

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**

**☐ 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**  
(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**

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).

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Yes " No: p

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

| <b>Class</b>                                    | <b>Number of Shares</b> |
|---|-------------------------|
| Class A Common Stock, par value \$.01 per share | 140,396,657             |

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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)**

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2006</b>               | <b>2005</b> |
| 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,         | December 31,      |
|---|-------------------|-------------------|
|   | 2006              | 2005              |
| <b>Assets</b>   |                   |                   |
| 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            |
| <b>Total current assets</b>   | <b>709,133</b>    | <b>663,423</b>    |
| 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             |
| <b>Total assets</b>   | <b>\$ 934,327</b> | <b>\$ 869,893</b> |
| <b>Liabilities and Stockholders Equity</b>  |                   |                   |
| Current liabilities:  |                   |                   |
| Accounts payable  | \$ 21,439         | \$ 16,420         |
| Accrued and other current liabilities   | 117,435           | 137,375           |
| <b>Total current liabilities</b>  | <b>138,874</b>    | <b>153,795</b>    |
| Other noncurrent liabilities  | 2,302             | 1,953             |
| <b>Total liabilities</b>  | <b>141,176</b>    | <b>155,748</b>    |
| 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             |
| <b>Total stockholders equity</b>  | <b>793,151</b>    | <b>714,145</b>    |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 934,327</b> | <b>\$ 869,893</b> |

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<br>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

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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:

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

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:

|   | <b>For the Three Months Ended<br/>March 31, 2006<br/>(Decrease)/Increase</b> |
|---|--|
| 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:

|                                | <b>Number of<br/>Options</b> | <b>Weighted Average<br/>Price<br/>(in dollars)</b> | <b>Weighted Average<br/>Remaining Life<br/>(in years)</b> | <b>Aggregate<br/>Intrinsic Value<br/>(in<br/>thousands)</b> |
|--------------------------------|------------------------------|--|---|---|
| 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  |

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|                               |           |    |      |     |    |         |
|-------------------------------|-----------|----|------|-----|----|---------|
| 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<br>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<br>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   |

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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  |



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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             |
| <b>Total short-term investments</b> | <b>\$ 257,186</b> | <b>\$ 227,063</b> |

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

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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           |
| <b>Revenues:</b>                       |                    |                |
| Financial services                     | \$ 135,845         | \$ 89,714      |
| Healthcare                             | 62,505             | 35,275         |
| Manufacturing / retail / logistics     | 44,995             | 35,936         |
| Other                                  | 42,134             | 20,756         |
| <br>Total revenue                      | <br>\$ 285,479     | <br>\$ 181,681 |
| <b>Segment Operating Profit:</b>       |                    |                |
| Financial services                     | \$ 49,634          | \$ 31,332      |
| Healthcare                             | 26,854             | 14,077         |
| Manufacturing / retail / logistics     | 16,066             | 11,974         |
| Other                                  | 15,535             | 7,623          |
| <br>Total segment operating profit     | <br>108,089        | <br>65,006     |
| Less: unallocated costs <sup>(1)</sup> | 54,933             | 27,723         |
| Less: other <sup>(2)</sup>             |                    | 96             |
| <br>Income from operations             | <br>\$ 53,156      | <br>\$ 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           |
| <b>Revenues<sup>(1)</sup></b> |                    |                |
| North America <sup>(2)</sup>  | \$ 247,206         | \$ 156,054     |
| Europe <sup>(3)</sup>         | 35,109             | 23,580         |
| Asia                          | 3,164              | 2,047          |
| <br>Total                     | <br>\$ 285,479     | <br>\$ 181,681 |

|  | As of             | As of                |
|--|-------------------|----------------------|
|  | March 31,<br>2006 | December 31,<br>2005 |
| <b>Long-lived Assets<sup>(4)</sup></b> |                   |                      |
| North America                          | \$ 34,803         | \$ 34,956            |
| Europe                                 | 6,890             | 6,850                |
| Asia <sup>(5)</sup>                    | 153,957           | 139,676              |
| <b>Total</b>                           | <b>\$ 195,650</b> | <b>\$ 181,482</b>    |

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

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- (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.

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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.

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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<br>Revenues | 2005       | % of<br>Revenues | Increase   | %     |
|--|------------|------------------|------------|------------------|------------|-------|
| Revenues   | \$ 285,479 | 100.0%           | \$ 181,681 | 100.0%           | \$ 103,798 | 57.1% |
| Cost of revenues <sup>(1)</sup>                    | 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 <sup>(2)</sup> | 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           |
| <b>Non-GAAP gross profit, excluding stock-based compensation expense</b>           | <b>\$ 130,038</b> | <b>45.6%</b>  |
| Income from operations, as reported  | \$ 53,156         | 18.6%         |
| Add: Stock-based compensation expense  | 7,602             | 2.7           |
| <b>Non-GAAP income from operations, excluding stock-based compensation expense</b> | <b>\$ 60,758</b>  | <b>21.3%</b>  |

*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.



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*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   | %     |
|----------------------------------|----------------|----------------|------------|-------|
| <b>Revenues:</b>                 |                |                |            |       |
| 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  |
| <b>Segment Operating Profit:</b> |                |                |            |       |
| Financial services               | \$ 49,634      | \$ 31,332      | \$ 18,302  | 58.4% |
| Healthcare                       | 26,854         | 14,077         | 12,777     | 90.8  |
| Manufacturing/retail/logistics   | 16,066         | 11,974         | 4,092      | 34.2  |
| Other                            | 15,535         | 7,623          | 7,912      | 103.8 |
| Total segment operating profit   | \$ 108,089     | \$ 65,006      | \$ 43,083  | 66.3  |

***Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005*****Financial Services Segment**

*Revenue.* Revenue increased by 51.4%, or approximately \$46.1 million, from approximately \$89.7 million during the three months ended March 31, 2005 to approximately \$135.8 million during the three months ended March 31, 2006. The increase in revenue was primarily driven by continued expansion of existing customer relationships as well as a significant number of new customers and acceptance of our expanded portfolio of services. Within the segment, growth was particularly strong among our insurance customers, where we saw strong growth from both existing customers as well as new customers won since the first 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 58.4%, or approximately \$18.3 million, from approximately \$31.3 million during the three months ended March 31, 2005 to approximately \$49.6 million during the three months ended March 31, 2006. The increase in segment operating profit was attributable primarily to increased revenues and achieving continued leverage on prior sales and marketing investments.

**Healthcare Segment**

*Revenue.* Revenue increased by 77.2%, or approximately \$27.2 million, from approximately \$35.3 million during the three months ended March 31, 2005 to approximately \$62.5 million during the three months ended March 31, 2006. The increase in revenue was primarily driven by continued expansion of existing customer relationships, particularly our life sciences customers, as well as a significant number of new customers and acceptance of our expanded portfolio of services. 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 90.8%, or approximately \$12.8 million, from approximately \$14.1 million during the three months ended March 31, 2005 to approximately \$26.9 million during the three months ended March 31, 2006. The increase in segment operating profit was attributable primarily to increased revenues and achieving continued leverage on prior sales and marketing investments.

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### **Manufacturing/Retail/Logistics Segment**

*Revenue.* Revenue increased by 25.2%, or approximately \$9.1 million, from approximately \$35.9 million during the three months ended March 31, 2005 to approximately \$45.0 million during the three months ended March 31, 2006. The increase in revenue within the manufacturing, logistics and retail groups was primarily driven by continued expansion of existing customer relationships as well as a significant number of new customers and acceptance of our expanded portfolio of services. 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 34.2%, or approximately \$4.1 million, from approximately \$12.0 million during the three months ended March 31, 2005 to approximately \$16.1 million during the three months ended March 31, 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 103.0%, or approximately \$21.4 million, from approximately \$20.8 million during the three months ended March 31, 2005 to approximately \$42.1 million during the three months ended March 31, 2006. The increase in revenue was partially due to the acquisition of Fathom in the second quarter of 2005 as well as the continued expansion of existing customer relationships and a significant number of new customers, particularly media and new technology customers, and acceptance of our expanded portfolio of services. 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 103.8%, or approximately \$7.9 million from approximately \$7.6 million during the three months ended March 31, 2005 to approximately \$15.5 million during the three months ended March 31, 2006. The increase in segment operating profit was attributable primarily to increased revenues, including the acquisition of Fathom, and achieving continued leverage on prior sales and marketing investments.

## **Liquidity and Capital Resources**

At March 31, 2006, we had cash and cash equivalents and short-term investments of approximately \$422.5 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 March 31, 2006, we had no third party debt and had working capital of approximately \$570.3 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.

Net cash used in operating activities was approximately \$3.9 million during the three months ended March 31, 2006 as compared to cash used in operations of approximately \$0.4 million during the three months ended March 31, 2005. The decrease is primarily attributed to the reclassification of excess tax benefits on stock option exercises from operating activities to financing activities of approximately \$9.1 million in 2006 as required by SFAS No. 123R and the increase in accounts receivables and unbilled receivables, partially offset by the increase in net income in 2006. 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 \$184.3 million at March 31, 2006. Unbilled accounts receivable increased from approximately \$22.7 million at December 31, 2005 to approximately \$33.3 million at March 31, 2006. The increase in trade accounts receivable and unbilled receivables as of March 31, 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 March 31, 2006, our days of sales outstanding, including unbilled receivables, was approximately 69 days as compared to 65 days at March 31, 2005.

Our investing activities used net cash of approximately \$50.7 million during the three months ended March 31, 2006 as compared to \$34.5 million during the three months ended March 31, 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.





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Our financing activities provided net cash of approximately \$22.7 million during the three months ended March 31, 2006 as compared to \$11.2 million during the three months ended March 31, 2005. The increase relates to a higher level of cash proceeds from the exercise of stock options and employee purchases of stock and the classification in 2006 of excess tax benefits on employee stock option exercises of approximately \$9.1 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 between IMS Health and us, 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 March 31, 2006, we have entered into fixed capital commitments of approximately \$74 million related to this India development center expansion program, of which approximately \$57 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.

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



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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.

## **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 that we will be able to recover cost increases through increases in the prices that we charge for our services in the United States and elsewhere.

## **Forward Looking Statements**

The statements contained in this Quarterly Report on Form 10-Q that are not historical facts are forward-looking statements (within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended) that involve risks and uncertainties. Such forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as believes, expects, may, will, should or anticipates or negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. From time to time, we or our representatives have made or may make forward-looking statements, orally or in writing. Such forward-looking statements may be included in various filings made by us with the Securities and Exchange Commission, or press releases or oral statements made by or with the approval of one of our authorized executive officers. These forward-looking statements, such as statements regarding anticipated future revenues, contract percentage completions, capital expenditures, and other statements regarding matters that are not historical facts, involve predictions. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. There are a number of important factors that could cause our results to differ materially from those indicated by such forward-looking statements. These factors include those set forth in Item 1A. Risk Factors .

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We are exposed to foreign currency exchange rate risk in the ordinary course of doing business as we transact or hold a portion of our funds in foreign currencies, particularly the Indian Rupee. Accordingly, we periodically evaluate the need for hedging strategies to mitigate the effect of foreign currency fluctuations. 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 may continue to enter into such instruments in the future to reduce foreign currency exposure to appreciation or depreciation in the value of certain foreign currencies. 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.

We do not believe we are exposed to material direct risks associated with changes in interest rates other than with our cash and cash equivalents and short-term investments. As of March 31, 2006, we had approximately \$422.5 million of cash and cash equivalents and short-term investments which are impacted almost immediately by changes in short-term interest rates. We limit our credit risk by investing primarily in AAA/Aaa rated securities as rated by Moody's, Standard & Poor's and Fitch rating services and restricting amounts that can be invested with any single issuer.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures and Changes in Internal Control over Financial Reporting**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2006. In designing and evaluating our disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of March 31, 2006, our disclosure controls and procedures were (1) effective in that they were designed to ensure that material information relating to us, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities, as appropriate, to allow timely decisions regarding required disclosures, and (2) effective in that they provide reasonable assurance that information required to be disclosed by us in our reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

During the first quarter of 2006, we implemented a new accounting system resulting in a material change in internal controls. Pre-implementation testing and post-implementation reviews were conducted by management to ensure that internal controls surrounding the system implementation process, the applications, and the closing process were properly designed to prevent material financial statement errors. We expect that the evaluation of the operating effectiveness of related key controls will be completed in the third quarter. Other than the changes related to this new system, no other changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1A. Risk Factors**

**Additional Factors That May Affect Future Results**

*If any of the following risks occur, our business, financial condition, results of operations or prospects could be materially adversely affected. In such case, the trading price of our Common Stock could decline.*

**A substantial portion of our assets and operations are located in India and we are subject to regulatory, economic and political uncertainties in India.**

We intend to continue to develop and expand our offshore facilities in India where, as of March 31, 2006, a majority of our technical professionals were located. While wage costs are lower in India than in the United States and other developed countries for comparably skilled professionals, wages in India are increasing at a faster rate than in the United States, which could result in our incurring increased costs for technical professionals and reduced operating margins. In addition, there is intense competition in India for skilled technical professionals and we expect that competition to increase.

India has also experienced civil unrest and terrorism and has been involved in conflicts with neighboring countries. In recent years, there have been military confrontations between India and Pakistan that have occurred in the region of Kashmir and along the Indian-Pakistan border. The potential for hostilities between the two countries has been high in light of tensions related to recent terrorist incidents in India and the unsettled nature of the regional geopolitical environment, including events in and related to Afghanistan and Iraq. If India were to become engaged in armed hostilities, particularly if these hostilities were protracted or involved the threat of or use of weapons of mass destruction, our operations would be materially adversely affected. In addition, United States companies may decline to contract with us for services in light of international terrorist incidents or armed hostilities even where India is not involved because of more generalized concerns about relying on a service provider utilizing international resources.

In the past, the Indian economy has experienced many of the problems confronting the economies of developing countries, including high inflation, erratic gross domestic product growth and shortages of foreign exchange. The Indian government has exercised and continues to exercise significant influence over many aspects of the Indian economy, and Indian government actions concerning the economy could have a material adverse effect on private sector entities, including us. In the past, the Indian government has provided significant tax incentives and relaxed certain regulatory restrictions in order to encourage foreign investment in specified sectors of the economy, including the software development services industry. Programs that have benefited us include, among others, tax holidays, liberalized import and export duties and preferential rules on foreign investment and repatriation. Notwithstanding these benefits, India's central and state governments remain significantly involved in the Indian economy as regulators. The elimination of any of the benefits realized by us from our Indian operations could have a material adverse effect on our business, results of operations and financial condition.

**We are investing substantial cash assets in new facilities and physical infrastructure, and our profitability could be reduced if our business does not grow proportionately.**

As of March 31, 2006, we had contractual commitments of approximately \$17 million related to capital expenditures on construction or expansion of our development centers. We may encounter cost overruns or project delays in connection with new facilities. These expansions may increase our fixed costs and if we are unable to grow our business and revenues proportionately, our profitability will be reduced.

**Our international sales and operations are subject to many uncertainties.**

Revenues from customers outside North America represented approximately 13% of our revenues for the year ended December 31, 2005 and for the three months ended March 31, 2006. We anticipate that revenues from customers outside North America will continue to account for a material portion of our revenues in the foreseeable future and may increase as we expand our international presence, particularly in Europe. In addition, a majority of our employees and almost all of our IT development centers are located in India. As a result, we may be subject to 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 or export or otherwise resulting from foreign policy or the variability of foreign economic conditions. From time to time, we



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may engage in hedging transactions to mitigate our risks relating to exchange rate fluctuations. Additional risks associated with international operations include difficulties in enforcing intellectual property rights, the burdens of complying with a wide variety of foreign laws, potentially adverse tax consequences, tariffs, quotas and other barriers and potential difficulties in collecting accounts receivable. In addition, we may face competition in other countries from companies that may have more experience with operations in such countries or with international operations generally. We may also face difficulties integrating new facilities in different countries into our existing operations, as well as integrating employees that we hire in different countries into our existing corporate culture. Our international expansion plans may not be successful and we may not be able to compete effectively in other countries. There can be no assurance that these and other factors will not have a material adverse effect on our business, results of operations and financial condition.

### **We face intense competition from other IT service providers.**

The intensely competitive IT professional services market includes a large number of participants and is subject to rapid change. This market includes participants from a variety of market segments, including:

systems integration firms;

contract programming companies;

application software companies;

Internet solutions providers;

the professional services groups of computer equipment companies; and

facilities management and outsourcing companies.

The market also includes numerous smaller local competitors in the various geographic markets in which we operate. Our direct competitors who use the on-site/offshore business model include, among others, Infosys Technologies, Tata Consultancy Services and WIPRO. In addition, many of our competitors have significantly greater financial, technical and marketing resources and greater name recognition than we do. Some of these larger competitors, such as Accenture, Electronic Data Systems and IBM Global Services, have offshore operations. We cannot assure you that we will be able to sustain our current levels of profitability or growth as competitive pressures, including competition for skilled IT development professionals and pricing pressure from competitors employing an on-site/offshore business model, increase.

### **Our business will suffer if we fail to develop new services and enhance our existing services in order to keep pace with the rapidly evolving technological environment.**

The IT services market is characterized by rapid technological change, evolving industry standards, changing customer preferences and new product and service introductions. Our future success will depend on our ability to develop solutions that keep pace with changes in the IT services market. We cannot assure you that we will be successful in developing new services addressing evolving technologies on a timely or cost-effective basis or, if these services are developed, that we will be successful in the marketplace. In addition, we cannot assure you that products, services or technologies developed by others will not render our services non-competitive or obsolete. Our failure to address these developments could have a material adverse effect on our business, results of operations and financial condition.

Our ability to remain competitive will also depend on our ability to design and implement, in a timely and cost-effective manner, solutions for customers moving from the mainframe environment to client/server or other advanced architectures. Our failure to design and implement solutions in a timely and cost-effective manner could have a material adverse effect on our business, results of operations and financial condition.





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### **We may face difficulties in providing end-to-end business solutions for our clients that could cause clients to discontinue their work with us, which in turn could harm our business.**

We have been expanding the nature and scope of our engagements and have added new service offerings, such as IT consulting, business process outsourcing, systems integration and outsourcing of entire portions of IT infrastructure. The success of these service offerings is dependent, in part, upon continued demand for such services by our existing and new clients and our ability to meet this demand in a cost-competitive and effective manner. In addition, our ability to effectively offer a wider breadth of end-to-end business solutions depends on our ability to attract existing or new clients to these service offerings. To obtain engagements for such end-to-end solutions, we also are more likely to compete with large, well-established international consulting firms, resulting in increased competition and marketing costs. Accordingly, we cannot be certain that our new service offerings will effectively meet client needs or that we will be able to attract existing and new clients to these service offerings.

The increased breadth of our service offerings may result in larger and more complex projects with our clients. This will require us to establish closer relationships with our clients and a thorough understanding of their operations. Our ability to establish such relationships will depend on a number of factors, including the proficiency of our IT professionals and our management personnel. Our failure to understand our client requirements or our failure to deliver services which meet the requirements specified by our clients could result in termination of client contracts, and we could be liable to our clients for significant penalties or damages.

Larger projects may involve multiple engagements or stages, and there is a risk that a client may choose not to retain us for additional stages or may cancel or delay additional planned engagements. These terminations, cancellations or delays may result from the business or financial condition of our clients or the economy generally, as opposed to factors related to the quality of our services. Such cancellations or delays make it difficult to plan for project resource requirements, and inaccuracies in such resource planning may have a negative impact on our profitability.

### **Competition for highly skilled technical personnel is intense and the success of our business depends on our ability to attract and retain highly skilled professionals.**

Our future success will depend to a significant extent on our ability to attract, train and retain highly skilled IT development professionals. In particular, we need to attract, train and retain project managers, IT engineers and other senior technical personnel. We believe there is a shortage of, and significant competition for, IT development professionals in the United States and India with the advanced technological skills necessary to perform the services we offer. We have subcontracted, to a limited extent in the past, and may do so in the future, with other service providers in order to meet our obligations to our customers. Our ability to maintain and renew existing engagements and obtain new business will depend, in large part, on our ability to attract, train and retain technical personnel with the skills that keep pace with continuing changes in information technology, evolving industry standards and changing customer preferences. Further, we must train and manage our growing work force, requiring an increase in the level of responsibility for both existing and new management personnel. We cannot assure you that the management skills and systems currently in place will be adequate or that we will be able to train and assimilate new employees successfully. Our failure to attract, train and retain current or future employees could have a material adverse effect on our business, results of operations and financial condition.

### **Our growth may be hindered by immigration restrictions.**

Our future success will depend on our ability to attract and retain employees with technical and project management skills from developing countries, especially India. The vast majority of our IT professionals in the United States and in Europe are Indian nationals. The ability of Indian nationals to work in the United States depends on their ability and our ability to obtain the necessary visas and work permits.

The H-1 B visa classification enables United States employers to hire qualified foreign workers in positions which require an education at least equal to a Baccalaureate Degree in the United States in specialty occupations such as IT systems engineering and systems analysis. The H-1 B visa usually permits an individual to work and live in the United States for a period of up to six years. There is a limit on the number of new H-1 B petitions that United States Citizenship and Immigration Services, or CIS, (one of the successor agencies to the Immigration and Naturalization Service) may approve in any federal fiscal year, and in years in which this limit is reached, we may be unable to obtain H-1 B visas necessary to bring foreign employees to the United States. In the current federal fiscal year, the limit is 65,000. The FY 2006 cap was reached on August 10, 2005. We can currently apply for H-1B s against the FY 2007 cap, for work starting October 1, 2006. The FY 2007 cap has not yet been reached but may be reached in the summer of 2006. However, as a part of our advanced planning process, we believe that we have sufficient employees visa-ready to meet our anticipated business growth in the current year. In addition, there are strict labor regulations associated with the H-1 B visa



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classification. Higher users of the H-1 B visa program are often subject to investigations by the Wage and Hour Division of the United States Department of Labor. A finding by the United States Department of Labor of willful or substantial failure by us to comply with existing regulations on the H-1 B classification may result in a ban on future use of the H-1 B program.

We also regularly transfer employees of our subsidiary in India to the United States to work on projects and at client sites, using the L-1 visa classification. The L-1 visa allows companies abroad to transfer certain managers, executives and employees with specialized company knowledge to related United States companies such as a parent, subsidiary, affiliate, joint venture or branch office. We have an approved Blanket L Program, under which the corporate relationships of our transferring and receiving entities have been pre-approved by the CIS, thus enabling individual L-1 applications to be presented directly to a United States consular post abroad rather than undergoing the pre-approval process in the United States. In recent years, both the United States consular posts that review initial L-1 applications and the CIS offices, which adjudicate extensions of L-1 status, have become more restrictive with respect to this category. As a result, the rate of refusals of initial L-1 applications and of extension denials has increased. In addition, even where L-1 visas are ultimately granted and issued, security measures undertaken by United States consular posts around the world have caused major delays in visa issuances. Our inability to bring qualified technical personnel into the United States to staff on-site customer locations would have a material adverse effect on our business, results of operations and financial condition.

On December 8, 2004, President Bush signed the FY 2005 Omnibus Appropriations Act. This legislation contained several important changes to the laws governing L-1 visa holders. All of the changes took effect on June 8, 2005. Under one provision of the new law, all L-1 applicants, including those brought to the United States under a Blanket Program, must have worked abroad with the related company for one full year in the prior three years. The provision allowing Blanket L applicants who had worked abroad for the related company for six months during the qualifying three-year period has been revoked. In addition, L-1B holders (intra-company transferees with specialized company knowledge) may not be primarily stationed at the work site of another employer if the L-1B holder will be controlled and supervised by an employer other than the petitioning employer. Finally, L-1B status may not be granted where placement of the L-1B visa holder at a third party site is part of an arrangement to provide labor for the third party, rather than placement at the site in connection with the provision of a product or service involving specialized knowledge specific to the petitioning employer.

We do not place L-1B workers at third party sites where they are under the supervision of a different employer, nor do we place L-1B holders at third party sites in an arrangement to provide labor for the third party, without providing a service involving our specialized knowledge. Since implementation of the new law, we have not encountered any difficulty in establishing this fact to the satisfaction of Citizenship and Immigration Services. However, the United States Department of State is still in the process of implementing this provision at United States consular posts abroad. If these posts decide to interpret these provisions in a very restrictive fashion, this could impair our ability to staff our projects in the United States with resources from our entities abroad. In addition, Citizenship and Immigration Services has not yet issued regulations governing these new provisions. If such regulations are restrictive in nature, this could impair our ability to staff our projects in the United States with resources from our entities abroad.

We also process immigrant visas for lawful permanent residence for employees to fill positions for which there are no able, willing and qualified United States workers available to fill the positions. Compliance with existing United States immigration and labor laws, or changes in those laws making it more difficult to hire foreign nationals or limiting our ability to successfully obtain permanent residence for our foreign employees in the United States, could require us to incur additional unexpected labor costs and expenses or could restrain our ability to retain the skilled professionals we need for our operations in the United States. Any of these restrictions or limitations on our hiring practices could have a material adverse effect on our business, results of operations and financial condition.

In addition to immigration restrictions in the United States, there are certain restrictions on transferring our employees to work in the United Kingdom, where we have experienced significant growth. The United Kingdom requires that employees who are not nationals of the European Economic Area (EEA), which includes nationals of all European Union countries plus Iceland, Norway, Liechtenstein and Switzerland, to obtain an intra-company transfer work permit before beginning to perform work. Under the work permit regulations, in order for us to transfer our non-EEA employees to the United Kingdom, we must demonstrate that the employee had been employed by us for at least six months prior to the transfer and that the position in the United Kingdom requires someone with either: (1) a United Kingdom degree level qualification; or (2) a Higher National Diploma (HND) level occupational qualification which entitles a person to do a specific job; or (3) a general HND level qualification plus one year's work experience doing the type of job for which the work permit is sought; or (4) at least three years' high-level specialist skills acquired through doing the type of job for which the work permit is sought. These restrictions restrain our ability to add the skilled professionals we need for our operations in Europe, and could have an adverse affect on our international strategy to expand our presence in Europe. As a result, the work permit legislation in the United Kingdom could have a material adverse effect on our business, results of operations and financial condition.



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Immigration and work permit laws and regulations in the United States, the United Kingdom and other countries are subject to legislative and administrative changes as well as changes in the application of standards and enforcement. Immigration and work permit laws and regulation can be significantly affected by political forces and levels of economic activity. Our international expansion strategy and our business, results of operations and financial condition may be materially adversely affected if changes in immigration and work permit laws and regulations or the administration or enforcement of such laws or regulations impair our ability to staff projects with IT professionals who are not citizens of the country where the work is to be performed.

### **Anti-outsourcing legislation, if adopted, could adversely affect our business, financial condition and results of operations and impair our ability to service our customers.**

The issue of outsourcing of services abroad by American companies is a topic of political discussion in the United States. Measures aimed at limiting or restricting outsourcing by United States companies are under discussion in Congress and in numerous state legislatures. While no substantive anti-outsourcing legislation has been introduced to date, given the ongoing debate over this issue, the introduction of such legislation is possible. If introduced, such measures are likely to fall within two categories: (1) a broadening of restrictions on outsourcing by federal and state government agencies and on government contracts with firms that outsource services directly or indirectly, and/or (2) measures that impact private industry, such as tax disincentives or intellectual property transfer restrictions. In the event that any of these measures become law, our business, financial condition and results of operations could be adversely affected and our ability to service our customers could be impaired.

### **An economic slowdown, hostilities involving the United States, and other acts of terrorism, violence or war could delay or reduce the number of new purchase orders we receive and impair our ability to service our customers, thereby adversely affecting our business, financial condition and results of operations.**

Approximately 87% of our revenue during the year ended December 31, 2005 and during the three months ended March 31, 2006, was derived from customers located in the United States. In the event of an economic slowdown, our customers may delay or reduce their IT spending significantly, which may in turn lower the demand for our services and could have a material adverse affect on our financial results. Further, hostilities involving the United States and other acts of terrorism, violence or war, such as the attacks of September 11, 2001 in the United States, the attacks of July 7, 2005 in the United Kingdom, and the continuing conflict in Iraq, could materially adversely affect our operations and our ability to service our customers. Hostilities involving the United States could cause customers in the United States to delay their decisions on IT spending, which could affect our financial results. In addition, acts of terrorism, violence or war could give rise to military or travel disruptions and restrictions affecting our employees. As of March 31, 2006, a majority of our technical professionals were located in India, and the vast majority of our technical professionals in the United States and Europe are Indian nationals who are able to work in the United States and Europe only because they hold current visas and work permits. Travel restrictions could cause us to incur additional unexpected labor costs and expenses or could restrain our ability to retain the skilled professionals we need for our operations in the United States and Europe.

Although we continue to believe that we have a strong competitive position in the United States, we continue to increase our efforts to geographically diversify our clients and revenue. Despite our efforts to diversify, an economic slowdown, hostilities involving the United States, and other acts of terrorism, violence or war may reduce the demand for our services and negatively affect our revenues and profitability.

### **Our ability to operate and compete effectively could be impaired if we lose key personnel.**

Our future performance depends to a significant degree upon the continued service of the key members of our management team, as well as marketing, sales and technical personnel, and our ability to attract and retain new management and other personnel. We do not maintain key man life insurance on any of our executive officers or significant employees. Competition for personnel is intense, and there can be no assurance that we will be able to retain our key employees or that we will be successful in attracting and retaining new personnel in the future. The loss of any one or more of our key personnel or the failure to attract and retain key personnel could have a material adverse effect on our business, results of operations and financial condition.

### **Restrictions in non-competition agreements with our executive officers may not be enforceable.**

We have entered into non-competition agreements with all of our executive officers. We cannot assure you, however, that the restrictions in these agreements prohibiting the executive officers from engaging in competitive activities are enforceable. Further, substantially all of our professional non-executive staff are not covered by agreements that would prohibit them from working for our



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competitors. If any of our key professional personnel leaves our employment and joins one of our competitors, our business could be adversely affected.

### **Our earnings may be adversely affected if we change our intent not to repatriate earnings in India.**

Effective January 1, 2002, pursuant to Accounting Principles Board Opinion No. 23, Accounting for Income Taxes-Special Areas, we no longer accrue incremental United States taxes on all Indian earnings recognized in 2002 and subsequent periods as these earnings are considered to be indefinitely reinvested outside of the United States. While we have no plans to do so, events may occur in the future that could effectively force us to change our intent on repatriating Indian earnings. If we change our intent and repatriate such earnings, we will have to accrue the applicable amount of taxes associated with such earnings and pay taxes at a substantially higher rate than our effective income rate in 2006. These increased taxes could have a material adverse effect on our business, results of operations and financial condition.

### **A significant portion of our projects are on a fixed-price basis, subjecting us to the risks associated with cost over-runs and operating cost inflation.**

We contract to provide services either on a time-and-materials basis or on a fixed-price basis, with fixed-price contracts accounting for approximately 25% of our revenues for the year ended December 31, 2005 and approximately 26% of our revenues for the three months ended March 31, 2006. We expect that an increasing number of our future projects will be contracted on a fixed-price basis. We bear the risk of cost over-runs and operating cost inflation in connection with projects covered by fixed-price contracts. Our failure to estimate accurately the resources and time required for a fixed-price project, or our failure to complete our contractual obligations within the time frame committed, could have a material adverse effect on our business, results of operations and financial condition.

### **If we do not continue to improve our operational, financial and other internal controls and systems to manage our rapid growth, our business may suffer and the value of our shareholders' investment may be harmed.**

Our anticipated growth will continue to place significant demands on our management and other resources. Our growth will require us to continue to develop and improve our operational, financial and other internal controls, both in the United States, India and elsewhere. In particular, our continued growth will increase the challenges involved in:

recruiting and retaining sufficiently skilled technical, marketing and management personnel;

adhering to our high quality standards;

maintaining high levels of client satisfaction;

developing and improving our internal administrative infrastructure, particularly our financial, operational, communications and other internal systems; and

preserving our culture, values and entrepreneurial environment.

As part of our growth strategy, we are expanding our operations in Europe and Asia. We may not be able to compete effectively in these markets and the cost of entering these markets may be substantially greater than we expect. If we fail to compete effectively in the new markets we enter, or if the cost of entering those markets is substantially greater than we expect, our business, results of operations and financial condition could be adversely affected. In addition, if we cannot compete effectively, we may be required to reconsider our strategy to invest in our international expansion plans and change our intent on the repatriation of our earnings.

### **We rely on a few customers for a large portion of our revenues.**

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Our top five customers generated approximately 34% of our revenues in the year ended December 31, 2005 and approximately 30% of our revenues in the three months ended March 31, 2006. The volume of work performed for specific customers is likely to vary from year to year, and a major customer in one year may not use our services in a subsequent year. The loss of one of our large customers could have a material adverse effect on our business, results of operations and financial condition.



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### **We generally do not have long-term contracts with our customers.**

Consistent with industry practice, we generally do not enter into long-term contracts with our customers. As a result, we are substantially exposed to volatility in the market for our services, and may not be able to maintain our level of profitability. If we are unable to market our services on terms we find acceptable, our financial condition and results of operations could suffer materially.

### **Our operating results experience significant quarterly fluctuations.**

We historically have experienced significant quarterly fluctuations in our revenues and results of operations and expect these fluctuations to continue. Among the factors causing these variations have been:

the number, timing, scope and contractual terms of IT development and maintenance projects in which we are engaged;

delays incurred in the performance of those projects;

the accuracy of estimates of resources and time required to complete ongoing projects; and

general economic conditions.

In addition, our future revenues, operating results and margins may fluctuate as a result of:

changes in pricing in response to customer demand and competitive pressures;

the mix of on-site and offshore staffing;

the ratio of fixed-price contracts versus time-and-materials contracts;

employee wage levels and utilization rates;

changes in foreign exchange rates;

the timing of collection of accounts receivable;

changes in domestic and international income tax rates and regulations; and

changes to levels and types of equity-based compensation awards and assumptions used to determine the fair value of such awards. A high percentage of our operating expenses, particularly personnel and rent, are relatively fixed in advance of any particular quarter. As a result, unanticipated variations in the number and timing of our projects or in employee wage levels and utilization rates may cause significant variations in our operating results in any particular quarter, and could result in losses. Any significant shortfall of revenues in relation to our

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expectations, any material reduction in utilization rates for our professional staff or variance in the on-site, offshore staffing mix, an unanticipated termination of a major project, a customer's decision not to pursue a new project or proceed to succeeding stages of a current project or the completion during a quarter of several major customer projects could require us to pay underutilized employees and could therefore have a material adverse effect on our business, results of operations and financial condition.

As a result of these factors, it is possible that in some future periods, our revenues and operating results may be significantly below the expectations of public market analysts and investors. In such an event, the price of our common stock would likely be materially and adversely affected.

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### **We may not be able to sustain our current level of profitability.**

For the year ended December 31, 2005, we had a gross margin of 45.8% and operating margin of 20.1%, compared to a gross margin of 45.5% and operating margin of 20.0% for the year ended December 31, 2004. Our gross margin was 44.4% and operating margin was 18.6% for the three months ended March 31, 2006. These margins have declined as a result of the adoption of SFAS 123R, which required us to record stock compensation effective January 1, 2006. They may decline further if we experience declines in demand and pricing for our services. In addition, wages in India are increasing at a faster rate than in the United States, which could result in us incurring increased costs for technical professionals. Additionally, the number of stock options issued and the assumptions used in the stock option pricing model may change resulting in increased stock option expense and lower margins. Although we have been able to partially offset wage increases and foreign currency fluctuations through further leveraging of our low-cost operating structure and obtaining price increases and have been issuing a lower number of options than in earlier years, we cannot assure you that we will be able to continue to do so in the future.

### **Liability claims for damages caused by disclosure of confidential information or system failures could have a material adverse effect on our business.**

Many of our engagements involve projects that are critical to the operations of our 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 us, regardless of our responsibility for the failure. Although we attempt to limit by contract our liability for damages arising from negligent acts, errors, mistakes or omissions in rendering our IT development and maintenance services, we cannot assure you that any contractual limitations on liability will be enforceable in all instances or will otherwise protect us from liability for damages.

In addition, we often have access to or are required to collect and store confidential client and customer data. If any person, including any of our employees, penetrates our network security or misappropriates sensitive data, we could be subject to significant liability from our clients or from our clients' customers for breaching contractual confidentiality provisions or privacy laws. Unauthorized disclosure of sensitive or confidential client and customer data, whether through breach of our computer systems, systems failure or otherwise, could damage our reputation and cause us to lose clients.

Although we have general liability insurance coverage, including coverage for errors or omissions, there can be no assurance that 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 business, results of operations and financial condition.

### **We may have potential liability arising from the IMS Health exchange offer in the event that we breach any of our representations in connection with the Distribution Agreement entered into with IMS Health.**

We entered into a Distribution Agreement, dated January 7, 2003, with IMS Health, the Distribution Agreement, that 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 United States federal income tax consequences of the exchange offer. In addition, pursuant to the Distribution Agreement, we agreed to indemnify 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 of the representations that we made 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 have a material adverse effect on our results of operations, financial position and cash flows.

### **We may be subject to legacy Dun & Bradstreet liabilities that could have an adverse effect on our results of operations and financial condition.**

In 1996, The Dun & Bradstreet Corporation, now known as R.H. Donnelly Corporation, split itself into three separate companies: The Dun & Bradstreet Corporation, Cognizant Corporation and ACNielsen Corporation. In connection with the split-up transaction, The Dun & Bradstreet Corporation, Cognizant Corporation (renamed Nielsen Media Research), of which we were once a part, and ACNielsen Corporation (now a subsidiary of the Dutch company VNU N.A.) entered into a distribution agreement. In the 1996



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distribution agreement, each party assumed the liabilities relating to the businesses allocated to it and agreed to indemnify the other parties and their subsidiaries against those liabilities and certain other matters. The 1996 distribution agreement also prohibited each party thereto from distributing to our stockholders any business allocated to it unless the distributed business delivered undertakings agreeing to be jointly and severally liable to the other parties under the 1996 distribution agreement for the liabilities of the distributing parent company under the 1996 distribution agreement. IMS Health made such undertaking when it was spun off by Nielsen Media Research in 1998 and, accordingly, IMS Health and Nielsen Media Research are jointly and severally liable to R.H. Donnelly and ACNielsen for Cognizant Corporation obligations under the terms of the 1996 distribution agreement. IMS Health has requested similar undertakings from us as a condition to the distribution of our shares in the exchange offer. IMS Health is obligated to procure similar undertakings from us to Nielsen Media Research and Synavant Inc. with respect to liabilities allocated to IMS Health in connection with Nielsen Media Research's spin-off of IMS Health and IMS Health's spin-off of Synavant Inc. In connection with the exchange offer, we gave these undertakings and, as a result, we may be subject to claims in the future in relation to legacy liabilities.

One possible legacy liability arises from a pending antitrust action filed by Information Resources Inc. in 1996, which names as joint defendants all parties to the 1996 distribution agreement. Information Resources' complaint alleges damages in excess of \$350 million, which amount it has asked to be trebled, plus punitive damages. ACNielsen Corporation agreed in connection with the 1996 distribution agreement to assume any and all liabilities resulting from the Information Resources claim to the extent that ACNielsen remains financially viable. In connection with VNU's acquisition of ACNielsen in 2001, VNU was required to assume this liability and to be included with ACNielsen for purposes of determining the amount that can be paid by ACNielsen in respect of any claim. IMS Health and Nielsen Media Research, Inc., successors to Cognizant Corporation, have agreed to share liabilities in excess of the amount ACNielsen is required to pay under the 1996 distribution agreement in respect of this claim on a 50-50 basis with The Dun & Bradstreet Corporation (subsequently separated into The Dun & Bradstreet Corporation and Moody's Corporation). IMS Health and Nielsen Media Research, Inc. further agreed to share their portion of the liabilities in relation to the Information Resources action on a 75-25 basis, subject to Nielsen Media Research, Inc.'s liability in respect of the Information Resources action and certain other contingent liabilities being capped at \$125.0 million. Based on our undertaking, we could be held liable for those amounts that VNU, IMS Health, Nielsen Media Research, Inc., and The Dun & Bradstreet Corporation and their successors are unable or unwilling to pay.

Other claims have arisen in the past and may arise in the future under the 1996 distribution agreement or the distribution agreements relating to Nielsen Media Research's spin-off of IMS Health and IMS Health's spin-off of Synavant Inc., in which case we may be jointly and severally liable for any losses suffered by the parties entitled to indemnification.

IMS Health has agreed to indemnify us for any and all liabilities that arise out of our undertakings to be jointly and severally liable for these liabilities, but if for any reason IMS Health does not perform on our indemnification obligation, these liabilities could have a material adverse effect on our financial condition and results of operations.

**If we are unable to protect our intellectual property rights, or if we infringe on the intellectual property rights of others, our business may be adversely affected.**

Our future success will depend in part on our ability to protect our intellectual property rights. We presently hold no patents or registered copyrights, and rely upon a combination of copyright and trade secret laws, non-disclosure and other contractual arrangements and various security measures to protect our intellectual property rights. India is a member of the Berne Convention, and has agreed to recognize protections on copyrights conferred under the laws of foreign countries, including the laws of the United States. We believe that laws, rules, regulations and treaties in effect in the United States and India are adequate to protect us from misappropriation or unauthorized use of our copyrights. However, there can be no assurance that these laws will not change and, in particular, that the laws of India or the United States will not change in ways that may prevent or restrict the transfer of software components, libraries and toolsets from India to the United States or from the United States to India. There can be no assurance that the steps we have taken to protect our intellectual property rights will be adequate to deter misappropriation of any of our intellectual property, or that we will be able to detect unauthorized use and take appropriate steps to enforce our rights. Unauthorized use of our intellectual property may result in development of technology, products or services which compete with our products and unauthorized parties may infringe upon or misappropriate our products, services or proprietary information.

Although we believe that our intellectual property rights do not infringe on the intellectual property rights of any of our competitors or others, there can be no assurance that infringement claims will not be asserted against us in the future, that assertion of infringement claims will not result in litigation or that we would prevail in that litigation or be able to obtain a license for the use of any infringed intellectual property from a third party on commercially reasonable terms, if at all. We expect that the risk of

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infringement claims against us will increase if our competitors are able to obtain patents for software products and processes. Any infringement claims, regardless of their outcome, could result in substantial cost to us and divert management's attention from our operations. Any infringement claim or litigation against us could, therefore, have a material adverse effect on our business, results of operations and financial condition.

### **We may be unable to integrate acquired companies or technologies successfully and we may be subject to certain liabilities assumed in connection with our acquisitions that could harm our operating results.**

We believe that opportunities exist in the fragmented IT services market to expand our business through selective strategic acquisitions and joint ventures. We believe that acquisition and joint venture candidates may enable us to expand our geographic presence, especially in the European market, enter new technology areas or expand our capacity. We cannot assure you that we will identify suitable acquisition candidates available for sale at reasonable prices, consummate any acquisition or joint venture or successfully integrate any acquired business or joint venture into our operations. Further, acquisitions and joint ventures involve a number of special risks, including diversion of management's attention, failure to retain key personnel, unanticipated events or circumstances and legal liabilities, some or all of which could have a material adverse effect on our business, results of operations and financial condition. We may finance any future acquisitions with cash, debt financing, the issuance of equity securities or a combination of the foregoing. We cannot assure you that we will be able to arrange adequate financing on acceptable terms. In addition, acquisitions financed with the issuance of our equity securities could be dilutive.

Although we conduct due diligence in connection with each of our acquisitions, there may be liabilities that we fail to discover or that we inadequately assess in our due diligence efforts. In particular, to the extent that prior owners of any acquired businesses or properties failed to comply with or otherwise violated applicable laws or regulations, or failed to fulfill their contractual obligations to customers, we, as the successor owner, may be financially responsible for these violations and failures and may suffer reputational harm or otherwise be adversely affected. While we generally require the selling party to indemnify us for any and all liabilities associated with such liabilities, if for any reason the seller does not perform their indemnification obligation, we may be held responsible for such liabilities. The discovery of any material liabilities associated with our acquisitions for which we are unable to receive indemnification for could harm our operating results.

### **System failure or disruptions in telecommunications could disrupt our business and result in lost customers and curtailed operations which would reduce our revenue and profitability.**

To deliver our services to our customers, we must maintain a high speed network of satellite, fiber optic and land lines and an active voice and data communications 24 hours a day between our main offices in Chennai, our other IT development centers in India and globally and the offices of our customers worldwide. Although we maintain redundancy facilities and satellite communications links, any systems failure or a significant lapse in our ability to transmit voice and data through satellite and telephone communications could result in lost customers and curtailed operations which would reduce our revenue and profitability.

### **Provisions in our charter, by-laws and stockholders' rights plan and provisions under Delaware law may discourage unsolicited takeover proposals.**

Provisions in our charter and by-laws, each as amended, our stockholders' rights plan and Delaware General Corporate Law, or DGCL, may have the effect of deterring unsolicited takeover proposals or delaying or preventing changes in our control or management, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. In addition, these documents and provisions may limit the ability of stockholders to approve transactions that they may deem to be in their best interests. Our board of directors has the authority, without further action by the stockholders, to fix the rights and preferences, and issue shares of preferred stock. Our charter provides for a classified board of directors, which will prevent a change of control of our board of directors at a single meeting of stockholders. The prohibition of our stockholders' ability to act by written consent and to call a special meeting will delay stockholder actions until annual meetings or until a special meeting is called by our chairman or chief executive officer or our board of directors. The supermajority-voting requirement for specified amendments to our charter and by-laws allows a minority of our stockholders to block those amendments. The DGCL also contains provisions preventing stockholders from engaging in business combinations with us, subject to certain exceptions. These provisions could also discourage bids for our common stock at a premium as well as create a depressive effect on the market price of the shares of our common stock.

Compliance with new and changing corporate governance and public disclosure requirements adds uncertainty to our compliance policies and increases our costs of compliance.



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Changing laws, regulations and standards relating to accounting, corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, and Nasdaq National Market rules, are creating uncertainty for companies like ours. These new or changed laws, regulations and standards may lack specificity and are subject to varying interpretations. Their application in practice may evolve over time, as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs of compliance as a result of ongoing revisions to such corporate governance standards.

In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding our required assessment of our internal controls over financial reporting and our external auditors' audit of that assessment requires the commitment of significant financial and managerial resources. We consistently assess the adequacy of our internal controls over financial reporting, remediate any control deficiencies that may be identified, and validate through testing that our controls are functioning as documented. While we do not anticipate any material weaknesses, 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.

We are committed to maintaining high standards of corporate governance and public disclosure, and our efforts to comply with evolving laws, regulations and standards in this regard have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In addition, the new laws, regulations and standards regarding corporate governance may make it more difficult for us to obtain director and officer liability insurance. Further, our board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with their performance of duties. As a result, we may face difficulties attracting and retaining qualified board members and executive officers, which could harm our business. If we fail to comply with new or changed laws, regulations or standards of corporate governance, our business and reputation may be harmed.

**Item 6. Exhibits.**

(a) Exhibits.

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 31.1*              | Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                |
| 31.2*              | Certification of principal financial and accounting officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                 |
| 32.1*              | Certification of principal executive officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. 1350.                |
| 32.2*              | Certification of principal financial and accounting officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. 1350. |

\* Filed herewith.



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Cognizant Technology Solutions Corporation

Date: May 9, 2006

By: /s/ Lakshmi Narayanan  
Lakshmi Narayanan,  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 9, 2006

By: /s/ Gordon Coburn  
Gordon Coburn,  
Executive Vice President, Chief Financial  
Officer, Treasurer and Secretary  
(Principal Financial and Accounting Officer)