

Edgar Filing: SYNTEL INC - Form 10-Q

SYNTEL INC  
Form 10-Q  
November 06, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006 or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

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

Commission file number 000-22903

SYNTEL, INC.

(Exact Name of Registrant as Specified in Its Charter)

Michigan

38-2312018

-----  
(State or Other Jurisdiction of  
Incorporation or Organization)

-----  
(IRS Employer  
Identification No.)

525 E. Big Beaver Road, Suite 300, Troy, Michigan

48083

-----  
(Address of Principal Executive Offices)

-----  
(Zip Code)

(248) 619-2800

-----  
(Registrant's Telephone Number, Including Area Code)

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

Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated - Filer

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

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

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Common Stock, no par value: 41,084,720 shares issued and outstanding as of October 31, 2006.

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SYNTEL, INC.

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SYNTEL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(IN THOUSANDS, EXCEPT SHARE DATA)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
Net Revenues	\$ 69,217	\$ 58,501	\$ 197,123	\$ 163,9
Cost of revenues	42,635	35,298	123,267	97,7
GROSS PROFIT	26,582	23,203	73,856	66,1

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Selling, general and administrative expenses	13,056	10,533	35,299	32,3
	-----	-----	-----	-----
Income from operations	13,526	12,670	38,557	33,7
Other income, principally interest	1,298	810	3,525	2,6
	-----	-----	-----	-----
Income before provision for income taxes	14,824	13,480	42,082	36,4
Provision for income taxes	293	1,741	4,443	5,9
	-----	-----	-----	-----
NET INCOME	\$ 14,531	\$ 11,739	\$ 37,639	\$ 30,4
	=====	=====	=====	=====
Dividend per share	\$ 1.31	\$ 0.06	\$ 1.43	\$ 1.
EARNINGS PER SHARE :				
Basic	\$ 0.36	\$ 0.29	\$ 0.92	\$ 0.
Diluted	\$ 0.35	\$ 0.29	\$ 0.92	\$ 0.
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING :				
Basic	40,865	40,576	40,783	40,4
Diluted	41,123	40,669	41,038	40,5

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

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SYNTEL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS)

	SEPTEMBER 30, 2006	DECEMBER 31, 2005
	-----	-----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 37,212	\$
Short term investments	38,579	
Accounts receivable, net of allowances for doubtful accounts of \$ 2,578 and \$ 2,575 at September 30, 2006 and December 31, 2005, respectively	40,491	
Revenue earned in excess of billings	9,052	
Deferred income taxes and other current assets	12,496	
	-----	-----
Total current assets	137,830	
Property and equipment	62,869	
Less accumulated depreciation and amortization	29,223	
	-----	-----
Property and equipment, net	33,646	
Goodwill	906	

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Deferred income taxes and other non current assets	2,291	
	-----	-----
TOTAL ASSETS	\$ 174,673	\$
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Current liabilities:		
Accounts payable	\$ 5,088	\$
Accrued payroll and related costs	17,033	
Income taxes payable	3,363	
Accrued liabilities	7,720	
Deferred revenue	4,121	
Dividends payable	2,442	
	-----	-----
Total current liabilities	39,767	
SHAREHOLDERS' EQUITY		
Total shareholders' equity	134,906	
	-----	-----
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 174,673	\$
	=====	=====

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

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SYNTEL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

	NINE MO
	SEPT
	2006
	-----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	\$ 37,63
Adjustments to reconcile net income to net cash provided by operating activities	
Depreciation and amortization	4,30
Bad debt provisions / (credits)	
Realized gains on sales of short term investments	(28
Deferred income taxes	1,08
Compensation expense related to restricted stock	1,36
Share based compensation expense	52
Changes in assets and liabilities :	
Accounts receivable and revenue earned in excess of billings, net	(11,96
Other current assets	(4,70
Accrued payroll and other liabilities	(6,17
Deferred revenues	(1,08
	-----

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Net cash provided by operating activities	20,70
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CASH FLOWS FROM INVESTING ACTIVITIES:	
Property and equipment expenditures	(9,35
Purchase of short term investments :	
Investments in mutual funds	(39,99
Investments in term deposits with banks	(56,95
Proceeds from sales of short term investments :	
Proceeds from sales of mutual funds	42,89
Maturities of term deposits with banks	36,25
<hr style="border-top: 1px dashed black;"/>	
Net cash (used in) / provided by investing activities	(27,14
<hr style="border-top: 1px dashed black;"/>	
CASH FLOWS FROM FINANCING ACTIVITIES:	
Net proceeds from issuance of common stock	1,60
Common stock repurchases	
Dividends paid	(58,63
<hr style="border-top: 1px dashed black;"/>	
Net cash used in financing activities	(57,02
<hr style="border-top: 1px dashed black;"/>	
Effect of foreign currency exchange rate changes on cash	1,29
<hr style="border-top: 1px dashed black;"/>	
Change in cash and cash equivalents	(62,17
<hr style="border-top: 1px dashed black;"/>	
Cash and cash equivalents, beginning of period	99,39
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Cash and cash equivalents, end of period	\$ 37,21
<hr style="border-top: 3px double black;"/>	
Non cash investing and financing activities:	
Cash dividends declared but unpaid	\$ 2,44
<hr style="border-top: 3px double black;"/>	
Cash paid for income taxes	\$ 10,41
<hr style="border-top: 3px double black;"/>	

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

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### SYNTEL, INC. AND SUBSIDIARIES

#### NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

##### 1. BASIS OF PRESENTATION:

The accompanying condensed consolidated financial statements of Syntel, Inc. (the "Company" or "Syntel") have been prepared by management, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial position of Syntel and its subsidiaries as of September 30, 2006, the results of their operations for

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the three month and nine month periods ended September 30, 2006 and 2005, and cash flows for the nine months ended September 30, 2006 and 2005. The year end condensed balance sheet as of December 31, 2005 was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2005.

Operating results for the nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

### 2. PRINCIPLES OF CONSOLIDATION AND ORGANIZATION

The consolidated financial statements include the accounts of Syntel, Inc. ("Syntel"), a Michigan corporation, its wholly owned subsidiaries, and a joint venture. All significant inter-company balances and transactions have been eliminated.

The wholly owned subsidiaries of Syntel, Inc. are:

- Syntel Limited ("Syntel India"), an Indian limited liability company formerly known as Syntel (India) Ltd.;
- Syntel Singapore PTE. Ltd. ("Syntel Singapore"), a Singapore limited liability company;
- Syntel Europe, Ltd. ("Syntel U.K."), a United Kingdom limited liability company;
- Syntel Canada Inc. ("Syntel Canada"), an Ontario limited liability company;
- Syntel Deutschland GmbH ("Syntel Germany"), a German limited liability company;
- Syntel Hong Kong Ltd. ("Syntel Hong Kong"), a Hong Kong limited liability company;
- Syntel (Australia) Pty. Limited ("Syntel Australia"), an Australian limited liability company;
- Syntel Delaware LLC ("Syntel Delaware"), a Delaware limited liability company;
- SkillBay LLC ("SkillBay"), a Michigan limited liability company;
- Syntel (Mauritius) Limited ("Syntel Mauritius"), a Mauritius limited liability company;
- Syntel Consulting Inc ("Syntel Consulting"), a Michigan corporation;
- Syntel Sterling BestShores (Mauritius) Limited ("SSBML"), a Mauritius limited liability company; and
- Syntel Worldwide (Mauritius) Limited ("Syntel Worldwide"), a Mauritius limited liability company.

The formerly wholly owned subsidiary of Syntel Delaware (as of December 31, 2004) that became a partially owned joint venture of Syntel Delaware LLC on February 1, 2005 is:

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- State Street Syntel Services (Mauritius) Ltd. ("SSSSML"), a Mauritius limited liability company formerly known as Syntel Solutions (Mauritius) Ltd.

The wholly owned subsidiary of SSSSML is:

- Syntel Sourcing Pvt. Ltd. ("Syntel Sourcing"), an Indian limited liability company.

The wholly owned subsidiaries of Syntel Mauritius are:

- Syntel International Pvt. Ltd. ("Syntel International"), an Indian limited liability company; and
- Syntel Global Pvt. Ltd. ("Syntel Global"), an Indian limited liability company.

The wholly owned subsidiary of SSBML is:

- Syntel Sterling BestShores Solutions Private Limited" ("SSBSPL"), an Indian limited liability company.

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### 3. USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Such estimates include, but are not limited to allowance for doubtful accounts, impairment of long-lived assets and goodwill, contingencies and litigation, the recognition of revenues and profits based on the proportional performance method and potential tax liabilities. Actual results could differ from those estimates and assumptions used in the preparation of the accompanying financial statements.

### 4. REVENUE RECOGNITION

The Company recognizes revenues from time and material contracts as the services are performed.

Revenue from fixed-price applications management, maintenance and support engagements is recognized as earned which generally results in straight-line revenue recognition as services are performed continuously over the term of the engagement.

Revenue on fixed-price, applications development and integration projects in the Company's application outsourcing and e-Business segments are measured using the proportional performance method of accounting. Performance is generally measured based upon the efforts incurred to date in relation to the total estimated efforts to the completion of the contract. The Company monitors estimates of total contract revenues and cost on a routine basis throughout the delivery period. The cumulative impact of any change in estimates of the contract revenues or costs is reflected in the period in which the changes become known. In the event that a loss is anticipated on a particular contract, provision is made for the estimated loss. The Company issues invoices related to fixed price contracts based on either the achievement of milestones during a project or other contractual terms. Differences between the timing of billings and the recognition of revenue based upon the proportional performance method of

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accounting are recorded as revenue earned in excess of billings or deferred revenue in the accompanying consolidated balance sheets.

Revenues are reported net of sales incentives.

Reimbursements of out-of-pocket expenses are included in revenue in accordance with Emerging Issues Task Force Consensus ("EITF") 01-14, "Income Statement Characterization of Reimbursement Received for 'Out of Pocket' Expenses Incurred".

### 5. CASH AND CASH EQUIVALENTS

For the purpose of reporting Cash and Cash Equivalents, the Company considers all liquid investments purchased with an original maturity of three months or less to be cash equivalents.

At September 30, 2006 and December 31, 2005, approximately \$6.6 million and \$60.8 million, respectively, represent corporate bonds and treasury notes held by JP Morgan Chase Bank NA, for which "AAA" rated letters of credit have been provided by the bank. The remaining amounts of cash and cash equivalents are invested in money market accounts with various banking and financial institutions.

### 6. STOCK WARRANTS SALES INCENTIVE

In 2000, the Company agreed to grant to a significant customer performance warrants entitling the customer to purchase shares of Company stock. The issuance of the performance warrants is dependent upon the customer meeting performance milestones by purchasing specified minimum levels of services from the Company over a specified period. The Company has estimated that such performance milestones will not be met during the year. Accordingly, the Company has not accounted for these performance warrants. If and when the Company estimates that such performance milestones will be met, the sales incentive associated with the performance warrants will be recorded as a reduction of revenue.

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### 7. COMPREHENSIVE INCOME

Total Comprehensive Income for the three and nine months ended September 30, 2006 and 2005 was as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Net income	\$ 14,531	\$ 11,739	\$ 37,639	\$ 30,419
Other comprehensive income				
- Unrealized gain (loss)	505	164	1,298	353
- Foreign currency translation adjustments	36	(439)	(1,460)	(1,098)
Total comprehensive income	\$ 15,072	\$ 11,464	\$ 37,477	\$ 29,674



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### 8. EARNINGS PER SHARE

Basic and diluted earnings per share are computed in accordance with Statement of Financial Accounting Standards ("SFAS") No 128 "Earnings Per Share".

Basic earnings per share are calculated by dividing net income by the weighted average number of shares outstanding during the applicable period.

The Company has stock options, which are considered to be potentially dilutive to the basic earnings per share. Diluted earnings per share is calculated using the treasury stock method for the dilutive effect of shares which have been granted pursuant to the stock option plan, by dividing the net income by the weighted average number of shares outstanding during the period adjusted for these potentially dilutive options, except when the results would be anti-dilutive. The potential tax benefits on exercise of stock options is considered as additional proceeds while computing dilutive earnings per share using the treasury stock method.

The following table summarizes the movement in the Capital Structure from June 30, 2006

PARTICULARS	NO. OF SHARES (IN THOUSANDS)
Balance as on June 30, 2006	40,839
ADD:	
Shares issued on exercise of stock options and restricted stock	73
	-----
Balance as on September 30, 2006	40,912
	=====

The following table sets forth the computation of earnings per share.

	THREE MONTHS ENDED SEPTEMBER 30,			
	2006		2005	
	Weighted Average Shares	Earnings per Shares	Weighted Average Shares	Earnings per Share
	-----	-----	-----	-----
	(in thousands, except per share earnings)			
Basic earnings per share	40,865	\$ 0.36	40,576	\$ 0.29
Potential dilutive effect of stock options outstanding	258	(0.01)	93	-
	-----	-----	-----	-----
DILUTED EARNINGS PER SHARE	41,123	\$ 0.35	40,669	\$ 0.29
	=====	=====	=====	=====

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	NINE MONTHS ENDED SEPTEMBER 30,			
	2006		2005	
	Weighted Average Shares	Earnings per Shares	Weighted Average Shares	Earnings per Share
	(in thousands, except per share earnings)			
Basic earnings per share	40,783	\$ 0.92	40,487	\$ 0.75
Potential dilutive effect of stock options outstanding	255	-	101	-
<b>DILUTED EARNINGS PER SHARE</b>	<b>41,038</b>	<b>\$ 0.92</b>	<b>40,588</b>	<b>\$ 0.75</b>

### 9. SEGMENT REPORTING

The Company is organized geographically and by business segment. For management purposes, the Company is primarily organized on a worldwide basis into four business segments:

- Applications Outsourcing ;
- e-Business ;
- TeamSourcing; and
- Business Process Outsourcing ("BPO")

These segments are the basis on which the Company reports its primary segment information to management. Management allocates all corporate expenses among the segments. No balance sheet/identifiable assets data is presented since the Company does not segregate its assets by segment. Financial data for each segment for the three month and nine month periods ended September 30, 2006 and 2005 is as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
<b>REVENUES:</b>				
Applications Outsourcing	\$ 49,394	\$ 43,872	\$ 142,433	\$ 124,725
e-Business	9,929	7,946	27,885	22,687
TeamSourcing	4,235	4,727	13,460	12,279
BPO	5,659	1,956	13,345	4,219
	69,217	58,501	197,123	163,910
<b>GROSS PROFIT:</b>				
Applications Outsourcing	18,286	18,443	53,592	52,224
e-Business	3,149	2,253	7,336	7,547
TeamSourcing	1,760	1,286	4,937	3,596
BPO	3,387	1,221	7,991	2,787
	26,582	23,203	73,856	66,154

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Selling, general and administrative expenses	13,056	10,533	35,299	32,397
	-----	-----	-----	-----
Income from operations	\$ 13,526	\$ 12,670	\$ 38,557	\$ 33,757
	=====	=====	=====	=====

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During the nine months ended September 30, 2006 and 2005, American Express Corp. contributed revenues in excess of 10% of total consolidated revenues. Revenue from this customer was \$35.6 million during the nine months ended September 30, 2006, contributing approximately 18% of total consolidated revenues, as compared to \$24.3 million during the nine months ended September 30, 2005, contributing approximately 14.8% of total consolidated revenues. At September 30, 2006 and December 31, 2005 accounts receivable, from this customer were \$3.8 million and \$1.1 million respectively.

10. GEOGRAPHIC INFORMATION

Customers of the Company are primarily located in the United States. Net revenues and net income (loss) were attributed to each geographic location as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS SEPTEMBER
	2006	2005	2006
	(in thousands)		(in thous
NET REVENUES			
North America, primarily United States	\$ 65,967	\$ 52,542	\$ 188,558
India	34,641	29,880	98,252
UK	3,186	3,138	8,341
Far East, primarily Singapore	1,375	592	3,107
Germany	85	439	538
Inter-company revenue elimination (primarily India)	(36,037)	(28,090)	(101,673)
	-----	-----	-----
TOTAL REVENUE	69,217	58,501	197,123
	=====	=====	=====
NET INCOME/(LOSS)			
North America, primarily United States	5,369	4,188	10,775
India	9,449	6,755	26,340
UK	245	506	1,058
Far East, primarily Singapore	(402)	84	(379)
Germany	(130)	206	(155)
	-----	-----	-----
INCOME/(LOSS) AFTER INCOME TAXES	\$ 14,531	\$ 11,739	\$ 37,639
	=====	=====	=====

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11. INCOME TAXES

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The following table accounts for the differences between the federal statutory tax rate of 35% and the Company's overall effective tax rate :

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Income before income taxes	\$ 14,824	\$ 13,480	\$ 42,082	\$ 36,411
Statutory provision	35.0%	35.0%	35.0%	35.0%
State taxes, net of federal benefit	1.1%	1.3%	1.1%	1.3%
Tax-free investment income	(0.7%)	0.0%	(0.7%)	(0.2%)
Foreign effective tax rates different from US statutory rate	(33.4%)	(23.4%)	(24.8%)	(19.6%)
<b>EFFECTIVE INCOME TAX RATE</b>	<b>2.0%</b>	<b>12.9%</b>	<b>10.6%</b>	<b>16.5%</b>

The Company records provisions for income taxes based on enacted tax laws and rates in the various taxing jurisdictions in which it operates. In determining the tax provisions, the Company also provides for tax contingencies based on the Company's assessment of future regulatory reviews of filed tax returns. Such reserves, which are recorded in income taxes payable, are based on management's estimates and accordingly are subject to revision based on additional information. The provision no longer required for any particular tax year, is credited to the current period's income tax expenses.

The provision for income tax contingencies no longer required for any particular tax year is credited to the current period's income tax expenses. During the three months ended September 30, 2006 and September 30, 2005, the effective income tax rate was 2% and 12.9% respectively. During the nine months ended September 30, 2006 and September 30, 2005, the effective income tax rate was 10.6% and 16.5% respectively. The tax rates for the three months and nine months ended September 30, 2006 is impacted by reversal of tax reserve of \$2.0 million. The tax rates for the three months and nine months ended September 30, 2005 were impacted by the reversal of a tax reserve of \$2.6 million and a provision for valuation allowance of \$1.7 million attributable to certain deferred tax benefits, on the write-off of certain investments in 2001, which are not expected to be materialized.

Syntel India has not provided for disputed Indian income tax liabilities amounting to \$2.46 million for the financial years 1995-96 to 2001-02. Syntel India has obtained an opinion from one independent legal counsel (a former Chief Justice of the Supreme Court of India) for the financial year 1998-99 and two opinions from another independent legal counsel (also a former Chief Justice of the Supreme Court of India) for the financial years 1995-96 to 1997-98 and 1999-2000 to 2001-02, which support Syntel India's position in this matter.

Syntel India filed an appeal with the Commissioner of Income Tax (Appeals) for the financial year 1998-99 and received a favorable decision. The Income tax department appealed this favorable decision with the Income Tax Appellate Tribunal ('ITAT'). During the three months ended June 30, 2006, the ITAT dismissed the appeal filed by the Income tax department. The Income tax department has recourse to file further appeal and hence there is no change in the relevant provision for tax.

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A similar appeal filed by Syntel India with the Commissioner of Income Tax (Appeals) for the financial year 1999-2000 was however dismissed in March 2004. Syntel India has appealed this decision with the Income Tax Appellate Tribunal. Syntel India has since also received orders for appeals filed with the Commissioner of Income Tax (Appeals) against the demands raised in March 2004 by the Income Tax Officer for similar matters relating to the financial years 1995-96 to 1997-98 and 2000-01 to 2001-02 and has received a favorable decision for 1995-96 and the contention of Syntel India was partially upheld for the other years. Syntel India has gone into further appeal with the Income Tax Appellate Tribunal for the amounts not allowed by the Commissioner of Income Tax (Appeals). The Income Tax Department has appealed the favorable decisions for 1995-96 and 1998-99 and the partially favorable decisions for the other years with the Income Tax Appellate Tribunal.

Syntel India has also not provided for other disputed Indian income tax liabilities aggregating \$4.32 million for the financial years 2001-02 and 2002-03, against which Syntel India has filed an appeal with the Commissioner of Income Tax (Appeals). The contention of Syntel India was partially upheld by the Commissioner of Income Tax (Appeals) for the financial year 2001-02. Syntel India has gone into further appeal with the ITAT for the amounts not allowed by the Commissioner of Income Tax (Appeals). The Income tax department has filed

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further appeal against the relief granted to Syntel India by the Commissioner of Income Tax (Appeals). The appeal for the financial year 2002-03 is not yet decided. Syntel India has obtained opinions from independent legal counsels, which support Syntel India's position in this matter.

Further, Syntel India has not provided for disputed income tax liabilities aggregating to \$0.10 million, for which Syntel India has filed necessary appeals or petitions.

All the above tax exposures involve complex issues and may need an extended period to resolve the issues with the Indian income tax authorities. Management, after consultation with legal counsel, believes that the resolution of the above matters will not have a material adverse effect on the Company's financial position.

### UNDISTRIBUTED EARNINGS OF FOREIGN SUBSIDIARIES

The Company intends to use accumulated and future earnings of foreign subsidiaries to expand operations outside the United States and accordingly undistributed earnings of foreign subsidiaries are considered to be indefinitely reinvested outside the United States and no provision for U. S. federal and state income tax or applicable dividend distribution tax has been provided thereon.

The American Jobs Creation Act of 2004 provided a special one-time favorable effective federal tax rate for U.S.-based organizations. The Company repatriated cash dividends of \$61.0 million during 2005 out of the retained earnings of its controlled foreign subsidiary, Syntel India, to the U.S. in accordance with the Act. The Company recorded a tax charge of approximately \$12.3 million, including U.S. Federal and state taxes and the Indian dividend distribution tax under the Indian Income Tax laws, during the fourth quarter of 2005. Proceeds from these extraordinary dividends are required to be invested in the United States for specific purposes permitted under Act pursuant to an approved written domestic reinvestment plan. As of June 30, 2006, the Company had fully invested proceeds from these cash dividends towards permitted investments under the Act.

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If the Company determines to repatriate all undistributed repatriable earnings of controlled foreign corporations as of September 30, 2006, the Company would have accrued taxes of approximately \$44.5 million.

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### 12. STOCK BASED COMPENSATION

#### SHARE BASED COMPENSATION:

The Company originally established a Stock Option and Incentive Plan in 1997 (the "1997 Plan"). On June 1, 2006 the Company adopted the Ammended and Restated Stock Option and Incentive Plan (the "Stock Option Plan") which amended and extended the 1997 Plan. Under the plans, a total of 8 million shares of Common Stock were reserved for issuance. The dates on which options granted under Stock Option Plan are first exercisable are determined by the Compensation Committee of the Board of Directors, but generally vest over a four-year period from the date of grant. The term of any option may not exceed ten years from the date of grant.

For certain options granted during 1997, the exercise price was less than the fair value of the Company's stock on the date of grant and, accordingly, compensation expense is being recognized over the vesting period for such difference. For the options granted thereafter, the Company grants the options at the fair market value on the date of grant of the options.

The shares issued upon the exercise of the options are generally new share issues. In some instances the shares are issued out of treasury stock purchased from the market.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan ("employee stock purchases") based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's financial statements as of and for the three and nine months ended September 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized under SFAS 123(R) for the three and nine months ended September 30, 2006 was \$0.97 million and \$1.89 million including charge for restricted stock.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statement of Income. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees [and directors] using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

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### RESTRICTED STOCK:

On different dates during the quarter ended June 30, 2004 the Company issued 319,300 shares of incentive restricted stock to its non-employee directors and some employees as well as to some employees of its subsidiaries. The shares were granted to employees for their future services as a retention tool at a zero exercise price, with the restrictions on transferability lapsing with regard to 10%, 20%, 30%, and 40% of the shares issued on or after the first, second, third and fourth anniversary of the grant dates, respectively.

On different dates during the year ended December 31, 2005 and nine months ended September 30, 2006 the Company issued 54,806 and 14,036 shares respectively, of incentive restricted stock to its non-employee directors and some employees as well as to some employees of its subsidiaries. The shares were granted to employees for their future services as a retention tool at a zero exercise price, with the restrictions on transferability lapsing with regard to 25% of the shares issued on or after the first, second, third and fourth anniversary of the grant dates. Generally, the shares to non-employee directors are granted for their future services starting from the date of the annual meeting to the date of the following annual meeting.

In addition to the shares of restricted stock described above, on different dates during the quarter ended September 30, 2006 the Company issued another 54,500 shares of incentive restricted stock to some employees as well as to some employees of its subsidiaries. The shares were granted to employees for their future services

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as a retention tool at a zero exercise price, with the restrictions on transferability lapsing with regard to 20% of the shares issued on or after the first, second, third, fourth and fifth anniversary of the grant dates.

During the quarter ended September 30, 2006 the Company issued 142,500 shares of performance restricted stock to some employees as well as to some employees of its subsidiaries. Each such performance restricted stock grant is divided in a pre-defined proportion with the vesting (lifting of restriction) of one portion based on the overall annual performance of the Company and the vesting (lifting of restriction) of the other portion based on the achievement of pre-defined long term goals of the Company. These stocks will vest (have the restrictions lifted) over a period of 5 years (at each anniversary) in equal installments, subject to meeting the above pre-defined criterias of overall annual performance and achievement of the long term goal. The stock linked to overall annual performance would lapse (revert to the Company) on non-achievement of the overall annual performance in the given year. However the stock linked to the achievement of the long term goal would roll over into a common pool and would lapse only on the non-achievement of the long term goal on or prior to the end of fiscal year 2012.

Based upon the market value on the grant dates, the Company recorded \$5.84 million during the three months ended June 30, 2004, \$0.89 million during the year ended December 31, 2005 and \$0.01 million during the nine months ended September 30, 2006 of unearned compensation included as a separate component of shareholders' equity to be expensed over the service period on a straight line basis. During the three months ended September 30, 2006 and 2005 the Company reversed \$0.0 million and \$0.25 million, respectively, of unearned compensation towards forfeiture of restricted stock on account of termination of employees and expensed \$0.51 million and \$0.32 million, respectively as compensation cost on account of these stock grants and during the nine months ended September 30, 2006 and 2005, the Company reversed \$0.14 million and \$1.03 million, respectively, of unearned compensation towards forfeiture of restricted stock on

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account of termination of employees and expensed \$0.94 million and \$0.81 million, respectively, as compensation cost on account of these stock grants.

The recipients are also eligible for dividends declared on their restricted stock. The dividends accrued or paid on shares of unvested restricted stock are charged to compensation cost. For the three months ended September 30, 2006 and 2005, the Company recorded \$0.39 million and \$0.02 million, respectively, and during the nine months ended September 30, 2006 and 2005, the Company recorded \$0.41 million and \$0.46 million, respectively, as compensation cost for dividends paid on shares of unvested restricted stock.

For the restricted stock issued during the year ended December 31, 2005 and nine months ended September 30, 2006, the dividend will be accrued and paid subject to the same restriction as the restriction on transferability.

### IMPACT OF THE ADOPTION OF FAS 123(R)

We adopted FAS 123(R) using the modified prospective transition method beginning January 1, 2006. Accordingly, during the nine months ended September 30, 2006, we recorded stock-based compensation expense for awards granted prior to, but not yet vested, as of January 1, 2006, as if the fair value method required for pro forma disclosure under FAS 123 were in effect for expense recognition purposes, adjusted for estimated forfeitures. As FAS 123(R) requires that stock-based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the nine months ended September 30, 2006 has been reduced for estimated forfeitures. When estimating forfeitures, we consider trends of actual option forfeitures. The impact on our results of operations of recording stock-based compensation (including impact of restricted stock) for the nine months ended September 30, 2006 was as follows (in thousands):

Cost of revenues	\$ 783
Selling, general and administrative expenses	1,111
	-----
	\$ 1,894
	=====

Cash received from option exercises under all share-based payment arrangements for the three months ended September 30, 2006 and 2005, was \$ 0.56 million and \$ 0.15 million, respectively and for the nine months ended September 30, 2006 and 2005, the same was \$ 1.23 million and \$ 1.92 million, respectively. New shares were issued for all options exercised during the nine months ended September 30, 2006. Prior to the adoption of FAS 123(R), the intrinsic value of restricted stock were recorded as unearned stock-based compensation as of December 31, 2005. Upon the adoption of FAS 123(R) in January 2006, the unearned stock-based compensation balance of approximately \$3.17 million was reclassified to additional-paid-in-capital.

As of September 30, 2006, the estimated compensation cost of non-vested options (excluding restricted stock) is \$ 0.18 million to be vested mainly over the next two years.

### VALUATION ASSUMPTIONS

We calculated the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for each



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respective period:

	THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
Assumptions		
Risk free interest rate	4.53%	4.19%
Expected life	5.00	5.00
Expected volatility	47.81%	69.01%
Expected dividend yield	6.80%	8.93%

Our computation of expected volatility for the nine months ended September 30, 2006 is based on a combination of historical volatility from exercised options on our stock. Prior to 2006 also, our computation of expected volatility was based on historical volatility. Our computation of expected life in 2006, was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

### SHARE-BASED PAYMENT AWARD ACTIVITY

The following table summarizes activity under our equity incentive plans for the nine months ended September 30, 2006 (in thousands, except per share amounts):

	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM (IN YEARS)	AG IN
	-----	-----	-----	-----
Outstanding at January 1, 2006	438,251	\$ 12.28		
Granted	--	--		
Exercised	134,905	9.12		
Forfeited	32,700	23.45		
Expired / Cancelled	31,036	10.01		
	-----	-----		
OUTSTANDING AT SEPTEMBER 30, 2006	239,610	\$ 12.67	5.25	\$ 2
	-----	-----	-----	-----
OPTIONS EXERCISABLE AT SEPTEMBER 30, 2006	196,110	\$ 11.28	4.89	\$ 2
	-----	-----	-----	-----

The weighted average grant-date fair value of options granted as of September 30, 2006 and 2005 was \$3.53 and \$3.21 respectively. The aggregate intrinsic value of options exercised as on September 30, 2006 was \$7.30 and fair value of shares vested and outstanding as on September 30, 2006 \$4.66.

### PRO FORMA INFORMATION FOR PERIODS PRIOR TO THE ADOPTION OF FAS 123(R)

Prior to the adoption of FAS No. 123(R), we provided the disclosures required under FAS No. 123, as amended by FAS No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosures." Employee stock-based compensation expense recognized under FAS 123(R) was not reflected in our results of

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operations for the three and nine months ended September 30, 2005 for employee stock option awards as all options were granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Our ESPP was deemed non-compensatory under the provisions of APB No. 25. Forfeitures of awards were recognized as they occurred. Previously reported amounts have not been restated.

The pro forma information for the three and nine months ended September 30, 2005 was as follows (in thousands, except per share amounts):

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	THREE MONTHS ENDED SEPTEMBER 30, 2005	NINE MONTHS ENDED SEPTEMBER 30, 2005
	-----	-----
NET INCOME		
As reported	\$ 11,739	\$ 30,419
Stock based Compensation expense recognized in statement of income, net of tax	290	1,111
Stock based compensation expense determined under the fair value method, net of tax	(327)	(1,419)
	-----	-----
PRO FORMA NET INCOME	\$ 11,702	\$ 30,111
	-----	-----
EARNINGS PER SHARE, PRO FORMA		
Basic earnings per share	\$ 0.29	\$ 0.74
Diluted earnings per share	\$ 0.29	\$ 0.74
EARNINGS PER SHARE AS REPORTED		
Basic earnings per share	\$ 0.29	\$ 0.75
Diluted earnings per share	\$ 0.29	\$ 0.75
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	40,576	40,487
Diluted	40,669	40,588

### 13. PROVISION FOR UNUTILIZED LEAVE

During the year ended December 31, 2005 Syntel India changed its leave policy, resulting in a reduction of the maximum permissible accumulation of unutilized leave from 150 days to 60 days. The balance exceeding maximum permissible accumulation is compulsorily encashed at basic salary. Accordingly an amount of \$0.51 million was paid at basic salary and \$1.14 million was reversed being the difference between the basic salary and gross compensation rates.

The gross charge for unutilized earned leave was \$0.29 million and \$0.41 million for the three months ended September 30, 2006 and September 30, 2005, respectively, and \$1.45 million and \$1.23 million for the nine months ended September 30, 2006 and September 30, 2005, respectively.

The amounts accrued for unutilized earned leave are \$4.81 million and \$3.70 million as of September 30, 2006 and December 31, 2005, respectively, and are included within 'Accrued payroll and related costs'.

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### 14. RECLASSIFICATION

Certain prior period amounts have been reclassified to conform with the current period presentation.

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

#### SYNTEL INC. AND SUBSIDIARIES

#### RESULTS OF OPERATIONS

**REVENUES.** The Company's revenues consist of fees derived from its Applications Outsourcing, e-Business, TeamSourcing and Business Process Outsourcing business segments. Net revenues in the three months ended September 30, 2006 increased to \$69.2 million from \$58.5 million in the three months ended September 30, 2005, representing a 18.3% increase. The Company's verticalization sales strategy focusing on Banking and Financial Services; Healthcare; Insurance; Telecom; Automotive; Retail; Logistics and Travel has enabled better focus and relationship with key customers leading to continued growth in business. Further, continued focus on execution and investments in new offerings such as our Testing Center of Excellence have started producing results. The focus is to continue investments in more new offerings. Worldwide billable headcount, including personnel employed by Syntel India, Syntel Singapore, Syntel U.K., and Syntel Germany as of September 30, 2006 increased by 33% to 5,130 employees as compared to 3,847 employees as of September 30, 2005. However, the growth in revenues was not commensurate with the growth in the billable headcount. This is primarily because a significant growth in the billable headcount was in India, where our revenues per offshore billable resource are generally lower as compared to an on-site based resource. As of September 30, 2006, the Company had approximately 71.3% of its billable workforce in India as compared to 64.2% as of September 30, 2005. The Company's top five customers accounted for 51.1% of the total revenues in the three months ended September 30, 2006, up from 44.5% of its total revenues in the three months ended September 30, 2005. Moreover, the Company's top 10 customers accounted for 70.7% of the total revenues in the three months ended September 30, 2006 as compared to 64.4% in the three months ended September 30, 2005.

**APPLICATIONS OUTSOURCING REVENUES.** Applications Outsourcing revenues increased to \$49.4 million for the three months ended September 30, 2006, or 71.4% of total revenues, from \$43.9 million, or 75% of total revenues for the three months ended September 30, 2005. The \$5.5 million increase was attributable primarily to revenues from new engagements and net increase in revenues from existing projects by \$22.1 million, largely offset by \$16.6 million in lost revenues as a result of project completion. The revenues for the nine months ended September 30, 2006 increased to \$142.4 million, or 72.3% of total revenues, from \$124.7 million or 76.1% of total revenues for the nine months ended September 30, 2005. The \$17.7 million increase for nine months ended September 30, 2006 was attributable principally to revenues from new engagements contributing \$65.4 million largely offset by \$47.7 million in lost revenues as a result of project completion and net reduction in revenues from existing projects.

**APPLICATIONS OUTSOURCING COST OF REVENUES.** Cost of revenues consists of costs directly associated with billable consultants in the US and offshore, including salaries, payroll taxes, benefits, relocation costs, immigration costs, finder's fees, trainee compensation and travel. Applications Outsourcing costs of revenues increased to 63.0% of total Applications Outsourcing revenues for the three months ended September 30, 2006, from 58.0% for the three months ended

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September 30, 2005. The 5.0 percentage point increase in cost of revenues, as a percent of revenues for the three months ended September 30, 2006 was attributable primarily, to offshore wage increases, cost related to a special dividend of \$1.25 per share on restricted stock of \$0.12 million and increased offshore headcount. Cost of revenues for the nine months ended September 30, 2006 increased to 62.4% of total Applications Outsourcing revenues, from 58.1% for the nine months ended September 30, 2005. The 4.3 percentage point increase in cost of revenues, as a percent of revenues for the nine months ended September 30, 2006 was attributable primarily to onsite wage increases effective January 2006, offshore wage increases effective April 2006, visa filing expenses, cost related to FAS123 (R), cost related to a special dividend of \$1.25 per share on restricted stock of \$0.12 million and increased offshore headcount.

E-BUSINESS REVENUES. e-Business revenues increased to \$9.9 million for the three months ended September 30, 2006, or 14.3% of total revenues, from \$7.9 million, or 13.6% of revenues for the three months ended September 30, 2005. The \$2.0 million increase was attributable primarily to revenues from new engagements and net increase in revenues from existing projects by \$4.1 million largely offset by \$2.1 million in lost revenues as a result of project completion. The revenues for the nine months ended September 30, 2006 increased to \$27.9 million, or 14.1% of total revenues, from \$22.7 million or 13.8% of total revenues for the nine months ended September 30, 2005. The \$5.2 million increase for nine months ended September 30, 2006 was attributable primarily to revenues from new engagements and net increase in revenues from existing projects by \$8.7 million largely offset by \$3.5 million in lost revenues as a result of project completion.

E-BUSINESS COST OF REVENUES. e-Business cost of revenues consists of costs directly associated with billable consultants in the US and offshore, including salaries, payroll taxes, benefits, relocation costs, immigration costs, finder's fees, trainee compensation, and travel. e-Business cost of revenues decreased to 68.3% of total

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e-Business revenues for the three months ended September 30, 2006, from 71.6% for the three months ended September 30, 2005. The 3.3 percentage point decrease in cost of revenues as a percent of revenues for the three months ended September 30, 2006 is principally attributable to increase in e-business revenue by 2 million during three months ended September 30, as compared to three months ended September 30, 2005 partly offset by increase in offshore wages, cost related to FAS 123(R) and cost related to a special dividend of \$1.25 per share on restricted stock of \$0.05 million. Cost of revenues for the nine months ended September 30, 2006 increased to 73.7% of total e-business revenues, from 66.7% for the nine months ended September 30, 2005. The 7.0 percentage point increase in cost of revenues, as a percent of revenues for the nine months ended September 30, 2006 was attributable primarily to onsite wage increases effective January 2006, offshore wage increase effective April 2006, visa filing expenses, cost related to FAS123 (R), cost related to a special dividend of \$1.25 per share on restricted stock of \$0.05 million and increased offshore headcount.

TEAMSOURCING REVENUES. TeamSourcing revenues decreased to \$4.2 million for the three months ended September 30, 2006, or 6.1% of total revenues, from 4.7 million, or 8.1% of total revenues for the three months ended September 30, 2005. The \$0.5 million decrease was attributable primarily to revenues from new engagements and revenue from the SkillBay web portal which helps clients of Syntel with their supplemental staffing requirements contributing \$2.2 million offset by \$2.7 million in lost revenues as a result of project completion and net reduction in revenues from existing projects. The revenues for the nine months ended September 30, 2006 increased to \$13.5 million, or 6.8% of total

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revenues, from \$12.3 million or 7.5% of total revenues for the nine months ended September 30, 2005. The \$1.2 million increase for nine months ended September 30, 2006 was attributable principally to revenues from new engagements and revenue from the SkillBay web portal contributing \$6.0 million largely offset by \$4.8 million in lost revenues as a result of project completion and net reduction in revenues from existing projects.

TEAMSOURCING COST OF REVENUES. TeamSourcing cost of revenues consists of costs directly associated with billable consultants in the US, including salaries, payroll taxes, benefits, relocation costs, immigration costs, finder's fees, trainee compensation, and travel. TeamSourcing cost of revenues decreased to 58.4% of TeamSourcing revenues for the three months ended September 30, 2006, from 72.8% for the three months ended September 30, 2005. Cost of revenues for the nine months ended September 30, 2006 decreased to 63.3% of total TeamSourcing revenues, from 70.7% for the nine months ended September 30, 2005. This decrease in cost of revenues, as a percent of total TeamSourcing revenues, for both periods was attributable primarily to the better utilization of TeamSourcing resources and by net revenues from Skillbay web portal placements.

BPO REVENUES. This segment started contributing revenues during the first quarter of 2004. Revenues from this segment were \$5.7 million or 8.2% of total revenues for the three months ended September 30, 2006 as against \$1.9 million or 3.3% for the three months ended September 30, 2005. The \$3.8 million increase was attributable primarily to revenues from new engagements and net increase in revenues from existing projects. The revenues for the nine months ended September 30, 2006 increased to \$13.3 million, or 6.8% of the total revenues, from \$4.2 million, or 2.6% of the total revenues for the nine months ended September 30, 2005. The \$9.1 million increase was attributable primarily to revenues from new engagements and net increase in revenues from existing projects by \$9.4 million partially offset by \$0.3 million in lost revenues as a result of project completion.

BPO COST OF REVENUES. BPO cost of revenues consists of costs directly associated with billable consultants, including salaries, payroll taxes, benefits, finder's fees, trainee compensation, and travel. Cost of revenues for the three months ended September 30, 2006 increased to 40.1% of BPO revenues from 37.6% for the three months ended September 30, 2005. Cost of revenues for the nine months ended September 30, 2006 increased to 40.1% of BPO revenues, from 33.9% for the nine months ended September 30, 2005. Both the 2.5% and 6.2% increase in cost of revenues, as a percent of total BPO revenues, was attributable primarily to increased billable headcount due to increased operations.

SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES. Selling, general, and administrative expenses consist primarily of salaries, payroll taxes and benefits for sales, solutions, finance, administrative, and corporate staff; travel; telecommunications; business promotions; and marketing and various facility costs for the Company's global development centers and other offices. Selling, general, and administrative costs for the three months ended September 30, 2006 were \$13.1 million or 18.9% of total revenues, compared to \$10.5 million or 18.0% of total revenues for the three months ended September 30, 2005.

The 0.9 percentage point increase is primarily due to increases in revenue, three specific charges, and increases in certain costs in the three months ended September 30, 2006 as against the three months ended September 30, 2005. The increase in revenue has resulted in an approximately 2.8 percentage point decrease. Selling, general and administrative costs for the three months ended September 30, 2006 include a one time provision for a claim

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payable to a customer of \$0.4 million, cost related to a special dividend of \$1.25 per share on restricted stock of \$0.2 million and write-offs of assets of \$0.2 million. Combined, these three items account for 1.2 percentage point increase in selling, general, and administrative expenses as a percentage of revenue. Cost increases include increase in travel of \$0.2 million, depreciation of \$0.5 million rent of \$0.6 million towards the additional new facilities at Mumbai, Pune and Chennai in India, telecommunication expenses of \$0.1 million, office expenses of \$0.8 million and professional expenses of \$0.2 million partially offset by decrease in legal fees of \$0.1 million and provision for doubtful debts of \$0.5 million, which has resulted in an approximately 2.5 percentage point increase.

Selling, general, and administrative costs for the nine months ended September 30, 2006 were \$35.3 million or 17.9% of total revenues, compared to \$32.4 million or 19.8% of total revenues for the nine months ended September 30, 2005.

Selling, general and administrative costs for the nine months ended September 30, 2006 include a one time legal expense related to settlement fees of \$0.6 million, provision for doubtful debts of \$0.1 million, provision for a claim payable to a customer of \$0.4 million, cost related to a special dividend of \$1.25 per share on restricted stock of \$0.2 million and write-offs of assets of \$0.2 million.

Selling, general, and administrative costs for the nine months ended September 30, 2005 include a one time special performance based incentive program for sales teams of \$0.4 million and compensation expense related to a special dividend of \$1.50 per share on restricted stock held by employees of \$0.1 million.

In addition to the above described items, the 1.9 percentage point decrease is primarily due to increases in revenue and increases in certain costs in the nine months ended September 30, 2006 as against the nine months ended September 30, 2005. The increase in revenue has resulted in an approximately 3.4 percentage point decrease. Cost increases include increase in travel of \$0.2 million, depreciation of \$0.7 million, rent of \$1.4 million towards the additional new facilities at Mumbai, Pune and Chennai in India, telecommunication expenses of \$0.3 million, office expenses of \$1.5 million and professional expenses of \$0.2 million partially offset by decrease in compensation cost of \$1.2 million, marketing cost of \$0.2 million and consultancy fees of \$0.6 million, which has resulted in an approximately 1.5 percentage point increase.

### INCOME TAXES

The Company records provisions for income taxes based on enacted tax laws and rates in the various taxing jurisdictions in which it operates. In determining the tax provisions, the Company also provides for tax contingencies based on the Company's assessment of future regulatory reviews of filed tax returns. Such reserves, which are recorded in income taxes payable, are based on management's estimates and accordingly are subject to revision based on additional information.

The provision for income tax contingencies no longer required for any particular tax year is credited to the current period's income tax expenses. During the three months ended September 30, 2006 and September 30, 2005, the effective income tax rate was 2.0% and 12.9% respectively. During the nine months ended September 30, 2006 and September 30, 2005, the effective income tax rate was 10.6% and 16.5% respectively. The tax rates for the three months and nine months ended September 30, 2006 is impacted by reversal of tax reserve of \$2.0 million. The tax rates for the three months and nine months ended September 30, 2005 were impacted by the reversal of a tax reserve of \$2.6 million and a provision for valuation allowance of \$1.7 million attributable to certain deferred tax benefits, on the write-off of certain investments in 2001, which are not

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expected to be materialized.

### FINANCIAL POSITION

CASH AND CASH EQUIVALENTS : Cash and Cash equivalents reduced from \$99.4 million to \$37.2 million primarily due to the payment during the three months ended September 30, 2006 of a special dividend of \$1.25 per share amounting to \$51.3 million.

### LIQUIDITY AND CAPITAL RESOURCES

The Company generally has financed its working capital needs through operations. The Company's cash and cash equivalents consist primarily of certificates of deposit, corporate bonds and treasury notes. These amounts are held by various banking institutions including US-based and India-based banks.

Net cash generated by operating activities was \$20.7 million for the nine months ended September 30, 2006, compared to \$27.8 million for the nine months ended September 30, 2005. The number of days sales outstanding

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in net accounts receivable was approximately 64 days and 65 days as of September 30, 2006 and September 30, 2005, respectively. The decrease in the number of day's sales outstanding in net accounts receivable was due to increased collections.

Net cash used in investing activities was \$27.1 million for the nine months ended September 30, 2006, consisting principally of \$96.9 million for the purchase of short term investments and \$9.3 million of capital expenditures consisting principally of capital work in progress, including capital advances towards construction of a Global Development Center at Pune, India, PCs and communications equipment, partially offset by the sale of short term investments of \$79.1 million. Net cash provided by investing activities was \$20.6 million for the nine months ended September 30, 2005, consisting principally of \$39.2 million for the sale of short term investments partially offset by \$11 million of capital expenditures and the purchase of short term investments of \$7.6 million.

Net cash used in financing activities was \$57.0 million for the nine months ended September 30, 2006, consisting principally of \$58.6 million in dividends paid out partially offset by \$1.6 million of proceeds from the issuance of shares under the Company's employee stock option plan and employee stock purchase plan. Net cash used in financing activities was \$66.6 million for the nine months ended September 30, 2005, consisting principally of \$68.4 million in dividends paid out and \$0.7 million in common stock repurchases, partially offset by \$2.5 million of proceeds from the issuance of shares under the Company's employee stock option plan and employee stock purchase plan.

The Company has a line of credit with JP Morgan Chase Bank NA, which provides for borrowings up to \$20.0 million. The line of credit has been renewed and amended and now expires on August 31, 2007. The line of credit has a sub-limit of \$5.0 million for letters of credit, which bear a fee of 1% per annum of the face value of each standby letter of credit issued. Borrowings under the line of credit bear interest at (i) a formula approximating the Eurodollar rate plus the applicable margin of 1.25%, (ii) the bank's prime rate minus 1.0% or (iii) negotiated rate plus 1.25%. There were no outstanding borrowings at September 30, 2006 and 2005.

The Company believes that the combination of present cash balances and future operating cash flows will be sufficient to meet the Company's currently

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anticipated cash requirements for at least the next 12 months.

### CRITICAL ACCOUNTING POLICIES

We believe the following critical accounting policy, among others, affects the more significant judgments and estimates used in the preparation of our consolidated financial statements. The Company has discussed this critical accounting policy and the estimates with the Audit Committee of the Board of Directors.

**REVENUE RECOGNITION.** Revenue recognition is the most significant accounting policy for the Company. The Company recognizes revenue from time and material contracts as services are performed. During the three months ended September 30, 2006 and 2005, revenues from time and material contracts constituted 58% and 51% of total revenues, respectively. Revenue from fixed-price, application management, maintenance and support engagements is recognized as earned, which generally results in straight-line revenue recognition as services are performed continuously over the term of the engagement. During the three months ended September 30, 2006 and 2005, revenues from fixed price application management and support engagements constituted 26% and 29% of total revenues, respectively.

Revenue on fixed price development projects is measured using the proportional performance method of accounting. Performance is generally measured based upon the efforts incurred to date in relation to the total estimated efforts required through the completion of the contract. The Company monitors estimates of total contract revenues and cost on a routine basis throughout the delivery period. The cumulative impact of any change in estimates of the contract revenues or costs is reflected in the period in which the changes become known. In the event that a loss is anticipated on a particular contract, provision is made for the estimated loss. The Company issues invoices related to fixed price contracts based on either the achievement of milestones during a project or other contractual terms. Differences between the timing of billings and the recognition of revenue based upon the proportional performance method of accounting are recorded as revenue earned in excess of billings or deferred revenue in the accompanying financial statements. During the three months ended September 30, 2006 and 2005, revenues from fixed price development contracts constituted 16% and 20% of total revenues, respectively.

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### SIGNIFICANT ACCOUNTING ESTIMATES

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses for the reporting period. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. The Company bases its estimates and judgments on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from those estimates.

**REVENUE RECOGNITION.** The use of the proportional performance method of accounting requires that the Company makes estimates about its future efforts and costs relative to its fixed price contracts. While the Company has procedures in place to monitor the estimates throughout the performance period, such estimates are subject to change as each contract progresses. The cumulative impact of any such changes is reflected in the period in which the changes become known.



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ALLOWANCE FOR DOUBTFUL ACCOUNTS. The Company records an allowance for doubtful accounts based on a specific review of aged receivables. The provision for the allowance for doubtful accounts is recorded in selling, general and administrative expenses. These estimates are based on our assessment of the probable collection from specific customer accounts, the aging of the accounts receivable, analysis of credit data, bad debt write-offs, and other known factors.

INCOME TAXES -- ESTIMATES OF EFFECTIVE TAX RATES AND RESERVES FOR TAX CONTINGENCIES. The Company records provisions for income taxes based on enacted tax laws and rates in the various taxing jurisdictions in which it operates. In determining the tax provisions, the Company also provides for tax contingencies based on the Company's assessment of future regulatory reviews of filed tax returns. Such reserves, which are recorded in income taxes payable, are based on management's estimates and accordingly are subject to revision based on additional information. The provision no longer required for any particular tax year is credited to the current period's income tax expense.

During the three months ended September 30, 2006 and September 30, 2005, the effective income tax rate was 2% and 12.9%, respectively.

ACCRUALS FOR LEGAL EXPENSES AND EXPOSURES. The Company estimates the costs associated with known legal exposures and their related legal expenses and accrues reserves for either the probable liability, if that amount can be reasonably estimated, or otherwise the lower end of an estimated range of potential liability.

UNDISTRIBUTED EARNINGS OF FOREIGN SUBSIDIARIES. The Company intends to use accumulated and future earnings of foreign subsidiaries to expand operations outside the United States and accordingly undistributed earnings of foreign subsidiaries are considered to be indefinitely reinvested outside the United States and no provision for U. S. federal and state income tax or applicable dividend distribution tax has been provided thereon.

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### FORWARD LOOKING STATEMENTS / RISK FACTORS

Certain information and statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this report, including the allowance for doubtful accounts, contingencies and litigation, potential tax liabilities, interest rate or foreign currency risks, and projections regarding our liquidity and capital resources, could be construed as forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements include statements containing words such as "could", "expects", "may", "anticipates", "believes", "estimates", "plans", and similar expressions. In addition, the Company or persons acting on its behalf may, from time to time, publish other forward looking statements. Such forward looking statements are based on management's estimates, assumptions and projections and are subject to risks and uncertainties that could cause actual results to differ materially from those discussed in the forward looking statements. Some of the factors that could cause future results to materially differ from the recent results or those projected in the forward looking statements include the following, which factors are more fully discussed in the Company's most recently filed Annual Report on Form 10-K and other SEC filings, in each case under the section entitled "Risk Factors":

- Recruitment and Retention of IT Professionals

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- Government Regulation of Immigration
- Variability of Quarterly Operating Results
- Customer Concentration; Risk of Termination
- Exposure to Regulatory and General Economic Conditions in India
- Intense Competition
- Ability to Manage Growth
- Fixed-Price Engagements
- Potential Liability to Customers
- Dependence on Key Personnel
- Risks Related to Possible Acquisitions
- Limited Intellectual Property Protection
- Potential Anti-Outsourcing Legislation
- Terrorist Activity, War or Natural Disasters
- Adverse Economic Conditions
- Failure to Successfully Develop and Market New Products and Services
- Benchmarking Provisions
- Corporate Governance Issues
- Telecom/Infrastructure Issues
- Confidentiality Issues
- New Facilities
- Stock Option Accounting
- Instability and Currency Fluctuations

The Company does not intend to update the forward looking statements or risk factors to reflect future events or circumstances.

### RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, FASB issued Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarified the accounting for income tax by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not determined the effect, if any; the adoption of FIN 48 will have on its results of operations or financial position.

In September 2006, the FASB issued Statement No. 157 (SFAS 157), Fair Value

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Measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles (GAAP). SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact; SFAS 157 will have on the Company's financial position, results of operations and liquidity and its related disclosures.

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In September 2006, FASB issued Statement No. 158 (SFAS 158) Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R), which requires companies to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income, which is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact; SFAS 158 will have on the Company's financial position, results of operations and liquidity and its related disclosures.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The Company is exposed to the impact of interest rate changes and foreign currency fluctuations.

#### INTEREST RATE RISK

The Company considers investments purchased with an original or remaining maturity of less than three months at date of purchase to be cash equivalents. The following table summarizes Company's cash and cash equivalents and short term investments:

	SEPTEMBER 30, 2006	DECEMBER 31, 2005	
	-----	-----	
	(in thousands)		
ASSETS			
Cash and cash equivalents	\$ 37,212	\$ 99,390	
Short term Investments	38,579	21,083	
	-----	-----	
TOTAL	\$ 75,791	\$ 120,473	
	=====	=====	

The Company's exposure to market rate risk for changes in interest rates relates primarily to its investment portfolio. The Company does not use derivative financial instruments in its investment portfolio. The Company's investments are in high-quality Indian Mutual Funds and, by policy, limit the amount of credit exposure to any one issuer. At any time, changes in interest rates could have an impact on interest earnings for its investment portfolio. The Company protects and preserves its invested funds by limiting default, market and reinvestment risk. Investments in interest earning instruments carry a degree of interest rate risk. Floating rate securities may produce less income than expected if there is a decline in interest rates. Due in part to these factors, the

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Company's future investment income may fall short of expectations, or the Company may suffer a loss in principal if the Company is forced to sell securities, which have declined in market value due to changes in interest rates as stated above.

### FOREIGN CURRENCY RISK

The Company's sales are primarily sourced in the United States and its subsidiary in the United Kingdom and are mostly denominated in U.S. dollars or UK pounds respectively. Its foreign subsidiaries incur most of their expenses in the local currency. Accordingly, all foreign subsidiaries use the local currency as their functional currency. The Company's business is subject to risks typical of an international business, including, but not limited to differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, the Company's future results could be materially adversely impacted by changes in these or other factors. The risk is partially mitigated as the Company has sufficient resources in the respective local currencies to meet immediate requirements. The Company is also exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, these results, when translated, may vary from expectations.

During the three months ended September 30, 2006, the Indian rupee has depreciated, against U.S. dollar, by 1% as compared to the three months ended June 30, 2006. The impact of this rupee depreciation positively impacted the Company's gross margin by 18 basis points, operating income by 24 basis points and net income by 24 basis points, each as a percentage of revenue. The Indian rupee denominated cost of revenues and selling, general and administrative expense was 28% and 33%, respectively, which did not have a material impact on the operating results of the company.

Although the Company cannot predict future movement in interest rates or fluctuations in foreign currency rates, the Company does not currently anticipate that interest rate risk or foreign currency risk will have a significant impact.

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### ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. Based on their evaluation of the Company's disclosure controls and procedures as of September 30, 2006 as well as mirror certifications from senior management, the Company's Chairman, President and Chief Executive Officer and Acting Chief Financial Officer have concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 (the Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are operating in an effective manner. There have been no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the last quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

DISCLOSURE CONTROLS AND INTERNAL CONTROLS. Disclosure Controls are procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities

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and Exchange Commission's (the SEC) rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and Acting CFO, as appropriate to allow timely decisions regarding required disclosure. Internal Controls are procedures designed to provide reasonable assurance that (1) our transactions are properly authorized; (2) our assets are safeguarded against unauthorized or improper use; and (3) our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with generally accepted accounting principles.

LIMITATIONS ON THE EFFECTIVENESS OF CONTROLS. The Company's management, including the CEO and Acting CFO, does not expect that our Disclosure Controls or our Internal Controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures.

SCOPE OF THE CONTROLS EVALUATION. In the course of the Controls Evaluation, we sought to identify data errors, control problems or acts of fraud and confirm that appropriate corrective actions, including process improvements, were being undertaken. Our Internal Controls are also evaluated on an ongoing basis by our Internal Audit Department and by other personnel in our organization. The overall goals of these various evaluation activities are to monitor our Disclosure Controls and our Internal Controls, and to modify them as necessary; our intent is to maintain the Disclosure Controls and the Internal Controls as dynamic systems that change as conditions warrant.

Among other matters, we sought in our evaluation to determine whether there were any "significant deficiencies" or "material weaknesses" in the Company's Internal Controls, and whether the company had identified any acts of fraud involving personnel with a significant role in the Company's Internal Controls. This information was important both for the Controls Evaluation generally, and because the Rule 13a-14 Certifications of the CEO and CFO require that the CEO and CFO disclose that information to our Board's Audit Committee and our independent auditors. We also sought to deal with other controls matters in the Controls Evaluation, and in each case if a problem was identified, we considered what revision, improvement and/or correction to make in accordance with our ongoing procedures.

CONCLUSIONS. Based upon the Controls Evaluation, our CEO and Acting CFO have concluded that as of September 30, 2006 our disclosure controls and procedures are effective to ensure that material information relating to Syntel and its consolidated subsidiaries is made known to management, including the CEO and Acting CFO, particularly during the period when our periodic reports are being prepared, and that our Internal Controls are effective to provide reasonable assurance that our financial statements are fairly presented in conformity with generally accepted accounting principles in the United States of America.

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### OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS.

While the Company is a party to ordinary routine litigation incidental to its business, the Company is not a party to any material pending legal proceedings.

#### ITEM 1A. RISK FACTORS.

There have been no material changes in the Company's risk factors as disclosed in the Company's annual report on Form 10-K for the year ended December 31, 2005.

#### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None

#### ITEM 5. OTHER INFORMATION.

None.

#### ITEM 6. EXHIBITS.

Exhibits

Exhibit No.	Description
10.1	Form of Restricted Stock Grant Agreement.
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.
32	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer.

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### SIGNATURES

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

SYNTEL, INC.

Date : November 6, 2006

/s/ Bharat Desai

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Bharat Desai, Chairman, President and  
Chief Executive Officer

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Date : November 6, 2006

/s/ Arvind Godbole

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Arvind Godbole, Acting Chief Financial Officer

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EXHIBIT INDEX

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32	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer.

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