COGNIZANT TECHNOLOGY SOLUTIONS CORP
Form 10-Q
May 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

þ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 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	**13-3728359**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
500 Glenpointe Centre West, Teaneck, New Jersey	**07666**
(Address of Principal Executive Offices)	**(Zip Code)**

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No: ¨

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

Large accelerated filer þ Accelerated filer ¨ 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: þ

Indicate the number of shares outstanding of each of the issuer s class of common stock, as of May 4, 2006:

Class	**Number of Shares**
Class A Common Stock, par value $.01 per share	140,396,657

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

(Unaudited)

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COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

(Unaudited)

(in thousands, except per share data)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Revenues	$ 285,479	$ 181,681
Cost of revenues	158,588	97,994
Gross profit	126,891	83,687
Selling, general and administrative expenses	66,705	41,410
Depreciation and amortization expense	7,030	5,090
Income from operations	53,156	37,187
Other income (expense), net:		
Interest income	3,437	1,840
Other income (expense) - net	(41)	(124)
Total other income (expense)	3,396	1,716
Income before provision for income taxes	56,552	38,903
Provision for income taxes	9,388	6,925
Net income	$ 47,164	$ 31,978
Basic earnings per share	$ 0.34	$ 0.24
Diluted earnings per share	$ 0.32	$ 0.22
Weighted average number of common shares outstanding Basic	139,665	134,485
Dilutive effect of shares issuable as of period-end under stock option plans	9,689	11,336
Weighted average number of common shares outstanding - Diluted	149,354	145,821
Comprehensive income:		
Net income	$ 47,164	$ 31,978
Foreign currency translation adjustments	722	(1,581)
Total comprehensive income	$ 47,886	$ 30,397

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

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COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Unaudited)

(in thousands, except par values)

	March 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 165,362	$ 196,938
Short-term investments	257,186	227,063
Trade accounts receivable, net of allowance of $2,325 and $2,325, respectively	184,356	153,971
Unbilled accounts receivable	33,327	22,725
Deferred income tax assets	43,847	42,752
Other current assets	25,055	19,974
Total current assets	709,133	663,423
Property and equipment, net of accumulated depreciation of $71,229 and $64,736, respectively	161,577	146,982
Goodwill	18,270	18,223
Other intangible assets, net	15,803	16,277
Deferred income tax assets	19,641	17,247
Other assets	9,903	7,741
Total assets	$ 934,327	$ 869,893
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 21,439	$ 16,420
Accrued and other current liabilities	117,435	137,375
Total current liabilities	138,874	153,795
Other noncurrent liabilities	2,302	1,953
Total liabilities	141,176	155,748
Commitments and Contingencies (See Note 5)		
Stockholders equity:		
Preferred stock, $.10 par value, 15,000 shares authorized, none issued		
Class A common stock, $.01 par value, 325,000 shares authorized, 140,377 and 139,346 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	1,403	1,393
Additional paid-in-capital	324,259	293,149
Retained earnings	464,646	417,482
Accumulated other comprehensive income	2,843	2,121
Total stockholders equity	793,151	714,145
Total liabilities and stockholders equity	$ 934,327	$ 869,893

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

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COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	For the Three Months Ended March 31, 2006	2005
Cash flows from operating activities:		
Net income	$ 47,164	$ 31,978
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	7,030	5,090
Provision for doubtful accounts	233	426
Deferred income taxes	(3,489)	(7,642)
Stock-based compensation expense	7,602	
Tax benefit related to stock option exercises	851	11,978
Changes in assets and liabilities:		
Trade accounts receivable	(31,705)	(16,806)
Other current assets	(15,611)	(8,103)
Other assets	(1,982)	(425)
Accounts payable	4,620	1,996
Accrued and other liabilities	(18,640)	(18,886)
Net cash used in operating activities	(3,927)	(394)
Cash flows from investing activities:		
Purchases of property and equipment	(20,587)	(8,640)
Purchases of short-term investments	(133,248)	(65,309)
Proceeds from maturity or sale of short-term investments	103,126	40,606
Acquisition, net of cash acquired		(1,183)
Net cash used in investing activities	(50,709)	(34,526)
Cash flows from financing activities:		
Proceeds from issued shares	13,587	11,182
Excess tax benefit on stock option exercises	9,080	
Net cash provided by financing activities	22,667	11,182
Effect of currency translation on cash and cash equivalents	393	(570)
Decrease in cash and cash equivalents	(31,576)	(24,308)
Cash and cash equivalents, beginning of year	196,938	199,296
Cash and cash equivalents, end of period	$ 165,362	$ 174,988

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

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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 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 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, Accounting for Stock-Based Compensation and as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure , to account for its employee stock option plans and employee stock purchase plan. 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. 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 1999 Incentive Compensation Plan (the Incentive Plan) provides for grants up to 37,500,000 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 Stock Option Plan (the Key Employees Plan) provides for the grant of up to 8,385,000 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.

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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 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 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. Stock-based compensation expense of $7,602 and related tax benefits of $1,309 were reflected in our operating results for the three months ended March 31, 2006. The allocation of stock-based compensation expense between cost of revenues and selling, general and administrative expenses was as follows:

	Three Months Ended March 31, 2006
Cost of revenues	$ 3,147
Selling, general and administrative expenses	4,455
Total stock-based compensation expense	$ 7,602

The following table shows the effect of adopting SFAS No. 123R on selected reported items, including certain tax-related adjustments, as compared to amounts that would have been reported under APB No. 25:

	For the Three Months Ended March 31, 2006 (Decrease)/Increase
Income before provision for income taxes	$ (7,602)
Net income	$ (6,469)
Net cash used in operating activities	$ (9,080)
Net cash provided by financing activities	$ 9,080
Basic earnings per share	$ (0.04)
Diluted earnings per share	$ (0.04)

A summary of changes in the Option Plans for the three months ended March 31, 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	373,100	$ 50.29		
Exercised	(925,535)	$ 9.51		
Cancelled	(101,033)	$ 26.64		
Expired	(1,100)	$ 28.53		
Outstanding at March 31, 2006	14,902,487	$ 14.36	6.5	$ 672,502

Exercisable at March 31, 2006	9,243,080	$	8.27	5.6	$ 473,429

As of March 31, 2006, the total remaining unrecognized stock-based compensation cost related to non-vested stock options expected to vest amounted to $37,733, which will be amortized over the weighted-average remaining requisite service period of

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1.91 years. At March 31, 2006, the Company has 2,993,148 and 2,290,835 shares available for future stock option grants and issuances under the Option Plans and Purchase Plan, respectively.

Other information pertaining to option activity during the three months ended March 31, 2006 and 2005 was as follows:

	For the Three Months Ended March 31,	
	2006	**2005**
Weighted average grant-date fair value of options granted	$ 20.38	$ 14.71
Total fair value of options vested	$ 14,953	$ 7,838
Total intrinsic value of options exercised	$ 42,754	$ 35,091

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 the period ended March 31, 2005:

	Three Months Ended March 31, 2005
Net income, as reported	$ 31,978
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	(5,124)
Pro Forma net earnings	$ 26,854
Earning per share:	
Basic-as reported	$ 0.24
Basic-pro forma	$ 0.20
Diluted-as reported	$ 0.22
Diluted-pro forma	$ 0.18

The fair value of each stock option was estimated on the date of grant using a Black-Scholes option-pricing model. For the three months ended March 31, 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 months ended March 31, 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 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 March 31,	
	2006	**2005**
Dividend yield	0%	0%
Weighted average volatility factor:		
Option Plans	37.08%	45.23%
Purchase Plan	34.18%	46.03%
Weighted average expected life (in years):		
Option Plans	5.25	4.0
Purchase Plan	0.25	0.25

Weighted average risk-free interest rate:		
Option Plans	4.27%	3.55%
Purchase Plan	4.09%	2.33%
Weighted average fair value:		
Option Plans	$ 20.38	$ 14.71
Purchase Plan	$ 8.71	$ 8.10

During the three months ended March 31, 2006, the Company issued 105,030 shares of Class A common stock under the Purchase Plan with a total vested fair value of approximately $915.

Note 3 Short-term Investments

The following is a summary of short-term investments:

	March 31, 2006	December 31, 2005
Auction rate securities	$ 250,450	$ 219,425
Other	6,736	7,638
Total short-term investments	$ 257,186	$ 227,063

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

Note 4 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 of 2009. On March 31, 2006, the tax holiday expired for one additional 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 months ended March 31, 2005 decreased to 16.6% for the three months ended March 31, 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 5 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 March 31, 2006, the Company has entered into fixed capital commitments of approximately $74,000 related to this India development center expansion program, of which approximately $57,000 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 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 6 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 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.

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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 March 31, 2006 and 2005 are as follows:

	Three Months Ended March 31,	
	2006	2005
Revenues:		
Financial services	$ 135,845	$ 89,714
Healthcare	62,505	35,275
Manufacturing / retail / logistics	44,995	35,936
Other	42,134	20,756
Total revenue	$ 285,479	$ 181,681
Segment Operating Profit:		
Financial services	$ 49,634	$ 31,332
Healthcare	26,854	14,077
Manufacturing / retail / logistics	16,066	11,974
Other	15,535	7,623
Total segment operating profit	108,089	65,006
Less: unallocated costs[1]	54,933	27,723
Less: other[2]		96
Income from operations	$ 53,156	$ 37,187

(1) Includes $7,602 of stock-based compensation expense for the three months ended March 31, 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 March 31, 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.

Geographic Area Information

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

	Three Months Ended March 31,	
	2006	2005
Revenues[1]		
North America[2]	$ 247,206	$ 156,054
Europe[3]	35,109	23,580
Asia	3,164	2,047
Total	$ 285,479	$ 181,681

	As of March 31, 2006	As of December 31, 2005
Long-lived Assets[4]		
North America	$ 34,803	$ 34,956
Europe	6,890	6,850
Asia[5]	153,957	139,676
Total	$ 195,650	$ 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 $27,230 and $17,763 in 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 quarter ended March 31, 2006. One customer, JPMorgan Chase, accounted for more than 10% of revenues during the quarter ended March 31, 2005.

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

Executive Summary

During the three months ended March 31, 2006, our revenue increased to $285.5 million compared to $181.7 million during the three months ended March 31, 2005. Net income, increased to $47.2 million or $0.32 per diluted share, which included stock-based compensation expense, net of tax, of approximately $6.3 million or $0.04 per diluted share, during the three months ended March 31, 2006 compared to $32.0 million or $0.22 per diluted share during the three months ended March 31, 2005. The key drivers of our revenue growth during the quarter ended March 31, 2006 were as follows:

- strong performance of our Financial Services, Healthcare and Other segments, which had revenue growth of approximately 51%, 77% and 103%, respectively, for the quarter as compared to the quarter ended March 31, 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; and

- increased penetration at existing customers, including strategic customers.

During 2005 and in the first quarter of 2006, we saw increasing demand from our customers for a broad range of IT solutions, particularly high performance web development initiatives, complex systems development engagements, testing, customer relationship management (CRM), enterprise resource planning (ERP), data warehousing and business intelligence. We finished the quarter with approximately 260 active clients compared to 233 as of March 31, 2005. During the quarter, we added 5 strategic clients to bring the total number of our strategic clients to 72. 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 42%, respectively, of our total revenues in 2006 as compared to approximately 35% and 47%, respectively, for the quarter ended March 31, 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 growth in the UK market and we are starting to see signs of increased demand in continental Europe. During the quarter ended March 31, 2006, our revenue from European customers increased by approximately 49% to approximately $35.1 million compared to approximately $23.6 million in the quarter ended March 31, 2005. For the quarter ended March 31, 2006, revenue from Europe, excluding the UK, increased by approximately $2.1 million or approximately 35.5% from approximately $5.8 million in the quarter ended March 31, 2005 to approximately $7.9 million. Continental 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 18.6% for the quarter ended March 31, 2006 compared to 20.5% for the quarter ended March 31, 2005. Excluding stock-based compensation costs of approximately $7.6 million, operating margin for the quarter ended March 31, 2006 was approximately 21.3%. This was greater than 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,

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(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.

We finished the quarter with total headcount of approximately 26,750, an increase of approximately 9,700 over the total headcount at March 31, 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 turnover, including both voluntary and involuntary, was approximately 11% during the quarter ended March 31, 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 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 March 31, 2006, we had cash and cash equivalents and short-term investments of $422.5 million. Further, we had no third party debt and working capital of approximately $570.3 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 $7.6 million have been recorded for the three months ended March 31, 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 will differ from the estimates used in the preparation of the accompanying consolidated financial statements. Our significant accounting policies are described in Note 2 to the 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.

Stock-Based Compensation. Effective January 1, 2006, we 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.

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.

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 or equity (if the deferred tax asset is related to tax benefits from stock option exercises that have not been realized) 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 an additional 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.

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 March 31, 2006, our goodwill balance was approximately $18.3 million.

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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. 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 independent auditor to provide us with an unqualified report as to the adequacy 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 March 31, 2006 Compared to Three Months Ended March 31, 2005

The following table sets forth, for the periods indicated, certain financial data expressed for the three months ended March 31:

(Dollars in thousands)

	2006	% of Revenues	2005	% of Revenues	Increase	% Increase
Revenues	$ 285,479	100.0%	$ 181,681	100.0%	$ 103,798	57.1%
Cost of revenues [1]	158,588	55.6	97,994	53.9	60,594	61.8
Gross profit	126,891	44.4	83,687	46.1	43,204	51.6
Selling, general and administrative[2]	66,705	23.4	41,410	22.8	25,295	61.1
Depreciation and amortization	7,030	2.4	5,090	2.8	1,940	38.1
Income from operations	53,156	18.6	37,187	20.5	15,969	42.9
Other income (expense), net	3,396		1,716		1,680	97.9
Provision for income taxes	9,388		6,925		2,463	35.6
Net income	$ 47,164	16.5%	$ 31,978	17.6%	15,186	47.5

(1) Includes stock-based compensation expense for the three months ended March 31, 2006 of $3,147.

(2) Includes stock-based compensation expense for the three months ended March 31, 2006 of $4,455.

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The following table includes non-GAAP financial measures, namely gross profit on a non-GAAP basis and income from operations on a non-GAAP basis, in each case excluding the impact of stock-based compensation resulting from the adoption of SFAS No. 123R. The table also includes reconciliations of gross profit and income from operations presented in accordance with U.S. generally accepted accounting principles to these non-GAAP measures. Management believes that the presentation of these non-GAAP financial measures provides useful information to investors because our statement of operations for the three months ended March 31, 2005 did not reflect the impact of the adoption of SFAS No. 123R and, therefore, the presentation of the non-GAAP financial measures enhances investors ability to make period to period comparisons of our operating results. A reconciliation of gross profit and income from operations as reported and non-GAAP gross profit and non-GAAP income from operations excluding stock-based compensation expense is as follows for the three months ended:

	March 31, 2006	% of Revenues
Gross profit, as reported	$ 126,891	44.4%
Add: Stock-based compensation expense	3,147	1.2
Non-GAAP gross profit, excluding stock-based compensation expense	$ 130,038	45.6%
Income from operations, as reported	$ 53,156	18.6%
Add: Stock-based compensation expense	7,602	2.7
Non-GAAP income from operations, excluding stock-based compensation expense	$ 60,758	21.3%

Revenue. Revenue increased by 57.1%, or approximately $103.8 million, from approximately $181.7 million during the three months ended March 31, 2005 to approximately $285.5 million during the three months ended March 31, 2006. This increase is primarily attributed to greater acceptance of the on-site/offshore delivery model among an increasing number of industries, our expanding range of service offerings which allowed us to access a larger share of our customers IT budgets, continued strength in our customers discretionary spending, increased revenue from existing customers and revenue from new customers added since March 31, 2005, including the acquisition of Fathom. We had approximately 260 active clients as of March 31, 2006 as compared to 233 active clients as of March 31, 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 $46.1 million and $27.2 million, respectively, of $103.8 million increase. Our IT consulting and technology services and IT outsourcing revenues increased by approximately 66% and 49%, respectively, compared to the quarter ended March 31, 2005 and represented approximately 51% and 49%, respectively, of total revenues for the quarter ended March 31, 2006. No customer accounted for sales in excess of 10% of revenues during the quarter ended March 31, 2006. JPMorgan Chase accounted for more than 10% of our revenues during the quarter ended March 31, 2005.

Gross Profit. 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, and the cost of sales commissions related to revenues. Our cost of revenues increased by 61.8%, or approximately $60.6 million, from approximately $98.0 million during the three months ended March 31, 2005 to approximately $158.6 million during the three months ended March 31, 2006. The increase was due primarily to higher compensation costs from the increase in the number of our technical professionals and the inclusion in 2006 of stock-based compensation expense of approximately $3.1 million. The increased number of our technical professionals is a direct result of greater demand for our services. Our gross profit increased by 51.6%, or approximately $43.2 million, from approximately $83.7 million during the three months ended March 31, 2005 to approximately $126.9 million during the three months ended March 31, 2006.

Gross profit margin decreased from 46.1% of revenues during the three months ended March 31, 2005 to 44.4% of revenues during the three months ended March 31, 2006. The decrease in gross profit margin was due primarily to the inclusion of stock-based compensation expense in our 2006 operating results. Excluding stock-based compensation expense, gross profit margin for the three months ended March 31, 2006 was 45.6% of revenues.

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 58.6%, or approximately $27.2 million, from approximately $46.5 million during the three months ended March 31, 2005 to approximately $73.7 million during the three months ended March 31, 2006, and increased as a percentage of revenue from 25.6% to 25.8%. The percentage increase in such expenses was primarily due to stock-based compensation expense of approximately $4.5 million recorded in the three months ended March 31, 2006, offset, in part, by our growing economies of scale.

Income from Operations. Income from operations increased 42.9%, or approximately $16.0 million, from approximately $37.2 million during the three months ended March 31, 2005 to approximately $53.2 million during the three months ended March 31, 2006, representing operating margins of 20.5% and 18.6% of revenues, respectively. The decrease in operating margin was due primarily to stock-based compensation expense of approximately $7.6 million recorded in the three months ended March 31, 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 three months ended March 31, 2006 was 21.3% of revenues. The increase in operating margin, excluding stock-based compensation costs, was driven by leverage achieved from increased revenues that resulted from our expanded sales and marketing activities in the current and prior years.

Other Income/Expense, Net. Other income/expense, net consists primarily of interest income and foreign currency transaction gains or losses. Interest income increased from $1.8 million during the three months ended March 31, 2005 to approximately $3.4 million during the three months ended March 31, 2006 due primarily to higher invested global cash balances as well as an increase in short-term interest rates.

Provision for Income Taxes. The provision for income taxes increased from approximately $6.9 million during the three months ended March 31, 2005 to approximately $9.4 million during the three months ended March 31, 2006. The effective tax rate of 17.8% for the three months ended March 31, 2005 decreased to 16.6% for the three months ended March 31, 2006 primarily due to the 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 $32.0 million for the three months ended March 31, 2005 to approximately $47. 2 million for the three months ended March 31, 2006, representing 17.6% and 16.5% 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 three months ended March 31, 2006, offset, in part, by the decrease in the overall effective income tax rate in 2006.

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.

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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 quarters ended March 31, 2006 and 2005 are as follows:

(Dollars in thousands)

	March 31, 2006	March 31, 2005	Increase	%
Revenues:				
Financial services	$ 135,845	$ 89,714	$ 46,131	51.4%
Healthcare	62,505	35,275	27,230	77.2
Manufacturing/retail/logistics	44,995	35,936	9,059	25.2
Other	42,134	20,756	21,378	103.0
Total revenues	$ 285,479	$ 181,681	$ 103,798	57.1
Segment Operating Profit:				
Financial services	$ 49,634	$ 31,332	$ 18,302	58.4%
Healthcare	26,854	14,077	12,777	90.8