

H&R BLOCK INC  
Form 10-Q  
December 11, 2006

**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

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

**For the quarterly period ended October 31, 2006**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-6089**

**H&R Block, Inc.**

**(Exact name of registrant as specified in its charter)**

**MISSOURI  
(State or other jurisdiction of  
incorporation or organization)**

**44-0607856  
(I.R.S. Employer  
Identification No.)**

**One H&R Block Way  
Kansas City, Missouri 64105  
(Address of principal executive offices, including zip code)**

**(816) 854-3000**

**(Registrant's telephone number, including area code)**

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of the registrant's Common Stock, without par value, at the close of business on November 30, 2006 was 322,303,715 shares.

**Form 10-Q for the Period Ended October 31, 2006**  
**Table of Contents**

	<u>Page</u>
PART I Financial Information	
<u>Item 1. Condensed Consolidated Balance Sheets October 31, 2006 and April 30, 2006</u>	1
<u>Condensed Consolidated Statements of Income and Comprehensive Income Three and Six Months Ended October 31, 2006 and 2005</u>	2
<u>Condensed Consolidated Statements of Cash Flows Six Months Ended October 31, 2006 and 2005</u>	3
<u>Notes to Condensed Consolidated Financial Statements</u>	4
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	41
<u>Item 4. Controls and Procedures</u>	41
PART II Other Information	
<u>Item 1. Legal Proceedings</u>	41
<u>Item 1A. Risk Factors</u>	44
<u>Item 2. Unregistered Sales of Equity Securities</u>	44
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	44
<u>Item 6. Exhibits</u>	45
<b><u>SIGNATURES</u></b>	46
<u>Omnibus Amendment No. 2</u>	
<u>Omnibus Amendment Number One</u>	
<u>Fourth Amended and Restated Pricing Side Letter</u>	
<u>Omnibus Amendment Number One</u>	
<u>Omnibus Amendment No. 3</u>	
<u>Omnibus Amendment Number Two</u>	
<u>Certification by Chief Executive Officer</u>	
<u>Certification by Chief Financial Officer</u>	
<u>Certification by Chief Executive Officer</u>	
<u>Certification by Chief Financial Officer</u>	

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**Table of Contents****CONDENSED CONSOLIDATED BALANCE SHEETS**

	(amounts in 000s, except share amounts)	
	October 31, 2006 (Unaudited)	April 30, 2006
<b>ASSETS</b>		
Cash and cash equivalents	\$ 442,273	\$ 694,358
Cash and cash equivalents restricted	416,855	394,069
Marketable securities trading	76,286	16,141
Receivables from customers, brokers, dealers and clearing organizations, net	413,237	496,577
Receivables, less allowance for doubtful accounts of \$64,871 and \$64,480	413,320	467,677
Mortgage loans held for sale	432,064	236,399
Prepaid expenses and other current assets	574,538	483,215
<b>Total current assets</b>	<b>2,768,573</b>	<b>2,788,436</b>
Residual interests in securitizations available-for-sale	148,966	159,058
Beneficial interest in Trusts trading	123,278	188,014
Mortgage servicing rights	269,679	272,472
Mortgage loans held for investment, net	683,839	407,538
Property and equipment, at cost less accumulated depreciation and amortization of \$755,730 and \$704,792	467,543	443,785
Intangible assets, net	196,444	219,494
Goodwill, net	1,134,576	1,100,452
Other assets	413,993	409,886
<b>Total assets</b>	<b>\$ 6,206,891</b>	<b>\$ 5,989,135</b>

**LIABILITIES AND STOCKHOLDERS EQUITY****Liabilities:**

Commercial paper	\$ 1,040,429	\$
Current portion of long-term debt	509,021	506,992
Accounts payable to customers, brokers and dealers	700,673	781,303
Customer banking deposits	595,769	
Accounts payable, accrued expenses and other current liabilities	651,156	768,505
Accrued salaries, wages and payroll taxes	146,589	330,946
Accrued income taxes	172,834	505,690
<b>Total current liabilities</b>	<b>3,816,471</b>	<b>2,893,436</b>
Long-term debt	411,705	417,539
Other noncurrent liabilities	350,086	530,361
<b>Total liabilities</b>	<b>4,578,262</b>	<b>3,841,336</b>

**Stockholders equity:**

Common stock, no par, stated value \$.01 per share, 800,000,000 shares authorized, 435,890,796 shares issued at October 31, 2006 and April 30, 2006	4,359	4,359
Additional paid-in capital	658,920	653,053
Accumulated other comprehensive income	21,593	21,948
Retained earnings	3,119,997	3,492,059
Less cost of 113,975,390 and 107,377,858 shares of common stock in treasury	(2,176,240)	(2,023,620)
Total stockholders equity	1,628,629	2,147,799
Total liabilities and stockholders equity	\$ 6,206,891	\$ 5,989,135

See Notes to Condensed Consolidated Financial Statements

-1-

**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

	(Unaudited, amounts in 000s, except per share amounts)			
	Three months ended October 31,		Six months ended October 31,	
	2006	2005	2006	2005
<b>Revenues:</b>				
Service revenues	\$ 462,828	\$ 384,263	\$ 884,527	\$ 699,391
Other revenues:				
Gains on sales of mortgage assets, net	38,601	147,267	102,514	383,698
Interest income	44,599	55,010	85,609	104,263
Product and other revenues	17,213	18,503	31,370	32,684
	563,241	605,043	1,104,020	1,220,036
<b>Operating expenses:</b>				
Cost of services	492,861	398,064	948,359	748,990
Cost of other revenues	97,236	134,864	189,250	258,221
Selling, general and administrative	229,116	195,702	435,705	377,246
	819,213	728,630	1,573,314	1,384,457
Operating loss	(255,972)	(123,587)	(469,294)	(164,421)
Interest expense	(12,091)	(12,385)	(24,226)	(24,820)
Other income, net	5,271	2,843	12,069	10,243
Loss before income tax benefit	(262,792)	(133,129)	(481,451)	(178,998)
Income tax benefit	(106,332)	(51,880)	(193,614)	(69,755)
Net loss	\$ (156,460)	\$ (81,249)	\$ (287,837)	\$ (109,243)
<b>Basic and diluted loss per share</b>	\$ (0.49)	\$ (0.25)	\$ (0.89)	\$ (0.33)
<b>Basic and diluted shares</b>	321,742	326,047	322,706	328,381
<b>Dividends per share</b>	\$ 0.14	\$ 0.13	\$ 0.26	\$ 0.24
<b>Comprehensive income (loss):</b>				
Net loss	\$ (156,460)	\$ (81,249)	\$ (287,837)	\$ (109,243)
	1,667	(23,653)	(844)	(29,464)

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Change in unrealized gain on available-for-sale securities, net				
Change in foreign currency translation adjustments	(329)	4,385	489	5,209
Comprehensive income (loss)	\$ (155,122)	\$ (100,517)	\$ (288,192)	\$ (133,498)

See Notes to Condensed Consolidated Financial Statements

-2-

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**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	(Unaudited, amounts in 000s)	
Six months ended October 31,	2006	2005
<b>Cash flows from operating activities:</b>		
Net loss	\$ (287,837)	\$ (109,243)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	96,384	90,173
Accretion of residual interests in securitizations	(26,387)	(64,341)
Impairments of available-for-sale residual interests	29,502	20,613
Additions to trading residual interests in securitizations, net	(111,405)	(185,645)
Proceeds from net interest margin transactions, net	52,580	85,472
Realized gain on sale of available-for-sale residual interests		(28,675)
Additions to mortgage servicing rights	(92,914)	(136,294)
Amortization and impairment of mortgage servicing rights	95,707	56,980
Tax benefits from stock-based compensation	8,888	14,129
Excess tax benefits from stock-based compensation	(1,567)	
Other, net of acquisitions	(953,243)	(448,028)
<b>Net cash used in operating activities</b>	<b>(1,190,292)</b>	<b>(704,859)</b>
<b>Cash flows from investing activities:</b>		
Cash received from available-for-sale residual interests	6,422	64,377
Cash received from sale of available-for-sale residual interests		30,497
Mortgage loans originated for investment, net	(278,003)	
Purchases of property and equipment, net	(94,787)	(77,635)
Payments made for business acquisitions, net of cash acquired	(13,609)	(200,309)
Other, net	8,088	13,151
<b>Net cash used in investing activities</b>	<b>(371,889)</b>	<b>(169,919)</b>
<b>Cash flows from financing activities:</b>		
Repayments of commercial paper	(2,295,573)	(1,101,729)
Proceeds from issuance of commercial paper	3,336,002	1,599,904
Customer deposits	595,769	
Dividends paid	(84,225)	(77,381)
Acquisition of treasury shares	(186,560)	(259,745)
Excess tax benefits from stock-based compensation	1,567	
Proceeds from exercise of stock options	10,640	42,663
Other, net	(67,524)	(36,657)
<b>Net cash provided by financing activities</b>	<b>1,310,096</b>	<b>167,055</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(252,085)</b>	<b>(707,723)</b>
<b>Cash and cash equivalents at beginning of the period</b>	<b>694,358</b>	<b>1,100,213</b>



<b>Cash and cash equivalents at end of the period</b>	\$ 442,273	\$ 392,490
<b>Supplementary cash flow data:</b>		
Income taxes paid	\$ 313,016	\$ 169,223
Interest paid	49,575	50,098

See Notes to Condensed Consolidated Financial Statements

-3-

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**Table of Contents**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

**1. Basis of Presentation**

The condensed consolidated balance sheet as of October 31, 2006, the condensed consolidated statements of income and comprehensive income for the three and six months ended October 31, 2006 and 2005, and the condensed consolidated statements of cash flows for the six months ended October 31, 2006 and 2005 have been prepared by the Company, without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows at October 31, 2006 and for all periods presented have been made.

H&R Block, the Company, we, our and us are used interchangeably to refer to H&R Block, Inc. or to H&R Block, Inc. and its subsidiaries, as appropriate to the context.

Certain reclassifications have been made to prior year amounts to conform to the current year presentation. These reclassifications had no effect on our results of operations or stockholders' equity as previously reported. In March 2006, the Office of Thrift Supervision (OTS) approved the charter of H&R Block Bank (HRB Bank). HRB Bank commenced operations on May 1, 2006, at which time we realigned certain segments of our business to reflect a new management reporting structure. The previously reported Investment Services segment, H&R Block Mortgage Corporation (HRBMC), which was previously included in the Mortgage Services segment, and HRB Bank have been combined in the Consumer Financial Services segment. Presentation of prior-year results reflects the new segment alignment. See note 11 for additional information on this new segment.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in our April 30, 2006 Annual Report to Shareholders on Form 10-K.

Operating revenues of the Tax Services and Business Services segments are seasonal in nature with peak revenues occurring in the months of January through April. Therefore, results for interim periods are not indicative of results to be expected for the full year.

**2. Earnings (Loss) Per Share**

Basic and diluted loss per share is computed using the weighted average shares outstanding during each period. The dilutive effect of potential common shares is included in diluted earnings per share except in those periods with a loss. Diluted earnings per share excludes the impact of shares of common stock issuable upon the lapse of certain restrictions or the exercise of options to purchase 32.5 million shares of stock for the three and six months ended October 31, 2006, and 32.6 million shares of stock for the three and six months ended October 31, 2005, as the effect would be antidilutive due to the net loss recorded during each of the respective periods.

The weighted average shares outstanding for the three and six months ended October 31, 2006 decreased to 321.7 million and 322.7 million, respectively, from 326.0 million and 328.4 million last year, primarily due to our purchases of treasury shares. The effect of these purchases was partially offset by the issuance of treasury shares related to our stock-based compensation plans.

During the six months ended October 31, 2006 and 2005, we issued 1.8 million and 3.3 million shares of common stock, respectively, pursuant to the exercise of stock options, employee stock purchases and awards of nonvested shares, in accordance with our stock-based compensation plans.

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During the six months ended October 31, 2006, we acquired 8.4 million shares of our common stock, of which 8.1 million shares were purchased from third parties with the remaining shares swapped or surrendered to us, at an aggregate cost of \$186.6 million. During the six months ended October 31, 2005, we acquired 9.2 million shares of our common stock, of which 9.0 million shares were purchased from third parties with the remaining shares swapped or surrendered to us, at an aggregate cost of \$259.7 million.

-4-

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**Table of Contents****3. Mortgage Banking Activities**

Activity related to trading residual interests in securitizations consists of the following:

	(in 000s)	
Six months ended October 31,	2006	2005
Balance, beginning of period	\$	\$
Additions resulting from securitization of mortgage loans	119,669	191,469
Cash received	(8,103)	(7,894)
Accretion	1,766	2,416
Change of fair value	(161)	2,070
Residuals securitized	(56,814)	(94,196)
Balance, end of period	\$ 56,357	\$ 93,865

At October 31, 2006 and 2005, we had \$56.4 million and \$93.9 million, respectively, in residual interests classified as trading securities, which are included in marketable securities - trading on the condensed consolidated balance sheets. These residual interests are the result of the initial securitization of mortgage loans and those held at October 31, 2006 are expected to be securitized in a net interest margin (NIM) transaction during our third quarter. There were no such trading securities recorded as of April 30, 2006. Cash received on trading residual interests is included in operating activities in the condensed consolidated statements of cash flows.

Activity related to available-for-sale residual interests in securitizations consists of the following:

	(in 000s)	
Six months ended October 31,	2006	2005
Balance, beginning of period	\$ 159,058	\$ 205,936
Additions from NIM transactions	4,234	8,724
Cash received	(6,422)	(64,377)
Cash received on sale of residual interests		(30,497)
Accretion	24,621	61,925
Impairment of fair value	(29,502)	(20,613)
Other	(1,672)	366
Changes in unrealized holding gains, net	(1,351)	(18,682)
Balance, end of period	\$ 148,966	\$ 142,782

Cash flows from available-for-sale residual interests of \$6.4 million and \$64.4 million were received from the securitization trusts for the six months ended October 31, 2006 and 2005, respectively, and is included in investing activities in the condensed consolidated statements of cash flows.

Aggregate unrealized gains on available-for-sale residual interests not yet accreted into income totaled \$42.5 million at October 31, 2006 and \$44.1 million at April 30, 2006. These unrealized gains are recorded net of deferred taxes in other comprehensive income, and may be recognized in income in future periods either through accretion or upon further securitization or sale of the related residual interest.

Activity related to mortgage servicing rights (MSRs) consists of the following:

	(in 000s)	
Six months ended October 31,	2006	2005

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Balance, beginning of period	\$ 272,472	\$ 166,614
Additions	92,914	136,294
Amortization and impairment of fair value	(95,707)	(56,980)
Balance, end of period	\$ 269,679	\$ 245,928

Estimated amortization of MSRs for fiscal years 2007 through 2011 is \$85.3 million, \$107.8 million, \$48.8 million, \$20.1 million and \$5.9 million, respectively.

-5-

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**Table of Contents**

The key weighted average assumptions we used to estimate the cash flows and values of the residual interests initially recorded during the six months ended October 31, 2006 and 2005 are as follows:

Six months ended October 31,	2006	2005
Estimated credit losses	3.33%	2.82%
Discount rate	18.24%	20.02%
	LIBOR forward curve at closing	
Variable returns to third-party beneficial interest holders	date	

The key weighted average assumptions we used to estimate the cash flows and values of the residual interests and MSR's at October 31, 2006 and April 30, 2006 are as follows:

	October 31, 2006	April 30, 2006
Estimated credit losses	3.10%	3.07%
Discount rate residual interests	20.53%	21.98%
Discount rate MSR's	18.00%	18.00%
	LIBOR forward curve at valuation	
Variable returns to third-party beneficial interest holders	date	

We originate both adjustable and fixed rate mortgage loans. A key assumption used to estimate the cash flows and values of the residual interests and MSR's is average annualized prepayment speeds. Prepayment speeds include voluntary prepayments, involuntary prepayments and scheduled principal payments. Prepayment rate assumptions are as follows:

	Prior to Initial Rate Reset Date	Months Outstanding After Initial Rate Reset Date Zero - 3	Remaining Life
Adjustable rate mortgage loans:			
With prepayment penalties	32%	71%	38%
Without prepayment penalties	36%	52%	34%
Fixed rate mortgage loans:			
With prepayment penalties	30%	47%	37%

For fixed rate mortgages without prepayment penalties, we use an average prepayment rate of 31% over the life of the loans. Prepayment rate is projected based on actual paydown including voluntary, involuntary and scheduled principal payments.

Expected static pool credit losses are as follows:

	Mortgage Loans Securitized in Fiscal Year						
	Prior to 2002	2002	2003	2004	2005	2006	2007
As of:							
October 31, 2006	4.92%	2.70%	2.09%	2.21%	2.25%	3.23%	3.31%
April 30, 2006	4.75%	2.69%	2.13%	2.18%	2.48%	3.05%	
April 30, 2005	4.52%	2.53%	2.08%	2.30%	2.83%		

Static pool credit losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets.

At October 31, 2006, the sensitivities of the current fair value of the residual interests and MSRs to 10% and 20% adverse changes in the above key assumptions are as presented in the following table. These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also in this table, the effect of a variation of a particular assumption on the fair value of the retained interest is calculated without changing any other assumptions; in reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

-6-

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**Table of Contents**

		Residential Mortgage Loans				(dollars in 000s)
		Available-for-Sale Residuals	Beneficial Interest in Trusts	Trading Residuals	MSRs	
Carrying amount/fair value		\$ 148,966	\$ 123,278	\$ 56,357	\$ 269,679	
Weighted average remaining life (in years)		1.6	1.9	1.4	1.3	
Prepayments (including defaults):						
Adverse 10%	\$ impact on fair value	\$ 2,777	\$ (5,019)	\$ (3,100)	\$ (24,048)	
Adverse 20%	\$ impact on fair value	8,029	(6,116)	(4,345)	(43,697)	
Credit losses:						
Adverse 10%	\$ impact on fair value	\$ (36,844)	\$ (5,877)	\$ (2,570)	Not applicable	
Adverse 20%	\$ impact on fair value	(61,519)	(10,825)	(5,120)	Not applicable	
Discount rate:						
Adverse 10%	\$ impact on fair value	\$ (3,509)	\$ (2,632)	\$ (1,035)	\$ (5,967)	
Adverse 20%	\$ impact on fair value	(6,795)	(5,184)	(2,029)	(11,715)	
Variable interest rates (LIBOR forward curve):						
Adverse 10%	\$ impact on fair value	\$ (4,119)	\$ (32,427)	\$ 472	Not applicable	
Adverse 20%	\$ impact on fair value	(9,470)	(61,904)	827	Not applicable	

Increases in prepayment rates related to available-for-sale residuals can generate a positive impact to fair value when reductions in estimated credit losses and increases in prepayment penalties exceed the adverse impact to accretion from accelerating the life of the available-for-sale residual interest.

Mortgage loans that have been securitized at October 31, 2006 and April 30, 2006, past due sixty days or more and the related credit losses incurred are presented below:

		(in 000s)				
		Total Principal Amount of Loans Outstanding		Principal Amount of Loans 60 Days or More Past Due		Credit Losses (net of recoveries)
		October 31, 2006	April 30, 2006	October 31, 2006	April 30, 2006	Three months ended October 31, 2006
Securitized mortgage loans		\$ 10,876,063	\$ 10,046,032	\$ 1,165,531	\$ 1,012,414	\$ 34,273
Mortgage loans in warehouse Trusts		4,739,862	7,845,834			\$ 35,307
Mortgage loans held for sale		487,436	255,224	197,571	98,906	71,984
						33,504



Total loans	\$ 16,103,361	\$ 18,147,090	\$ 1,363,102	\$ 1,111,320	\$ 106,257	\$ 68,811
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#### 4. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill for the six months ended October 31, 2006 consist of the following:

	April 30, 2006	Additions	Other	(in 000s) October 31, 2006
Tax Services	\$ 376,515	\$ 5,308	\$ 66	\$ 381,889
Mortgage Services	136,586			136,586
Business Services	397,516	28,750		426,266
Consumer Financial Services	189,835			189,835
Total goodwill	\$ 1,100,452	\$ 34,058	\$ 66	\$ 1,134,576

We test goodwill for impairment annually at the beginning of our fourth quarter, or more frequently if events occur indicating it is more likely than not the fair value of a reporting unit's net assets has been reduced below its carrying value. No such events were identified within any of our segments during the six months ended October 31, 2006.

**Table of Contents**

Intangible assets consist of the following:

	October 31, 2006			April 30, 2006			(in 000s)
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net	
Tax Services:							
Customer relationships	\$ 28,762	\$ (12,628)	\$ 16,134	\$ 27,257	\$ (10,842)	\$ 16,415	
Noncompete agreements	19,002	(17,895)	1,107	18,879	(17,686)	1,193	
Business Services:							
Customer relationships	157,801	(87,999)	69,802	153,844	(81,178)	72,666	
Noncompete agreements	33,460	(16,049)	17,411	32,534	(14,300)	18,234	
Trade name amortizing	4,050	(2,506)	1,544	4,050	(1,823)	2,227	
Trade name non-amortizing	55,637	(4,868)	50,769	55,637	(4,868)	50,769	
Consumer Financial Services:							
Customer relationships	293,000	(253,323)	39,677	293,000	(235,010)	57,990	
Total intangible assets	\$ 591,712	\$ (395,268)	\$ 196,444	\$ 585,201	\$ (365,707)	\$ 219,494	

Amortization of intangible assets for the three and six months ended October 31, 2006 was \$14.3 million and \$29.3 million, respectively. Amortization of intangible assets for the three and six months ended October 31, 2005 was \$15.3 million and \$30.6 million, respectively. Estimated amortization of intangible assets for fiscal years 2007 through 2011 is \$55.3 million, \$38.6 million, \$15.2 million, \$13.2 million and \$10.8 million, respectively.

In October 2005, we acquired all outstanding common stock of American Express Tax and Business Services, Inc. for an aggregate purchase price of \$190.7 million. The purchase price is subject to certain contractual post-closing adjustments which have not been finalized and any future adjustment would be made to goodwill. During the six months ended October 31, 2006, we adjusted deferred tax balances initially recorded in connection with this acquisition resulting in an increase of \$21.3 million to goodwill.

**5. Derivative Instruments**

A summary of our derivative instruments as of October 31, 2006 and April 30, 2006, and gains or losses incurred during the three and six months ended October 31, 2006 and 2005 is as follows:

	(in 000s)					
	Asset (Liability)	Balance at	Gain (Loss) for the Three Months Ended		Gain (Loss) for the Six Months Ended	
	October 31, 2006	April 30, 2006	October 31, 2006	October 31, 2005	October 31, 2006	October 31, 2005
Rate-lock equivalents	\$ 5,673	\$ (317)	\$ (3,716)	\$ 354	\$ 4,030	\$ (738)
Forward loan sale commitments	2,493	1,961	9,575		2,493	
Put options on Eurodollar futures	1,317	3,282	(2,019)		(2,058)	
Prime short sales	(470)	777	1,556	492	995	1,487

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Interest rate swaps	(5,430)	8,831	(33,447)	59,742	(20,267)	85,285
Interest rate caps				162		802
	\$ 3,583	\$ 14,534	\$ (28,051)	\$ 60,750	\$ (14,807)	\$ 86,836

The notional amount of interest rate swaps to which we were a party at October 31, 2006 and April 30, 2006 was \$4.3 billion and \$8.8 billion, respectively, with a weighted average duration at each date of 1.9 years. The notional value and the contract value of our forward loan sale commitments at October 31, 2006 was \$3.0 billion and \$3.1 billion, respectively, and at April 30, 2006 the notional value and contract value was \$3.1 billion.

None of our derivative instruments qualify for hedge accounting treatment as of October 31, 2006 or April 30, 2006.

**Table of Contents****6. Stock-Based Compensation**

Beginning May 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123R) under the modified prospective approach. Under SFAS 123R, we continue to measure and recognize the fair value of stock-based compensation consistent with our past practice under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, which we adopted on May 1, 2003 under the prospective transition method. The adoption of SFAS 123R did not have a material impact on our consolidated financial statements.

The following is a comparison of reported and pro forma results had compensation cost for all stock-based compensation grants been determined in accordance with SFAS 123 for the three and six months ended October 31, 2005.

	(in 000s, except per share amounts)	
	Three months ended October 31, 2005	Six months ended October 31, 2005
Net loss as reported	\$ (81,249)	\$ (109,243)
Add: Stock-based compensation expense included in reported net loss, net of related tax effects	6,246	12,011
Deduct: Total stock-based compensation expense determined under fair value method for all awards, net of related tax effects	(8,790)	(17,098)
Pro forma net loss	\$ (83,793)	\$ (114,330)
Basic and diluted loss per share:		
As reported	\$ (0.25)	\$ (0.33)
Pro forma	(0.26)	(0.35)

Stock-based compensation expense of \$11.3 million and \$21.8 million and the related tax benefits of \$3.7 million and \$7.4 million are included in our results for the three and six months ended October 31, 2006.

SFAS 123R requires the reclassification, in the statement of cash flows, of the excess tax benefits from stock-based compensation from operating cash flows to financing. As a result, we classified \$1.6 million as a cash inflow from financing activities rather than as an operating activity for the six months ended October 31, 2006.

We have four stock-based compensation plans which have been approved by our shareholders. As of October 31, 2006, we had approximately 21.9 million shares reserved for future awards under these plans. We issue shares from our treasury stock to satisfy the exercise or release of stock-based awards.

Our 2003 Long-Term Executive Compensation Plan provides for awards of options (both incentive and nonqualified), nonvested shares, performance nonvested share units and other stock-based awards to employees. These awards are granted to employees and entitle the holder to shares or the right to purchase shares of common stock as the award vests, typically over a three-year period with one-third vesting each year. Nonvested shares receive dividends during the vesting period and performance nonvested share units receive cumulative dividends at the end of the vesting period. We measure the fair value of options on the grant date or modification date using the Black-Scholes option valuation model. We measure the fair value of nonvested shares and performance nonvested share units based on the closing price of our common stock on the grant date. Generally, we expense the grant-date

fair value, net of estimated forfeitures, over the vesting period on a straight-line basis. Upon adoption of SFAS 123R, awards granted to employees who are of retirement age, or reach retirement age at least one year after the grant date but prior to the end of the service period of the award, are expensed over the shorter of the two periods. Options are granted at a price equal to the fair market value of our common stock on the grant date and have a contractual term of ten years.

Our 1999 Stock Option Plan for Seasonal Employees provides for awards of nonqualified options to employees. These awards are granted to seasonal employees in our Tax Services segment and entitle the holder to the right to purchase shares of common stock as the award vests, typically over a two-year period. We measure the fair value of options on the grant date using the Black-Scholes

**Table of Contents**

option valuation model. We expense the grant-date fair value, net of estimated forfeitures, over the service period. Options are granted at a price equal to the fair market value of our common stock on the grant date, are exercisable during September through November in each of the two years following the calendar year of the grant and have a contractual term of 29 months.

Our 1989 Stock Option Plan for Outside Directors provides for awards of nonqualified options to outside directors. These awards are granted to outside directors and entitle the holder to the right to purchase shares of common stock. We measure the fair value of options on the grant date using the Black-Scholes option valuation model. These awards vest immediately upon issuance and are therefore fully expensed on the grant date. Options are granted at a price equal to the fair market value of our common stock on the grant date and have a contractual term of ten years.

Our 2000 Employee Stock Purchase Plan (ESPP) provides employees the option to purchase shares of our Common Stock through payroll deductions. The purchase price of the stock is 90% of the lower of either the fair market value of our Common Stock on the first trading day within the Option Period or on the last trading day of the Option Period. The Option Periods are six-month periods beginning on January 1 and July 1 each year. We measure the fair value of options on the grant date utilizing the Black-Scholes option valuation model in accordance with FASB Technical Bulletin 97-1, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option. We expense the grant-date fair value over the six-month vesting period.

A summary of options for the six months ended October 31, 2006 is as follows:

			(in 000s, except per share amounts)	
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of period	26,048	\$ 21.40		
Granted	4,986	23.85		
Exercised	(726)	14.70		
Forfeited or expired	(364)	23.45		
Outstanding, end of period	29,944	21.94	4 years	\$ 68,501
Exercisable, end of period	21,979	\$ 21.15	4 years	\$ 64,710
Exercisable and expected to vest	28,530	21.80	4 years	68,474

The total intrinsic value of options exercised during the six months ended October 31, 2006 and 2005 were \$0.6 million and \$8.9 million, respectively. We utilize the Black-Scholes option pricing model to value our options on the grant date. We estimated the expected volatility using our historical stock price data. We also used historical exercise and forfeiture behaviors to estimate the options expected term and our forfeiture rate. The following assumptions were used to value options during the periods:

Six months ended October 31,	2006		2005	
Options management and director:				
Expected volatility	22.84%	29.06%	27.05%	27.81%
Expected term	4	7 years		5 years
Dividend yield	2.15%	2.62%	1.71%	2.15%
Risk-free interest rate	4.70%	5.10%	3.65%	4.30%
Weighted-average fair value	\$	5.17	\$	7.40

Options seasonal:

Expected volatility	20.05%		23.28%
Expected term	2 years		2 years
Dividend yield	2.26%		1.71%
Risk-free interest rate	5.11%		3.61%
Weighted-average fair value	\$ 3.17	\$	4.16

ESPP options:

Expected volatility	26.30%		24.52%
Expected term	0.5 years		0.5 years
Dividend yield	2.26%		1.71%
Risk-free interest rate	5.24%		3.37%
Weighted-average fair value	\$ 1.91	\$	2.12

-10-

**Table of Contents**

A summary of nonvested shares and performance nonvested share units for the six months ended October 31, 2006 is as follows:

	Shares		(shares in 000s) Weighted Average Grant Date Fair Value
Outstanding, beginning of period	2,455	\$	25.27
Granted	999		23.79
Released	(776)		25.03
Forfeited	(150)		25.09
Outstanding, end of period	2,528		25.13

The total fair value of shares vesting during the six months ended October 31, 2006 and 2005 was \$18.4 million and \$16.8 million, respectively. Upon the grant of nonvested shares and performance nonvested share units, unearned compensation cost is recorded as an offset to additional paid in capital and is amortized as compensation expense over the vesting period. As of October 31, 2006, we had \$50.9 million of total unrecognized compensation cost related to these shares. This cost is expected to be recognized over a weighted-average period of two years.

**7. Supplemental Cash Flow Information**

The following transactions were treated as non-cash investing activities in the condensed consolidated statement of cash flows:

Six months ended October 31,	2006	(in 000s) 2005
Residual interest mark-to-market	\$ 8,157	\$ 25,791
Additions to residual interests	4,234	8,724

**8. Regulatory Requirements****Registered Broker-Dealer**

HRBFA is subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers. At October 31, 2006, HRBFA's net capital of \$123.8 million, which was 27.6% of aggregate debit items, exceeded its minimum required net capital of \$9.0 million by \$114.8 million.

Pledged securities at October 31, 2006 totaled \$47.4 million, an excess of \$7.3 million over the margin requirement. Pledged securities at April 30, 2006 totaled \$53.0 million, an excess of \$9.9 million over the margin requirement.

**Banking**

HRB Bank is subject to various regulatory capital guidelines and requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on HRB Bank's



operations. Under these capital adequacy guidelines and the regulatory framework for prompt corrective action, HRB Bank must meet specific capital guidelines that involve quantitative measures of HRB Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. HRB Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require HRB Bank to maintain minimum amounts and ratios of capital to assets. As shown in the table below, at September 30, 2006, the most recent date of reporting to Federal banking agencies, HRB Bank is categorized as "well capitalized" for regulatory purposes, which is the highest classification. There are no conditions or events since September 30, 2006 that management believes have changed HRB Bank's category. At October 31, 2006, management believes that HRB Bank meets all capital adequacy requirements to which it is subject. However, events beyond management's control, such as fluctuations in interest rates or a downturn in the economy in areas in which HRB Bank's loans or securities are concentrated, could adversely affect future earnings and consequently, HRB Bank's ability to meet its future capital requirements.

-11-

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**Table of Contents**

HRB Bank's capital amounts and ratios as of September 30, 2006 are presented in the table below:

	Actual		(dollars in 000s) Minimum Required to Qualify as Well Capitalized	
	Amount	Ratio	Amount	Ratio
Tier 1 capital to adjusted total assets (leverage)	\$ 161,597	23.1%	\$ 34,953	5.0%
Total risk-based capital to total risk-weighted assets	\$ 163,159	48.1%	\$ 33,929	10.0%

Additionally, H&R Block, Inc. is now subject to a three percent minimum ratio of adjusted tangible capital to adjusted total assets, as defined by the OTS.

**9. Commitments and Contingencies**

Changes in the deferred revenue liability related to our Peace of Mind (POM) program are as follows:

Six months ended October 31,	(in 000s)	
	2006	2005
Balance, beginning of period	\$ 141,684	\$ 130,762
Amounts deferred for new guarantees issued	1,178	1,107
Revenue recognized on previous deferrals	(48,694)	(44,476)
Balance, end of period	\$ 94,168	\$ 87,393

The following table summarizes certain of our other contractual obligations and commitments:

As of	(in 000s)	
	October 31, 2006	April 30, 2006
Commitment to fund mortgage loans	\$ 3,531,737	\$ 4,032,045
Commitment to sell mortgage loans	3,000,000	3,052,688
Commitment to fund Franchise Equity Lines of Credit	79,673	75,909
Contingent business acquisition obligations	17,174	24,482

In the normal course of business, we maintain recourse with standard representations and warranties customary to the mortgage banking industry. Violations of these representations and warranties, such as early payment defaults by borrowers, may require us to repurchase loans previously sold. Repurchased loans are normally sold in subsequent sale transactions. The following table summarizes the loan repurchase activity in our Mortgage Services segment:

Three months ended		Six months ended		(dollars in 000s)
October 31,		October 31,		Fiscal year
2006	2005	2006	2005	ended
				April 30,
				2006
\$316,453	\$58,518	\$408,791	\$118,484	\$297,606

Loans repurchased during the period					
Repurchase reserves added during period	\$ 45,821	\$17,164	\$138,558	\$ 31,357	\$ 64,098
Repurchase reserves added as a percent of originations	0.69%	0.16%	0.96%	0.16%	0.18%

We established a liability, related to the potential loss we expect to incur on repurchase of loans previously sold and premium recapture, totaling \$84.1 million and \$33.4 million at October 31, 2006 and April 30, 2006, respectively. On an ongoing basis, we monitor the adequacy of our repurchase liability, which is established upon the initial sale of the loans, and is included in accounts payable, accrued expenses and other current liabilities in the condensed consolidated balance sheets. During the six months ended October 31, 2006, we experienced higher early payment defaults, resulting in an increase in actual and expected loan repurchase activity. As a result, we increased our reserves

**Table of Contents**

accordingly. In establishing our reserves, we've assumed all loans that are currently delinquent and subject to contractual repurchase terms will be repurchased, and that 5% of loans previously sold but not yet subject to contractual repurchase terms will be repurchased. Based on historical experience, we assumed 30% of all loans we repurchase will cure with no loss incurred, and of those that do not cure, we assumed an average 17% loss severity as of October 31, 2006.

HRB Bank is a member of the Federal Home Loan Bank (FHLB) of Des Moines, which extends credit availability to member banks based on eligible collateral and asset size. At October 31, 2006, HRB Bank had FHLB advance capacity of \$266.7 million, but no amounts had been drawn on this facility.

We routinely enter into contracts that include embedded indemnifications that have characteristics similar to guarantees, including obligations to protect counterparties from losses arising from the following: (a) tax, legal and other risks related to the purchase or disposition of businesses; (b) penalties and interest assessed by Federal and state taxing authorities in connection with tax returns prepared for clients; (c) indemnification of our directors and officers; and (d) third-party claims relating to various arrangements in the normal course of business. Typically, there is no stated maximum payment related to these indemnifications, and the term of indemnities may vary and in many cases is limited only by the applicable statute of limitations. The likelihood of any claims being asserted against us and the ultimate liability related to any such claims, if any, is difficult to predict. While we cannot provide assurance that such claims will not be successfully asserted, we believe the fair value of these guarantees and indemnifications is not material as of October 31, 2006.

**Restructuring Charge**

During fiscal year 2006, we initiated a restructuring plan to reduce costs within our mortgage operations. Changes in the restructuring charge liability during the six months ended October 31, 2006 are as follows:

	Accrual Balance as of April 30, 2006	Cash Payments	Other Adjustments	(in 000s) Accrual Balance as of October 31, 2006
Employee severance costs	\$ 1,737	\$ (1,737)	\$	\$
Contract termination costs	5,821	(2,884)	(496)	2,441
	\$ 7,558	\$ (4,621)	\$ (496)	\$ 2,441

The remaining liability related to this restructuring charge is included in accounts payable, accrued expenses and other current liabilities on our condensed consolidated balance sheet and relates to lease obligations for vacant space resulting from branch office closings.

On November 6, 2006, we announced an additional restructuring plan, also within our mortgage operations, which will be recorded primarily during our third and fourth quarters.

**10. Litigation and Related Contingencies**

We have been named as a defendant in numerous lawsuits throughout the country regarding our refund anticipation loan programs (the RAL Cases). The RAL Cases have involved a variety of legal theories asserted by plaintiffs. These theories include allegations that, among others, (i) disclosures in the RAL applications were inadequate, misleading and untimely; (ii) the RAL interest rates were usurious and unconscionable; (iii) we did not disclose that we would receive part of the finance charges paid by the customer for such loans; (iv) untrue,

misleading or deceptive statements in marketing RALs; (v) breach of state laws on credit service organizations; (vi) breach of contract, unjust enrichment, unfair and deceptive acts or practices; (vii) violations of the federal Racketeer Influenced and Corrupt Organizations Act; (viii) violations of the federal Fair Debt Collection Practices Act and unfair competition regarding debt collection activities; and (ix) we owe, and breached, a fiduciary duty to our customers in connection with the RAL program.

The amounts claimed in the RAL Cases have been very substantial in some instances. We have successfully defended against numerous RAL cases, some of which were dismissed on our motions

-13-

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**Table of Contents**

for dismissal or summary judgment, and others were dismissed voluntarily by the plaintiffs after denial of class certification. Other cases have been settled, with one settlement resulting in a pretax expense of \$43.5 million in fiscal year 2003 and the combined pretax expense for such settlements in fiscal year 2006 totaling \$70.2 million.

Other putative RAL class action cases and a state attorney general lawsuit are still pending, with the amounts claimed on a collective basis being very substantial. The ultimate cost of this litigation could be substantial. We believe we have meritorious defenses to the remaining RAL Cases and we intend to defend them vigorously. There can be no assurances, however, as to the outcome of the pending RAL Cases individually or in the aggregate or the associated impact on our financial statements.

We are also a party to claims and lawsuits pertaining to our electronic tax return filing services, our Peace of Mind guarantee program, our Express IRA product, business valuation services and tax planning services. These claims and lawsuits include actions by individual plaintiffs, as well as cases in which plaintiffs seek to represent a class of similarly situated customers. The amounts claimed in these claims and lawsuits are substantial in some instances, and the ultimate liability with respect to such litigation and claims is difficult to predict. We intend to continue defending these cases vigorously, although there are no assurances as to their outcome.

In addition we and certain of our current and former directors and officers are party to a putative class action alleging violations of certain securities laws. The putative securities class action currently alleges, among other things, deceptive, material and misleading financial statements, failure to prepare financial statements in accordance with generally accepted accounting principles and concealment of the potential for lawsuits stemming from the allegedly fraudulent nature of our operations. The amount claimed in the putative securities class action is substantial, and the ultimate liability is difficult to predict. We intend to continue defending this case vigorously, although there are no assurances as to its outcome.

In addition to the aforementioned types of cases, we are parties to claims and lawsuits that we consider to be ordinary, routine disputes incidental to our business (Other Claims and Lawsuits), including claims and lawsuits concerning the preparation of customers' income tax returns, tax planning services, the fees charged customers for various services, investment products, relationships with franchisees, contract disputes, employment matters and civil actions, arbitrations, regulatory inquiries and class actions arising out of our business as a broker-dealer and provider of investment products and as a servicer of mortgage loans. We believe we have meritorious defenses to each of the Other Claims and Lawsuits and are defending them vigorously. Although we cannot provide assurance we will ultimately prevail in each instance, we believe that amounts, if any, required to be paid in the discharge of liabilities or settlements pertaining to Other Claims and Lawsuits will not have a material adverse effect on our consolidated financial statements. Regardless of outcome, claims and litigation can adversely affect us due to defense costs, diversion of management attention and time, and publicity related to such matters.

**Table of Contents****11. Segment Information**

Information concerning our operations by reportable operating segment is as follows:

	(in 000s)						
	Tax Services	Mortgage Services	Business Services	Consumer Financial Services	Corporate	Eliminations	Consolidated
<b>Three months ended October 31, 2006:</b>							
Revenues:							
External	\$ 82,090	\$ 146,372	\$ 228,554	\$ 102,636	\$ 3,589	\$	\$ 563,241
Loan sales to HRB Bank		4,065				(4,065)	
HRBMC loan sales to OOMC		(10,612)		10,612			
Other intersegment	7	751	549	(804)	3,136	(3,639)	
	\$ 82,097	\$ 140,576	\$ 229,103	\$ 112,444	\$ 6,725	\$ (7,704)	\$ 563,241
Pretax loss	\$ (167,442)	\$ (39,041)	\$ (18,744)	\$ (6,640)	\$ (27,851)	\$ (3,074)	\$ (262,792)
<b>Three months ended October 31, 2005:</b>							
Revenues:							
External	\$ 80,805	\$ 239,567	\$ 166,276	\$ 116,602	\$ 1,793	\$	\$ 605,043
HRBMC loan sales to OOMC		(5,088)		5,088			
Other intersegment	8	1,272	529		2,590	(4,399)	
	\$ 80,813	\$ 235,751	\$ 166,805	\$ 121,690	\$ 4,383	\$ (4,399)	\$ 605,043
Pretax income (loss)	\$ (142,864)	\$ 48,800	\$ (2,143)	\$ (10,467)	\$ (26,695)	\$ 240	\$ (133,129)
<b>Six months ended October 31, 2006:</b>							
Revenues:							
External	\$ 148,108	\$ 313,333	\$ 433,571	\$ 202,924	\$ 6,084	\$	\$ 1,104,020
Loan sales to HRB Bank		14,443				(14,443)	
HRBMC loan sales to OOMC		(19,084)		19,084			

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Other intersegment	24	1,560	663	(1,266)	6,199	(7,180)	
	\$ 148,132	\$ 310,252	\$ 434,234	\$ 220,742	\$ 12,283	\$ (21,623)	\$ 1,104,020
Pretax loss	\$ (320,590)	\$ (43,965)	\$ (33,309)	\$ (14,420)	\$ (56,363)	\$ (12,804)	\$ (481,451)
<b>Six months ended</b>							
<b>October 31, 2005:</b>							
Revenues:							
External	\$ 137,970	\$ 547,843	\$ 293,015	\$ 236,747	\$ 4,461	\$	\$ 1,220,036
HRBMC loan sales to OOMC		(9,323)		9,323			
Other intersegment	34	2,278	636		4,926	(7,874)	
	\$ 138,004	\$ 540,798	\$ 293,651	\$ 246,070	\$ 9,387	\$ (7,874)	\$ 1,220,036
Pretax income (loss)	\$ (287,370)	\$ 179,464	\$ (8,908)	\$ (14,215)	\$ (48,457)	\$ 488	\$ (178,998)

HRB Bank commenced operations on May 1, 2006, at which time we realigned certain segments of our business to reflect a new management reporting structure. The previously reported Investment Services segment, HRBMC (which was previously included in the Mortgage Services segment), and HRB Bank are now reported in the Consumer Financial Services segment. Presentation of prior-year results reflects the new segment alignment.

The Consumer Financial Services segment is primarily engaged in offering advice-based brokerage services and investment planning through HRBFA, mortgage loans through HRBMC and



**Table of Contents**

full-service banking through HRB Bank. HRB Bank offers traditional banking services, including checking and savings accounts, home equity lines of credit, individual retirement accounts, certificates of deposit and prepaid debit card accounts. HRB Bank also purchases loans from Option One Mortgage Corporation (OOMC), HRBMC and other lenders to hold for investment purposes. HRBMC originates non-prime loans for sale to OOMC and prime loans for sale to HRB Bank and other third-party buyers.

All intersegment transactions are eliminated in consolidation. The largest intersegment revenue transactions include gains recognized on loans sold to HRB Bank by OOMC and mortgage fees earned by HRBMC on loans sold to OOMC.

**12. New Accounting Pronouncements**

In September 2006, Statement of Financial Accounting Standards No. 157, Fair Value Instruments, (SFAS 157), was issued. The provisions of this standard include guidelines about the extent to which companies measure assets and liabilities at fair value, the effect of fair value measurements on earnings, risk-adjusted fair value and establishes a fair value hierarchy that prioritizes the information used in developing assumptions used when valuing an asset or liability. The provisions of this standard are effective as of the beginning of our fiscal year 2009. We are currently evaluating what effect the adoption of SFAS 157 will have on our consolidated financial statements.

In September 2006, Staff Accounting Bulletin No. 108, Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year for Financial Statements (SAB 108), was issued. SAB 108 provides guidance on how prior year misstatements should be quantified when determining if current year financial statements are materially misstated. These provisions are effective for the current fiscal year, with earlier interim period adoption permitted. We are currently evaluating what effect the adoption of SAB 108 will have on our consolidated financial statements.

In June 2006, FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), was issued. The interpretation requires that a tax position meet a more-likely-than-not recognition threshold for the benefit of the uncertain tax position to be recognized in the financial statements and provides guidance on the measurement of the benefit. The interpretation also requires interim period estimated tax benefits of uncertain tax positions to be accounted for in the period of change rather than as a component of the annual effective tax rate. The provisions of this standard are effective as of the beginning of our fiscal year 2008. We are currently evaluating what effect the adoption of FIN 48 will have on our consolidated financial statements.

In June 2006, Emerging Issues Task Force Issue No. 06-3, How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation) (EITF 06-3) was issued. EITF 06-3 requires disclosure of the presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis as an accounting policy decision. The provisions of this standard are effective for interim and annual reporting periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our consolidated financial statements.

In March 2006, Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets An Amendment of FASB Statement No. 140, (SFAS 156), was issued. The provisions of this standard require mortgage servicing rights to be initially valued at fair value. SFAS 156 allows servicers to choose to subsequently measure their servicing rights at fair value or to continue using the amortization method under SFAS 140. The provisions of this standard are effective as of the beginning of our fiscal year 2008. We are currently evaluating what effect the adoption of SFAS 156 will have on our consolidated financial statements.

In February 2006, Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Instruments An Amendment of FASB Statements No. 133 and 140 (SFAS 155), was issued. The provisions of this standard establish a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. The standard permits a hybrid financial instrument to be accounted for in its entirety if the holder irrevocably elects to

**Table of Contents**

measure the hybrid financial instrument at fair value, with changes in fair value recognized currently in earnings. The provisions of this standard are effective as of the beginning of our fiscal year 2008. Our residual interests typically have interests in derivative instruments embedded within the securitization trusts. If we elect to account for our residual interests on a fair value basis, changes in fair value will impact earnings in the period in which the change occurs. We are currently evaluating what effect the adoption of SFAS 155 will have on our consolidated financial statements.

**13. Condensed Consolidating Financial Statements**

Block Financial Corporation (BFC) is an indirect, wholly owned consolidated subsidiary of the Company. BFC is the Issuer and the Company is the Guarantor of the Senior Notes issued on April 13, 2000 and October 26, 2004. These condensed consolidating financial statements have been prepared using the equity method of accounting. Earnings of subsidiaries are, therefore, reflected in the Company's investment in subsidiaries account. The elimination entries eliminate investments in subsidiaries, related stockholder's equity and other intercompany balances and transactions.

<i>Condensed Consolidating Income Statements</i>					(in 000s)
Three months ended	H&R Block, Inc.	BFC	Other		Consolidated
October 31, 2006	(Guarantor)	(Issuer)	Subsidiaries	Elims	H&R Block
Total revenues	\$	\$ 316,076	\$ 248,689	\$ (1,524)	\$ 563,241
Cost of services		125,395	367,465	1	492,861
Cost of other revenues		94,106	3,130		97,236
Selling, general and administrative		109,680	120,961	(1,525)	229,116
Total expenses		329,181	491,556	(1,524)	819,213
Operating loss		(13,105)	(242,867)		(255,972)
Interest expense		(11,810)	(281)		(12,091)
Other income, net	(262,792)	1,194	4,077	262,792	5,271
Loss before tax benefit	(262,792)	(23,721)	(239,071)	262,792	(262,792)
Income tax benefit	(106,332)	(9,362)	(96,970)	106,332	(106,332)
Net loss	\$ (156,460)	\$ (14,359)	\$ (142,101)	\$ 156,460	\$ (156,460)
Three months ended	H&R Block, Inc.	BFC	Other		Consolidated
October 31, 2005	(Guarantor)	(Issuer)	Subsidiaries	Elims	H&R Block
Total revenues	\$	\$ 395,825	\$ 213,175	\$ (3,957)	\$ 605,043
Cost of services		115,818	282,203	43	398,064
Cost of other revenues		129,316	5,548		134,864
Selling, general and administrative		96,960	102,742	(4,000)	195,702

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Total expenses		342,094	390,493	(3,957)	728,630
Operating income (loss)		53,731	(177,318)		(123,587)
Interest expense		(11,811)	(574)		(12,385)
Other income, net	(133,129)		2,843	133,129	2,843
Income (loss) before taxes	(133,129)	41,920	(175,049)	133,129	(133,129)
Income taxes (benefit)	(51,880)	16,349	(68,229)	51,880	(51,880)
Net income (loss)	\$ (81,249)	\$ 25,571	\$ (106,820)	\$ 81,249	\$ (81,249)

-17-

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**Table of Contents**

Six months ended October 31, 2006	H&R Block, Inc. (Guarantor)	BFC (Issuer)	Other Subsidiaries	Elims	Consolidated H&R Block
Total revenues	\$	\$ 639,737	\$ 467,254	\$ (2,971)	\$ 1,104,020
Cost of services		251,193	697,133	33	948,359
Cost of other revenues		182,797	6,453		189,250
Selling, general and administrative		211,271	227,438	(3,004)	435,705
Total expenses		645,261	931,024	(2,971)	1,573,314
Operating loss		(5,524)	(463,770)		(469,294)
Interest expense		(23,618)	(608)		(24,226)
Other income, net	(481,451)	3,966	8,103	481,451	12,069
Loss before tax benefit	(481,451)	(25,176)	(456,275)	481,451	(481,451)
Income tax benefit	(193,614)	(9,929)	(183,685)	193,614	(193,614)
Net loss	\$ (287,837)	\$ (15,247)	\$ (272,590)	\$ 287,837	\$ (287,837)

Six months ended October 31, 2005	H&R Block, Inc. (Guarantor)	BFC (Issuer)	Other Subsidiaries	Elims	Consolidated H&R Block
Total revenues	\$	\$ 856,465	\$ 370,840	\$ (7,269)	\$ 1,220,036
Cost of service revenues		225,171	523,687	132	748,990
Cost of other revenues		250,216	8,005		258,221
Selling, general and administrative		188,148	196,499	(7,401)	377,246
Total expenses		663,535	728,191	(7,269)	1,384,457
Operating income (loss)		192,930	(357,351)		(164,421)
Interest expense		(23,621)	(1,199)		(24,820)
Other income, net	(178,998)		10,243	178,998	10,243
Income (loss) before taxes	(178,998)	169,309	(348,307)	178,998	(178,998)
Income taxes (benefit)	(69,755)	66,031	(135,786)	69,755	(69,755)
Net income (loss)	\$ (109,243)	\$ 103,278	\$ (212,521)	\$ 109,243	\$ (109,243)

*Condensed Consolidating Balance Sheets*

	BFC	Other	(in 000s) Consolidated
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October 31, 2006	H&R Block, Inc. (Guarantor)	(Issuer)	Subsidiaries	Elims	H&R Block
Cash & cash equivalents	\$	\$ 200,417	\$ 241,856	\$	\$ 442,273
Cash & cash equivalents restricted		393,563	23,292		416,855
Receivables from customers, brokers and dealers, net		413,237			413,237
Receivables, net	108	104,626	308,586		413,320
Mortgage loans held for sale		432,064			432,064
Mortgage loans held for investment		683,839			683,839
Intangible assets and goodwill, net		368,788	962,232		1,331,020
Investments in subsidiaries	4,840,520	215		(4,840,520)	215
Other assets		1,355,454	718,745	(131)	2,074,068
<b>Total assets</b>	<b>\$ 4,840,628</b>	<b>\$ 3,952,203</b>	<b>\$ 2,254,711</b>	<b>\$ (4,840,651)</b>	<b>\$ 6,206,891</b>
Commercial paper	\$	\$ 1,040,429	\$	\$	\$ 1,040,429
Accts. payable to customers, brokers and dealers		700,673			700,673
Customer deposits		595,769			595,769
Long-term debt		398,118	13,587		411,705
Other liabilities	2	1,009,214	820,470		1,829,686
Net intercompany advances	3,211,997	(1,557,872)	(1,654,125)		
Stockholders' equity	1,628,629	1,765,872	3,074,779	(4,840,651)	1,628,629
<b>Total liabilities and stockholders' equity</b>	<b>\$ 4,840,628</b>	<b>\$ 3,952,203</b>	<b>\$ 2,254,711</b>	<b>\$ (4,840,651)</b>	<b>\$ 6,206,891</b>

-18-

**Table of Contents**

April 30, 2006	H&R Block, Inc. (Guarantor)	BFC (Issuer)	Other Subsidiaries	Elims	Consolidated H&R Block
Cash & cash equivalents	\$	\$ 151,561	\$ 542,797	\$	\$ 694,358
Cash & cash equivalents restricted		377,445	16,624		394,069
Receivables from customers, brokers and dealers, net		496,577			496,577
Receivables, net	161	128,123	339,393		467,677
Intangible assets and goodwill, net		387,194	932,752		1,319,946
Investments in subsidiaries	5,237,611	215	456	(5,237,611)	671
Other assets		2,116,900	499,477	(540)	2,615,837
<b>Total assets</b>	<b>\$ 5,237,772</b>	<b>\$ 3,658,015</b>	<b>\$ 2,331,499</b>	<b>\$ (5,238,151)</b>	<b>\$ 5,989,135</b>
Accts. payable to customers, brokers and dealers	\$	\$ 781,303	\$	\$	\$ 781,303
Long-term debt		398,001	19,538		417,539
Other liabilities	2	1,042,611	1,599,881		2,642,494
Net intercompany advances	3,089,971	(355,358)	(2,734,567)	(46)	
Stockholders' equity	2,147,799	1,791,458	3,446,647	(5,238,105)	2,147,799
<b>Total liabilities and stockholders' equity</b>	<b>\$ 5,237,772</b>	<b>\$ 3,658,015</b>	<b>\$ 2,331,499</b>	<b>\$ (5,238,151)</b>	<b>\$ 5,989,135</b>

*Condensed Consolidating Statements of Cash  
Flows*

(in 000s)

Six months ended October 31, 2006	H&R Block, Inc. (Guarantor)	BFC (Issuer)	Other Subsidiaries	Elims	Consolidated H&R Block
Net cash provided by (used in) operating activities:	\$ 29,170	\$ (83,836)	\$ (1,135,626)	\$	\$ (1,190,292)
Cash flows from investing:					
Cash received on residuals		6,422			6,422
Mortgage loans originated for investment, net		(278,003)			(278,003)
Purchase property & equipment		(12,285)	(82,502)		(94,787)
Payments for business acquisitions			(13,609)		(13,609)
Net intercompany advances	216,983			(216,983)	
Other, net			8,088		8,088
	216,983	(283,866)	(88,023)	(216,983)	(371,889)

Net cash provided by (used in) investing activities					
Cash flows from financing:					
Repayments of commercial paper		(2,295,573)			(2,295,573)
Proceeds from commercial paper		3,336,002			3,336,002
Customer deposits		595,769			595,769
Dividends paid	(84,225)				(84,225)
Acquisition of treasury shares	(186,560)				(186,560)
Proceeds from stock options	10,640				10,640
Excess tax benefits on stock-based compensation	1,567				1,567
Net intercompany advances		(1,202,514)	985,531	216,983	
Other, net	12,425	(17,126)	(62,823)		(67,524)
Net cash provided by (used in) financing activities	(246,153)	416,558	922,708	216,983	1,310,096
Net increase (decrease) in cash		48,856	(300,941)		(252,085)
Cash beginning of period		151,561	542,797		694,358
Cash end of period	\$	\$ 200,417	\$ 241,856	\$	\$ 442,273



**Table of Contents**

Six months ended October 31, 2005	H&R Block, Inc. (Guarantor)	BFC (Issuer)	Other Subsidiaries	Elims	Consolidated H&R Block
Net cash provided by (used in) operating activities:	\$ 24,257	\$ (229,003)	\$ (500,113)	\$	\$ (704,859)
Cash flows from investing:					
Cash received on residuals		64,377			64,377
Cash received on sale of residuals		30,497			30,497
Purchase property & equipment		(20,228)	(57,407)		(77,635)
Payments for business acquisitions		(2,948)	(197,361)		(200,309)
Net intercompany advances	264,868			(264,868)	
Other, net			13,151		13,151
Net cash provided by (used in) investing activities	264,868	71,698	(241,617)	(264,868)	(169,919)
Cash flows from financing:					
Repayments of commercial paper		(1,101,729)			(1,101,729)
Proceeds from commercial paper		1,599,904			1,599,904
Dividends paid	(77,381)				(77,381)
Acquisition of treasury shares	(259,745)				(259,745)
Proceeds from common stock	42,663				42,663
Net intercompany advances		(322,298)	57,430	264,868	
Other, net	5,338	3,390	(45,385)		(36,657)
Net cash provided by (used in) financing activities	(289,125)	179,267	12,045	264,868	167,055
Net increase (decrease) in cash		21,962	(729,685)		(707,723)
Cash beginning of period		162,983	937,230		1,100,213
Cash end of period	\$	\$ 184,945	\$ 207,545	\$	\$ 392,490

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**RESULTS OF OPERATIONS**

H&R Block is a diversified company delivering tax services and financial advice, investment, mortgage and banking services, and business and consulting services. For more than 50 years, we have been developing relationships with millions of tax clients and our strategy is to expand on these relationships. Our Tax Services segment provides income tax return preparation services, electronic filing services and other services and products related to income tax return preparation to the general public primarily in the United States, Canada and Australia. Our Mortgage Services segment offers a full range of home mortgage services through OOMC. RSM McGladrey Business Services, Inc. (RSM) is a national accounting, tax and business consulting firm primarily serving mid-sized businesses. Our Consumer Financial Services segment offers investment services through H&R Block Financial Advisors, Inc. (HRBFA), full-service banking through HRB Bank and mortgage services through HRBMC.

As announced November 6, 2006, we are evaluating strategic alternatives for OOMC, including a possible sale or other transaction through the public markets. Any proposed transaction will be subject to approval by our Board of Directors. We also announced an additional restructuring plan within our mortgage operations, including closure of twelve offices and affecting approximately 300 positions. Liabilities and charges for this restructuring, which we expect to be between \$10 million and \$12 million, will be recorded primarily during our third and fourth quarters.

**Our Mission**

To help our clients achieve their financial objectives  
by serving as their tax and financial partner.

Key to achieving our mission is the enhancement of client experiences through consistent delivery of valuable services and advice. Operating through multiple lines of business allows us to better meet the changing financial needs of our clients.

The analysis that follows should be read in conjunction with the tables below and the condensed consolidated income statements found on page 2.

<b>Tax Services</b>	<b>Operating Results</b>				(in 000s)
	Three months ended October		Six months ended October		
	31, 2006	2005	31, 2006	2005	
Service revenues:					
Tax preparation and related fees	\$ 44,332	\$ 40,185	\$ 69,994	\$ 63,822	
Other services	31,211	32,264	66,239	61,231	
	75,543	72,449	136,233	125,053	
Royalties	4,458	4,161	7,381	6,557	
Other	2,096	4,203	4,518	6,394	
Total revenues	82,097	80,813	148,132	138,004	
Cost of services:					
Compensation and benefits	59,303	51,917	105,143	94,509	
Occupancy	70,156	62,283	137,827	121,596	
Depreciation	9,709	10,328	18,963	20,497	

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Other	42,165	39,065	90,402	79,032
	181,333	163,593	352,335	315,634
Other, selling, general and administrative	68,206	60,084	116,387	109,740
Total expenses	249,539	223,677	468,722	425,374
Pretax loss	\$ (167,442)	\$ (142,864)	\$ (320,590)	\$ (287,370)

**Three months ended October 31, 2006 compared to October 31, 2005**

Tax Services revenues increased \$1.3 million, or 1.6%, for the three months ended October 31, 2006 compared to the prior year.

-21-

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**Table of Contents**

Tax preparation and related fees increased \$4.1 million, or 10.3%, for the current quarter. This increase is primarily due to improved performance in our Australian operations coupled with an increase of 8.4% in the net average fee per U.S. client served.

Total expenses increased \$25.9 million, or 11.6%, for the three months ended October 31, 2006. Cost of services increased \$17.7 million, or 10.8%, from the prior year. Our real estate expansion efforts have contributed to a total increase of \$6.8 million across all cost of services categories. Compensation and benefits increased \$7.4 million, or 14.2%, primarily due to costs associated with our earlier office openings and initiatives addressing operational readiness for the upcoming tax season. Occupancy expenses increased \$7.9 million, or 12.6%, primarily as a result of higher rent expenses due to an 8.2% increase in company-owned offices under lease and a 4.9% increase in the average rent. Other cost of services increased \$3.1 million, or 7.9%, due to claims expenses associated with our POM guarantees, coupled with additional corporate shared services for information technology projects and higher travel expenses.

Selling, general and administrative expenses increased \$8.1 million, or 13.5%, primarily due to a \$6.5 million increase in corporate shared services and a \$4.3 million increase in corporate wages. Both of these increases were principally technology-related to support operational readiness for the upcoming tax season.

The pretax loss was \$167.4 million for the three months ended October 31, 2006 compared to a loss of \$142.9 million in the prior year.

**Six months ended October 31, 2006 compared to October 31, 2005**

Tax Services revenues increased \$10.1 million, or 7.3%, for the six months ended October 31, 2006 compared to the prior year.

Tax preparation and related fees increased \$6.2 million, or 9.7%, for the current period. This increase is primarily due to an increase of 8.1% in the net average fee per U.S. client served coupled with improved performance in our Australian and Canadian operations.

Other service revenues increased \$5.0 million, or 8.2%, primarily due to an increase in the recognition of deferred fee revenue from our POM guarantees, which resulted from an increase in claims.

Total expenses increased \$43.3 million, or 10.2%, for the six months ended October 31, 2006. Cost of services increased \$36.7 million, or 11.6%, from the prior year. Our real estate expansion efforts have contributed to a total increase of \$12.2 million across all cost of services categories. Compensation and benefits increased \$10.6 million, or 11.3%, primarily due to costs associated with our earlier office openings and initiatives addressing operational readiness for the upcoming tax season. Occupancy expenses increased \$16.2 million, or 13.3%, primarily as a result of higher rent expenses due to an 8.7% increase in company-owned offices under lease and a 5.2% increase in the average rent. Other cost of services increased \$11.4 million, or 14.4%, due to \$5.5 million in additional corporate shared services for information technology projects, coupled with increases in claims expenses associated with our POM guarantee and travel expenses.

Selling, general and administrative expenses increased \$6.6 million, or 6.1%, primarily due to a \$7.2 million increase in corporate wages, primarily technology support personnel to support operational readiness for the upcoming tax season. An increase of \$3.8 million in corporate shared services was partially offset by a \$4.3 million decrease in legal expenses.

The pretax loss was \$320.6 million for the six months ended October 31, 2006 compared to a loss of \$287.4 million in the prior year.

**RAL Litigation**

We are named as a defendant in putative class-action lawsuits and a pending state attorney general lawsuit alleging that we engaged in wrongdoing with respect to the RAL program. We believe we have meritorious defenses to these lawsuits and will vigorously defend our position. Nevertheless, the amounts claimed in these lawsuits are, in some instances, very substantial. In fiscal year 2006, we entered into settlement agreements regarding several RAL Cases, with the combined pretax expense for such settlements totaling \$70.2 million. There can be no assurances as to the ultimate outcome of the remaining pending RAL Cases, or as to their impact on our financial statements. See additional discussion of RAL Litigation in note 10 to the consolidated financial statements and in Part II, Item 1,

Legal Proceedings.



**Table of Contents****MORTGAGE SERVICES**

This segment is primarily engaged in the origination and acquisition of non-prime mortgage loans through an independent broker network and its relationship with HRBMC, the sale and securitization of mortgage loans and residual interests, and the servicing of non-prime loans.

<b>Mortgage Services Operating Statistics</b>	(dollars in 000s)			
	Three months ended October		Six months ended October 31,	
	2006	31, 2005	2006	2005
Volume of loans originated and purchased:				
Third-party brokers	\$ 6,149,293	\$ 11,078,960	\$ 13,356,925	\$ 20,616,187
Intersegment (HRBMC)	471,182	1,111,924	1,055,607	2,062,730
	\$ 6,620,475	\$ 12,190,884	\$ 14,412,532	\$ 22,678,917
Loan characteristics:				
Weighted average FICO score	611	629	613	626
Weighted average interest rate for borrowers (WAC)	8.75%	7.48%	8.71%	7.50%
Weighted average loan-to-value	82.2%	80.6%	82.4%	80.8%
Origination margin (% of origination volume): (1)				
Loan sale premium	1.48%	0.44%	1.55%	1.12%
Residual cash flows from beneficial interest in Trusts	0.29%	0.43%	0.44%	0.64%
Gain (loss) on derivative instruments	(0.44%)	0.53%	(0.12%)	0.41%
Loan sale repurchase reserves	(0.69%)	(0.16%)	(0.96%)	(0.16%)
Retained mortgage servicing rights	0.65%	0.71%	0.64%	0.60%
	1.29%	1.95%	1.55%	2.61%
Cost of acquisition	(0.52%)	(0.88%)	(0.52%)	(0.97%)
Direct origination expenses	(0.40%)	(0.44%)	(0.42%)	(0.45%)
Net gain on sale gross margin <sup>(2)</sup>	0.37%	0.63%	0.61%	1.19%
Other revenues	(0.05%)	0.02%	(0.04%)	0.01%
Other cost of origination	(1.19%)	(0.85%)	(1.09%)	(0.89%)
Net margin	(0.87%)	(0.20%)	(0.52%)	0.31%
Total cost of origination <sup>(1)</sup>	1.59%	1.29%	1.51%	1.34%
Total cost of origination and acquisition	2.11%	2.17%	2.03%	2.31%

Loan delivery:

Loan sales:

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Third-party buyers	\$ 6,228,161	\$ 12,067,658	\$ 13,882,606	\$ 22,511,068
Intersegment (HRB Bank)	169,622		723,124	
	\$ 6,397,783	\$ 12,067,658	\$ 14,605,730	\$ 22,511,068
Execution price <sup>(3)</sup>	1.67%	1.63%	1.53%	2.09%

(1) See Reconciliation of Non-GAAP Financial Information at the end of Part I, Item 2.

(2) Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.

(3) Defined as total premium received divided by total balance of loans delivered to third-party investors or securitization vehicles (excluding mortgage servicing rights and the effect of loan origination expenses).

**Table of Contents****Mortgage Services Operating Results**

	Three months ended October 31,		Six months ended October 31,	
	2006	2005	2006	2005
(in 000s)				
Components of gains on sales:				
Gain on mortgage loans	\$ 54,125	\$ 21,942	\$ 104,473	\$ 190,910
Gain (loss) on derivatives	(29,359)	55,067	(16,839)	79,014
Gain on sales of residual interests		28,675		28,675
Impairment of residual interests	(12,236)	(8,738)	(29,502)	(20,613)
	12,530	96,946	58,132	277,986
Interest income:				
Accretion residual interests	12,878	33,564	26,387	64,341
Other	1,452	4,605	2,977	7,373
	14,330	38,169	29,364	71,714
Loan servicing revenue	113,684	100,386	222,724	190,655
Other	32	250	32	443
Total revenues	140,576	235,751	310,252	540,798
Cost of services	79,625	67,811	158,313	132,203
Cost of other revenues:				
Compensation and benefits	38,738	54,108	72,922	104,937
Occupancy	4,757	7,034	9,263	16,602
Other	14,777	23,946	35,509	44,069
	58,272	85,088	117,694	165,608
Selling, general and administrative	41,720	34,052	78,210	63,523
Total expenses	179,617	186,951	354,217	361,334
Pretax income (loss)	\$ (39,041)	\$ 48,800	\$ (43,965)	\$ 179,464

**Three months ended October 31, 2006 compared to October 31, 2005**

Mortgage Services revenues decreased \$95.2 million, or 40.4%, for the three months ended October 31, 2006 compared to the prior year.

The following table summarizes the key drivers of loan origination volumes and related gains on sales of mortgage loans:

Three months ended October 31,	2006	2005
(dollars in 000s)		
Application process:		
Total number of applications	67,330	101,297
Number of sales associates <sup>(1)</sup>	1,825	2,473



Closing ratio <sup>(2)</sup>	48.6%	63.6%
Originations:		
Total number of loans originated/acquired	32,723	64,440
WAC	8.75%	7.48%
Average loan size	\$ 202	\$ 189
Total volume of loans originated/acquired	\$ 6,620,475	\$ 12,190,884
Direct origination and acquisition expenses, net	\$ 60,786	\$ 161,028
Revenue (loan value):		
Net gain on sale gross margin <sup>(3)</sup>	0.37%	0.63%

(1) Includes all direct sales and back office sales support associates.<sup>(2)</sup> Percentage of loans funded divided by total applications in the period. <sup>(3)</sup> Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.

Gains on sales of mortgage loans net of derivative activities, decreased \$52.2 million, primarily due to lower origination volumes and higher loss provisions for loan repurchases recorded during the current quarter, partially offset by improved loan sale premiums and cost of acquisition.

Premium on loan sales increased to 1.48%, up 104 basis points over the prior year primarily due to favorable interest rates and a higher WAC. Our WAC increased 127 basis points, up to 8.75% from 7.48% in the prior year. Market interest rates, based on the two-year swap, increased from an average of 4.46% last year to 5.24% in the current quarter.

**Table of Contents**

To mitigate the risk of short-term changes in market interest rates related to our loan originations, including our rate-lock equivalents and beneficial interest in Trusts, we use interest rate swaps, put options on Eurodollar futures and forward loan sale commitments. We generally enter into interest rate swap arrangements related to existing loan applications and applications we expect to receive prior to our next anticipated change in rates charged to borrowers. During the quarter, we recorded a net \$29.4 million in losses, compared to gains of \$55.1 million in the prior year, related to our various derivative instruments. The loss for the current quarter was caused by market interest rates, based on the two-year swap, declining 33 basis points compared to an increase of 43 basis points during the prior year quarter. See note 5 to the condensed consolidated financial statements.

During the quarter we continued to experience higher early payment defaults, resulting in an increase in actual and expected loan repurchase activity. As a result, we recorded total loss provisions of \$45.8 million during the three months ended October 31, 2006 compared to \$17.2 million in the prior year. The provision recorded in the current quarter consists of \$33.2 million recorded on loans sold during the current quarter and, due primarily to increases in our estimated loss severity assumption, also included \$12.6 million related to loans sold in prior quarters. Loss provisions as a percent of loan volumes increased 53 basis points over the prior year. See additional discussion of our reserves and repurchase obligations in note 9 to our condensed consolidated financial statements.

The value of MSR recorded in the second quarter decreased to 65 basis points from 71 basis points in the prior year due to changes in our assumptions used to value MSRs and other factors. This decrease, coupled with a decline in origination volumes, resulted in a net decrease of \$44.2 million in gains on sales of mortgage loans. See additional discussion of our MSR assumptions in Item 1, note 3 to the condensed consolidated financial statements and in Item 2, Critical Accounting Policies.

Our cost of acquisition improved 36 basis points to 0.52% primarily as a result of a decrease in the cost to acquire loans from HRBMC and lower third-party broker commissions. Our total cost of origination increased 30 basis points to 1.59% primarily due to a 45.7% decline in origination volumes.

For the three months ended October 31, 2006, gains on sales of mortgage loans includes \$4.1 million in gains on sales of loans to HRB Bank and \$10.6 million in acquisition costs paid to HRBMC to purchase its non-prime loans, both of which are eliminated in consolidation.

During the current quarter, we recorded impairments of \$12.2 million in gains on sales of mortgage assets. We also recorded favorable pretax mark-to-market adjustments in other comprehensive income, which increased the fair value of our residual interests \$8.4 million during the quarter. These adjustments were recorded net of write-downs of \$0.8 million and deferred taxes of \$2.9 million, and will be accreted into income throughout the remaining life of those residual interests. Future changes in interest rates or other assumptions, based on market conditions or actual loan pool performance, could cause additional adjustments to the fair value of the residual interests and could cause changes to the accretion of these residual interests in future periods. In the prior year we also recorded a \$28.7 million gain on the sale of residual interests.

Accretion of residual interests of \$12.9 million for the three months ended October 31, 2006 represents a decrease of \$20.7 million from the prior year. This decrease is primarily due to the sale of previously securitized residual interests during fiscal year 2006 and lower write-ups to residual interest balances.

**Table of Contents**

The following table summarizes the key metrics related to our loan servicing business:

	(dollars in 000s)	
Three months ended October 31,	2006	2005
Average servicing portfolio:		
With related MSR	\$ 64,068,803	\$ 55,150,897
Without related MSR	9,896,993	22,065,265
	\$ 73,965,796	\$ 77,216,162
Ending servicing portfolio:		
With related MSR	\$ 63,904,746	\$ 57,760,815
Without related MSR	9,115,001	24,614,920
	\$ 73,019,747	\$ 82,375,735
Number of loans serviced	427,590	500,935
Average delinquency rate	8.69%	4.37%
Weighted average FICO score	621	622
Weighted average interest rate (WAC) of portfolio	8.06%	7.47%
Carrying value of MSR	\$ 269,679	\$ 245,928

Loan servicing revenues increased \$13.3 million, or 13.2%, compared to the prior year. The increase reflects a higher annualized rate earned on our servicing portfolio. The annualized rate earned on our entire servicing portfolio was 36 basis points for the current quarter, compared to 33 basis points in the prior year. This increase was partially offset by a decline in our average servicing portfolio, which decreased \$3.3 billion, or 4.2%, to \$74.0 billion.

Total expenses for the three months ended October 31, 2006 declined \$7.3 million, or 3.9%, from the prior year. Cost of services increased \$11.8 million as a result of increased amortization of MSR.

Cost of other revenues decreased \$26.8 million, primarily due to \$15.4 million in lower compensation and benefits as a result of the restructuring in the prior year. Occupancy expenses decreased \$2.3 million primarily due to the closing of certain offices during the fourth quarter of fiscal year 2006. Other expenses decreased \$9.2 million, also due primarily to the restructuring in the prior year.

Selling, general and administrative expenses increased \$7.7 million due primarily to a \$2.5 million reduction in costs allocated to HRBMC and higher consulting expenses.

The pretax loss for the three months ended October 31, 2006 was \$39.0 million compared to income of \$48.8 million in the prior year.

**Six months ended October 31, 2006 compared to October 31, 2005**

Mortgage Services revenues decreased \$230.5 million, or 42.6%, for the six months ended October 31, 2006 compared to the prior year.

The following table summarizes the key drivers of loan origination volumes and related gains on sales of mortgage loans:

	(dollars in 000s)	
Six months ended October 31,	2006	2005
Application process:		
Total number of applications	138,048	207,384
Number of sales associates <sup>(1)</sup>	1,825	2,473
Closing ratio <sup>(2)</sup>	51.3%	61.6%

## Originations:

Total number of loans originated/acquired	70,756	127,802
WAC	8.71%	7.50%
Average loan size	\$ 204	\$ 177
Total volume of loans originated/acquired	\$ 14,412,532	\$ 22,678,917
Direct origination and acquisition expenses, net	\$ 135,381	\$ 321,048
Revenue (loan value):		
Net gain on sale gross margin <sup>(3)</sup>	0.61%	1.19%

(1) Includes all direct sales and back office sales support associates.

(2) Percentage of loans funded divided by total applications in the period.

(3) Defined as gain on sale of mortgage loans (including gain or loss on derivatives, mortgage servicing rights and net of direct origination and acquisition expenses) divided by origination volume.

**Table of Contents**

Gains on sales of mortgage loans, net of derivative activities, decreased \$182.3 million from the prior year. This decrease resulted primarily from lower origination volumes and higher loss provisions for loan repurchases recorded during the current year, partially offset by improved loan sale premiums, cost of acquisition and MSR gains.

Our WAC increased 121 basis points, up to 8.71% from 7.50% in the prior year. Market interest rates, based on the two-year swap, increased from an average of 4.26% last year to 5.38% in the current year. These changes in interest rates caused our premium on loan sales to increase 43 basis points, to 1.55% from 1.12% last year.

During the current year, we recorded a net \$16.8 million in losses, compared to gains of \$79.0 million in the prior year, related to our various derivative instruments. The loss for the current year was caused by market interest rates, based on the two-year swap, declining 23 basis points compared to an increase of 80 basis points during the prior year. See note 5 to the condensed consolidated financial statements.

During the current year we experienced higher early payment defaults, resulting in an increase in actual and expected loan repurchase activity. As a result, we recorded total loss provisions of \$138.6 million during the six months ended October 31, 2006 compared to \$31.4 million in the prior year. The provision recorded in the current year consists of \$76.6 million recorded on loans sold during the current period and \$62.0 million related to loans sold in prior periods. Loss provisions as a percent of loan volumes increased 80 basis points over the prior year. See additional discussion of our reserves and repurchase obligations in note 9 to our condensed consolidated financial statements.

The value of MSRs recorded in the current year increased to 64 basis points from 60 basis points in the prior year due to changes in our assumptions used to value MSRs and other factors. However, this increase was offset by a decline in origination volumes, which resulted in a net decrease of \$43.4 million in gains on sales of mortgage loans. See additional discussion of our MSR assumptions in note 3 to the condensed consolidated financial statements and in Item 2, Critical Accounting Policies.

Our cost of acquisition improved 45 basis points to 0.52% primarily as a result of a decrease in the cost to acquire loans from HRBMC and lower third-party broker commissions. Our total cost of origination increased 17 basis points to 1.51% primarily due to lower origination volumes.

For the six months ended October 31, 2006, gains on sales of mortgage loans includes \$14.4 million in gains on sales of loans to HRB Bank and \$19.1 million in acquisition costs paid to HRBMC to purchase its non-prime loans, both of which are eliminated in consolidation.

During the current year, we recorded impairments of \$29.5 million in gains on sales of mortgage assets due to higher credit losses and interest rates. We also recorded favorable pretax mark-to-market adjustments in other comprehensive income, which increased the fair value of our residual interests \$11.8 million during the current year. These adjustments were recorded net of write-downs of \$3.7 million and deferred taxes of \$3.1 million, and will be accreted into income throughout the remaining life of those residual interests. In the prior year we also recorded a \$28.7 million gain on the sale of residual interests.

Accretion of residual interests of \$26.4 million for the six months ended October 31, 2006 represents a decrease of \$38.0 million from the prior year. This decrease is primarily due to the sale of previously securitized residual interests during fiscal year 2006 and lower write-ups to residual interest balances.

**Table of Contents**

The following table summarizes the key metrics related to our loan servicing business:

		(dollars in 000s)	
Six months ended October 31,	2006	2005	
Average servicing portfolio:			
With related MSR	\$ 63,802,118	\$ 52,515,036	
Without related MSR	10,107,535	21,363,081	
	\$ 73,909,653	\$ 73,878,117	
Ending servicing portfolio:			
With related MSR	\$ 63,904,746	\$ 57,760,815	
Without related MSR	9,115,001	24,614,920	
	\$ 73,019,747	\$ 82,375,735	
Number of loans serviced	427,590	500,935	
Average delinquency rate	8.01%	4.69%	
Weighted average FICO score	621	621	
Weighted average interest rate (WAC) of portfolio	7.99%	7.41%	
Carrying value of MSR	\$ 269,679	\$ 245,928	

Loan servicing revenues increased \$32.1 million, or 16.8%, compared to the prior year. The increase reflects a higher annualized rate earned on our servicing portfolio. The annualized rate earned on our entire servicing portfolio was 36 basis points for the current year, compared to 33 basis points in the prior year.

Total expenses for the six months ended October 31, 2006 declined \$7.1 million, or 2.0%, from the prior year. Cost of services increased \$26.1 million as a result of increased amortization of MSR.

Cost of other revenues decreased \$47.9 million, primarily due to \$32.0 million in lower compensation and benefits as a result of the restructuring in the prior year. Occupancy expenses decreased \$7.3 million primarily due to the closing of certain offices during the fourth quarter of fiscal year 2006. Other expenses decreased \$8.6 million, also due primarily to the restructuring in the prior year.

Selling, general and administrative expenses increased \$14.7 million due primarily to a \$6.4 million reduction in costs allocated to HRBMC, coupled with increases in depreciation and consulting expenses.

The pretax loss for the six months ended October 31, 2006 was \$44.0 million compared to income of \$179.5 million in the prior year.

**Table of Contents****BUSINESS SERVICES**

This segment offers middle-market companies accounting, tax and consulting services, wealth management, retirement resources, corporate finance and financial process outsourcing.

**Business Services Operating Statistics**

	Three months ended October 31,		Six months ended October 31,	
	2006	2005	2006	2005
Accounting, tax and consulting:				
Chargeable hours	1,196,377	768,740	2,221,026	1,316,731
Chargeable hours per person	308	310	584	580
Net billed rate per hour	\$ 148	\$ 139	\$ 146	\$ 137
Average margin per person	\$ 24,492	\$ 22,913	\$ 43,798	\$ 40,327

**Business Services Operating Results**

	Three months ended		Six months ended October	
	October 31,		31,	
	2006	2005	2006	2005
				(in 000s)
Service revenues:				
Accounting, tax and consulting	\$ 190,546	\$ 121,790	\$ 352,396	\$ 205,618
Capital markets	16,447	15,355	30,107	30,827
Payroll, benefits and retirement services	7,992	8,617	15,402	16,894
Other services	2,874	11,113	15,807	20,995
	217,859	156,875	413,712	274,334
Other	11,244	9,930	20,522	19,317
Total revenues	229,103	166,805	434,234	293,651
Cost of services:				
Compensation and benefits	142,412	94,894	264,031	166,541
Occupancy	19,529	11,012	38,837	19,175
Other	26,365	16,388	48,220	30,436
	188,306	122,294	351,088	216,152
Amortization of intangible assets	4,126	3,805	9,005	7,608
Other, selling, general and administrative	55,415	42,849	107,450	78,799
Total expenses	247,847	168,948	467,543	302,559
Pretax loss	\$ (18,744)	\$ (2,143)	\$ (33,309)	(8,908)

**Three months ended October 31, 2006 compared to October 31, 2005**

Business Services revenues for the three months ended October 31, 2006 increased \$62.3 million, or 37.3%, from the prior year. This increase was primarily due a \$68.8 million increase in accounting, consulting and tax revenue, primarily attributable to the acquisition of American Express Tax and Business Services, Inc. (AmexTBS) as of October 1, 2005.

Other service revenues decreased \$8.2 million primarily due to a decline in revenue in our financial process outsourcing business.

Total expenses increased \$78.9 million, or 46.7%, for the three months ended October 31, 2006 compared to the prior year. Cost of services increased \$66.0 million, due to increases in compensation and benefits and occupancy expenses. Compensation and benefits increased \$47.5 million, primarily due to the AmexTBS acquisition. Increases in the number of personnel and the average wage per employee, driven by marketplace competition for professional staff, also contributed to the increase. Occupancy expenses and other expenses increased \$8.5 million and \$10.0 million, respectively, primarily due to the AmexTBS acquisition.

Selling, general and administrative expenses increased \$12.6 million, or 29.3%, primarily due to acquisitions and additional costs associated with our business development initiatives.

The pretax loss for the three months ended October 31, 2006 of \$18.7 million compares to a pretax loss of \$2.1 million in the prior year. The increased pretax loss is primarily due to higher losses in our financial process outsourcing and payroll businesses, coupled with additional expenditures for brand initiatives.



**Table of Contents**

**Six months ended October 31, 2006 compared to October 31, 2005**

Business Services revenues for the six months ended October 31, 2006 increased \$140.6 million, or 47.9%, from the prior year. This increase was primarily due to the acquisition of AmexTBS, which increased accounting, tax and consulting revenues \$122.6 million.

Total expenses increased \$165.0 million, or 54.5%, for the six months ended October 31, 2006 compared to the prior year. Cost of services increased \$134.9 million, due to increases in compensation and benefits and occupancy expenses. Compensation and benefits increased \$97.5 million, primarily due to the AmexTBS acquisition. Increases in the number of personnel and the average wage per employee, driven by marketplace competition for professional staff, also contributed to the increase. Occupancy expenses and other expenses increased \$19.7 million and \$17.8 million, respectively, primarily due to the AmexTBS acquisition.

Selling, general and administrative expenses increased \$28.7 million primarily due to acquisitions and additional costs associated with our business development initiatives.

The pretax loss for the six months ended October 31, 2006 of \$33.3 million compares to a pretax loss of \$8.9 million in the prior year. The increased pretax loss is primarily due to higher losses in our financial process outsourcing and payroll businesses, additional expenditures for brand initiatives and, to a lesser extent, off-season losses of AmexTBS.

**Table of Contents****CONSUMER FINANCIAL SERVICES**

This segment is primarily engaged in offering advice-based brokerage services and investment planning through HRBFA, full-service banking through HRB Bank and prime and non-prime mortgage loans through HRBMC. HRBFA, HRB Bank and HRBMC, our Block-branded businesses, are focused on increasing client loyalty and retention by offering expanded financial services to our retail tax clients. HRBFA offers our customers traditional brokerage services, as well as annuities, insurance, fee-based accounts, online account access, equity research and focus lists, model portfolios, asset allocation strategies, and other investment tools and information. HRB Bank offers traditional banking services including checking and savings accounts, home equity lines of credit, individual retirement accounts, certificates of deposit and prepaid debit card accounts. HRB Bank also purchases loans from OOMC, HRBMC and other lenders to hold for investment purposes and HRBFA utilizes HRB Bank for certain FDIC-insured deposits for its customers. HRBMC originates mortgage loans for sale to OOMC, HRB Bank or other third-party buyers.

**Consumer Financial Services Operating Statistics**

	Three months ended October 31,		Six months ended October 31,	
	2006	2005	2006	2005
<b>Broker-dealer:</b>				
Traditional brokerage accounts <sup>(1)</sup>	402,278	428,543	402,278	428,543
New traditional brokerage accounts funded by HRB Tax clients	2,154	3,234	5,155	7,458
Cross-service revenue as a percent of total production revenue	16.1%	15.6%	16.8%	16.5%
Average assets per traditional brokerage account	\$ 80,089	\$ 68,837	\$ 80,089	\$ 68,837
Average margin balances (millions)	\$ 404	\$ 560	\$ 427	\$ 567
Average customer payable balances (millions)	\$ 601	\$ 794	\$ 623	\$ 817
Number of advisors	919	995	919	995
<b>Banking:</b>				
Efficiency ratio <sup>(2)</sup>	40%	N/A	38%	N/A
Annualized net interest margin <sup>(3)</sup>	2.68%	N/A	3.05%	N/A
Annualized return on average assets <sup>(4)</sup>	1.48%	N/A	1.35%	N/A
Total assets (thousands)	\$762,074	N/A	\$ 762,074	N/A
Loans purchased from OOMC (thousands)	\$169,622	N/A	\$ 723,124	N/A
<b>Retail mortgage activities:</b>				
<b>Volume of loans originated (thousands):</b>				
Total	\$769,344	\$1,541,848	\$1,613,658	\$2,892,250
Loans originated to HRB Tax clients	\$123,405	\$ 220,056	\$ 263,648	\$ 546,577
Average loan size (thousands)	\$ 171	\$ 152	\$ 173	\$ 150
Loans sold to OOMC (thousands)	\$471,182	\$1,111,924	\$1,055,607	\$2,062,730

(1) Includes only accounts with a positive balance.

- (2) Defined as non-interest expense divided by revenue net of interest expense. See Reconciliation of Non-GAAP Financial Information at the end of Part I, Item 2.
- (3) Defined as annualized net interest revenue divided by average assets. See Reconciliation of Non-GAAP Financial Information at the end of Part I, Item 2.
- (4) Defined as annualized pretax banking income divided by average assets. See Reconciliation of Non-GAAP Financial Information at the end of Part I, Item 2.

**Table of Contents****Consumer Financial Services Operating Results**

			(in 000s)	
	Three months ended		Six months ended	
	October 31,		October 31,	
	2006	2005	2006	2005
Service revenues:				
Financial advisor production revenue	\$ 45,444	\$ 46,394	\$ 92,463	\$ 91,500
Other	9,212	8,064	17,580	16,271
	54,656	54,458	110,043	107,771
Gain on sale of mortgage loans, net	30,756	51,593	60,138	107,990
Net interest revenue on:				
Margin lending and other	13,030	13,335	26,772	26,072
Banking activities	4,392		8,121	
	17,422	13,335	34,893	26,072
Loan loss reserves mortgage loans held for investment	(364)		(1,702)	
Other	427	813	783	1,390
Total revenues <sup>(1)</sup>	102,897	120,199	204,155	243,223
Cost of services:				
Compensation and benefits	32,458	32,676	64,322	63,211
Occupancy	4,847	5,187	9,908	10,352
Other	5,193	5,541	10,358	10,476
	42,498	43,404	84,588	84,039
Cost of other revenues	12,800	38,203	26,640	73,371
Amortization of intangible assets	9,156	9,156	18,312	18,312
Selling, general and administrative	45,083	39,903	89,035	81,716
Total expenses	109,537	130,666	218,575	257,438
Pretax loss	\$ (6,640)	\$ (10,467)	\$ (14,420)	\$ (14,215)

(1) Total revenues, less interest expense and loan loss reserves on mortgage loans held for

investment.

**Three months ended October 31, 2006 compared to October 31, 2005**

Consumer Financial Services revenues, net of interest expense and loan loss reserves, for the three months ended October 31, 2006 decreased \$17.3 million, or 14.4%, from the prior year, primarily due to lower gains on sales of mortgage loans.

Financial advisor production revenue, which consists primarily of fees earned on assets under administration and commissions on customer trades, was down \$1.0 million from the prior year, as higher annuitized revenues were offset by declining transactional revenues. The following table summarizes the key drivers of production revenue:

Three months ended October 31,	2006	2005
Customer trades	215,289	233,262
Average revenue per trade	\$ 121.86	\$ 123.16
Ending balance of assets under administration (billions)	\$ 32.5	\$ 29.8
Annualized productivity per advisor	\$ 187,000	\$ 180,000

Gain on sale of mortgage loans decreased \$20.8 million, or 40.4%, from the prior year primarily due to a 50.1% decline in origination volumes, partially offset by higher margins on mortgage loans sold. Origination volumes fell primarily due to a decline in applications as well as a decline in the closing ratio. HRBMC sells its non-prime loans to OOMC and its prime loans to other third-party buyers. For the three months ended October 31, 2006, gains on sales of mortgage loans includes \$10.6 million in gains on loans sold to OOMC, which is eliminated in consolidation.

-32-

**Table of Contents**

Net interest revenue on banking activities totaled \$4.4 million for the three months ended October 31, 2006. The following table summarizes the key drivers of net interest revenue on banking activities:

Three months ended October 31,	(in 000s)	
	2006	2005
Average loans	\$ 612,055	N/A
Average investments	\$ 38,641	N/A
Average deposits	\$ 492,315	N/A

Total segment expenses decreased \$21.1 million, or 16.2%, from the prior year. Cost of other revenues decreased \$25.4 million, or 66.5%, primarily as a result of the restructuring of our mortgage operations in fiscal year 2006.

Selling, general and administrative expenses increased \$5.2 million, or 13.0%, primarily due to the expenses of HRB Bank, which opened May 1, 2006.

The pretax loss for Consumer Financial Services for the three months ended October 31, 2006 was \$6.6 million compared to the prior year loss of \$10.5 million.

**Six months ended October 31, 2006 compared to October 31, 2005**

Consumer Financial Services revenues, net of interest expense and loan loss reserves, for the six months ended October 31, 2006 decreased \$39.1 million, or 16.1%, from the prior year, primarily due to lower gains on sales of mortgage loans.

Financial advisor production revenue, which consists primarily of fees earned on assets under administration and commissions on customer trades, increased \$1.0 million over the prior year due primarily to higher annuitized revenues, partially offset by declining transactional revenues. The following table summarizes the key drivers of production revenue:

Six months ended October 31,	2006	2005
Customer trades	439,337	459,640
Average revenue per trade	\$ 117.18	\$ 124.90
Ending balance of assets under administration (billions)	\$ 32.5	\$ 29.8
Annualized productivity per advisor	\$ 194,000	\$ 180,000

Gain on sale of mortgage loans decreased \$47.9 million, or 44.3%, from the prior year primarily due to a 44.2% decline in origination volumes, coupled with lower margins on mortgage loans sold. Origination volumes fell primarily due to a decline in applications as well as a decline in the closing ratio. HRBMC sells its non-prime loans to OOMC and its prime loans to other third-party buyers. For the six months ended October 31, 2006, gains on sales of mortgage loans includes \$19.1 million in gains on loans sold to OOMC, which is eliminated in consolidation.

Net interest revenue on banking activities totaled \$8.1 million for the six months ended October 31, 2006. The following table summarizes the key drivers of net interest revenue on banking activities:

Six months ended October 31,	(in 000s)	
	2006	2005
Average loans	\$ 496,472	N/A
Average investments	\$ 29,793	N/A
Average deposits	\$ 369,942	N/A

Total segment expenses decreased \$38.9 million, or 15.1%, over the prior year. Cost of other revenues decreased \$46.7 million, or 63.7%, primarily as a result of the restructuring of our mortgage operations in fiscal year 2006.

Selling, general and administrative expenses increased \$7.3 million, or 9.0%, primarily due to the expenses of HRB Bank, which opened May 1, 2006.

The pretax loss for Consumer Financial Services for the six months ended October 31, 2006 was \$14.4 million compared to the prior year loss of \$14.2 million.

-33-

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**Table of Contents****FINANCIAL CONDITION**

These comments should be read in conjunction with the condensed consolidated balance sheets and condensed consolidated statements of cash flows found on pages 1 and 3, respectively.

**CAPITAL RESOURCES & LIQUIDITY BY SEGMENT**

Our sources of capital include cash from operations, issuances of common stock and debt. We use capital primarily to fund working capital requirements, pay dividends, repurchase our shares and acquire businesses.

**Cash From Operations.** Cash used in operations totaled \$1.2 billion and \$704.9 million for the six months ended October 31, 2006 and 2005, respectively. The increase in cash used in operating activities is primarily due to higher losses during the current year, an increase of \$143.8 million in income tax payments and increases in mortgage loans held for sale.

**Issuance of Common Stock.** We issue shares of common stock, in accordance with our stock-based compensation plans, out of treasury shares. Proceeds from the issuance of common stock totaled \$17.4 million and \$48.0 million for the six months ended October 31, 2006 and 2005, respectively.

**Dividends.** Dividends paid totaled \$84.2 million and \$77.4 million for the six months ended October 31, 2006 and 2005, respectively.

**Share Repurchases.** On June 7, 2006, our Board approved an additional authorization to repurchase 20.0 million shares. During the six months ended October 31, 2006, we repurchased 8.1 million shares pursuant to this authorization and a prior authorization at an aggregate price of \$180.9 million or an average price of \$22.22 per share. There are 22.4 million shares remaining under these authorizations at October 31, 2006. We plan to continue to purchase shares on the open market in accordance with this authorization, subject to various factors including the price of the stock, the availability of excess cash, our ability to maintain liquidity and financial flexibility, securities law restrictions, targeted capital levels and other investment opportunities available.

**Debt.** We plan to refinance our \$500.0 million in Senior Notes, which are due in April 2007.

**Restricted Cash.** We hold certain cash balances that are restricted as to use. Cash and cash equivalents restricted totaled \$416.9 million at October 31, 2006 compared to \$394.1 million at April 30, 2006. Consumer Financial Services held \$341.0 million of this total segregated in a special reserve account for the exclusive benefit of its broker-dealer customers. Restricted cash held by Mortgage Services totaled \$52.6 million and is held primarily for outstanding commitments to fund mortgage loans. Restricted cash of \$23.0 million at October 31, 2006 held by Business Services is related to funds held to pay payroll taxes on behalf of its customers.

**Segment Cash Flows.** A condensed consolidating statement of cash flows by segment for the six months ended October 31, 2006 follows. Generally, interest is not charged on intercompany activities between segments.

	(in 000s)					
	Tax Services	Mortgage Services	Business Services	Consumer Financial Services	Corporate	Consolidated H&R Block
Cash provided by (used in):						
Operations	\$ (408,842)	\$ (132,513)	\$ (6,573)	\$ 33,718	\$ (676,082)	\$ (1,190,292)
Investing	(24,697)	2,758	(13,661)	(295,896)	(40,393)	(371,889)
Financing	(44,146)		(4,600)	578,643	780,199	1,310,096
Net intercompany	455,383	141,582	11,852	(277,963)	(330,854)	

Net intercompany activities are excluded from investing and financing activities within the segment cash flows. We believe that by excluding intercompany activities, the cash flows by segment more clearly depicts the cash generated and used by each segment. Had intercompany activities been included, those segments in a net lending situation would have been included in investing activities, and those in a net borrowing situation would have been included in financing activities.



**Tax Services.** Tax Services has historically been our largest provider of annual operating cash flows. The seasonal nature of Tax Services generally results in a large positive operating cash flow in the fourth quarter. Tax Services used \$408.8 million in its current six-month operations to cover off-season costs and working capital requirements. This segment used \$24.7 million in investing

**Table of Contents**

activities primarily related to capital expenditures and acquisitions, and used \$44.1 million in financing activities related to book overdrafts.

**Mortgage Services.** This segment primarily generates cash as a result of the sale and securitization of mortgage loans and residual interests, and as its residual interests begin to cash flow. Mortgage Services used \$132.5 million in cash from operating activities primarily due to losses during the current year, and loan originations exceeding loan sales during the six months ended October 31, 2006. Cash flows provided by investing activities consist primarily of \$6.4 million in cash receipts on available-for-sale residual interests.

We believe the sources of liquidity available to the Mortgage Services segment are sufficient for its needs.

**Business Services.** Business Services funding requirements are largely related to receivables for completed work and work in process. We provide funding sufficient to cover their working capital needs. This segment used \$6.6 million in operating cash flows during the first six months of the year. Business Services used \$13.7 million in investing activities primarily related to capital expenditures and used \$4.6 million in financing activities primarily due to payments on acquisition debt.

**Consumer Financial Services.** In the first six months of fiscal year 2007, Consumer Financial Services provided \$33.7 million in cash from its operating activities primarily due to the timing of cash deposits that are restricted for the benefit of its broker-dealer customers. The segment also used \$295.9 million in investing activities primarily for the purchase of mortgage loans held for investment and provided \$578.6 million in financing activities due primarily to \$595.8 million in FDIC-insured deposits held at HRB Bank.

To finance our prime mortgage loan originations, we utilize an on-balance sheet warehouse facility with capacity up to \$25 million. This annual facility bears interest at one-month LIBOR plus 140 to 200 basis points. As of October 31, 2006 and April 30, 2006, the balance outstanding under this facility was \$3.2 million and \$1.6 million, respectively.

HRB Bank is a member of the FHLB of Des Moines, which extends credit availability to member banks based on eligible collateral and asset size. At October 31, 2006, HRB Bank had FHLB advance capacity of \$266.7 million, but no amounts had been drawn on this facility.

We believe the funding sources for Consumer Financial Services are stable. Liquidity risk within this segment is primarily limited to maintaining sufficient capital levels to obtain securities lending liquidity to support margin borrowing by customers.

**OFF-BALANCE SHEET FINANCING ARRANGEMENTS**

There have been no material changes in our off-balance sheet financing arrangements from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**COMMERCIAL PAPER ISSUANCE AND SHORT-TERM BORROWINGS**

There have been no material changes in our commercial paper program from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

There have been no material changes in our contractual obligations and commercial commitments from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**REGULATORY ENVIRONMENT**

In March 2006, the OTS approved the federal savings bank charter of HRB Bank. HRB Bank commenced operations on May 1, 2006, at which time H&R Block, Inc. became a savings and loan holding company. As a savings and loan holding company, H&R Block, Inc. is subject to regulation by the OTS. Federal savings banks are subject to extensive regulation and examination by the OTS, their primary federal regulator, as well as the Federal Deposit Insurance Corporation (FDIC). H&R Block, Inc. is now subject to a three percent minimum ratio of adjusted tangible capital to adjusted total assets, as defined by the OTS, and HRB Bank is subject to various OTS capital requirements. A banking institution's capital category depends upon where its capital levels are in relation to

**Table of Contents**

relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure, a tangible equity ratio measure, and certain other factors. See note 8 to the condensed consolidated financial statements for additional discussion of regulatory capital requirements and classifications.

HRB Bank is an indirect wholly-owned subsidiary of H&R Block, Inc. and is insured by the FDIC. If an insured institution fails, claims for administrative expenses of the receiver and for deposits in U.S. branches (including claims of the FDIC as subrogee of the failed institution) have priority over the claims of general unsecured creditors. In addition, the FDIC has authority to require H&R Block, Inc. to reimburse it for losses it incurs in connection with the failure of HRB Bank or with the FDIC's provision of assistance to a banking subsidiary that is in danger of failure.

Other than the items discussed above, there have been no material changes in our regulatory environment from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**CRITICAL ACCOUNTING POLICIES**

The following discussion is an update to previous disclosure regarding certain of our critical accounting policies and should be read in conjunction with the complete critical accounting policies disclosures included in our Annual Report on Form 10-K for the year ended April 30, 2006. For all of our critical accounting policies, we caution that future events rarely develop precisely as forecasted, and estimates routinely require adjustment and may require material adjustment.

**Gains on Sales of Mortgage Assets**

We sell substantially all of the non-prime mortgage loans we originate to warehouse trusts (the Trusts) which are qualifying special purpose entities (QSPEs), with servicing rights generally retained. Prime mortgage loans are sold in loan sales, servicing released, to third-party buyers. Gains on sales of mortgage assets are recognized when control of the assets is surrendered (when loans are sold to third-party buyers, including the Trusts) and are based on the difference between net proceeds received (cash proceeds less recourse obligations) and the allocated cost of the assets sold. We determine the allocated cost of assets sold based on the relative fair values of net proceeds (i.e. the loans sold), retained MSR and the beneficial interest in Trusts, which represents our residual interest in the ultimate expected outcome from the disposition of the loans by the Trusts.

The following is an example of a hypothetical gain on sale calculation:

	(in 000s)
Acquisition cost of underlying mortgage loans	\$ 1,000,000
Fair values:	
Net proceeds	
Cash received	\$ 999,000
Less recourse obligation	(4,000)
	\$ 995,000
Beneficial interest in Trusts	20,000
MSRs	7,000
	\$ 1,022,000
Computation of gain on sale:	
Net proceeds	\$ 995,000
Less allocated cost ( $\$995,000 / \$1,022,000 \times \$1,000,000$ )	973,581
Recorded gain on sale	\$ 21,419
Recorded beneficial interest in Trusts ( $\$20,000 / \$1,022,000 \times \$1,000,000$ )	\$ 19,570

Recorded value of MSR $s$  ( $\$7,000 / \$1,022,000 \times \$1,000,000$ ) \$ 6,849

Recorded liability for recourse obligation \$ 4,000

Variations in the assumptions we use affect the estimated fair values and the reported gains on sales. Gains on sales of mortgage loans totaled \$58.1 million and \$278.0 million for six months ended October 31, 2006 and 2005, respectively.

Our recourse obligation relates to potential losses that could be incurred related to the repurchase of sold loans or indemnification of losses as a result of early payment defaults or breaches of other representations and warranties customary to the mortgage banking industry.

-36-

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**Table of Contents**

The substantial majority of loan repurchases or indemnification for losses occurs within nine months from the date the loans are sold. We estimate the fair value of the recourse liability at the time the loan is sold. Provisions for losses are charged to gain on sale of mortgage loans and credited to the recourse liability, while actual losses are charged to the liability. We evaluate, and adjust if necessary, the fair value of the recourse obligation quarterly based on current information and trends in underlying loan performance. The amount of losses we expect to incur related to the repurchase of sold loans depends primarily on the frequency of early payment defaults, the rate at which defaulted loans subsequently become current on payments (cure rate), the propensity of the buyer of the loans to demand recourse under the loan sale agreement and the severity of loss incurred on loans which have been repurchased. The frequency of early payment defaults, cure rates and loss severity may vary depending on the creditworthiness of the borrower and economic factors such as home price appreciation and interest rates. To the extent actual losses related to repurchase activity are different from our estimates, the fair value of our recourse obligation will increase or decrease.

During the six months ended October 31, 2006 we experienced higher early payment defaults, resulting in an increase in actual and expected loan repurchase activity. As a result, we recorded total loss provisions of \$138.6 million during the six months ended October 31, 2006 compared to \$31.4 million in the prior year. Loss provisions recorded in the current year consist of \$76.6 million recorded on loans sold during the current year and \$62.0 million related to loans sold in prior periods. At October 31, 2006, we assumed that substantially all loans that failed to make timely payments according to contractual early payment default provisions will be repurchased, and that 5% of loans will be repurchased from sales that have not yet reached the contractual date upon which repurchases can be determined. Based on historical experience and review of current early payment default, cure rate and loss severity trends, we assumed 30% of all loans we repurchase will cure with no loss incurred, and of those that do not cure, we assumed an average 17% loss severity. During the three months ended October 31, 2006, we increased our estimated loss severity assumption from 15% to 17% and, as a result, recorded \$12.6 million in reserves related to loans sold in prior quarters.

Based on our analysis as of October 31, 2006, we estimated our liability for recourse obligations to be \$84.1 million. The sensitivity of the recourse liability to 10% and 20% adverse changes in loss assumptions is \$8.4 million and \$16.8 million, respectively.

**Valuation of MSRs**

MSRs are recorded when we sell loans to third-parties with the servicing of those loans retained. At the time of the loan sale, we determine and record on our balance sheet the allocated historical cost of the MSRs attributable to loans sold, as illustrated above. These MSRs are amortized into expense over the estimated life of the underlying loans. MSRs are carried at the lower of cost or market (LOCOM). On a quarterly basis, MSRs are assessed to determine if our carrying value exceeds fair value. Fair value is estimated using a discounted cash flow approach by stratifying the MSRs based on underlying loan characteristics, including the calendar year the loans are sold. To the extent fair value is less than carrying value we record an impairment charge and adjust the carrying value of the MSRs.

A market price of our MSRs is not readily available because non prime MSRs are not actively traded in the marketplace. Therefore, the fair value of our MSRs is estimated using a discounted cash flow approach, using valuation methods and assumptions we believe incorporate assumptions used by market participants. Certain of these assumptions are subjective and require a high level of management judgment. MSR valuation assumptions are reviewed and approved by management on a quarterly basis. In determining the assumptions to be used to value MSRs, we review the historical performance of our MSRs, including back-testing of the performance of certain individual assumptions (comparison of actual results to those expected). In addition, we periodically review third-party valuations of certain of our MSRs and peer group MSR valuation surveys to assess the reasonableness of our valuation assumptions and resulting fair value estimates.

Critical assumptions used in our discounted cash flow model include mortgage prepayment speeds, discount rates, costs to service and ancillary income. Variations in our assumptions could materially affect the estimated fair values. Changes to our assumptions are made when current trends and market data indicate that new trends have developed. Certain assumptions, such as



**Table of Contents**

ancillary interest income, may change from quarter to quarter as market conditions and projected interest rates change. Other assumptions, such as expected prepayment speeds, discount rates and costs of servicing may change less frequently as they are less sensitive to near-term market conditions.

Prepayment speeds may be affected by economic factors such as home price appreciation, market interest rates, the availability of other credit products to our borrowers and customer payment patterns. Prepayment speeds include the impact of all borrower prepayments including full payoffs, additional principal payments and the impact of loans paid off due to foreclosure liquidations. As market interest rates decline, prepayment speeds will generally increase as customers refinance existing mortgages under more favorable interest rate terms. As prepayment speeds increase, anticipated cash flows will generally decline resulting in a potential reduction, or impairment, to the fair value of the capitalized MSR. Alternatively, an increase in market interest rates may cause a decrease in prepayment speeds, and an increase in fair value of MSR. Many of our loans include prepayment penalties during the first two to three years. Prepayment penalties tend to lower prepayment speeds during the early life of our loans, regardless of market interest rate movements, therefore decreasing the sensitivity of expected prepayment speeds to changes in interest rates. Prepayment speeds are estimated based on historical experience and third-party market sources. Changes are made as necessary to ensure such estimates reflect current market conditions specific to our individual MSR stratas.

Discount rates are determined by reviewing market rates used by market participants. These rates may vary based on economic factors such as market perception of risk and changes in the risk-free interest rates. Changes are made as necessary to ensure such estimates reflect current market conditions for MSR assets.

Costs to service includes the cost to process loan payments, make payments to bondholders, collect delinquent accounts and administrative foreclosure activities. Market trends and changes to underlying expenses are evaluated to determine if updates to assumptions are necessary. The economic factors affecting costs to service include unemployment rates, the housing market and the cost of labor. Higher unemployment rates may lead to higher delinquency and foreclosure rates resulting in higher costs to service loans. The housing market, including home price appreciation rates, impacts sale prices for homes in foreclosure and our borrowers' ability to refinance or sell their properties in the event that they can no longer afford their homes, thus impacting delinquencies and foreclosures.

Ancillary fees and income include late charges, non-sufficient funds fees, collection fees and interest earning funds held in deposit. These fees could be impacted by state legislation efforts, customer behavior, fee waiver policies and industry trends.

During the period from October 31, 2005 to the current quarter ended October 31, 2006, assumptions used in valuing MSRs have been updated. The significant changes and their impact, both in dollars and basis points of loans sold during the quarter of initial implementation, are outlined below beginning with the most recent changes.

Description	Change	Impact	(dollars in 000s) Quarter Implemented
Ancillary fees	Decreased average number of days of interest collected related to prepayments	(\$3,677) or (5) basis points	July 31, 2006
Discount rate	15% to 18%	(\$2,555) or (3) basis points	January 31, 2006
Costs to service	Decreased the number of days of interest paid to investors	\$12,893 or 11 basis points	October 31, 2005

During the period ended July 31, 2006, we updated our assumption related to the average number of days of interest collected on funds received as a result of prepayments (Ancillary fees on the table above). We decreased the average number of days of interest collected following a review of the servicing portfolio data. During the quarter ended January 31, 2006, we increased the discount

**Table of Contents**

rate assumption (Discount rate on the table above) used to determine the fair value of MSR from 15% to 18% as a result of an analysis of third party data including rates used by other market participants. During the quarter ended October 31, 2005, we updated our assumption for number of days of interest paid to investors (Costs to service on the table above) on monthly loan prepayments upon the completion of a review of the historical performance of the servicing portfolio. The cumulative net impact of the changes outlined above and other less significant changes made during the period from October 31, 2005 to October 31, 2006 was an increase of approximately 5 basis points for MSRs initially recorded in the current quarter compared to the prior year quarter.

The changes outlined above are applied not only when we determine the allocated historical cost of MSRs, but are also used in our evaluation of the fair value of the MSR portfolio in conjunction with our impairment review. The changes in assumptions primarily impact the recognition of our initial MSR value through calculation of the gain on sale of mortgage assets. Because MSRs are recorded at LOCOM, we are unable to adjust our MSR portfolio value upward, thus have not recognized the positive impact of the assumption changes on the MSR portfolio as a whole.

MSRs with a book value of \$269.7 million are included in our condensed consolidated balance sheet at October 31, 2006. While changes in any assumption could impact the value of our MSRs, the primary drivers of significant changes to the value of our MSRs are prepayment speeds, discount rates, costs to service and ancillary fees. Below is a table showing the effect of a variation of a particular assumption on the fair value of our MSRs without changing any other assumptions. In reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

Assumption	Impact on Fair Value
Prepayments (including defaults):	
Adverse 10% % impact on fair value	(9%)
Adverse 20% % impact on fair value	(16%)
Discount rate:	
Adverse 10% % impact on fair value	(2%)
Adverse 20% % impact on fair value	(4%)
Ancillary Fees and Income:	
Adverse 10% % impact on fair value	(4%)
Adverse 20% % impact on fair value	(8%)
Costs to service:	
Adverse 10% % impact on fair value	(4%)
Adverse 20% % impact on fair value	(7%)

**FORWARD-LOOKING INFORMATION**

In this report, and from time to time throughout the year, we share our expectations for our future performance. These forward-looking statements are based upon current information, expectations, estimates and projections regarding the Company, the industries and markets in which we operate, and our assumptions and beliefs at that time. These statements speak only as of the date on which they are made, are not guarantees of future performance, and involve certain risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results could materially differ from what is expressed, implied or forecast in these forward-looking statements. Words such as believe, will, plan, expect, intend, estimate, approximate, and similar expressions may identify such forward-looking statements.

**RECONCILIATION OF NON-GAAP FINANCIAL INFORMATION**



We report our financial results in accordance with generally accepted accounting principles (GAAP). However, we believe certain non-GAAP performance measures and ratios used in managing the business may provide additional meaningful comparisons between current year results and prior periods. Reconciliations to GAAP financial measures are provided below. These non-GAAP financial measures should be viewed in addition to, not as an alternative for, our reported GAAP results.

**Table of Contents****Origination Margin**

	(dollars in 000s)			
	Three months ended October 31,		Six months ended October 31,	
	2006	2005	2006	2005
Total expenses	\$ 179,617	\$ 186,951	\$ 354,217	\$ 361,334
Add: Expenses netted against gain on sale revenues	60,786	161,028	135,381	321,048
Less:				
Cost of services	(79,625)	(67,811)	(158,313)	(132,203)
Cost of acquisition	(34,543)	(107,366)	(75,230)	(220,377)
Allocated support departments	(5,828)	(5,472)	(11,123)	(10,242)
Other	(15,392)	(10,409)	(27,774)	(16,779)
	\$ 105,015	\$ 156,921	\$ 217,158	\$ 302,781
Divided by origination volume	\$ 6,620,475	\$ 12,190,884	\$ 14,412,532	\$ 22,678,917
Total cost of origination	1.59%	1.29%	1.51%	1.34%

**Banking Ratios**

	(dollars in 000s)	
	Three months ended October 31, 2006	Six months ended October 31, 2006
Efficiency Ratio:		
Total Consumer Financial Services expenses	\$ 119,084	\$ 235,162
Less: Interest and non-banking expenses	(117,244)	(231,987)
Non-interest banking expenses	\$ 1,840	\$ 3,175
Total Consumer Financial Services revenues	\$ 112,444	\$ 220,742
Less: Non-banking revenues and interest expense	(107,820)	(212,278)
Banking revenue net of interest expense	\$ 4,624	\$ 8,464
	40%	38%
Net Interest Margin (annualized):		
Net banking interest revenue	\$ 4,392	\$ 8,121
Net banking interest revenue (annualized)	\$ 17,568	\$ 16,242
Divided by average assets	\$ 656,024	\$ 532,131
	2.68%	3.05%
Return on Average Assets (annualized):		
Total Consumer Financial Services pretax loss	\$ (6,640)	(14,420)

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Less: Non-banking pretax loss		9,060		18,008
Pretax banking income	\$	2,420	\$	3,588
Pretax banking income (annualized)	\$	9,680	\$	7,176
Divided by average assets	\$	656,024	\$	532,131
		1.48%		1.35%

-40-

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**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The sensitivities of certain financial instruments to changes in interest rates as of October 31, 2006 are presented below. The following table represents hypothetical instantaneous and sustained parallel shifts in interest rates and should not be relied on as an indicator of future expected results.

	Carrying Value at October 31, 2006	Basis Point Change					
		-300	-200	-100	+100	+200	+300
Mortgage loans held for investment	\$ 683,839	\$ 23,326	\$ 17,029	\$ 10,195	\$ (15,805)	\$ (32,493)	\$ (48,864)
Mortgage loans held for sale	432,064	18,108	11,762	5,882	(5,930)	(11,506)	(15,470)

There have been no other material changes in our market risks from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**ITEM 4. CONTROLS AND PROCEDURES****EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

As of the end of the period covered by this Form 10-Q, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There were no changes that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The information below should be read in conjunction with the information included in note 10 to our condensed consolidated financial statements.

**RAL LITIGATION**

We reported in our annual report on Form 10-K for the year ended April 30, 2006, certain events and information regarding lawsuits throughout the country regarding the RAL Cases. The RAL Cases have involved a variety of legal theories asserted by plaintiffs. These theories include allegations that, among other things, disclosures in the RAL applications were inadequate, misleading and untimely; the RAL interest rates were usurious and unconscionable; we did not disclose that we would receive part of the finance charges paid by the customer for such loans; untrue, misleading or deceptive statements in marketing RALs; breach of state laws on credit service organizations; breach of contract, unjust enrichment, unfair and deceptive acts or practices; violations of the federal Racketeer Influenced and Corrupt Organizations Act; violations of the federal Fair Debt Collection Practices Act and unfair competition regarding debt collection activities; and that we owe, and breached, a fiduciary duty to our customers in connection with the RAL program.

The amounts claimed in the RAL Cases have been very substantial in some instances. We have successfully defended against numerous RAL Cases, some of which were dismissed on our motions for dismissal or summary judgment, and others were dismissed voluntarily by the plaintiffs after denial of class certification. Other cases have been settled, with one settlement resulting in a pretax expense of \$43.5 million in fiscal year 2003 (the Texas RAL Settlement ) and other settlements resulting in a combined pretax expense in fiscal year 2006 of \$70.2 million (the 2006 Settlements ).

We believe we have meritorious defenses to the remaining RAL Cases and we intend to defend them vigorously. There can be no assurances, however, as to the outcome of the pending RAL Cases



**Table of Contents**

individually or in the aggregate. Likewise, there can be no assurances regarding the impact of the RAL Cases on our financial statements. We have accrued our best estimate of the probable loss related to the RAL Cases. The following is updated information regarding the pending RAL Cases that are attorney general actions or class actions or putative class actions:

*Lynne A. Carnegie, et al. v. Household International, Inc., H&R Block, Inc., et al.*, (formerly Joel E. Zawikowski, et al. v. Beneficial National Bank, H&R Block, Inc., Block Financial Corporation, et al.) Case No. 98 C 2178, United States District Court for the Northern District of Illinois, Eastern Division, instituted on April 18, 1998. This case constitutes one of the 2006 Settlements. On April 19, 2006, we entered into a settlement agreement regarding this case, subject to final court approval. The settlement was approved by the court on August 28, 2006. Appeals have been filed and are pending.

*Sandra J. Basile, et al. v. H&R Block, Inc., et al.*, April Term 1992 Civil Action No. 3246 in the Court of Common Pleas, First Judicial District Court of Pennsylvania, Philadelphia County, instituted on April 23, 1993. The court decertified the class on December 31, 2003. The Pennsylvania appellate court subsequently reversed the trial court's decertification decision. On September 26, 2006, the Pennsylvania Supreme Court reversed the appellate court's reversal of the trial court's decision to decertify the class. The plaintiff is seeking further review by the appellate court.

*Deadra D. Cummins, et al. v. H&R Block, Inc., et al.*, Case No. 03-C-134 in the Circuit Court of Kanawha County, West Virginia, instituted on January 22, 2003. The court approved the settlement of this case on June 8, 2006. An appeal has been filed and is pending.

**PEACE OF MIND LITIGATION**

*Lorie J. Marshall, et al. v. H&R Block Tax Services, Inc., et al.*, Civil Action 2003L000004, in the Circuit Court of Madison County, Illinois, is a class action case filed on January 18, 2002, that was granted class certification on August 27, 2003. Plaintiffs' claims consist of five counts relating to the Peace of Mind (POM) program under which the applicable tax return preparation subsidiary assumes liability for additional tax assessments attributable to tax return preparation error. The plaintiffs allege that the sale of POM guarantees constitutes (i) statutory fraud by selling insurance without a license, (ii) an unfair trade practice, by omission and by cramming (*i.e.*, charging customers for the guarantee even though they did not request it or want it), and (iii) a breach of fiduciary duty. In August 2003, the court certified the plaintiff classes consisting of all persons who from January 1, 1997 to final judgment (i) were charged a separate fee for POM by H&R Block or a defendant H&R Block class member; (ii) reside in certain class states and were charged a separate fee for POM by H&R Block or a defendant H&R Block class member not licensed to sell insurance; and (iii) had an unsolicited charge for POM posted to their bills by H&R Block or a defendant H&R Block class member. Persons who received the POM guarantee through an H&R Block Premium office and persons who reside in Alabama are excluded from the plaintiff class. The court also certified a defendant class consisting of any entity with names that include H&R Block or HRB, or are otherwise affiliated or associated with H&R Block Tax Services, Inc., and that sold or sells the POM product. The trial court subsequently denied the defendants' motion to certify class certification issues for interlocutory appeal. Discovery is proceeding. No trial date has been set, although plaintiffs have indicated that they plan to seek a trial in July 2007.

There is one other putative class action pending against us in Texas that involves the POM guarantee. This case is being tried before the same judge that presided over the Texas RAL Settlement, involves the same plaintiffs' attorneys that are involved in the Marshall litigation in Illinois, and contains similar allegations. No class has been certified in this case.

We believe the claims in the POM actions are without merit, and we intend to defend them vigorously. The amounts claimed in the POM actions are substantial, however, and there can be no assurances as to the outcome of these pending actions individually or in the aggregate. Likewise, there can be no assurances regarding the impact of these actions on our consolidated financial statements.

**EXPRESS IRA LITIGATION**

On March 15, 2006, the New York Attorney General filed a lawsuit in the Supreme Court of the State of New York, County of New York (Index No. 06/401110) entitled *The People of New York v.*

**Table of Contents**

*H&R Block, Inc. and H&R Block Financial Advisors, Inc.* The complaint alleges fraudulent business practices, deceptive acts and practices, common law fraud and breach of fiduciary duty with respect to the Express IRA product. The complaint seeks equitable relief, disgorgement of profits, damages and restitution, civil penalties and punitive damages. On December 1, 2006, the Supreme Court of the State of New York issued a ruling that dismissed the New York Attorney General's lawsuit in its entirety, but granted the New York Attorney General leave to amend and refile the lawsuit. We intend to defend this case vigorously, but there are no assurances as to its outcome.

In addition to the New York Attorney General action, a number of civil actions were filed against us concerning the Express IRA matter, the first of which was filed on March 17, 2006. All of the civil actions pending in federal court have been consolidated by the panel for Multi-District Litigation into a single action styled *In re H&R Block, Inc. Express IRA Marketing Litigation* in the United States District Court for the Western District of Missouri. We intend to defend these cases vigorously, but there are no assurances as to their outcome.

**SECURITIES AND SHAREHOLDER DERIVATIVE LITIGATION**

On March 17, 2006, the first of three putative class actions alleging violations of certain securities laws were filed against the Company and certain of its current and former officers and directors (the Securities Class Action Cases). In addition, on April 5, 2006, the first of six shareholder derivative actions purportedly brought on behalf of the Company (which is named as a nominal defendant) were filed against certain of the Company's current and former directors and officers (the Derivative Cases). The Securities Class Action Cases alleged, among other things, deceptive, material and misleading financial statements, failure to prepare financial statements in accordance with generally accepted accounting principles and concealment of the potential for lawsuits stemming from the allegedly fraudulent nature of the Company's operations. The actions seek unspecified damages and equitable relief. The Derivative Cases generally involved allegations of breach of fiduciary duty, abuse of control, gross mismanagement, waste and unjust enrichment pertaining to (i) the Company's restatement of financial results due to errors in determining the Company's state effective income tax rate and (ii) certain of the Company's products and other business activities. On September 20, 2006, the United States District Court for the Western District of Missouri ordered all of the Securities Class Action Cases and the Derivative Cases consolidated into a single action styled *In re H&R Block Securities Litigation*. The court will appoint a lead plaintiff who will then file a consolidated complaint. We intend to defend this litigation vigorously, but there are no assurances as to its outcome.

**OTHER CLAIMS AND LITIGATION**

As reported previously, the NASD brought charges against HRBFA regarding the sale by HRBFA of Enron debentures in 2001. A hearing for this matter commenced in May 2006, was recessed until the fall of 2006 and is scheduled to continue through August 2007. We intend to defend the NASD charges vigorously, although there can be no assurances regarding the outcome and resolution of the matter.

As part of an industry-wide review, the IRS is investigating tax-planning strategies that certain RSM clients utilized during fiscal years 2000 through 2003. Specifically, the IRS is examining these strategies to determine whether RSM complied with tax shelter reporting and listing regulations and whether such strategies were abusive as defined by the IRS. If the IRS were to determine that RSM did not comply with the tax shelter reporting and listing regulations, it might assess fines or penalties against RSM. Moreover, if the IRS were to determine that the tax planning strategies were inappropriate, clients that utilized the strategies could face penalties and interest for underpayment of taxes. Some of these clients are seeking or may attempt to seek recovery from RSM. There can be no assurance regarding the outcome of and resolution of this matter.

We have from time to time been party to claims and lawsuits not discussed herein arising out of our business operations. These claims and lawsuits include actions by state attorneys general, individual plaintiffs, and cases in which plaintiffs seek to represent a class of similarly situated customers. The amounts claimed in these claims and lawsuits are substantial in some instances, and the ultimate liability with respect to such litigation and claims is difficult to predict. Some of these claims and lawsuits pertain to RALs, the electronic filing of customers' income tax returns, the POM guarantee program, business valuation services and our Express IRA program. We believe we have meritorious defenses to each of these claims, and we are defending or intend to defend them vigorously, although there is no assurance as to their outcome.





**Table of Contents**

In addition to the aforementioned types of cases, we are parties to claims and lawsuits that we consider to be ordinary, routine litigation incidental to our business, including claims and lawsuits (Other Claims) concerning investment products, the preparation of customers' income tax returns, the fees charged customers for various products and services, losses incurred by customers with respect to their investment accounts, relationships with franchisees, denials of mortgage loans, contested mortgage foreclosures, other aspects of the mortgage business, intellectual property disputes, employment matters and contract disputes. We believe we have meritorious defenses to each of the Other Claims, and we are defending them vigorously. While we cannot provide assurance that we will ultimately prevail in each instance, we believe the amount, if any, we are required to pay in the discharge of liabilities or settlements in these Other Claims will not have a material adverse effect on our consolidated financial statements.

**ITEM 1A. RISK FACTORS**

**Consumer Financial Services.** H&R Block, Inc. is a savings and loan holding company, and HRB Bank is a federal savings bank, which is subject to regulation by the OTS and FDIC. Federal and state laws and regulations govern numerous matters including: changes in the ownership or control of banks and bank holding companies; maintenance of adequate capital and the financial condition of a financial institution; permissible types, amounts and terms of extensions of credit and investments; permissible non-banking activities; the level of reserves against deposits; and restrictions on dividend payments. If we do not comply with these regulations, it could result in regulatory actions and negative publicity, which could adversely affect our results of operations.

Other than the item discussed above, there have been no material changes in our risk factors from those reported at April 30, 2006 in our Annual Report on Form 10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES**

A summary of our purchases of H&R Block common stock during the second quarter of fiscal year 2007 is as follows:

		(shares in 000s)			
		Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(2)</sup>	Maximum Number of Shares that May Be Purchased Under the Plans or Programs <sup>(2)</sup>
August 1	August 31	6	\$ 23.49		22,352
September 1	September 30	6	\$ 21.97		22,352
October 1	October 31	(2)	\$ 25.10		22,352

- (1) We purchased 9,911 shares in connection with the funding of employee income tax withholding obligations arising upon the exercise of stock options or the lapse of restrictions on

nonvested  
shares.

- (2) On June 9, 2004, our Board of Directors approved the repurchase of 15.0 million shares of H&R Block, Inc. common stock. On June 7, 2006, our Board approved an additional authorization to repurchase 20.0 million shares. These authorizations have no expiration date.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Our annual meeting of shareholders was held on September 7, 2006, at which four Class II directors were elected to serve three-year terms and the proposals set forth below were submitted to a vote of shareholders. The number of votes cast for, against or withheld, the number of abstentions, and the number of no votes (if applicable) for the election of directors and each proposal were as follows:

##### Election of Class II Directors

Nominee	Votes FOR	Votes WITHHELD	Votes AGAINST
Jerry D. Choate	256,809,629	11,097,642	
Henry F. Frigon	250,383,059	17,524,212	
Roger W. Hale	250,693,550	17,213,721	
Len J. Lauer	256,711,052	11,196,219	
Peter Skillern			267,906,972

-44-

**Table of Contents**

## Approval of Amendment to 1999 Stock Option Plan for Seasonal Employees

Votes For	187,679,313
Votes Against	47,643,970
Abstain	2,462,535

## Approval of Material Terms of Performance Goals for Performance Shares Issued Pursuant to the 2003 Long-Term Executive Compensation Plan

Votes For	251,458,763
Votes Against	13,370,783
Abstain	3,008,727

## Ratification of the Appointment of KPMG LLP as our Independent Accountants for the fiscal year ended April 30, 2007

Votes For	229,774,327
Votes Against	35,720,366
Abstain	2,411,470

At the close of business on July 5, 2006, the record date for the annual meeting of shareholders, there were 324,545,858 shares of our Common Stock outstanding and entitled to vote at the meeting. There were 267,906,572 shares represented at the annual meeting of shareholders.

**ITEM 6. EXHIBITS**

- 10.1 Omnibus Amendment No. 2 dated as of September 8, 2006 among Option One Mortgage Corporation, Option One Owner Trust 2002-3 and UBS Real Estate Securities Inc.
- 10.2 Omnibus Amendment Number One to the Option One Owner Trust Facility dated as of September 21, 2006, among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2005-7, Wells Fargo Bank, N. A., HSBC Securities (USA) Inc., HSBC Bank USA, N.A. and Bryant Park Funding LLC.
- 10.3 Fourth Amended and Restated Pricing Side Letter dated as of October 3, 2006 among Option One Owner Trust 2003-4, Option One Loan Warehouse Corporation, Option One Mortgage Corporation and Wells Fargo Bank, N.A., Falcon Asset Securitization Company LLC, JPMorgan Chase Bank, N.A. and Park Avenue Receivables Company LLC.
- 10.4 Omnibus Amendment Number One to the Option One Owner Trust 2005-8 Warehouse Facility dated as of October 6, 2006 among Option One Loan Warehouse Corporation, Option One Mortgage Corporation, Option One Owner Trust 2005-8, Merrill Lynch Bank USA and Wells Fargo Bank, N.A.,
- 10.5 Omnibus Amendment No. 3 dated as of October 10, 2006 among Option One Mortgage Corporation, Option One Owner Trust 2002-3 and UBS Real Estate Securities Inc.
- 10.6 Omnibus Amendment Number Two to the Option One Owner Trust Facility Dated as of October 31, 2006, among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2005-7, Wells Fargo Bank, N. A., HSBC Securities (USA) Inc., HSBC Bank USA, N.A. and Bryant Park Funding LLC.
- 31.1 Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2 Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by Chief Executive Officer furnished pursuant to 18 U.S.C. 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification by Chief Financial Officer furnished pursuant to 18 U.S.C. 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002.

-45-

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**Table of Contents**

**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.

**H&R BLOCK, INC.**

Mark A. Ernst  
Chairman of the Board, President  
and Chief Executive Officer  
December 11, 2006

William L. Trubeck  
Executive Vice President and  
Chief Financial Officer  
December 11, 2006

Jeffrey E. Nachbor  
Senior Vice President and  
Corporate Controller  
December 11, 2006

-46-