⁾	\$ 291,797	\$ 184,945	\$ 539,003	\$ 341,008
Europe ⁽³⁾	42,413	25,013	77,522	48,584
Asia	2,626	1,753	5,790	3,800
Total	\$ 336,836	\$ 211,711	\$ 622,315	\$ 393,392

	As of	As of
	June 30, 2006	December 31, 2005
Long-lived Assets⁽⁴⁾		
North America	\$ 34,451	\$ 34,956
Europe	7,425	6,850
Asia ⁽⁵⁾	171,245	139,676
Total	\$ 213,121	\$ 181,482

(1) Revenues are attributed to regions based upon customer location.

(2) Substantially all relates to operations in the United States.

(3) Includes revenue from operations in United Kingdom of \$32,081 and \$19,824 and \$59,311 and \$37,579 for the three and six months ended June 30, 2006 and 2005, respectively.

(4) Long-lived assets include property and equipment and intangible assets, net of accumulated depreciation and amortization, respectively, and goodwill.

(5) Substantially all of these long-lived assets relate to the Company's operations in India.

No customer accounted for revenues in excess of 10% of total revenues for the three and six months ended June 30, 2006. One customer, JPMorgan Chase, accounted for more than 10% of revenues during the three and six months ended June 30, 2005.

Note 9 Recent Accounting Pronouncement

On July 13, 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires recognition in the financial statements of the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions are effective for the Company beginning in the first quarter of 2007 with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to the opening balance of retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its consolidated financial statements.

Table of Contents

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

Executive Summary

During the three and six months ended June 30, 2006, our revenue increased to \$336.8 million and \$622.3 million compared to \$211.7 million and \$393.4 million during the three and six months ended June 30, 2005. Net income increased to \$55.1 million and \$102.2 million, respectively, or \$0.37 and \$0.68 per diluted share, including stock-based compensation expense, net of tax, equal to \$0.04 and \$0.08 per diluted share, during the three and six months ended June 30, 2006 compared to \$36.0 million and \$68.0 million or \$0.25 and \$0.47 per diluted share during the three and six months ended June 30, 2005, which excludes stock-based compensation expense. The key drivers of our revenue growth during the quarter ended June 30, 2006 were as follows:

strong performance of our Financial Services, Healthcare and Other segments, which had revenue growth of approximately 56.5%, 84.7% and 61.6%, respectively, for the quarter as compared to the quarter ended June 30, 2005;

expansion of our service offerings, which enabled us to cross-sell new services to our customers and meet the rapidly growing demand for complex large-scale outsourcing solutions;

increased penetration at existing customers, including strategic customers; and

greater penetration at our European customers.

During 2005 and in the first half of 2006, we saw increasing demand from our customers for a broad range of IT solutions particularly high performance web development initiatives and complex systems development engagements, testing, customer relationship management (CRM) and enterprise resource planning (ERP), and data warehousing and business intelligence. We finished the quarter with approximately 270 active clients compared to 246 as of June 30, 2005. During the quarter, we added 5 strategic clients to bring the total number of our strategic clients to 77. We define a strategic client as one offering the potential to generate between \$5.0 million and \$40.0 million or more in annual revenues at maturity. Our top five and top ten customers accounted for approximately 30% and 41%, respectively, of our total revenues in 2006 as compared to approximately 34% and 46%, respectively, for the quarter ended June 30, 2005. As we continue to add new customers and increase our penetration at existing customers, we expect the percentage of revenues from our top five and top ten customers to continue to trend down over time.

In Europe, we continue to see strong growth. During the quarter ended June 30, 2006, our revenue from European customers increased by approximately 70% to approximately \$42.4 million compared to approximately \$25.0 million in the quarter ended June 30, 2005. For the quarter ended June 30, 2006, revenue from Europe, excluding the UK, increased by approximately \$5.1 million or approximately 99% from approximately \$5.2 million in the quarter ended June 30, 2005 to approximately \$10.3 million. Europe will continue to be an area of heavy investment for us in 2006 as we see this area as a growth opportunity for the long-term.

Our operating margin decreased to approximately 18.0% for the quarter ended June 30, 2006 compared to 20.0% for the quarter ended June 30, 2005. Excluding stock-based compensation costs of approximately \$6.8 million, operating margin for the quarter ended June 30, 2006 was approximately 20.0%. This was in line with our historic targeted operating margin range, excluding stock-based compensation costs, of 19% to 20% of total revenues. Historically, we have invested the profitability above the 19% to 20% operating margin level, which excludes stock-based compensation, back into our business, which we believe is a significant contributing factor to our strong revenue growth. This investment is primarily focused in the areas of: (i) hiring client partners and relationship personnel with specific industry experience or domain expertise, (ii) training our technical staff in a broader range of IT service offerings, (iii) strengthening our business analytic capabilities, (iv) strengthening and expanding our portfolio of services, (v) continuing to expand our geographic presence for both sales and delivery, and (vi) recognizing and rewarding exceptional performance by our employees. In addition, we maintain a deep bench of resources, trained in a broad range of service offerings, in order to be well positioned to respond to our customer requests to take on additional projects. This also has an effect of reducing our operating margins and lowering our utilization levels. For the year ending December 31, 2006, we expect to continue to invest amounts in excess of our historical targeted operating margin levels back into the business.

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

We finished the quarter with total headcount of approximately 29,675, an increase of approximately 10,400 over the total headcount at June 30, 2005. The increase in the number of our technical personnel and related infrastructure costs, to meet the demand for our services, are the primary drivers of the increase in our operating expenses in 2006. Annualized

Table of Contents

turnover, including both voluntary and involuntary, was approximately 15% during the quarter ended June 30, 2006. The majority of our turnover occurs in India, resulting in on-site annualized attrition rates below the global rate. In addition, attrition is weighted toward the more junior members of our staff. We have experienced wage inflation in India, which may continue in the future; however, this has not had a material impact on our results of operations as Indian wages represent less than 20% of our total operating expenses.

We are continuing with our strategy of moving from leased facilities to owned facilities as a way of reducing overall operating costs. We recently expanded our plans to construct additional fully-owned development centers to now include over 1.7 million square feet as compared to previous plans, announced in October 2004, to add 900,000 square feet of space. The 1.7 million square feet of facilities will be located in Chennai, Pune, Kolkata, Hyderabad and Bangalore, India. The total construction expenditure related to this expanded program is estimated to be approximately \$140 million, an increase of approximately \$64 million when compared to the expansion program announced in October 2004, which we expect to fund primarily from current operations.

At June 30, 2006, we had cash and cash equivalents and short-term investments of \$468.2 million. Further, we had no third party debt and working capital of approximately \$642.3 million. Accordingly, we do not anticipate any near-term liquidity issues.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, utilizing the modified prospective method. SFAS No. 123R requires the recognition of stock-based compensation expense in the consolidated financial statements for awards of equity instruments to employees and non-employee directors based on the grant-date fair value of those awards. Under the modified prospective method, the provisions of SFAS No. 123R apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), are recognized in net income in the periods after the date of adoption. Pre-tax stock-based compensation costs of \$6.8 million and \$14.4 million have been recorded for the three and six months ended June 30, 2006. In accordance with the modified prospective method of adoption under SFAS No. 123R, prior period financial statements have not been restated to reflect stock-based compensation costs. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flow and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under the prior accounting rules.

Critical Accounting Estimates and Risks

Management's discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported for assets and liabilities, including the recoverability of tangible and intangible assets, disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. On an on-going basis, we evaluate our estimates. The most significant estimates relate to the recognition of revenue and profits based on the percentage of completion method of accounting for certain fixed-bid contracts, the allowance for doubtful accounts, income taxes, valuation of goodwill and other long-lived assets, assumptions used in valuing stock-based compensation arrangements, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The actual amounts may differ from the estimates used in the preparation of the accompanying unaudited condensed consolidated financial statements. Our significant accounting policies are described in Note 2 to the audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

We believe the following critical accounting policies require a higher level of management judgments and estimates than others in preparing the consolidated financial statements:

Revenue Recognition. Revenues related to our fixed-price contracts are recognized as the service is performed using the percentage of completion method of accounting, under which the total contract revenue during the term of an agreement is recognized on the basis of the percentage that each contract's cost to date bears to the total estimated cost (cost to cost method). Estimates of total contract revenues and costs are continuously monitored during the term of the contract, and recorded revenues and costs are subject to revision as the contract progresses. Such revisions may result in increases or decreases to revenues and income and are reflected in the consolidated financial statements in the periods in which they are first identified.

Table of Contents

Stock-Based Compensation. Effective January 1, 2006, we were required to account for stock-based awards in accordance with the fair value recognition provisions of SFAS No. 123R. Under the fair value recognition provisions of SFAS No. 123R, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating the expected term of stock options and the expected volatility of our stock. In addition, judgment is also required in estimating the income tax benefits related to the stock-based awards and the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from our estimates, stock-based compensation expense and our results of operations could be materially impacted.

Income Taxes. Determining the consolidated provision for income tax expense, deferred tax assets and liabilities and related valuation allowance, if any, involves judgment. As a global company, we are required to calculate and provide for income taxes in each of the jurisdictions where we operate. This involves estimating current tax exposures in each jurisdiction as well as making judgments regarding the recoverability of deferred tax assets. Tax exposures can involve complex issues and may require an extended period to resolve. In the period of resolution, adjustments may need to be recorded that result in increases or decreases to income. Changes in the geographic mix or estimated level of annual pre-tax income can also affect the overall effective income tax rate.

On an on-going basis, we evaluate whether a valuation allowance is needed to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and on-going prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we determine that we will be able to realize deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should we determine that we will not be able to realize all or part of the net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

Our Indian subsidiary, Cognizant India, is an export-oriented company, which, under the Indian Income Tax Act of 1961, is entitled to claim tax holidays for a period of ten consecutive years for each Software Technology Park (STP) with respect to export profits for each STP. Substantially all of the earnings of Cognizant India are attributable to export profits. The majority of the Company's STPs in India are currently entitled to a 100% exemption from Indian income tax. Under current law, these tax holidays will be completely phased out by March of 2009. On March 31, 2006, the tax holiday expired for a second STP; however, we do not expect the incremental Indian taxes due on the operating profits of this STP to have a significant effect on our 2006 effective income tax rate as we anticipate the percentage of Indian earnings subject to the tax holiday in India will increase as a percentage of total Indian earnings in 2006. In anticipation of the complete phase out of the tax holidays in March 2009, we expect to locate a portion of our new development centers in areas designated as Special Economic Zones (SEZ). Development centers operating in SEZ will be entitled to certain income tax incentives for periods up to 15 years. Under current Indian tax law, export profits after March 31, 2009 from our existing STPs will be fully taxable at the Indian statutory rate (currently 33.66%) in effect at such time.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The allowance for doubtful accounts is determined by evaluating the relative credit-worthiness of each customer, historical collections experience and other information, including the aging of the receivables. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Goodwill. We evaluate goodwill for impairment at least annually, or as circumstances warrant. When determining the fair value of our reporting units, we utilize various assumptions, including projections of future cash flows. Any adverse changes in key assumptions about our businesses and their prospects or an adverse change in market conditions may cause a change in the estimation of fair value and could result in an impairment charge. As of June 30, 2006, our goodwill balance was approximately \$18.4 million.

Long-lived Assets. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In general, we will recognize an impairment loss when the sum of undiscounted expected future cash flows is less than the carrying amount of such asset. The measurement for such an impairment loss is then based on the fair value of the asset. If such assets were determined to be impaired, it could have a material adverse effect on our business, results of operations and financial condition.

Risks. Most of our IT development centers, including a majority of our employees, are located in India. As a result, we may be subject to certain risks associated with international operations, including risks associated with foreign currency exchange rate fluctuations and risks associated with the application and imposition of protective legislation and regulations relating to import and export or otherwise resulting from foreign policy or the variability of foreign economic or political conditions.

Table of Contents

Additional risks associated with international operations include difficulties in enforcing intellectual property rights, the burdens of complying with a wide variety of foreign laws, potential geo-political and other risks associated with terrorist activities and local and cross border conflicts, potentially adverse tax consequences, tariffs, quotas and other barriers. We are also subject to risks associated with our overall compliance with Section 404 of the Sarbanes-Oxley Act of 2002. The inability of our management and our independent auditor to provide us with an unqualified report as to the adequacy and effectiveness, respectively, of our internal controls over financial reporting for future year ends could result in adverse consequences to us, including, but not limited to, a loss of investor confidence in the reliability of our financial statements, which could cause the market price of our stock to decline. See Item 1A. Risk Factors .

Results of Operations**Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005**

The following table sets forth, for the periods indicated, certain financial data expressed for the three months ended June 30:

(Dollars in thousands)

	2006	% of Revenues	2005	% of Revenues	Increase	% Increase
Revenues	\$ 336,836	100.0%	\$ 211,711	100.0%	\$ 125,125	59.1%
Operating Expenses:						
Cost of revenues ⁽¹⁾	188,320	55.9	117,768	55.6	70,552	59.9
Selling, general and administrative ⁽²⁾	80,044	23.8	46,126	21.8	33,918	73.5
Depreciation and amortization	7,801	2.3	5,449	2.6	2,352	43.2
Income from operations	60,671	18.0	42,368	20.0	18,303	43.2
Other income (expense), net	5,361		1,466		3,895	265.7
Provision for income taxes	10,961		7,802		3,159	40.5
Net income	\$ 55,071	16.3%	\$ 36,032	17.0%	19,039	52.8

(1) Includes stock-based compensation expense for the three months ended June 30, 2006 of \$3,332. Exclusive of depreciation and amortization expense.

(2) Includes stock-based compensation expense for the three months ended June 30, 2006 of \$3,437.

The following table includes a non-GAAP financial measure, namely income from operations on a non-GAAP basis, excluding the impact of stock-based compensation resulting from the adoption of SFAS No. 123R. The table also includes reconciliations of income from operations presented in accordance with U.S. generally accepted accounting principles to this non-GAAP measure. Management believes that the presentation of this non-GAAP financial measure provides useful information to investors because our unaudited condensed consolidated statement of operations for the three months ended June 30, 2005 did not reflect the impact of the adoption of SFAS No. 123R and, therefore, the presentation of the non-GAAP financial measure enhances investors' ability to make period to period comparisons of our operating results. A reconciliation of income from operations as reported and non-GAAP income from operations excluding stock-based compensation expense is as follows for the three months ended June 30:

(Dollars in thousands)

	2006	% of Revenues
Income from operations, as reported	\$ 60,671	18.0%

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

Add: Stock-based compensation expense	6,769	2.0
---------------------------------------	-------	-----

Non-GAAP income from operations, excluding stock-based compensation expense	\$ 67,440	20.0%
---	-----------	-------

Revenue. Revenue increased by 59.1%, or approximately \$125.1 million, from approximately \$211.7 million during the three months ended June 30, 2005 to approximately \$336.8 million during the three months ended June 30, 2006. This increase is attributed to greater acceptance of the on-site/offshore delivery model among an increasing number of industries and continued strength in our customers' discretionary spending. Revenue from customers existing as of June 30, 2005 increased by approximately \$97.7 million and revenue from new customers added since June 30, 2005 was approximately \$27.4 million or approximately 8.1% of total revenues for the three months ended June 30, 2005. We had approximately 270 active clients as of June 30, 2006 as compared to 246 active clients as of June 30, 2005. In addition, we experienced strong demand

Table of Contents

across all of our business segments for an increasingly broad range of services. Our Financial Services and Healthcare business segments accounted for approximately \$58.7 million and \$33.7 million, respectively, of the \$125.1 million increase. Our IT consulting and technology services and IT outsourcing revenues increased by approximately 61% and 58%, respectively, compared to the quarter ended June 30, 2005 and represented approximately 49% and 51%, respectively, of total revenues for the quarter ended June 30, 2006. No customer accounted for sales in excess of 10% of revenues during the quarter ended June 30, 2006. JPMorgan Chase accounted for more than 10% of revenues during the quarter ended June 30, 2005.

Cost of Revenues (Exclusive of Depreciation and Amortization Expense). Our cost of revenues consists primarily of the cost of salaries, stock-based compensation expense, payroll taxes, benefits, immigration and project-related travel for technical personnel, the cost of subcontracting, and the cost of sales commissions related to revenues. Our cost of revenues increased by 59.9%, or approximately \$70.6 million, from approximately \$117.8 million during the three months ended June 30, 2005 to approximately \$188.3 million during the three months ended June 30, 2006. The increase was due to higher compensation and benefits costs of approximately \$55.3 million and the inclusion in 2006 of stock-based compensation expense of approximately \$3.3 million.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of salaries, stock-based compensation expense, employee benefits, travel, promotion, communications, management, finance, administrative and occupancy costs as well as depreciation and amortization expense. Selling, general and administrative expenses, including depreciation and amortization, increased by 70.3%, or approximately \$36.3 million, from approximately \$51.6 million during the three months ended June 30, 2005 to approximately \$87.8 million during the three months ended June 30, 2006, and increased as a percentage of revenue from 24.4% to 26.1%. The majority of the percentage increase in such expenses was due to stock-based compensation expense of approximately \$3.4 million or 1% of revenues during the three months ended June 30, 2006.

Income from Operations. Income from operations increased 43.2%, or approximately \$18.3 million, from approximately \$42.4 million during the three months ended June 30, 2005 to approximately \$60.7 million during the three months ended June 30, 2006, representing operating margins of 20.0% and 18.0% of revenues, respectively. The decrease in operating margin was due to stock-based compensation expense of approximately \$6.8 million, or 2.0% of revenues, recorded in the three months ended June 30, 2006. Excluding stock-based compensation expense, operating margin for the three months ended June 30, 2006 was 20.0% of revenues.

Other Income/Expense, Net. Other income/expense, net consists primarily of interest income and foreign currency gains or losses. The increase in other income/expense, net of \$3.9 million is attributed to an increase in interest income of \$1.8 million from \$2.1 million during the three months ended June 30, 2005 to approximately \$3.9 million during the three months ended June 30, 2006 plus a period-over-period increase of \$2.1 million in income due to the remeasurement of certain balance sheet accounts for movements in foreign currency exchange rates. The increase in interest income is due to higher invested global cash balances and an increase in short-term interest rates.

Provision for Income Taxes. The provision for income taxes increased from approximately \$7.8 million during the three months ended June 30, 2005 to approximately \$11.0 million during the three months ended June 30, 2006. The effective tax rate of 17.8% for the three months ended June 30, 2005 decreased to 16.6% for the three months ended June 30, 2006 primarily due to our overall growth, which resulted in a greater percentage of Cognizant India's revenue falling under the income tax holiday.

Net Income. Net income increased from approximately \$36.0 million for the three months ended June 30, 2005 to approximately \$55.1 million for the three months ended June 30, 2006, representing 17.0% and 16.3% of revenues, respectively. The decrease in net income as a percentage of revenues compared to the prior period was due to the stock-based compensation expense recorded for the three months ended June 30, 2006, representing a decrease of 2.0% of revenues, offset, in part, by the decrease in the overall effective income tax rate in 2006 equal to 0.4% of revenues and an increase in other income/expense, net, of equal to 0.9% of revenues.

Table of Contents**Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005**

The following table sets forth, for the periods indicated, certain financial data for the six months ended June 30:

(Dollars in thousands)

		% of		% of		
	2006	Revenues	2005	Revenues	Increase	% Increase
Revenues	\$ 622,315	100.0%	\$ 393,392	100.0%	\$ 228,923	58.2%
Operating Expenses:						
Cost of revenues ⁽¹⁾	346,908	55.7	215,762	54.8	131,146	60.8
Selling, general and administrative ⁽²⁾	146,749	23.6	87,536	22.3	59,213	67.6
Depreciation and amortization	14,831	2.4	10,539	2.7	4,292	40.7
Income from operations	113,827	18.3%	79,555	20.2%	34,272	43.1
Other income (expense), net	8,757		3,182		5,575	175.2
Provision for income taxes	20,349		14,727		5,622	38.2
Net income	\$ 102,235	16.4%	\$ 68,010	17.3%	34,225	50.3

(1) Includes stock-based compensation expense for the six months ended June 30, 2006 of \$6,479. Exclusive of depreciation and amortization expense.

(2) Includes stock-based compensation expense for the six months ended June 30, 2006 of \$7,892.

The following table includes a non-GAAP financial measure, namely income from operations on a non-GAAP basis, excluding the impact of stock-based compensation resulting from the adoption of SFAS No. 123R. The table also includes reconciliations of income from operations presented in accordance with U.S. generally accepted accounting principles to this non-GAAP measure. Management believes that the presentation of this non-GAAP financial measure provides useful information to investors because our unaudited condensed consolidated statement of operations for the three months ended June 30, 2005 did not reflect the impact of the adoption of SFAS No. 123R and, therefore, the presentation of the non-GAAP financial measure enhances investors' ability to make period to period comparisons of our operating results. A reconciliation of income from operations as reported and non-GAAP income from operations excluding stock-based compensation expense is as follows for the six months ended June 30:

	2006	% of
	Revenues	
Income from operations, as reported	\$ 113,827	18.3%
Add: Stock-based compensation expense	14,371	2.3
Non-GAAP income from operations, excluding stock-based compensation expense	\$ 128,198	20.6%

Revenue. Revenue increased by 58.2%, or approximately \$228.9 million, from approximately \$393.4 million during the six months ended June 30, 2005 to approximately \$622.3 million during the six months ended June 30, 2006. This increase is primarily attributed to greater acceptance of the on-site/offshore delivery model among an increasing number of industries and continued strength in our customers discretionary spending. Revenue from customers existing as of June 30, 2005, increased by \$181.5 million and revenue from new customers added since June 30, 2005 was approximately \$47.5 million or 7.6% of revenues for the six months ended June 30, 2005. We had approximately 270 active clients as of June 30, 2006 as compared to 246 active clients as of June 30, 2005. In addition, we experienced strong demand across all of our business segments for an increasingly broad range of services. Our Financial Services and Healthcare business segments accounted for approximately \$104.8 million and \$60.9 million, respectively, of the \$228.9 million increase. Our IT consulting and technology services and IT

Edgar Filing: COGNIZANT TECHNOLOGY SOLUTIONS CORP - Form 10-Q

outsourcing revenues increased by approximately 63% and 54%, respectively, compared to the six months ended June 30, 2005 and represented approximately 50% and 50%, respectively, of total revenues for the six months ended June 30, 2006. No customer accounted for sales in excess of 10% of revenues during the six months ended June 30, 2006. JPMorgan Chase accounted for more than 10% of our revenues during the six months ended June 30, 2005.

Cost of Revenues (Exclusive of Depreciation and Amortization Expense). Our cost of revenues consists primarily of the cost of salaries, payroll taxes, benefits, immigration and project-related travel for technical personnel, the cost of subcontracting, and the cost of sales commissions related to revenues. Our cost of revenues increased by 60.8%, or approximately \$131.1 million, from approximately \$215.8 million during the six months ended June 30, 2005 to approximately \$346.9 million during the six months ended June 30, 2006. The increase was due to higher compensation and benefits costs of approximately \$102.7 million and the inclusion in 2006 of stock-based compensation expense of approximately \$6.5 million.

Table of Contents

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of salaries, employee benefits, travel, promotion, communications, management, finance, administrative and occupancy costs as well as depreciation and amortization expense. Selling, general and administrative expenses, including depreciation and amortization, increased by 64.8%, or approximately \$63.5 million, from approximately \$98.1 million during the six months ended June 30, 2005 to approximately \$161.6 million during the six months ended June 30, 2006, and increased as a percentage of revenue from 24.9% to 26.0%. The majority of the percentage increase in such expenses was due to stock-based compensation expense of approximately \$7.9 million or 1.3% of revenues during the six months ended June 30, 2006.

Income from Operations. Income from operations increased 43.1%, or approximately \$34.3 million, from approximately \$79.6 million during the six months ended June 30, 2005 to approximately \$113.8 million during the six months ended June 30, 2006, representing operating margins of 20.2% and 18.3% of revenues, respectively. The decrease in operating margin was due primarily to stock-based compensation expense of approximately \$14.4 million, or 2.3% of revenues, recorded in the six months ended June 30, 2006, offset, in part, by the leverage achieved from increased revenues that resulted from our expanded sales and marketing activities in the current and prior years. Excluding stock-based compensation expense, operating margin for the six months ended June 30, 2006 was 20.6% of revenues.

Other Income/Expense, Net. Other income/expense, net consists primarily of interest income and foreign currency gains or losses. The increase in other income/expense, net of \$5.6 million is attributed to an increase in interest income of \$3.4 million from approximately \$3.9 million during the six months ended June 30, 2005 to approximately \$7.3 million during the six months ended June 30, 2006 plus a period-over-period increase of approximately \$2.2 million in income due to the remeasurement of certain balance sheet accounts for movements in foreign currency exchange rates. The increase in interest income is due to higher invested global cash balances and an increase in short-term interest rates.

Provision for Income Taxes. The provision for income taxes increased from approximately \$14.7 million during the six months ended June 30, 2005 to approximately \$20.3 million during the six months ended June 30, 2006. The effective tax rate of 17.8% for the six months ended June 30, 2005 decreased to 16.6% for the six months ended June 30, 2006 primarily due to overall growth in our business which resulted in a greater percentage of Cognizant India's income falling under the income tax holiday.

Net Income. Net income increased from approximately \$68.0 million for the six months ended June 30, 2005 to approximately \$102.2 million for the six months ended June 30, 2006, representing 17.3% and 16.4% of revenues, respectively. The decrease in net income as a percentage of revenues compared to the prior period was primarily due to the stock-based compensation expense recorded for the six months ended June 30, 2006, representing a decrease of 2.3% of revenues, offset, in part, by the decrease in the overall effective income tax rate in 2006 equal to 0.5% of revenues and the increase in other income/expense, net, of 0.7% of revenues.

Results by Business Segment

Our reportable segments are: Financial Services, which includes customers providing banking / transaction processing, capital markets and insurance services; Healthcare, which includes healthcare providers and payers as well as life sciences customers; Manufacturing / Retail / Logistics, which includes manufacturers, retailers, travel and other hospitality customers, as well as customers providing logistics services; and Other, which is an aggregation of industry operating segments which, individually, are less than 10% of consolidated revenues and segment operating profit. The Other reportable segment includes media, information services, telecommunications and high technology operating segments. Our sales managers, account executives, account managers and project teams are aligned in accordance with the specific industries they serve.

The Company's chief operating decision maker evaluates Cognizant's performance and allocates resources based on segment revenues and operating profit. Segment operating profit is defined as income from operations before unallocated costs. Generally, operating expenses for each operating segment have similar characteristics and are subject to the same factors, pressures and challenges. However, the economic environment and its effects on industries served by our operating groups may affect revenue and operating expenses to differing degrees. Expenses included in segment operating profit consist principally of direct selling and delivery costs as well as a per seat charge for use of the development centers. Certain expenses, such as general and administrative, and a portion of depreciation and amortization, are not specifically allocated to specific segments as management does not believe it is practical to allocate such costs to individual segments because they are not directly attributable to any specific segment. Further, stock-based compensation expense is not allocated to individual segments in internal management reports used by the chief decision maker. Accordingly, these expenses are separately disclosed as unallocated and adjusted only against the total income from operations.

Table of Contents***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Revenues from external customers and segment operating profit, before unallocated expenses, for the Financial Services, Healthcare, Manufacturing / Retail / Logistics, and Other reportable segments for the three months ended June 30, 2006 and 2005 are as follows:

(Dollars in thousands)

	June 30, 2006	June 30, 2005	Increase	%
Revenues:				
Financial services	\$ 162,597	\$ 103,912	\$ 58,685	56.5%
Healthcare	73,392	39,736	33,656	84.7
Manufacturing/retail/logistics	52,242	37,993	14,249	37.5
Other	48,605	30,070	18,535	61.6
Total revenues	\$ 336,836	\$ 211,711	\$ 125,125	59.1
Segment Operating Profit:				
Financial services	\$ 58,878	\$ 33,830	\$ 25,048	74.0%
Healthcare	28,859	15,612	13,247	84.9
Manufacturing/retail/logistics	17,994	10,672	7,322	68.6
Other	15,758	10,198	5,560	54.5
Total segment operating profit	\$ 121,489	\$ 70,312	\$ 51,177	72.8

Financial Services Segment

Revenue. Revenue increased by 56.5%, or approximately \$58.7 million, from approximately \$103.9 million during the three months ended June 30, 2005 to approximately \$162.6 million during the three months ended June 30, 2006. The increase in revenue was driven by continued expansion of existing customer relationships as well as new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$51.6 million and approximately \$7.1 million, respectively. Within the segment, growth was particularly strong among our insurance customers, where revenue increased approximately \$31.6 million over the second quarter of last year. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 74.0%, or approximately \$25.0 million, from approximately \$33.8 million during the three months ended June 30, 2005 to approximately \$58.9 million during the three months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues and achieving continued leverage on prior sales and marketing investments.

Healthcare Segment

Revenue. Revenue increased by 84.7%, or approximately \$33.7 million, from approximately \$39.7 million during the three months ended June 30, 2005 to approximately \$73.4 million during the three months ended June 30, 2006. The increase in revenue was driven by continued expansion of existing customer relationships as well as new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$31.3 million and approximately \$2.4 million, respectively. Within the segment, growth was particularly strong among our life sciences customers, where revenue increased by approximately \$18.5 million over the second quarter of last year. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 84.9%, or approximately \$13.2 million, from approximately \$15.6 million during the three months ended June 30, 2005 to approximately \$28.9 million during the three months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues.

Manufacturing/Retail/Logistics Segment

Revenue. Revenue increased by 37.5%, or approximately \$14.2 million, from approximately \$38.0 million during the three months ended June 30, 2005 to approximately \$52.2 million during the three months ended June 30, 2006. The increase in revenue within the manufacturing, logistics and retail groups was driven by continued expansion of existing customer relationships as well as new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$6.0 million and approximately \$8.2 million, respectively. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Table of Contents

Segment Operating Profit. Segment operating profit increased 68.6%, or approximately \$7.3 million, from approximately \$10.7 million during the three months ended June 30, 2005 to approximately \$18.0 million during the three months ended June 30, 2006. The increase in segment operating profit was attributable primarily to increased revenues and achieving continued leverage on prior sales and marketing investments.

Other Segment

Revenue. Revenue increased by 61.6%, or approximately \$18.5 million, from approximately \$30.1 million during the three months ended June 30, 2005 to approximately \$48.6 million during the three months ended June 30, 2006. The increase in revenue was due to continued expansion of existing customer relationships and a significant number of new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$8.8 million and approximately \$9.7 million, respectively. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 54.5%, or approximately \$5.6 million from approximately \$10.2 million during the three months ended June 30, 2005 to approximately \$15.8 million during the three months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues partially offset by continuing investment in sales and marketing.

Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005

Revenues from external customers and segment operating profit, before unallocated expenses, for the Financial Services, Healthcare, Manufacturing / Retail / Logistics, and Other reportable segments for the six months ended June 30, 2006 and 2005 are as follows:

(Dollars in thousands)

	June 30,	June 30,		
	2006	2005	Increase	%
Revenues:				
Financial services	\$ 298,442	\$ 193,626	\$ 104,816	54.1%
Healthcare	135,897	75,011	60,886	81.2
Manufacturing/retail/logistics	97,237	73,928	23,309	31.5
Other	90,739	50,827	39,912	78.5
Total revenues	\$ 622,315	\$ 393,392	\$ 228,923	58.2
Segment Operating Profit:				
Financial services	\$ 108,512	\$ 65,162	\$ 43,350	66.5%
Healthcare	55,713	29,689	26,024	87.7
Manufacturing/retail/logistics	34,060	22,646	11,414	50.4
Other	31,293	17,821	13,472	75.6
Total segment operating profit	\$ 229,578	\$ 135,318	\$ 94,260	69.7

Financial Services Segment

Revenue. Revenue increased by 54.1%, or approximately \$104.8 million, from approximately \$193.6 million during the six months ended June 30, 2005 to approximately \$298.4 million during the six months ended June 30, 2006. The increase in revenue was driven by continued expansion of existing customer relationships as well as new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$92.7 million and \$12.1 million, respectively. Within the segment, growth was particularly strong among our insurance customers, where revenue increased by approximately \$54.8 million over last year. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Table of Contents

Segment Operating Profit. Segment operating profit increased 66.5%, or approximately \$43.4 million, from approximately \$65.2 million during the six months ended June 30, 2005 to approximately \$108.5 million during the six months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues and achieving continued leverage on prior sales and marketing investments.

Healthcare Segment

Revenue. Revenue increased by 81.2%, or approximately \$60.9 million, from approximately \$75.0 million during the six months ended June 30, 2005 to approximately \$135.9 million during the six months ended June 30, 2006. The increase in revenue was driven by continued expansion of existing customer relationships as well as new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$53.8 million and \$7.1 million, respectively. Within the segment, growth was particularly strong among our life sciences customers, where revenue increased \$33.6 million over last year. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 87.7%, or approximately \$26.0 million, from approximately \$29.7 million during the six months ended June 30, 2005 to approximately \$55.7 million during the six months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues and sales and achieving continued leverage on prior sales and marketing investments.

Manufacturing/Retail/Logistics Segment

Revenue. Revenue increased by 31.5%, or approximately \$23.3 million, from approximately \$73.9 million during the six months ended June 30, 2005 to approximately \$97.2 million during the six months ended June 30, 2006. The increase in revenue within the manufacturing, logistics and retail groups was driven by continued expansion of existing customer relationships as well as a significant number of new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was approximately \$10.6 million and \$12.7 million, respectively. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 50.4%, or approximately \$11.4 million, from approximately \$22.6 million during the six months ended June 30, 2005 to approximately \$34.1 million during the six months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues and achieving continued leverage on prior sales and marketing investments.

Other Segment

Revenue. Revenue increased by 78.5%, or approximately \$39.9 million, from approximately \$50.8 million during the six months ended June 30, 2005 to approximately \$90.7 million during the six months ended June 30, 2006. The increase in revenue was due to the continued expansion of existing customer relationships and a significant number of new customers. The increase in revenue from customers existing as of June 30, 2005 and customers added since such date was \$24.3 million and \$15.6 million, respectively. The increase can also be attributed to leveraging sales and marketing investments in this business segment as well as greater acceptance of the onsite/offshore IT services delivery model.

Segment Operating Profit. Segment operating profit increased 75.6%, or approximately \$13.5 million from approximately \$17.8 million during the six months ended June 30, 2005 to approximately \$31.3 million during the six months ended June 30, 2006. The increase in segment operating profit was attributable to increased revenues.

Liquidity and Capital Resources

At June 30, 2006, we had cash and cash equivalents and short-term investments of approximately \$468.2 million. We have used, and plan to use, such cash for (i) expansion of existing operations, including our offshore software development centers; (ii) continued development of new service lines; (iii) possible acquisitions of related businesses; (iv) formation of joint ventures; and (v) general corporate purposes, including working capital. As of June 30, 2006, we had no third party debt and had working capital of approximately \$642.3 million as compared to working capital of approximately \$509.6 million, with no third party debt, as of December 31, 2005. Accordingly, we do not anticipate any near-term liquidity issues.

Table of Contents

Net cash provided by operating activities was approximately \$47.7 million during the six months ended June 30, 2006 as compared to cash provided by operations of approximately \$30.7 million during the six months ended June 30, 2005. The increase is primarily attributed to the increase in net income in 2006, partially offset by the reclassification of excess tax benefits on stock option exercises from operating activities to financing activities of approximately \$14.6 million in 2006 as required by SFAS No. 123R. Beginning in 2006, income tax benefits generated on exercise of employee stock options in excess of the stock-based compensation costs for the exercised options are required to be reported as an inflow from financing activities. In 2005, this portion of the tax benefit on employee stock option exercise was reported as a cash inflow from operating activities. Trade accounts receivable increased from approximately \$154.0 million at December 31, 2005 to approximately \$228.0 million at June 30, 2006. Unbilled accounts receivable increased from approximately \$22.7 million at December 31, 2005 to approximately \$38.3 million at June 30, 2006. The increase in trade accounts receivable and unbilled receivables as of June 30, 2006 was due primarily to increased revenues and a higher number of days of sales outstanding. We monitor turnover, aging and the collection of accounts receivable through the use of management reports that are prepared on a customer basis and evaluated by our finance staff. At June 30, 2006, our days of sales outstanding, including unbilled receivables, was approximately 72 days as compared to 72 days at June 30, 2005.

Our investing activities used net cash of approximately \$83.0 million during the six months ended June 30, 2006 as compared to \$70.3 million during the six months ended June 30, 2005. The increase in net cash used in investing activities primarily relates to greater investment in 2006 to expand our offshore IT development centers and increased investment of excess cash generated from operations to achieve a higher return on invested balances.

Our financing activities provided net cash of approximately \$37.4 million during the six months ended June 30, 2006 as compared to \$23.0 million during the six months ended June 30, 2005. The increase relates to the classification in 2006 of excess tax benefits on employee stock option exercises of approximately \$14.6 million in financing activities as required by SFAS No. 123R.

We believe that our available funds and the cash flows expected to be generated from operations will be adequate to satisfy our current and planned operations and needs for at least the next 12 months. Our ability to expand and grow our business in accordance with current plans, to make acquisitions and form joint ventures and to meet our long-term capital requirements beyond this 12-month period will depend on many factors, including the rate, if any, at which our cash flow increases, our ability and willingness to accomplish acquisitions and joint ventures with capital stock, our continued intent not to repatriate earnings from India, our ability not to breach the Distribution Agreement with IMS Health, especially as it relates to our tax indemnities, and the availability of public and private debt and equity financing. We cannot be certain that additional financing, if required, will be available on terms favorable to us, if at all.

During July 2004, we entered into a foreign currency forward contract, with a six-month term and notional amount of \$12.5 million, to sell the Indian Rupee for U.S. dollars which was settled in January 2005. We entered into this forward contract to manage a portion of our foreign currency risk related to Indian Rupee denominated asset balances, primarily cash investments, at our Indian subsidiary, Cognizant India. Movement in the exchange rate for the Indian Rupee results in foreign currency gains or losses upon remeasurement of Cognizant India's financial statements into its functional currency, the U.S. dollar. Our objective was to reduce foreign currency exposure to appreciation or depreciation in the value of the Indian Rupee by offsetting a portion of such exposure with gains or losses on the forward contract, referred to above. The forward contract was marked to market and recorded at fair value with unrealized gains and losses reported along with foreign currency gains or losses in the caption "other income (expense), net" on our consolidated statements of operations and comprehensive income.

Other than the aforementioned forward contract, we have not engaged in hedging activities nor have we entered into off-balance sheet transactions, arrangements or other relationships with unconsolidated entities or other persons that are likely to affect liquidity or the availability of or requirements for capital resources.

Commitments and Contingencies

We have expanded our plans to construct additional fully-owned IT development centers to now include over 1.7 million square feet of space as compared to previous plans, announced in October 2004, to add 900,000 square feet of space. The 1.7 million square feet of facilities will be located in Chennai, Pune, Kolkata, Hyderabad and Bangalore, India. As of June 30, 2006, we have entered into fixed capital commitments of approximately \$87 million related to this India development center expansion program, of which approximately \$77 million has been spent to date.

In connection with the acquisition of substantially all the assets of Fathom, additional purchase price, not to exceed \$16.0 million, payable in 2007, is contingent on Fathom achieving certain financial and operating targets over the two years ended April 30, 2007.

Table of Contents

Contingent purchase price payments relating to acquisitions are recorded when the contingencies are resolved. The contingent consideration, if paid, will be recorded as an additional element of the cost of the acquired company. Any additional payments relating to the achievement of post-acquisition financial and operating targets are expected to be funded by cash flows from operations.

We are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the outcome of such claims and legal actions, if decided adversely, is not expected to have a material adverse effect on our quarterly or annual operating results, cash flows, or consolidated financial position. Additionally, many of our engagements involve projects that are critical to the operations of our customers' business and provide benefits that are difficult to quantify. Any failure in a customer's computer system could result in a claim for substantial damages against us, regardless of our responsibility for such failure. Although we attempt to contractually limit our liability for damages arising from negligent acts, errors, mistakes, or omissions in rendering our application design, development and maintenance services, there can be no assurance that the limitations of liability set forth in our contracts will be enforceable in all instances or will otherwise protect us from liability for damages. Although we have general liability insurance coverage, including coverage for errors or omissions, there can be no assurance that such coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. The successful assertion of one or more large claims against us that exceed available insurance coverage or changes in our insurance policies, including premium increases or the imposition of large deductible or co-insurance requirements, could have a material adverse effect on our quarterly and annual operating results, financial position and cash flows.

In connection with our split-off from IMS Health, we entered into a Distribution Agreement, dated January 7, 2003, with IMS Health, referred to as the Distribution Agreement. The Distribution Agreement provides, among other things, that IMS Health and we will comply with, and not take any action during the relevant time period that is inconsistent with, the representations made to and relied upon by McDermott, Will & Emery in connection with rendering its opinion regarding the United States federal income tax consequences of the exchange offer. In addition, pursuant to the Distribution Agreement, we indemnified IMS Health for any tax liability to which they may be subject as a result of the exchange offer but only to the extent that such tax liability resulted solely from a breach in the representations we made to and were relied upon by McDermott, Will & Emery in connection with rendering its opinion regarding the United States federal income tax consequences of the exchange offer. If we breach any of our representations in connection with the Distribution Agreement, the related indemnification liability could be material to our quarterly and annual operating results, financial position and cash flows.

Exit Activity

On June 29, 2004, we announced our plans to wind-down operations at our development center located in Limerick, Ireland and close the facility by March 31, 2005. During the year ended December 31, 2004, we recorded expenses of approximately \$1.5 million primarily for severance, retention bonuses and an obligation to repay funds previously received through local job grant programs and made payments of \$1.0 million through December 31, 2004. As of March 31, 2005, we completed the wind-down of our Limerick development facility. During the quarter ended March 31, 2005, we recorded additional expenses of approximately \$0.1 million and made payments of approximately \$0.6 million primarily for severance and retention bonuses. All costs have been paid as of December 31, 2005.

Foreign Currency Translation

Overall, we believe that we are not exposed to significant revenue risk resulting from movement in foreign exchange rates as approximately 87% of our revenues are generated from customers located in the United States. However, a portion of our costs in India are denominated in local currency and subject to foreign exchange rate fluctuations, which has an impact on our results of operations. In addition, a portion of our balance sheet is exposed to foreign exchange rate fluctuations, which results in non-operating foreign exchange gains and losses. On an ongoing basis we manage a portion of this risk by limiting our net monetary asset exposure to the Indian Rupee in our Indian subsidiary.

Recent Accounting Pronouncement

On July 13, 2006, the Financial Accounting Standards Board issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*—an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires recognition in the financial statements of the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. We are required to adopt FIN 48 beginning in the first quarter of 2007 with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening balance of retained earnings. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

Table of Contents

Effects of Inflation

Our most significant costs are the salaries and related benefits for our programming staff and other professionals. Competition in India, the United States and Europe for professionals with advanced technical skills necessary to perform our services offered have caused wages to increase at a rate greater than the general rate of inflation. As with other IT service providers, we must adequately anticipate wage increases, particularly on our fixed-price contracts. There can be no assurance