



2001 ANNUAL REPORT



2001

A D S Financial Services Solutions (Nasdaq: ADSC) provides information technology (IT) strategy consulting and systems integration services to the financial services industry. ADS offers rapid, cost-effective IT solutions to the business challenges faced by financial services companies through its in-depth financial services experience, technological expertise and project management skills. The company's service offerings are organized around four practice areas: e-Business, Customer Relationship Management (CRM), IT Strategy and Consulting, and Conversions and Consolidations.

Potential

ABOUT ADS

We believe we have served our clients well over the past year. In this report, you will read about some of the success stories—clients that ADS has helped meet their business objectives and achieve their goals of “*Potential realized.*”

To Our Shareholders

Fiscal year 2001 was a year of transition for ADS. In an effort to better align the Company with our clients' business objectives and to take greater advantage of our core competencies, we executed our strategy to refocus the business through four practices: e-Business, CRM, IT Strategy and Consulting, and Conversions and Consolidations. Our repositioning of ADS has come at an opportune, but challenging time; many “dot-coms” and New Economy start-ups have seen their values plummet. Although the economic environment has been difficult, we have made solid progress—making investments that we believe will help us generate revenue from new sources, improve our earnings, and consequently build shareholder value.

We invested in strengthening our sales support function to provide better intelligence on customer and industry trends. We have also improved our training programs in leadership, technology and project management. And in the past fiscal year, we met our goal to expand our sales force from seven to ten Business Development Managers.

We continued to see encouraging results from the Alliance investments that we began to make in January 1999. Our work as the integration arm for firms such as Brokat Financial Systems (a wholly owned subsidiary of

Brokat Infosystems, AG), S2 Systems, and Siemens Ltd., Ireland paid off. Our Alliance revenue grew by 130.4% over fiscal 2000. We are also pleased that we have been able to expand our relationships beyond integration work; we are now working collaboratively with our partners in a number of sales and marketing endeavors.

During the past year, we further developed our practice offerings to help our clients stay competitive as they respond to an increased demand for on-line services and diverse delivery channels. We believe our offerings are currently well aligned with our clients' needs, and the growth of both our e-Business and CRM Practices seems to bear out that belief. The annual revenues from our e-Business and CRM Practices grew 154.3% in fiscal 2001 versus fiscal 2000. This trend is consistent with industry research estimates that financial services institutions will continue to increase their e-Business and CRM spending. One industry analyst, for example, has projected that industry CRM spending will increase from \$475 million in calendar year 2000 to \$545 million in calendar 2001, a growth rate of approximately 15%.

As we move into fiscal 2002, we are seeing a shift of emphasis within our client base away from top-line revenue and toward bottom-line profits. Accordingly, our clients are shying away from “business transforma-

Robert W. Howe
Chairman and Chief Executive Officer

William H. Gallagher
President and Chief Operating Officer



tion projects” that seek to implement entirely new business models. Instead, clients are increasingly moving toward improving their capabilities to manage and integrate their existing assets via upgrades of infrastructure to support new and more robust applications. These changes in priorities fit well with ADS’ historical strengths: financial services experience, technological expertise and project management skills.

Our financial results for fiscal year 2001 reflected both our transitional focus and the effects of the “roller coaster ride” in both the financial services and IT consulting sectors. However, despite the difficult economy, our year-end cash position of \$36.7 million remained strong, allowing us to focus on the fundamentals, achieving operational and financial stability and generating sustainable operating cash flow. In January 2001, and again in April, we took the necessary steps to bring expenses more in line with anticipated revenues, reducing our headcount by a total of 62 people, or approximately 31% of the total number of staff at December 31, 2000.

For fiscal year 2001, ADS recorded revenues of \$34.1 million, or 3% less than the prior year’s \$35.2 million. Net income was \$26,000 or \$0.00 per share, compared to \$19,000 or \$0.00 per share in fiscal 2000. Largely by increasing our average billing and utilization rates, we were able to improve our gross profit margin by 4.5 basis points from 25.5% of revenue to 30.0%, despite the decline in revenues. We also decreased general and administrative expenses by 7%, or

\$521,000. Our \$1,624,000 increase in sales and marketing expense reflects the investments we made to strengthen our sales support function, to expand our Business Development team, and to execute our strategy to refocus the business.

In spite of newspaper headlines trumpeting disappointing earnings, layoffs and depressed stock prices within the IT services sector, we believe that the demand for IT services within the financial services industry will continue to grow, albeit at a slower rate. Most analysts are projecting growth between 5 and 7% for the industry in the current year.

We believe ADS has served its clients well over the past year. In this report, you will read about four of our recent successes—clients that ADS has helped to meet their business objectives and to achieve their goal of “*Potential realized.*”

Our assistance to Zions Bank in Salt Lake City, Utah, is just one of several examples where our CRM Practice was called in to facilitate an executive educational workshop for the bank’s management. After successfully setting the stage strategically, we were able to win a follow-on engagement to implement a data repository that will allow the bank to improve its analysis capability and increase its shareholder value.

At Citizens Banking Corporation, headquartered in Flint, Michigan, we helped our client meet its regulatory requirements under the Gramm-Leach-Bliley Act. As part of the engagement, a comprehensive assess-

Looking ahead, ADS is a stronger and more focused company. We are committed in Fiscal 2002 to increasing shareholder value.

ment of over thirty departments by our IT Strategy and Consulting Practice became the basis for the processes by which the bank developed (and implemented) its mandated privacy policy.

Another example of how ADS adds value for our customers is the work performed by our e-Business Practice with SunTrust Bank of Atlanta, Georgia. Our team's assistance to the bank at a strategic level, defining the business case for an Internet-based account aggregation service, was the basis for the project's funding. ADS consultants did the research and provided the analysis to document and justify the decision to move forward. As a result of this work, ADS was chosen by SunTrust Bank to be its Phase II partner. As such, we will provide the financial services experience, technology expertise, and project management capabilities, required to see the Phase II project to completion.

Finally, you will read how our Conversions and Consolidations Practice, a cornerstone of our business for over twenty years, has assisted NBT Bancorp in Norwich, New York, in managing its conversion and consolidation efforts. As part of this engagement, we were asked by the bank to take a leadership role in designing an infrastructure to better support future growth through its merger activities.

ADS enters fiscal year 2002 as a stronger and more focused company, committed to increasing shareholder value. First among our priorities is to improve earnings growth. To help us achieve this fundamental goal, we intend to carefully manage our costs through continued improvements to our expense control program.

As a company, we will continue to make strategic investments in our sales organization, enhancing our ability to identify and close opportunities. We will also

continue to look at strategic opportunities to invest our cash while ensuring that the value proposition can be quantified in ways that are meaningful to our clients and shareholders.

As a service provider, we must always remember that our people remain our greatest asset. We need to continue to actively recruit and train employees on the key technologies that are essential to delivering value to our clients. We also recognize that to attract and retain quality people we must provide our employees a place to grow. We have made considerable progress in this area recently through leadership development and mentoring programs. We will continue to make similar investments, particularly in Project Management training, which is essential to delivering value to our clients.

Finally, we want to thank the employees of ADS for the hard work, dedication, and team spirit they have shown throughout the year. We have made real progress toward our goals. We also want to thank our investors for their continued confidence in ADS. Although we still have challenges to overcome, we remain confident that we can successfully build on the foundation we have carefully established over the past year.



Robert W. Howe
Chairman and Chief Executive Officer



William H. Gallagher
President and Chief Operating Officer

C. Gene Kirby, Jr.
Senior Vice President and Director of Internet & E-Business
SunTrust Banks, Inc.

e-Vision realized.

SunTrust Banks, Inc. is the nation's ninth largest commercial banking organization, with total assets of \$103.7 billion and total deposits of \$65.5 billion. Offering a full line of consumer and commercial banking services to more than 5.5 million customers from Florida to Maryland, SunTrust's primary businesses include traditional deposit and credit services as well as trust and investment services. Through various subsidiaries, SunTrust also provides credit cards, mortgage banking, insurance, brokerage and capital market services.

Recently, SunTrust began a major initiative to define and execute a comprehensive e-Business strategy to help the company retain current customers, increase revenue, and maintain its competitiveness. In the course of developing this strategy, the SunTrust Internet & eBusiness Group identified and prioritized more than thirty-five projects to pursue within the scope of its e-Business efforts.

To prove the value of pursuing one of these initiatives, SunTrust turned to a trusted partner—ADS. Having worked with ADS on an electronic banking system prior to this engagement, the people at SunTrust knew that ADS understood e-Business. And since ADS had performed project management work on a wide range of projects for SunTrust in the past, they also knew that ADS would deliver results.

ADS' e-Business consultants were initially assigned three tasks: complete the Discovery Phase of the project; perform an Opportunity Analysis; and develop a Business Case.



The ADS team immediately went to work, assessing and evaluating SunTrust's current e-Business assets, identifying opportunities, and developing specific recommendations for the company. In the first phase of the project, ADS' e-Business experts delivered several key documents to SunTrust. The Business Proposal provided SunTrust with a detailed description of the product to be delivered; this was used to ensure that everyone in the company shared a common understanding of what was expected. The Opportunity Analysis identified relevant industry and technology trends, and quantified the anticipated value the project would deliver to SunTrust and its clients. Finally, the Project Definition outlined the scope and details of the effort. All of these components were delivered on time and within the budget.

Pleased with the results of the first phase, SunTrust Online gave ADS the green light to begin the process by developing the Client Business Requirements and Functional Specifications. These two documents will provide a blueprint for the e-Business development team. SunTrust has also launched other e-Business projects that will follow the same fast-track method of analysis and implementation used by ADS.

There are other vendors who understand the technology part of e-Business, but ADS brings much more to the table, including their understanding of the banking business and best practices, and their proven ability to deliver on schedule and on budget.

—C. Gene Kirby, Jr.
Senior Vice President and Director of Internet & E-Business
SunTrust Banks, Inc.

e-BUSINESS

After merger-related activities stalled our previous CRM initiative in the implementation process, ADS was able to quickly come in, assess what we had, what we needed, and how to proceed. Equally important, they were instrumental in gaining consensus across the bank and moving the project forward.

—George B. Hofmann III
Executive Vice President, Retail Banking Division
Zions First National Bank

Relationships realized.

Zions Bank is one of the nation's premier financial services companies, operating a growing portfolio of banks in high-growth markets—from Washington to Arizona and from Colorado to California. Besides being a leader in electronic bond trading, Zions is also the only primary dealer in government securities headquartered in the western U.S. The company, which also pioneered Internet certification, was recently recognized by the *Wall Street Journal* and *Fortune* for providing the best total return to shareholders over the past decade of any large institution surveyed.

Like many large financial institutions, Zions has also been actively acquiring other banks—as many as twelve in one eighteen-month period. While ADS consultants were working on some merger-related issues in 2000, the discussion turned to the company's Customer Relationship Management (CRM) efforts. Zions' officials reported that they had invested in a CRM data repository solution but its implementation had been slowed by merger-related activities and there were several issues limiting its full potential.

Because the ADS experts had demonstrated a clear understanding of CRM from both strategic and technological perspectives, Zions' executives asked them to conduct a CRM educational workshop for executives of the company. Zions also engaged ADS to evaluate the institution's in-house CRM-related assets and to propose a high-level approach for a CRM program adoption.



The CRM workshop had the intended effect of promoting a common understanding of CRM. It also served to alert company executives to other, related issues that needed to be addressed.

Meanwhile, ADS consultants were analyzing the company's existing CRM data repository and the issues regarding its implementation. Included in the analysis were the activities necessary for the bank to adopt the Shareholder Value Added (SVA) method of internal measurement. The ADS analysis work resulted in a comprehensive report that provided Zions with a clear understanding of its strengths and challenges in implementing the data warehouse, as well as identifying key success factors.

This work was instrumental in enabling Zions to expedite its CRM efforts and accelerate its implementation. ADS consultants are currently engaged with the bank in the effort to implement a customer and operational data repository at Zions for both CRM and SVA, ensuring that the correct information is properly structured to meet their business objectives. When the work is completed, Zions will have the proper base in place to support future CRM efforts.

Profits realized.

Michigan-based Citizens Banking Corporation is a diversified financial services company with banking assets of \$7.9 billion and \$3.8 billion in trust assets. With more than 200 branches throughout Michigan, Illinois, Wisconsin, Minnesota, and Iowa, Citizens provides a full range of commercial, consumer, mortgage, trust, and financial planning services to both companies and individuals.

Like all US banks, Citizens was facing the July 1, 2001 deadline to comply with the Gramm-Leach-Bliley Act of 1999, which requires banks to establish and implement a policy that ensures the security and confidentiality of customers' private financial information. This policy must also include a mechanism to allow customers to "opt-out" of having their information shared by their bank.

The timing was not good for Citizens, which was deeply involved in several major projects, including computer conversions of twenty-four separate banks. To comply with the statute, the bank would have to assess the security policies and procedures in every department and make a number of major operational, training, and management changes.

Needing a vendor it could rely on to deliver solid results on time and within budget, Citizens retained ADS, which was already working with the bank on its conversion projects.

Consultants from ADS' IT Strategy and Consulting Practice began by assessing literally every function within the bank's operations where customer information was stored or handled. The team began work in August 2000, evaluating all thirty departments within the Citizens organization and collecting detailed information about the customer data in each department, including how it was managed and shared with other departments.

Because Citizens had decided to follow an "opt-out" policy, giving customers the choice of having some, all, or none of their financial information shared by the bank, ADS proceeded to develop the specific processes needed to support the policy in all departments. An ADS systems consultant then worked with Citizens staff and its processor Metavante to install the system enhancements necessary to ensure that each customer's "opt-out" choices would be carried out appropriately and consistently. In addition, ADS developed sets of detailed training materials, each one tailored to the level of customer contact of a particular position in the bank, from tellers and customer service representatives to back office staff to executives. Finally, ADS assisted in preparing the actual privacy policy statement for communication with all bank customers.

By December, ADS had completed its work—well ahead of the Gramm-Leach-Bliley deadline. The resulting privacy policy meets the needs of Citizens' customers without unduly restricting bank operations—and it enabled Citizens' heavily committed staff to focus its efforts on more strategically important activities.



*Richard Albee, Executive Vice President
Mary Russell, Senior Vice President, Corporate Systems and Project Support
Citizens Banking Corporation*

We have turned to ADS for everything from consolidations to Y2K to training to data warehousing to IT strategy work. They have consistently demonstrated an ability to translate complex needs into concrete plans that take all factors into account.

—Richard Albee,
Executive Vice President

—Mary Russell,
Senior Vice President, Corporate Systems and Project Support
Citizens Banking Corporation

IT STRATEGY AND CONSULTING

There's a tremendous sense of reassurance when you work with ADS, knowing that they will supply the leadership and the resources—and do whatever it takes, from changing signs to converting databases—to effect a successful and seamless merger.

—Daryl Forsythe,
President and Chief Executive Officer

—Michael Chewens,
Executive Vice President and Chief Financial Officer
NBT Bancorp, Inc.

CONVERSIONS AND CONSOLIDATIONS

Results realized.

NBT Bancorp, Inc., is a financial holding company headquartered in Norwich, NY, with combined assets of \$2.7 billion in 2000. Its subsidiaries include NBT Bank and Pennstar Bank, both full-service community banks that together serve more than 100,000 customers from 78 locations throughout New York State and Pennsylvania.

In May of last year, NBT Bancorp was faced with a formidable challenge. It needed to execute the conversion of four acquisitions that, when completed, would quadruple the size of NBT Bank. In need of a partner to manage this large undertaking, NBT officials consulted informally with other bank executives and received a favorable report on ADS from Hudson United Bank, which had recently engaged ADS to handle a particularly challenging multi-bank migration project.

The NBT acquisition plan called for Pennsylvania's Lake Ariel Bank and Pioneer American Bank to be merged—along with six branches from Sovereign Bank—to form Pennstar Bank. Around the same time, NBT had announced a merger of equals between NBT Bank and another community bank in upstate New York.

After ADS was awarded the project, NBT and ADS agreed on a plan and resource teams to handle the conversion and consolidation efforts. The scope of the ADS engagement was comprehensive, including: a management assessment to support the structuring of the new organization; a project plan; the development and building of a blended project team composed of representatives from all four institutions and ADS consultants; and the establishment and staffing of a Program Office to manage and drive the project.

The team was assembled and conversion efforts were well underway when due diligence findings led to the cancellation of the merger between the two New York banks—approximately six weeks before the Lake Ariel Bank was to be converted. The cancellation was a major

blow to the project team, which lost several members—thereby leaving key positions vacant in mid-project.

To keep the project moving forward, ADS personnel shifted their roles—in a single day—from consultants and project managers to active project team members. Additional ADS experts were brought in to fill vacancies. At the same time, ADS project managers worked with NBT to review and renegotiate vendor agreements, since they were initially based upon the greater processing volumes anticipated by the New York bank merger. This brought added pressure to an already tightly constrained schedule.

Because ADS had the depth of resources and skills to supplement the conversion effort on a moment's notice, the NBT/ADS project team was able to successfully convert the Lake Ariel Bank, Sovereign branches, and Pioneer American Bank on schedule. The team established centralized and consolidated Loan and Deposit Operations at NBT Bancorp in Norwich, with account processing outsourced to FiServ CBS in Arlington Heights, and item processing outsourced to NCR's Utica, NY location. By the summer of 2001, the NBT Bank and Pennstar account databases will be merged within the FiServ system to complete the merger process.



*Daryl Forsythe, President and Chief Executive Officer
Michael Chewens, Executive Vice President and Chief Financial Officer
NBT Bancorp, Inc.*

Financial

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SELECTED FINANCIAL DATA

The selected financial data presented below as of and for the fiscal years ended March 31, 2001, 2000, 1999, 1998 and 1997 have been derived from our audited consolidated financial statements. This data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," our Consolidated Financial Statements and related notes thereto, and other financial information appearing elsewhere in this Annual Report. All amounts are in thousands except per share data.

		Year Ended March 31,			
	2001	2000	1999	1998	1997
Consolidated Income Statement Data:					
Total revenue	\$ 34,135	\$ 35,186	\$ 66,763	\$ 42,830	\$ 23,843
Income (loss) from operations	(1,868)	(1,694)	12,362	8,303	3,185
Net income	26	19	7,759	4,898	2,041
Basic earnings per share	—	—	0.62	0.49	0.20
Diluted earnings per share	—	—	0.60	0.49	0.20
Shares used in computing earnings per share (basic)	12,998	12,925	12,468	9,952	9,952
Shares used in computing earnings per share (diluted)	13,213	13,254	12,855	9,952	9,952

		Year Ended March 31,			
	2001	2000	1999	1998	1997
Consolidated Balance Sheets Data:					
Cash and cash equivalents	\$ 36,655	\$ 38,347	\$ 37,326	\$ 3,401	\$ 2,653
Working capital	37,000	39,670	39,077	7,480	5,069
Total assets	44,617	46,115	46,883	14,485	8,201
Total stockholders' equity	41,165	40,976	40,745	8,683	5,816
Cash dividends paid	—	—	—	3,000	1,500

FORWARD LOOKING STATEMENTS

This Report includes forward-looking statements, which are made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements when you see us using words such as “expect,” “anticipate,” “believe,” “intend,” “may,” “predict,” and other similar expressions. These forward-looking statements cover, among other items: events, conditions and financial trends that may affect the Company’s future plans of operation, business strategy, growth of operations and financial position, including statements regarding revenue and earnings or loss per share projections, variability of revenues and operating results, intended capital expenditures, adequacy of capital resources, dependence on the financial services industry, intentions regarding potential acquisitions, dependence upon a limited number of customers, potential litigation, increased competition, the effects of deregulation and consolidation in the financial services industry, sales and marketing expenses, decreased utilization rates, liquidity expectations, variability in revenues from our practice areas, and interest rate risks. Any forward-looking statements are not guarantees of future performance and are necessarily subject to a number of risks and uncertainties, some of which are beyond our control. Because of these risks and uncertainties, the forward-looking events discussed in this Report might not transpire.

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

ADS provides information technology (“IT”) strategy consulting and systems integration services to the financial services industry. We offer rapid, cost-effective IT solutions to the business challenges faced by financial services companies through our in-depth financial services experience, technological expertise and project management skills. Our service offerings are organized around four practice areas: e-Business, Customer Relationship Management (“CRM”), IT Strategy and Consulting, and Conversions and Consolidations.

Our revenues are derived primarily from professional fees billed to customers on a time and materials basis or, in certain instances, on a fixed price basis. Included in revenues are reimbursable contract-related travel and entertainment expenses, which are separately billed to customers. Substantially all of our contracts, other than fixed price contracts, are terminable by the customer following limited notice and without significant penalty to the customer. Revenues from fixed price contracts represented approximately 7.3% and 1.0% of our revenues for the fiscal years ended March 31, 2001 and 2000, respectively.

We have derived, and expect to continue to derive, a significant portion of our revenues from a relatively limited number of customers. Revenues from our five largest customers in fiscal 2001, 2000 and 1999 were 65.4%, 56.5% and 63.8%, respectively, as a percentage of revenues. In fiscal 2001, FleetBoston Financial Corporation, Citizens Banking Corporation (MI), Brokat Financial Systems, NBT Bancorp and Corillian Corporation accounted for approximately 27.2%, 12.5%, 9.2%, 8.3% and 8.2%, respectively, of revenues. In fiscal 2000, FleetBoston Financial Corporation, Citizens Banking Corporation (MI), First Security Information Technology, Inc., UST Data Services, Inc. and Corillian Corporation accounted for approximately 25.5%, 11.3%, 8.5%, 5.7% and 5.5%, respectively, of revenues. In fiscal 1999, First Security Information Technology, Inc., National City Corporation, Associated Banc-Corp., UST Data Services, Inc. and Susquehanna Bancshares Corp. accounted for approximately 18.4%, 16.4%, 13.8%, 9.6% and 5.6%, respectively, of revenues. Because a significant portion of our revenues are derived from services related to deregulation and consolidation activities in the financial services industry, changes in the regulatory environment or a reduction in consolidation activity have in the past, and could in the future, have a material adverse effect on our business, financial condition and results of operations. In addition, the loss of a major customer or termination of a major project as a result of an acquisition of a customer by an organization to which the Company does not currently provide services, or for any other reason, could have a material adverse effect on our business, financial condition and results of operations.

Cost of revenues consists primarily of salaries and employee benefits for personnel dedicated to customer assignments, fees paid to subcontractors for work performed in connection with customer assignments, and reimbursable contract-related travel and entertainment expenses incurred in connection with the delivery of our services. Customer project margins and personnel utilization percentages are the most significant variables in determining our income from continuing operations. We manage our personnel utilization rates by monitoring personnel needs and generally adjust personnel levels based on specific project requirements. The number of staff assigned to particular projects may vary widely depending on the size, duration, and degree of completion and complexity of each engagement. Delays in project completion and in implementation may result in periods when personnel are not assigned to active projects and, accordingly, result in lower average utilization rates during such periods, which could have a materially adverse effect on our operating results. In addition, we must maintain appropriate numbers of senior professionals both to oversee existing engagements and for business development activities.

Sales and marketing expenses consist primarily of salaries, employee benefits, travel expenses and promotional costs. General and administrative expenses consist primarily of expenses associated with our management, finance and administrative groups, including recruiting, training, depreciation and amortization, and occupancy costs.

Recent Developments

In the first quarter of fiscal 2002, we reduced our headcount by 37 employees and expect to take a pre-tax restructuring charge of approximately \$925,000. We anticipate that first quarter revenue will be in the \$5.0 to \$6.0 million range with a net loss exclusive of the aforementioned restructuring charge in the range of \$(.07) to \$(.04) per share.

Results of Operations

The following table sets forth, for the periods indicated, certain financial data as a percentage of revenues:

	Year Ended March 31,		
	2001	2000	1999
Revenues	100.0%	100.0%	100.0%
Cost of revenues	70.0	74.5	61.5
Gross profit	30.0	25.5	38.5
Operating expenses:			
Sales and marketing	14.2	9.2	6.7
General and administrative	20.3	21.1	13.3
Restructuring expense	1.0	—	—
Total operating expenses	35.5	30.3	20.0
Income (loss) from operations	(5.5)	(4.8)	18.5
Interest income, net	6.3	5.2	1.9
Income before provision for income taxes	0.8	0.4	20.4
Provision for income taxes	0.7	0.3	8.8
Net income	0.1%	0.1%	11.6%

Variability of Operating Results

Variations in our revenues and operating results have occurred from quarter to quarter and may continue to occur as a result of a number of factors. Quarterly revenues and operating results can depend on:

- the number, size and scope of customer projects commenced and completed during a quarter,
- changes in employee utilization rates,
- changes in average billing rates,
- the number of working days in a quarter,
- the timing of introduction of new service offerings, both by us and our competitors,
- changes in pricing, both by us and our competitors,
- loss of a significant customer,
- increased competition from our competitors,
- loss of key personnel,
- other factors that adversely impact the financial services industry,
- general economic conditions,
- potential acquisitions and our ability to successfully integrate the acquired business or technologies into our existing business and operations, and
- our ability to develop and introduce new service offerings, improve existing service offerings and develop and maintain the skills necessary to keep pace with changing technologies.

The timing of revenues is difficult to forecast because our sales cycle is relatively long, ranging from one to six months for new projects with existing customers and three to six months for new customers, and may depend on factors such as the size and scope of projects or other factors that adversely impact the financial services industry and general economic conditions. In addition, the relatively long length of our sales cycle may negatively impact the operating results for any particular quarter as a result of increased sales and marketing expenses without associated increases in revenues in the particular quarter. Furthermore, many of our projects are, and may be in the future, terminable without customer penalty. An unanticipated termination of a major project or loss of a major customer could require us to maintain or terminate underutilized employees, resulting in a higher than expected number of unassigned persons or higher than expected severance expenses.

Year Ended March 31, 2001 Compared to Year Ended March 31, 2000

Revenues

Revenues decreased 3.0% for the year ended March 31, 2001 compared to the year ended March 31, 2000, to \$34.1 million from \$35.2 million. This decrease was due to an approximate 11% decrease in the number of billable hours for fiscal year 2001 versus fiscal year 2000, offset by an approximate 8.0% increase in the average billing rate from \$112 per hour for fiscal 2000 to \$121 per hour for fiscal 2001.

Cost of Revenues

Cost of revenues decreased 8.8% to \$23.9 million in fiscal 2001 compared to \$26.2 million in fiscal 2000, representing 70.0% and 74.5% of revenues, respectively. The dollar decrease in cost of revenues was primarily due to a decrease in the average number of billable personnel from 189 for fiscal 2000 to 150 for fiscal 2001. The decrease in cost of revenues as a percentage of revenues is due to the aforementioned increase in the average billing rate and a 12.3% increase in the average utilization rate from 66.7% for fiscal 2000 to 74.9% for fiscal 2001.

Sales and Marketing

Sales and marketing expenses increased 50.2% to \$4.9 million in fiscal 2001 compared to \$3.2 million in fiscal 2000, representing 14.2% and 9.2% of revenues, respectively. The overall dollar increase was primarily due to an increase in the average number of sales and marketing personnel from 15 for fiscal 2000 to 21 for fiscal 2001, increased travel related expenses, and increased investments in marketing initiatives.

General and Administrative

General and administrative expenses decreased 7.0% to \$6.9 million in fiscal 2001 compared to \$7.4 million in fiscal 2000, representing 20.3% and 21.1% of revenues, respectively. The dollar decrease is primarily due to a decrease in recruiting efforts for new employees and a decrease in the average number of general and administrative personnel from 30 employees for fiscal 2000 to 28 for fiscal 2001.

Restructuring Expense

In January of fiscal 2001, we reduced our headcount by 28 employees, resulting in a pre-tax restructuring expense of \$337,000.

Interest Income, Net

Interest income, net increased \$322,000 to \$2.1 million in fiscal 2001 compared to \$1.8 million for fiscal 2000. This increase was primarily due to the increase in interest rates.

Provision for Income Taxes

The provision for income taxes increased \$141,000 to \$250,000 in fiscal 2001 compared to \$109,000 in fiscal 2000, resulting in effective tax rates of 91.0% and 85.2%, respectively. Our tax rate may vary from period to period based on our expansion into areas with varying state and local statutory income tax rates. The increase in the effective tax rate percentage, and the fact that the effective rates are so much higher than the statutory rates, is primarily due to permanent differences relating to meals and entertainment expenses.

Year Ended March 31, 2000 Compared to Year Ended March 31, 1999

Revenues

Revenues decreased 47.3% for the year ended March 31, 2000 compared to the year ended March 31, 1999, to \$35.2 million from \$66.8 million. This decrease was primarily due to a decrease in volume of services delivered to customers and a decrease in our utilization rate. We continued to experience lower bookings and our financial results were affected by the slowdown in merger activity within the banking sector. Further, many of our customers had completed their use of external resources for their Year 2000 projects, which negatively impacted revenue generation.

Cost of Revenues

Cost of revenues decreased 36.2% to \$26.2 million in fiscal 2000 compared to \$41.1 million in fiscal 1999, representing 74.5% and 61.5% of revenues, respectively. The dollar decrease in cost of revenues was primarily due to a decrease in the average number of billable personnel from 301 for fiscal 1999 to 189 for fiscal 2000. The increase in cost of revenues as a percentage of revenues was due primarily to a decrease in the average utilization rates from 83.5% for fiscal 1999 to 66.7% for fiscal 2000.

Sales and Marketing

Sales and marketing expenses decreased 27.7% to \$3.2 million in fiscal 2000 compared to \$4.5 million in fiscal 1999, representing 9.2% and 6.7% of revenues, respectively. This decrease resulted primarily from a decrease in sales commissions, as well as decreased investments in marketing initiatives.

General and Administrative

General and administrative expenses decreased 15.9% to \$7.4 million in fiscal 2000 compared to \$8.8 million in fiscal 1999, representing 21.1% and 13.3% of revenues, respectively. The dollar decrease was primarily due to decreases in recruiting efforts for new employees and a decrease in the provision for doubtful accounts. The increase in general and administrative expenses as a percentage of revenues reflects the significant decrease in revenues for fiscal year 2000 compared to fiscal year 1999.

Interest Income, Net

Interest income, net increased \$560,000 to \$1.82 million in fiscal 2000 compared to \$1.26 million for fiscal 1999. This increase was primarily due to the increase in the amount of cash and cash equivalents available for investment as well as increases in interest rates.

Provision for Income Taxes

The provision for income taxes decreased \$5.8 million to \$109,000 in fiscal 2000 compared to \$5.9 million in fiscal 1999, resulting in effective tax rates of 85.2% and 43.0%, respectively. Our tax rate may vary from period to period based on our expansion into areas with varying state and local statutory income tax rates. The increase in the effective tax rate percentage was primarily due to permanent differences relating to meals and entertainment expenses.

Liquidity and Capital Resources

During the first quarter of fiscal 1999, we completed our initial public offering. Our net proceeds after deducting underwriting discounts, commissions and offering expenses were approximately \$23.4 million.

We have no long-term debt and continue to operate primarily debt-free. Working capital decreased to \$37.0 million at March 31, 2001 compared to \$39.7 million at March 31, 2000. This decrease was primarily due to a decrease in cash and cash equivalents because of our \$3 million preferred stock investment in S2 Systems, Inc., a software solution provider in the banking and diversified financial services market. Our days sales in accounts receivable at March 31, 2001 was 47 compared to 49 days at March 31, 2000. The decrease in days sales outstanding was the result of increased emphasis on collections. While we believe that the risk with respect to collection of accounts receivable is minimized by the creditworthiness of our customers, primarily banks and other financial institutions, and our credit and collection policies, there can be no assurance that we will not encounter collection problems in the future. We attempt to further minimize this risk by performing ongoing credit valuations of our customers and maintaining an allowance for potential credit losses. We believe that our allowance for doubtful accounts and collection policies are adequate.

Capital expenditures were approximately \$246,000 and \$249,000 for fiscal years 2001 and 2000, respectively, and were used principally for computer and other equipment, software and, to a lesser extent, leasehold improvements. For fiscal 2002, capital expenditures are expected to be approximately \$500,000, and will be used principally for computers and other equipment.

We expect that existing cash and cash equivalent balances, together with cash provided from operations, will be sufficient to meet the Company's working capital and capital expenditure requirements for at least the next twelve months.

To date, inflation has not had a material impact on the Company's financial results.

New Accounting Pronouncements

In the beginning of the fourth quarter of fiscal 2001, the Company adopted Staff Accounting Bulletin 101 ("SAB 101"), Revenue Recognition, which was issued by the Securities and Exchange Commission ("SEC") in December 1999. SAB 101 outlines the basic criteria that must be met to recognize revenue and it provides guidance for presentation and disclosure of revenue recognition policies in financial statements filed with the SEC. Adoption of SAB 101 had no material impact on ADS' reported revenues and results of operations.

In June 1998, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Investments and Hedging Activities." This statement establishes new standards for the recognition of gains and losses on derivative instruments and provides guidance as to whether a derivative may be accounted for as a hedging instrument. Gain or loss from hedging transactions may be wholly or partially recorded in earnings or comprehensive income as part of a cumulative translation adjustment, depending upon the classification of the hedge transaction. Gain or loss on a derivative instrument not classified as a hedging instrument is recognized in earnings in the period of change. SFAS No. 133 will be effective for the Company beginning in fiscal 2001. We do not believe the adoption of SFAS No. 133 will have a material impact on our financial position or our results of operations.

Quantitative and Qualitative Disclosure About Market Risk

We are exposed to market risk from changes in interest rates due to investments in instruments made for non-trading purposes. The interest rate risk relates primarily to our portfolio of short-term investment grade securities. As of March 31, 2001 we did not, nor do we intend to, use derivative financial instruments for speculative trading purposes.

The majority of our sales are denominated in U.S. dollars and take place in North America.

We believe that interest rate risk and foreign currency exchange rate risks are both immaterial to the Company.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders of Atlantic Data Services, Inc:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Atlantic Data Services, Inc and its subsidiary (the "Company") at March 31, 2001, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2001 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



Boston, Massachusetts

April 23, 2001

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

	March 31, 2001	March 31, 2000
Assets		
Current assets:		
Cash and cash equivalents	\$ 36,655	\$ 38,347
Accounts receivable, net of allowances for doubtful accounts of \$375 and \$650 at March 31, 2001 and 2000, respectively	3,090	5,514
Prepaid expenses	243	103
Deferred taxes	464	845
Total current assets	40,452	44,809
Long-term investment	3,000	—
Property and equipment, net	629	919
Other assets	536	387
Total assets	\$ 44,617	\$ 46,115
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 538	\$ 757
Accrued expenses and other liabilities	2,828	3,997
Billings in excess of costs and estimated earnings	86	42
Income taxes payable	—	343
Total current liabilities	3,452	5,139
Commitments		
Stockholders' equity:		
Preferred stock, \$.01 par value, 1,000,000 authorized, no shares issued or outstanding	—	—
Common stock, \$.01 par value, 60,000,000 shares authorized, 13,135,126 shares issued and 13,023,126 outstanding at March 31, 2001 and 13,087,599 shares issued and 12,975,599 outstanding at March 31, 2000	131	131
Additional paid-in capital	26,900	26,737
Retained earnings	14,159	14,133
Treasury stock (112,000 shares carried at cost)	(25)	(25)
Total stockholders' equity	41,165	40,976
Total liabilities and stockholders' equity	\$ 44,617	\$ 46,115

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	Year Ended March 31, 2001	Year Ended March 31, 2000	Year Ended March 31, 1999
Revenues	\$ 34,135	\$ 35,186	\$ 66,763
Cost of revenues	23,890	26,207	41,083
Gross profit	10,245	8,979	25,680
Operating expenses:			
Sales and marketing	4,856	3,232	4,469
General and administrative	6,920	7,441	8,849
Restructuring expense	337	—	—
Total operating expenses	12,113	10,673	13,318
Income (loss) from operations	(1,868)	(1,694)	12,362
Interest income, net	2,144	1,822	1,261
Income before provision for income taxes	276	128	13,623
Provision for income taxes	250	109	5,864
Net income	\$ 26	\$ 19	\$ 7,759
Basic earnings per share	\$ 0.00	\$ 0.00	\$ 0.62
Diluted earnings per share	\$ 0.00	\$ 0.00	\$ 0.60
Shares used in computing earnings per share (basic)	12,998	12,925	12,468
Shares used in computing earnings per share (diluted)	13,213	13,254	12,855

The accompanying notes are an integral part of these consolidated financial statements.

	Common Stock		Class A Common Stock		Special Common Stock	
	Shares	Amount	Shares	Amount	Shares	Amount
Balance at March 31, 1998	6,847,960	\$ 68	928,790	\$ 9	3,104,080	\$ 31
Conversion of Class A common stock and special common stock to common stock	4,032,870	40	(928,790)	(9)	(3,104,080)	(31)
Issuance of common stock, net of issuance costs	2,000,000	20	—	—	—	—
Shares issued under stock option plans	137,561	2	—	—	—	—
Income tax benefit from exercise of stock options	—	—	—	—	—	—
Net income	—	—	—	—	—	—
Balance at March 31, 1999	13,018,391	130	—	—	—	—
Shares issued under stock option plans	69,208	1	—	—	—	—
Income tax benefit from exercise of stock options	—	—	—	—	—	—
Net income	—	—	—	—	—	—
Balance at March 31, 2000	13,087,599	131	—	—	—	—
Shares issued under stock option plans	47,527	—	—	—	—	—
Net income	—	—	—	—	—	—
Balance at March 31, 2001	13,135,126	\$ 131	—	\$ —	—	\$ —

Additional Paid-In Capital	Retained Earnings	Treasury Stock		Total
		Shares	Amount	
\$ 2,245	\$ 6,355	112,000	\$ (25)	\$ 8,683
—	—	—	—	—
23,351	—	—	—	23,371
839	—	—	—	841
91	—	—	—	91
—	7,759	—	—	7,759
26,526	14,114	112,000	(25)	40,745
210	—	—	—	211
1	—	—	—	1
—	19	—	—	19
26,737	14,133	112,000	(25)	40,976
163	—	—	—	163
—	26	—	—	26
\$ 26,900	\$ 14,159	112,000	\$ (25)	\$ 41,165

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	Year Ended March 31, 2001	Year Ended March 31, 2000	Year Ended March 31, 1999
Increase (Decrease) in Cash and Cash Equivalents			
Cash flows from operating activities:			
Net income	\$ 26	\$ 19	\$ 7,759
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	536	676	668
Deferred taxes	381	(106)	(455)
Tax benefit from exercise of stock options	—	1	91
Change in assets and liabilities:			
Accounts receivable	2,424	1,523	2,063
Prepaid expenses and other assets	(289)	(55)	270
Accounts payable	(219)	(436)	132
Accrued expenses and other liabilities	(1,169)	(518)	1,279
Billings in excess of costs and estimated earnings on contracts	44	42	(640)
Federal and state income taxes	(343)	(74)	(413)
Net cash provided by operating activities	1,391	1,072	10,754
Cash flows from investing activities:			
Long-term investment	(3,000)	—	—
Purchase of property and equipment	(246)	(249)	(1,019)
Net cash used in investing activities	(3,246)	(249)	(1,019)
Cash flows from financing activities:			
Principal payments under capital lease obligation	—	(13)	(22)
Proceeds from exercise of stock options under stock option plans	163	211	841
Net proceeds from initial public offering	—	—	23,371
Net cash provided by financing activities	163	198	24,190
Net increase (decrease) in cash and cash equivalents	(1,692)	1,021	33,925
Cash and cash equivalents, beginning of year	38,347	37,326	3,401
Cash and cash equivalents, end of year	\$ 36,655	\$ 38,347	\$ 37,326
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Taxes	\$ 759	\$ 853	\$ 6,689

The accompanying notes are an integral part of these consolidated financial statements.

1. DESCRIPTION OF BUSINESS

Atlantic Data Services, Inc. (“ADS” or the “Company”), provides information technology (“IT”) strategy consulting and systems integration services to customers exclusively in the financial services industry, primarily banks. The Company offers IT solutions to the business challenges faced by financial services companies through our in-depth financial services experience, technological expertise and project management skills. The Company’s service offerings are organized around four practice areas: e-Business, Customer Relationship Management (“CRM”), IT Strategy and Consulting, and Conversions and Consolidations.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES*Principles of Consolidation*

The consolidated financial statements include the accounts of Atlantic Data Services, Inc. and its wholly owned subsidiary, ADS Securities Corp. (collectively “the Company”). All intercompany accounts and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity date of three months or less to be cash equivalents. Cash equivalents consist of money market accounts and repurchase agreements, which are collateralized by U.S. Treasury Securities and controlled by major financial institutions. These investments are subject to minimal credit and market risk.

At March 31, 2001 and 2000, cash equivalents were comprised of money market funds totaling approximately \$31,993,000 and \$31,586,000, respectively, and repurchase agreements totaling approximately \$4,268,000 and \$6,627,000, respectively. At March 31, 2001 and 2000, cash equivalents are classified as available-for-sale and recorded at cost, which approximates fair value.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of cash equivalents and accounts receivable. The risk with respect to cash equivalents is minimized by the Company’s policies in which investments have relatively short maturities and are only placed with highly rated issuers. A significant portion of the Company’s revenues and accounts receivable are derived from services provided to banks and other financial institutions. The risk with respect to accounts receivable is minimized by creditworthiness of the Company’s customers and the Company’s credit and collection policies. The Company performs ongoing credit evaluations of its customers, generally does not require collateral, and maintains allowances for potential credit losses which, when realized, have been within the range of management’s expectations.

Revenue Recognition

The Company primarily derives its revenue from consulting services under time and material billing arrangements. Under these arrangements, revenue is recognized as the services are provided. Deferred revenue pertains to time and material billing arrangements and represents cash collected in advance of the performance of services.

Revenue on fixed price contracts is recognized using the percentage of completion method of accounting and is adjusted monthly for the cumulative impact of any revision in estimates. The Company determines the percentage of completion of its contracts by comparing costs incurred to date to total estimated costs. Contract costs include all direct labor and expenses related to the contract performance. Losses, if any, are provided for in the period in which the loss is determined. “Billings in excess of costs and estimated earnings,” represents billings in excess of revenues recognized.

Included in revenues for the years ended March 31, 2001, 2000 and 1999 are reimbursable contract-related travel and entertainment expenses of \$5,777,000, \$5,517,000 and \$9,413,000, respectively, which are separately billed to customers.

In the beginning of the fourth quarter of fiscal 2001, the Company adopted Staff Accounting Bulletin 101 (“SAB 101”), Revenue Recognition, which was issued by the Securities and Exchange Commission (“SEC”) in December 1999. SAB 101 outlines the basic criteria that must be met to recognize revenue and it provides guidance for presentation and disclosure of revenue recognition policies in financial statements filed with the SEC. Adoption of SAB 101 had no material impact on ADS’ reported revenues and results of operations.

Property and Equipment

Property and equipment are stated at cost, less depreciation. Depreciation expense is recognized using the straight-line method over the estimated useful lives of the related assets. When assets are sold or retired, the related costs and accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations.

Leases

Leases are recorded as capital or operating leases. Any lease where substantially all of the benefits and risks related to the ownership of the leased asset are transferred to the lessee, as defined by Statement of Financial Accounting Standards ("SFAS") No. 13, "Accounting for Leases," is accounted for as if the asset was acquired and as if the obligation were assumed as of the date of the lease. All other leases are recorded as operating leases, whereby the related costs are charged to income on a straight-line basis over the lesser of the lease term or the useful life of the lease.

Stock-Based Compensation

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of the grant. The Company accounts for stock options granted to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations, and applies the disclosure only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" (see Note 7).

Segment Information

The Company follows SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information." SFAS No. 131 prescribes the use of the "management" approach whereby the Company's reportable segments are established based on the internal reporting that is used by management for making operating decisions and assessing performance. Also required by SFAS No. 131 are disclosures about products and services, geographic areas and major customers (see Note 11).

Earnings per Common Share

The Company follows SFAS No. 128, "Earnings per Share." SFAS No. 128 requires the presentation of two amounts, basic earnings per share and diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock and special common stock outstanding during the period. Diluted earnings per share is computed using the weighted average number of common stock and special common stock outstanding during the period, plus the dilutive effect of common stock equivalents.

Income Taxes

In accordance with FAS 109, the Company recognizes deferred tax assets and liabilities for the expected consequences of temporary differences between the financial statement basis and tax basis of the Company's assets and liabilities. A deferred tax valuation allowance is established if, in management's opinion, it is more likely than not that all or a portion of the Company's deferred tax assets will not be realized.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

3. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	Useful Life in Years	March 31, 2001	March 31, 2000
		<i>(in thousands)</i>	
Computer equipment and software	3-5	\$ 2,165	\$ 2,020
Office furniture and equipment	5-7	667	623
Leasehold improvements	Lease Term	509	509
Building	31.5	183	183
		3,524	3,335
Accumulated depreciation and amortization		(2,895)	(2,416)
		\$ 629	\$ 919

Depreciation and amortization expense relating to fixed assets was \$536, \$676 and \$668 for the years ended March 31, 2001, 2000 and 1999, respectively, of which \$22, \$13 and \$37, respectively, related to amortization of office furniture and equipment held under capital leases. Accumulated amortization of office furniture and equipment held under capital leases was approximately \$122, \$100 and \$87 at March 31, 2001, 2000 and 1999, respectively.

4. ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consist of the following:

	March 31, 2001	March 31, 2000
	<i>(in thousands)</i>	
Accrued payroll	\$ 1,500	\$ 2,054
Accrued medical	395	391
Compensated absences	196	219
Other	737	1,333
	\$ 2,828	\$ 3,997

5. INCOME TAXES

Significant components of the provision for income taxes are presented below:

	March 31, 2001	March 31, 2000	March 31, 1999
	<i>(in thousands)</i>		
Current:			
Federal	\$ (37)	\$ 112	\$ 5,193
State	106	24	1,172
Deferred:			
Federal	250	(22)	(404)
State	(69)	(5)	(97)
	\$ 250	\$ 109	\$ 5,864

The reconciliation of the consolidated effective tax rate of the Company for the years ended March 31, 2001, 2000 and 1999 is as follows:

	2001	2000	1999
	<i>(in thousands)</i>		
Pretax income	\$276	\$128	\$13,623
Statutory income tax rate	\$ 96	\$ 44	\$ 4,768
State taxes, net of federal benefit	24	12	699
Permanent differences	134	151	256
Other	(4)	(98)	141
Total provision	\$250	\$109	\$ 5,864

The Company's deferred tax assets are comprised of the following:

	March 31, 2001	March 31, 2000
	<i>(in thousands)</i>	
Allowance for doubtful accounts	\$ 151	\$ 261
Compensated absence accrual	79	88
Depreciation	245	198
Net operating loss carryforward	130	—
Other accruals	257	496
	\$ 862	\$ 1,043

The Company continually reviews the recoverability of its deferred tax assets and would, if necessary, establish a valuation allowance if it is more likely than not that such deferred tax assets will not be realized. At March 31, 2001 and 2000, management believes that it is more likely than not that the tax benefit will be realized for its deferred tax assets.

6. STOCKHOLDERS' EQUITY

On May 21, 1998, the Company commenced an initial public offering of 2,500,000 shares of common stock, generating proceeds of \$23,371,000, net of underwriting commissions and other expenses incurred in connection with the offering. Of the 2,500,000 shares of common stock offered, 2,000,000 shares were offered and sold by the Company and 500,000 shares were offered and sold by certain selling stockholders. In addition, certain underwriters exercised an overallotment option to purchase an additional 375,000 shares of common stock from selling stockholders in June 1998.

In connection with the initial public offering, all issued and outstanding shares of Class A common stock and special common stock converted into 4,032,870 shares of common stock on a share-for-share basis. Holders of the common stock are entitled to one vote per share and to receive dividends, when and if declared by the Company's Board of Directors.

7. STOCK OPTION PLANS

Key Person Stock Plan

In March 1985, the Board of Directors approved the Company's Key Person Stock Plan (the "Key Person Plan") and authorized that 560,000 shares of Class A common stock be reserved for issuance under such plan. Under the terms of the Key Person Plan, the Company is authorized to sell shares at the then fair market value of Class A common stock to officers and other key employees of and consultants to the Company. To date, 394,800 have been issued under the Key Person Plan, of which an aggregate 112,000 shares were repurchased by the Company and are held in treasury at March 31, 2001 and 2000. No Class A common stock was issued pursuant to this plan during the years ended March 31, 2001, 2000 and 1999. At March 31, 2001, 165,200 shares of common stock were available for future issuance; however, the Company does not intend to issue additional shares under the Key Person Plan.

Incentive Stock Option Plan

On January 26, 1993, the Board of Directors approved the Company's 1992 Incentive Stock Option Plan (the "1992 Plan"). Under the terms of the 1992 Plan, the Company is authorized to grant incentive stock options to purchase shares of Class A common stock to officers and other employees of and consultants to the Company. The aggregate number of shares of Class A common stock which may be issued pursuant to the 1992 Plan is 812,000. Vesting is determined by the Board of Directors. All options issued were issued to employees and vested immediately upon issuance. All options granted under the 1992 Plan were converted to options to purchase common stock on May 28, 1998. At March 31, 2001, no options were available for future grant under the 1992 Plan.

1997 Stock Plan

In October 1997, the Board of Directors approved the Company's 1997 Stock Plan (the "Plan"), and authorized that 500,000 shares of Class A common stock be reserved for issuance under such plan. Under the terms of the Plan, the Company is authorized to grant incentive stock options and non-qualified stock options, as well as awards and direct purchases of Class A common stock to employees, consultants, directors and officers of the Company. In March 1998, the Board of Directors voted to amend the Stock Plan to provide, among other things, that the number of shares reserved for issuance under the Stock Plan be increased from 500,000 shares of Class A common stock to 1,500,000 shares of Class A common stock. In connection with the conversion of Class A common stock to common stock as part of the initial public offering, all options granted and available for grant under the Plan were converted to options to purchase common stock on May 28, 1998. In March 1999, the Board of Directors voted to increase the authorized number of shares for issuance under the Plan to 3,000,000, which vote was ratified and approved by the Company's shareholders at the July 28, 1999 Annual Meeting of Shareholders.

1998 Employee Stock Purchase Plan

The 1998 Employee Stock Purchase Plan (the "1998 Plan"), provides for the grant of rights to eligible employees on a semi-annual basis to purchase shares of the Company's common stock. The 1998 Plan allows eligible employees to purchase up to 500 shares at the lesser of (1) 85% of the average market price of the common stock on the first business day of the Payment Period or (2) 85% of the average market price of the common stock on the last business day of the Payment Period. The participant can contribute up to 10% of total compensation to the 1998 Plan.

Stock Option Activity

The option activity for the years ended March 31, 2001, 2000 and 1999 was as follows:

	2001		2000		1999	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding options at beginning of year:	1,990,625	\$ 5.64	1,908,125	\$ 6.23	649,510	\$ 6.41
Granted	1,019,000	4.28	590,000	4.34	1,502,500	7.70
Exercised	(26,000)	4.97	—	—	(63,260)	6.01
Cancelled	(726,625)	5.39	(507,500)	6.34	(180,625)	12.98
Outstanding options at end of year	2,257,000	5.08	1,990,625	5.64	1,908,125	\$ 6.23
Exercisable at end of year	1,085,625	5.47	846,377	5.43	542,000	\$ 4.98
Available for future grant at end of year	932,750	—	1,043,500	—	1,306,625	—
Weighted average fair value of options granted during the year	\$ 3.77		\$ 3.19		\$ 4.29	

The following table summarizes stock options outstanding at March 31, 2001:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.91	277,000	4.44	\$ 0.91	277,000	\$ 0.91
2.38	168,000	9.68	2.38	—	—
2.63	30,000	9.93	2.63	—	—
3.63	46,000	9.18	3.63	—	—
3.81	90,000	8.40	3.81	70,000	3.81
3.88	36,000	8.67	3.88	12,000	3.88
4.00	64,000	9.55	4.00	—	—
4.13	109,000	8.57	4.13	21,000	4.13
4.25	60,000	6.78	4.25	60,000	4.25
4.69	263,000	9.42	4.69	—	—
5.05	45,000	9.30	5.05	—	—
5.06	614,000	7.94	5.06	364,333	5.06
5.25	60,000	9.09	5.25	—	—
5.31	45,000	9.04	5.31	—	—
7.13	8,000	8.91	7.13	2,667	7.13
8.38	15,000	9.01	8.38	—	—
9.00	136,750	6.87	9.00	136,750	9.00
13.00	73,250	7.14	13.00	53,375	13.00
13.44	40,000	7.16	13.44	20,000	13.44
14.13	60,000	7.53	14.13	60,000	14.13
15.00	17,000	7.47	15.00	8,500	15.00
\$0.91 - \$15.00	<u>2,257,000</u>	7.91	\$ 5.07	<u>1,085,625</u>	\$ 5.45

Pro forma information regarding net income (loss) and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee share options under the fair value method of that statement. The fair value for employee options granted during this year was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

	For the Year Ended		
	March 31, 2001	March 31, 2000	March 31, 1999
Risk free interest rate	4.7 - 6.6%	5.6%	4.2 - 6.7%
Volatility	118%	80%	80%
Dividend yield	—	—	—
Expected life in years	4 years	4 years	4 years

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period, which includes actual accelerated vesting entitlements during the year.

The Company's pro forma information follows (in thousands except for earnings per share information):

	For the Year Ended		
	March 31, 2001	March 31, 2000	March 31, 1999
Pro forma net income (loss)	\$ (3,812,000)	\$ (2,032,000)	\$ 6,267,000
Pro forma earnings per share (basic)	\$ (0.29)	\$ (0.16)	\$ 0.50
Pro forma earnings per share (diluted)	\$ (0.29)	\$ (0.15)	\$ 0.49

The effect on net income and earnings per share may not be indicative of the effects in future years as options vest over several years and the Company continues to grant stock options to new employees.

8. EARNINGS PER SHARE

The following table sets forth per share earnings for the year ended March 31, 2001 and 2000:

	For the Year Ended	
	March 31, 2001	March 31, 2000
Numerator:		
Net income (numerator for earnings per common share and earnings per common share assuming dilution)	\$ 25,511	\$ 19,197
Denominator:		
Denominator for basic earnings per share - weighted average shares	12,997,765	12,925,059
Effect of dilutive securities:		
Employee stock options	215,003	328,867
Denominator for diluted earnings per share - adjusted weighted average shares and assumed conversions	13,212,768	13,253,926
Basic earnings per share	\$ 0.00	\$ 0.00
Diluted earnings per share	\$ 0.00	\$ 0.00

In addition, as of March 31, 2001 and 2000, there were options outstanding to purchase 1,782,000 and 235,125 shares, respectively, that are potentially anti-dilutive.

9. MAJOR CUSTOMERS

The nature of the Company's services results in the Company deriving significant amounts of revenue from certain customers in a particular year. For the year ended March 31, 2001, two customers accounted for 27.2% and 12.5% of the Company's revenues. At March 31, 2001, these customers accounted for 35.1% and 0.2% of accounts receivable. For the year ended March 31, 2000, two customers accounted for 25.5% and 11.3% of the Company's revenue. At March 31, 2000, these customers accounted for 24.0% and 10.5% of accounts receivable. For the year ended March 31, 1999, three customers accounted for 18.4%, 16.4% and 13.8% of the Company's revenues. At March 31, 1999, these customers represented 29.7%, 1.1% and 6.4% of accounts receivable.

10. EMPLOYEE RETIREMENT PLAN

The Company maintains a defined contribution retirement plan under Section 401(k) of the Internal Revenue Code for eligible employees (the "401(k) Plan"). The 401(k) Plan is funded by employee contributions of up to 15% of gross compensation and by discretionary Company contributions. In accordance with the provisions of the 401(k) Plan, employees may make tax-deferred contributions and the Company, at its discretion, may match 50% of employee contributions up to 5% of their earnings. The Company may also elect to make additional contributions to the plan. Company contributions vest over five years of employment. Company contributions amounted to \$357,998, \$391,067 and \$477,365 for the years ended March 31, 2001, 2000 and 1999, respectively.

11. SEGMENT INFORMATION

The Company operates in a single business segment, which offers similar products and services. The Company's products are similar in nature, providing information technology strategy consulting and systems integration services to customers primarily in the financial services industry, with a primary focus on banks.

12. LONG-TERM INVESTMENT

On September 8, 2000, the Company made a \$3 million preferred stock investment, representing a minority interest, in S2 Systems, Inc., a software solution provider in the banking and diversified financial services markets. The investment is stated at cost.

13. COMMITMENTS

The Company leases its facilities and other equipment under operating leases. Rent expense recognized under these leases during the fiscal years ended March 31, 2001, 2000 and 1999 totaled approximately \$639,000, \$546,000 and \$519,000, respectively. Future minimum lease payments due under noncancelable operating leases are as follows:

	<u>Required Minimum Payments</u> <i>(in thousands)</i>
Year ending March 31:	
2002	\$ 700
2003	719
2004	718
2005	741
2006	—
Total minimum lease payments	<u>\$2,878</u>

There were no capital leases outstanding as of March 31, 2001.

14. SUBSEQUENT EVENT

On April 20, 2001, we reduced our headcount by 37 employees and expect to take a pre-tax restructuring charge of approximately \$925,000.

15. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table presents unaudited quarterly financial information for the years ended March 31, 2001 and 2000 (in thousands, except per share data):

	For the Quarters Ended			
	June 30, 2000	September 30, 2000	December 31, 2000	March 31, 2001
Revenue	\$ 9,527	\$ 10,467	\$ 8,223	\$ 5,918
Income (loss) from operations	4	594	(307)	(2,159)
Net income (loss)	290	621	112	(997)
Basic earnings per share	\$ 0.02	\$ 0.05	\$ 0.01	\$ (0.08)
Diluted earnings per share	\$ 0.02	\$ 0.05	\$ 0.01	\$ (0.08)

	For the Quarters Ended			
	June 30, 1999	September 30, 1999	December 31, 1999	March 31, 2000
Revenue	\$ 10,251	\$ 6,789	\$ 8,111	\$10,036
Income (loss) from operations	(46)	(1,781)	(467)	600
Net income (loss)	204	(805)	(9)	629
Basic earnings per share	\$ 0.02	\$ (0.06)	\$ 0.00	\$ 0.05
Diluted earnings per share	\$ 0.02	\$ (0.06)	\$ 0.00	\$ 0.05

MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Price Range of Common Stock

The Company's common stock is currently included on The Nasdaq National Market ("Nasdaq") under the symbol "ADSC." The following table sets forth, on a per share basis for the periods shown, the high and low sales price of our common stock as reported on Nasdaq. Such information reflects inter-dealer prices, without retail markup, markdown or commission and may not represent actual transactions.

	High	Low
Fiscal Year 2001:		
First Quarter (April 1 – June 30, 2000)	\$ 9.2500	\$ 3.2500
Second Quarter (July 1 – Sept. 30, 2000)	5.8750	3.5625
Third Quarter (Oct. 1 – Dec. 31, 2000)	4.1875	1.3750
Fourth Quarter (Jan. 1 – March 31, 2001)	3.5625	1.6875
Fiscal Year 2000:		
First Quarter (April 1 – June 30, 1999)	\$ 6.2500	\$ 3.0000
Second Quarter (July 1 – Sept. 30, 1999)	5.3125	3.4375
Third Quarter (Oct. 1 – Dec. 31, 1999)	7.1250	3.5000
Fourth Quarter (Jan. 1 – March 31, 2000)	12.0000	5.2500

On June 1, 2001, the last reported sale price of the common stock on The Nasdaq National Market was \$2.40 per share. As of June 1, 2001, there were approximately 135 holders of record of the common stock.

Dividend Policy

We do not intend to pay cash dividends in the foreseeable future. The payment of any future dividends will be at the discretion of our Board of Directors and will depend upon, among other things, future earnings, operations, capital requirements of the Company, business conditions and contractual restrictions on payment of dividends, if any.

Executive Officers

Robert W. Howe
*Chief Executive Officer and Chairman
of the Board of Directors*

William H. Gallagher
*President, Chief Operating Officer,
Assistant Clerk and Director*

Paul K. McGrath
*Senior Vice President, Finance and
Administration, Chief Financial
Officer, Treasurer and Clerk*

Peter A. Cahill
*Executive Vice President,
Business Development*

Paul James (P.J.) Lynch
*Executive Vice President,
Corporate Development*

Erik C. Golz
*Senior Vice President and
Director of Operations*

Irv H. Naar
Senior Vice President, Recruiting

Board of Directors

Robert W. Howe
*Chairman and Chief Executive Officer
Atlantic Data Services, Inc.*

William H. Gallagher
*President and Chief Operating Officer,
Assistant Clerk
Atlantic Data Services, Inc.*

David C. Hodgson
*Managing Member
General Atlantic Partners, LLC
General Partner
General Atlantic Partners, II, LP*

Lee M. Kennedy
*Chairman and Chief Executive Officer
Lee Kennedy Co., Inc.*

George F. Raymond
*President and Founder, Retired
Automatic Business Centers, Inc.*

Richard D. Driscoll
*Director
Chittenden Corporation and
the Massachusetts Business
Development Corporation*

Corporate Offices

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One Batterymarch Park
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Telephone: 617.770.3333
Fax: 617.689.1102

Independent Accountants

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One Post Office Square
Boston, Massachusetts 02109

Corporate Counsel

Testa, Hurwitz & Thibault, LLP
High Street Tower
125 High Street
Boston, Massachusetts 02110

Shares Traded

Nasdaq: ADSC

Transfer Agent

FleetBank, N.A.
c/o EquiServe, L.P.
Blue Hills Office Park
150 Royall Street
Canton, Massachusetts 02021
Phone 877.282.1168
www.EquiServe.com

Annual Shareholders Meeting

The Annual Meeting of Shareholders will be held at 8:30 a.m. on July 26, 2001 at the Boston College Club, 100 Federal Street, Boston, MA.

Shareholder Inquiries

Communications concerning transfer requirements, lost certificates and changes of address should be directed to the Registrar and Transfer Agent.

Investor Inquiries

Analysts, investment professionals, individual investors and members of the press should direct their questions to Investor Relations at Atlantic Data Services' Corporate Offices.

Form 10-K

Shareholders may obtain, free of charge, a copy of the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission, by contacting: Investor Relations Department
A D S Financial Services Solutions™
One Batterymarch Park
Quincy, Massachusetts 02169
617.770.3333
<http://www.adsfs.com>



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