

H&R BLOCK INC  
Form 10-Q/A  
March 31, 2006

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

**FORM 10-Q/A  
Amendment No. 1**

*(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, 2005**

**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.)*

**4400 Main Street**

**Kansas City, Missouri 64111**

*(Address of principal executive offices, including zip code)*

**(816) 753-6900**

*(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, 2005 was 327,638,203 shares.

**Form 10-Q/A for the Period Ended October 31, 2005**  
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**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A ( Form 10-Q/A ) to the company's Quarterly Report on Form 10-Q for the quarterly period ended October 31, 2005, initially filed with the Securities and Exchange Commission on December 12, 2005, is being filed to reflect restatements of our consolidated balance sheets at October 31, 2005 and April 30, 2005, consolidated statements of income and comprehensive income for the three and six months ended October 31, 2005 and 2004, and of cash flows for the six months ended October 31, 2005 and 2004, and the notes related thereto. See detail discussion of the restatements in Item 1, note 2 to the condensed consolidated financial statements.

On February 22, 2006, the Company's management and the Audit Committee of the Board of Directors concluded to restate previously issued consolidated financial statements for the fiscal quarters ended October 31, 2005 and July 31, 2005, the fiscal years ended April 30, 2005 and 2004 and the related fiscal quarters. The Company arrived at this conclusion during the course of its closing process for the quarter ended January 31, 2006.

The restatement pertains primarily to errors in determining the Company's state effective income tax rate, including errors in identifying changes in state apportionment, expiring state net operating losses and related factors.

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

(amounts in 000s, except share amounts)

|   | Restated<br>October 31,<br>2005<br>(Unaudited) | Restated<br>April 30, 2005 |
|---|--|----------------------------|
| <b>ASSETS</b>   |  |                            |
| Cash and cash equivalents   | \$ 392,490                                     | \$ 1,100,213               |
| Cash and cash equivalents restricted  | 464,480  | 516,909                    |
| Marketable securities trading   | 114,136  | 11,790                     |
| Receivables from customers, brokers, dealers and clearing organizations, net                              | 577,506  | 590,226                    |
| Receivables, less allowance for doubtful accounts of \$59,332 and \$38,879                                | 693,302  | 418,788                    |
| Prepaid expenses and other current assets   | 464,005  | 432,708                    |
| <b>Total current assets</b>   | <b>2,705,919</b>                               | <b>3,070,634</b>           |
| Residual interests in securitizations available-for-sale  | 142,782  | 205,936                    |
| Beneficial interest in Trusts trading   | 169,378  | 215,367                    |
| Mortgage servicing rights   | 245,928  | 166,614                    |
| Property and equipment, at cost less accumulated depreciation and amortization of \$714,971 and \$658,425 | 362,041  | 330,150                    |
| Intangible assets, net  | 247,849  | 247,092                    |
| Goodwill, net   | 1,087,587                                      | 1,015,947                  |
| Other assets  | 334,468  | 286,316                    |
| <b>Total assets</b>   | <b>\$ 5,295,952</b>                            | <b>\$ 5,538,056</b>        |

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

|  |                  |                  |
|--|------------------|------------------|
| Commercial paper   | \$ 498,175       | \$               |
| Current portion of long-term debt                                | 16,946           | 25,545           |
| Accounts payable to customers, brokers and dealers               | 846,913          | 950,684          |
| Accounts payable, accrued expenses and other current liabilities | 639,812          | 564,749          |
| Accrued salaries, wages and payroll taxes                        | 170,056          | 318,644          |
| Accrued income taxes   | 225,245          | 375,174          |
| <b>Total current liabilities</b>                                 | <b>2,397,147</b> | <b>2,234,796</b> |
| Long-term debt   | 917,884          | 923,073          |
| Other noncurrent liabilities                                     | 428,395          | 430,919          |
| <b>Total liabilities</b>   | <b>3,743,426</b> | <b>3,588,788</b> |

**Stockholders equity:**

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|   |              |              |
|---|--------------|--------------|
| Common stock, no par, stated value \$.01 per share, 800,000,000 shares authorized, 435,890,796 shares issued at October 31, 2005 and April 30, 2005 | 4,359        | 4,359        |
| Additional paid-in capital  | 612,207      | 598,388      |
| Accumulated other comprehensive income  | 44,463       | 68,718       |
| Retained earnings   | 2,975,058    | 3,161,682    |
| Less cost of 110,565,669 and 104,649,850 shares of common stock in treasury   | (2,083,561)  | (1,883,879)  |
| Total stockholders' equity  | 1,552,526    | 1,949,268    |
| Total liabilities and stockholders' equity  | \$ 5,295,952 | \$ 5,538,056 |

See Notes to Condensed Consolidated Financial Statements

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**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS  
OF  
INCOME AND COMPREHENSIVE INCOME**(Unaudited, amounts in 000s,  
except per share amounts)

|   | Three months ended October<br>31, |                  | Six months ended October<br>31, |                  |
|---|-----------------------------------|------------------|---------------------------------|------------------|
|   | Restated<br>2005                  | Restated<br>2004 | Restated<br>2005                | Restated<br>2004 |
| <b>Revenues:</b>                        |                                   |                  |                                 |                  |
| Service revenues                        | \$ 384,263                        | \$ 290,232       | \$ 699,391                      | \$ 538,820       |
| Other revenues:                         |                                   |                  |                                 |                  |
| Gains on sales of mortgage assets, net  | 147,267                           | 184,148          | 383,698                         | 367,508          |
| Interest income                         | 55,010                            | 48,552           | 104,263                         | 88,272           |
| Product and other revenues              | 18,503                            | 19,021           | 32,684                          | 33,904           |
|   | 605,043                           | 541,953          | 1,220,036                       | 1,028,504        |
| <b>Operating expenses:</b>              |                                   |                  |                                 |                  |
| Cost of services                        | 387,217                           | 324,084          | 730,435                         | 615,059          |
| Cost of other revenues                  | 134,864                           | 96,249           | 258,221                         | 174,644          |
| Selling, general and administrative     | 206,549                           | 184,867          | 395,801                         | 345,063          |
|   | 728,630                           | 605,200          | 1,384,457                       | 1,134,766        |
| Operating loss                          | (123,587)                         | (63,247)         | (164,421)                       | (106,262)        |
| Interest expense                        | 12,385                            | 18,081           | 24,820                          | 35,874           |
| Other income, net                       | 2,843                             | 1,510            | 10,243                          | 3,518            |
| Loss before taxes                       | (133,129)                         | (79,818)         | (178,998)                       | (138,618)        |
| Income tax benefit                      | (51,880)                          | (31,016)         | (69,755)                        | (53,862)         |
| Net loss                                | \$ (81,249)                       | \$ (48,802)      | \$ (109,243)                    | \$ (84,756)      |
| <b>Basic and diluted loss per share</b> | \$ (0.25)                         | \$ (0.15)        | \$ (0.33)                       | \$ (0.25)        |
| <b>Basic and diluted shares</b>         | 326,047                           | 329,372          | 328,381                         | 333,442          |
| <b>Dividends per share</b>              | \$ 0.13                           | \$ 0.11          | \$ 0.24                         | \$ 0.21          |
| <b>Comprehensive income (loss):</b>     |                                   |                  |                                 |                  |
| Net loss                                | \$ (81,249)                       | \$ (48,802)      | \$ (109,243)                    | \$ (84,756)      |

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|   |              |             |              |             |
|---|--------------|-------------|--------------|-------------|
| Change in unrealized gain on available-for-sale securities, net | (23,653)     | 8,084       | (29,464)     | 29,554      |
| Change in foreign currency translation adjustments              | 4,385        | 8,371       | 5,209        | 8,041       |
| Comprehensive income (loss)                                     | \$ (100,517) | \$ (32,347) | \$ (133,498) | \$ (47,161) |

See Notes to Condensed Consolidated Financial Statements

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| <b>CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS</b>                      | (Unaudited, amounts in 000s) |                   |
|---|------------------------------|-------------------|
| Six months ended October 31,  | Restated<br>2005             | Restated<br>2004  |
| <b>Cash flows from operating activities:</b>                                |                              |                   |
| Net loss  | \$ (109,243)                 | \$ (84,756)       |
| Adjustments to reconcile net loss to net cash used in operating activities: |                              |                   |
| Depreciation and amortization   | 90,173                       | 80,267            |
| Accretion of residual interests in securitizations                          | (64,341)                     | (63,514)          |
| Impairments of available-for-sale residual interests                        | 20,613                       | 2,609             |
| Additions to trading securities residual interests in securitizations, net  | (185,645)                    | (68,618)          |
| Proceeds from net interest margin transactions, net                         | 85,472                       | 53,348            |
| Realized gain on sale of available-for-sale residual interests              | (28,675)                     |                   |
| Additions to mortgage servicing rights                                      | (136,294)                    | (58,894)          |
| Amortization and impairment of mortgage servicing rights                    | 56,980                       | 38,653            |
| Net change in beneficial interest in Trusts                                 | 45,989                       | 25,524            |
| Other, net of acquisitions  | (479,888)                    | (591,893)         |
| <b>Net cash used in operating activities</b>                                | <b>(704,859)</b>             | <b>(667,274)</b>  |
| <b>Cash flows from investing activities:</b>                                |                              |                   |
| Cash received from available-for-sale residual interests                    | 64,377                       | 73,477            |
| Cash received from sale of available-for-sale residual interests            | 30,497                       |                   |
| Purchases of property and equipment, net                                    | (77,635)                     | (60,598)          |
| Payments made for business acquisitions, net of cash acquired               | (200,309)                    | (5,472)           |
| Other, net  | 13,151                       | 12,138            |
| <b>Net cash provided by (used in) investing activities</b>                  | <b>(169,919)</b>             | <b>19,545</b>     |
| <b>Cash flows from financing activities:</b>                                |                              |                   |
| Repayments of commercial paper  | (1,101,729)                  | (1,376,877)       |
| Proceeds from issuance of commercial paper                                  | 1,599,904                    | 1,692,933         |
| Proceeds from issuance of long-term debt, net                               |                              | 395,221           |
| Dividends paid  | (77,381)                     | (69,997)          |
| Acquisition of treasury shares  | (259,745)                    | (529,558)         |
| Proceeds from issuance of common stock                                      | 48,001                       | 53,933            |
| Other, net  | (41,995)                     | (24,600)          |
| <b>Net cash provided by financing activities</b>                            | <b>167,055</b>               | <b>141,055</b>    |
| <b>Net decrease in cash and cash equivalents</b>                            | <b>(707,723)</b>             | <b>(506,674)</b>  |
| <b>Cash and cash equivalents at beginning of the period</b>                 | <b>1,100,213</b>             | <b>1,072,745</b>  |
| <b>Cash and cash equivalents at end of the period</b>                       | <b>\$ 392,490</b>            | <b>\$ 566,071</b> |





**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. Basis of Presentation**

The condensed consolidated balance sheet as of October 31, 2005, the condensed consolidated statements of income and comprehensive income for the three and six months ended October 31, 2005 and 2004, and the condensed consolidated statements of cash flows for the six months ended October 31, 2005 and 2004 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, 2005 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. Adjustments related to the restatements of previously issued financial statements are detailed in note 2.

On June 8, 2005, our Board of Directors declared a two-for-one stock split of the Company's Common Stock in the form of a 100% stock distribution, effective August 22, 2005, to shareholders of record as of the close of business on August 1, 2005. All share and per share amounts in this document have been adjusted to reflect the effect of the stock split.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States 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, 2005 Annual Report to Shareholders on Form 10-K/A.

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. Restatements of Previously Issued Financial Statements**

(A) On February 22, 2006, management and the Audit Committee of the Board of Directors concluded to restate previously issued consolidated financial statements for the fiscal quarters ended October 31, 2005 and July 31, 2005, the fiscal years ended April 30, 2005 and 2004 and the related fiscal quarters. We arrived at this conclusion during the course of our closing process for the quarter ended January 31, 2006. This restatement pertains primarily to errors in determining the Company's state effective income tax rate, including errors in identifying changes in state apportionment, expiring state net operating losses and related factors. These errors resulted in an understatement of income tax benefit (net of federal income tax benefit) of \$5.0 million and \$5.4 million for the three and six months ended October 31, 2005, respectively, and \$1.1 million and \$1.9 million for the three and six months ended October 31, 2004, respectively, an overstatement of deferred income tax assets of \$1.2 million as of October 31, 2005 and April 30, 2005, and an understatement of accrued income taxes of \$20.5 million and \$25.9 million as of October 31, 2005 and April 30, 2005, respectively. The effect of the above adjustments on the condensed consolidated financial statements is set forth in 2C below.

(B) On June 7, 2005, management and the Audit Committee of the Board of Directors determined that restatement of our previously issued consolidated financial statements, including financial statements for the three and six months ended October 31, 2004, was appropriate as a result of the errors noted below. All amounts listed are pretax, unless otherwise noted.

§ An error in calculating the gain on sale of residual interests in fiscal year 2003. This error was corrected by deferring a portion of the gain on sale of residual interests as of the transaction date in fiscal year 2003 and recognizing revenue from the sale as interest income from accretion of residual interests in subsequent periods. Interest income from accretion increased \$2.7 million and \$5.7 million for the three and six months ended October 31, 2004, respectively. This correction also decreased impairments of residual

interests \$0.9 million for the six months ended

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October 31, 2004 and decreased comprehensive income \$1.7 million and \$4.0 million for the three and six months ended October 31, 2004, respectively.

- § An error in the calculation of an incentive compensation accrual at our Mortgage Services segment as of April 30, 2004. This error resulted in an overstatement of compensation expense for the six months ended October 31, 2004 of \$12.1 million.
- § An error in accounting for leased properties related to rent holidays and mandatory rent escalation in our Tax Services, Mortgage Services and Investment Services segments. Rent expense was understated for the three and six months ended October 31, 2004 by \$0.4 million and \$0.6 million, respectively.
- § An error from the capitalization of certain branch office costs at our Investment Services segment, which should have been expensed as incurred. This error resulted in an understatement of occupancy expenses and an overstatement of depreciation expense and capital expenditures, resulting in a net overstatement of operating expenses of \$5.7 million and \$5.5 million for the three and six months ended October 31, 2004, respectively.
- § Errors related to accounting for acquisitions at our Business Services and Investment Services segments, the largest of which was the acquisition of OLDE in fiscal year 2000. Amortization of customer relationships was understated by \$1.8 million and \$3.7 million for the three and six months ended October 31, 2004, respectively, and the provision for income taxes was overstated by approximately \$3.7 million and \$7.5 million, respectively.

The effect of the above adjustments on the condensed consolidated financial statements is set forth in 2C below.

(C) Notes 5, 6, 8, 12, and 14 have been restated to reflect the above described adjustments.

The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated balance sheet as of October 31, 2005:

|  | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | (in 000s)<br>Restated |
|--|---|-------------------------------|-----------------------|
| Other assets                               | \$ 335,695                                  | \$ (1,227)                    | \$ 334,468            |
| Total assets                               | 5,297,179                                   | (1,227)                       | 5,295,952             |
| Accrued income taxes                       | 204,725                                     | 20,520                        | 225,245               |
| Total current liabilities                  | 2,376,627                                   | 20,520                        | 2,397,147             |
| Total liabilities                          | 3,722,906                                   | 20,520                        | 3,743,426             |
| Retained earnings                          | 2,996,805                                   | (21,747)                      | 2,975,058             |
| Total stockholders' equity                 | 1,574,273                                   | (21,747)                      | 1,552,526             |
| Total liabilities and stockholders' equity | 5,297,179                                   | (1,227)                       | 5,295,952             |

- (1) As reported in our Form 10-Q filed on December 12, 2005 for the six months ended October 31,

2005.

- (2) Adjusted to reflect the restatement described in 2A above.

The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated statement of income and comprehensive income for the three and six months ended October 31, 2005:

|                                     | (in 000s, except per share amounts)         |                               |              |
|-------------------------------------|---|-------------------------------|--------------|
|                                     | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | Restated     |
| Three months ended October 31, 2005 |   |                               |              |
| Income tax benefit                  | \$ (46,854)                                 | \$ (5,026)                    | \$ (51,880)  |
| Net loss                            | (86,275)                                    | 5,026                         | (81,249)     |
| Basic and diluted loss per share    | \$ (0.26)                                   | \$ 0.01                       | \$ (0.25)    |
| Comprehensive income (loss)         | \$ (105,543)                                | \$ 5,026                      | \$ (100,517) |

- (1) As reported in our Form 10-Q filed on December 12, 2005 for the six months ended October 31, 2005.

- (2) Adjusted to reflect the restatement described in 2A above.

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|                                   | (in 000s, except per share amounts)         |                               |              |
|-----------------------------------|---|-------------------------------|--------------|
|                                   | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | Restated     |
| Six months ended October 31, 2005 |   |                               |              |
| Income tax benefit                | \$ (64,399)                                 | \$ (5,356)                    | \$ (69,755)  |
| Net loss                          | (114,599)                                   | 5,356                         | (109,243)    |
| Basic and diluted loss per share  | \$ (0.35)                                   | \$ 0.02                       | \$ (0.33)    |
| Comprehensive income (loss)       | \$ (138,854)                                | \$ 5,356                      | \$ (133,498) |

(1) As reported in our Form 10-Q filed on December 12, 2005 for the six months ended October 31, 2005.

(2) Adjusted to reflect the restatement described in 2A above.

The following is a summary of the impact of the restatements on our condensed consolidated statement of income and comprehensive income for the three and six months ended October 31, 2004:

|                                      | (in 000s, except per share amounts)            |                               |   |                               |            |
|--------------------------------------|--|-------------------------------|---|-------------------------------|------------|
|                                      | Three months ended October 31, 2004            |                               |   |                               |            |
|                                      | As<br>Previously<br>Reported<br><sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | As<br>Previously<br>Restated <sup>(3)</sup> | Adjustments<br><sup>(4)</sup> | Restated   |
| Gain on sale of mortgage assets, net | \$ 184,114                                     | \$ 34                         | \$ 184,148                                  | \$                            | \$ 184,148 |
| Interest income                      | 45,888   | 2,664                         | 48,552                                      |                               | 48,552     |
| Total revenues                       | 539,255  | 2,698                         | 541,953                                     |                               | 541,953    |
| Total operating expenses             | 608,608  | (3,408)                       | 605,200                                     |                               | 605,200    |
| Operating loss                       | (69,353)                                       | 6,106                         | (63,247)                                    |                               | (63,247)   |
| Loss before taxes                    | (85,924)                                       | 6,106                         | (79,818)                                    |                               | (79,818)   |
| Income tax benefit                   | (33,725)                                       | 3,779                         | (29,946)                                    | (1,070)                       | (31,016)   |
| Net loss                             | (52,199)                                       | 2,327                         | (49,872)                                    | 1,070                         | (48,802)   |
| Basic and diluted loss per share     | \$ (0.16)                                      | \$ 0.01                       | \$ (0.15)                                   | \$                            | \$ (0.15)  |

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|   |          |            |          |       |          |
|---|----------|------------|----------|-------|----------|
| Change in unrealized gain on available-for-sale securities, net | \$ 9,752 | \$ (1,668) | \$ 8,084 | \$    | \$ 8,084 |
| Comprehensive income (loss)                                     | (34,076) | 659        | (33,417) | 1,070 | (32,347) |

Six months ended October 31, 2004

|   | As<br>Previously<br>Reported<br>(1) | Adjustments<br>(2) | As<br>Previously<br>Restated (3) | Adjustments<br>(4) | Restated   |
|---|-------------------------------------|--------------------|----------------------------------|--------------------|------------|
| Gain on sale of mortgage assets, net                            | \$ 366,648                          | \$ 860             | \$ 367,508                       | \$                 | \$ 367,508 |
| Interest income   | 82,594                              | 5,678              | 88,272                           |                    | 88,272     |
| Total revenues  | 1,021,966                           | 6,538              | 1,028,504                        |                    | 1,028,504  |
| Total operating expenses  | 1,148,098                           | (13,332)           | 1,134,766                        |                    | 1,134,766  |
| Operating loss  | (126,132)                           | 19,870             | (106,262)                        |                    | (106,262)  |
| Loss before taxes   | (158,488)                           | 19,870             | (138,618)                        |                    | (138,618)  |
| Income tax benefit  | (62,206)                            | 10,202             | (52,004)                         | (1,858)            | (53,862)   |
| Net loss  | (96,282)                            | 9,668              | (86,614)                         | 1,858              | (84,756)   |
| Basic and diluted loss per share                                | \$ (0.29)                           | \$ .03             | \$ (0.26)                        | \$ 0.01            | \$ (0.25)  |
| Change in unrealized gain on available-for-sale securities, net | \$ 33,595                           | \$ (4,041)         | \$ (29,554)                      | \$                 | \$ 29,554  |
| Comprehensive income (loss)                                     | (54,646)                            | 5,627              | (49,019)                         | 1,858              | (47,161)   |

(1) As reported in our Form 10-Q filed on December 8, 2004 for the six months ended October 31, 2004. Amounts have been reclassified to conform to current year presentation. See discussion of reclassifications in note 1.

(2) Adjusted to reflect the restatement described in 2B above, as derived from the Company's Form 10-K/A filed on

August 5, 2005  
for the year  
ended April 30,  
2005.

- (3) As reported in  
our Form 10-Q  
filed on  
December 12,  
2005 for the six  
months ended  
October 31,  
2005.
- (4) Adjusted to  
reflect the  
restatement  
described in 2A  
above.



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The following is a summary of the impact of the restatement described in 2A above on our condensed consolidated statement of cash flows for the six months ended October 31, 2005:

|                            | (in 000s)                                   |                               |              |
|----------------------------|---|-------------------------------|--------------|
|                            | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | Restated     |
| Net loss                   | \$ (114,599)                                | \$ 5,356                      | \$ (109,243) |
| Other, net of acquisitions | (474,532)                                   | (5,356)                       | (479,888)    |

(1) As reported in our Form 10-Q filed on December 12, 2005 for the six months ended October 31, 2005.

(2) Adjusted to reflect the restatement described in 2A above.

The following is a summary of the impact of the restatements on our condensed consolidated statement of cash flows for the six months ended October 31, 2004:

|   | (in 000s)                                   |                               |   |                               |             |
|---|---|-------------------------------|---|-------------------------------|-------------|
|   | As<br>Previously<br>Reported <sup>(1)</sup> | Adjustments<br><sup>(2)</sup> | As<br>Previously<br>Restated <sup>(3)</sup> | Adjustments<br><sup>(4)</sup> | Restated    |
| Net loss  | \$ (96,282)                                 | \$ 9,668                      | \$ (86,614)                                 | \$ 1,858                      | \$ (84,756) |
| Depreciation and amortization                       | 76,768                                      | 3,499                         | 80,267                                      |                               | 80,267      |
| Accretion of residual interests in securitizations  | (57,835)                                    | (5,679)                       | (63,514)                                    |                               | (63,514)    |
| Impairment of available-for-sale residual interests | 3,469                                       | (860)                         | 2,609                                       |                               | 2,609       |
| Other, net of acquisitions                          | (588,756)                                   | (1,279)                       | (590,035)                                   | (1,858)                       | (591,893)   |
| Net cash used in operating activities               | (672,623)                                   | 5,349                         | (667,274)                                   |                               | (667,274)   |
| Purchases of property and equipment, net            | (55,249)                                    | (5,349)                       | (60,598)                                    |                               | (60,598)    |
| Net cash provided by (used in) investing activities | 24,894                                      | (5,349)                       | 19,545                                      |                               | 19,545      |

- (1) As reported in our Form 10-Q filed on December 8, 2004 for the six months ended October 31, 2004. Amounts have been reclassified to conform to current year presentation. See discussion of reclassifications in note 1.
- (2) Adjusted to reflect the restatement described in 2B above, as derived from the Company's Form 10-K/A filed on August 5, 2005 for the fiscal year ended April 30, 2005.
- (3) As reported in our Form 10-Q filed on December 12, 2005 for the six months ended October 31, 2005.
- (4) Adjusted to reflect the restatement described in 2A above.

The restatements had no impact on our cash flows from financing activities as previously reported.

### **3. Business Combinations**

Effective October 1, 2005, we acquired all outstanding common stock of American Express Tax and Business Services, Inc. for cash payments totaling \$191.4 million. The initial purchase price is subject to a post-closing

adjustment based upon determination of the final September 30, 2005 net asset value. Results related to American Express Tax and Business Services, Inc. have been included in our condensed consolidated financial statements since October 1, 2005. Pro forma results of operations have not been presented because the effects of this acquisition were not material to our results. The accompanying balance sheet reflects a preliminary allocation of the purchase price to assets acquired and liabilities assumed as follows:

|                              | (in 000s)  |
|------------------------------|------------|
| Property and equipment       | \$ 18,590  |
| Other assets                 | 136,169    |
| Liabilities                  | (57,420)   |
| Amortizing intangible assets | 28,100     |
| Goodwill                     | 65,987     |
| <br>                         |            |
| Total cash paid              | \$ 191,426 |

Goodwill recognized in these transactions is included in the Business Services segment and is not deductible for tax purposes. The preliminary purchase price allocations are subject to change and will be adjusted based upon resolution of several matters including, but not limited to, the following:

- § Determination of the post-closing adjustment and final purchase price;
- § Completion of our valuation of intangible assets and determination of useful lives;

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§ Determination of final liabilities relating to planned exit activities; and

§ Determination of the tax basis of acquired assets and liabilities, and deferred tax balances of the acquired business.

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

Basic earnings (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 (loss) 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 32.6 million shares of stock for the three and six months ended October 31, 2005 and 35.2 million shares for the three and six months ended October 31, 2004, as the effect would be antidilutive due to the net loss recorded during the periods.

The weighted average shares outstanding for the three and six months ended October 31, 2005 decreased to 326.0 million and 328.4 million, respectively, from 329.4 million and 333.4 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 each of the six month periods ended October 31, 2005 and 2004, we issued 3.3 million shares of common stock pursuant to the exercise of stock options, employee stock purchases and awards of restricted shares, in accordance with our stock-based compensation plans.

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. During the six months ended October 31, 2004, we acquired 22.5 million shares of our common stock, nearly all of which were purchased from third parties, at an aggregate cost of \$529.6 million.

**5. Mortgage Banking Activities**

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

|   |            | (in 000s)<br>Restated |
|---|------------|-----------------------|
| Six months ended October 31,                          | 2005       | 2004                  |
| Balance, beginning of period                          | \$ 205,936 | \$ 210,973            |
| Additions from net interest margin (NIM) transactions | 8,724      | 15,270                |
| Cash received   | (64,377)   | (73,477)              |
| Cash received on sale of residual interests           | (30,497)   |                       |
| Accretion   | 61,925     | 63,514                |
| Impairments of fair value                             | (20,613)   | (2,609)               |
| Other   | 366        |                       |
| Changes in unrealized holding gains, net              | (18,682)   | 47,832                |
| Balance, end of period                                | \$ 142,782 | \$ 261,503            |

We sold \$23.3 billion and \$13.3 billion of mortgage loans in loan sales to warehouse trusts (Trusts) or other buyers during the six months ended October 31, 2005 and 2004, respectively, with gains totaling \$288.8 million and \$372.0 million, respectively, recorded on these sales.

Net additions to trading residual interests recorded in connection with the securitization of mortgage loans totaled \$185.6 million and \$68.6 million during the six months ended October 31, 2005 and 2004, respectively. Trading residuals valued at \$94.2 million were securitized in net interest margin (NIM) transactions during the current year, with net cash proceeds of \$85.5 million received in connection with NIM transactions. In the prior year, all trading residuals, which totaled \$68.6 million, were securitized with net cash proceeds of \$53.3 million received on the

transactions. Total net additions to residual interests from NIM transactions for the six months ended October 31, 2005 and 2004 were \$8.7 million and \$15.3 million, respectively.

During the six months ended October 31, 2005, we completed the sale of \$40.5 million of previously securitized residual interests and recorded a gain of \$28.7 million. We received cash proceeds of \$30.5 million and retained a \$10.0 million residual interest in the sale. This sale

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accelerates cash flows from the residual interests and recognition of unrealized gains included in other comprehensive income.

At October 31, 2005, we had \$93.9 million in residual interests classified as trading securities. These residual interests are the result of the initial securitization of mortgage loans and are expected to be securitized in a NIM transaction during our third quarter. Trading residuals are included in marketable securities trading on the condensed consolidated balance sheet with mark-to-market adjustments included in gains on sales of mortgage assets on the condensed consolidated income statement. Such adjustments resulted in a net loss of \$1.4 million and a net gain of \$2.1 million for the three and six months ended October 31, 2005, respectively. Similar adjustments resulted in a net gain of \$4.9 million for the three and six months ended October 31, 2004. Cash flows from trading residuals of \$7.9 million were received for the six months ended October 31, 2005 and are included in operating activities in the accompanying condensed consolidated statement of cash flows. There were no such trading securities recorded as of April 30, 2005.

Cash flows from available-for-sale residual interests of \$64.4 million and \$73.5 million were received from the securitization trusts for the six months ended October 31, 2005 and 2004, respectively. Cash received on available-for-sale residual interests is included in investing activities in the condensed consolidated statements of cash flows.

Aggregate net unrealized gains on residual interests not yet accreted into income totaled \$67.9 million at October 31, 2005 and \$115.4 million at April 30, 2005. 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:

| Six months ended October 31, | (in 000s)  |            |
|------------------------------|------------|------------|
|                              | 2005       | 2004       |
| Balance, beginning of period | \$ 166,614 | \$ 113,821 |
| Additions                    | 136,294    | 58,894     |
| Amortization                 | (56,660)   | (38,653)   |
| Impairment                   | (320)      |            |
| Balance, end of period       | \$ 245,928 | \$ 134,062 |

Estimated amortization of MSRs for fiscal years 2006 through 2010 is \$69.9 million, \$100.9 million, \$48.0 million, \$18.9 million and \$8.2 million, respectively.

During the current quarter, we completed an evaluation of assumptions used to value our MSRs. The changes in our assumptions as a result of this evaluation resulted in an increase to MSRs recorded in conjunction with loans originated during the second quarter. This change in assumptions increased our weighted average value of MSRs by approximately 14 basis points, primarily as a result of lower servicing costs, in particular interest paid to bondholders on monthly loan prepayments. As a result, additions to MSRs and gains on sales of mortgage loans during our second quarter were approximately \$16.8 million higher than would have been recorded under our previous assumptions.

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, 2005 are as follows:

| Six months ended October 31,                                | 2005                           | 2004   |
|---|--------------------------------|--------|
| Estimated credit losses                                     | 2.82%                          | 3.08%  |
| Discount rate   | 20.02%                         | 25.00% |
| Variable returns to third-party beneficial interest holders | LIBOR forward curve at closing |        |

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The key weighted average assumptions we used to estimate the cash flows and values of the residual interests and MSR's at October 31, 2005 and April 30, 2005 are as follows:

|   | October<br>31, 2005                   | April 30,<br>2005 |
|---|---------------------------------------|-------------------|
| Estimated credit losses                                     | 2.96%                                 | 3.03%             |
| Discount rate residual interests                            | 19.24%                                | 21.01%            |
| Discount rate MSR's   | 15.00%                                | 12.80%            |
| Variable returns to third-party beneficial interest holders | LIBOR forward curve at valuation date |                   |

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

|                                 | Prior to<br>Initial<br>Rate<br>Reset<br>Date | Months Outstanding After<br>Initial Rate Reset Date<br>Zero -<br>3 | Remaining<br>Life |
|---------------------------------|--|--|-------------------|
| Adjustable rate mortgage loans: |  |  |                   |
| With prepayment penalties       | 31%  | 70%  | 43%               |
| Without prepayment penalties    | 37%  | 53%  | 41%               |
| Fixed rate mortgage loans:      |  |  |                   |
| With prepayment penalties       | 30%  | 50%  | 41%               |

For fixed rate mortgages without prepayment penalties, we use an average prepayment rate of 34% 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<br>to<br>2002 | 2002  | 2003  | 2004  | 2005  | 2006  |
|------------------|---------------------|-------|-------|-------|-------|-------|
| As of:           |                     |       |       |       |       |       |
| October 31, 2005 | 4.52%               | 2.49% | 2.05% | 2.16% | 2.93% | 2.84% |
| July 31, 2005    | 4.53%               | 2.53% | 2.03% | 2.20% | 2.86% | 2.70% |
| April 30, 2005   | 4.52%               | 2.53% | 2.08% | 2.30% | 2.83% |       |
| April 30, 2004   | 4.46%               | 3.58% | 4.35% | 3.92% |       |       |

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, 2005, the sensitivities of the current fair value of the residual interests and MSR's to 10% and 20% adverse changes in the above key assumptions are as follows:

|  | (dollars in 000s)          |                                     |                     |                     |
|--|----------------------------|-------------------------------------|---------------------|---------------------|
|  | Residential Mortgage Loans |                                     |                     |                     |
|  | NIM<br>Residuals           | Beneficial<br>Interest<br>in Trusts | Trading<br>Residual | Servicing<br>Assets |
| Carrying amount/fair value                 | \$ 142,782                 | \$ 169,378                          | \$ 93,865           | \$ 245,928          |
| Weighted average remaining life (in years) | 1.4                        | 2.1                                 | 1.9                 | 1.3                 |
| Prepayments (including defaults):          |                            |                                     |                     |                     |
| Adverse 10% \$ impact on fair value        | \$ 4,200                   | \$ (3,523)                          | \$ (1,303)          | \$ (32,334)         |
| Adverse 20% \$ impact on fair value        | 11,888                     | (2,511)                             | (2,112)             | (53,876)            |



## Credit losses:

|             |                         |             |            |            |                |
|-------------|-------------------------|-------------|------------|------------|----------------|
| Adverse 10% | \$ impact on fair value | \$ (34,306) | \$ (8,044) | \$ (3,060) | Not applicable |
| Adverse 20% | \$ impact on fair value | (59,982)    | (15,179)   | (6,101)    | Not applicable |

## Discount rate:

|             |                         |            |            |            |            |
|-------------|-------------------------|------------|------------|------------|------------|
| Adverse 10% | \$ impact on fair value | \$ (3,572) | \$ (3,441) | \$ (2,485) | \$ (3,732) |
| Adverse 20% | \$ impact on fair value | (6,924)    | (6,786)    | (4,849)    | (7,364)    |

## Variable interest rates (LIBOR forward curve):

|             |                         |             |             |          |                |
|-------------|-------------------------|-------------|-------------|----------|----------------|
| Adverse 10% | \$ impact on fair value | \$ (10,099) | \$ (59,826) | \$ 3,270 | Not applicable |
| Adverse 20% | \$ impact on fair value | (19,190)    | (93,728)    | 6,264    | Not applicable |

These sensitivities are hypothetical and should be used with caution. 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 is calculated without changing any other assumptions. It is likely that changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

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Mortgage loans that have been securitized at October 31, 2005 and April 30, 2005, 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, 2005                            | April 30, 2005 | October 31, 2005                                   | April 30, 2005 | Three months ended October 31, 2005 | April 30, 2005 |
| Securitized mortgage loans         | \$ 11,716,390                               | \$ 10,300,805  | \$ 992,040   | \$ 1,128,376   | \$ 29,153                           | \$ 21,641      |
| Mortgage loans in warehouse Trusts | 9,566,572                                   | 6,742,387      |  |                |                                     |                |
| Total loans                        | \$ 21,282,962                               | \$ 17,043,192  | \$ 992,040   | \$ 1,128,376   | \$ 29,153                           | \$ 21,641      |

**6. Goodwill and Intangible Assets**

Changes in the carrying amount of goodwill for the six months ended October 31, 2005 consist of the following:

|                     |                |           |          |                  | (in 000s) |
|---------------------|----------------|-----------|----------|------------------|-----------|
|                     | April 30, 2005 | Additions | Other    | October 31, 2005 |           |
| Tax Services        | \$ 360,781     | \$ 5,648  | \$ 289   | \$ 366,718       |           |
| Mortgage Services   | 152,467        |           |          | 152,467          |           |
| Business Services   | 328,745        | 66,428    | (725)    | 394,448          |           |
| Investment Services | 173,954        |           |          | 173,954          |           |
| Total goodwill      | \$ 1,015,947   | \$ 72,076 | \$ (436) | \$ 1,087,587     |           |

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 impairment or events indicating impairment were identified within any of our segments during the six months ended October 31, 2005. Our evaluation of impairment is dependent upon various assumptions, including assumptions regarding projected operating results and cash flows of reporting units. Actual results could differ materially from our projections and those differences could alter our conclusions regarding the fair value of a reporting unit and its goodwill.

Intangible assets consist of the following:

|  | October 31, 2005 | April 30, 2005 |
|--|------------------|----------------|
|  |                  |                |

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|                              | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net        | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net        |
|------------------------------|-----------------------------|-----------------------------|------------|-----------------------------|-----------------------------|------------|
| Tax Services:                |                             |                             |            |                             |                             |            |
| Customer relationships       | \$ 24,327                   | \$ (8,868)                  | \$ 15,459  | \$ 23,717                   | \$ (7,207)                  | \$ 16,510  |
| Noncompete agreements        | 18,501                      | (14,607)                    | 3,894      | 17,677                      | (11,608)                    | 6,069      |
| Business Services:           |                             |                             |            |                             |                             |            |
| Customer relationships       | 153,186                     | (74,193)                    | 78,993     | 130,585                     | (68,433)                    | 62,152     |
| Noncompete agreements        | 31,470                      | (12,558)                    | 18,912     | 27,796                      | (11,274)                    | 16,522     |
| Trade name amortizing        | 4,550                       | (1,030)                     | 3,520      | 1,450                       | (995)                       | 455        |
| Trade name<br>non-amortizing | 55,637                      | (4,868)                     | 50,769     | 55,637                      | (4,868)                     | 50,769     |
| Investment Services:         |                             |                             |            |                             |                             |            |
| Customer relationships       | 293,000                     | (216,698)                   | 76,302     | 293,000                     | (198,385)                   | 94,615     |
| Total intangible assets      | \$ 580,671                  | \$ (332,822)                | \$ 247,849 | \$ 549,862                  | \$ (302,770)                | \$ 247,092 |

Amortization of intangible assets for the three and six months ended October 31, 2005 was \$15.3 million and \$30.6 million, respectively. Amortization of intangible assets for the three and six months ended October 31, 2004 was \$15.3 million and \$30.4 million, respectively. Estimated amortization of intangible assets for fiscal years 2006 through 2010 is \$64.1 million, \$54.5 million, \$37.4 million, \$14.7 million and \$12.6 million, respectively.

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The goodwill and intangible assets added in the Business Services segment relate primarily to the acquisition of American Express Tax and Business Services, Inc. and are preliminary, as discussed in note 3. Additionally, due to the preliminary nature of these assets and their associated useful lives, amounts included above in estimated future amortization are subject to change.

**7. Derivative Instruments**

We enter into derivative instruments to reduce risks relating to mortgage loans we originate and sell, and therefore all gains or losses are included in gains on sales of mortgage assets, net in the condensed consolidated income statements. A summary of our derivative instruments as of October 31, 2005 and April 30, 2005, and gains or losses incurred during the three and six months ended October 31, 2005 and 2004 is as follows:

(in 000s)

|                       | Asset (Liability) Balance |                         | Gain (Loss) for the                             |   | Gain (Loss) for the Six                       |   |
|-----------------------|---------------------------|-------------------------|---|---|---|---|
|                       | October<br>31,<br>2005    | at<br>April 30,<br>2005 | Three<br>Months Ended<br>October<br>31,<br>2005 | Three<br>Months Ended<br>October<br>31,<br>2004 | Six<br>Months Ended<br>October<br>31,<br>2005 | Six<br>Months Ended<br>October<br>31,<br>2004 |
| Interest rate swaps   | \$ 27,118                 | \$ (1,325)              | \$ 59,742                                       | \$ (2,104)                                      | \$ 85,285                                     | \$ (2,104)                                    |
| Interest rate caps    | 69                        | 12,458                  | 162   |   | 802   |   |
| Rate-lock equivalents | 62                        | 801                     | 354   | 215   | (738)   | 1,699   |
| Prime short sales     | 1,329                     | (805)                   | 492   | (717)   | 1,487   | (1,525)                                       |
|                       | \$ 28,578                 | \$ 11,129               | \$ 60,750                                       | \$ (2,606)                                      | \$ 86,836                                     | \$ (1,930)                                    |

We generally use interest rate swaps and forward loan sale commitments to reduce interest rate risk associated with non-prime loans. We generally enter into interest rate swap arrangements related to existing loan applications with rate-lock commitments and for rate-lock commitments we expect to make in the next 30 days. Interest rate swaps represent an agreement to exchange interest rate payments. These contracts increase in value as rates rise and decrease in value as rates fall. The notional amount of interest rate swaps to which we were a party at October 31, 2005 was \$10.0 billion, with a weighted average duration of 1.77 years.

We generally enter into interest rate caps or swaps to mitigate interest rate risk associated with mortgage loans that will be securitized and residual interests that are classified as trading securities because they will be sold in a subsequent NIM transaction. These instruments enhance the marketability of the securitization and NIM transactions. An interest rate cap represents a right to receive cash if interest rates rise above a contractual strike rate, its value therefore increases as interest rates rise. The interest rate used in our interest rate caps is based on LIBOR.

We enter into forward loan commitments to sell our non-prime mortgage loans to manage interest rate risk. Forward loan sale commitments for non-prime loans are not considered derivative instruments and therefore cannot be recorded in our financial statements. The notional value and the contract value of the forward commitments at October 31, 2005 were \$3.5 billion and \$3.6 billion, respectively. Most of our forward commitments give us the option to under- or over-deliver by five to ten percent.

In the normal course of business, we enter into commitments with our customers to fund both non-prime and prime mortgage loans for specified periods of time at locked-in interest rates. These derivative instruments represent commitments to fund loans ( rate-lock equivalents ). The fair value of non-prime loan commitments is calculated using a binomial option model, although we do not initially record an asset for non-prime commitments to fund loans. The fair value of prime loan commitments is calculated based on the current market pricing of short sales of FNMA, FHLMC and GNMA mortgage-backed securities and the coupon rates of the eligible loans.

We sell short FNMA, FHLMC and GNMA mortgage-backed securities to reduce our risk related to our commitments to fund fixed-rate prime loans. The position on certain or all of the fixed-rate mortgage loans is closed approximately 10-15 days prior to standard Public Securities Association (PSA) settlement dates.

None of our derivative instruments qualify for hedge accounting treatment as of October 31, 2005 or April 30, 2005.

**Table of Contents****8. Stock-Based Compensation**

Effective May 1, 2003, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), under the prospective transition method as described in Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Had compensation cost for all stock-based compensation plan grants been determined in accordance with the fair value accounting method prescribed under SFAS 123, our net loss and loss per share would have been as follows:

|  | (in 000s, except per share amounts) |                  |                                 |                  |
|--|-------------------------------------|------------------|---------------------------------|------------------|
|  | Three months ended October<br>31,   |                  | Six months ended October<br>31, |                  |
|  | Restated<br>2005                    | Restated<br>2004 | Restated<br>2005                | Restated<br>2004 |
| Net loss as reported   | \$ (81,249)                         | \$ (48,802)      | \$ (109,243)                    | \$ (84,756)      |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects                              | 6,246                               | 5,242            | 12,011                          | 8,342            |
| Deduct: Total stock-based compensation expense determined under fair value method for all awards, net of related tax effects | (8,790)                             | (7,923)          | (17,098)                        | (13,705)         |
| Pro forma net loss   | \$ (83,793)                         | \$ (51,483)      | \$ (114,330)                    | \$ (90,119)      |
| Basic and diluted loss per share:  |                                     |                  |                                 |                  |
| As reported  | \$ (0.25)                           | \$ (0.15)        | \$ (0.33)                       | \$ (0.25)        |
| Pro forma  | (0.26)                              | (0.16)           | (0.35)                          | (0.27)           |

**9. Supplemental Cash Flow Information**

During the six months ended October 31, 2005, we paid \$169.2 million and \$50.1 million for income taxes and interest, respectively. During the six months ended October 31, 2004, we paid \$316.8 million and \$37.3 million for income taxes and interest, respectively. See note 3 for discussion of cash payments made, assets acquired and liabilities assumed related to our acquisition of American Express Tax and Business Services, Inc.

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

|                                  | (in 000s) |           |
|----------------------------------|-----------|-----------|
| Six months ended October 31,     | 2005      | 2004      |
| Residual interest mark-to-market | \$ 25,791 | \$ 88,867 |
| Additions to residual interests  | 8,724     | 15,270    |

**10. Commitments and Contingencies**

We maintain two unsecured committed lines of credit (CLOCs) for working capital, support of our commercial paper program and general corporate purposes. The two CLOCs are from a consortium of thirty-one banks and expire in August 2010. These lines are subject to various affirmative and negative covenants, including a

minimum net worth covenant. These CLOCs were undrawn at October 31, 2005.

We offer guarantees under our Peace of Mind (POM) program to tax clients whereby we will assume the cost of additional taxes attributable to tax return preparation errors for which we are responsible. We defer all revenues and direct costs associated with these guarantees, recognizing these amounts over the term of the guarantee based upon historic and actual payment of claims. Changes in the deferred revenue liability are as follows:

| Six months ended October 31,               | (in 000s)  |            |
|--|------------|------------|
|  | 2005       | 2004       |
| Balance, beginning of period               | \$ 130,762 | \$ 123,048 |
| Amounts deferred for new guarantees issued | 1,107      | 798        |
| Revenue recognized on previous deferrals   | (44,476)   | (41,627)   |
| Balance, end of period                     | \$ 87,393  | \$ 82,219  |

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We have commitments to fund mortgage loans to customers as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. The commitments to fund loans amounted to \$4.1 billion and \$3.9 billion at October 31, 2005 and April 30, 2005, respectively. External market forces impact the probability of commitments being exercised, and therefore, total commitments outstanding do not necessarily represent future cash requirements.

We have entered into loan sale agreements with investors in the normal course of business, which include standard representations and warranties customary to the mortgage banking industry. Violations of these representations and warranties may require us to repurchase loans previously sold. A liability has been established related to the potential loss on repurchase of loans previously sold of \$54.9 million and \$41.2 million at October 31, 2005 and April 30, 2005, respectively, based on historical experience. Repurchased loans are normally sold in subsequent sale transactions.

Option One Mortgage Corporation provides a guarantee up to a maximum amount equal to approximately 10% of the aggregate principal balance of mortgage loans held by the Trusts before ultimate disposition of the loans. This guarantee would be called upon in the event adequate proceeds were not available from the sale of the mortgage loans to satisfy the payment obligations of the Trusts. No losses have been sustained on this commitment since its inception. The total principal amount of Trust obligations outstanding as of October 31, 2005 and April 30, 2005 was \$9.5 billion and \$6.7 billion, respectively. The fair value of mortgage loans held by the Trusts as of October 31, 2005 and April 30, 2005 was \$9.6 billion and \$6.8 billion, respectively.

We have various contingent purchase price obligations in connection with prior acquisitions. In many cases, contingent payments to be made in connection with these acquisitions are not subject to a stated limit. We estimate the potential payments (undiscounted) total approximately \$8.8 million and \$5.1 million as of October 31, 2005 and April 30, 2005, respectively. Our estimate is based on current financial conditions. Should actual results differ materially from our assumptions, the potential payments will differ from the above estimate. Such payments, if and when paid, would be recorded as additional cost of the acquired business, generally goodwill.

We have contractual commitments to fund certain franchises requesting draws on Franchise Equity Lines of Credit (FELCs). Our commitment to fund FELCs as of October 31, 2005 and April 30, 2005 totaled \$72.1 million and \$68.9 million, respectively. We have a receivable of \$47.9 million and \$39.0 million, which represents the amounts drawn on the FELCs, as of October 31, 2005 and April 30, 2005, respectively.

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, 2005.

**11. Litigation Commitments and Contingencies**

We have been involved in a number of class actions and putative class action cases since 1990 regarding our RAL programs. These cases are based on a variety of legal theories and allegations. These theories and allegations include, among others, that (i) we improperly did not disclose license fees we received from RAL lending banks for RALs they make to our clients, (ii) we owe and breached a fiduciary duty to our clients and (iii) the RAL program violates laws such as state credit service organization laws and the federal Racketeer Influenced and Corrupt Organizations (RICO) Act. Although we have successfully defended many RAL cases, we incurred a pretax expense of \$43.5 million in fiscal year 2003 in connection with settling one RAL case. Several of the RAL cases are



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still pending and the amounts claimed in some of them are very substantial. The ultimate cost of this litigation could be substantial. We intend to continue defending the RAL cases vigorously, although there are no assurances as to their outcome.

We are also parties to claims and lawsuits pertaining to our electronic tax return filing services and our POM guarantee program associated with income tax preparation 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 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, 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 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.

It is our policy to accrue for amounts related to legal matters if it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Many of the various legal proceedings are covered in whole or in part by insurance. Any receivable for insurance recoveries is recorded separately from the corresponding litigation reserve, and only if recovery is determined to be probable. Receivables for insurance recoveries at October 31, 2005 were immaterial.

**12. Segment Information**

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

|                       | (in 000s)                  |                  |                          |                  |
|-----------------------|----------------------------|------------------|--------------------------|------------------|
|                       | Three months ended October |                  | Six months ended October |                  |
|                       | 31,                        |                  | 31,                      |                  |
|                       | 2005                       | Restated<br>2004 | 2005                     | Restated<br>2004 |
| Revenues:             |                            |                  |                          |                  |
| Tax Services          | \$ 80,813                  | \$ 74,106        | \$ 138,004               | \$ 124,553       |
| Mortgage Services     | 286,151                    | 284,332          | 646,589                  | 556,305          |
| Business Services     | 166,805                    | 129,047          | 293,651                  | 238,149          |
| Investment Services   | 70,018                     | 53,761           | 138,001                  | 107,342          |
| Corporate             | 1,256                      | 707              | 3,791                    | 2,155            |
|                       | \$ 605,043                 | \$ 541,953       | \$ 1,220,036             | \$ 1,028,504     |
| Pretax income (loss): |                            |                  |                          |                  |
| Tax Services          | \$ (142,864)               | \$ (133,932)     | \$ (287,370)             | \$ (246,578)     |
| Mortgage Services     | 46,239                     | 108,472          | 180,707                  | 217,497          |
| Business Services     | (2,143)                    | (4,892)          | (8,908)                  | (14,937)         |
| Investment Services   | (7,906)                    | (20,764)         | (15,458)                 | (41,107)         |
| Corporate             | (26,455)                   | (28,702)         | (47,969)                 | (53,493)         |

|                   |              |             |              |              |
|-------------------|--------------|-------------|--------------|--------------|
| Loss before taxes | \$ (133,129) | \$ (79,818) | \$ (178,998) | \$ (138,618) |
|-------------------|--------------|-------------|--------------|--------------|

**13. New Accounting Pronouncements**

Exposure Drafts Amendments of SFAS 140

In August 2005, the Financial Accounting Standards Board (FASB) issued three exposure drafts which amend Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

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The first exposure draft seeks to clarify the derecognition requirements for financial assets and the initial measurement of interests related to transferred financial assets that are held by a transferor. Our current off-balance sheet warehouse facilities (the Trusts) in our Mortgage Services segment would be required to be consolidated in our financial statements based on the provisions of the exposure draft. We will continue to monitor the status of the exposure draft and consider what changes, if any, could be made to the structure of the Trusts to continue to derecognize mortgage loans transferred to the Trusts. At October 31, 2005, the Trusts held loans totaling \$9.5 billion, which we would be required to consolidate into our financial statements under the provisions of this exposure draft.

The second exposure draft would require mortgage servicing rights to be initially valued at fair value. This provision would not have a material impact to our financial statements. In addition, this exposure draft would permit us to choose to continue to amortize mortgage servicing rights in proportion to and over the period of estimated net servicing income, as currently required under SFAS 140, or report mortgage servicing rights at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur. We have not yet determined how we would elect to account for mortgage servicing rights under this provision or the potential impact to the financial statements.

The third exposure draft, among other things, would establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are free-standing derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. Alternatively, this exposure draft would permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Our residual interests in securitizations typically have interests in derivative instruments embedded within the securitization trusts. We have not yet determined if these embedded derivatives meet the criteria for bifurcation as outlined in the exposure draft.

The final standard for the first exposure draft is scheduled to be issued in the second quarter of calendar year 2006, and the final standards for the second and third exposure drafts are scheduled for the first quarter of calendar year 2006.

**American Jobs Creation Act**

In October 2004, the American Jobs Creation Act (the Act) was signed into law. The Act introduces a one-time deduction for dividends received from the repatriation of certain foreign earnings, provided certain criteria are met. During the three months ended October 31, 2005, we completed our evaluation of the effects of the Act, and have elected not to repatriate foreign earnings. Because we intend to indefinitely reinvest foreign earnings outside the United States, we have not provided deferred taxes on such earnings.

**14. 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.

*Condensed Consolidating Income Statements* (in 000s)

| Three months ended<br>October 31, 2005 (Restated) | H&R<br>Block, Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims      | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|------------|---------------------------|
| Total revenues                                    | \$                                | \$ 395,825      | \$ 213,175            | \$ (3,957) | \$ 605,043                |
| Cost of services                                  |                                   | 115,818         | 271,356               | 43         | 387,217                   |
| Cost of other revenues                            |                                   | 129,316         | 5,548                 |            | 134,864                   |
| Selling, general and administrative               |                                   | 96,960          | 113,589               | (4,000)    | 206,549                   |
| 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    |

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| Three months ended<br>October 31, 2005 (Restated) | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims     | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|-----------|---------------------------|
| 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)               |

| Three months ended<br>October 31, 2004 (Restated) | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims      | Consolidated<br>H&R<br>Block |
|---|-----------------------------------|-----------------|-----------------------|------------|------------------------------|
| Total revenues                                    | \$                                | \$ 340,865      | \$ 204,440            | \$ (3,352) | \$ 541,953                   |
| Cost of services                                  |                                   | 93,705          | 230,316               | 63         | 324,084                      |
| Cost of other revenues                            |                                   | 90,764          | 5,485                 |            | 96,249                       |
| Selling, general and administrative               |                                   | 71,454          | 116,828               | (3,415)    | 184,867                      |
| Total expenses                                    |                                   | 255,923         | 352,629               | (3,352)    | 605,200                      |
| Operating income (loss)                           |                                   | 84,942          | (148,189)             |            | (63,247)                     |
| Interest expense                                  |                                   | 17,348          | 733                   |            | 18,081                       |
| Other income, net                                 | (79,818)                          |                 | 1,510                 | 79,818     | 1,510                        |
| Income (loss) before taxes                        | (79,818)                          | 67,594          | (147,412)             | 79,818     | (79,818)                     |
| Income taxes (benefit)                            | (31,016)                          | 26,395          | (57,411)              | 31,016     | (31,016)                     |
| Net income (loss)                                 | \$ (48,802)                       | \$ 41,199       | \$ (90,001)           | \$ 48,802  | \$ (48,802)                  |

| Six months ended<br>October 31, 2005 (Restated) | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims      | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|------------|---------------------------|
| Total revenues                                  | \$                                | \$ 856,465      | \$ 370,840            | \$ (7,269) | \$ 1,220,036              |
| Cost of service revenues                        |                                   | 225,171         | 505,132               | 132        | 730,435                   |
| Cost of other revenues                          |                                   | 250,216         | 8,005                 |            | 258,221                   |
| Selling, general and administrative             |                                   | 188,148         | 215,054               | (7,401)    | 395,801                   |
| Total expenses                                  |                                   | 663,535         | 728,191               | (7,269)    | 1,384,457                 |

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|                            |              |            |              |            |              |
|----------------------------|--------------|------------|--------------|------------|--------------|
| 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) |

| Six months ended<br>October 31, 2004 (Restated) | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims      | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|------------|---------------------------|
| Total revenues                                  | \$                                | \$ 669,468      | \$ 365,655            | \$ (6,619) | \$ 1,028,504              |
| Cost of services                                |                                   | 186,970         | 427,980               | 109        | 615,059                   |
| Cost of other revenues                          |                                   | 167,745         | 6,899                 |            | 174,644                   |
| Selling, general and administrative             |                                   | 143,642         | 208,149               | (6,728)    | 345,063                   |
| Total expenses                                  |                                   | 498,357         | 643,028               | (6,619)    | 1,134,766                 |
| Operating income (loss)                         |                                   | 171,111         | (277,373)             |            | (106,262)                 |
| Interest expense                                |                                   | 34,150          | 1,724                 |            | 35,874                    |
| Other income, net                               | (138,618)                         |                 | 3,518                 | 138,618    | 3,518                     |
| Income (loss) before taxes                      | (138,618)                         | 136,961         | (275,579)             | 138,618    | (138,618)                 |
| Income taxes (benefit)                          | (53,862)                          | 53,483          | (107,345)             | 53,862     | (53,862)                  |
| Net income (loss)                               | \$ (84,756)                       | \$ 83,478       | \$ (168,234)          | \$ 84,756  | \$ (84,756)               |

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**Table of Contents***Condensed Consolidating Balance Sheets*

(in 000s)

| October 31, 2005 (Restated)                             | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer)     | Other<br>Subsidiaries | Elims                 | Consolidated<br>H&R Block |
|---|-----------------------------------|---------------------|-----------------------|-----------------------|---------------------------|
| Cash & cash equivalents                                 | \$                                | \$ 184,945          | \$ 207,545            | \$                    | \$ 392,490                |
| Cash & cash equivalents restricted                      |                                   | 405,743             | 58,737                |                       | 464,480                   |
| Receivables from customers,<br>brokers and dealers, net |                                   | 577,506             |                       |                       | 577,506                   |
| Receivables, net  | 1,724                             | 376,076             | 315,502               |                       | 693,302                   |
| Intangible assets and goodwill, net                     |                                   | 405,600             | 929,836               |                       | 1,335,436                 |
| Investments in subsidiaries                             | 4,719,456                         | 215                 | 539                   | (4,719,456)           | 754                       |
| Other assets  |                                   | 1,476,631           | 354,722               | 631                   | 1,831,984                 |
| <b>Total assets</b>                                     | <b>\$ 4,721,180</b>               | <b>\$ 3,426,716</b> | <b>\$ 1,866,881</b>   | <b>\$ (4,718,825)</b> | <b>\$ 5,295,952</b>       |
| Commercial paper  | \$                                | \$ 498,175          | \$                    | \$                    | \$ 498,175                |
| Accts. payable to customers,<br>brokers and dealers     |                                   | 846,913             |                       |                       | 846,913                   |
| Long-term debt  |                                   | 897,008             | 20,876                |                       | 917,884                   |
| Other liabilities                                       | 2                                 | 554,760             | 925,692               |                       | 1,480,454                 |
| Net intercompany advances                               | 3,168,652                         | (976,206)           | (2,192,829)           | 383                   |                           |
| Stockholders equity                                     | 1,552,526                         | 1,606,066           | 3,113,142             | (4,719,208)           | 1,552,526                 |
| <b>Total liabilities and stockholders<br/>equity</b>    | <b>\$ 4,721,180</b>               | <b>\$ 3,426,716</b> | <b>\$ 1,866,881</b>   | <b>\$ (4,718,825)</b> | <b>\$ 5,295,952</b>       |
| April 30, 2005 (Restated)                               | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer)     | Other<br>Subsidiaries | Elims                 | Consolidated<br>H&R Block |
| Cash & cash equivalents                                 | \$                                | \$ 162,983          | \$ 937,230            | \$                    | \$ 1,100,213              |
| Cash & cash equivalents restricted                      |                                   | 488,761             | 28,148                |                       | 516,909                   |
| Receivables from customers,<br>brokers and dealers, net |                                   | 590,226             |                       |                       | 590,226                   |
| Receivables, net  | 101                               | 199,990             | 218,697               |                       | 418,788                   |
| Intangible assets and goodwill, net                     |                                   | 421,036             | 842,003               |                       | 1,263,039                 |
| Investments in subsidiaries                             | 4,851,680                         | 210                 | 449                   | (4,851,680)           | 659                       |
| Other assets  |                                   | 1,407,082           | 241,532               | (392)                 | 1,648,222                 |
| <b>Total assets</b>                                     | <b>\$ 4,851,781</b>               | <b>\$ 3,270,288</b> | <b>\$ 2,268,059</b>   | <b>\$ (4,852,072)</b> | <b>\$ 5,538,056</b>       |
| Accts. payable to customers,<br>brokers and dealers     | \$                                | \$ 950,684          | \$                    | \$                    | \$ 950,684                |
| Long-term debt  |                                   | 896,591             | 26,482                |                       | 923,073                   |

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|  |              |              |              |                |              |
|--|--------------|--------------|--------------|----------------|--------------|
| Other liabilities                          | 2            | 532,562      | 1,182,459    | 8              | 1,715,031    |
| Net intercompany advances                  | 2,902,511    | (641,611)    | (2,262,818)  | 1,918          |              |
| Stockholders' equity                       | 1,949,268    | 1,532,062    | 3,321,936    | (4,853,998)    | 1,949,268    |
| Total liabilities and stockholders' equity | \$ 4,851,781 | \$ 3,270,288 | \$ 2,268,059 | \$ (4,852,072) | \$ 5,538,056 |

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**Table of Contents***Condensed Consolidating Statements of Cash Flows*

(in 000s)

| Six months ended<br>October 31, 2005 (Restated)         | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims     | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|-----------|---------------------------|
| Net cash provided by (used in)<br>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)<br>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                              | 48,001                            |                 |                       |           | 48,001                    |
| Net intercompany advances                               |                                   | (322,298)       | 57,430                | 264,868   |                           |
| Other, net  |                                   | 3,390           | (45,385)              |           | (41,995)                  |
| Net cash provided by (used in)<br>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                |

| Six months ended<br>October 31, 2004 (Restated)         | H&R Block,<br>Inc.<br>(Guarantor) | BFC<br>(Issuer) | Other<br>Subsidiaries | Elims | Consolidated<br>H&R Block |
|---|-----------------------------------|-----------------|-----------------------|-------|---------------------------|
| Net cash provided by (used in)<br>operating activities: | \$ 810                            | \$ 37,152       | \$ (705,236)          | \$    | \$ (667,274)              |
| Cash flows from investing:                              |                                   |                 |                       |       |                           |
| Cash received on residuals                              |                                   | 73,477          |                       |       | 73,477                    |
| Purchase property & equipment                           |                                   | (18,135)        | (42,463)              |       | (60,598)                  |
| Payments for business acquisitions                      |                                   |                 | (5,472)               |       | (5,472)                   |

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|   |           |             |            |           |             |
|---|-----------|-------------|------------|-----------|-------------|
| Net intercompany advances                           | 544,812   |             |            | (544,812) |             |
| Other, net  |           | (96)        | 12,234     |           | 12,138      |
| Net cash provided by (used in) investing activities | 544,812   | 55,246      | (35,701)   | (544,812) | 19,545      |
| Cash flows from financing:                          |           |             |            |           |             |
| Repayments of commercial paper                      |           | (1,376,877) |            |           | (1,376,877) |
| Proceeds from commercial paper                      |           | 1,692,933   |            |           | 1,692,933   |
| Proceeds from long-term debt                        |           | 395,221     |            |           | 395,221     |
| Dividends paid                                      | (69,997)  |             |            |           | (69,997)    |
| Acquisition of treasury shares                      | (529,558) |             |            |           | (529,558)   |
| Proceeds from common stock                          | 53,933    |             |            |           | 53,933      |
| Net intercompany advances                           |           | (770,746)   | 225,934    | 544,812   |             |
| Other, net  |           |             | (24,600)   |           | (24,600)    |
| Net cash provided by (used in) financing activities | (545,622) | (59,469)    | 201,334    | 544,812   | 141,055     |
| Net increase (decrease) in cash                     |           | 32,929      | (539,603)  |           | (506,674)   |
| Cash beginning of period                            |           | 133,188     | 939,557    |           | 1,072,745   |
| Cash end of period                                  | \$        | \$ 166,117  | \$ 399,954 | \$        | \$ 566,071  |

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**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 and mortgage services, and business and consulting services. For 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 in the United States, Canada, Australia and the United Kingdom. We also offer investment services through H&R Block Financial Advisors, Inc. (HRBFA). Our Mortgage Services segment offers a full range of home mortgage services through Option One Mortgage Corporation (OOMC) and H&R Block Mortgage Corporation (HRBMC). RSM McGladrey Business Services, Inc. (RSM), together with its attest-firm affiliations, is the fifth largest national accounting, tax and consulting firm primarily serving mid-sized businesses.

**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 accompanying Management's Discussion and Analysis of Financial Condition and Results of Operations reflects the restatements of previously issued financial statements, as discussed in note 2 to our condensed consolidated financial statements. The analysis that follows should be read in conjunction with the tables below and the condensed consolidated income statements found on page 2.

**Consolidated H&R Block, Inc. Operating Results** (in 000s, except per share amounts)

|                       | Three months ended October<br>31, |                  | Six months ended October<br>31, |                  |
|-----------------------|-----------------------------------|------------------|---------------------------------|------------------|
|                       | Restated<br>2005                  | Restated<br>2004 | Restated<br>2005                | Restated<br>2004 |
| Revenues:             |                                   |                  |                                 |                  |
| Tax Services          | \$ 80,813                         | \$ 74,106        | \$ 138,004                      | \$ 124,553       |
| Mortgage Services     | 286,151                           | 284,332          | 646,589                         | 556,305          |
| Business Services     | 166,805                           | 129,047          | 293,651                         | 238,149          |
| Investment Services   | 70,018                            | 53,761           | 138,001                         | 107,342          |
| Corporate             | 1,256                             | 707              | 3,791                           | 2,155            |
|                       | \$ 605,043                        | \$ 541,953       | \$ 1,220,036                    | \$ 1,028,504     |
| Pretax income (loss): |                                   |                  |                                 |                  |
| Tax Services          | \$ (142,864)                      | \$ (133,932)     | \$ (287,370)                    | \$ (246,578)     |
| Mortgage Services     | 46,239                            | 108,472          | 180,707                         | 217,497          |
| Business Services     | (2,143)                           | (4,892)          | (8,908)                         | (14,937)         |
| Investment Services   | (7,906)                           | (20,764)         | (15,458)                        | (41,107)         |
| Corporate             | (26,455)                          | (28,702)         | (47,969)                        | (53,493)         |
|                       | (133,129)                         | (79,818)         | (178,998)                       | (138,618)        |
| Income tax benefit    | (51,880)                          | (31,016)         | (69,755)                        | (53,862)         |
| Net loss              | \$ (81,249)                       | \$ (48,802)      | \$ (109,243)                    | \$ (84,756)      |

|                                  |    |        |    |        |    |        |    |        |
|----------------------------------|----|--------|----|--------|----|--------|----|--------|
| Basic and diluted loss per share | \$ | (0.25) | \$ | (0.15) | \$ | (0.33) | \$ | (0.25) |
|----------------------------------|----|--------|----|--------|----|--------|----|--------|

**OVERVIEW**

A summary of our results compared to the prior year is as follows:

Basic and diluted loss per share for the three months ended October 31, 2005 and 2004 was \$0.25 and \$0.15 per share, and \$0.33 and \$0.25 per share in the respective six month periods.

Tax Services revenues increased \$6.7 million and \$13.5 million for the three and six months ended October 31, 2005, respectively. Tax Services pretax loss increased \$8.9 million to \$142.9

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million for the quarter, while the pretax loss increased \$40.8 million to \$287.4 million for the six months compared to the prior year. The higher losses were primarily due to off-season costs related to offices added during fiscal year 2005 and costs incurred for new offices to be opened in the coming tax season.

Mortgage Services revenues increased \$1.8 million and \$90.3 million for the three and six months ended October 31, 2005, respectively, while pretax income decreased \$62.2 million and \$36.8 million, respectively. Higher revenues are due to increased gains on derivatives, higher loan servicing revenue and a gain on sales of residual interests, partially offset by lower margins on mortgage loans sold. Declining profits reflect lower origination margins due to increases in funding costs outpacing our increases in coupon rates.

Business Services revenues increased \$37.8 million and \$55.5 million for the three and six months ended October 31, 2005, respectively, primarily due to a higher billed rate per hour in our accounting, tax and consulting business, coupled with acquisition-related growth in our payroll processing and financial process outsourcing businesses. The acquisition of American Express Tax and Business Services, Inc., effective as of October 1, 2005, contributed \$20.6 million in revenues and \$3.3 million in losses since acquisition. The pretax loss for the segment improved \$2.7 million and \$6.0 million for the three and six month periods, primarily due to revenue growth.

Investment Services revenues increased \$16.3 million and \$30.7 million for the three and six months, respectively. The pretax loss for the three and six months ended October 31, 2005 improved \$12.9 million and \$25.6 million, respectively. This improvement is primarily due to higher production and interest revenues, and actions implemented to reduce costs and enhance advisor performance.

**TAX SERVICES**

This segment primarily consists of our income tax preparation businesses retail, online and software.

**Tax Services Operating Results**

(in 000s)

|                                  | Three months ended October<br>31, |                  | Six months ended October<br>31, |                  |
|----------------------------------|-----------------------------------|------------------|---------------------------------|------------------|
|                                  | 2005                              | Restated<br>2004 | 2005                            | Restated<br>2004 |
| Service revenues:                |                                   |                  |                                 |                  |
| Tax preparation and related fees | \$ 40,185                         | \$ 33,933        | \$ 63,822                       | \$ 52,977        |
| Online tax services              | 620                               | 609              | 1,253                           | 1,309            |
| Other services                   | 31,644                            | 28,722           | 59,978                          | 53,059           |
|                                  | 72,449                            | 63,264           | 125,053                         | 107,345          |
| Royalties                        | 4,161                             | 3,739            | 6,557                           | 5,351            |
| Software sales                   | 1,016                             | 1,324            | 2,209                           | 2,707            |
| Other                            | 3,187                             | 5,779            | 4,185                           | 9,150            |
| Total revenues                   | 80,813                            | 74,106           | 138,004                         | 124,553          |
| Cost of services:                |                                   |                  |                                 |                  |
| Compensation and benefits        | 49,255                            | 43,239           | 90,152                          | 73,923           |

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|                                     |              |              |              |              |
|-------------------------------------|--------------|--------------|--------------|--------------|
| Occupancy                           | 62,283       | 52,799       | 121,596      | 103,127      |
| Depreciation                        | 10,328       | 9,636        | 20,497       | 18,614       |
| Other                               | 35,743       | 38,121       | 72,935       | 69,349       |
|                                     | 157,609      | 143,795      | 305,180      | 265,013      |
| Cost of software sales              | 3,852        | 3,985        | 6,737        | 7,152        |
| Selling, general and administrative | 62,216       | 60,258       | 113,457      | 98,966       |
| Total expenses                      | 223,677      | 208,038      | 425,374      | 371,131      |
| Pretax loss                         | \$ (142,864) | \$ (133,932) | \$ (287,370) | \$ (246,578) |

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**Table of Contents****Three months ended October 31, 2005 compared to October 31, 2004**

Tax Services revenues increased \$6.7 million, or 9.1%, for the three months ended October 31, 2005 compared to the prior year.

Tax preparation and related fees increased \$6.3 million, or 18.4%, for the current quarter. This increase is primarily due to an increase in the average fee per U.S. client served, coupled with an increase in U.S. clients served in company-owned offices. The average fee per U.S. client served increased 12.6% over last year, and U.S. clients served in company-owned offices increased 7.4%. Improved performance during the Australian tax season also contributed \$2.5 million of additional tax preparation revenues in the current quarter.

Other service revenues increased \$2.9 million primarily as a result of additional revenues associated with POM guarantees and Express IRAs.

Other revenues declined \$2.6 million primarily due to lower supply sales to franchises during the current quarter.

Total expenses increased \$15.6 million, or 7.5%. Cost of services for the three months ended October 31, 2005 increased \$13.8 million, or 9.6%, from the prior year. Our real estate expansion efforts have contributed to a total increase of \$9.1 million across all cost of services categories. Compensation and benefits increased \$6.0 million primarily due to the addition of costs related to our small business initiatives in the current year, an increase in the number of off-season support staff needed for our new offices and related payroll taxes. Occupancy expenses increased \$9.5 million, or 18.0%, primarily as a result of higher rent expenses, due to a 7.6% increase in company-owned offices under lease and an 8.9% increase in the average rent. Utilities and real estate taxes related to these new offices also contributed to the increase.

The pretax loss was \$142.9 million for the three months ended October 31, 2005 compared to a prior year loss of \$133.9 million.

Due to the seasonal nature of this segment's business, operating results for the three months ended October 31, 2005 are not comparable to the three months ended July 31, 2005 and are not indicative of the expected results for the entire fiscal year.

**Six months ended October 31, 2005 compared to October 31, 2004**

Tax Services revenues increased \$13.5 million, or 10.8%, for the six months ended October 31, 2005 compared to the prior year.

Tax preparation and related fees increased \$10.8 million, or 20.5%, primarily due to an increase in the average fee per U.S. client served, coupled with an increase in U.S. clients served in company-owned offices. The average fee per U.S. client served increased 11.0% over last year, and U.S. clients served in company-owned offices increased 6.6%. Additionally, the extension of the Canadian tax season into the month of May resulted in a \$1.7 million increase to our current year revenues. Improved performance during the Australian tax season also contributed \$2.6 million of additional tax preparation revenues in the current year.

Other service revenues increased \$6.9 million primarily as a result of additional revenues associated with POM guarantees, Express IRAs and our small business initiatives.

Other revenues declined \$5.0 million primarily due to lower supply sales to franchises.

Total expenses increased \$54.2 million, or 14.6%. Cost of services for the six months ended October 31, 2005 increased \$40.2 million, or 15.2%, from the prior year. Our real estate expansion efforts have contributed to a total increase of \$16.6 million across all cost of services categories. Compensation and benefits increased \$16.2 million primarily due to the addition of costs related to our small business initiatives and an increase in the number of off-season support staff needed for our new offices. Occupancy expenses increased \$18.5 million, or 17.9%, primarily as a result of higher rent expenses, due to a 6.8% increase in company-owned offices under lease and a 9.7% increase in the average rent. Utilities and real estate taxes related to these new offices also contributed to the increase. Other cost of service expenses increased \$3.6 million primarily due to additional expenses associated with our POM program.

Selling, general and administrative expenses increased \$14.5 million over the prior year primarily due to a \$7.2 million increase in legal expenses, \$3.5 million in additional national office wages, \$3.4

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million in additional costs from corporate shared services and a \$1.2 million increase in consulting expenses.

The pretax loss was \$287.4 million for the six months ended October 31, 2005 compared to a prior year loss of \$246.6 million.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for the Tax Services segment has not changed materially from the discussion in our April 30, 2005 Form 10-K/A. We currently believe we will meet or exceed the high-end of our goal to open between 500 and 700 company-owned and franchise offices this year.

**RAL Litigation**

We have been named as a defendant in a number of lawsuits alleging that we engaged in wrongdoing with respect to the RAL program. We believe we have strong defenses to the various RAL cases and will vigorously defend our position. Nevertheless, the amounts claimed by the plaintiffs are, in some instances, very substantial, and there can be no assurances as to the ultimate outcome of the pending RAL cases, or as to the impact of the RAL cases on our financial statements. See additional discussion of RAL Litigation in note 11 to the condensed consolidated financial statements and in Part II, Item 1, Legal Proceedings.

**MORTGAGE SERVICES**

This segment is primarily engaged in the origination of non-prime mortgage loans through an independent broker network, the origination of prime and non-prime mortgage loans through a retail office network, the sale and securitization of mortgage loans and residual interests, and the servicing of non-prime loans.



**Table of Contents****Mortgage Services Operating Statistics**

(dollars in 000s)

| Three months ended   | October 31,<br>2005 | Restated<br>October 31,<br>2004 | July 31, 2005 |
|--|---------------------|---------------------------------|---------------|
| Volume of loans originated:                                  |                     |                                 |               |
| Wholesale (non-prime)  | \$ 11,078,960       | \$ 5,528,361                    | \$ 9,537,227  |
| Retail: Non-prime  | 1,111,924           | 800,975                         | 950,806       |
| Prime  | 429,924             | 183,647                         | 399,596       |
|  | \$ 12,620,808       | \$ 6,512,983                    | \$ 10,887,629 |
| Loan characteristics:  |                     |                                 |               |
| Weighted average FICO score <sup>(1)</sup>                   | 629                 | 609                             | 623           |
| Weighted average interest rate for borrowers <sup>(1)</sup>  | 7.48%               | 7.46%                           | 7.52%         |
| Weighted average loan-to-value <sup>(1)</sup>                | 80.6%               | 78.3%                           | 81.1%         |
| Origination margin (% of origination volume): <sup>(2)</sup> |                     |                                 |               |
| Loan sale premium  | 0.55%               | 2.95%                           | 2.32%         |
| Residual cash flows from beneficial interest in Trusts       | 0.41%               | 0.80%                           | 0.47%         |
| Gain (loss) on derivative instruments                        | 0.48%               | (0.04%)                         | 0.24%         |
| Loan sale repurchase reserves                                | (0.16%)             | (0.13%)                         | (0.15%)       |
| Retained mortgage servicing rights                           | 0.69%               | 0.47%                           | 0.45%         |
|  | 1.97%               | 4.05%                           | 3.33%         |
| Cost of acquisition  | (0.40%)             | (0.47%)                         | (0.48%)       |
| Direct origination expenses                                  | (0.56%)             | (0.75%)                         | (0.57%)       |
| Net gain on sale gross margin <sup>(3)</sup>                 | 1.01%               | 2.83%                           | 2.28%         |
| Other revenues   | 0.02%               | 0.03%                           | 0.01%         |
| Other cost of origination                                    | (1.23%)             | (1.72%)                         | (1.37%)       |
| Net margin   | (0.20%)             | 1.14%                           | 0.92%         |
| Total cost of origination                                    | 1.79%               | 2.47%                           | 1.94%         |
| Total cost of origination and acquisition                    | 2.19%               | 2.94%                           | 2.42%         |
| Loan delivery:   |                     |                                 |               |
| Loan sales   | \$ 12,497,526       | \$ 6,560,780                    | \$ 10,843,006 |
| Execution price <sup>(4)</sup>                               | 1.63%               | 2.94%                           | 2.50%         |

(1) Represents non-prime production.

(2) See Reconciliation

of Non-GAAP  
Financial  
Information on  
page 44.

- (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.
  
- (4) 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**

(in 000s)

| Three months ended                  | October 31,<br>2005 | Restated<br>October 31,<br>2004 | July 31,<br>2005 |
|-------------------------------------|---------------------|---------------------------------|------------------|
| Components of gains on sales:       |                     |                                 |                  |
| Gain on mortgage loans              | \$ 66,580           | \$ 186,754                      | \$ 222,220       |
| Gain (loss) on derivatives          | 60,750              | (2,606)                         | 26,086           |
| Gain on sales of residual interests | 28,675              |                                 |                  |
| Impairment of residual interests    | (8,738)             |                                 | (11,875)         |
|                                     | 147,267             | 184,148                         | 236,431          |
| Interest income:                    |                     |                                 |                  |
| Accretion residual interests        | 33,564              | 34,837                          | 30,777           |
| Other interest income               | 4,605               | 2,444                           | 2,768            |
|                                     | 38,169              | 37,281                          | 33,545           |
| Loan servicing revenue              | 100,386             | 62,596                          | 90,269           |
| Other                               | 329                 | 307                             | 193              |
| Total revenues                      | 286,151             | 284,332                         | 360,438          |
| Cost of services                    | 67,811              | 52,931                          | 64,392           |
| Cost of other revenues:             |                     |                                 |                  |
| Compensation and benefits           | 84,151              | 55,214                          | 80,283           |
| Occupancy                           | 10,531              | 8,913                           | 12,629           |
| Other                               | 28,737              | 21,062                          | 22,878           |
|                                     | 123,419             | 85,189                          | 115,790          |
| Selling, general and administrative | 48,682              | 37,740                          | 45,788           |
| Total expenses                      | 239,912             | 175,860                         | 225,970          |
| Pretax income                       | \$ 46,239           | \$ 108,472                      | \$ 134,468       |

**Three months ended October 31, 2005 compared to October 31, 2004**

Mortgage Services revenues increased \$1.8 million, or 0.6%, for the three months ended October 31, 2005 compared to the prior year. Revenues increased as a result of higher gains on derivatives, higher loan servicing revenue and a gain on sales of residual interests, offset by lower margins on mortgage loans sold.

The following table summarizes the key drivers of gains on sales of mortgage loans:

| Three months ended October 31, | 2005 | (dollars in 000s)<br>2004 |
|--------------------------------|------|---------------------------|
|--------------------------------|------|---------------------------|

Application process:

|  |               |              |
|--|---------------|--------------|
| Total number of applications                       | 105,444       | 72,699       |
| Number of sales associates <sup>(1)</sup>          | 3,910         | 3,369        |
| Closing ratio <sup>(2)</sup>                       | 63.8%         | 57.0%        |
| Originations:                                      |               |              |
| Total number of originations                       | 67,264        | 41,422       |
| Weighted average interest rate for borrowers (WAC) | 7.48%         | 7.46%        |
| Average loan size                                  | \$ 188        | \$ 157       |
| Total originations                                 | \$ 12,620,808 | \$ 6,512,983 |
| Direct origination and acquisition expenses, net   | \$ 120,981    | \$ 79,850    |
| Revenue (loan value):                              |               |              |
| Net gain on sale gross margin <sup>(3)</sup>       | 1.01%         | 2.83%        |

(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.

Despite substantial increases in loan origination volume, gains on sales of mortgage loans decreased \$120.2 million, primarily as a result of rapidly rising two-year swap rates, additional credit enhancement requirements by rating agencies and moderating demand by loan buyers. Market interest rates, based on the two-year swap, increased from an average of 2.88% last year to 4.46% in the current quarter. However, our WAC increased only 2 basis points, up to 7.48% from 7.46% in the prior year. Because our WAC was not more aligned with market rates, and because of increases in our funding costs offset by derivative gains, our gross margin declined 182 basis points,

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to 1.01% from 2.83% last year. Origination volumes increased 93.8% over the prior year, due to increased productivity of our account executives and support staff, new product introductions, increased applications and a higher closing ratio.

In the current quarter, we completed an evaluation of the assumptions used to value our MSR's. Based on the changes in our assumptions as a result of this evaluation, the gain on sale for our retained MSR's increased by approximately 14 basis points, or approximately \$16.8 million, from the prior year, primarily as a result of lower servicing costs, in particular interest paid to bondholders on monthly loan prepayments. In addition, the increase in average loan size from \$157,000 in the prior year to \$188,000 in the current year resulted in an approximate 8 basis point increase in the value of the MSR's recorded in the quarter. Overall, the value of MSR's we recorded in the quarter increased to 69 basis points from 47 basis points in the prior year, which coupled with an increase in origination volume from \$6.5 billion in the prior year quarter to \$12.6 billion in the current year, resulted in an increase of \$56.6 million in gains on sales of mortgage loans.

To mitigate the risk of short-term changes in market interest rates related to our loan originations, we use interest rate swaps and forward loan sale commitments. We generally enter into interest rate swap arrangements related to existing loan applications with rate-lock commitments and for rate-lock commitments we expect to make in the next 30 days. During the current quarter, we recorded a net \$60.8 million in gains, compared to a net loss of \$2.6 million in the prior year, related to our various derivative instruments. The higher gains in the current quarter are primarily a result of rising interest rates and an increase in the notional amounts of interest rate swaps in place as a result of increased origination volumes. See note 7 to the condensed consolidated financial statements.

During the current quarter, we recorded a \$28.7 million gain on the sale of available-for-sale residual interests. This gain accelerated cash flows from residual interests, and resulted in realization of previously recorded unrealized gains included in other comprehensive income. We had no similar transaction in the prior year. During the current quarter, we recorded \$1.4 million in net unfavorable mark-to-market adjustments to our trading residuals, compared to \$4.9 million in net favorable adjustments in the prior year.

During the current quarter, our available-for-sale residual interests performed better than expected in our internal valuation models, with lower credit losses than originally modeled, partially offset by higher interest rates. We recorded favorable pretax mark-to-market adjustments, which increased the fair value of our residual interests \$15.0 million during the quarter. These adjustments were recorded, net of write-downs of \$2.1 million and deferred taxes of \$4.9 million, in other comprehensive income and will be accreted into income throughout the remaining life of those residual interests. Offsetting this increase were impairments of \$8.7 million, which were recorded in gains on sales of mortgage assets. 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.

During the current quarter, Gulf Coast hurricanes caused severe damage to property, including property securing mortgage loans underlying our beneficial and residual interests. As of November 30, 2005, we have exposure to losses related to approximately \$424 million of loans in the affected areas, including \$378 million related to loans underlying securitizations in which we hold a residual interest and \$46 million related to loans that are in the Trusts or have been repurchased from the Trusts. At November 30, 2005, total 31+ days delinquencies in the affected areas were approximately \$106 million, compared to approximately \$50 million that were 31+ days delinquent prior to the hurricanes. We recorded a specific provision for estimated losses arising from hurricane damage totaling \$6.0 million during the three months ended October 31, 2005, based on an analysis of delinquent loans within the federally declared disaster areas. Of the total provision, \$3.1 million was recorded as a reserve for losses on loans that we have or may be required to repurchase pursuant to existing standard representations and warranties, and \$2.9 million was recorded as an impairment of our residual interests. In addition to the residual impairments recorded this quarter, future write-downs of residual interests may be incurred and recorded in other comprehensive income. We are

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continuing to analyze our exposure to potential losses and the amount of losses ultimately realized may differ from amounts recorded in this quarter.

The following table summarizes the key drivers of loan servicing revenues:

|   | (dollars in 000s) |               |
|---|-------------------|---------------|
| Three months ended October 31,                    | 2005              | 2004          |
| Average servicing portfolio:                      |                   |               |
| With related MSR's                                | \$ 55,150,897     | \$ 39,407,600 |
| Without related MSR's                             | 22,065,265        | 11,917,124    |
|   | \$ 77,216,162     | \$ 51,324,724 |
| Number of loans serviced                          | 500,935           | 362,430       |
| Average delinquency rate                          | 4.37%             | 5.19%         |
| Weighted average FICO score                       | 622               | 615           |
| Weighted average interest rate (WAC) of portfolio | 7.47%             | 7.46%         |
| Value of MSR's                                    | \$ 245,928        | \$ 134,062    |

Loan servicing revenues increased \$37.8 million, or 60.4%, compared to the prior year. The increase reflects a higher loan servicing portfolio resulting from our continued origination growth. The average servicing portfolio for the three months ended October 31, 2005 increased \$25.9 billion, or 50.4%, to \$77.2 billion.

Total expenses for the three months ended October 31, 2005, increased \$64.1 million, or 36.4%, over the prior year. Cost of services increased \$14.9 million as a result of a higher average servicing portfolio during the current quarter. Cost of other revenues increased \$38.2 million, primarily due to \$28.9 million in increased compensation and benefits as a result of a 16.1% increase in sales associates, coupled with related increases in payroll taxes and origination-based incentives. Other expenses increased \$7.7 million primarily as a result of \$4.7 million in additional interest expense, coupled with increases in depreciation and supplies.

Selling, general and administrative expenses increased \$10.9 million due to \$8.1 million in additional retail marketing costs.

Pretax income decreased \$62.2 million to \$46.2 million for the three months ended October 31, 2005.

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

Mortgage Services revenues decreased \$74.3 million, or 20.6%, for the three months ended October 31, 2005, compared to the first quarter of fiscal year 2006. Revenues decreased primarily due to declining margins, partially offset by increased gains on derivatives, higher loan servicing revenue and a gain on sale of residual interests.

The following table summarizes the key drivers of gains on sales of mortgage loans:

|  | (dollars in 000s)   |               |
|--|---------------------|---------------|
| Three months ended                                 | October 31,<br>2005 | July 31, 2005 |
| Application process:                               |                     |               |
| Total number of applications                       | 105,444             | 109,929       |
| Number of sales associates <sup>(1)</sup>          | 3,910               | 3,692         |
| Closing ratio <sup>(2)</sup>                       | 63.8%               | 60.1%         |
| Originations:                                      |                     |               |
| Total number of originations                       | 67,264              | 66,041        |
| Weighted average interest rate for borrowers (WAC) | 7.48%               | 7.52%         |
| Average loan size                                  | \$ 188              | \$ 165        |
| Total originations                                 | \$ 12,620,808       | \$ 10,887,629 |

|  |    |         |    |         |
|--|----|---------|----|---------|
| Direct origination and acquisition expenses, net | \$ | 120,981 | \$ | 114,224 |
| Revenue (loan value):                            |    |         |    |         |
| Net gain on sale gross margin <sup>(3)</sup>     |    | 1.01%   |    | 2.28%   |

(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.

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Gains on sales of mortgage loans decreased \$155.6 million primarily as a result of rapidly rising two-year swap rates, additional credit enhancement requirements by rating agencies and moderating demand by loan buyers. Market interest rates increased to an average of 4.46% from 4.06% in the preceding quarter. In response to rising rates, we implemented a 40 basis point increase in our coupon rate effective September 1, 2005, followed by a 25 basis point increase on October 1 and another 22 basis point increase on October 23, 2005. However, there is generally a 30 to 45 day lag from the time we increase rates to when those rates effect funded loans, and as a result, our WAC decreased 4 basis points, from 7.52% to 7.48%. These rate changes, coupled with increases in funding costs offset by derivative gains, caused our net gain on sale gross margin to decrease 127 basis points. Loan origination volumes increased 15.9% from the first quarter primarily due to increased productivity of our account executives and support staff.

As a result of the changes in our MSR assumptions, the gain on sale for our retained MSRs increased by approximately 14 basis points, or approximately \$16.8 million, from the first quarter, primarily as a result of lower servicing costs, in particular interest paid to bondholders on monthly loan prepayments. In addition, the increase in average loan size from \$165,000 in the first quarter to \$188,000 in the current quarter resulted in an approximate 8 basis point increase in the value of MSRs recorded in the quarter. Overall, the value of MSRs we recorded in the quarter increased to 69 basis points from 45 basis points in the first quarter, which coupled with an increase in origination volume from \$10.9 billion in the first quarter to \$12.6 billion in the second quarter, resulted in an increase of \$37.7 million in gains on sales of mortgage loans.

To mitigate the risk of short-term changes in market interest rates, we use interest rate swaps and forward loan sale commitments. We recorded a net \$60.8 million in gains during the second quarter, compared to \$26.1 million in the first quarter, related to our various derivative instruments. These higher gains resulted primarily from rising interest rates and an increase in the notional amounts of interest rate swaps in place as a result of increased origination volumes during the current quarter. See note 7 to the condensed consolidated financial statements.

We also recorded a gain of \$28.7 million during the current quarter on the sale of residual interests, with no similar transaction during the first quarter. During the current quarter, we recorded \$1.4 million in net unfavorable mark-to-market adjustments to our trading residuals, compared to \$3.5 million in net favorable adjustments in the first quarter.

The following table summarizes the key drivers of loan servicing revenues:

|   | (dollars in<br>000s) |               |
|---|----------------------|---------------|
|   | October 31,<br>2005  | July 31, 2005 |
| Three months ended                                |                      |               |
| Average servicing portfolio:                      |                      |               |
| With related MSRs                                 | \$ 55,150,897        | \$ 49,635,474 |
| Without related MSRs                              | 22,065,265           | 20,070,745    |
|   | \$ 77,216,162        | \$ 69,706,219 |
| Number of loans serviced                          | 500,935              | 451,310       |
| Average delinquency rate                          | 4.37%                | 4.28%         |
| Weighted average FICO score                       | 622                  | 619           |
| Weighted average interest rate (WAC) of portfolio | 7.47%                | 7.38%         |
| Value of MSRs                                     | \$ 245,928           | \$ 188,708    |

Loan servicing revenues increased \$10.1 million, or 11.2%, compared to the first quarter. The increase reflects a higher loan servicing portfolio. The average servicing portfolio for the three months ended October 31, 2005 increased \$7.5 billion, or 10.8%.



Total expenses increased \$13.9 million compared to the first quarter. Cost of services increased \$3.4 million as a result of a higher average servicing portfolio during the current quarter. Cost of other revenues increased \$7.6 million, primarily due to \$3.9 million in increased compensation and benefits as a result of a 5.9% increase in sales associates, coupled with related increases in payroll taxes and origination-based incentives. Other expenses increased \$5.9 million for the current quarter, primarily due to \$2.0 million in additional interest expense coupled with higher allocated shared services and depreciation expenses.

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Pretax income decreased \$88.2 million, or 65.6%, for the three months ended October 31, 2005 compared to the preceding quarter.

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**Table of Contents****Mortgage Services Operating Statistics**

(dollars in 000s)

| Six months ended   | October 31,<br>2005 | Restated<br>October 31,<br>2004 |
|--|---------------------|---------------------------------|
| Volume of loans originated:                                  |                     |                                 |
| Wholesale (non-prime)  | \$ 20,616,187       | \$ 11,509,465                   |
| Retail: Non-prime  | 2,062,730           | 1,421,101                       |
| Prime  | 829,520             | 398,934                         |
|  | \$ 23,508,437       | \$ 13,329,500                   |
| Loan characteristics:  |                     |                                 |
| Weighted average FICO score <sup>(1)</sup>                   | 626                 | 609                             |
| Weighted average interest rate for borrowers <sup>(1)</sup>  | 7.50%               | 7.33%                           |
| Weighted average loan-to-value <sup>(1)</sup>                | 80.8%               | 78.1%                           |
| Origination margin (% of origination volume): <sup>(2)</sup> |                     |                                 |
| Loan sale premium  | 1.38%               | 3.06%                           |
| Residual cash flows from beneficial interest in Trusts       | 0.43%               | 0.73%                           |
| Gain (loss) on derivative instruments                        | 0.37%               | (0.01%)                         |
| Loan sale repurchase reserves                                | (0.16%)             | (0.15%)                         |
| Retained mortgage servicing rights                           | 0.58%               | 0.44%                           |
|  | 2.60%               | 4.07%                           |
| Cost of acquisition  | (0.44%)             | (0.54%)                         |
| Direct origination expenses                                  | (0.56%)             | (0.75%)                         |
| Net gain on sale gross margin <sup>(3)</sup>                 | 1.60%               | 2.78%                           |
| Other revenues   | 0.02%               | 0.02%                           |
| Other cost of origination                                    | (1.30%)             | (1.66%)                         |
| Net margin   | 0.32%               | 1.14%                           |
| Total cost of origination                                    | 1.86%               | 2.41%                           |
| Total cost of origination and acquisition                    | 2.30%               | 2.95%                           |
| Loan delivery:   |                     |                                 |
| Loan sales   | \$ 23,340,532       | \$ 13,304,836                   |
| Execution price <sup>(4)</sup>                               | 2.09%               | 3.43%                           |

(1) Represents non-prime production.

(2) See Reconciliation of Non-GAAP

Financial  
Information on  
page 44.

- (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.
- (4) 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).

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| <b>Mortgage Services</b>            | <b>Operating Results</b> |    | (in 000s)               |
|-------------------------------------|--------------------------|----|-------------------------|
|                                     | October 31,              |    | Restated<br>October 31, |
| Six months ended                    | 2005                     |    | 2004                    |
| Components of gains on sales:       |                          |    |                         |
| Gain on mortgage loans              | \$ 288,800               | \$ | 372,047                 |
| Gain (loss) on derivatives          | 86,836                   |    | (1,930)                 |
| Gain on sales of residual interests | 28,675                   |    |                         |
| Impairment of residual interests    | (20,613)                 |    | (2,609)                 |
|                                     | 383,698                  |    | 367,508                 |
| Interest income:                    |                          |    |                         |
| Accretion residual interests        | 64,341                   |    | 63,514                  |
| Other interest income               | 7,373                    |    | 3,884                   |
|                                     | 71,714                   |    | 67,398                  |
| Loan servicing revenue              | 190,655                  |    | 120,762                 |
| Other                               | 522                      |    | 637                     |
| Total revenues                      | 646,589                  |    | 556,305                 |
| Cost of services                    | 132,203                  |    | 102,792                 |
| Cost of other revenues:             |                          |    |                         |
| Compensation and benefits           | 164,434                  |    | 101,120                 |
| Occupancy                           | 23,160                   |    | 16,922                  |
| Other                               | 51,615                   |    | 39,342                  |
|                                     | 239,209                  |    | 157,384                 |
| Selling, general and administrative | 94,470                   |    | 78,632                  |
| Total expenses                      | 465,882                  |    | 338,808                 |
| Pretax income                       | \$ 180,707               | \$ | 217,497                 |

**Six months ended October 31, 2005 compared to October 31, 2004**

Mortgage Services revenues increased \$90.3 million, or 16.2%, for the six months ended October 31, 2005 compared to the prior year. Revenues increased as a result of increased gains on derivatives, higher loan servicing revenues and a gain on sale of residual interests, partially offset by lower margins on mortgage loans sold.

The following table summarizes the key drivers of gains on sales of mortgage loans:

|                              |      |                      |
|------------------------------|------|----------------------|
|                              |      | (dollars in<br>000s) |
| Six months ended October 31, | 2005 | 2004                 |

## Application process:

|  |               |               |
|--|---------------|---------------|
| Total number of applications                       | 215,373       | 147,191       |
| Number of sales associates <sup>(1)</sup>          | 3,910         | 3,369         |
| Closing ratio <sup>(2)</sup>                       | 61.9%         | 58.0%         |
| Originations:                                      |               |               |
| Total number of originations                       | 133,305       | 85,348        |
| Weighted average interest rate for borrowers (WAC) | 7.50%         | 7.33%         |
| Average loan size                                  | \$ 176        | \$ 156        |
| Total originations                                 | \$ 23,508,437 | \$ 13,329,500 |
| Direct origination and acquisition expenses, net   | \$ 235,205    | \$ 172,339    |
| Revenue (loan value):                              |               |               |
| Net gain on sale gross margin <sup>(3)</sup>       | 1.60%         | 2.78%         |

(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.

Gains on sales of mortgage loans decreased \$83.2 million, primarily as a result of rapidly rising two-year swap rates, additional credit enhancement requirements by rating agencies and moderating demand by loan buyers, partially offset by increased origination volume. Market interest rates, based on the two-year swap, increased from an average of 2.96% last year to 4.26% in the current year. However, our WAC increased only 17 basis points, up to 7.50% from 7.33% in the prior year. Because

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our WAC was not more aligned with market rates and because of increased funding costs offset by derivative gains, our gross margin declined 118 basis points, to 1.60% from 2.78% last year. Origination volumes increased 76.4% over the prior year, due to increased productivity of our account executives and support staff, new product introductions, increased applications and a higher closing ratio.

As a result of the changes in our MSR assumptions and an increase in the average loan size from \$156,000 in the prior year to \$176,000 in the current year, the gain on sale for our retained MSRs increased to 58 basis points from 44 basis points in the prior year, which coupled with an increase in origination volume from \$13.3 billion in the prior year to \$23.5 billion in the current year, resulted in an increase of \$77.4 million in gains on sales of mortgage loans.

As a result of rising interest rates and an increase in the notional amounts of interest rate swaps in place as a result of increased origination volumes during the current year, we recorded a net \$86.8 million in gains, compared to a net loss of \$1.9 million in the prior year, related to our various derivative instruments. See note 7 to the condensed consolidated financial statements.

We recorded a \$2.1 million net favorable mark-to-market adjustment for our trading residuals during the current period, and a gain of \$28.7 million on the sale of residual interests. During the prior year, we recorded \$4.9 million in net favorable mark-to-market adjustments for our trading residuals in the prior year.

During the first half of fiscal year 2006, our available-for-sale residual interests performed better than expected in our internal valuation models, with lower credit losses than originally modeled, partially offset by higher interest rates. We recorded favorable pretax mark-to-market adjustments, which increased the fair value of our residual interests \$30.9 million during the period. These adjustments were recorded, net of write-downs of \$5.2 million and deferred taxes of \$9.9 million, in other comprehensive income and will be accreted into income throughout the remaining life of those residual interests. Offsetting this increase were impairments of available-for-sale residual interests totaling \$20.6 million, which were recorded in gains on sales of mortgage assets. Impairments increased \$18.0 million over the prior year due to interest rates increasing greater than originally modeled and a decline in the value of older residuals based on loan performance.

The following table summarizes the key drivers of loan servicing revenues:

|   | (dollars in<br>000s) |               |
|---|----------------------|---------------|
| Six months ended October 31,                      | 2005                 | 2004          |
| Average servicing portfolio:                      |                      |               |
| With related MSRs                                 | \$ 52,515,036        | \$ 38,436,169 |
| Without related MSRs                              | 21,363,081           | 10,998,659    |
|   | \$ 73,878,117        | \$ 49,434,828 |
| Number of loans serviced                          | 500,935              | 362,430       |
| Average delinquency rate                          | 4.69%                | 5.10%         |
| Weighted average FICO score                       | 621                  | 613           |
| Weighted average interest rate (WAC) of portfolio | 7.41%                | 7.43%         |
| Value of MSRs                                     | \$ 245,928           | \$ 134,062    |

Loan servicing revenues increased \$69.9 million, or 57.9%, compared to the prior year. The increase reflects a higher loan servicing portfolio. The average servicing portfolio for the six months ended October 31, 2005 increased \$24.4 billion, or 49.4%, to \$73.9 billion.

Total expenses for the six months ended October 31, 2005, increased \$127.1 million, or 37.5%, over the prior year. Cost of services increased \$29.4 million as a result of a higher average servicing portfolio during the current period and increased amortization of higher MSR balances. Cost of other revenues increased \$81.8 million, primarily due to \$63.3 million in increased compensation and benefits as a result of a 16.1% increase in sales associates, coupled with

related increases in payroll taxes and origination-based incentives. Occupancy expenses increased \$6.2 million, or 36.9%, primarily as a result of an increase in branch offices and related equipment and utilities costs. Other expenses increased \$12.3 million primarily as a result of \$7.2 million in additional interest expense, coupled with increases in depreciation and supplies.

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Selling, general and administrative expenses increased \$15.8 million primarily due to \$15.9 million in additional retail marketing costs.

Pretax income decreased \$36.8 million to \$180.7 million for the six months ended October 31, 2005.

**Fiscal 2006 outlook**

For the third and fourth quarters of fiscal year 2006, we believe we can achieve funding volumes consistent with first-quarter levels of \$10 billion to \$11 billion per quarter resulting in full year origination growth of approximately 40%. We implemented two rate increases in November, and during that time our funded WAC was approaching 8%. With our rate increases during the second half of the year, a stable external rate environment and cost-saving measures, we believe we will see origination margins of 40 to 50 basis points in the third quarter and 90 to 100 basis points in the fourth quarter, resulting in an origination margin of 50 to 55 basis points for the full fiscal year. We believe that for the remainder of fiscal year 2006 our cost of origination will remain close to our second quarter level approximately 175 basis points.

**BUSINESS SERVICES**

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

**Business Services Operating Statistics**

|                                 | Three months ended October |             | Six months ended October |             |
|---------------------------------|----------------------------|-------------|--------------------------|-------------|
|                                 | 2005                       | 31,<br>2004 | 2005                     | 31,<br>2004 |
| Accounting, tax and consulting: |                            |             |                          |             |
| Chargeable hours                | 768,740                    | 674,302     | 1,316,731                | 1,211,337   |
| Chargeable hours per person     | 310                        | 322         | 580                      | 601         |
| Net billed rate per hour        | \$ 139                     | \$ 129      | \$ 137                   | \$ 126      |
| Average margin per person       | \$ 22,913                  | \$ 22,706   | \$ 40,327                | \$ 39,134   |

**Business Services Operating Results**

(in 000s)

|   | Three months ended October |                         | Six months ended October |                         |
|---|----------------------------|-------------------------|--------------------------|-------------------------|
|   | 2005                       | 31,<br>Restated<br>2004 | 2005                     | 31,<br>Restated<br>2004 |
| Service revenues:                         |                            |                         |                          |                         |
| Accounting, tax and consulting            | \$ 121,790                 | \$ 93,380               | \$ 205,618               | \$ 167,931              |
| Capital markets                           | 15,355                     | 14,898                  | 30,827                   | 30,678                  |
| Payroll, benefits and retirement services | 8,617                      | 3,828                   | 16,894                   | 8,499                   |
| Other services                            | 11,113                     | 8,347                   | 20,995                   | 14,106                  |
|   | 156,875                    | 120,453                 | 274,334                  | 221,214                 |
| Other                                     | 9,930                      | 8,594                   | 19,317                   | 16,935                  |
| Total revenues                            | 166,805                    | 129,047                 | 293,651                  | 238,149                 |
| Cost of services:                         |                            |                         |                          |                         |
| Compensation and benefits                 | 94,894                     | 73,886                  | 166,541                  | 137,989                 |
| Occupancy                                 | 11,012                     | 5,873                   | 19,175                   | 10,404                  |
| Other                                     | 12,487                     | 11,216                  | 23,297                   | 23,022                  |

|                                     |            |            |            |             |
|-------------------------------------|------------|------------|------------|-------------|
|                                     | 118,393    | 90,975     | 209,013    | 171,415     |
| Selling, general and administrative | 50,555     | 42,964     | 93,546     | 81,671      |
| Total expenses                      | 168,948    | 133,939    | 302,559    | 253,086     |
| Pretax loss                         | \$ (2,143) | \$ (4,892) | \$ (8,908) | \$ (14,937) |

**Three months ended October 31, 2005 compared to October 31, 2004**

Business Services revenues for the three months ended October 31, 2005 increased \$37.8 million, or 29.3%, from the prior year. This increase was primarily due to a \$28.4 million increase in accounting, tax and consulting revenues resulting primarily from the acquisition of American Express Tax and Business Services, Inc., which increased revenues \$20.6 million. We also benefited from a 7.8%

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increase in the net billed rate per hour. These increases were partially offset by a 3.7% decline in chargeable hours per person.

Payroll, benefits and retirement services revenues increased \$4.8 million, or 125.1%, primarily due to acquisitions completed during the third and fourth quarters of fiscal year 2005. Other service revenues increased \$2.8 million as a result of growth in wealth management services and acquisitions completed in the fourth quarter of fiscal year 2005 in our financial process outsourcing business.

Total expenses increased \$35.0 million, or 26.1%, for the three months ended October 31, 2005 compared to the prior year. Cost of services increased \$27.4 million, primarily due to a \$21.0 million increase in compensation and benefits. Compensation and benefits increased \$14.1 million due to the American Express Tax and Business Services, Inc. acquisition. Baseline 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 increased \$5.1 million, or 87.5%, due primarily to acquisitions.

Selling, general and administrative expenses increased \$7.6 million primarily due to acquisitions and additional costs associated with our business development initiatives.

The pretax loss for the three months ended October 31, 2005 of \$2.1 million, which includes losses of \$3.3 million from American Express Tax and Business Services, Inc., compared to a loss of \$4.9 million in the prior year.

Due to the seasonal nature of this segment's business, operating results for the three months ended October 31, 2005 are not comparable to the three months ended July 31, 2005 and are not indicative of the expected results for the entire fiscal year.

**Six months ended October 31, 2005 compared to October 31, 2004**

Business Services revenues for the six months ended October 31, 2005 increased \$55.5 million, or 23.3%, from the prior year. This increase was primarily due to a \$37.7 million increase in accounting, tax and consulting revenues resulting primarily from the acquisition of American Express Tax and Business Services, Inc., which increased revenues \$20.6 million. We also benefited from an 8.7% increase in the net billed rate per hour. These increases were partially offset by a 3.5% decline in chargeable hours per person.

Payroll, benefits and retirement services revenues increased \$8.4 million, or 98.8%, primarily due to acquisitions completed during the third and fourth quarters of fiscal year 2005. Other service revenues increased \$6.9 million as a result of growth in wealth management services and acquisitions completed in the fourth quarter of fiscal year 2005 in our financial process outsourcing business.

Total expenses increased \$49.5 million, or 19.5%, for the six months ended October 31, 2005 compared to the prior year. Cost of services increased \$37.6 million, primarily due to a \$28.6 million increase in compensation and benefits. Compensation and benefits increased \$14.1 million due to the American Express Tax and Business Services, Inc. acquisition. Baseline increases in the number of personnel and the average wage per employee, driven by marketplace competition for professional staff and other acquisitions completed in the third and fourth quarters of fiscal year 2005, also contributed to this increase. Occupancy expenses increased \$8.8 million, or 84.3%, due primarily to acquisitions.

Selling, general and administrative expenses increased \$11.9 million primarily due to acquisitions and additional costs associated with our business development initiatives.

The pretax loss for the six months ended October 31, 2005 was \$8.9 million compared to \$14.9 million in the prior year.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for our Business Services segment is consistent with the discussion in our April 30, 2005 Form 10-K/A, except for the previously announced acquisition of American Express Tax and Business Services, Inc. effective October 1, 2005. We expect organic growth for this segment's pretax income of approximately 30%, and expect the acquisition of American Express Tax and Business Services, Inc. will be accretive by two cents per diluted share for fiscal year 2006, after

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expected integration costs. We expect Business Services pretax income for fiscal year 2006 to increase nearly 75% over the prior year.

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**Table of Contents****INVESTMENT SERVICES**

This segment is primarily engaged in offering advice-based brokerage services and investment planning. Our integration of investment advice and new service offerings are allowing us to shift our emphasis from a transaction-based client relationship to a more advice-based focus.

**Investment Services Operating Statistics**

| Three months ended  | October 31,<br>2005 | October 31,<br>2004 | July 31,<br>2005 |
|---|---------------------|---------------------|------------------|
| Customer trades <sup>(1)</sup>  | 233,262             | 192,909             | 226,378          |
| Customer daily average trades   | 3,589               | 3,014               | 3,593            |
| Average revenue per trade <sup>(2)</sup>  | \$ 123.16           | \$ 125.13           | \$ 126.71        |
| Customer accounts: <sup>(3)</sup>   |                     |                     |                  |
| Traditional brokerage   | 428,543             | 444,770             | 431,046          |
| Express IRAs  | 378,200             | 334,928             | 379,432          |
|   | 806,743             | 779,698             | 810,478          |
| Ending balance of assets under administration (billions)                        | \$ 29.8             | \$ 27.2             | \$ 30.0          |
| Average assets per traditional brokerage account                                | \$ 68,837           | \$ 60,225           | \$ 68,870        |
| Average margin balances (millions)  | \$ 560              | \$ 590              | \$ 573           |
| Average customer payable balances (millions)                                    | \$ 794              | \$ 962              | \$ 841           |
| Number of advisors  | 995                 | 982                 | 985              |
| Included in the numbers above are the following relating to fee-based accounts: |                     |                     |                  |
| Customer household accounts   | 8,547               | 7,046               | 7,985            |
| Average revenue per account   | \$ 2,164            | \$ 2,044            | \$ 2,235         |
| Ending balance of assets under administration (millions)                        | \$ 2,217            | \$ 1,755            | \$ 2,126         |
| Average assets per active account   | \$ 259,355          | \$ 249,068          | \$ 266,222       |

(1) Includes only trades on which revenues are earned ( revenue trades ). Revenues are earned on both transactional and annuitized trades.

(2) Calculated as total trade revenues divided by revenue trades.

(3) Includes only accounts with a

positive  
balance.

| <b>Investment Services</b>          | <b>Operating Results</b> |                                 |                  | (in 000s) |
|-------------------------------------|--------------------------|---------------------------------|------------------|-----------|
| Three months ended                  | October 31,<br>2005      | Restated<br>October 31,<br>2004 | July 31,<br>2005 |           |
| Service revenue:                    |                          |                                 |                  |           |
| Transactional revenue               | \$ 23,332                | \$ 19,988                       | \$ 22,835        |           |
| Annuitized revenue                  | 23,062                   | 17,199                          | 22,271           |           |
| Production revenue                  | 46,394                   | 37,187                          | 45,106           |           |
| Other service revenue               | 8,064                    | 6,527                           | 8,207            |           |
|                                     | 54,458                   | 43,714                          | 53,313           |           |
| Margin interest revenue             | 14,826                   | 10,038                          | 14,093           |           |
| Less: interest expense              | (1,363)                  | (541)                           | (1,254)          |           |
| Net interest revenue                | 13,463                   | 9,497                           | 12,839           |           |
| Other                               | 734                      | 9                               | 577              |           |
| Total revenues <sup>(1)</sup>       | 68,655                   | 53,220                          | 66,729           |           |
| Cost of services:                   |                          |                                 |                  |           |
| Compensation and benefits           | 32,676                   | 27,074                          | 30,535           |           |
| Occupancy                           | 5,187                    | 4,773                           | 5,165            |           |
| Depreciation                        | 909                      | 1,089                           | 1,034            |           |
| Other                               | 4,632                    | 3,447                           | 3,901            |           |
|                                     | 43,404                   | 36,383                          | 40,635           |           |
| Selling, general and administrative | 33,157                   | 37,601                          | 33,646           |           |
| Total expenses                      | 76,561                   | 73,984                          | 74,281           |           |
| Pretax loss                         | \$ (7,906)               | \$ (20,764)                     | \$ (7,552)       |           |

(1) Total revenues,  
less interest  
expense.

**Three months ended October 31, 2005 compared to October 31, 2004**

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Investment Services revenues, net of interest expense, for the three months ended October 31, 2005 increased \$15.4 million, or 29.0%, over the prior year.

Production revenue increased \$9.2 million, or 24.8%, over the prior year. Transactional revenue (which is based on sales of individual securities) increased \$3.3 million, or 16.7%, from the prior year due primarily to a 17.8% increase in transactional trading volume, partially offset by a 1.2% decrease in average revenue per transactional trade. Annuitized revenue (which is based on sales of various fee based products) increased \$5.9 million, or 34.1%, due to increased sales of annuities, insurance, mutual funds, wealth management accounts and UITs.

Annualized productivity averaged approximately \$180,000 per advisor during the current quarter compared to \$148,000 in the prior year. Increased productivity was due, in part, to minimum production standards put into place during the fourth quarter of fiscal year 2005, which caused an increase in the productivity of our lowest producing advisors. These standards resulted in 116 low-producing advisors leaving the company to date. We expect average advisor productivity to continue increasing throughout the remainder of the fiscal year.

Margin interest revenue increased \$4.8 million, or 47.7%, from the prior year, as a result of higher interest rates earned, partially offset by a decline in average margin balances.

Total expenses increased \$2.6 million, or 3.5%. Cost of services increased \$7.0 million, or 19.3%, primarily as a result of \$5.6 million of additional compensation and benefits resulting from higher production revenues.

Selling, general and administrative expenses decreased \$4.4 million, or 11.8%, primarily due to a decline in legal expenses, gains on the disposition of certain assets during the quarter and reduced back-office headcount relating to cost containment efforts. These decreases were partially offset by increased bonus accruals associated with improved performance.

The pretax loss for Investment Services for the three months ended October 31, 2005 was \$7.9 million compared to the prior year loss of \$20.8 million.

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

Investment Services revenues, net of interest expense, for the three months ended October 31, 2005 increased \$1.9 million, or 2.9% compared to the preceding quarter.

Production revenue increased \$1.3 million, or 2.9%, over the preceding quarter, primarily due to increased sales of annuities and insurance.

Total expenses increased \$2.3 million, or 3.1%. Compensation and benefits increased \$2.1 million, primarily resulting from higher production revenues.

The pretax loss for the Investment Services segment was \$7.9 million, compared to a loss of \$7.6 million in the first quarter of fiscal year 2006.

**Table of Contents****Investment Services Operating Statistics**

| Six months ended  | October 31,<br>2005 | October 31,<br>2004 |
|---|---------------------|---------------------|
| Customer trades <sup>(1)</sup>  | 459,640             | 398,857             |
| Customer daily average trades   | 3,591               | 3,166               |
| Average revenue per trade <sup>(2)</sup>  | \$ 124.90           | \$ 122.33           |
| Customer accounts: <sup>(3)</sup>   |                     |                     |
| Traditional brokerage   | 428,543             | 444,770             |
| Express IRAs  | 378,200             | 334,928             |
|   | 806,743             | 779,698             |
| Ending balance of assets under administration (billions)                        | \$ 29.8             | \$ 27.2             |
| Average assets per traditional brokerage account                                | \$ 68,837           | \$ 60,225           |
| Average margin balances (millions)  | \$ 567              | \$ 594              |
| Average customer payable balances (millions)                                    | \$ 817              | \$ 987              |
| Number of advisors  | 995                 | 982                 |
| Included in the numbers above are the following relating to fee-based accounts: |                     |                     |
| Customer household accounts   | 8,547               | 7,046               |
| Average revenue per account   | \$ 2,199            | \$ 2,030            |
| Ending balance of assets under administration (millions)                        | \$ 2,217            | \$ 1,755            |
| Average assets per active account   | \$ 259,355          | \$ 249,068          |

(1) Includes only trades on which revenues are earned ( revenue trades ). Revenues are earned on both transactional and annuitized trades.

(2) Calculated as total trade revenues divided by revenue trades.

(3) Includes only accounts with a positive balance.

**Investment Services Operating Results**

(in 000s)



| Six months ended                    | October 31,<br>2005 | Restated<br>October 31,<br>2004 |
|-------------------------------------|---------------------|---------------------------------|
| Service revenue:                    |                     |                                 |
| Transactional revenue               | \$ 46,167           | \$ 39,940                       |
| Annuitized revenue                  | 45,333              | 35,732                          |
| Production revenue                  | 91,500              | 75,672                          |
| Other service revenue               | 16,271              | 12,789                          |
|                                     | 107,771             | 88,461                          |
| Margin interest revenue             | 28,919              | 18,798                          |
| Less: interest expense              | (2,617)             | (840)                           |
| Net interest revenue                | 26,302              | 17,958                          |
| Other                               | 1,311               | 83                              |
| Total revenues <sup>(1)</sup>       | 135,384             | 106,502                         |
| Cost of services:                   |                     |                                 |
| Compensation and benefits           | 63,211              | 55,922                          |
| Occupancy                           | 10,352              | 10,562                          |
| Depreciation                        | 1,943               | 2,153                           |
| Other                               | 8,533               | 7,202                           |
|                                     | 84,039              | 75,839                          |
| Selling, general and administrative | 66,803              | 71,770                          |
| Total expenses                      | 150,842             | 147,609                         |
| Pretax loss                         | \$ (15,458)         | \$ (41,107)                     |

(1) Total revenues,  
less interest  
expense.

**Six months ended October 31, 2005 compared to October 31, 2004**

Investment Services revenues, net of interest expense, for the six months ended October 31, 2005 increased \$28.9 million, or 27.1%, over the prior year.

Production revenue increased \$15.8 million, or 20.9%, over the prior year. Transactional revenue increased \$6.2 million, or 15.6%, from the prior year due primarily to an 11.0% increase in

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transactional trading volume and a 5.8% increase in average revenue per transactional trade. Annuitized revenue increased \$9.6 million, or 26.9%, due to increased sales of annuities, insurance, mutual funds, wealth management accounts and UITs.

Annualized productivity averaged approximately \$180,000 per advisor during the current year compared to \$151,000 in the prior year. Increased productivity was due, in part, to minimum production standards we put into place during the fourth quarter of fiscal year 2005 which caused an increase in production per advisor, with 151 advisors increasing their production to date. These standards also resulted in 116 low-producing advisors leaving the company to date. We expect this trend to continue throughout the remainder of the fiscal year.

Other service revenue increased \$3.5 million due to increased underwriting fees.

Margin interest revenue increased \$10.1 million, or 53.8%, from the prior year, as a result of higher interest rates earned, partially offset by lower average margin balances.

Total expenses increased \$3.2 million, or 2.2%. Cost of services increased \$8.2 million, or 10.8%, primarily as a result of \$7.3 million of additional compensation and benefits. This increase is primarily due to higher production revenues, partially offset by cost containment measures implemented in the fourth quarter of fiscal year 2005.

Selling, general and administrative expenses decreased \$5.0 million, or 6.9%, primarily due to reduced back-office headcount relating to cost containment efforts, a decline in legal expenses and gains on the disposition of certain assets during the year. These decreases were partially offset by increased bonuses associated with improved performance.

The pretax loss for Investment Services for the first half of fiscal year 2006 was \$15.5 million compared to the prior year loss of \$41.1 million.

**Fiscal 2006 outlook**

Our fiscal year 2006 outlook for our Investment Services segment has improved slightly from the discussion in our April 30, 2005 Form 10-K/A. We now anticipate the loss for Investment Services for fiscal year 2006 will be approximately \$30 million to \$35 million less than the loss reported in fiscal year 2005, instead of the \$25 million to \$35 million improvement we previously discussed.

**CORPORATE**

This segment consists primarily of corporate support departments, which provide services to our operating segments. These support departments consist of marketing, information technology, facilities, human resources, executive, legal, finance, government relations and corporate communications. Support department costs are generally allocated to our operating segments. Our captive insurance and franchise financing subsidiaries are also included within this segment, as was our small business initiatives subsidiary in the first half of fiscal year 2005.

**Table of Contents****Corporate Operating Results**

(in 000s)

|                               | Three months ended October<br>31,<br>Restated<br>2005 |             | Six months ended October<br>31,<br>Restated<br>2005 |             |
|-------------------------------|---|-------------|---|-------------|
|                               | 2005  | 2004        | 2005  | 2004        |
| Operating revenues            | \$ 4,403  | \$ 2,432    | \$ 9,409  | \$ 6,865    |
| Eliminations                  | (3,147)   | (1,725)     | (5,618)   | (4,710)     |
| Total revenues                | 1,256   | 707         | 3,791   | 2,155       |
| Corporate expenses:           |   |             |   |             |
| Interest expense              | 15,438  | 18,512      | 29,232  | 34,736      |
| Other                         | 14,375  | 11,939      | 31,837  | 23,105      |
|                               | 29,813  | 30,451      | 61,069  | 57,841      |
| Shared services:              |   |             |   |             |
| Information technology        | 29,095  | 27,234      | 55,547  | 52,412      |
| Marketing                     | 6,640   | 7,691       | 11,081  | 11,262      |
| Finance                       | 13,271  | 8,706       | 25,066  | 17,513      |
| Other                         | 23,445  | 26,366      | 44,334  | 46,595      |
|                               | 72,451  | 69,997      | 136,028   | 127,782     |
| Allocation of shared services | (72,789)  | (69,995)    | (136,418)   | (127,799)   |
| Other income, net             | 1,764   | 1,044       | 8,919   | 2,176       |
| Pretax loss                   | \$ (26,455)   | \$ (28,702) | \$ (47,969)   | \$ (53,493) |

**Three months ended October 31, 2005 compared to October 31, 2004**

Corporate expenses decreased \$0.6 million primarily due to a decrease of \$3.1 million in interest expense, partially offset by an increase of \$2.1 million in increased allocated costs from finance shared services.

Finance department expenses increased \$4.6 million, primarily due to \$1.9 million of additional consulting expenses and increases in compensation expenses.

The pretax loss was \$26.5 million, compared with last year's second quarter loss of \$28.7 million.

Due to the nature of this segment, the three months ended October 31, 2005 are not comparable to the three months ended July 31, 2005 and are not indicative of the expected results for the entire fiscal year.

**Six months ended October 31, 2005 compared to October 31, 2004**

Corporate expenses increased \$3.2 million primarily due an increase of \$4.2 million in increased allocated costs from finance shared services and \$1.5 million in additional consulting, accounting and auditing expenses related to the restatement of our previously issued financial statements.

Our consolidated interest expense, both operating and non-operating, totaled \$42.6 million for the six months ended October 31, 2005, an increase of \$2.4 million over the prior year. Of the \$42.6 million in total interest, \$24.8 million related to interest expense on previous acquisitions, with the remaining \$17.8 million related to our operations recorded directly in our operating segments. Intercompany interest expense, which is also recorded directly in our operating segments, is eliminated within the Corporate segment. These eliminations resulted in a decline of \$5.5 million in interest expense recorded in our Corporate segment for the current period.

Finance department expenses increased \$7.6 million, primarily due to \$4.2 million of additional consulting expenses and an increase of \$2.8 million in compensation expenses.

Other income increased \$6.7 million primarily as a result of a \$3.4 million gain recognized on the sale of an investment.

The pretax loss was \$48.0 million, compared with last year's loss of \$53.5 million.

**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 \$704.9 million and \$667.3 million for the six months ended October 31, 2005 and 2004, respectively. The increase in cash used in operating activities is primarily due to increases in mortgage loans held for sale, trading residuals and MSRs during the current year. These items were partially offset by a decline in income tax payments. Income tax payments totaled \$169.2 million during the current year, a decrease of \$147.5 million from the prior year.

**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 \$48.0 million and \$53.9 million for the six months ended October 31, 2005 and 2004, respectively.

**Dividends.** Dividends paid totaled \$77.4 million and \$70.0 million for the six months ended October 31, 2005 and 2004, respectively. On June 8, 2005, our Board of Directors declared a two-for-one stock split of the Company's Common Stock in the form of a 100% stock distribution, effective August 22, 2005, to shareholders of record as of the close of business on August 1, 2005. All share and per share amounts in this document have been adjusted to reflect the retroactive effect of the stock split.

**Share Repurchases.** On June 9, 2004, our Board of Directors approved an authorization to repurchase 15 million shares. During the six months ended October 31, 2005, we repurchased 9.0 million shares pursuant to this authorization and a prior authorization at an aggregate price of \$254.2 million or an average price of \$28.18 per share. There are 10.5 million shares remaining under this authorization at October 31, 2005. 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.

**Restricted Cash.** We hold certain cash balances that are restricted as to use. Cash and cash equivalents restricted totaled \$464.5 million at October 31, 2005 compared to \$516.9 million at April 30, 2005. Investment Services held \$330.0 million of this total segregated in a special reserve account for the exclusive benefit of customers. Restricted cash of \$58.7 million at October 31, 2005 held by Business Services is related to funds held to pay payroll taxes on behalf of its customers. Restricted cash held by Mortgage Services totaled \$75.7 million and is held primarily for outstanding commitments to fund mortgage loans.

**Segment Cash Flows.** A condensed consolidating statement of cash flows by segment for the six months ended October 31, 2005 follows. Generally, interest is not charged on intercompany activities between segments.

(in 000s)

|                                | Tax<br>Services | Mortgage<br>Services | Business<br>Services | Investment<br>Services | Corporate    | Consolidated<br>H&R Block |
|--------------------------------|-----------------|----------------------|----------------------|------------------------|--------------|---------------------------|
| Cash provided by (used<br>in): |                 |                      |                      |                        |              |                           |
| Operations                     | \$ (203,902)    | \$ (258,155)         | \$ (13,072)          | \$ 36,289              | \$ (266,019) | \$ (704,859)              |
| Investing                      | (14,816)        | 74,654               | (209,895)            | 5,996                  | (25,858)     | (169,919)                 |
| Financing                      | (28,517)        |                      | (15,616)             | 3,390                  | 207,798      | 167,055                   |
| Net intercompany               | 244,750         | 206,999              | 252,681              | (6,880)                | (697,550)    |                           |

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



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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 \$203.9 million in its current six-month operations to cover off-season costs and working capital requirements. Cash used for seasonal working capital requirements was partially offset by a signing bonus received from HSBC during the quarter in connection with the execution of a RAL distribution agreement. The signing bonus was recorded as deferred revenue at October 31, 2005. This segment also used \$28.5 million in financing activities, primarily 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 \$258.2 million in cash from operating activities primarily due to a \$207.6 million increase in mortgage loans held for sale and \$93.9 million in trading residuals held at October 31, 2005 that had not yet been securitized in a NIM transaction. Additions to MSRs also increased \$77.4 million over the prior year. Cash flows from investing activities consist of \$64.4 million in cash receipts on residual interests and \$30.5 million in cash received for the sale of residual interests, partially offset by \$20.1 million in capital expenditures.

**Gains on sales.** Gains on sales of mortgage assets totaled \$383.7 million, with the cash received primarily recorded as operating activities. The percentage of cash proceeds we receive from our capital market transactions, which are included within the gains on sales of mortgage assets, is reconciled below. The decline in the percentage of cash proceeds is due to \$93.9 million in trading residuals recorded at October 31, 2005, which we expect to securitize in a NIM transaction during our third quarter.

|  | (in 000s)  |                  |
|--|------------|------------------|
| Six months ended October 31,                                   | 2005       | Restated<br>2004 |
| Cash proceeds:   |            |                  |
| Loans sold by the Trusts                                       | \$ 248,130 | \$ 401,791       |
| Sale of residual interests                                     | 30,497     |                  |
| Residual cash flows from beneficial interest in Trusts         | 102,000    | 103,700          |
| Loans securitized  | 81,221     | 21,620           |
| Derivative instruments   | 79,552     |                  |
|  | 541,400    | 527,111          |
| Non-cash:  |            |                  |
| Retained mortgage servicing rights                             | 136,294    | 58,894           |
| Additions to balance sheet <sup>(1)</sup>                      | 102,204    | 15,270           |
|  | 238,498    | 74,164           |
| Portion of gain on sale related to capital market transactions | 779,898    | 601,275          |
| Other items included in gain on sale:                          |            |                  |
| Changes in beneficial interest in Trusts                       | (111,195)  | (36,348)         |
| Impairments to fair value of residual interests                | (20,613)   | (2,609)          |
| Net change in fair value of derivative instruments             | 7,284      | (1,930)          |
| Direct origination and acquisition expenses, net               | (235,205)  | (172,339)        |
| Loan sale repurchase reserves                                  | (36,471)   | (20,541)         |

|  |            |            |
|--|------------|------------|
|  | (396,200)  | (233,767)  |
| Reported gains on sales of mortgage assets   | \$ 383,698 | \$ 367,508 |
| Percent of gain on sale related to capital market transactions received as cash <sup>(2)</sup> | 69%        | 88%        |

(1) Includes residual interests and interest rate caps.

(2) Cash proceeds divided by portion of gain on sale related to capital market transactions.

Warehouse funding. To finance our prime 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, 2005 and April 30, 2005, the balance outstanding under this facility was \$2.0 million and \$4.4 million, respectively.



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To fund our non-prime originations, we utilize eight off-balance sheet warehouse Trusts. The facilities used by the Trusts had a total committed capacity of \$13.5 billion as of October 31, 2005. Amounts drawn on the facilities by the Trusts totaled \$9.5 billion at October 31, 2005. See additional discussion below in Off-Balance Sheet Financing Arrangements.

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 \$13.1 million in operating cash flows during the first six months of the year. Business Services used \$209.9 million in investing activities primarily related to the American Express Tax and Business Services, Inc. acquisition and, to a lesser extent, capital expenditures.

**Investment Services.** Investment Services, through HRBFA, is subject to regulatory requirements intended to ensure the general financial soundness and liquidity of broker-dealers.

At October 31, 2005, HRBFA's net capital of \$116.4 million, which was 19.1% of aggregate debit items, exceeded its minimum required net capital of \$12.2 million by \$104.2 million.

In the first six months of fiscal year 2005, Investment Services provided \$36.3 million in cash from its operating activities primarily due to working capital changes, including the timing of cash deposits that are restricted for the benefit of customers.

Liquidity needs relating to client trading and margin-borrowing activities are met primarily through cash balances in client brokerage accounts and working capital. We believe these sources of funds will continue to be the primary sources of liquidity for Investment Services. Stock loans have historically been used as a secondary source of funding and could be used in the future, if warranted.

Pledged securities at October 31, 2005 totaled \$47.0 million, an excess of \$9.0 million over the margin requirement. Pledged securities at the end of fiscal year 2005 totaled \$44.6 million, an excess of \$7.9 million over the margin requirement.

We believe the funding sources for Investment 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**

Substantially all non-prime mortgage loans we originate are sold daily to the Trusts. The Trusts purchase the loans from us utilizing eight warehouse facilities that were arranged by us, bear interest at one-month LIBOR plus 45 to 400 basis points and expire on various dates during the year. During the second quarter, the warehouse facilities were increased from \$10.0 billion to \$13.5 billion. An additional uncommitted facility of \$1.0 billion brings total capacity to \$14.5 billion.

In August 2005, the FASB issued three exposure drafts which amend Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. See discussion in note 13 to the condensed consolidated financial statements.

There have been no other material changes in our off-balance sheet financing arrangements from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

## **COMMERCIAL PAPER ISSUANCE**

We maintain two unsecured CLOCs for working capital, support of our commercial paper program and general corporate purposes. In August 2005, the first CLOC expired and was replaced with a new \$1.0 billion CLOC, which expires in August 2010. Also in August 2005, the second CLOC was extended, and now expires in August 2010.

There have been no other material changes in our commercial paper program from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**Table of Contents****CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

There have been no material changes in our contractual obligations and commercial commitments from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**REGULATORY ENVIRONMENT**

There have been no material changes in our regulatory environment from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**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.

There have been no material changes in our risk factors from those reported at April 30, 2005 in our Annual Report on Form 10-K/A.

**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, by excluding certain items that do not represent results from our basic operations. 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.

**Origination Margin**

(dollars in 000s)

|  | Three months ended |                         |              | Six months ended |                         |
|--|--------------------|-------------------------|--------------|------------------|-------------------------|
|  | October 31,        | Restated<br>October 31, | July 31,     | October 31,      | Restated<br>October 31, |
|  | 2005               | 2004                    | 2005         | 2005             | 2004                    |
| Total expenses   | \$ 239,912         | \$ 175,860              | \$ 225,970   | \$ 465,882       | \$ 338,808              |
| Add: Expenses netted<br>against<br>gain on sale revenues | 120,981            | 79,850                  | 114,224      | 235,205          | 172,339                 |
| Less:  |                    |                         |              |                  |                         |
| Cost of services   | 67,811             | 52,931                  | 64,392       | 132,203          | 102,792                 |
| Cost of acquisition                                      | 50,591             | 30,410                  | 52,306       | 102,897          | 72,110                  |
| Allocated support<br>departments                         | 6,793              | 6,804                   | 5,831        | 12,624           | 12,149                  |
| Other  | 10,300             | 4,400                   | 6,255        | 16,555           | 3,500                   |
|  | \$ 225,398         | \$ 161,065              | \$ 211,410   | \$ 436,808       | \$ 320,596              |
| Divided by origination<br>volume                         | \$12,620,808       | \$6,512,983             | \$10,887,629 | \$23,508,437     | \$13,329,500            |
| Total cost of origination                                | 1.79%              | 2.47%                   | 1.94%        | 1.86%            | 2.41%                   |

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

We have established disclosure controls and procedures (Disclosure Controls) to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls were designed to provide reasonable assurance that the controls and

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procedures would meet their objectives. Our management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our Disclosure Controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the designed control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusions of two or more people, or by management override of the control. Because of the inherent limitations in a cost-effective, maturing control system, misstatements due to error or fraud may occur and not be detected.

As of the end of the period covered by this Form 10-Q/A, we evaluated the effectiveness of the design and operation of our Disclosure Controls. The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, and included consideration of the material weakness initially disclosed in our Annual Report on Form 10-K/A for the year ended April 30, 2005. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our Disclosure Controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q/A because of the material weakness described below.

As disclosed initially in our Annual Report on Form 10-K/A for the year ended April 30, 2005, management identified a material weakness in our accounting for income taxes. Specifically, the Company did not maintain sufficient resources in the corporate tax function to accurately identify, evaluate and report, in a timely manner, non-routine and complex transactions. In addition, the Company had not completed the requisite historical analysis and related reconciliations to ensure tax balances were appropriately stated prior to the completion of the Company's April 30, 2005 internal control activities.

In February 2006, as a result of the ongoing controls and procedural work to remediate the material weakness in the Company's internal controls over accounting for income taxes as of April 30, 2005, management discovered additional income tax errors which required the restatement of prior periods. In preparation for its revised 10-Q/A filing, management reviewed this disclosure and continues to believe it accurately describes the nature of the internal control deficiencies that contributed to the material weakness as of April 30, 2005.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

In order to remediate the aforementioned material weakness, management completed the requisite historical analysis including creation of the necessary tax basis balance sheets and current and deferred reconciliations required and related internal control testing to ensure propriety of all tax related financial statement account balances as of the Form 10-K/A filing date. The Company believes it established appropriate controls and procedures and created appropriate tax account analysis and support subsequent to April 30, 2005.

Additionally, in our efforts to remediate the material weakness management has engaged a third-party firm to assist us in performing a comprehensive evaluation of the corporate tax function, including resource requirements. We expect this third-party evaluation to be completed by December 31, 2005. Since August 1, 2005, we have hired an Income Tax Accounting Manager, a Corporate Tax Manager and two additional Tax Analysts. In addition to implementing management's action plan addressing items from the comprehensive evaluation, we will continue to monitor the improvements in the controls over accounting for income taxes to ensure remediation of the material weakness.

Other than the changes outlined above, there were no changes that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 6. EXHIBITS**

- 10.1 Amended and Restated Sale and Servicing Agreement dated August 5, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2003-4 and Wells Fargo Bank, National Association, filed as Exhibit 10.1 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.2 Amended and Restated Note Purchase Agreement dated August 5, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2003-4, Falcon Asset Securitization Corporation, Jupiter Securitization Corporation, Preferred Receivables Funding Corporation, financial institutions party thereto and JPMorgan Chase Bank, N.A., filed as Exhibit 10.2 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.3 Amended and Restated Five-Year Credit and Guarantee Agreement dated as of August 10, 2005 among Block Financial Corporation, H&R Block, Inc., the lenders party thereto, Bank of America, N.A., HSBC Bank USA, National Association, Royal Bank of Scotland PLC, JPMorgan Chase Bank, N.A., and J.P. Morgan Securities Inc., filed as Exhibit 10.3 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.4 Five-Year Credit and Guarantee Agreement dated as of August 10, 2005 among Block Financial Corporation, H&R Block, Inc., the lenders party thereto, Bank of America, N.A., HSBC Bank USA, National Association, Royal Bank of Scotland PLC, JPMorgan Chase Bank, N.A. and J.P. Morgan Securities Inc., filed as Exhibit 10.4 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.5 Sale and Servicing Agreement dated as of September 1, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2005-7 and Wells Fargo Bank, N.A., filed as Exhibit 10.5 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.6 Note Purchase Agreement dated as of September 1, 2005 among Option One Loan Warehouse Corporation, Option One Owner Trust 2005-7, HSBC Securities (USA) Inc., HSBC Bank USA, N.A., Bryant Park Funding LLC and HSBC Securities (USA) Inc., filed as Exhibit 10.6 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.7 Indenture dated as of September 1, 2005 between Option One Owner Trust 2005-7 and Wells Fargo Bank, N.A., filed as Exhibit 10.7 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.8 Omnibus Amendment No. 1 dated as of September 8, 2005 among Option One Mortgage Corporation, Option One Owner Trust 2002-3 and Wells Fargo Bank, N.A., filed as Exhibit 10.8 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.9 Other Income License Agreement (Products and/or Services) dated September 15, 2005 between Wal-Mart Stores, Inc. and H&R Block Services, Inc., filed as Exhibit 10.9 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.

- 10.10 Employment Agreement dated September 27, 2005 between HRB Management, Inc. and Jeff Nachbor, filed as Exhibit 10.10 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.11 Amendment No. Six to Amended and Restated Note Purchase Agreement dated November 25, 2003 among Option One Loan Warehouse Corporation, Option One Owner Trust 2001-2 and Bank of America, N.A., filed as Exhibit 10.11 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.12 Amendment Number Two to the Second Amended and Restated Sale and Servicing Agreement dated as of March 8, 2005 among Option One Owner Trust 2001-2, Option One Loan Warehouse Corporation, Option One Mortgage Corporation and Wells Fargo Bank N.A., filed as Exhibit

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- 10.12 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.13 Amendment Number Three to the Second Amended and Restated Sale and Servicing Agreement dated as of March 8, 2005 among Option One Owner Trust 2001-2, Option One Loan Warehouse Corporation, Option One Mortgage Corporation and Wells Fargo Bank N.A., filed as Exhibit 10.13 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.14 HSBC Retail Settlement Products Distribution Agreement dated as of September 23, 2005 among HSBC Bank USA, National Association, HSBC Taxpayer Financial Services Inc., Beneficial Franchise Company Inc., Household Tax Masters Acquisition Corporation, H&R Block Services, Inc., H&R Block Tax Services, Inc., H&R Block Enterprises, Inc., H&R Block Eastern Enterprises, Inc., H&R Block Digital Tax Solutions, LLC, H&R Block Associates, L.P., HRB Royalty, Inc. HSBC Finance Corporation and H&R Block, Inc., filed as Exhibit 10.14 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 10.15 HSBC Digital Settlement Products Distribution Agreement dated as of September 23, 2005 among HSBC Bank USA, National Association, HSBC Taxpayer Financial Services Inc., H&R Block Digital Tax Solutions, LLC and H&R Block Services, Inc., filed as Exhibit 10.15 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 10.16 HSBC Refund Anticipation Loan Participation Agreement dated as of September 23, 2005 among Household Tax Masters Acquisition Corporation, Block Financial Corporation, HSBC Bank USA, National Association and HSBC Taxpayer Financial Services Inc., filed as Exhibit 10.16 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 10.17 HSBC Settlement Products Servicing Agreement dated as of September 23, 2005 among HSBC Bank USA, National Association, HSBC Taxpayer Financial Services Inc., Household Tax Masters Acquisition Corporation and Block Financial Corporation, filed as Exhibit 10.17 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 10.18 HSBC Program Appendix of Defined Terms and Rules of Construction, filed as Exhibit 10.18 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 10.19 Sale and Servicing Agreement dated as of October 1, 2005 among Option One Mortgage Corporation, Option One Loan Warehouse Corporation, Option One Owner Trust 2005-8 and Wells Fargo Bank, N.A., filed as Exhibit 10.19 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.20 Note Purchase Agreement dated as of October 1, 2005 among Option One Loan Warehouse Corporation, Option One Owner Trust 2005-8 and Merrill Lynch Bank USA, filed as Exhibit 10.20 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.21

Indenture dated as of October 1, 2005 between Option One Owner Trust 2005-8 and Wells Fargo Bank, N.A., filed as Exhibit 10.21 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.

- 10.22 Fourth Amended and Restated Loan Purchase and Contribution Agreement dated as of September 1, 2005 between Option One Loan Warehouse Corporation and Option One Mortgage Corporation, filed as Exhibit 10.22 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.
- 10.23 Second Amendment to Second Amended and Restated Refund Anticipation Loan Operations Agreement dated as of August 31, 2005 among H&R Block Services, Inc., H&R Block Tax Services, Inc., HRB Royalty, Inc., HSBC Taxpayer Financial Services, Inc., HSBC Bank USA, National Association and Beneficial Franchise Company, filed as Exhibit 10.23 to the Company's quarterly report on Form 10-Q for the quarter ended October 31, 2005, file number 1-6089, is incorporated by reference.\*
- 31.1 Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.



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- 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.
- \* Confidential information has been omitted from this exhibit and filed separately with the Commission pursuant to a confidential treatment request under Rule 24b-2.

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**SIGNATURES**

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

**H&R BLOCK, INC.**

Mark A. Ernst  
Chairman of the Board, President  
and Chief Executive Officer  
March 31, 2006

William L. Trubeck  
Executive Vice President and  
Chief Financial Officer  
March 31, 2006

Jeffrey E. Nachbor  
Senior Vice President and  
Corporate Controller  
March 31, 2006

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