BLACKBAUD INC
Form 10-K/A
May 25, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K/A
(Amendment No. 1)

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

For the Fiscal Year ended December 31, 2006

OR

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: 000-50600
Blackbaud, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**11-2617163**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

2000 Daniel Island Drive
Charleston, South Carolina 29492
(Address of principal executive offices, including zip code)
(843) 216-6200
(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
Common Stock, $0.001 Par Value	**The NASDAQ Stock Market LLC (NASDAQ Global Select Market)**

Securities Registered Pursuant to Section 12(g) of the Act: None

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The aggregate market value of the registrant s common stock held by non-affiliates of the registrant on June 30, 2006 (based on the closing sale price of $22.70 on that date), was approximately $981,483,804. Common stock held by each officer and director and by each person known to the registrant who owned 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the registrant s common stock outstanding at February 20, 2007 was 44,328,585.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the 2007 Annual Meeting of Stockholders currently scheduled to be held June 13, 2007 are incorporated by reference into Part III hereof.

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ANNUAL REPORT ON FORM 10-K/A
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EXPLANATORY NOTE

Why we are filing this Amendment to our Form 10-K

We are filing this amendment to our Annual Report on Form 10-K/A for the fiscal year ended December 31, 2006 (2006 Form 10-K) to restate our consolidated financial statements and related disclosures resulting from our misapplication of SEC Staff Accounting Bulletin 108 (SAB 108). During preparation of our Form 10-Q for the quarter ended March 31, 2007, we determined that SAB 108 was misapplied in connection with reporting our consolidated financial position and results of operations as of and for the period ended December 31, 2006. We are restating our consolidated financial statements for December 31, 2006, 2005 and 2004.

We have historically recognized maintenance and subscription revenue using a monthly convention rather than on an actual-days basis. The effect on the statements of operations of the difference between these two methods has been evaluated in the past and it was concluded that the impact was immaterial. However under SAB 108, we should have recorded a one-time adjustment to our retained earnings to correct for the cumulative impact of using the actual-days method.

This amendment includes our restated consolidated balance sheets as of December 31, 2006 and 2005 and our restated statements of operations, stockholders equity and cash flows for the fiscal years ended December 31, 2006, 2005, and 2004 and selected consolidated financial data for the years 2004, 2003 and 2002 presented in Item 6.

The restatement adjustments had the cumulative effect of reducing our retained earnings balance by $1.2 million, increasing our deferred revenue by $2.0 million and increasing our deferred tax asset by $0.8 million, all as of January 1, 2004. In addition, previously reported net income of $30.5 million, $33.3 million and $12.6 million for the years ended December 31, 2006, 2005 and 2004 has been reduced by $0.4 million, $0.2 million and $0.1 million, respectively.

Amended Items of Form 10-K

We are amending the following items of our 2006 Form 10-K:

Part II	Item 6	Selected Financial Data
Part II	Item 7	Management s Discussion and Analysis of Financial Condition and Results of Operations
Part II	Item 8	Financial Statements and Supplementary Data
Part II	Item 9A	Controls and Procedures
Part IV	Item 15	Exhibits and Financial Statement Schedules

All information not affected by the restatement is unchanged

We have not changed any information included in our 2006 Form 10-K that is not affected by the restatement. Accordingly, the information included in our 2006 Form 10-K and included in this amendment that is not affected by the restatement describes conditions as they existed and were presented in the 2006 Form 10-K at the time we filed that report with the Securities and Exchange Commission on February 28, 2007. We have not taken into account any other events occurring after the original filing of our 2006 Form 10-K that might have affected those disclosures, nor have we modified or updated those disclosures.

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Item 6. ***Selected consolidated financial data***

The following selected financial data should be read in conjunction with our consolidated financial statements and related notes thereto and with Management s discussion and analysis of financial condition and results of operations included elsewhere in this Form 10-K/ A. The information presented in the following tables has been adjusted to reflect the restatement of our financial results, which is more fully described in the Explanatory Note of this Form 10-K/ A and in Note 2 Restatement of financial statements in the Notes to the consolidated financial statements. The statements of operations data for each of the years ended December 31, 2003 and 2002 and the balance sheet data at December 31, 2004, 2003 and 2002 are derived from unaudited financial statements not included in this Form 10-K/ A.

	Year Ended December 31, (as restated)				
(In thousands, except per share data)	**2006**	**2005**	**2004**	**2003 (unaudited)**	**2002 (unaudited)**
Consolidated statements of operations data:					
Revenue					
License fees	$ 32,500	$ 29,978	$ 25,387	$ 21,339	$ 20,572
Services	61,242	52,606	42,793	34,263	26,739
Maintenance	80,893	71,163	63,081	56,767	52,702
Subcriptions	10,605	6,965	3,686	1,867	
Other revenue	6,140	5,237	4,316	4,352	5,130
Total revenue	191,380	165,949	139,263	118,588	105,143
Cost of revenue					
Cost of license fees	2,260	4,380	3,545	2,819	2,547
Cost of services(1)	33,717	28,409	22,807	21,006	14,234
Cost of maintenance(1)	13,225	10,926	10,474	11,471	10,588
Cost of subscriptions(1)	2,360	1,472	388	366	
Cost of other revenue	5,709	4,943	3,986	3,712	3,611
Total cost of revenue	57,271	50,130	41,200	39,374	30,980
Gross profit	134,109	115,819	98,063	79,214	74,163
Sales and marketing(1)	41,405	33,491	26,663	23,700	19,173
Research and development(1)	23,118	21,138	17,418	17,857	14,385
General and administrative(1)	21,757	15,795	32,512	31,282	10,631
Amortization	699	18	32	848	1,045
Cost of initial public offering			2,455		
Total operating expenses	86,979	70,442	79,080	73,687	45,234
Income from operations	47,130	45,377	18,983	5,527	28,929
Interest income	1,584	964	331	97	138
Interest expense	(48)	(49)	(272)	(2,559)	(4,410)

Other (expense) income, net	(238)	6	356	235	63
Income before provision for income taxes	48,428	46,298	19,398	3,300	24,720
Income tax provision	18,275	13,211	6,848	3,882	9,130
Net income (loss)	$ 30,153	$ 33,087	$ 12,550	$ (582)	$ 15,590
Earnings (loss) per share					
Basic	$ 0.70	$ 0.78	$ 0.30	$ (0.01)	$ 0.37
Diluted	$ 0.68	$ 0.72	$ 0.27	$ (0.01)	$ 0.37
Common shares and equivalents outstanding					
Basic weighted average shares	43,320	42,559	42,496	42,396	42,360
Diluted weighted average shares	44,668	46,210	46,541	42,396	42,360
Dividends per share	$ 0.28	$ 0.20			

(1) Includes stock-based compensation as set forth in tabular summary of stock-based compensation (benefit) for all periods presented. We adopted SFAS 123(R) on January 1, 2006 using the modified prospective method.

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(In thousands, except per share data)	Year Ended December 31, (as restated) 2006	2005	2004	2003 (unaudited)	2002 (unaudited)
Summary of stock-based compensation (benefit):					
Cost of services	$ 531	$ 269	$ (540)	$ 3,342	$
Cost of maintenance	117	33	(91)	505	
Cost of subscriptions	19				
Total included in cost of revenue	667	302	(631)	3,847	
Sales and marketing	813	217	(112)	1,817	
Research and development	746	139	(457)	2,341	
General and administrative	5,174	(343)	19,579	19,533	
Total included in operating expenses	6,733	13	19,010	23,691	
Total stock-based compensation	$ 7,400	$ 315	$ 18,379	$ 27,538	$

(In thousands, except per share data)	December 31, (as restated) 2006	2005	2004 (unaudited)	2003 (unaudited)	2002 (unaudited)
Consolidated balance sheet data:					
Cash and cash equivalents	$ 67,783	$ 22,683	$ 42,144	$ 6,708	$ 18,703
Deferred tax asset, including current portion	67,620	80,052	88,896	89,514	91,627
Working capital	14,125	(16,866)	(7,542)	(31,540)	(20,107)
Total assets	195,009	148,463	161,640	122,494	133,591
Deferred revenue	76,952	63,222	54,440	45,636	40,841
Total liabilities	99,651	83,711	73,156	63,850	101,194
Common stock	49	48	43	41,613	10,740
Additional paid-in capital	88,409	73,583	55,292		
Total stockholders equity	$ 95,358	$ 64,752	$ 88,484	$ 58,644	$ 32,397

Item 7. ***Management s discussion and analysis of financial condition and results of operations***

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this amended Annual Report on Form 10-K/A. This report contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements reflect our current view with respect to future events and financial performance and are subject to risks and uncertainties, including those set forth under Item 1A, *Risk factors, and elsewhere in this report, that could cause actual results to differ materially from historical results or anticipated results.*

Overview

We are the leading global provider of software and related services designed specifically for nonprofit organizations. Our products and services enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage their finances and optimize internal operations. We have focused solely on the nonprofit market since our incorporation in 1982 and have developed our suite of products and services based upon our extensive knowledge of the operating challenges facing nonprofit organizations. At the end of 2006, we had over 15,500 customers, of which 97% or almost 15,000 pay annual maintenance and support fees. Our customers operate in multiple verticals within the nonprofit market including religion, education, foundations, health and human services, arts and cultural, public and societal benefits, environment and animal welfare, and international and foreign affairs.

We derive revenue from licensing software products and providing a broad offering of services, including consulting, training, installation, implementation, and donor prospect research and modeling services, as well as ongoing customer support and maintenance. Consulting, training and implementation are generally not essential to the functionality of our software products and are sold separately. Accordingly, we recognize revenue from these services separately from license fees.

Critical accounting policies and estimates

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP). The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenue and expenses during the reporting period and related disclosures of contingent assets and liabilities. The most significant estimates and assumptions relate to our revenue recognition, allowance for sales returns and doubtful accounts, impairment of long-lived and intangible assets, stock-based compensation and provision for income taxes and realization of deferred tax assets.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. On an ongoing basis, we reconsider and evaluate our estimates and assumptions. We are not aware of any circumstances in the past, which have caused these estimates and assumptions to be materially wrong. Furthermore, we are not currently aware of any material changes in our business that might cause these assumptions or estimates to differ significantly. In our discussion below of deferred taxes, the most significant asset subject to such assumptions and estimates, we have described the sensitivity of these assumptions or estimates to potential deviations in actual results. Actual results could differ from any of our estimates under different assumptions or conditions.

We believe the critical accounting policies listed below affect significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue recognition

We recognize revenue in accordance with the provisions of the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition, as modified by SOPs 98-4 and 98-9, as well as Technical Practice Aids issued from time to time by the American Institute of Certified Public Accountants, and in accordance with the SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements.

The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. As we develop new products, we may experience difficulty in determining VSOE regarding the fair value of those new products. This would result in the deferral of revenue on those transactions until all elements of the arrangement have been delivered or until VSOE is established.

We recognize revenue from the sale of software licenses when persuasive evidence of an arrangement exists, the product has been delivered, title and risk of loss have transferred to the customer, the fee is fixed or determinable and collection of the resulting receivable is probable. Delivery occurs when the product is delivered. Our typical license agreement does not include customer acceptance provisions; if acceptance provisions are provided, delivery is deemed to occur upon acceptance. We consider the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable with our standard payment terms. We consider payment terms greater than 90 days to be beyond our customary payment terms. If we determine that collection is not probable, we postpone recognition of the revenue until cash collection. We sell software licenses with maintenance and, frequently, professional services. We allocate revenue to delivered components, normally the license component of the arrangement, using the residual value method based on objective evidence of the fair value of the undelivered elements, which is specific to our company. Fair value for the maintenance services associated with our software licenses is based upon renewal rates stated in our agreements, which vary according to the level of the maintenance program. Fair value of professional services and other products and services, which is evaluated at least annually, is based on sales of these products and services to other customers when sold on a stand-alone basis.

We recognize revenue from maintenance services ratably over the contract term, which is usually one year. Maintenance revenue also includes the right to unspecified product upgrades on an if-and-when available basis.

Subscription revenue includes fees for hosted solutions, data enrichment services and hosted online training programs. Subscription-based revenue and any related set-up fees are recognized ratably over the twelve-month service period of the contracts. Hosting revenues are recognized ratably over the thirty-six month period of the hosting contracts.

Our services, which include consulting, installation and implementation services, are generally billed based on hourly rates plus reimbursable travel-related expenses. For small service engagements, less than approximately $10,000, we frequently contract for and bill based on a fixed fee plus reimbursable travel-related expenses. We recognize this revenue upon completion of the work performed. When our services include software customization, these services are provided to support customer requests for assistance in creating special reports and other minor enhancements that will assist with efforts to improve operational efficiency and/or to support business process improvements. These services are not essential to the functionality of our software and rarely exceed three months in duration. We recognize revenue as these services are performed. When we sell hosting separately from consulting, installation and implementation services, we recognize that revenue ratably over the service period.

We sell training at a fixed rate for each specific class, at a per-attendee price, or at a packaged price for several attendees, and revenue is recognized only upon the customer attending and completing training. During the second quarter of 2005, we introduced the Blackbaud Training Pass, which permits customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions. This revenue is recognized ratably over the contract period that is typically one year. We recognize revenue from donor prospect research and data modeling service engagements upon delivery.

To the extent that our customers are billed and/or pay for the above-described services in advance of delivery, the amounts are recorded in deferred revenue.

Sales returns and allowance for doubtful accounts

We provide customers a 30-day right of return and maintain a reserve for returns. We estimate the amount of this reserve based on historical experience and existing economic conditions. Provisions for sales returns are charged against the related revenue items.

We maintain an allowance for doubtful accounts at an amount we estimate to be sufficient to provide adequate protection against losses resulting from extending credit to our customers. In judging the adequacy of the allowance for doubtful accounts, we consider multiple factors including historical bad debt experience, the general economic environment, the need for specific customer reserves and the aging of our receivables. Any necessary provision is reflected in general and administrative expense. A considerable amount of judgment is required in assessing these factors and if any receivables were to deteriorate, an additional provision for doubtful accounts could be required.

Valuation of long-lived and intangible assets and goodwill

We review identifiable intangible and other long-lived assets for impairment when events change or circumstances indicate the carrying amount may not be recoverable. Events or changes in circumstances that indicate the carrying amount may not be recoverable include, but are not limited to, a significant decrease in the market value of the business or asset acquired, a significant adverse change in the extent or manner in which the business or asset acquired is used or significant adverse change in the business climate. If such events or changes in circumstances are present, the undiscounted cash flow method is used to determine whether the asset is impaired. Cash flows would include the estimated terminal value of the asset and exclude any interest charges. To the extent that the carrying value of the asset exceeds the

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undiscounted cash flows over the estimated remaining life of the asset, the impairment is measured using discounted cash flows. The discount rate utilized would be based on our best estimate of the related risks and return at the time the impairment assessment is made.

In accordance with Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets, we test goodwill for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test compares the fair value of the reporting unit with its carrying amount. If the carrying amount exceeds its fair value, impairment is indicated. All of the goodwill is assigned to the various reporting units.

Stock-based compensation

Effective January 1, 2006, we adopted the provisions of the Financial Accounting Standards Board s (FASB) SFAS Statement No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)), using the modified prospective application method. SFAS No. 123(R) replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. Under the modified prospective application method, prior periods are not revised for comparative purposes. The provisions of SFAS No. 123(R) apply to grants made after the adoption date and existing grants which were partially unvested at that date. Compensation expense for grants outstanding on the date of adoption is being recognized over the remaining service period using the grant date fair values and amortization methods determined previously for the SFAS No. 123 pro forma disclosures.

Prior to January 1, 2006, we accounted for stock-based compensation under APB No. 25, which provided that no compensation expense should be recorded for stock options or other stock-based awards to employees that are granted with an exercise price that is equal to or greater than the estimated fair value per share of our common stock on the grant date of the award. Certain of our option grants were accounted for as variable awards under the provisions of APB No. 25, which required us to record deferred compensation, and recognize compensation expense over the requisite vesting period, for the difference between the exercise price and the fair market value of the stock at each reporting date.

The adoption of SFAS No. 123(R) resulted in the reclassification of approximately $6.5 million of unamortized deferred compensation to additional paid-in capital that had previously been subject to variable accounting under APB No. 25, and a nominal cumulative effect adjustment to apply an assumed forfeiture rate to expense previously taken on options unvested as of the date of adoption, which was recorded in general and administrative expense. The adoption of SFAS 123(R) did not cause us to modify any existing awards, change any terms of existing awards, or otherwise modify our share-based compensation plans.

The adoption of SFAS No. 123(R) had a material impact on our consolidated balance sheets, consolidated statements of operations and consolidated statements of cash flows. See Note 12 of our consolidated financial statements for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods under the provisions of SFAS No. 123. No new stock options were issued in the year ended December 31, 2006. The fair value of options issued in prior periods was determined using the Black-Scholes option-pricing model.

The fair value of our restricted stock awards was determined by using the closing price of the Company s shares, as traded on the Nasdaq Global Select Market on the date of the grant.

The fair value of our stock appreciation rights (SARs), which were granted for the first time in 2006, was determined using the Black-Scholes option-pricing model. See Note 12 of our consolidated financial statements for further information regarding SARs.

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We have separately disclosed stock-based compensation throughout this discussion and in our consolidated financial statements because, in managing our operations, we believe such costs significantly affect our ability to better understand and manage other operating expenses and cash needs.

Provision for income tax and valuation of deferred tax assets

We account for income taxes using the asset and liability approach as prescribed by SFAS Statement No. 109, Accounting for Income Taxes. This approach requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the consolidated financial statements or income tax returns. Using the enacted tax rates in effect for the year in which we expect the differences to reverse, we determine deferred tax assets and liabilities based on the differences between the financial reporting and the tax basis of an asset or liability. We record a valuation allowance when it is more likely than not that the deferred tax asset will not be realized.

Significant judgment is required in determining our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in a net deferred tax asset, which is included on our consolidated balance sheets. The final tax outcome of these matters might be different than that which is reflected in our historical income tax provisions, benefits and accruals. Any difference could have a material effect on our income tax provision and net income in the period in which such a determination is made.

Prior to October 13, 1999, we were organized as an S corporation under the Internal Revenue Code and, therefore, were not subject to federal income taxes. In addition, we were not subject to income tax in many of the states in which we operated as a result of our S corporation status. We historically made distributions to our stockholders to cover the stockholders anticipated tax liability. In connection with a recapitalization agreement (See Note 1 to the consolidated financial statements), we converted our U.S. taxable status from an S corporation to a C corporation. Accordingly, since October 14, 1999, we have been subject to federal and state income taxes. Upon the conversion and in connection with the recapitalization, we recorded a one-time benefit of $107.0 million to establish a deferred tax asset as a result of the recapitalization agreement.

We must assess the likelihood that the net deferred tax asset will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance; we must include an expense within the tax provision in the statement of operations. Except with respect to certain state income tax credits as discussed in Note 1 of these consolidated financial statements, we have not recorded a valuation allowance as of December 31, 2006 and 2005, because we expect to be able to utilize our entire net deferred tax asset. The ability to utilize our net deferred tax asset is solely dependent on our ability to generate future taxable income. Based on current estimates of revenue and expenses, we expect future taxable income will be more than sufficient to recover the annual amount of additional tax deductions permitted. Even if actual results are significantly below our current estimates, the recovery still remains likely and no valuation allowance would be necessary.

Significant judgment is required in determining the provision for income taxes. To the extent that the final results differ from these estimated amounts that were initially recorded, such differences will impact the income tax provision in the period in which such determination is made and could have an impact on the deferred tax asset. Our deferred tax assets and liabilities are recorded at an amount based upon a blended U.S. federal income tax rate of 34.9%. This U.S. federal income tax rate is based on our expectation that our deductible and taxable temporary differences will reverse over a period of years during which, except for 2006 due to stock option exercises and other reductions to income, we will have annual taxable income exceeding $10.0 million per year. If our results of operations fall below that threshold in the future, we will adjust our deferred tax assets and liabilities to an amount reflecting a reduced expected U.S. federal income tax rate, consistent with the corresponding expectation of lower taxable income.

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Contingencies

We are subject to the possibility of various loss contingencies in the normal course of business. We accrue for loss contingencies when a loss is estimable and probable.

The following table sets forth our statements of operations data expressed as a percentage of total revenue for the periods indicated.

Consolidated statements of operations, percent of revenue

	Year ended December 31,		
	2006	**2005**	**2004**
Revenue			
License fees	17.0%	18.1%	18.2%
Services	32.0	31.7	30.7
Maintenance	42.3	42.9	45.3
Subscriptions	5.5	4.2	2.7
Other revenue	3.2	3.1	3.1
Total revenue	100.0%	100.0%	100.0%
Cost of revenue			
Cost of license fees	1.2	2.6	2.5
Cost of services	17.6	17.1	16.4
Cost of maintenance	6.9	6.6	7.5
Cost of subscriptions	1.2	0.9	0.3
Cost of other	3.0	3.0	2.9
Total cost of revenue	29.9	30.2	29.6
Gross profit	70.1	69.8	70.4
Operating expenses			
Sales and marketing	21.6	20.2	19.2
Research and development	12.1	12.8	12.5
General and administrative	11.4	9.5	23.3
Amortization	0.4	0.0	0.0
Cost of initial public offering	0.0	0.0	1.8
Total operating expenses	45.5	42.5	56.8
Income from operations	24.6	27.3	13.6
Interest income	0.8	0.6	0.2
Interest expense	0.0	0.0	(0.2)
Other (expense) income, net	(0.1)	0.0	0.3
Income before provision for income taxes	25.3	27.9	13.9
Income tax provision	9.5	8.0	4.9
Net income	15.8%	19.9%	9.0%

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Comparison of years ended December 31, 2006, 2005 and 2004
Revenue

(in millions)	2006	2005	2004	2006 versus 2005 Change	2006 versus 2005 % Change	2005 versus 2004 Change	2005 versus 2004 % Change
Revenue							
License fees	$ 32.5	$ 30.0	$ 25.4	$2.5	8%	$4.6	18%
Services	61.2	52.6	42.8	8.6	16%	9.8	23%
Maintenance	80.9	71.2	63.1	9.7	14%	8.1	13%
Subscriptions	10.6	6.9	3.7	3.7	54%	3.2	86%
Other revenue	6.2	5.2	4.3	1.0	19%	0.9	21%
Total revenue	$ 191.4	$ 165.9	$ 139.3	$25.5	15%	$26.6	19%

The increase in revenue in both years is due to growth in services and license fees to new customers as well as the introduction of new product offerings. Also contributing to the growth is revenue from new maintenance contracts associated with license agreements and revenue from our subscription offerings, which includes hosting revenues. The following sections discuss the components of revenue.

License fees

Revenue from license fees is derived from the sale of our software products, typically under a perpetual license agreement. License fee revenue growth in 2006, which is primarily volume driven, is attributable to a $2.7 million increase in product sales to new customers, including those obtained in the acquisition of Campagne Associates, Ltd., offset by a $0.2 million decrease in sales to existing clients. The decrease in sales to existing clients is the result of discontinuing our reseller sales channel which principally impacted sales of our financial products. License fee growth in 2005 is comprised of $2.5 million in sales to new clients and $2.1 million in sales to existing clients. Included in this growth is $1.0 million of incremental revenue resulting from sales of our Patron Edge ticketing product that more than doubled compared to the prior year.

Services

Revenue from services includes fees received from customers for consulting, installation, implementation, training, donor prospect research and data modeling services. The rates charged for our service offerings have remained relatively constant over 2006, 2005 and 2004 and, as such, the revenue increases are primarily due to volume of services provided. The following table shows the contribution of the different services to the total services revenue.

(in millions)	2006	2005	2004	Percentage of total services revenue 2006	2005	2004
Consulting, installation and implementation services	$ 36.5	$ 30.9	$ 23.2	60%	59%	54%
Donor prospect research and data modeling services	7.5	5.7	5.1	12%	11%	12%
Education services	17.2	16.0	14.5	28%	30%	34%
Total services revenue	$ 61.2	$ 52.6	$ 42.8	100%	100%	100%

Consulting, installation and implementation services involve converting data from a customer s existing system, assistance in file set up and system configuration, and/or process re-engineering. Donor prospect research and data modeling services involve the performance of assessments of customer donor (current and prospective) information, the end product of which enables the customer to more effectively target its fundraising activities. These assessments are performed using our proprietary analytical tools. Education services involve customer training activities.

Revenue from services increased 16% in 2006 compared to 2005. This increase is comprised of a $5.6 million increase in consulting, installation and implementation services delivered, a $1.8 million increase in donor prospect research and data modeling services delivered and a $1.2 million increase in education services delivered. Revenue from services increased 23% in 2005 compared to 2004. This increase is comprised of a $7.7 million increase in consulting, installation and implementation services delivered, a $0.6 million increase in donor prospect research and data modeling services delivered and a $1.5 million increase in education services delivered.

Maintenance

Revenue from maintenance is comprised of annual fees derived from maintenance contracts associated with new software licenses and annual renewals of existing maintenance contracts. These contracts provide customers updates, enhancements, upgrades to our software products and online, telephone and email support. The maintenance revenue increase during 2006 is comprised primarily of $8.2 million of new maintenance contracts associated with new license agreements, including new products, $2.8 million from maintenance contract inflationary rate adjustments, and $1.5 million from maintenance agreements associated with customers acquired as part of the purchase of Campagne Associates, Ltd., offset by $2.8 million in reductions and maintenance contracts that were not renewed. The maintenance revenue increase during 2005 is principally the result of $10.1 million of new maintenance contracts associated with new license agreements, and $1.9 million from inflationary rate adjustments, offset by $4.0 million in reductions and non-renewals of maintenance contracts.

Subscriptions

Revenue from subscriptions is principally comprised of revenue from hosting our software applications for customers, certain data services, our online subscription training offerings and our hosted Internet fundraising application. The increase in subscriptions revenue in 2006 over 2005 is comprised primarily of a $1.1 million increase in revenue from our hosted Internet fundraising application, a $1.0 million increase in revenue from our online analytics products and a $0.9 million increase in revenue from our software hosting activities. Other subscription revenue contributed $0.5 million of the increase, of which $0.2 million related to Campagne products. The increase in 2005 was primarily due to a $1.7 million increase in revenue from our online analytics products, a $1.2 million increase from our hosted Internet fundraising application, a $0.4 million increase in revenue from our online education services products and a $0.2 million increase in revenue from our software hosting activities.

Other revenue

Other revenue includes the sale of business forms that are used in conjunction with our software products; reimbursement of travel-related expenses, primarily incurred during the performance of services at customer locations; fees from user conferences; and sale of hardware in conjunction with The Patron Edge. Other revenue increased in 2006 primarily due to a $0.4 million increase in reimbursable travel-related costs from our services businesses and a $0.2 million increase from the sale of business forms. Other revenue increased in 2005 due to greater reimbursable travel-related costs from our services businesses.

Stock-based compensation

Beginning on January 1, 2006, we adopted SFAS No. 123(R), using the modified prospective transition method. The adoption of SFAS No. 123(R) had a significant impact on our results of operations. Prior to the adoption of SFAS No. 123(R), we accounted for options under APB No. 25. Because of certain provisions in certain of the option agreements, we were required to account for these options under variable accounting. Variable accounting requires marking these options to the market price on the reporting date and recognizing a corresponding expense or benefit in the financial statements, which can cause significant fluctuations in compensation expense and resulted in a significant decrease in stock-based compensation in 2005 compared to 2004.

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Our consolidated statements of operations for the years ended December 31, 2006, 2005 and 2004 includes $7.4 million, $0.3 million and $18.4 million of stock-based compensation expense, respectively, illustrated below:

	Years ended December 31,		
(in thousands)	**2006**	**2005**	**2004**
Cost of services	$ 531	$ 269	$ (540)
Cost of maintenance	117	33	(91)
Cost of subscriptions	19		
Sales and marketing	813	217	(112)
Research and development	746	139	(457)
General and administrative	5,174	(343)	19,579
Total	$ 7,400	$ 315	$ 18,379

We have separately disclosed stock-based compensation throughout this discussion and in our consolidated financial statements and we have shown a reconciliation of stock-based compensation as it relates to all affected categories of expenses above. We have discussed our segment costs on a basis excluding stock-based compensation, because we believe this presentation allows investors better understandability and comparability of our operating expenses.

Cost of revenue

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of license fees	$ 2.3	$ 4.4	$ 3.5	$(2.1)	(48)%	$0.9	26%
Cost of services	33.7	28.4	22.8	5.3	19 %	5.6	25%
Cost of maintenance	13.2	10.9	10.5	2.3	21 %	0.4	4%
Cost of subscriptions	2.4	1.5	0.4	0.9	60 %	1.1	275%
Cost of other revenue	5.7	4.9	4.0	0.8	16 %	0.9	23%
Total cost of revenue	$ 57.3	$ 50.1	$ 41.2	$ 7.2	14 %	$8.9	22%

The increase in cost of revenue in 2006 is due primarily to increased headcount as we continue to grow our business to meet customer demand. The following sections discuss the components of cost of revenue.

Cost of license fees

Cost of license fees includes third-party software royalties, variable reseller commissions and costs of shipping software products to our customers. The decrease in cost of license fees in 2006 was primarily due to reduced reseller commissions that have declined by $1.6 million as a result of the discontinued use of that sales channel. Incremental royalty payments for The Patron Edge software of $1.1 million were the largest factor in the increase in cost of license fees in 2005 over 2004.

Cost of services

Cost of services is principally comprised of salary and benefits, including stock-based compensation charges, third-party contractor expenses, data expenses and classroom rentals. Additionally, cost of services includes an allocation of facilities and depreciation expense and other costs incurred in providing consulting, installation, implementation, donor prospect research and data modeling services and customer training. During 2006, salaries, benefits and bonus expense increased $3.2 million as we increased headcount to meet growing customer demand. Other increases include increased travel-related expense and

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services from contractors totaling $0.9 million, increases in recruiting and relocation costs totaling $0.2 million and higher training class costs of $0.2 million. Additionally, stock-based compensation increased $0.3 million. During 2005, salaries, benefits and bonus expense increased $3.7 million related to increased headcount. Additionally, stock-based compensation increased $0.8 million and costs of providing services, such as data expenses and classroom rental costs, rose $0.5 million.

To provide more insight into our services business, we discuss costs of services at the business component level. For additional presentation of these and other segments, see Note 15 to the consolidated financial statements.

Cost of consulting and education services

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of consulting and education services	$ 29.7	$ 24.4	$ 19.5	$5.3	22%	$4.9	25%
Percentage of related revenue	55%	52%	52%				
Stock-based compensation included in cost of consulting and education services	0.5	0.2	(0.4)	$0.3	150%	$0.6	150%
Cost of consulting and education services, excluding stock-based compensation	$ 29.2	$ 24.2	$ 19.9	$5.0	21%	$4.3	22%
Percentage of related revenue	54%	52%	53%				

Cost of revenue in providing consulting, installation, implementation and customer training (consulting and education services) increased $4.9 million during 2006, excluding stock-based compensation. This increase was primarily due to an increase in salary, benefit and bonus expense of $3.4 million as we added headcount to meet increased customer demand for these services. Other increases include increased travel-related expense and services from contractors totaling $0.8 million, recruiting and relocation costs totaling $0.2 million and higher training class costs of $0.2 million. The increases in salary, benefits and bonus and outside consultant costs contributed to the margin compression experienced in 2006 compared to 2005. During 2005, despite headcount additions, margins improved as we recognized operational efficiencies and education services experienced a shift in our training mix to higher margin regional training classes.

Cost of analytic services

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of analytic services	$ 4.0	$ 4.0	$ 3.3	$	0%	$0.7	21%
Percentage of related revenue	53%	70%	65%				
Stock-based compensation included in cost of analytic services			(0.2)	$		$0.2	100%
Cost of analytic services, excluding stock-based compensation	$ 4.0	$ 4.0	$ 3.5	$	0%	$0.5	14%
Percentage of related revenue	53%	70%	69%				

During 2006, the cost of revenue in providing donor prospect research and data modeling services (analytic services) remained relatively flat improving margins as we recognized efficiencies and were able to deliver more services with a nominal increase in headcount. During 2005 and 2004, the variable costs of data used to perform analytics, as well as a higher mix of more expensive data relating to our WealthPoint offerings, caused margin compression in both years. Also driving up costs during these periods was increased headcount needed to meet the demand for analytic services.

Cost of maintenance

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of maintenance	$ 13.2	$ 10.9	$ 10.5	$2.3	21%	$0.4	4%
Percentage of related revenue	16%	15%	17%				
Stock-based compensation included in cost of maintenance	0.1		(0.1)	$0.1		$0.1	100%
Cost of maintenance excluding stock-based compensation expense	$ 13.1	$ 10.9	$ 10.6	$2.2	20%	$0.3	3%
Percentage of related revenue	16%	15%	17%				

Cost of maintenance is primarily comprised of human resource costs, including stock-based compensation, third-party contractor expenses, third-party royalty costs and data expenses, an allocation of our facilities and depreciation expenses, and other costs incurred in providing support and services to our customers. As compared with 2005, the cost of maintenance increase in 2006 is principally the result of a $1.5 million increase in salary, benefit and bonus expense due to increased headcount required to support the higher volumes of these services, and a $0.7 million increase in royalty payments related to our Patron Edge product based on maintenance revenue. During 2005, the cost of maintenance increase was primarily comprised of a $0.7 million increase in salary, benefit and bonus expense due to increased headcount required to support the higher volumes of these services offset by a $0.3 million decrease in third-party royalty costs, data expenses and other expenses.

Cost of subscriptions

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of subscriptions	$ 2.4	$ 1.5	$ 0.4	$0.9	60%	$1.1	275%
Percentage of related revenue	22%	22%	11%				

Cost of subscriptions is primarily comprised of human resource costs, including an insignificant amount of stock-based compensation, third-party royalty and data expenses, hosting expenses, an allocation of our facilities and depreciation expenses, and other costs incurred in providing support and services to our customers. During 2006, the cost of subscriptions increased primarily due to an increase in salary, benefit and bonus expense, which increased $0.7 million as we increased headcount to support growing customer demand. During 2005, the cost of subscriptions increased primarily due to increases in data expense and hosting costs totaling $0.8 million reflecting the investments made as we introduced new subscription products in 2005.

Cost of other revenue

	2006 versus 2005		2005 versus 2004	

(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Cost of other revenue	$ 5.7	$ 4.9	$ 4.0	$0.8	16%	$0.9	23%
Percentage of related revenue	90%	94%	93%				

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Cost of other revenue includes salaries and benefits, costs of business forms, reimbursable expense relating to the performance of services at customer locations and an allocation of facilities and depreciation expenses. The absolute dollar increase in 2006 is due to the increase in reimbursable expenses related to providing services at clients sites. The margin increase is due primarily to decreases in conference costs and salaries, benefits and bonus expense totaling $0.3 million. The absolute dollar increase as well as the margin decrease in 2005 was due to the increase in reimbursable expenses relating to providing services at clients sites.

Operating expenses

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Sales and marketing	$ 41.4	$ 33.5	$ 26.7	$7.9	24%	$6.8	25%
Research and development	23.1	21.1	17.4	2.0	9%	3.7	21%
General and administrative	21.8	15.8	32.5	6.0	38%	(16.7)	(51)%
Amortization	0.7			0.7			
Cost of initial public offering			2.5			(2.5)	(100)%
Total operating expenses	$ 87.0	$ 70.4	$ 79.1	$16.6	24%	$(8.7)	(11)%

Sales and marketing

				2006 versus 2005		2005 versus 2004	
(in millions)	**2006**	**2005**	**2004**	**Change**	**% Change**	**Change**	**% Change**
Sales and marketing	$ 41.4	$ 33.5	$ 26.7	$7.9	24%	$6.8	25%
Percentage of total revenue	22%	20%	19%				
Stock-based compensation included in sales and marketing	0.8	0.2	(0.1)	$0.6	300%	$0.3	(300)%
Sales and marketing excluding stock-based compensation expense	$ 40.6	$ 33.3	$ 26.8	$7.3	22%	$6.5	24%
Percentage of total revenue	21%	20%	19%				

Sales and marketing expenses include salaries and related human resource costs, travel-related expenses, sales commissions, advertising and marketing materials, public relations and an allocation of facilities and depreciation expenses. Both years increased costs are due to higher commissions paid related to higher commissionable sales in each year as well as increases in the size and skill set of our sales force. During 2006 and 2005, salaries, benefits and bonus expenses increased $3.4 million and $2.9 million, respectively, related to increased headcount. Commissions increased $1.9 and $2.3 million during 2006 and 2005, respectively. During 2006, travel-related expenses increased $0.8 million, marketing costs increased $0.6 million and recruiting and relocation costs increased $0.1 million. During 2005, travel-related expenses increased $0.4 million and marketing costs increased $0.4 million.

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Research and development

(in millions)	2006	2005	2004	2006 versus 2005 Change	2006 versus 2005 % Change	2005 versus 2004 Change	2005 versus 2004 % Change
Research and development	$ 23.1	$ 21.1	$ 17.4	$2.0	9%	$3.7	21%
Percentage of total revenue	12%	13%	12%				
Stock-based compensation included in research and development	0.7	0.1	(0.5)	$0.6	600%	$0.6	(120)%
Research and development excluding stock-based compensation expense	$ 22.4	$ 21.0	$ 17.9	$1.4	7%	$3.1	17%
Percentage of total revenue	12%	13%	13%				

Research and development expenses include salaries and related human resource costs, third-party contractor expenses, software development tools, an allocation of facilities and depreciation expenses and other expenses in developing new products and upgrading and enhancing existing products. During 2006, the increase in research and development costs is primarily due to a $1.7 million increase in salaries, benefits and bonus expenses associated with increased headcount as development projects with offshore contractors ended and additional staffing was needed to develop new product offerings internally. Additionally stock-based compensation increased $0.6 million. These increases were offset by a $0.3 million decrease in outside contractor expenses as a result of the development projects with offshore contractors ending. In 2005, we incurred increased salaries, benefits and bonus expenses of $2.0 million related to headcount increases as well as a $0.6 million increase in stock-based compensation. Also, outside contractor costs grew $0.8 million with increased outsourced development costs. Those expense increases were associated with enhancements to our existing products.

General and administrative

(in millions)	2006	2005	2004	2006 versus 2005 Change	2006 versus 2005 % Change	2005 versus 2004 Change	2005 versus 2004 % Change
General and administrative	$ 21.8	$ 15.8	$ 32.5	$6.0	38%	$(16.7)	(51)%
Percentage of total revenue	11%	10%	23%				
Stock-based compensation included in general and administrative	5.2	(0.3)	19.6	$5.5	(1833)%	$(19.9)	(102)%
General and administrative excluding stock-based compensation expense	$ 16.6	$ 16.1	$ 12.9	$0.5	3%	$3.2	25%
Percentage of total revenue	9%	10%	9%				

General and administrative expenses consist primarily of salaries and related human resource expenses for general corporate functions, including finance, accounting, legal, human resources, facilities and corporate development, third-party professional fees, insurance, and other administrative expenses. During 2006, general and administrative expenses increased $0.5 million excluding the impact of stock-based compensation. This increase was primarily driven by a $0.9 million increase in salaries, benefits and bonus expenses associated with additional headcount offset by a $0.4 million decrease in expenses associated with Sarbanes-Oxley Act of 2002 compliance and costs to recruit a successor Chief Executive Officer. General and administrative expenses were $3.2 million higher in 2005 compared to 2004 excluding the impact of stock-based compensation as we incurred an additional $1.3 million in expenses related to Sarbanes-Oxley Act of 2002 compliance, $0.2 million of insurance, and $0.4 million in attorney and audit fees associated with operating as a public company. Also we had a $1.6 million increase in employee-related and general operational expenses to support our growth, partially offset by reduced bad debt expense of $0.5 million.

Costs of initial public offering

The costs of our initial public offering, which were $2.5 million during 2004, include professional fees such as attorney and accountant fees, printing costs and filing fees.

Interest expense

Interest expense was less than $0.1 million in 2006 and 2005 compared to $0.3 million in 2004. The decrease in interest expense is directly related to repayment of our term loan early in 2004 and no subsequent borrowing.

We expect interest expenses to increase in 2007 due to the utilization of the credit facility in January 2007 in the amount of $30.0 million. See the discussion in Liquidity and capital resources below for additional information regarding the credit facility.

Other (expense) income

Other (expense) income consists of foreign exchange gains or losses and miscellaneous non-operating income and expense items. Other (expense) income, from foreign exchange (losses) or gains in each year, was $(0.2) million in 2006, a nominal amount in 2005 and $0.4 million in 2004.

Income tax provision

We record income tax expense in our consolidated financial statements based on an estimated annual effective income tax rate. We had an effective tax rate of 37.7%, 28.5% and 35.3% in 2006, 2005 and 2004, respectively. In 2005, the lower effective tax rate was attributable to recognizing the benefit of certain state income tax credits.

Significant judgment is required in determining the provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We account for income taxes using the asset and liability approach as prescribed by SFAS No. 109, Accounting for Income Taxes. This approach requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the consolidated financial statements or income tax returns. Using the enacted tax rates in effect for the year in which the differences are expected to reverse, deferred tax assets and liabilities are determined based on the differences between the financial reporting and the tax basis of an asset or liability. A valuation allowance is recorded when it is more likely than not that the deferred tax asset will not be realized. If a change in the effective tax rate to be applied to the timing differences or a change in a valuation reserve is determined to be appropriate, it will affect the provision for income taxes during the period that the determination is made.

In 2006, we increased our deferred tax asset valuation allowance by $0.1 million for state credits that are expected to expire unused.

In 2005, we recognized an income tax