PEROT SYSTEMS CORP
Form 10-K
February 25, 2009

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

# FORM 10-K

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

For the Fiscal Year Ended December 31, 2008

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

For the Transition Period From to

**Commission File Number 1-14773**

**PEROT SYSTEMS CORPORATION**
*(Exact Name of Registrant as Specified in its Charter)*

| | |
|---|---|
| **Delaware**<br>*(State or other jurisdiction of incorporation or organization)* | 75-2230700<br>(I.R.S. Employer Identification No.) |
| **2300 WEST PLANO PARKWAY**<br>**PLANO, TEXAS**<br>*(Address of Principal Executive Offices)* | 75075<br>(Zip Code) |

**(972) 577-0000**
**(Registrant s Telephone Number including area code)**

**Securities registered pursuant to Section 12(b) of the Act:**

| **Title of Each Class** | **Name of Each Exchange On Which Registered** |
|---|---|

| | |
|---|---|
| Class A Common Stock<br>Par Value $0.01 per share | New York Stock Exchange |

**Securities registered pursuant to Section 12(g) of the Act:**
**Preferred Stock Purchase Rights**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

| | | | |
|---|---|---|---|
| þ Large accelerated filer | o Accelerated filer | o Non-accelerated filer (Do not check if a smaller reporting company) | o Smaller reporting company |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of June 30, 2008, the aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant, based upon the closing sales price for the registrant s common stock as reported on the New York Stock Exchange, was approximately $1,267,845,482 (calculated by excluding shares owned beneficially by directors and officers).

Number of shares of registrant s common stock outstanding as of February 20, 2009: 119,464,311 shares of Class A Common Stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

The following documents (or parts thereof) are incorporated by reference into the following parts of this Form 10-K: certain information required in Part III of this Form 10-K is incorporated from the registrant s Proxy Statement for its 2009 Annual Meeting of Stockholders, which is expected to be filed not later than 120 days after the registrant s fiscal year ended December 31, 2008.

**FORM 10-K**

**For the Year Ended December 31, 2008**

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*This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, forecasts, expects, plans, anticipates, believes, estimates, predicts, potential, see, target, continue or the negative of such terms and other comparable terminology. These statements reflect our current expectations, estimates, and projections. These statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that are difficult to predict. Actual events or results may differ materially from what is expressed or forecasted in these forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risks outlined below under the caption Risk Factors. These risk factors describe reasons why our actual results may differ materially from any forward-looking statement. We disclaim any intention or obligation to update any forward-looking statement.*

## PART I

### Item 1. *Business*

### Overview

Perot Systems Corporation, originally incorporated in the state of Texas in 1988 and reincorporated in the state of Delaware on December 18, 1995, is a worldwide provider of information technology (commonly referred to as IT) services and business solutions to a broad range of customers. We offer our customers integrated solutions designed around their specific business objectives, chosen from a breadth of services, including technology infrastructure services, applications services, business process services, and consulting services.

Through our flexible and collaborative approach, we integrate expertise from across the company to deliver custom solutions that enable clients to accelerate growth, streamline operations and create new levels of customer value.

### Our Services

We provide the following categories of services to our customers either on a standalone basis or bundled within a comprehensive solution. Within our market-facing units and as described in more detail below, we offer a mix of these services as part of our solutions.

- Infrastructure services
- Applications services
- Business process services
- Consulting services

*Infrastructure Services*

Infrastructure services are typically performed under multi-year contracts in which we assume operational responsibility for various aspects of our customers businesses, including data center and systems management, Web hosting and Internet access, desktop solutions, messaging services, program management, hardware maintenance and monitoring, network management, including VPN services, service desk capabilities, physical security, network security, risk management, and virtualization (the management of leveraged computing environments). We also offer our global services under a modular concept, which allows our customers to select all services mentioned above or only certain subsets, depending on their needs. We are responsible for defining the infrastructure technology strategies for our customers. We identify new technology offerings and innovations that deliver value to our customers. We manage, resolve, and document problems in our customers computing environments and provide comprehensive monitoring, planning, and safeguarding of information technology systems against intrusion by monitoring system and network status, collecting and analyzing data regarding system and network performance, and applying appropriate corrective actions. All of these activities are either performed at customer facilities or delivered through centralized data processing centers that we maintain. We typically hire a significant

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portion of the customer s staff that supported these functions prior to the transition of services. We then apply our expertise and operating methodologies and utilize technology to increase the efficiency of the operations, which usually results in increased operational quality at a lower cost.

*Applications Services*

Applications services include services such as application development and maintenance, including the development and maintenance of custom and packaged application software for customers, and application systems migration and testing, which includes the migration of applications from legacy environments to current technologies, as well as performing quality assurance functions on custom applications. We also provide other applications services such as application assessment and evaluation, hardware and architecture consulting, systems integration, and Web-based services.

*Business Process Services*

Business process services include services such as product engineering, claims processing, life insurance policy administration, call center management, payment and settlement management, security, and services to improve the collection of receivables. In addition, business process services include engineering support and other technical and administrative services that we provide to the U.S. federal government.

*Consulting Services*

Consulting services include strategy consulting, enterprise consulting, technology consulting, the implementation of prepackaged software applications, and research. The consulting services provided to customers within our Industry Solutions and Government Services segments typically consist of customized, industry-specific business solutions provided by associates with industry expertise. Consulting services are typically viewed as discretionary services by our customers, with the level of business activity depending on many factors, including economic conditions and specific customer needs.

## Our Contracts

Our contracts include services priced using a wide variety of pricing mechanisms. In determining how to price our services, we consider the delivery, credit, and pricing risk of a business relationship. For the year ended December 31, 2008:

> Approximately 49% of our revenue was from fixed-price contracts and per-unit priced contracts. Under fixed-price contracts, our customers pay us a set amount for contracted services. Fixed-price contracts frequently include a variable component of pricing based on service volumes that exceed or fall below a defined range of volumes, which adds a per-unit pricing component to these fixed-price arrangements. For some fixed-price contracts, the price is set so the customer realizes immediate savings in relation to their current expense for the services we will be performing. On contracts of this nature, our profitability generally increases over the term of the contract as we become more efficient. The time that it takes for us to realize these efficiencies can range from a few months to a few years, depending on the complexity of the services. Under per-unit priced contracts, our customers pay us based on the volumes of units provided at the unit rate specified. In some contracts, the per-unit prices may vary over the term of the contract, which may result in the customer realizing immediate savings at the beginning of the contract.

> Approximately 30% of our revenue was from time and materials contracts where our billings are based on measurements such as hours, days or months, and an agreed upon rate. In some cases, the rate the customer

pays for a unit of time can vary over the term of a contract, which may result in the customer realizing immediate savings at the beginning of a contract.

Approximately 21% of our revenue was from cost plus contracts where our billings are based in part on the amount of expense we incur in providing services to a customer.

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We also utilize other pricing mechanisms, including license fees and risk/reward relationships where we participate in the benefit associated with delivering a certain outcome. Revenue from these other pricing mechanisms totaled less than 1% of our revenue.

Depending on a customer s business requirements and the pricing structure of the contract, the amount of profit generated from a contract can vary significantly during a contract s term. With fixed- or unit-priced contracts, or when an upfront payment is made to purchase assets or as a sales incentive, an outsourcing services contract will typically produce less profit at the beginning of the contract with significantly more profit being generated as efficiencies are realized later in the term. With a cost plus contract, the amount of profit generated tends to be relatively consistent over the term of the contract.

## Our Lines of Business

We offer our services under two primary lines of business: Industry Solutions and Government Services. We consider these two lines of business to be reportable segments and include financial information and disclosures about these reportable segments in our consolidated financial statements. You can find this financial information in Note 15, Segment and Certain Geographic Data, of the Notes to Consolidated Financial Statements included herein. We routinely evaluate the historical performance of and growth prospects for various areas of our business, including our lines of business, delivery groups, and service offerings. Based on a quantitative and qualitative analysis of varying factors, we may increase or decrease the amount of ongoing investment in each of these business areas, make acquisitions that strengthen our market position, or divest, exit, or downsize aspects of a business area.

### *Industry Solutions*

Industry Solutions, which is our largest line of business and represented approximately 77%, 79%, and 87% of our total revenue for 2008, 2007, and 2006, respectively, provides services to our customers primarily under long-term contracts in strategic relationships. These services include technology, applications, and business process services, as well as industry domain-based, short-term project and consulting services. Industry Solutions also provides software-related services, including the implementation of prepackaged software applications, application development and maintenance, and application systems migration and testing under short-term contracts related to specific projects. Our Industry Solutions line of business consists of two delivery groups Healthcare and Commercial.

*Healthcare*

Our Healthcare group, which represented approximately 47%, 51%, and 48% of our total revenue for 2008, 2007, and 2006, respectively, and approximately 61%, 65%, and 55% of revenue for the Industry Solutions line of business for 2008, 2007, and 2006, respectively, provides services primarily to providers of healthcare, but we also serve health insurance organizations and organizations that are a part of the healthcare supply chain:

> *Providers* including hospitals, physician practices, and public sector agencies. Our hospital customers include health systems and freestanding hospitals. Our physician practice customers include large and community practice groups. Within the public sector, we focus on federal government healthcare agencies such as the Veterans Health Administration;
>
> *Health insurance organizations* including national insurers, Blue Cross and Blue Shield plans and regional managed care organizations; and
>
> *Healthcare supply chain* including medical surgical suppliers and distributors and retail pharmacy.

Our Healthcare group provides a full range of services, including consulting, applications, infrastructure, and business process services. Our associates deliver technology-based solutions to meet the demanding challenges of the healthcare industry globally to:

- Improve patient safety and quality;

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- Lower the healthcare cost trend and achieve new levels of customer satisfaction; and

- Achieve administrative transaction process efficiency.

For hospitals, we provide information technology, revenue cycle, and supply chain sourcing solutions, as well as operational and clinical transformation services that drive lower costs, increase cash and improve the delivery of care. We employ the industry s leading clinical, technological, and process know-how to provide our services.

For physicians, we deploy electronic health records and operate information technology and revenue cycle management functions.

For health insurance organizations, we enable the transformation to consumer health models by supporting administrative process efficiency with our technology platform and business process services.

For healthcare supply chain, we provide technology infrastructure support and solutions that enhance the integration of the supply chain process among suppliers, distributors, hospitals, and physician organizations.

For public sector healthcare, we utilize our commercial healthcare expertise to support federal government healthcare initiatives.

*Commercial*

Our Commercial group, which represented approximately 30%, 28%, and 39% of our total revenue for 2008, 2007, and 2006, respectively, and approximately 39%, 35%, and 45% of revenue for the Industry Solutions line of business for 2008, 2007, and 2006, respectively, provides services to customers primarily in three markets:

- *Consumer* including customers in technology, travel, transportation, telecom, and publishing industries.

- *Manufacturing* including customers in automotive and automotive components and parts, machinery and durable goods.

- *Financial Services* including customers in capital markets, banking, insurance, and credit rating agencies.

Within Commercial, we provide a full range of services including consulting, applications, infrastructure, product engineering, and business process services. Our infrastructure and application services are designed to help clients reduce technology costs while increasing operational quality. Our product engineering services are focused on helping manufacturers to develop their products more effectively and include research and design engineering, program management, and manufacturing engineering. Our industry-specific consulting services include the business and technology solutions that improve the efficiencies of critical processes, including product design, supply chain execution, call centers, collaborative engineering tools, manufacturing plant floor processes, and consulting and implementation of enterprise resource planning software packages.

***Government Services***

Our Government Services group, which represented approximately 23%, 21%, and 13% of our total revenue for 2008, 2007, and 2006, respectively, provides information technology infrastructure and application services, consulting, engineering support, and technology-based business process solutions for the Department of Defense, the Department of Homeland Security, various civilian agencies including the Department of Education and NASA, various federal intelligence agencies, and other governmental agencies.

Our core product portfolio includes information technology and business process outsourcing, business process services, IT infrastructure and applications support, and a wide array of professional services. These services include the direct support of engineering, safety, quality assurance, logistics, environmental, and program management for federal managers across a broad spectrum of critical programs. We provide IT infrastructure support to the federal government through management consulting services, information technology and systems support, application design and development, government financial services, business process services and outreach, media, and communications services.

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## Perot Systems Associates

The markets for IT personnel and business integration professionals are intensely competitive. A key part of our business strategy is the hiring, training, and retaining of highly motivated personnel with strong character and leadership traits. We believe that employing associates with such traits is and will continue to be an integral factor in differentiating us from our competitors in the IT industry. In seeking such associates, we screen candidates for employment through a rigorous interview process. In addition to competitive salaries, we distribute cash bonuses that are paid promptly to reward excellent performance, and we have various incentive compensation programs, including a year-end bonus based on our performance in relation to our business and financial targets.

As of December 31, 2008, we employed approximately 23,100 associates. Some of our associates in Europe are members of work councils and have worker representatives. We believe that our relations with our associates are good.

## Competition

We operate in extremely competitive markets, and the technology required to meet our customers needs changes. In each of our lines of business, we frequently compete with companies that have greater financial resources; more technical, sales, and marketing capacity; and larger customer bases than we do. Because many of the factors on which we compete, as discussed below, are outside of our control, we cannot be sure that we will be successful in the markets in which we compete. If we fail to compete successfully, our business, financial condition, and results of operations will be materially and adversely affected.

### *Competitors*

We compete with a number of different information technology service providers depending upon the region, country, and/or market we are addressing. Some of our more frequent competitors include: Accenture Ltd., Affiliated Computer Services, Inc., Cap Gemini Ernst & Young, Computer Sciences Corporation, HP Services (a division of Hewlett Packard Company), IBM Global Services (a division of International Business Machines Corporation), and Unisys Corporation. Our Industry Solutions line of business also frequently competes with Atos Origin, CGI Group, Inc., Cerner Corporation, Cognizant Technology Solutions Corporation, Deloitte Consulting LLP (a member of Deloitte Touche Tomatsu), HCL Technologies, iGate Global Solutions Limited, Infosys Technologies Limited, L&T Infotech Ltd., Mastek Limited, McKesson Corporation, MphasiS, Patni Computer Systems Limited, Polaris Software Lab Limited, Sapient Corporation, Siemens Business Services, Inc., Tata Consultancy Services Limited, Tech Mahindra, Wipro Limited, smaller consulting firms with industry expertise in areas such as healthcare or financial services, and the consulting divisions of large systems integrators and information technology services providers. In addition, our Government Services line of business frequently competes with Booz-Allen and Hamilton, CACI International, Inc., General Dynamics, Lockheed Martin Corporation, Northrop Grumman Corporation, Science Applications International Corporation, SRA International, Stanley, Inc., and Verizon Communications Inc. We may also compete with non-IT outsourcing providers who enter into marketing and business alliances with our customers that provide for the consolidation of services. As we enter new markets, we expect to encounter additional competitors. We also frequently compete with our customers own internal information technology capability, which may constitute a fixed cost for our customer.

### *How We Compete*

We compete on the basis of a number of factors, including the attractiveness and breadth of the business strategy and professional services that we offer, pricing, technological innovation, industry expertise, and quality of service. Our Industry Solutions line of business also competes on our scale. For our Industry Solutions Segment, emerging offshore development capacity in countries such as India, Mexico, and the Philippines is increasing the degree of competition for our software development services. For our Government segment, we frequently compete in federal and defense programs with declining budgets, which creates pressure to lower our prices. In addition, the market for consulting services is affected by an oversupply of consulting talent, both domestically and offshore, which results in downward price pressure for our services. All of these factors may increase pricing pressure on us.

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### Financial Information About Foreign and Domestic Operations

See Note 15, Segment and Certain Geographic Data, to the Consolidated Financial Statements included elsewhere in this report.

### Intellectual Property

While we attempt to retain intellectual property rights arising from customer engagements, our customers often have the contractual right to such intellectual property. We rely on a combination of nondisclosure and other contractual arrangements and trade secret, copyright, and trademark laws to protect our proprietary rights and the proprietary rights of third parties from whom we license intellectual property. We enter into confidentiality agreements with our associates and limit distribution of proprietary information. There can be no assurance that the steps we take in this regard will be adequate to deter misappropriation of proprietary information or that we will be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights.

We license the right to use the names Perot Systems and Perot in our current and future businesses, products, or services from the Perot Systems Family Corporation and Ross Perot Jr., our Chairman. The license is a non-exclusive, royalty-free, worldwide, non-transferable license. We may also sublicense our rights to the Perot name to some of our affiliates. Under the license agreement, either party may, in its sole discretion, terminate the license at any time, with or without cause and without penalty, by giving the other party written notice of such termination. Upon termination by either party, we must discontinue all use of the Perot name within one year following notice of termination. The termination of this license agreement could materially and adversely affect our business, financial condition, and results of operations. Except for the license of our name, we do not believe that any particular copyright, trademark, or group of copyrights and trademarks is of material importance to our business taken as a whole.

### Our Website and Availability of SEC Reports and Corporate Governance Documents

Our Internet address is www.perotsystems.com and the investor relations section of our website is located at www.perotsystems.com/investors. We make available free of charge, on or through the investor relations section of our website, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Also, posted on our corporate responsibility section of our website (located at www.perotsystems.com/responsibility), and available in print upon request of any shareholder to our Investor Relations department, are our charters for our Audit Committee, Compensation Committee, and Nominating and Governance Committee, as well as our Standards & Ethical Principles and our Corporate Governance Guidelines (which include our Director Qualification Guidelines and Director Independence Standards). Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Standards & Ethical Principles and any waiver applicable to our executive officers or directors.

### Item 1A. *Risk Factors*

*An investment in our Class A common stock involves a high degree of risk. You should carefully consider the following risk factors in evaluating an investment in our common stock. The risks described below are not the only ones that we face. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our business operations. If any of the following risks actually occurs, our business, financial condition, or results of operations could be materially and adversely affected. In such case, the trading price of our Class A common stock could decline, and you could lose all or part of your investment. You should also refer to the other information set forth in this report, including our Consolidated Financial Statements and the related notes.*

*Our business may be adversely affected by a number of economic and business factors.*

Our business may be adversely affected by a number of factors, including general economic conditions, the amount and type of technology spending that our customers undertake, and the business strategies and financial condition of our customers and the industries we serve, which could result in increases or decreases in the amount of services that we provide to our customers and the pricing of such services. For instance, in the current economic downturn, our customers are deferring many purchasing decisions regarding our services. This could have a negative effect on our revenue and profit if a significant number of them continue to defer or elect not to proceed with new contracts. Our ability to identify and effectively respond to these factors is important to our future financial and growth position. Both of our major lines of business have distinct economic factors, business trends, and risks that could have a material adverse effect on our results of operations and financial condition.

We maintain an investment portfolio of various short-term financial instruments. However, our investments, including our cash and cash equivalents, are subject to general credit, liquidity, market, and interest rate risk and these risks are heightened in the current economic environment. If the global credit markets continue to deteriorate, our investments may be negatively impacted, which could result in reduced liquidity or investment losses.

*If customers reduce spending that is currently above contractual minimums, our revenue and profits could diminish.*

Some of our outsourcing customers request services in excess of the minimum level of services required by the contract. These services are often in the form of project work and are discretionary to our customers. Our customers ability to continue discretionary project spending may depend on a number of factors including, but not limited to, their financial condition, and industry and strategic direction. Spending above contractual minimums by customers could end with limited notice and result in lower revenue and earnings. In the current economic climate, these amounts are at greater risk.

*If we are unable to collect our receivables, our results of operations and cash flows could be adversely affected.*

Our business depends on our ability to successfully obtain payment from our clients of the amounts they owe us for work performed. The current economic downturn could result in financial difficulties for our clients, and as result cause clients to delay payments to us, request modifications to their payment arrangements or default on their payment obligations. We evaluate the financial condition of our clients and usually bill and collect on relatively short cycles. We maintain allowances against receivables, but actual losses on client balances could differ from those that we currently anticipate and as a result we might need to adjust our allowances. There is no guarantee that we will accurately assess the creditworthiness of our clients. In addition, timely collection of client balances depends on our ability to complete our contractual commitments and bill and collect our contracted revenues. If we are unable to meet our contractual requirements, we might experience delays in collection of and/or be unable to collect our client balances, and if this occurs, our results of operations and cash flows could be adversely affected.

*We may bear the risk of cost overruns relating to software development and implementation services, and, as a result, cost overruns could adversely affect our profitability.*

We provide services related to the development of software applications and the implementation of complex software packages for some of our customers. The effort and cost associated with the completion of these software development and implementation services are difficult to estimate and, in some cases, may significantly exceed the estimates made at the time we begin the services. We provide these software development and implementation services under time and materials and fixed-price contracts. The time and materials contracts are usually based on level-of-effort or direct costs plus a fee. Under those arrangements, we are able to bill our customer based on the actual cost of completing the services, even if the ultimate cost of the services exceeds our initial estimates. However, if the ultimate cost exceeds our initial estimate by a significant amount, we may have difficulty collecting the full amount that we are due under the contract, depending upon many factors, including the reasons for the increase in cost, our communication with the customer throughout the project, and the customer s satisfaction with the services. As a result, we could incur losses with respect to these software development and implementation services even when they are priced on a time and materials basis. If we provide these software development or implementation services under a fixed-price contract, we bear all the risk that the ultimate cost of the project will exceed the price to be charged to the customer.

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*Our largest customers account for a substantial portion of our revenue and profits, and the loss of any of these customers could result in decreased revenue and profits.*

Our 10 largest customers accounted for 33% of our revenue for 2008. Generally, we may lose a customer as a result of a merger or acquisition, contract expiration, the selection of another provider of information technology services, entry into strategic business and marketing alliances with other business partners, business failure or bankruptcy, or our performance. Our outsourcing contracts typically require us to maintain specified performance levels with respect to the services that we deliver to our customer, with the result that if we fail to perform at the specified levels, we may be required to pay or credit the customer with amounts specified in the contract. In the event of significant failures to deliver the services at the specified levels, a number of these contracts provide that the customer has the right to terminate the agreement. In addition, some of these contracts provide the customer the right to terminate the contract at the customer s convenience. The customer s right to terminate for convenience typically requires the customer to pay us a fee. We may not retain long-term relationships or secure renewals of short-term relationships with our large customers in the future.

*Profitability of our contracts may be materially, adversely affected if we do not accurately estimate the costs of services and the timing of the completion of projects.*

The services that we provide, and projects we undertake, pursuant to our contracts are increasingly complex. Our success in accurately estimating the costs of services and the timing of the completion of projects and other initiatives to be provided pursuant to our contracts is critical to our ability to price our contracts for long-term profitability. While these estimates reflect our best judgment regarding preexisting costs, efficiencies that we will be able to deliver, and resources that will be required for implementation and performance, any increased or unexpected costs, delays or failures to achieve anticipated cost reductions could materially, adversely affect the profitability of these contracts.

*If entities we acquire fail to perform in accordance with our expectations or if their liabilities exceed our expectations, our profits could be diminished and our financial results could be adversely affected.*

In connection with any acquisition we make, there may be liabilities that we fail to discover or that we inadequately assess. To the extent that the acquired entity failed to fulfill any of its contractual obligations, we may be financially responsible for these failures or otherwise be adversely affected. In addition, acquired entities may not perform according to the forecasts that we used to determine the price paid for the acquisition. If the acquired entity fails to achieve these forecasts, our financial condition and operating results may be adversely affected, including the potential for impairment of goodwill.

*Development of our software products may cost more than we initially project, and we may encounter delays or fail to perform well in the market, which could decrease our profits.*

Our business has risks associated with the development of software products. There is the risk that capitalized costs of development may not be fully recovered if the market for our products or the ability of our products to capture a portion of the market differs materially from our estimates. In addition, there is the risk that the cost of product development differs materially from our estimates or a delay in product introduction may reduce the portion of the market captured by our product.

*Our ability to perform on contracts on which we partner with third parties may be materially and adversely affected if these third parties fail to successfully or timely deliver their commitments.*

Our engagements often require that our products and services incorporate or coordinate with the software or systems of other vendors and service providers. Our ability to deliver our commitments may depend on the delivery by these vendors and service providers of their commitments. If these third parties fail to deliver their commitments on time or at all, our ability to perform may be adversely affected, which could have a material adverse effect on our business, revenue, profitability or cash flow. In addition, in some cases, we may be responsible for the performance of other vendors or service providers delivering software, systems or other requirements.

*Our government contracts contain early termination and reimbursement provisions that may adversely affect our revenue and profits.*

Our Government Services line of business provides services as a contractor and subcontractor on various projects with U.S. government entities. Despite the fact that a number of government projects for which we serve as a contractor or subcontractor are planned as multi-year projects, the U.S. government normally funds these projects on an annual or more frequent basis. Generally, the government has the right to change the scope of, or terminate, these projects at its discretion or as a result of changes in laws or regulations that might affect our ability to qualify to perform the projects. The termination or a major reduction in the scope of a major government project could have a material adverse effect on our results of operations and financial condition. Approximately 99% of the revenue from the Government Services line of business in 2008 is from contracts with the U.S. government for which we serve as a contractor or subcontractor.

U.S. government entities audit our contract costs, including allocated indirect costs, or conduct inquiries and investigations of our business practices with respect to our government contracts. If the government finds that we incorrectly charged costs to a contract, the costs are not reimbursable or, if already reimbursed, the cost must be refunded to the government. If the government discovers improper or illegal activities in the course of audits or investigations, the contractor may be subject to various civil and criminal penalties and administrative sanctions, which may include termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with the U.S. government. These government remedies could have a material adverse effect on our results of operations and financial condition.

*Our operating results may be adversely affected by fluctuations in foreign currency exchange rates.*

While we report our operating results in U.S. dollars, a percentage of our revenues is denominated in currencies other than the U.S. dollar. Although we hedge a portion of our foreign currency exposures, fluctuations in foreign currency exchange rates can have adverse effects on us.

> As we continue to leverage our global delivery model, more of our expenses are incurred in currencies other than those in which we bill for the related services. An increase in the value of certain currencies, such as the Indian rupee, against the U.S. dollar could increase costs for delivery of services at offshore sites by increasing labor and other costs that are denominated in local currency, and there can be no assurance that our contractual provisions or our currency hedging activities would offset this impact. This could result in a decrease in the profitability of our contracts that are utilizing delivery center resources.
>
> Because our consolidated financial statements are presented in U.S. dollars, we must translate revenues, expenses and income, as well as assets and liabilities, into U.S. dollars at exchange rates in effect during or at the end of each reporting period. Therefore, changes in the value of the U.S. dollar against other currencies will affect our revenues, operating income and the value of balance-sheet items originally denominated in other currencies. Declines in the value of other currencies against the U.S. dollar could cause our consolidated earnings stated in U.S. dollars to be lower than our consolidated earnings in local currency and could affect our reported results when compared against other periods. Conversely, increases in the value of other currencies against the U.S. dollar could cause our consolidated earnings stated in U.S. dollars to be higher than our consolidated earnings in local currency and could affect our reported results when compared against other periods. There is no guarantee that our financial results will not be adversely affected by currency exchange rate fluctuations.

*Our international operations expose our assets to increased risks and could result in business loss or in more expensive or less efficient operations.*

We have operations in many countries around the world. In addition to the risks related to fluctuations in currency exchange rates and the additional risk associated with doing business in India discussed above, risks that affect these international operations include:

- complicated licensing and work permit requirements may hinder our ability to operate in some jurisdictions;

- our intellectual property rights may not be well protected in some jurisdictions;

our operations may be vulnerable to terrorist actions or harmed by government responses;

governments may restrict our ability to convert currencies or repatriate cash; and

additional expenses and risks inherent in conducting operations in geographically distant locations, with customers speaking different languages and having different cultural approaches to the conduct of business.

*We have a significant business presence in India, and risks associated with doing business there could decrease our revenue and profits.*

A significant portion of our operations is located in India. In addition to the risks regarding fluctuations in currency exchange rates and regarding international operations discussed above, the following risks associated with doing business in India could decrease our revenue and profits:

governments could enact legislation that restricts the provision of services from offshore locations;

potential wage increases and retention of associates in India; and

cost increases if the Government of India reduces or withholds tax benefits and other incentives provided to us or from the expiration of our existing tax holiday benefits in 2009 and 2010.

*We could lose rights to our company name, which may adversely affect our ability to market our services.*

*We do not own the right to our company name.* We have a license agreement with Ross Perot Jr., our Chairman, and the Perot Systems Family Corporation that allows us to use the name Perot and Perot Systems in our business on a royalty-free basis. Mr. Perot and the Perot Systems Family Corporation may terminate this agreement at any time and for any reason. Beginning one year following such a termination, we would not be allowed to use the names Perot or Perot Systems in our business. Mr. Perot s or the Perot Systems Family Corporation s termination of our license agreement could materially and adversely affect our ability to attract and retain customers, which could have a material adverse effect on our business, financial condition, and results of operations.

*If we are unable to successfully integrate acquired entities, our profits may be less and our operations more costly or less efficient.*

We have completed several acquisitions in recent years, and we will continue to analyze and consider potential acquisition candidates. Acquisitions involve significant risks, including the following:

companies we acquire may have a lower quality of internal controls and reporting standards, which could cause us to incur expenses to increase the effectiveness and quality of the acquired company s internal controls and reporting standards;

we may have difficulty integrating the systems and operations of acquired businesses, which may increase anticipated expenses relating to integrating our business with the acquired company s business and delay or reduce full benefits that we anticipate from the acquisition;

integration of an acquired business may divert our attention from normal daily operations of the business, which may adversely affect our management, financial condition, and profits; and we may not be able to retain key employees of the acquired business, which may delay or reduce the full benefits that we anticipate from the acquisition and increase costs anticipated to integrate and manage the acquired company.

*Our contracts generally contain provisions that could allow customers to terminate the contracts and sometimes contain provisions that enable the customer to require changes in pricing or require us to renegotiate pricing, decreasing our revenue and profits and potentially damaging our business reputation.*

Our contracts with customers generally permit termination in the event our performance is not consistent with service levels specified in those contracts. The ability of our customers to terminate contracts creates an uncertain revenue and profit stream. If customers are not satisfied with our level of performance, our reputation in the industry may suffer, which may also adversely affect our ability to market our services to other customers. Furthermore, some of our contracts contain pricing provisions that permit a customer to request a benchmark study by a mutually acceptable third-party benchmarker. Generally, if the benchmarking study shows that our pricing has a difference outside a specified range and the difference is not due to the unique requirements of the customer, then the parties will negotiate in good faith any appropriate adjustments to the pricing. This may result in the reduction of our rates for the benchmarked services and could negatively impact our results of operations or cash flow. Our fixed-price contracts that have per-unit pricing adjustments for service volumes that exceed or fall below a specified range of volumes generally also have a limit on these adjustments, requiring renegotiation if volumes greatly exceed or fall below a specified range of volumes, which could result in reduced revenues and profits.

*Some contracts contain fixed- and unit-price provisions or penalties that could result in decreased profits.*

Some of our contracts contain pricing provisions that require the payment of a set fee or per-unit fee by the customer for our services regardless of the costs we incur in performing these services, or provide for penalties in the event we fail to achieve certain service levels. In such situations, we are exposed to the risk that we will incur significant unforeseen costs or such penalties in performing the services under the contract.

*If we fail to compete successfully in the highly competitive markets in which we operate, our business, financial condition, and results of operations will be materially and adversely affected.*

We operate in extremely competitive markets, and the technology required to meet our customers needs changes. In both of our lines of business, we frequently compete with companies that have greater financial resources; more technical, sales, and marketing capacity; and larger customer bases than we do. Because many of the factors on which we compete are outside of our control, we cannot be sure that we will be successful in the markets in which we compete. If we fail to compete successfully, our business, financial condition, and results of operations will be materially and adversely affected.

*Increasingly complex regulatory environments may increase our costs.*

Our customers are subject to complex and constantly changing regulatory environments. These regulatory environments change and in ways that cannot be predicted. For example, our financial services customers are subject to domestic and foreign privacy and electronic record handling rules and regulations, and our customers in the healthcare industry have been made subject to increasingly complex and pervasive privacy laws and regulations. These regulations may increase our potential liabilities if our services contribute to a failure by our customers to comply with the regulatory regime and may increase the cost to comply as regulatory requirements increase or change.

*Our quarterly financial results may vary.*

We expect our financial results to vary from quarter to quarter. Such variations are likely to be caused by many factors that are, to some extent, outside our control, including:

- the mix, timing, and completion of customer projects;
- unforeseen costs on fixed- or unit-price contracts;
- implementation and transition issues with respect to new contracts;
- hiring, integrating, retaining, and utilizing associates;

the timing of new contracts and changes in scope of services performed under existing contracts;

the resolution of outstanding tax issues from prior years;

the issuance of common shares and options, together with acquisition and integration costs, in connection with acquisitions;

- currency exchange rate fluctuations; and
- costs to exit certain activities or terminate projects.

Accordingly, we believe that quarter-to-quarter comparisons of financial results for preceding quarters are not necessarily meaningful. You should not rely on the results of one quarter as an indication of our future performance.

*The use of derivative financial instruments exposes us to credit and market risk.*

By using derivative financial instruments, we are exposed to credit and market risk. If a counterparty fails to fulfill its performance obligations under a derivative contract, our credit risk will equal the fair-value gain in a derivative financial instrument. Generally, when the fair value of a derivative financial instrument is positive, this indicates that the counterparty owes us, thus creating a repayment risk for us. When the fair value of a derivative financial instrument is negative, we owe the counterparty and, therefore, assume no repayment risk. We minimize the credit (or repayment) risk in derivative financial instruments by entering into transactions with high-quality counterparties that are reviewed periodically by our Treasurer.

*Changes in technology could adversely affect our competitiveness, revenue, and profit.*

The markets for our information technology services change rapidly because of technological innovation, new product introductions, changes in customer requirements, declining prices, and evolving industry standards, among other factors. New products and new technology often render existing information services or technology infrastructure obsolete, excessively costly, or otherwise unmarketable. As a result, our success depends on our ability to timely innovate and integrate new technologies into our service offerings. We cannot guarantee that we will be successful at adopting and integrating new technologies into our service offerings in a timely manner.

*Failure to recruit, train, and retain technically skilled personnel could increase costs or limit growth.*

We must continue to hire and train technically skilled people in order to perform services under our existing contracts and new contracts into which we will enter. The people capable of filling these positions have historically been in great demand, and recruiting and training such personnel requires substantial resources. We may be required to pay an increasing amount to hire and retain a technically skilled workforce. In addition, during periods in which demand for technically skilled resources is great, our business may experience significant turnover. These factors could create variations and uncertainties in our compensation expense and efficiencies that could directly affect our profits. If we fail to recruit, train, and retain sufficient numbers of these technically skilled people, our business, financial condition, and results of operations may be materially and adversely affected.

*Alleged or actual infringement of intellectual property rights could result in substantial additional costs.*

Our suppliers, customers, competitors, and others may have or obtain patents and other proprietary rights that cover technology we employ. We are not, and cannot be, aware of all patents or other intellectual property rights of which our services may pose a risk of infringement. Others asserting rights against us could force us to defend ourselves or our customers against alleged infringement of intellectual property rights. We could incur substantial costs to prosecute or defend any intellectual property litigation, and we could be forced to do one or more of the following:

- cease selling or using products or services that incorporate the disputed technology;

- obtain from the holder of the infringed intellectual property right a license to sell or use the relevant technology; or
- redesign those services or products that incorporate such technology.

*Provisions of our certificate of incorporation, bylaws, and Delaware law could deter takeover attempts.*

Our Board of Directors may issue up to 5,000,000 shares of preferred stock and may determine the price, rights, preferences, privileges, and restrictions, including voting and conversion rights, of these shares of preferred stock without any further vote or action by our stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock may make it more difficult for a third party to acquire a majority of our outstanding voting stock.

Some provisions of our certificate of incorporation and bylaws and of Delaware General Corporation Law could also delay, prevent, or make more difficult a merger, tender offer, or proxy contest involving our company. Among other things, these provisions:

- require a 662/3% vote of the stockholders to amend our certificate of incorporation or approve any merger or sale, lease, or exchange of all or substantially all of our property and assets;
- require an 80% vote for stockholders to amend our bylaws;
- require advance notice for stockholder proposals and director nominations to be considered at a vote of a meeting of stockholders;
- permit only our Chairman, President, or a majority of our Board of Directors to call stockholder meetings, unless our Board of Directors otherwise approves;
- prohibit actions by stockholders without a meeting, unless our Board of Directors otherwise approves; and
- limit transactions between our company and persons who acquire significant amounts of stock without approval of our Board of Directors.

**Item 1B.** ***Unresolved Staff Comments***

None.

**Item 2.** ***Properties***

As of December 31, 2008, we had offices in approximately 100 locations in the United States and nine countries outside the United States. Our office space and other facilities cover approximately 3,000,000 square feet. We own our corporate headquarters facility in Plano, Texas. Our Industry Solutions line of business uses the corporate headquarters facility and data center. The Government Services line of business does not make significant use of the facility. In addition, we own two campus facilities in India. We own the buildings and lease the land (under a 99-year lease agreement) of our Delhi facility and we own both the land and buildings of our Bangalore facility. The majority of our remaining office space and other facilities are leased.

In addition to these properties, we also occupy office space at customer locations throughout the world. We generally occupy this space under the terms of the agreement with the particular customer. We believe that our current facilities are suitable and adequate for our business.

We have commitments related to data processing facilities, office space, and computer equipment under non-cancelable operating leases and fixed maintenance agreements for remaining periods ranging from one to 10 years. We have disclosed future minimum commitments under these leases and agreements as of December 31, 2008, in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 16, Commitments and Contingencies, to the Consolidated Financial Statements, which are included elsewhere in this report. Upon expiration of our leases, we do not anticipate any significant difficulty in obtaining renewals or alternative space.

**Item 3.** ***Legal Proceedings***

We are, from time to time, involved in various litigation matters. We do not believe that the outcome of the litigation matters in which we are currently a party, either individually or taken as a whole, will have a material adverse effect on our consolidated financial condition, results of operations or cash flows. However, we cannot predict with certainty any eventual loss or range of possible loss related to such matters.

We currently purchase and intend to continue to purchase the types and amounts of insurance coverage customary for the industry and geographies in which we operate. We have evaluated our risk and consider the coverage we carry to be adequate both in type and amount for the business we conduct.

*IPO Allocation Securities Litigation*

In July and August 2001, we, as well as some of our current and former officers and directors and the investment banks that underwrote our initial public offering, were named as defendants in two purported class action lawsuits seeking unspecified damages for alleged violations of the Securities Exchange Act of 1934 and the Securities Act of 1933. These cases focus on alleged improper practices of investment banks. Our case has been consolidated for pretrial purposes with approximately 300 similar cases in the IPO Allocation Securities Litigation and certain issues, including class certification issues, are being considered in a limited number of test cases. In December 2006, the Second Circuit Court of Appeals vacated the trial court s class certifications in the test cases, finding the predominance of common questions over individual questions that is required for class certification cannot be met by those plaintiffs.

*Other*

In addition to the matters described above, we have been, and from time to time are, named as a defendant in various legal proceedings in the normal course of business, including arbitrations, class actions and other litigation involving commercial and employment disputes. Certain of these proceedings include claims for substantial compensatory or punitive damages or claims for indeterminate amounts of damages. We are contesting liability and/or the amount of damages in each pending matter.

### Item 4. *Submission of Matters to a Vote of Security Holders*

We did not submit any matters to a vote of our security holders during the fourth quarter of the fiscal year ended December 31, 2008.

## PART II

### Item 5. *Market for Registrant s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities*

Our Class A Common Stock is traded on the New York Stock Exchange (the NYSE ) under the symbol PER. The table below shows the range of reported per share sales prices for each quarterly period within the two most recent fiscal years.

| | High | Low |
|---|---|---|
| 2007 | | |
| First Quarter | $ 18.21 | $ 15.64 |
| Second Quarter | 18.70 | 16.13 |
| Third Quarter | 17.37 | 14.53 |
| Fourth Quarter | 17.65 | 12.58 |
| 2008 | | |
| First Quarter | $ 15.63 | $ 11.10 |
| Second Quarter | 16.93 | 14.67 |
| Third Quarter | 18.82 | 14.79 |

| | | |
|---|---|---|
| Fourth Quarter | 17.29 | 10.71 |

The last reported sale price of our Class A Common Stock on the NYSE on February 20, 2009, was $11.34 per share. As of February 20, 2009, the approximate number of record holders of our Class A Common Stock was 2,305.

We have never paid cash dividends on shares of our Class A Common Stock and have no current plans to pay dividends in the future.

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**Issuer Purchases of Equity Securities**

The following table provides information relating to our purchase of common stock for the fourth quarter of 2008.

| Period | Total Number of Shares Purchased(1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans(2) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans(2) |
|---|---|---|---|---|
| November 1, 2008 to November 30, 2008 | 1,723,000 | $ 11.62 | 1,723,000 | $ 37,800,000 |

(1) Shares of Class A Common Stock.

(2) Shares of Class A Common Stock. The plan that existed at December 31, 2007, was replaced by a new stock buyback program adopted on February 26, 2008, authorizing the purchase of up to $75 million of our common stock. The program authorizes the purchase of our common stock from time to time in the open market, under a Rule 10b5-1 plan, or through privately negotiated, block transactions, which may include substantial blocks purchased from unaffiliated holders.

**Performance Graph**

The graph below compares the performance of our Class A Common Stock since December 31, 2003.

**COMPARISON OF CUMULATIVE TOTAL RETURN AMONG PEROT SYSTEMS CORPORATION, NYSE MARKET INDEX AND HEMSCOTT GROUP INDEX**

**ASSUMES $100 INVESTED ON DEC. 31, 2003.**

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## Equity Compensation Plan Information

The following table gives information about our Class A Common Stock that may be issued under our equity compensation plans as of December 31, 2008. See Note 10, Common and Preferred Stock, and Note 11, Stock Options and Stock-Based Compensation, to the Consolidated Financial Statements included herein for information regarding the material features of these plans.

| Plan Category | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a) | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b) | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c) |
|---|---|---|---|
| Equity compensation plans approved by security holders | 11,302,714(1) | $ 15.86 | 40,550,048(2) |
| Equity compensation plans not approved by security holders | 4,117,253 | $ 13.56 | 21,029(3) |
| **Total** | 15,419,967 | $ 15.25 | 40,571,077 |

(1) Excludes 1,030,473 restricted stock units that have been granted under the 2001 Long-Term Incentive Plan.

(2) Includes 35,868,380 shares available to be issued under the 2001 Long-Term Incentive Plan, 4,301,668 shares available to be issued under the 1999 Employee Stock Purchase Plan, and 380,000 shares available to directors for annual equity compensation.

(3) Shares available to be issued to directors who elect to receive stock in lieu of their cash retainer.

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**Item 6.** ***Selected Financial Data***

We have derived the following consolidated statement of income data for 2008, 2007, and 2006 and consolidated balance sheet data as of December 31, 2008 and 2007 from our financial statements included herein. We have derived the following statement of income data for 2005 and 2004 and consolidated balance sheet data as of December 31, 2006, 2005, and 2004 from our 2006 Form 10-K filed on February 28, 2007 and our 2005 Form 10-K filed on February 27, 2006. This information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements and the related Notes to Consolidated Financial Statements, which are included herein.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (Dollars in millions, except per share data) | | | | |
| **Operating Data:** | | | | | |
| Revenue | $ 2,779 | $ 2,612 | $ 2,298 | $ 1,998 | $ 1,773 |
| Direct cost of services | 2,292 | 2,130 | 1,905 | 1,575 | 1,405 |
| Gross profit | 487 | 482 | 393 | 423 | 368 |
| Selling, general and administrative expenses | 301 | 298 | 280 | 249 | 236 |
| Operating income | 186 | 184 | 113 | 174 | 132 |
| Interest income (expense), net | (2) | (3) | 5 | 4 | 1 |
| Other income, net | 3 | 1 | 2 | 2 | 2 |
| Income before taxes | 187 | 182 | 120 | 180 | 135 |
| Provision for income taxes | 70 | 67 | 39 | 69 | 41 |
| Net income | $ 117 | $ 115 | $ 81 | $ 111 | $ 94 |
| Earnings per share of common stock: | | | | | |
| Basic, Class A | $ 0.98 | $ 0.94 | $ 0.67 | $ 0.94 | $ 0.82 |
| Basic, Class B | | $ 0.94 | $ 0.67 | $ 0.94 | $ 0.82 |
| Diluted | $ 0.97 | $ 0.92 | $ 0.66 | $ 0.91 | $ 0.78 |
| Diluted, Class B | | $ 0.92 | $ 0.66 | $ 0.91 | $ 0.78 |
| Weighted average number of common shares outstanding (in thousands): | | | | | |
| Basic, Class A | 120,144 | 121,759 | 118,686 | 115,973 | 111,921 |
| Basic, Class B | | 566 | 817 | 1,907 | 3,282 |
| Diluted | 121,924 | 124,650 | 122,118 | 121,867 | 120,532 |
| Diluted, Class B | | 566 | 817 | 1,965 | 4,040 |
| **Balance Sheet Data (at Period End):** | | | | | |
| Cash and cash equivalents | $ 234 | $ 187 | $ 250 | $ 260 | $ 305 |
| Total assets | 1,978 | 1,900 | 1,581 | 1,371 | 1,226 |
| Long-term debt | 181 | 213 | 84 | 77 | |
| Stockholders equity | 1,305 | 1,243 | 1,105 | 961 | 862 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Other Data:** | | | | | | | | | | |
| Capital expenditures | $ | 55 | $ | 75 | $ | 93 | $ | 70 | $ | 33 |

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### Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and related Notes to the Consolidated Financial Statements, which are included herein.

### Overview

Perot Systems Corporation, originally incorporated in the state of Texas in 1988 and reincorporated in the state of Delaware on December 18, 1995, is a worldwide provider of information technology (commonly referred to as IT) services and business solutions to a broad range of customers. We offer our customers integrated solutions designed around their specific business objectives, chosen from a breadth of services, including technology infrastructure services, applications services, business process services, and consulting services.

Through our flexible and collaborative approach, we integrate expertise from across the company to deliver custom solutions that enable clients to accelerate growth, streamline operations and create new levels of customer value.

### Our Services

Our customers may contract with us for any one or more of the following categories of services:

- Infrastructure services
- Applications services
- Business process services
- Consulting services

*Infrastructure Services*

Infrastructure services are typically performed under multi-year contracts in which we assume operational responsibility for various aspects of our customers businesses, including data center and systems management, Web hosting and Internet access, desktop solutions, messaging services, program management, hardware maintenance and monitoring, network management, including VPN services, service desk capabilities, physical security, network security, risk management, and virtualization (the management of leveraged computing environments). We also offer our global services under a modular concept, which allows our customers to select all services mentioned above or only certain subsets, depending on their needs. We are responsible for defining the infrastructure technology strategies for our customers. We identify new technology offerings and innovations that deliver value to our customers. We manage, resolve, and document problems in our customers computing environments and provide comprehensive monitoring, planning, and safeguarding of information technology systems against intrusion by monitoring system and network status, collecting and analyzing data regarding system and network performance, and applying appropriate corrective actions. All of these activities are either performed at customer facilities or delivered through centralized data processing centers that we maintain. We typically hire a significant portion of the customer s staff that supported these functions prior to the transition of services. We then apply our expertise and operating methodologies and utilize technology to increase the efficiency of the operations, which usually results in increased operational quality at a lower cost.

*Applications Services*

Applications services include services such as application development and maintenance, including the development and maintenance of custom and packaged application software for customers, and application systems migration and testing, which includes the migration of applications from legacy environments to current technologies, as well as performing quality assurance functions on custom applications. We also provide other applications services such as application assessment and evaluation, hardware and architecture consulting, systems integration, and Web-based services.

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*Business Process Services*

Business process services include services such as product engineering, claims processing, life insurance policy administration, call center management, payment and settlement management, security, and services to improve the collection of receivables. In addition, business process services include engineering support and other technical and administrative services that we provide to the U.S. federal government.

*Consulting Services*

Consulting services include strategy consulting, enterprise consulting, technology consulting, the implementation of prepackaged software applications, and research. The consulting services provided to customers within our Industry Solutions and Government Services segments typically consist of customized, industry-specific business solutions provided by associates with industry expertise. Consulting services are typically viewed as discretionary services by our customers, with the level of business activity depending on many factors, including economic conditions and specific customer needs.

## Our Contracts

Our contracts include services priced using a wide variety of pricing mechanisms. In determining how to price our services, we consider the delivery, credit, and pricing risk of a business relationship. For the year ended December 31, 2008:

> Approximately 49% of our revenue was from fixed-price contracts and per-unit priced contracts. Under fixed-price contracts, our customers pay us a set amount for contracted services. Fixed-price contracts frequently include a variable component of pricing based on service volumes that exceed or fall below a defined range of volumes, which adds a per-unit pricing component to these fixed-price arrangements. For some fixed-price contracts, the price is set so the customer realizes immediate savings in relation to their current expense for the services we will be performing. On contracts of this nature, our profitability generally increases over the term of the contract as we become more efficient. The time that it takes for us to realize these efficiencies can range from a few months to a few years, depending on the complexity of the services. Under per-unit priced contracts, our customers pay us based on the volumes of units provided at the unit rate specified. In some contracts, the per-unit prices may vary over the term of the contract, which may result in the customer realizing immediate savings at the beginning of the contract.
>
> Approximately 30% of our revenue was from time and materials contracts where our billings are based on measurements such as hours, days or months, and an agreed upon rate. In some cases, the rate the customer pays for a unit of time can vary over the term of a contract, which may result in the customer realizing immediate savings at the beginning of a contract.
>
> Approximately 21% of our revenue was from cost plus contracts where our billings are based in part on the amount of expense we incur in providing services to a customer.

We also utilize other pricing mechanisms, including license fees and risk/reward relationships where we participate in the benefit associated with delivering a certain outcome. Revenue from these other pricing mechanisms totaled less than 1% of our revenue.

Depending on a customer s business requirements and the pricing structure of the contract, the amount of profit generated from a contract can vary significantly during a contract s term. With fixed- or unit-priced contracts, an outsourcing services arrangement will typically produce less profit at the beginning of the contract with significantly more profit being generated as efficiencies are realized later in the term. With a cost plus contract, the amount of profit generated tends to be relatively consistent over the term of the contract.

**Our Lines of Business**

As of July 1, 2008, we combined our Consulting and Applications Solutions line of business with our Industry Solutions line of business, resulting in a reduction from three reportable segments to two reportable segments: Industry Solutions and Government Services. We include financial information and disclosures about these reportable segments in our consolidated financial statements. You can find this financial information in Note 15, Segment and Certain Geographic Data, of the Notes to Consolidated Financial Statements included herein. This realignment helps us unify teams where these two lines of business had an overlap in markets, leverage our domain expertise, and build upon the growing collaboration between these lines of business in providing globally delivered services.

Industry Solutions, our largest line of business, provides services to our customers primarily under long-term contracts in strategic relationships. These services include technology and business process services, as well as industry domain-based, short-term project and consulting services. Industry Solutions also provides software-related services, including the implementation of prepackaged software applications, application development and maintenance, and application systems migration and testing under short-term contracts related to specific projects. The Government Services segment provides information technology infrastructure and application services, consulting, engineering support, and technology-based business process solutions for the Department of Defense, the Department of Homeland Security, various civilian agencies including the Department of Education and NASA, various federal intelligence agencies, and other governmental agencies. Based on a quantitative and qualitative analysis of varying factors, we may increase or decrease the amount of ongoing investment in both of these business areas, make acquisitions that strengthen our market position, or divest, exit, or downsize aspects of a business area.

## Results of Operations

### *Overview of Our Financial Results for 2008*

Our financial results are affected by a number of factors, including broad economic conditions, the amount and type of technology spending by our customers, and the business strategies and financial condition of our customers and the industries we serve, which could result in increases or decreases in the amount of services that we provide to our customers and the pricing of such services. Our ability to identify and effectively respond to these factors is important to our future financial growth.

We are monitoring current macroeconomic and credit market conditions and levels of business confidence and their potential effect on our clients and on us. A severe or prolonged economic downturn could adversely affect our clients financial condition and the levels of business activities in the industries and geographies in which we operate. This could reduce demand and depress pricing for our services, especially with respect to discretionary project services that are above contractual backlog. Non-backlog revenues represented approximately 33.6% of our revenues in 2008. Additionally, our clients and suppliers may be unable to generate cash flows or obtain financing to meet payment or delivery obligations to us, may decide to downsize, or may defer or cancel contracts, all of which could negatively affect revenue. These potential consequences of a severe or prolonged economic downturn could have a material adverse effect on our results of operations or financial condition.

We evaluate our consolidated performance on the basis of several performance indicators. The four key performance indicators we use are revenue growth, earnings growth, free cash flow, and the value of contracts signed. We compare these key performance indicators to both annual target amounts established by management and to our performance for prior periods. We establish the targets for these key performance indicators primarily on an annual basis, but we may revise them during the year. We assess our performance using these key indicators on a quarterly and annual basis.

Certain of these performance indicators are extracted from consolidated financial information and are not required by generally accepted accounting principles (GAAP) and are considered non-GAAP financial measures as defined by SEC rules. Specifically, we refer to free cash flow. As required by SEC rules, we provide a reconciliation of each non-GAAP financial measure and an explanation why we believe that the presentation of the non-GAAP financial measure provides useful information to investors. Non-GAAP financial measures should be considered in addition to, but not as a substitute for or superior to, other measures of financial performance prepared in accordance with GAAP.

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*Revenue Growth*

Revenue growth is a measure of the growth we generate through sales of services to new customers, retention of existing contracts, acquisitions, and discretionary services from existing customers. Revenue for 2008 grew by 6.4% as compared to 2007. As discussed in more detail below, this revenue growth came primarily from the following:

- Revenue from new contracts signed during 2008 and from new contracts signed in 2007 for which we did not recognize a full year of revenue in 2007.
- Revenue from companies acquired in the second and fourth quarters of 2008 and revenue from companies acquired in the first and third quarters of 2007 for which we did not recognize a full year of revenue in 2007.
- Revenue from expansion of base services from existing accounts and project work.

Offsetting these increases was a decrease in revenue due to the termination of a services agreement in the fourth quarter of 2007. See Note 13 Customer Contract Termination to the Consolidated Financial Statements, which are included herein.

*Earnings Growth*

We measure earnings growth using diluted earnings per share, which is a measure of our effectiveness in delivering profitable growth. Diluted earnings per share for 2008 increased 5.4% to $0.97 per share from $0.92 per share for 2007. This increase came primarily from:

- Industry Solutions, which contributed $84 million of growth or approximately $0.43 per diluted share due to additional project work on existing contracts, increasing the profitability of outsourcing contracts, the profit impact of new contracts and acquisitions, and profit improvement related to our cost reduction activities initiated in the fourth quarter of 2007.

These improvements to our earnings were partially offset by:

- An increase in incentive compensation of $38 million, or approximately $0.20 per diluted share.
- An $8 million reduction in earnings, or approximately $0.04 per diluted share, in Government Services, primarily attributable to losses in 2008 on a project that ended during the year, partially offset by profit improvement in outsourcing contracts.

In addition, the comparison of 2008 to 2007 earnings was impacted by:

- A decrease of $18 million in expense related to cost reduction activities implemented in 2007 of approximately $0.09 per diluted share.
- A decrease of $46 million in earnings, or approximately $0.23 per diluted share, due to the termination of a services agreement in the fourth quarter of 2007. See Note 13 Customer Contract Termination to the Consolidated Financial Statements.

*Free Cash Flow*

We calculate free cash flow as net cash provided by operating activities less purchases of property, equipment and purchased software, as stated in our consolidated statements of cash flows. We use free cash flow as a measure of our ability to generate cash for both our short-term and long-term operating and business expansion needs. We believe this measure provides important supplemental information to investors and allows them to assess our ability to meet our working capital requirements and business expansion needs. Free cash flow for the year ended December 31, 2008, was $162 million as compared to $43 million for the year ended December 31, 2007. Free cash flow, which is a non-GAAP measure, can be reconciled to Net cash provided by operating activities as follows (in millions):

| | Year Ended December 31 2008 | 2007 |
|---|---|---|
| Net cash provided by operating activities | $ 217 | $ 118 |
| Purchases of property, equipment and purchased software | (55) | (75) |
| Free cash flow | $ 162 | $ 43 |

See Liquidity and Capital Resources below for additional discussion of net cash provided by operating activities (under Operating Activities ) and additional discussion of our purchases of property, equipment and purchased software (under Investing Activities ).

*TCV of Contracts Signed*

The amount of Total Contract Value (commonly referred to as TCV) that we sell during a 12-month period is a measure of our success in capturing new business in the various outsourcing and consulting markets in which we provide services and includes contracts with new customers and contracts for new services with existing customers. We measure TCV as our estimate of the total expected revenue from contracts that are expected to generate revenue in excess of a defined amount during a contract term that exceeds a defined length of time.

Various factors may impact the timing of the signing of contracts with customers, including the complexity of the contract, competitive pressures, and customer demands. As a result, we generally measure our success in this area over a 12-month period because of the significant variations that typically occur in the amount of TCV signed during each quarterly period. During the 12-month period ended December 31, 2008, the amount of TCV signed was $0.9 billion, as compared to $1.8 billion for the 12-month period ended December 31, 2007.

During the second half of 2008, we believe that macroeconomic events caused a reduced level of contract signings as client decision making slowed and sales cycles lengthened. While this limited our 2008 new contract signings, we did not experience the same reduction in total bookings, which remained strong in 2008 and included several contract extensions.

*Additional Measurements*

Both of our primary lines of business have distinct economic factors, business trends, and risks that could affect our results of operations. As a result, in addition to the four metrics discussed above that we use to measure our consolidated financial performance, we use similar metrics for both of these lines of business and for certain industry groups and operating units within these lines of business.

***Comparison of 2008 to 2007***

*Revenue*

Revenue for 2008 increased from 2007 across all segments. Below is a summary of our revenue for 2008 as compared to 2007 (in millions):

| | Year Ended December 31 | | | |
|---|---|---|---|---|
| | 2008 | 2007 | $ Change | % Change |
| Industry Solutions | $ 2,128 | $ 2,060 | $ 68 | 3.3% |
| Government Services | 654 | 554 | 100 | 18.1% |
| Elimination of intersegment revenue | (3) | (2) | (1) | 50.0% |
| Total | $ 2,779 | $ 2,612 | $ 167 | 6.4% |

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We combined our Consulting and Applications Solutions line of business with our Industry Solutions line of business, resulting in a reduction from three segments to two segments: Industry Solutions and Government Services. See Note 15, Segment and Certain Geographic Data, for further discussion.

*Industry Solutions*

The net increase in revenue from the Industry Solutions segment for 2008 as compared to 2007 was primarily attributable to:

- $101 million increase from new contracts signed during 2008 and from new contracts signed in 2007 for which we did not recognize a full year of revenue in 2007. This increase was composed of $68 million and $33 million in revenue from new contracts signed in the Commercial and Healthcare groups, respectively. The services that we are providing to these new customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers.

- $59 million increase from revenue related to acquisitions within our Commercial group during the second quarter, and an acquisition within our Healthcare group during the fourth quarter of 2008, and revenue related to an acquisition during the third quarter of 2007.

- $42 million net increase from existing accounts and short-term project work. This net increase resulted from expanding our base services to existing long-term customers and from providing additional discretionary services to these customers. The discretionary services that we provide, which include short-term project work, can vary from period to period depending on many factors, including specific customer and industry needs and economic conditions.

Partially offsetting these increases was a $134 million decrease in revenue due to the termination of a services agreement in 2007. See Note 13 Customer Contract Termination to the Consolidated Financial Statements.

*Government Services*

The $100 million, or 18.1%, net increase in revenue from the Government Services segment for 2008 as compared 2007 was primarily attributable to the ramp up of new contracts, an increase in base services to existing customers, and to the acquisition of QSS Group, Inc. (QSS) on January 30, 2007. Prior to the acquisition, QSS had recognized $25 million in revenue in the first quarter of 2007. Our business with the federal government will fluctuate due to annual federal funding limits and the specific needs of the federal agencies we serve.

*Domestic Revenue*

Domestic revenue grew by 5.4% in 2008 to $2,423 million from $2,298 million in 2007. The growth in domestic revenue is due to $159 million increase in domestic revenue within our Industry Solutions line of business due to acquisitions, growth in existing accounts, and new contracts signed in 2008 and from new contracts signed in 2007 for which we did not recognize a full year of revenue in 2007, and $100 million increase in domestic revenue within our Government Services line of business due to the ramp up of new contracts, an increase in base services to existing customers, and to the acquisition of QSS on January 30, 2007. Partially offsetting these increases was a $134 million decrease in domestic revenue within our Industry Solutions line of business due to the termination of a customer contract in 2007. See Note 13 Customer Contract Termination to the Consolidated Financial Statements.

*Non-domestic Revenue*

Non-domestic revenue, consisting primarily of European and Asian operations, increased by 13.4% in 2008 to $356 million from $314 million in 2007. The revenue growth was driven by European operations, which generated revenue of $208 million in 2008, as compared to $165 million in 2007. The largest components of our European operations are in the United Kingdom and Germany. In the United Kingdom, revenue for 2008 increased to $123 million from $112 million primarily due to growth of existing accounts. Revenue in Germany increased to $62 million for 2008 from $36 million for 2007 due to growth of existing accounts and our acquisition of HighQ$^{IT}$ for the manufacturing industry GmbH ( HighQ$^{IT}$ ) (See Note 5, Acquisitions ).

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*Gross Margin*

Gross margin, which is calculated as gross profit divided by revenue, for 2008 was 17.5% of revenue, as compared to the gross margin for 2007 of 18.5%. This year-to-year decrease in gross margin was primarily due to the following:

- The termination of a services agreement during 2007, which contributed $46 million of termination-related profit in the fourth quarter of 2007. See Note 13 Customer Contract Termination to the Consolidated Financial Statements.
- Increased incentive compensation, net of amounts reimbursable by our customers, which reduced gross profit by $22 million.
- An $8 million reduction in gross margin for Government Services, primarily attributable to losses on a project that ended during the year, partially offset by profit improvement in outsourcing contracts.

These decreases to gross margin were partially offset by an $81 million improvement in Industry Solutions gross profit due to incremental project work on existing accounts, increasing profitability of outsourcing contracts, the profit impact of new contracts and acquisitions, and profit improvement related to cost reduction activities initiated in the fourth quarter of 2007.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses for 2008 increased 1.0% to $301 million from $298 million in 2007. The increase in SG&A was primarily caused by an increase in employee incentive compensation and other employee related costs, offset by a decrease in SG&A of $18 million associated with cost reduction activities in 2007.

As a percentage of revenue, SG&A for 2008 was 10.8% of revenue, which was slightly lower than SG&A for 2007 of 11.4% of revenue.

*Other Income Statement Items*

Our effective income tax rate for the year ended December 31, 2008, was 37.4% as compared to 36.8% for the year ended December 31, 2007. Income tax expense for 2008 includes a charge to revalue deferred tax assets resulting from the extension of a holiday applicable to our India operations, offset by benefits attributable to our foreign operations. See Note 14, Income Taxes for a further explanation of the effective tax rate.

*Reserves for Uncertain Tax Positions*

As discussed in Note 14, Income Taxes of the Notes to the Consolidated Financial Statements, we adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 as of January 1, 2007. At December 31, 2008, we had gross reserves for uncertain tax positions totaling $16 million. We believe that we will reach resolution within the next 12 months on certain issues under audit by the Internal Revenue Service for tax years ended December 31, 2003 and December 31, 2004. Consequently, we anticipate a change to the total amount of unrecognized tax benefits within the next 12 months, the amount of which cannot be determined at this time.

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***Comparison of 2007 to 2006***

*Revenue*

Revenue for 2007 increased from 2006 across both segments. Below is a summary of our revenue for 2007 as compared to 2006 (in millions):

| | Year Ended December 31 | | | |
|---|---|---|---|---|
| | **2007** | **2006** | **$ Change** | **% Change** |
| Industry Solutions | $ 2,060 | $ 2,009 | $ 51 | 2.5% |
| Government Services | 554 | 291 | 263 | 90.4% |
| Elimination of intersegment revenue | (2) | (2) | | |
| Total | $ 2,612 | $ 2,298 | $ 314 | 13.7% |

We combined our Consulting and Applications Solutions line of business with our Industry Solutions line of business, resulting in a reduction from three segments to two segments: Industry Solutions and Government Services. See Note 15, Segment and Geographic Data, for further discussion.

*Our UBS Relationship*

UBS AG was our largest customer through December 31, 2006. We earned approximately 13.4% of our revenue in connection with services performed on behalf of UBS and its affiliates for 2006. We performed most of our services for UBS under an infrastructure outsourcing contract called the IT Services Agreement, which ended January 1, 2007. During 2006, the amount of annual revenue that we earned from UBS and its affiliates under the IT Services Agreement was $265 million, and the amount of gross profit earned was $58 million. We continue to provide applications services to UBS, which are provided outside the scope of the infrastructure outsourcing contract that ended January 1, 2007.

*Industry Solutions*

The net increase in revenue from the Industry Solutions segment for 2007 as compared to 2006 was primarily attributable to:

$127 million net increase from existing accounts and short-term project work. This net increase resulted from expanding our base services to existing long-term customers and from providing additional discretionary services to these customers. The discretionary services that we provide, which include short-term project work, can vary from period to period depending on many factors, including specific customer and industry needs and economic conditions. This increase was primarily related to contracts in the healthcare industry.

$84 million net increase from a Healthcare client, which includes $59 million of revenue recognized due to the contract termination, (see Note 13 Customer Contract Termination to the Consolidated Financial Statements) and $25 million increase in revenue primarily related to software implementation.

$64 million increase from new contracts signed during 2007 and from new contracts signed in 2006 for which we did not recognize a full year of revenue in 2006. This increase was composed of $35 million, $26 million, and $3 million from new contracts signed in the Commercial, Healthcare, and Insurance and Business Process Solutions groups, respectively. The services that we are providing to these new customers are primarily the same services that we provide to the majority of our other long-term outsourcing customers.

$28 million increase from revenue related to an acquisition within our Healthcare group during the third quarter of 2007.

$13 million increase from revenue related to an acquisition within our Commercial group in the first quarter of 2006. The acquired company is a provider of product engineering outsourcing services.

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Offsetting these increases was a $265 million decrease in revenue from the expiration of our infrastructure outsourcing contract with UBS on January 1, 2007.

*Government Services*

The $263 million, or 90.4%, net increase in revenue from the Government Services segment for 2007 as compared 2006 was primarily attributable to the $260 million in revenue from the acquisition of QSS, an information technology services company providing services to the U.S. federal government. Our business with the federal government will fluctuate due to annual federal funding limits and the specific needs of the federal agencies we serve.

*Domestic Revenue*

Domestic revenue grew by 21.2% in 2007 to $2,298 million from $1,896 million in 2006. Domestic revenue growth for our Industry Solutions segment came primarily from the healthcare industry, where we experienced strong growth from existing accounts and short-term project work, and from acquisitions within our Healthcare and Commercial groups. Offsetting these increases was a decrease in revenue from the expiration of our infrastructure outsourcing contract with UBS on January 1, 2007.

*Non-domestic Revenue*

Non-domestic revenue, consisting primarily of European and Asian operations, decreased by 21.9% in 2007 to $314 million from $402 million in 2006. Asian operations generated revenue of $132 million in 2007 as compared to $135 million in 2006. This decrease was primarily due to the end of the UBS infrastructure outsourcing contract. The largest components of our European operations are in the United Kingdom and Germany. In the United Kingdom, revenue for 2007 decreased to $112 million from $182 million primarily due to the end of the UBS infrastructure outsourcing contract partially offset by increases in revenue from existing accounts and short-term project work. Revenue in Germany increased to $36 million for 2007 from $31 million for 2006. Revenue in Switzerland, which was primarily from the UBS infrastructure outsourcing contract in 2006, decreased to $2 million for 2007 from $34 million for 2006. The UBS infrastructure outsourcing contract ended January 1, 2007.

*Gross Margin*

Gross margin, which is calculated as gross profit divided by revenue, for 2007 was 18.5% of revenue, as compared to gross margin for 2006 of 17.1%. This year-to-year increase in gross margin was primarily due to the following:

During the third quarter of 2006, we modified an existing contract that included both construction services and non-construction services. The construction services related to a software development and implementation project, which was modified to eliminate the fixed-price development and implementation deliverables in the original contract. Following the contract modification in September 2006, we impaired $44 million of the deferred costs and recorded this charge to direct cost of services in the consolidated income statements.

$48 million increase in gross profit related to a client of which $46 million is related to the termination of the services agreement discussed in Note 13 Customer Contract Termination to the Consolidated Financial Statements.

$15 million reduction to employee-related expenses, consisting of incentive compensation.

These improvements to our gross margin were partially offset by:

$58 million decrease in gross profit from the expiration of our infrastructure outsourcing contract with UBS that is reported within the Industry Solutions line of business.

Reduced gross margin for Government Services primarily attributable to the acquisition of QSS. The gross margins associated with the acquisition are typically lower than those we realize within our consolidated margins because of the cost plus nature of their work. Additionally, lower margins were realized within our

Government Services group as a result of contract scope reductions on existing contracts related to federal government budget pressure.

Reductions to gross margin within Industry Solutions as a result of a renegotiated contract that will not reach full levels of profitability until after 2007 and profit pressures from new contracts signed in the last two years.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses for 2007 increased 6.4% to $298 million from $280 million in 2006. The increase resulted primarily from $23 million in SG&A related to our acquisitions in the first and third quarter of 2007 and $18 million recorded in the fourth quarter of 2007 associated with cost reduction activities. These increases were partially offset by a $12 million decrease in associate incentive compensation in 2007. Additionally, 2006 included $5 million of expense related to cost reduction activities and an asset impairment.

As a percentage of revenue, SG&A for 2007 was 11.4% of revenue, which was slightly lower than SG&A for 2006 of 12.2% of revenue. The decrease in SG&A as a percentage of revenue was primarily due to the lower SG&A rate on a business acquired in 2007, the decrease in incentive compensation in 2007 mentioned above, the impact of the $59 million of revenue recognized in the fourth quarter of 2007 as a result of the termination of a services agreement, as discussed in Note 13 Customer Contract Termination to the Consolidated Financial Statements, and the $5 million of expense related to cost reduction activities and an asset impairment recorded in 2006. Partially offsetting these decreases is $18 million of expense recorded in the fourth quarter of 2007 related to cost reduction activities.

*Other Income Statement Items*

Interest income for 2007 decreased by $2 million as compared to 2006 due primarily to lower average balances of cash and cash equivalents and short-term investments during 2007 as compared to 2006. Interest expense for 2007 increased by $6 million as compared to 2006 due primarily to higher debt.

Our effective income tax rate for the year ended December 31, 2007, was 36.8% as compared to 32.5% for the year ended December 31, 2006. The increase in the effective tax rate is primarily due to additional taxes from the expiration of one of our tax holidays in India and higher state income taxes, and is offset by a $2 million tax benefit from the reduction of a valuation allowance against our deferred tax assets in Europe. Income tax expense for 2006 included a greater benefit related to tax-exempt investment income. The increase in effective tax rate from December 31, 2006 to December 31, 2007 is further explained in Note 14, Income Taxes.

**Liquidity and Capital Resources**

At December 31, 2008, we had cash and cash equivalents of $234 million, of which $138 million was held by our foreign subsidiaries. We also had short-term investments of $36 million at December 31, 2008, which were held in the U.S. While we are aware of no restrictions on access to our cash balances in any foreign jurisdiction, it is our intent to permanently reinvest our foreign earnings or to remit such earnings to the U.S. in a tax-free manner, and we do not provide for U.S. income tax on the undistributed earnings of our foreign subsidiaries, as described more fully in Note 14, Income Taxes, to the Consolidated Financial Statements.

During 2008, cash and cash equivalents increased $47 million as compared to decreases of $63 million and $10 million for 2007 and 2006, respectively.

We believe that we will be able to meet our future liquidity and cash needs through a combination of cash flows from operating activities, existing cash balances, our available line of credit, and other financing activities. However, during this current economic downturn, we continue to actively monitor the financial markets. Although the condition of these markets continues to be volatile, we believe we will continue to have access to them if the need arises, although their volatility could directly affect the cost and terms of any future debt financing, which could in turn impact our decisions to make acquisitions, purchase shares of our Class A common stock, or make other investments in our business.

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### Operating Activities

Net cash provided by operating activities was $217 million in 2008 as compared to $118 million in 2007 and $213 million in 2006. The primary reasons for the changes in cash provided by operating activities for these three years are as follows:

Net income was $117 million, $115 million, and $81 million in 2008, 2007, and 2006, respectively. Depreciation and amortization expense, which are non-cash expenses, were $112 million, $104 million, and $79 million in 2008, 2007, and 2006, respectively. The increase in depreciation and amortization expense in 2008 as compared to 2007 and 2006 was due primarily to amortization of deferred contract costs and depreciation and amortization expense on property, equipment, and purchased software. The increased depreciation and amortization expense from property, equipment, and purchased software is associated primarily with acquisitions and our recent data center expansion. The increased amortization of deferred contract costs is primarily associated with transition services and new contract signings.

During 2008, cash provided due to changes in accounts receivables was $24 million, compared to cash used in 2007 and 2006 of $63 million and $49 million, respectively. We typically collect our accounts receivable within 60-65 days, and therefore our accounts receivable balance at the end of each period can change based on the amount of revenue for that period and the timing of collection from our customers, which may vary significantly from period to period.

Cash used in accounts payable and accrued liabilities was $3 million in 2008, and cash provided by accounts payable and accrued liabilities was $4 million and $33 million in 2007 and 2006. This change is primarily due to the timing of vendor payments.

Incentive compensation paid to associates in 2008, 2007, and 2006 (including payments of annual bonuses relating to the prior year s bonus plan) were $34 million, $58 million, and $72 million, respectively. Included in the bonus amounts that were paid in 2008, 2007, and 2006 were approximately $7 million, $4 million, and $24 million, respectively, of bonus payments that are reimbursable by our customers. The amount of bonuses that we pay each year is based on several factors, including our financial performance and management s discretion. The increase in accrued compensation in 2008 primarily represents accrued annual incentive compensation, which is expected to be paid in the first quarter of 2009.

During 2008, 2007, and 2006, we made net cash payments for income taxes of $90 million, $52 million, and $50 million, respectively. Payments remitted in 2008 include amounts attributable to anticipated settlement of issues relating to prior tax periods.

During 2008 and 2007, cash used in other current and non-current assets was $10 million and $1 million. This increase is largely attributable cash payments to customers in the form of a sales incentive. In 2006, cash provided due to changes in other current assets was $1 million.

Deferred revenue received from clients was $12 million in 2008. During 2007, cash used due to changes in deferred revenue was $5 million. During 2007, there was a decrease in deferred revenue from clients as compared to 2006, due primarily to deferred revenue received in 2006 from a client whose services agreement terminated in the fourth quarter of 2007 (see Note 13 Customer Contract Termination to the Consolidated Financial Statements).

During 2008 and 2007, we increased our spending on deferred contract costs as we entered into new contracts that require significant start-up costs in order to perform our contractual obligations.

*Investing Activities*

Net cash used in investing activities was $100 million for 2008 as compared to $298 million for 2007 and $255 million for 2006. These changes in cash used in investing activities were primarily attributable to the following:

During 2008, we purchased $55 million of property, equipment and purchased software as compared to $75 million during 2007 and $93 million during 2006. The increased levels of purchases in 2007 and 2006 were primarily related to our business expansion needs for data center and office facilities.

During 2008, we paid $33 million for acquisitions of businesses, including $14 million, net of cash acquired for the acquisition of HighQ$^{IT}$, $13 million, net of cash acquired for the acquisition of Tellurian Networks, Inc., and $4 million, net of cash acquired for an acquisition completed in the second quarter. Moreover, we paid $4 million additional consideration for the acquisition of eServ LLC ( eServ ), a provider of product engineering outsourcing services, and we benefited from $2 million in adjustments of purchase price adjustments for other acquisitions.

During 2007, we paid $338 million for acquisitions of businesses, including $248 million, net of cash acquired for the acquisition of QSS, $86 million, net of cash acquired for the acquisition of JJ Wild Holdings, Inc. and JJ Wild, Inc., and $4 million of additional consideration for the acquisition of eServ.

During 2006, we paid $29 million for acquisitions of businesses, including $21 million for the acquisition of eServ, and $8 million as additional consideration related to the acquisition of Technical Management, Inc. and its subsidiaries, including Transaction Applications Group, Inc.

During 2008, we made net purchases of $13 million, as compared to liquidated short-term investments of $110 million, net in 2007. During 2006, we made net purchases of $133 million.

*Financing Activities*

Net cash used in financing activities was $51 million for 2008, compared to net cash provided by financing activities of $109 million in 2007 and net cash used in financing activities of $27 million in 2006. During 2008, we paid $34 million against our long-term debt. During 2007, we borrowed $130 million against our credit facility in connection with our acquisitions. We purchased $44 million, $47 million, and $18 million of treasury stock in 2008, 2007, and 2006, respectively.

We routinely maintain cash balances in certain European and Asian currencies to fund operations in those regions. During 2008, foreign exchange rate fluctuations had a net negative impact on our non-domestic cash balances of $19 million, as the U.S. dollar strengthened against the Indian rupee and British Pound. We manage foreign exchange exposures that are likely to significantly impact net income or working capital. At December 31, 2008, we had derivative financial instruments to purchase and sell various currencies in the amount of $192 million, which expire at various times before the end of 2011.

*Contractual Obligations and Contingent Commitments*

The following table sets forth our significant contractual obligations at December 31, 2008, and the effect such obligations are expected to have on our liquidity and cash flows for the periods indicated (in millions):

| | 2009 | 2010-2011 | 2012-2013 | Thereafter | Total |
|---|---|---|---|---|---|
| Operating leases | $ 58 | $ 72 | $ 34 | $ 22 | $ 186 |
| Capital leases | 1 | 1 | | | 2 |
| Debt | 2 | 180 | | | 182 |
| Purchase commitments | 3 | 2 | | | 5 |
| Estimated interest expense on long-term debt | 7 | 6 | | | 13 |
| Total | $ 71 | $ 261 | $ 34 | $ 22 | $ 388 |

We discuss these contractual obligations in Note 9, Debt, and Note 16, Commitments and Contingencies to the Consolidated Financial Statements, which are included herein.

As discussed in Note 5, Acquisitions, to the Consolidated Financial Statements, we may be required to make additional payments related to completed acquisitions of $6 million, $5 million, and $2 million in 2009, 2010, and 2011, respectively. Additional payments are contingent upon the acquired companies achievement of certain financial targets.

*Reserves for Uncertain Tax Positions*

As discussed in Note 14, Income Taxes of the Notes to the Consolidated Financial Statements, we adopted FIN 48 as of January 1, 2007. At December 31, 2008, we had gross reserves for uncertain tax positions totaling $16 million. We believe that we will reach resolution on certain issues under audit by the Internal Revenue Service for tax years ended December 31, 2003 and December 31, 2004. Consequently, we anticipate a change to the total amount of unrecognized tax benefits within the next 12 months, the amount of which cannot be determined at this time.

*Credit Facility*

We currently have a credit facility with a syndicate of banks that allows us to borrow up to $275 million that expires in August 2011. Borrowings under the credit facility will be either through loans or letter of credit obligations. The credit facility is guaranteed by certain of our domestic subsidiaries. In addition, we have pledged a portion of the stock of several of our non-domestic subsidiaries as security on the facility. Interest on borrowings varies with usage and begins at an alternate base rate, as defined in the credit facility agreement, or the LIBOR rate plus an applicable spread based upon our debt/EBITDA ratio applicable on such date. We are also required to pay a facility fee of 0.1% based upon the unused credit commitment and certain other fees related to letter of credit issuance. The credit facility requires certain financial covenants, including a debt/EBITDA ratio and a minimum interest coverage ratio, each as defined in the credit facility agreement. We are in compliance with our debt covenants as of December 31, 2008. We currently have borrowings of $177 million under the credit facility and $98 million available.

***Concentrations of credit risk***

Financial instruments, which potentially subject us to concentrations of credit risk, consist of cash equivalents, short-term investments, and accounts receivable. Our cash equivalents consist primarily of short-term money market deposits, which are deposited with reputable financial institutions. Our short-term investments consist of Variable Rate Demand Notes (VRDN), which are tax-exempt instruments of high credit quality. We believe the risk of loss associated with both our cash equivalents and short-term investments to be remote. We have accounts receivable from customers engaged in various industries including banking, insurance, healthcare, manufacturing, telecommunications, travel and energy, as well as government customers in defense and other governmental agencies, and our accounts receivable are not concentrated in any specific geographic region. These specific industries may be affected by economic factors, which may impact accounts receivable. Generally, we do not require collateral from our customers. We do not believe that any single customer, industry or geographic area represents significant credit risk.

No customer accounted for 10% or more of our total revenue or accounts receivable (including accounts receivable recorded in both accounts receivable, net, and long-term accrued revenue) at December 31, 2008 or at December 31, 2007.

**Critical Accounting Policies**

The Consolidated Financial Statements and Notes to Consolidated Financial Statements contain information that is important to management s discussion and analysis. 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 the disclosure of contingent assets and liabilities.

Critical accounting policies are those that reflect significant judgments and uncertainties and may result in materially different results under different assumptions and conditions. We believe that our critical accounting policies are limited to those described below. For a detailed discussion on the application of these and other accounting policies, see Note 1, Nature of Operations and Summary of Significant Accounting Policies, to the Consolidated Financial Statements.

***Revenue recognition***

We provide services to our customers under contracts that contain various pricing mechanisms and other terms. The fees under these arrangements are generally based on the level of effort incurred in delivering the services, including cost plus and time and materials fee arrangements, on a contracted fixed price for contracted services, or on a contracted per-unit price for each unit of service delivered. These services include infrastructure services, applications services, business process services, and consulting services.

Within these four categories of services, our contracts include non-construction service deliverables, including infrastructure services and business process services, and construction service deliverables, such as application development and implementation services.

Application of the various accounting principles related to the measurement and recognition of revenue requires us to make judgments and estimates. Specifically, complex arrangements with nonstandard terms and conditions may require contract interpretation to determine the appropriate accounting, including whether the deliverables specified in a multiple-deliverable arrangements should be treated as separate units of accounting. Revenue recognized using the percentage-of-completion accounting method requires the use of estimates and judgment as discussed below.

*Accounting for Revenue in Single-Deliverable Arrangements*

Revenue for non-construction service deliverables is recognized as the services are delivered in accordance with SEC Staff Accounting Bulletin No. 104, Revenue Recognition, which provides that revenue should be recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been performed, the fee is fixed or determinable, and collectibility is reasonably assured. Under our policy, persuasive evidence of an arrangement exists when a final understanding between us and our customer exists as to the specific nature and terms of the services that we are going to provide, as documented in the form of a signed agreement between us and the customer.

Revenue for non-construction services priced under fixed-price arrangements is recognized on a straight-line basis over the longer of the term of the contract or the expected service period, regardless of the amounts that can be billed in each period, unless evidence suggests that the revenue is earned or our obligations are fulfilled in a different pattern. If we are to provide a similar level of non-construction services each period during the term of a contract, we would recognize the revenue on a straight-line basis since our obligations are being fulfilled in a straight-line pattern. If our obligations are being fulfilled in a pattern that is not consistent over the term of a contract, then we would recognize revenue consistent with the proportion of our obligations fulfilled in each period. In determining the proportion of our obligations fulfilled in each period, we consider the nature of the deliverables we are providing to the customer and whether the volumes of those deliverables are easily measured, such as when we provide a contractual number of full time equivalent associate resources. If the amount of our obligations fulfilled in each period is not easily distinguished by reference to the volumes of services provided, then we would recognize revenue on a straight-line basis.

Revenue for construction services that do not include a license to one of our software products is recognized in accordance with the provisions of AICPA Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. In general, SOP 81-1 requires the use of the percentage-of-completion method to recognize revenue and profit as our work progresses, and we primarily use hours incurred to date to measure our progress toward completion. This method relies on estimates of total expected hours to complete the construction service, which are compared to hours incurred to date, to arrive at an estimate of how much revenue and profit has been earned to date. Although we primarily measure our progress toward completion using hours incurred to date, we may measure our progress toward completion using costs incurred to date if the construction services involve a significant amount of non-labor costs. Due to the longer term nature of these projects, developing the estimates of costs often requires significant judgment. Factors that must be considered in estimating the progress of work completed and ultimate cost of the projects include, but are not limited to, the availability of labor and labor productivity, the nature and complexity of the work to be performed, and the impact of delayed performance. If changes occur in delivery, productivity or other factors used in developing the estimates of costs or revenues, we revise our cost and revenue estimates, which may result in increases or decreases in revenues and costs, and such revisions are reflected in income in the period in which the facts that give rise to that revision become known.

Revenue for the sale of a license from our software products or the sale of services relating to a software license is recognized in accordance with the provisions of SOP No. 97-2, Software Revenue Recognition. In general, SOP 97-2 addresses the separation and the timing of revenue recognition for software and software-related services, such as implementation and maintenance services. SOP 97-2 also requires the application of the percentage-of-completion method as described in SOP 81-1 for those software arrangements that require significant production, modification, or customization of the software. As a result, the accounting for revenue related to software arrangements includes many of the estimates and significant judgments discussed above.

Revenue for services priced under time and materials contracts and unit-priced contracts is recognized as the services are provided at the contractual unit price.

Revenue for fixed-price contracts with variable components of pricing based on volumes above or below a defined range of volumes is recognized as services are provided at the contractual price.

*Accounting for Revenue in Multiple-Deliverable Arrangements*

For those arrangements that include multiple deliverables, we first determine whether each service, or deliverable, meets the separation criteria of Financial Accounting Standards Board Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. In general, a deliverable (or a group of deliverables) meets the separation criteria if the deliverable has standalone value to the customer and if there is objective and reliable evidence of the fair value of the remaining deliverables in the arrangement. Each deliverable that meets the separation criteria is considered a separate unit of accounting. We allocate the total arrangement consideration to each unit of accounting based on the relative fair value of each unit of accounting. The amount of arrangement consideration that is allocated to a delivered unit of accounting is limited to the amount that is not contingent upon the delivery of another unit of accounting.

After the arrangement consideration has been allocated to each unit of accounting, we apply the appropriate revenue recognition method for each unit of accounting as described previously based on the nature of the arrangement and the services included in each unit of accounting. All deliverables that do not meet the separation criteria of EITF 00-21 are combined into one unit of accounting, and the most appropriate revenue recognition method is applied.

In arrangements for both non-construction and construction services, we may bill the customer prior to performing services, which would require us to record deferred revenue. In other arrangements, we may perform services prior to billing the customer, which could require us to record unbilled receivables or to defer the costs associated with either the non-construction or construction services, depending on the terms of the arrangement and the application of the revenue separation criteria of EITF 00-21.

In certain arrangements we may pay consideration to the customer at the beginning of a contract as an incentive, which is most commonly in the form of cash. This consideration is recorded in other non-current assets on the consolidated balance sheets and is amortized as a reduction to revenue over the term of the related contract.

As a result of our adoption of EITF 00-21 in 2003, we recognized revenue of approximately $6 million, $5 million, and $5 million during the years ended December 31, 2008, 2007, and 2006, respectively, that was recognized prior to 2003 under our accounting for revenue prior to the adoption of EITF 00-21 and was also included in the cumulative effect of a change in accounting principle, which we recorded in the first quarter of 2003.

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### *Contract costs*

Costs to deliver services are expensed as incurred, with the exception of setup costs and the cost of certain construction and non-construction services for which the related revenue must be deferred under EITF 00-21 or other accounting literature. We defer and subsequently amortize certain setup costs related to activities that enable us to provide the contracted services to customers. Deferred contract setup costs may include costs incurred during the setup phase of a customer arrangement relating to data center migration, implementation of certain operational processes, employee transition, and relocation of key personnel. We amortize deferred contract setup costs on a straight-line basis over the lesser of their estimated useful lives or the term of the related contract. Useful lives range from three years up to a maximum of the term of the related customer contract.

For a construction service in a single-deliverable arrangement, if the total estimated costs to complete the construction service exceed the total amount that can be billed under the terms of the arrangement, then a loss would generally be recorded in the period in which the loss first becomes probable. For a construction service in a multiple-deliverable arrangement, if the total estimated costs to complete the construction service exceed the amount of revenue that is allocated to the separate construction service unit of accounting (based on the relative fair value allocation, limited to the amount that is not contingent), then the actual costs incurred to complete the construction service in excess of the allocated fair value would be deferred, up to the amount of the relative fair value, and amortized over the remaining term of the contract. A loss would generally be recorded on a construction service in a multiple-deliverable arrangement if the total costs to complete the service exceed the relative fair value of the service.

Deferred contract costs are evaluated for realizability whenever events or changes in circumstances indicate that the carrying amount may not be realizable. Our evaluation is based on the amount of non-refundable deferred revenue that is related to the deferred contract costs and our projection of the remaining gross profits from the related customer contract. To the extent that the carrying amount of the deferred contract costs is greater than the amount of non-refundable deferred revenue and the remaining net gross profits from the customer contract, a charge is recorded to reduce the carrying amount to equal the amount of non-refundable deferred revenue and remaining gross profits.

### *Year-end bonus plan*

One of our compensation methods is to pay to certain associates a year-end bonus, which is based on associate and team performance, our financial results, and management s discretion. The amount of bonus expense that we record each quarter is based on several factors, including our financial performance for that quarter, our latest expectations for full year results, and management s estimate of the amount of bonus to be paid at the end of the year. As a result, the amount of bonus expense that we record in each quarter and each year can vary significantly.

### *Contingencies*

We account for claims and contingencies in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. FAS 5 requires that we record an estimated loss from a claim or loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. If we determine that it is reasonably possible but not probable that an asset has been impaired or a liability has been incurred or the amount of a probable loss cannot be reasonably estimated, then we may disclose the amount or range of estimated loss if the amount or range of estimated loss is material. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business.

### *Goodwill and other intangibles*

We allocate the cost of acquired businesses to the assets acquired and liabilities assumed based on estimated fair values at the date of acquisition, and any cost of the acquired companies not allocated to assets acquired or liabilities assumed is recorded as goodwill. Goodwill is not amortized, but instead is evaluated at least annually for impairment. Other intangible assets are amortized on a straight-line basis over their estimated useful lives, which range from 12 months to seven years.

Goodwill is tested for impairment annually in the third quarter or whenever an event occurs or circumstances change that may reduce the fair value of the reporting unit below its book value. The impairment test is conducted for each reporting unit in which goodwill is recorded by comparing the fair value of the reporting unit to its carrying value. Fair value is determined primarily by computing the future discounted cash flows expected to be generated by the reporting unit. If the carrying value exceeds the fair value, goodwill may be impaired. If this occurs, the fair value of the reporting unit is then allocated to its assets and liabilities in a manner similar to a purchase price allocation in order to determine the implied fair value of the goodwill of the reporting unit. If the implied fair value is less than the carrying amount of the goodwill of the reporting unit, we would recognize an impairment loss to write down the goodwill to fair value.

The determination of fair value requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. We base our fair value estimates on projected financial information which we believe to be reasonable. However, actual future results may differ from those projections, and those differences may be material. The valuation methodology used to estimate the fair value of our reporting units requires inputs and assumptions that reflect current market conditions as well as management judgment. Future changes in expected operating results or unfavorable changes in other projected financial information used to estimate fair values could result in an impairment of goodwill.

***Income taxes***

We account for income taxes in accordance with FAS No. 109, Accounting for Income Taxes. Under this method, deferred income taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. On a quarterly basis, we evaluate the need for and adequacy of valuation allowances based on the expected realizability of our deferred tax assets and adjust the amount of such allowances, if necessary. The factors used to assess the likelihood of realization include our latest forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Income tax expense consists of our current and deferred provisions for U.S. and foreign income taxes.

We do not provide for U.S. income tax on the undistributed earnings of our foreign subsidiaries. We intend to either permanently invest our foreign earnings or remit such earnings in a tax-free manner. The cumulative amount of undistributed earnings (as calculated for income tax purposes) of our foreign subsidiaries was approximately $199 million at December 31, 2008, $232 million at December 31, 2007, and $182 million at December 31, 2006. Such earnings include pre-acquisition earnings of foreign entities acquired through stock purchases and are intended to be invested outside of the U.S. indefinitely. The ultimate tax liability related to repatriation of our undistributed earnings is dependent upon future tax planning opportunities and is not estimable at the present time.

Effective January 1, 2007, we adopted the FIN 48, which clarifies the accounting for and disclosure of uncertainty in tax positions. Additionally, FIN 48 provides guidance on the recognition, measurement, derecognition, classification and disclosure of tax positions and on the accounting for related interest and penalties. As a result of the adoption of FIN 48, we recognize accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense.

Determining the consolidated provision for income taxes involves judgments regarding the application of tax laws, estimates regarding the ultimate taxability of transactions, and the application of complex tax rules and regulations. As a global company, we are required to provide for income taxes in each of the jurisdictions where we operate, including estimated liabilities for uncertain tax positions. We are subject to income tax audits by federal, state, and foreign tax authorities and we are currently under audit by the Internal Revenue Service and the Indian taxing authorities. We fully cooperate with all audits, but we defend our positions vigorously. Although we believe that we have provided adequate liabilities for uncertain tax positions, the actual liability resulting from examinations by tax authorities could differ from the recorded income tax liabilities and could result in additional income tax expense. Changes to our recorded income tax liabilities resulting from the resolution of tax matters are reflected in income tax expense in the period of resolution. Other factors may cause us to revise our estimates of income tax liabilities including the expiration of statutes of limitations, changes in tax regulations, and tax rulings. Changes in estimates of income tax liabilities are reflected in our income tax provision in the period in which the factors resulting in our change in estimate become known to us. As a result, our effective tax rate may fluctuate on a quarterly basis.

***Financial instruments***

The carrying amounts reflected in our consolidated balance sheets for cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and short-term and long-term debt approximate their respective fair values. Fair values are based primarily on current prices for those or similar instruments.

*Derivative financial instruments*

As part of our risk management strategy, we enter into derivative financial instruments to mitigate certain financial risks related to foreign currencies and interest rates. We have a risk management