

CONVERGYS CORP
Form 10-Q
August 07, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2007

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 1-14379

CONVERGYS CORPORATION

Incorporated under the laws of the State of Ohio

201 East Fourth Street, Cincinnati, Ohio 45202

I.R.S. Employer Identification Number 31-1598292

Telephone - Area Code (513) 723-7000

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

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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.

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

At July 31, 2007, there were 135,583,159 common shares outstanding, excluding amounts held in Treasury of 45,439,413.

PART I - FINANCIAL INFORMATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

AND COMPREHENSIVE INCOME

(Unaudited)

(Amounts in millions, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues	\$ 707.0	\$ 691.8	\$ 1,426.9	\$ 1,367.1
Operating Costs and Expenses				
Cost of providing services and products sold	461.6	438.6	920.4	862.0
Selling, general and administrative	137.1	132.0	281.8	264.8
Research and development costs	19.6	21.4	38.7	41.8
Depreciation	28.4	32.3	58.3	65.1
Amortization	2.2	4.7	4.4	8.6
Total costs and expenses	648.9	629.0	1,303.6	1,242.3
Operating Income	58.1	62.8	123.3	124.8
Equity in Earnings of Cellular Partnerships	3.6	1.5	5.6	2.9
Other Income, net	0.5	0.8	2.7	1.1
Interest Expense	(4.6)	(5.8)	(9.4)	(11.5)
Income Before Income Taxes	57.6	59.3	122.2	117.3
Income Tax Expense	18.8	19.5	39.8	40.8
Net Income	\$ 38.8	\$ 39.8	\$ 82.4	\$ 76.5
Other Comprehensive Income (Loss), net of tax:				
Foreign currency translation adjustments	\$ 7.7	\$ 2.8	\$ 8.5	\$ 3.2
Change related to pension liability	2.8		2.8	
Unrealized gains (losses) on hedging activities	25.4	(5.8)	30.1	(7.5)
Total other comprehensive income (loss)	35.9	(3.0)	41.4	(4.3)
Comprehensive Income	\$ 74.7	\$ 36.8	\$ 123.8	\$ 72.2
Earnings Per Common Share				
Basic	\$ 0.28	\$ 0.29	\$ 0.60	\$ 0.55
Diluted	\$ 0.28	\$ 0.28	\$ 0.59	\$ 0.54
Average Common Shares Outstanding				
Basic	136.3	139.1	136.5	139.2
Diluted	140.2	142.4	140.5	142.3

See Notes to Consolidated Financial Statements.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts In Millions)	(Unaudited) June 30, 2007	December 31, 2006
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 221.8	\$ 235.9
Receivables, net of allowances of \$9.4 and \$12.0	551.5	545.6
Deferred income tax benefits	29.2	53.5
Prepaid expenses	41.9	37.3
Other current assets	107.7	57.9
Total current assets	952.1	930.2
Property and equipment, net	354.2	368.6
Goodwill, net	886.4	880.2
Other intangibles, net	45.6	49.9
Investment in Cellular Partnerships	55.1	49.5
Deferred charges	246.2	228.0
Other assets	36.0	33.9
Total Assets	\$ 2,575.6	\$ 2,540.3
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Debt maturing within one year	\$ 20.6	\$ 83.9
Payables, deferred revenue and other current liabilities	373.5	512.0
Total current liabilities	394.1	595.9
Long-term debt	291.9	259.6
Deferred income tax liability	58.6	43.9
Accrued pension liability	113.1	105.0
Deferred revenue and other long-term liabilities	168.4	80.8
Total liabilities	1,026.1	1,085.2
Shareholders' Equity		
Preferred shares without par value, 5.0 authorized; none outstanding		
Common shares without par value, 500.0 authorized; 181.0 outstanding in 2007 and 179.6 outstanding in 2006	985.1	965.1
Treasury stock 44.7 shares in 2007 and 43.1 in 2006	(791.0)	(749.4)
Retained earnings	1,310.3	1,235.7
Accumulated other comprehensive income	45.1	3.7
Total shareholders' equity	1,549.5	1,455.1
Total Liabilities and Shareholders' Equity	\$ 2,575.6	\$ 2,540.3

See Notes to Consolidated Financial Statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in millions)	Six Months Ended June 30,	
	2007	2006
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Net income	\$ 82.4	\$ 76.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	62.7	73.7
Deferred income tax expense	29.5	(0.5)
Cellular Partnerships results in excess of distributions	(5.6)	(2.9)
Stock compensation expense	12.3	13.7
Changes in assets and liabilities, net of effects from acquisitions:		
Increase in receivables	(5.9)	(37.7)
(Increase)/decrease in other current assets	(0.9)	2.2
Increase in deferred charges, net	(10.6)	(32.0)
Change in other assets and liabilities	20.6	16.9
(Decrease)/increase in payables and other current liabilities	(77.5)	15.5
Other, net	(1.9)	(5.2)
Net cash provided by operating activities	105.1	120.2
<u>CASH FLOWS FROM INVESTING ACTIVITIES</u>		
Capital expenditures	(45.9)	(52.2)
Proceeds from disposal of property and equipment	0.3	2.1
Purchase of auction rate securities, net	(8.7)	
Return of capital from Cellular Partnerships		5.8
Net cash used in investing activities	(54.3)	(44.3)
<u>CASH FLOWS FROM FINANCING ACTIVITIES</u>		
Repayments of commercial paper and other debt, net	(31.0)	(43.3)
Excess tax benefits from share-based payment arrangements	1.7	1.8
Purchase of treasury shares	(41.6)	(39.4)
Issuance of common shares	6.0	10.1
Net cash used in financing activities	(64.9)	(70.8)
Net (decrease) /increase in cash and cash equivalents	(14.1)	5.1
Cash and cash equivalents at beginning of period	235.9	196.0
Cash and cash equivalents at end of period	\$ 221.8	\$ 201.1

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

(1) BACKGROUND AND BASIS OF PRESENTATION

Convergys Corporation (the Company or Convergys) is a global leader in providing customer care, billing and human resource services. For over twenty years, enterprises with a large number of customers and employees have turned to Convergys for support. By providing value-added billing, customer care and employee care solutions for our clients, the Company has developed a base of recurring revenues generally under multiple year contracts.

The Company reports three segments: (i) Customer Care, which provides outsourced customer service as well as professional and consulting service to in-house customer care operations; (ii) Information Management, which provides billing and information solutions; and (iii) Employee Care, which provides human resource business process outsourcing solutions.

These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and, in the opinion of management, include all adjustments necessary for a fair presentation of the results of operations, financial position and cash flows for each period shown. All adjustments are of a normal and recurring nature. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted. Interim consolidated financial statements are not necessarily indicative of the financial position or operating results for an entire year. These interim financial statements should be read in conjunction with the audited financial statements and the notes thereto included in the Company's annual report on Form 10-K for the period ended December 31, 2006. Certain previously reported amounts have been reclassified to conform to current period presentation.

We file annual, quarterly, current reports and proxy statements with the SEC. These filings are available to the public over the Internet on the SEC's Web site at <http://www.sec.gov> and on the Company's Web site at <http://www.convergys.com>. You may also read and copy any document we file with the SEC at its public reference facilities in Washington, D.C. You can also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information relating to the operation of the public reference facilities. You can also inspect periodic and current reports, proxy statements and other information about Convergys at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

(2) RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This new Standard provides guidance for using fair value to measure assets and liabilities. The Standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the effects that SFAS No. 157 will have on its financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 allows entities to voluntarily choose, at specified election dates, to measure many financial and certain non-financial assets and liabilities at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. This Statement is effective as of the first fiscal year that begins after November 15, 2007. The adoption of this Standard will not have a material impact on the Company's financial statements.

(3) STOCK-BASED COMPENSATION PLANS

The Company's operating results for the three and six months ended June 30, 2007 included long-term incentive plan expense of \$8.2 and \$16.7, respectively, compared to \$8.0 and \$14.3, respectively, for the same periods in 2006. Long-term incentive plan expense for the three months and six months ended June 30, 2007 included stock compensation expense of \$7.0 and \$12.3, respectively, compared to \$8.0 and \$14.3, respectively, for the same periods in 2006. Included in the stock compensation expense of \$14.3 for the six months ended June 30, 2006 was pretax compensation expense of \$0.9 (\$0.6, net of tax) related to the expensing of the Company's stock options due to the adoption of SFAS 123(R), Share-Based Payment.

Stock Options

A summary of stock option activity for the six months ended June 30, 2007 is presented below:

Shares in Thousands	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Weighted Average Fair Value at Date of Grant (per share)
Outstanding at Jan. 1, 2007	12,828	\$ 28.69		
Exercised	(880)	15.32		
Forfeited/cancelled	(242)	35.69		
Outstanding at Jun. 30, 2007	11,706	\$ 29.55	3.4	\$ 12.46
Options exercisable at June 30, 2007	11,706	\$ 29.55	3.4	\$ 12.46

Restricted Stock and Restricted Stock Units

During the first six months of 2007, the Company granted 1.5 shares of restricted stock units with a weighted average fair value of \$24.15. Included in the above were approximately 440,000 of performance-related restricted stock units granted at the fair value of \$21.14 per share that vest upon the Company's satisfaction of certain financial performance conditions (relative shareholder return versus the S&P 500 return) as of December 31, 2009. During the six months ended June 30, 2006, the Company granted 1.8 shares of restricted stock units at a weighted-average fair value of \$18.04. Included in the above were 554,000 of performance-related restricted stock units granted at the fair value of \$16.08 per share that vest upon the Company's satisfaction of certain financial conditions as of December 31, 2008.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

The Company used a Monte Carlo simulation model to estimate the fair value for performance-based restricted stock units issued during 2007 and 2006. The assumptions used in this model for the 2007 awards are noted in the table below. Expected volatilities are based on historical volatility and daily returns for the three-year period ended January 1, 2007 of the Company's stock and S&P 500 companies. The total stock return for the Company over the performance period is based on comparing Convergys' average closing price from the fourth quarter of 2006 with the average closing price for the fourth quarter of 2009. The total stock return of the S&P 500 companies is computed by comparing the closing price of the S&P 500 companies on December 29, 2006 with the closing price at the end of December 2009. The risk-free interest rate for the expected term of the award granted is based on the U.S. Treasury yield curve in effect at the time of grant.

	June 30, 2007
Expected volatility	27.5%
Expected term (in years)	3.0
Risk-free interest rate	4.6%

The total compensation cost related to non-vested restricted stock and restricted stock units not yet recognized as of June 30, 2007 was approximately \$40, which is expected to be recognized over a weighted average of 1.8 years. Changes to non-vested restricted stock and restricted stock units for the six months ended June 30, 2007 were as follows:

Shares in Millions Except		Weighted Average Fair Value at Date Of Grant
Per Share Amounts	Number of Shares	
Non-vested at December 31, 2006	4.4	\$ 15.76
Granted	1.5	24.15
Vested	(1.5)	(15.10)
Forfeited	(0.2)	(18.29)
Non-vested at June 30, 2007	4.2	\$ 19.12

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

(4) BUSINESS RESTRUCTURING AND ASSET IMPAIRMENT**2006 Restructuring**

As discussed more fully in the Business Restructuring and Asset Impairment section of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, the Company initiated a restructuring plan in the fourth quarter of 2006. The plan resulted in a net restructuring charge of \$12.5 and included \$24.1 of severance costs, \$0.5 of facility closure costs and the reversal of \$12.1 in abandonment costs for a facility being brought back into service to support consolidation of operations at an international location. Restructuring actions were taken in each business segment, of which \$6.5 related to Customer Care, \$0.8 related to Information Management, \$2.1 related to Employee Care and \$3.1 related to Corporate. The severance charge of \$24.1 is being paid pursuant to our existing severance policy and employment agreements and includes cash-related payments of \$21.3 and a non-cash charge of \$2.8 related to acceleration of equity-based awards. These actions, which will affect approximately 630 professional employees, are expected to be completed by the end of 2007. Through June 2007, the Company completed approximately 400 of the planned headcount reductions.

Restructuring liability activity for the 2006 plan consisted of the following:

Balance at January 1, 2007	\$ 20.5
Severance costs	(7.6)
Lease termination payments	(0.5)
Balance at June 30, 2007	\$ 12.4

2002 Restructuring

In connection with a restructuring plan initiated during the fourth quarter of 2002, the Company made headcount reductions that affected professional and administrative employees worldwide and closed certain Customer Care and Information Management facilities.

Restructuring liability activity for the 2002 plan consisted of the following:

	2007	2006
Balance at January 1	\$ 3.0	\$ 16.0
Lease termination payments	(0.4)	(1.7)
Other	(1.1)	0.6
Balance at June 30	\$ 1.5	\$ 14.9

In the fourth quarter of 2006, the Company made a decision to consolidate operations in certain U.K. locations and move into one of the facilities that was originally abandoned in 2002. This resulted in the reversal of facility abandonment costs of \$12.1 at December 31, 2006.

The remaining accrual of \$1.5 reflects facility abandonment costs, which will be paid over several years until the leases expire. The accrual is equal to the future costs associated with those abandoned facilities, net of the proceeds from any probable future sublease agreements. The Company used estimates, based on consultation with its real estate advisors, to arrive at the proceeds from any future sublease agreements. The Company will continue to evaluate such estimates in recording the facilities abandonment charge. Consequently, there may be additional reversals or charges in the future.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

(5) GOODWILL AND OTHER INTANGIBLE ASSETS

As discussed more fully in the Goodwill and Other Intangible Assets section of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, the Company is required to test goodwill for impairment annually and at other times if events have occurred or circumstances exist that indicate the carrying value of goodwill may no longer be recoverable. The Company performed its annual impairment tests during the fourth quarter of 2006 and concluded that no goodwill impairment existed.

Goodwill increased to \$886.4 at June 30, 2007 from \$880.2 at December 31, 2006, as a result of currency translation adjustments.

As of June 30, 2007, the Company's other intangible assets acquired primarily through business combinations consisted of the following:

	Gross Carrying Amount	Accumulated Amortization	Net
Software (classified with Property, Plant & Equipment)	\$ 44.3	\$ (39.8)	\$ 4.5
Customer relationships and other intangibles	140.5	(94.9)	45.6
Total	\$ 184.8	\$ (134.7)	\$ 50.1

Intangible amortization expense for the six-month period ended June 30, 2007 and 2006 was \$4.4 and \$8.6, and is estimated to be approximately \$9 for the year ending December 31, 2007. Estimated intangible amortization expense for the five subsequent fiscal years is:

For the year ended 12/31/08	\$ 8
For the year ended 12/31/09	\$ 8
For the year ended 12/31/10	\$ 7
For the year ended 12/31/11	\$ 6
For the year ended 12/31/12	\$ 6
Thereafter	\$ 10

The intangible assets are being amortized over the following periods: five to seven years for software and three to twelve years for customer relationships and other. The weighted average amortization period for intangible assets subject to amortization is nine years (six years for software, and ten years for customer relationships and other).

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(Unaudited)

(6) ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

On January 1, 2007, the Company adopted the provisions of Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 creates a single model to address uncertainty in income tax positions. FIN 48 prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition and, excludes income taxes from Statement of Financial Accounting Standard (SFAS) No. 5, Accounting for Contingencies. FIN 48 applies to all tax positions related to income taxes subject to SFAS No. 109, Accounting for Income Taxes. This includes tax positions considered to be routine as well as those with a high degree of uncertainty. As a result of the adoption of FIN 48, the Company recognized a \$7.9 increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the retained earnings balance as of January 1, 2007. Additionally, adoption of FIN 48 caused balance sheet reclassifications from deferred tax and accrued tax accounts to a FIN 48 liability for unrecognized tax benefits. The FIN 48 tax liability for unrecognized tax benefits of \$88.8 as of January 1, 2007 included an accrual for interest and penalties of \$17.6. The impact of timing differences and tax attributes are considered when calculating interest and penalty accruals associated with the tax reserve. The Company's policy is to recognize interest and penalties accrued on unrecognized tax benefits as part of income tax expense. The total amount of net unrecognized tax benefits that would affect income tax expense, if ever recognized in the financial statements, is \$62.4. This amount includes net interest and penalties of \$12.9.

As of June 30, 2007, the liability for unrecognized tax benefits was \$83.2 of which \$7.9 is recorded within other current liabilities and \$75.3 is recorded within other long-term liabilities in the accompanying Consolidated Financial Statements. The Company does not presently anticipate that the unrecognized tax benefits will materially increase or decrease prior to December 31, 2007; however, actual developments in this area could differ from those currently expected.

The Company files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With a few exceptions, the Company is no longer subject to examinations by tax authorities for years before 2002.

(7) DEFERRED CHARGES

The Company often performs, in connection with its outsourcing arrangements, certain set-up activities or implementations, including the installation and customization of the Company's proprietary software. Additionally, with respect to arrangements where all of the services are accounted for as a single unit of accounting, the Company defers all revenue until it begins to deliver the final service. In connection with these arrangements, the Company capitalizes all direct and incremental multiple-element costs (by analogy to SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases) to the extent recovery of these costs is probable. All implementation and set-up activity costs are amortized ratably over the life of the arrangements as costs of providing service. Deferred amounts are protected in the event of early termination of the contract and are monitored regularly for impairment.

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(Unaudited)

In the event these costs are not deemed recoverable, the costs are expensed as incurred. The Company evaluates the probability of recovery by considering profits to be earned during the term of the related contract, the creditworthiness of the client and, if applicable, contract termination penalties payable by the client in the event that the client terminates the contract early. During the second quarter of 2007, the Company expensed \$6.1 of implementation costs related to a large, Employee Care, HR BPO contract as they were deemed not recoverable in accordance with the Company's accounting policy. Refer to the "Deferred Charges" section of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 for more detailed discussions on deferred charges and the Company's policy on assessing recoverability of deferred charges.

In connection with certain of the Company's outsourcing arrangements, the Company from time to time will incur costs that are non-refundable cash payments to clients to acquire or extend a contractual relationship. To the extent recovery of these costs is probable, the Company capitalizes these client acquisition costs (by analogy to SFAS No. 91) and amortizes them ratably over the life of the contract as a reduction of revenue.

During the six months ended June 30, 2007 and 2006, the Company capitalized \$41.7 and \$57.2, respectively, of client acquisition and implementation costs. The related amortization for these periods was \$23.5 and \$25.2, respectively.

(8) PAYABLES AND OTHER CURRENT LIABILITIES

	At Jun. 30, 2007	At Dec. 31, 2006
Accounts payable	\$ 21.4	\$ 27.2
Accrued taxes	0.9	94.7
Accrued payroll-related expenses	119.0	152.1
Executive deferred compensation plan	6.0	8.6
Accrued expenses, other	122.4	105.2
Restructuring and exit costs	13.9	23.5
Deferred revenue and government grants	89.9	100.7
	\$ 373.5	\$ 512.0

(9) EMPLOYEE BENEFIT PLANS

The Company sponsors a defined benefit pension plan, which includes both a qualified and non-qualified portion, for all eligible employees (the cash balance plan). The Company also sponsors a non-qualified, unfunded executive deferred compensation plan and a supplemental, non-qualified, unfunded plan for certain senior executives (the executive pension plans). The pension benefit formula for the cash balance plan is determined by a combination of compensation and age-based credits and annual guaranteed interest credits. Benefits for the executive deferred compensation plan are based on employee deferrals, matching contributions and investment earnings on participant accounts. Benefits for the supplemental plan are based on age, years of service and eligible pay. Funding of the qualified portion of the cash balance plan has been achieved through contributions made to a trust fund. The contributions have been determined using the aggregate cost method. The Company's measurement date for all plans is December 31. The projected unit credit cost method is used for determining the unfunded executive pension cost for financial reporting purposes. Pension costs for the cash balance plan are determined based on the traditional unit credit cost method. The plan assumptions are evaluated annually and are updated as necessary.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

Components of pension cost for the cash balance plan are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Service cost (benefits earned during the period)	\$ 4.4	\$ 6.0	\$ 9.0	\$ 11.9
Interest cost on projected benefit obligation	2.7	2.7	5.8	5.5
Expected return on plan assets	(3.7)	(3.7)	(7.3)	(7.4)
Amortization and deferrals net	0.5	0.5	1.3	1.0
Pension cost	\$ 3.9	\$ 5.5	\$ 8.8	\$ 11.0

Pension cost for the unfunded executive pension plans included the following components:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Service cost (benefits earned during the period)	\$ 0.9	\$ 0.9	\$ 1.9	\$ 2.2
Interest cost on projected benefit obligation	1.0	1.1	2.2	2.4
Settlement loss			0.6	
Amortization and deferrals net	0.2	0.2	0.5	0.6
Pension cost	\$ 2.1	\$ 2.2	\$ 5.2	\$ 5.2

The Company expects to contribute approximately \$19 to its cash balance plan during the third quarter of 2007 to satisfy pension funding requirements under the Employee Retirement Income Security Act of 1974.

(10) SHAREHOLDERS EQUITY

The Company's Board of Directors has authorized the repurchase of up to 30 million of the Company's common shares. Through December 31, 2006, the Company repurchased 25.4 million shares of Convergys stock for \$398.3 million pursuant to these authorizations. During the six months ended June 30, 2007, the Company repurchased 1.6 million shares of Convergys stock for a total cost of \$41.6. At June 30, 2007, the Company may repurchase 3.0 million of additional common shares pursuant to this authorization.

From July 1 to August 3, 2007, the Company repurchased 1.2 million shares of Convergys stock for \$22.5 pursuant to these authorizations.

(11) SIGNIFICANT CUSTOMERS

The Customer Care and Information Management segments derive significant revenues from AT&T Inc. (AT&T). Revenues from AT&T were 15.0% and 16.5% of the Company's consolidated revenues for the three months ended June 30, 2007 and 2006, respectively and 14.9% and 17.2% of the Company's consolidated revenues for the six-month periods ended June 30, 2007 and 2006, respectively. Related accounts receivable from AT&T totaled \$69.8 and \$76.4 at June 30, 2007 and December 31, 2006, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in Millions Except Per Share Amounts)

(Unaudited)

(12) COMMITMENTS AND CONTINGENCIES

The Company is from time to time subject to claims and administrative proceedings that are filed in the ordinary course of business. The Company believes that the results of any such claims or administrative proceedings, either individually or in the aggregate, will not have a materially adverse effect on the Company's financial condition.

As discussed more fully in the Accounting Policies section of Notes to Consolidated Financial Statements in the Company's 2006 Annual Report on Form 10-K for the year ended December 31, 2006, Convergys is a limited partner of Cincinnati SMSA Limited Partnership. From December 2003 through February 2004, six separate lawsuits were filed in the Court of Common Pleas, Cuyahoga County, Ohio, against Cincinnati SMSA Limited Partnership and other defendants. Five of the suits were filed by companies purporting to be resellers (the Resellers Cases), while the sixth was filed by an individual consumer purporting to represent a class of damaged consumers (the Consumer Case). Each of the Reseller Cases seeks damages ranging from \$1 to \$3 plus treble damages under Ohio law. The Consumer Case seeks damages in excess of \$60 plus treble damages under Ohio law. At June 30, 2007, all five of the Reseller Cases were dismissed.

A motion by Cincinnati SMSA Limited Partnership to dismiss the Consumer Case was granted, in part, and overruled, in part, by the trial court. Cincinnati SMSA Limited Partnership sought review by the Ohio Supreme Court of the part of the trial court's decision that overruled the motion to dismiss. The Ohio Supreme Court denied review of the consumer class action. The Consumer Case has now been stayed pending the resolution of the start of the statute of limitations.

Pursuant to the partnership agreement, Convergys, as a limited partner, has no right to direct or participate in the defense of these actions and, therefore, has no current ability to assess the merit of any claims made in these actions or to identify any possible loss, which could result from these claims against the partnership.

Global Docugraphix, Inc., also known as Document Imaging, Inc. and GDxdata (GDx), is an electronic document management company previously engaged by the Company to perform work under the Company's human resources outsourcing contract with the Florida Department of Management Services (DMS). GDx has been the subject of two lawsuits filed in the Florida courts. The first lawsuit names GDx, together with its parent company, Global Docugraphix, Inc., as defendants in a false claims action filed on behalf of the State of Florida by two former employees of GDx on or around March 1, 2005 under seal in the Circuit Court of the Second Judicial Circuit in Leon County, Florida. The complaint alleges that GDx submitted invoices for work performed by GDx, which work was in violation of its subcontract with Convergys, and Convergys' contract with DMS, involving the security of the human resources data provided to GDx. The Complaint further alleges that by submitting such invoices, which allegedly were paid from funds paid to Convergys by the State, GDx submitted false invoices to the State. The Complaint seeks treble damages, penalties, attorney fees and costs from GDx based on the amount of the allegedly improper invoices. The State of Florida's Attorney General's Office has not intervened in this case, but continues to monitor it.

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(Amounts in Millions Except Per Share Amounts)

(Unaudited)

On April 12, 2006, GDX and Global Docugraphix, Inc. filed a Motion to Dismiss the lawsuit (Motion). The Motion remains pending before the Court. In addition, Global Docugraphix, Inc. has filed a suggestion of bankruptcy.

Convergys is not a party to this litigation and both Convergys and the State have investigated the allegations against GDX. The Company is providing certain credit protection and credit monitoring services to State of Florida employees who have chosen to enroll in these services. The Company continues to provide services to the State of Florida pursuant to the existing human resources outsourcing contract identified above. At June 30, 2007, the Company does not believe this matter will have a materially adverse impact on the financial condition of the Company.

The Company has the right to seek indemnity against GDX for any claims brought against the Company or losses suffered by the Company as a result of the actions and conduct of GDX.

On January 3, 2006, in the Circuit Court of Leon County, Florida, Samuel McDowell, a former employee of the Company, as Relator, filed a false claims action alleging that the Company failed to provide proper data security under the Company's contract with DMS, and as a result, falsely invoiced the State of Florida. The State of Florida's Attorney General's office exercised its right to intervene in this action. The Company has been served with the Complaint, but has not yet been required to respond.

Because the claim relates to the Company's contract with DMS, the Attorney General has invoked the pre-suit dispute resolution procedures set forth in such contract, which require various discussions and then mediation between the parties to determine whether the claims can be resolved without resorting to further litigation. Discussions are continuing (and have included DMS and the GDX plaintiffs). While the Company has made progress in the discussions, this matter was not resolved at June 30, 2007. The Company does not believe this matter will have a materially adverse impact on the Company's financial condition.

The Company is currently attempting to resolve tax audits relating to prior years in various jurisdictions. The Company believes that it is appropriately reserved with regard to these audits as of June 30, 2007. However, to the extent that the ultimate resolutions vary from the amounts reserved, such impact would be recorded to the tax provision in the period in which such resolution is reached.

The Company leases certain facilities and equipment used in its operations under operating leases. This includes the Company's office complex in Orlando, Florida, which is leased from Wachovia Development Corporation (Lessor), a wholly owned subsidiary of Wachovia Corporation, under an agreement that expires in June 2010. Upon termination or expiration of the lease, the Company must either purchase the property from the Lessor for \$65.0 or arrange to have the office complex sold to a third party. If the office complex is sold to a third party for an amount less than the \$65.0, the amount paid by the Lessor for the purchase of the complex from an unrelated third party, the Company has agreed under a residual value guarantee to pay the Lessor up to \$55.0. If the office complex is sold to a third party for an amount in excess of \$65.0, the Company is entitled to collect the excess. At the inception of the lease, the Company recognized a liability of approximately \$5 for the related residual value guarantee. The value of the guarantee was determined by computing the estimated present value of probability-weighted cash flows that might be expended under the guarantee. The Company recorded a liability for the fair value of the obligation with a corresponding asset recorded as prepaid rent, which is being amortized to rental expense over the lease term. The liability will remain on the balance sheet until the end of the lease term. Under the terms of the lease, the Company also provides certain indemnities to the Lessor, including environmental indemnities. Due to the nature of such potential obligations, it is not possible to estimate the maximum amount of such exposure or the fair value.

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(Unaudited)

The Company does not expect such amounts, if any, to be material. The Company has concluded that it is not required to consolidate the Lessor pursuant to FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51.

At June 30, 2007, the Company had outstanding letters of credit of \$42.6 related to performance and payment guarantees. The Company believes that any guarantee obligation that may arise will not be material.

The Company also has purchase commitments with three telecommunications providers of \$18.1 for the remainder of 2007 and \$26.1 for 2008.

(13) BUSINESS SEGMENT INFORMATION

As discussed in Note 1, the Company has three segments, which are identified by service offerings. Customer Care provides outsourced customer care service as well as professional and consulting services to in-house customer care operations. Information Management provides billing and information solutions. Employee Care provides human resource business processing outsourcing solutions. These segments are consistent with the Company's management of the business and reflect its internal financial reporting structure and operating focus.

The Company does not allocate activities below the operating income level to its reported segments. The Company's business segment information is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues:				
Customer Care	\$ 460.6	\$ 446.2	\$ 929.6	\$ 880.2
Information Management	183.4	195.4	369.3	384.2
Employee Care	63.0	50.2	128.0	102.7
	\$ 707.0	\$ 691.8	\$ 1,426.9	\$ 1,367.1
Depreciation:				
Customer Care	\$ 13.6	\$ 15.7	\$ 27.6	\$ 32.5
Information Management	8.1	8.4	17.1	17.0
Employee Care	2.1	3.5	4.4	6.3
Corporate	4.6	4.7	9.2	9.3
	\$ 28.4	\$ 32.3	\$ 58.3	\$ 65.1
Amortization:				
Customer Care	\$ 0.6	\$ 0.7	\$ 1.2	\$ 2.7
Information Management	0.9	3.6	1.9	4.9
Employee Care	0.7	0.4	1.3	1.0
	\$ 2.2	\$ 4.7	\$ 4.4	\$ 8.6

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Operating Income (Loss):				
Customer Care	\$ 44.7	\$ 48.2	\$ 101.0	\$ 94.4
Information Management	38.4	30.5	63.7	62.0
Employee Care	(17.1)	(8.2)	(24.5)	(17.8)
Corporate	(7.9)	(7.7)	(16.9)	(13.8)
	\$ 58.1	\$ 62.8	\$ 123.3	\$ 124.8

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(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Capital Expenditures: ⁽¹⁾				
Customer Care	\$ 8.1	\$ 8.3	\$ 15.8	\$ 16.5
Information Management	2.7	12.9	7.1	21.3
Employee Care	2.4	2.4	3.8	5.2
Corporate ⁽²⁾	8.7	4.1	19.2	9.2
	\$ 21.9	\$		