

COMPUTER SOFTWARE INNOVATIONS INC

Form 424B3

August 14, 2006

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**PROSPECTUS SUPPLEMENT NO. 10**

**Filed Pursuant to Rule 424(b)(3)**

**To Prospectus dated February 14, 2006**

**Registration No. 333-129842**

**Computer Software Innovations, Inc.**

**15,295,728 SHARES OF COMMON STOCK**

This Prospectus Supplement supplements the Prospectus dated February 14, 2006, as amended and supplemented, relating to the offer and sale by the selling stockholder identified in the Prospectus of up to 15,295,728 shares of common stock of Computer Software Innovations, Inc. (the Company ).

This Prospectus Supplement includes the Company's Quarterly Report on Form 10-QSB (without exhibits) filed with the Securities and Exchange Commission on August 14, 2006. Part II, Item 5 of the Form 10-QSB includes an update to the risk factors in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

The information contained in the report included in this Prospectus Supplement is dated as of the period of such report. This Prospectus should be read in conjunction with the Prospectus dated February 14, 2006, as supplemented on March 31, 2006, April 20, 2006, April 24, 2006, May 3, 2006, May 5, 2006, May 15, 2006, June 23, 2006, July 14, 2006 and July 19, 2006, which supplements are to be delivered with this Prospectus Supplement. This Prospectus Supplement is qualified by reference to the Prospectus except to the extent the information in this Prospectus Supplement updates and supersedes the information contained in the Prospectus dated February 14, 2006, including any supplements or amendments thereto.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this Prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this Prospectus Supplement No. 10 is August 14, 2006

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB**

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(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2006.

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**

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

Commission file number 000-51758

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**COMPUTER SOFTWARE INNOVATIONS, INC.**

(Name of Small Business Issuer as Specified in Its Charter)

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**Delaware**  
(State or Other Jurisdiction of

Incorporation or Organization)

**98-0216911**  
(I.R.S. Employer

Identification No.)

900 East Main Street, Suite T

Easley, South Carolina 29640

(864) 855-3900

(Address and Telephone Number of Principal Executive Offices and Principal Place of Business)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 3,405,680 as of August 10, 2006.

Transitional Small Business Disclosure Format (Check one): Yes  No

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****COMPUTER SOFTWARE INNOVATIONS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)**

|   | Three Months Ended |              | Six Months Ended |              |
|---|--------------------|--------------|------------------|--------------|
|   | June 30,           | June 30,     | June 30,         | June 30,     |
|   | 2006               | 2005         | 2006             | 2005         |
| <b>REVENUES</b>   |                    |              |                  |              |
| Software applications segment   | \$ 1,446,005       | \$ 1,142,039 | \$ 2,550,077     | \$ 2,128,788 |
| Technology solutions segment  | 10,718,231         | 6,156,389    | 14,456,562       | 9,261,944    |
| Net sales and service revenue   | 12,164,236         | 7,298,428    | 17,006,639       | 11,390,732   |
| <b>COST OF SALES</b>  |                    |              |                  |              |
| <i>Software applications segment</i>                                  |                    |              |                  |              |
| Cost of sales excluding depreciation, amortization and capitalization | 691,312            | 499,477      | 1,165,567        | 1,005,915    |
| Depreciation  | 17,885             | 6,689        | 36,285           | 14,715       |
| Amortization of capitalized software costs                            | 207,751            | 121,049      | 358,760          | 254,672      |
| Capitalization of software costs                                      | (407,816)          | (125,813)    | (589,591)        | (327,074)    |
| Total software applications segment cost of sales                     | 509,132            | 501,402      | 971,021          | 948,228      |
| <i>Technology solutions segment</i>                                   |                    |              |                  |              |
| Cost of sales excluding depreciation                                  | 9,251,524          | 4,250,616    | 12,106,832       | 6,729,104    |
| Depreciation  | 28,469             | 8,539        | 50,069           | 17,834       |
| Total technology solutions segment cost of sales                      | 9,279,993          | 4,259,155    | 12,156,901       | 6,746,938    |
| Total cost of sales   | 9,789,125          | 4,760,557    | 13,127,922       | 7,695,166    |
| Gross profit  | 2,375,111          | 2,537,871    | 3,878,717        | 3,695,566    |
| <b>OPERATING EXPENSES</b>   |                    |              |                  |              |
| Salaries and wages and benefits (excluding stock-based compensation)  | 894,324            | 773,474      | 1,665,539        | 1,375,865    |
| Stock based compensation  | 81,258             |              | 695,212          | 631,174      |
| Reverse acquisition costs   |                    |              |                  | 759,283      |
| Professional and legal compliance and litigation costs                | 86,034             | 220,303      | 430,888          | 220,303      |
| Marketing costs   | 59,952             |              | 149,856          |              |
| Travel and mobile costs   | 149,815            | 90,168       | 232,260          | 152,394      |
| Depreciation  | 41,513             | 14,772       | 76,624           | 27,451       |
| Other selling, general and administrative expenses                    | 210,051            | 183,337      | 303,588          | 323,568      |
| Total operating expenses  | 1,522,947          | 1,282,054    | 3,553,967        | 3,490,038    |
| Operating income  | 852,164            | 1,255,817    | 324,750          | 205,528      |
| <b>OTHER INCOME (EXPENSE)</b>   |                    |              |                  |              |
| Interest income   | 819                |              | 3,000            | 6,023        |
| Interest expense  | (96,592)           | (77,198)     | (188,977)        | (90,202)     |

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|   |                 |                  |                  |                    |
|---|-----------------|------------------|------------------|--------------------|
| Amortization of loan fees                         |                 |                  | (17,458)         | (24,442)           |
| Gain (loss) on disposal of property and equipment |                 |                  |                  | 100                |
| Unrealized loss on warrants                       |                 | (108,267)        |                  | (3,193,188)        |
| <b>Net other income (expense)</b>                 | <b>(95,773)</b> | <b>(185,465)</b> | <b>(203,435)</b> | <b>(3,301,709)</b> |
| Income (loss) before income taxes                 | 756,391         | 1,070,352        | 121,315          | (3,096,181)        |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>               | <b>248,567</b>  | <b>481,762</b>   | <b>43,023</b>    | <b>(1,235,328)</b> |
| <b>NET INCOME (LOSS)</b>                          | <b>507,824</b>  | <b>588,590</b>   | <b>78,292</b>    | <b>(1,860,853)</b> |
| <b>BASIC EARNINGS (LOSS) PER SHARE</b>            | <b>\$ 0.15</b>  | <b>\$ 0.22</b>   | <b>\$ 0.03</b>   | <b>\$ (0.71)</b>   |
| <b>DILUTED EARNINGS (LOSS) PER SHARE</b>          | <b>\$ 0.05</b>  | <b>\$ 0.05</b>   | <b>\$ 0.01</b>   | <b>\$ (0.71)</b>   |
| <b>WEIGHTED AVERAGE SHARES OUTSTANDING:</b>       |                 |                  |                  |                    |
| Basic   | 3,340,004       | 2,631,786        | 3,119,657        | 2,631,786          |
| Diluted   | 11,362,728      | 12,474,658       | 11,262,792       | 2,631,786          |

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

**Table of Contents****COMPUTER SOFTWARE INNOVATIONS, INC.****CONSOLIDATED BALANCE SHEETS**

|  | June 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| <b>CURRENT ASSETS</b>  |                                 |                      |
| Cash   | 334,310                         | \$ 5,891,950         |
| Accounts receivable, net   | 9,726,406                       | 5,891,950            |
| Inventories  | 15,197                          |                      |
| Prepaid expenses   | 97,700                          | 70,962               |
| Taxes receivable   | 272,532                         | 192,918              |
| Total current assets   | 10,446,145                      | 6,155,830            |
| <b>PROPERTY AND EQUIPMENT, net</b>   | <b>718,671</b>                  | <b>411,835</b>       |
| <b>COMPUTER SOFTWARE COSTS, net</b>  | <b>1,254,485</b>                | <b>983,654</b>       |
| <b>OTHER ASSETS</b>  | <b>55,737</b>                   | <b>22,475</b>        |
|  | <b>\$ 12,475,038</b>            | <b>\$ 7,573,794</b>  |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)</b>   |                                 |                      |
| <b>CURRENT LIABILITIES</b>   |                                 |                      |
| Accounts payable   | \$ 4,822,768                    | \$ 2,349,785         |
| Deferred revenue   | 2,530,429                       | 1,498,418            |
| Deferred tax liability   | 415,082                         | 298,764              |
| Bank line of credit  | 1,842,000                       | 1,701,000            |
| Current portion of note payable  | 100,000                         |                      |
| Subordinated notes payable to shareholders   | 2,250,400                       | 2,250,400            |
| Total current liabilities  | 11,960,679                      | 8,098,367            |
| <b>NOTE PAYABLE, less current portion</b>  | <b>265,428</b>                  |                      |
|  | <b>12,226,107</b>               | <b>8,098,367</b>     |
| <b>SHAREHOLDERS EQUITY (DEFICIT)</b>   |                                 |                      |
| Common stock - \$0.001 par value; 40,000,000 shares authorized; 3,369,030 shares issued and outstanding    | 3,369                           | 2,632                |
| Preferred stock - \$0.001 par value; 15,000,000 shares authorized; 7,012,736 shares issued and outstanding | 7,013                           | 7,218                |
| Additional paid-in capital   | 6,005,049                       | 5,111,736            |
| Retained earnings (deficit)  | (5,567,867)                     | (5,646,159)          |
| Unearned stock compensation  | (198,633)                       |                      |
| Total shareholders equity (deficit)  | 248,931                         | (524,573)            |
|  | <b>\$ 12,475,038</b>            | <b>\$ 7,573,794</b>  |

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





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|  | Common          |                 | Additional          | Retained              | Unearned            |                   |
|--|-----------------|-----------------|---------------------|-----------------------|---------------------|-------------------|
|  | Stock           | Preferred       | Paid-In             | Earnings              | Stock               | Total             |
|  | Stock           | Stock           | Capital             | (Deficit)             | Compensation        | Total             |
| <b>Balances at December 31, 2005</b>                     | \$ 2,632        | \$ 7,218        | \$ 5,111,736        | \$ (5,646,159)        | \$                  | \$ (524,573)      |
| Barron's conversion of preferred stock into common stock | 205             | (205)           |                     |                       |                     |                   |
| Stock based compensation                                 | 532             |                 | 893,313             |                       | (198,633)           | 695,212           |
| Net income for six months ended June 30, 2006            |                 |                 |                     | 78,292                |                     | 78,292            |
| <b>Balances at June 30, 2006</b>                         | <b>\$ 3,369</b> | <b>\$ 7,013</b> | <b>\$ 6,005,049</b> | <b>\$ (5,567,867)</b> | <b>\$ (198,633)</b> | <b>\$ 248,931</b> |

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

**Table of Contents****COMPUTER SOFTWARE INNOVATIONS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

|  | <b>Six Months Ended</b>  |                          |
|--|--------------------------|--------------------------|
|  | <b>June 30,<br/>2006</b> | <b>June 30,<br/>2005</b> |
| <b>OPERATING ACTIVITIES</b>  |                          |                          |
| Net income (loss)  | \$ 78,292                | \$ (1,860,853)           |
| Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities |                          |                          |
| Depreciation and amortization  | 539,196                  | 314,672                  |
| Stock compensation expense, net  | 695,212                  | 631,174                  |
| Deferred income taxes  | 116,318                  | (1,209,508)              |
| Gain on disposal of fixed assets   |                          | (100)                    |
| Unrealized loss on financial instrument  |                          | 3,193,188                |
| Changes in deferred and accrued amounts  |                          |                          |
| Accounts receivable  | (3,834,456)              | (3,465,393)              |
| Inventories  | (15,197)                 | (168,729)                |
| Prepaid expenses and other assets  | (44,196)                 | (28,043)                 |
| Accounts payable   | 2,472,983                | 810,892                  |
| Deferred revenue   | 1,032,011                | 885,947                  |
| Taxes payable (receivable)   | (79,614)                 | (325,054)                |
| Net cash provided by (used for) operating activities   | 960,549                  | (1,221,807)              |
| <b>INVESTING ACTIVITIES</b>  |                          |                          |
| Purchase of property and equipment   | (469,814)                | (93,278)                 |
| Capitalization of computer software  | (589,591)                | (327,074)                |
| Purchase of computer software  | (40,000)                 |                          |
| Trademarks   | (33,262)                 |                          |
| Net cash used for investing activities   | (1,132,667)              | (420,352)                |
| <b>FINANCING ACTIVITIES</b>  |                          |                          |
| Net borrowings under line of credit  | 141,000                  | 1,051,000                |
| Borrowings under note payable  | 400,000                  |                          |
| Repayments of note payable   | (34,572)                 |                          |
| Payment of debt issuance costs   |                          | (83,800)                 |
| Proceeds from notes payable to shareholders  |                          | 1,875,200                |
| Repayments under notes payable to shareholders   |                          | (1,500,000)              |
| Dividends paid   |                          | (3,460,000)              |
| Redemption of stock options  |                          | (899,144)                |
| Purchase of VerticalBuyer shell  |                          | (415,024)                |
| Payments for purchase of stock from shareholders   |                          | (3,624,800)              |
| Proceeds from issuance of preferred stock and related warrants                                     |                          | 5,042,250                |
| Net cash provided by (used for) financing activities   | 506,428                  | (2,014,318)              |
| Net increase (decrease) in cash and cash equivalents   | 334,310                  | (3,656,477)              |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>  |                          | <b>3,656,477</b>         |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>  | <b>\$ 334,310</b>        | <b>\$</b>                |

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:**

Cash paid during the period for:

|              |            |            |
|--------------|------------|------------|
| Interest     | \$ 304,554 | \$ 12,512  |
| Income Taxes | \$ 6,318   | \$ 308,500 |

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

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***COMPUTER SOFTWARE INNOVATIONS, INC.***

***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***

***(UNAUDITED)***

**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACTIVITIES**

**Description of business and disclosure regarding segments**

Computer Software Innovations, Inc. ( CSI, Company, we or us ) develops software and provides hardware-based technology solutions. We monitor our business results as two segments, the software applications segment and the technology solutions segment, but operate the business collectively, taking advantage of cross-selling and integration opportunities. By strategically combining our internally developed software with our ability to integrate computer and other hardware, we have been successful in providing a variety of technological solutions to over 400 clients located in South Carolina, North Carolina and Georgia. We are pursuing a national presence with a primary, initial focus on the southeast region of the United States. Our client base consists primarily of municipalities, school districts and local governments, although we continue to expand the products and services we can provide to corporate and other non-governmental entities.

Our internally developed software consists of fund accounting based financial management software and standards based lesson planning software. Our primary software product, fund accounting based financial management software, is developed for those entities which track expenditures and investments by fund, or by source and purpose of funding. Our fund accounting software is used primarily by public sector and not-for-profit entities. In September 2005, we acquired a standards based lesson planning software. The software is designed to allow education professionals to create, monitor and document lesson plans and their compliance with a state s curriculum standards. Our results of operations related to our internally developed software, including an allocation of overheads are reported through our software applications segment.

Our technology solutions are provided to more than 200 organizations. These solutions include, among other capabilities, planning, installation and management of computer, telephone, wireless, video conference, security monitoring and distance and classroom learning projects. The technology solutions segment also provides subsequent support, monitoring and maintenance of equipment and systems. We have established associations with some of the largest vendors in the industry and others whom we believe offer innovative products. The results of operations related to our technology solutions, including an allocation of overheads, are reported under technology solutions segment.

**Organization**

CSI (formerly VerticalBuyer, Inc.), a Delaware corporation, was incorporated on September 24, 1999. The Company currently trades in the over the counter market and is reported on the OTC Bulletin Board under the symbol CSWI.OB.

In the first quarter of 2005, we concluded a series of recapitalization transactions which began January 31, 2005 with a change in control due to the purchase of a majority of our common stock by Computer Software Innovations, Inc., a South Carolina corporation since 1989 ( CSI South Carolina ). These transactions culminated on February 11, 2005 with the merger of CSI South Carolina into us, our issuance of preferred stock, common stock, warrants and certain subordinated notes, and the change of our name to Computer Software Innovations, Inc. We refer to the Company prior to such merger as VerticalBuyer.

The series of transactions was accounted for as a reverse acquisition, in accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 141, Business Combinations, with CSI South Carolina being designated for accounting purposes as the acquirer, and the surviving corporation, VerticalBuyer, Inc., being designated for accounting purposes as the acquiree. The assets of CSI South Carolina as the accounting acquirer were recorded at their historical costs. The assets and liabilities of VerticalBuyer as the acquiree would have been recorded at fair value, but no assets or liabilities existed at the date of acquisition; accordingly, no goodwill was recorded in connection with the reverse acquisition. Costs associated with the reverse merger were expensed as incurred. Shares issued in the transaction are shown as outstanding for all periods presented and our activities are included only from the date of the transaction forward. Shareholders equity of CSI South Carolina, after giving effect for differences in par value, has been carried forward after the transaction.

**Basis of presentation**

The consolidated financial statements include the accounts of Computer Software Innovations, Inc., and CSI Technology Resources, Inc., a wholly-owned subsidiary. CSI Technology Resources, Inc. was acquired by CSI on May 1, 2000 and became the technology services division of CSI through which its activities were reported for approximately one year. This subsidiary no longer has any significant operations or separate

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accounting, as all activities are now accounted for within CSI, except that certain vendor contracts are still in the name of CSI Technology Resources, Inc. At a future date, the name on

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these contracts may be converted and the subsidiary deactivated, subject to a review of any tax or legal implications. The consolidated balance sheet and the related consolidated statements of operations, changes in shareholders' equity (deficit) and cash flows are unaudited. Intercompany balances and transactions have been eliminated. The Company uses the accrual basis of accounting. In our opinion, all adjustments (consisting of normal recurring adjustments) necessary for fair presentation of the interim financial statements have been made. The results of the six month period ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the consolidated financial statements, critical accounting policies, significant accounting policies and the notes to the consolidated financial statements included in our most recent annual report on Form 10-KSB.

**NOTE 2 EARNINGS (LOSS) PER SHARE**

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common stock shares outstanding during the period. Diluted earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common and potential common shares outstanding during the period. The weighted average number of common stock shares outstanding was 3,340,004 and 2,631,786 for the quarters ended June 30, 2006 and 2005. The weighted average number of common and potential common shares outstanding for the quarter ended June 30, 2006 was 11,362,728 (consisting of 3,340,004 shares outstanding and shares underlying the preferred stock, warrants and options of 7,012,736, 760,105, and 249,883, respectively) and 11,262,792 for the six months ended June 30, 2006 (consisting of 3,119,657 shares outstanding and shares underlying the preferred stock, warrants and options of 7,085,361, 807,584, and 250,190, respectively). The shares underlying the outstanding warrants and options of 7,217,736 and 268,343, respectively, were outstanding for the quarter and the six months ended June 30, 2006 and are reduced by application of the treasury stock method which assumes the proceeds from the exercise of the warrants and options are used to buy back shares off the market thereby reducing the number of outstanding shares for the earnings per share calculation. The weighted average number of common and potential common shares outstanding for the quarter ended June 30, 2005 was 12,474,658 (consisting of 2,631,786 shares outstanding and shares underlying preferred stock, warrants and options of 7,217,736, 2,369,361, and 255,775, respectively) and 12,379,346 for the six months ended June 30, 2005 (consisting of 2,631,786 shares outstanding and shares underlying the preferred stock, warrants and options of 7,217,736, 2,274,294, and 255,530, respectively). The shares underlying the outstanding warrants and options of 7,217,736 and 268,343, respectively, were assumed outstanding for the quarter ended and six months ended June 30, 2005 and are reduced by application of the treasury stock method. Generally accepted accounting principles ( GAAP ) require that in the case of thinly traded stock, management assess, among other factors, whether the market quoted price is representative of the price which would be effective were all shares issued in connection with various transactions, which would include the issuance of significant additional shares in dilutive transactions. Following consultation with accounting and valuation experts and applying the principle of conservatism, which is a basis of the dilution calculation under GAAP, management uses the higher of a cashflow based stock value computation based on comparisons to peer public companies, or the quoted market price, on a weighted average basis, for the repurchase of shares in the diluted earnings per share calculation. Once management, in consultation with its accounting and financial experts considers the stock no longer thinly traded, management will use the quoted market price exclusively.

The common and potential common shares are used in the calculation of diluted earnings per share for the quarter and six months ended June 30, 2006. For the quarter ended June 30, 2005, the potential common shares were used in the calculation of diluted earnings per share, while for the six months end June 30, 2005 they were not, as their effect would have been anti-dilutive due to the net loss reported for that period.

**NOTE 3 ACQUISITION AND MERGER**

In the first quarter of 2005, we concluded a series of recapitalization transactions which began January 31, 2005 with a change in control due to the purchase of a majority of our common stock by Computer Software Innovations, Inc., a South Carolina corporation, ( CSI - South Carolina ). These transactions culminated on February 11, 2005 with the merger of CSI - South Carolina into us, and our issuance of preferred stock, common stock, warrants and certain subordinated notes.

The significant merger related cash activity in the order it occurred is as follows:

|   |              |
|---|--------------|
| Purchase of VerticalBuyer shell company <sup>(1)</sup>  | \$ (415,024) |
| CSI - South Carolina redemption of options for common stock   | (899,144)    |
| Initial cash payment of portion of CSI - South Carolina \$3,460,000 dividends declared to shareholders  | (960,000)    |
| Proceeds from sale of warrants in merger  | 5,042,250    |
| Proceeds from issuance of subordinated note to Barron Partners, LP ( Barron )                           | 1,875,200    |
| Payment of remaining outstanding dividends declared, from preferred stock and warrant proceeds          | (2,500,000)  |
| Payment on first of the two sets of subordinated notes issued to shareholders in connection with merger | (3,624,800)  |

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|   |                       |
|---|-----------------------|
| Payment of debt issuance costs for \$3,000,000 revolving credit facility                              | (83,800)              |
| Initial borrowings under revolving credit facility  | 1,500,000             |
| Payment on second set of shareholder (\$1,875,200) and Barron s (1,875,200) notes, from loan proceeds | (1,500,000)           |
| <b>Net effect of merger transactions on cash, and cash used for financing activities</b>              | <b>\$ (1,565,318)</b> |

- <sup>(1)</sup> The net cash purchase cost of VerticalBuyer consisted of an agreed to purchase price of \$450,000 and legal costs of approximately \$20,000, net of \$50,000 waived reimbursement for the advisory fee previously paid by Barron to Maximum Ventures as earnest money and a \$5,000 allowance from Maximum Ventures to defray a portion of the estimated costs of preparation of tax returns for 2001, 2002, 2003 and 2004 and accountant fees for the 2004 audit.

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In addition to the cash used for the purchase of Vertical Buyer and other financing activities related to the merger, the Company incurred approximately \$700,000 in legal and professional fees, which were expensed.

The above transactions are described in more detail below.

*Change of Control.* On January 31, 2005, approximately 77% of the ownership of the Company, known then as VerticalBuyer, Inc. ( VerticalBuyer or VBYS ) which had been maintained as a corporate shell since it discontinued operations in September 2001, was acquired by CSI South Carolina for \$415,024.

*Reverse Stock Split.* On January 31, 2005, the board of directors of VerticalBuyer approved a 40 to 1 consolidation of shares or reverse stock split of its common stock in contemplation of a potential merger of VBYS with CSI South Carolina. The reverse stock split was paid effective February 11, 2005 to shareholders of record as of February 10, 2005. Pursuant to the reverse stock split, every 40 shares of the VBYS common stock issued and outstanding on the record date was converted and combined into one share of post-split shares. The par value of all shares of common stock was maintained at \$0.001 per share. No fractional shares were issued, nor was any cash paid in lieu thereof. Rather, all fractional shares were rounded up to the next higher number of post-split shares and the same issued to any beneficial holder of such post-split shares which would have resulted in fractional shares. Accordingly, each beneficial holder of the common stock had the right to receive at least one post-split share.

*Redemption of Options.* Prior to the merger, CSI South Carolina, for \$899,144, redeemed options to purchase 738,195 shares, as allowed for under a stock option plan which had provided to certain non-executive employees options to purchase 1,065,746 shares of common stock. The 738,195 non-executive employees options redeemed represented 73.34% of the 1,006,538 options outstanding at the time of the merger. Pursuant to the plan, the option holders retained the remaining portion of their options.

*Declaration of Dividends.* Prior to the merger, CSI South Carolina also declared dividends to its five shareholders totaling \$3,460,000, of which \$960,000 was paid immediately in cash and \$2.5 million was recorded as subordinated dividend notes payable to each stockholder. These subordinated dividend notes payable were paid subsequent to the closing of the transaction and prior to March 31, 2005 from the proceeds of the issuance of preferred stock and warrants discussed below.

*Name Change.* On February 10, 2005, VBYS changed its name from VerticalBuyer, Inc to Computer Software Innovations, Inc.

*Merger Agreement.* On February 10, 2005, VBYS entered into an Agreement and Plan of Merger (the Merger Agreement ) with CSI South Carolina. The Merger Agreement provided that, upon the terms and conditions set forth in the agreement, CSI South Carolina would merge into VerticalBuyer, with VerticalBuyer continuing as the surviving corporation. The merger and related transactions were consummated on February 11, 2005 via the surrender (and cancellation) of CSI South Carolina s shares in VerticalBuyer, representing 77% ownership of the common stock of VerticalBuyer before the merger, and an exchange by the five shareholders of CSI South Carolina of their shares in CSI South Carolina for shares in the surviving corporation representing 96% ownership in VerticalBuyer (now known as CSI) following the merger, and the issuance of notes payable to the shareholders, and cash (as detailed below).

SFAS 141 states that, In identifying the acquiring entity in a combination effected through an exchange of equity interests, all pertinent facts and circumstances should be considered, and includes the following as significant factors in the decision process: which of the combining entities owners as a group retain the larger portion of voting rights, composition of the governing body and senior management positions, and the terms of the exchange of equity securities.

Following the merger, the former majority shareholders of CSI South Carolina as a group held 96% of the voting stock of the Company, occupied two of five board seats with the remaining three seats being filled by independent directors, and retained senior management positions of the combined company. Preferred stock issued subsequent to the merger sold to assist with the payment for shares and dividends payable to the CSI South Carolina shareholders, cannot be converted to common stock in excess of 4.9% ownership, except in the event of a change in control, defined as (i) a consolidation or merger of our company with or into another company or entity in which we are not the surviving entity, or (ii) the sale of all or substantially all of the assets of our company to another company or entity not controlled by our then existing stockholders



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in a transaction or series of transactions. We are obligated to give Barron (or any subsequent holder of preferred stock) thirty days notice prior to a change in control. In addition, the preferred stock has no voting rights (except under limited circumstances under Delaware law) and generally no provisions granting rights with respect to governance of the Company. Accordingly, under SFAS No. 141 the merger of CSI South Carolina into us was considered to be a reverse acquisition, where by CSI South Carolina is considered to be the acquirer even though it is not the surviving corporation. Accordingly, the assets and liabilities of CSI South Carolina continued to be recorded at their actual cost. The assets and liabilities of VerticalBuyer would have been recorded at fair value, but no assets or liabilities existed at the time of acquisition; therefore no goodwill is recorded. Under reverse acquisition accounting, the financial statements of the surviving corporation (VerticalBuyer) are the financial statements of the acquirer (CSI South Carolina). Costs associated with the reverse acquisition are expensed as incurred. Shares issued in the transaction are shown as outstanding for all periods presented and our activities (activities of VerticalBuyer) are included only from the date of the transaction forward. Shareholders' equity of CSI - South Carolina, after giving effect for differences in par value, has been carried forward after the acquisition.

Pursuant to the Merger Agreement, in the merger and related CSI South Carolina dividend transactions, the former shareholders of CSI South Carolina received, in exchange for their shares of common stock, approximately \$6.7 million of cash, subordinated notes aggregating approximately \$2.3 million and 2,526,905 shares of common stock of the Company. The shares of VerticalBuyer's common stock previously held by CSI South Carolina, representing approximately 77 percent of VerticalBuyer's issued and outstanding capital stock, were cancelled, as was the common stock of CSI South Carolina. The remaining shareholders of VerticalBuyer retained their existing shares, subject to the 40 to 1 reverse stock split.

*Preferred Stock Purchase Agreement.* In connection with the merger, CSI entered into a Preferred Stock Purchase Agreement dated February 10, 2005 (the Preferred Stock Agreement) with Barron, whereby CSI agreed to issue 7,217,736 shares of its newly created Series A convertible, non-voting preferred stock to Barron in exchange for payment of \$5,042,250. Each share of preferred stock is convertible into one share of common stock, subject to certain anti-dilution adjustments. The proceeds of the preferred stock issuance were used to pay the outstanding dividends as declared by CSI South Carolina and a portion of the subordinated notes. Barron has agreed, generally, not to convert at any time its preferred stock into shares of the Company common stock or exercise its warrants to purchase shares of common stock if and to the extent that Barron's beneficial ownership of CSI common stock would exceed 4.9%, except in the case of a change in control as discussed previously.

*Warrants.* Pursuant to the Preferred Stock Agreement, Barron was issued two warrants to purchase 7,217,736 shares of CSI's common stock (the Warrant Shares). The respective exercise prices of the warrants are \$1.3972 and \$2.0958 per share, with each warrant exercisable for half of the total Warrant Shares. The terms and conditions of the warrants are identical except with respect to exercise price. Barron has agreed, generally, not to convert at any time its preferred stock into shares of the Company common stock or exercise its warrants to purchase shares of common stock if and to the extent that Barron's beneficial ownership of CSI common stock would exceed 4.9%, except in the case of a change in control as discussed previously.

*Subordinated Promissory Notes.* In connection with the merger and sale of preferred stock, CSI issued six subordinated promissory notes payable, respectively, to Barron and the five former shareholders of CSI South Carolina. All such notes rank equally in right of payment in the event of bankruptcy or liquidation of CSI, or similar events, and are subordinated in right of payment to all other non-subordinated debt of CSI. Payments of principal and interest may be paid as agreed under such subordinated notes so long as, generally, CSI is not in default under any of its senior indebtedness.

The Barron note provides that CSI will pay to Barron \$1,875,200, with interest accruing at the prime rate plus two percent (10.25% as of June 30, 2006). Any past due and unpaid amounts bear interest at the rate of 15% per annum until paid in full. The amount outstanding under this note totaled \$1,125,200 at June 30, 2006.

The aggregate principal sum borrowed under the notes payable by CSI to the five former shareholders of CSI South Carolina is \$1,875,200, or \$375,040 per individual. Other than the principal amount, the terms of the notes are substantially identical to the note payable to Barron. Amounts outstanding under these notes totaled \$1,125,200 at June 30, 2006.

The principal on these notes was to be paid in full on or before May 10, 2006. In consultation with its board of directors, senior debt holders, and the holders of these notes, the Company determined it was not in the best interest of all parties to pay these notes at maturity; accordingly, the Company's interest cost on the notes has increased to 15% per annum. See Item 2. Management's Discussion and Analysis or Plan of Operation under Credit Arrangements for a further discussion of the subordinated notes. From discussions with the holders of the subordinated notes, we anticipate that they will continue to cooperate with the Company in formulating a new repayment schedule, later payment date or some other resolution. Such notes are also subordinated to our senior debt, and we believe the ability of the subordinated debt holders to have direct



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recourse against the Company is currently limited. However, the holders of the subordinated notes may take actions that could adversely affect the Company, including taking legal or other adverse collection actions against the Company, or acting to accelerate the subordinated debt, thereby potentially triggering a default under our credit facility with our bank. We have received a waiver from our bank for any potential default which might have been triggered by our decision not to pay the subordinated notes on their due date.

Also in connection with the merger, CSI issued five promissory notes payable to the five former shareholders of CSI South Carolina as additional consideration related to the equity exchange totaling \$3,624,800. These amounts were paid immediately following the merger from proceeds from the issuance of the preferred stock and warrants and the \$1,875,200 subordinated note issued to Barron.

*Merger Expenses and Other.* Expenses for the merger consisted of legal and professional fees, commissions and compensation expense related to the merger. Of the \$759,283 in fees paid, \$275,000 was paid to a third-party broker, Liberty Company, LLC, as a commission for its assistance in the preferred stock sale and warrant issuance. No commission was paid to Barron, the investment group which purchased the preferred stock and received the warrants. The remaining fees of \$484,283 consisted of merger related fees paid principally for legal and accounting services.

**NOTE 4 STOCK-BASED COMPENSATION AND SUBSEQUENT EVENT**

The Company has a stock based compensation plan, the 2005 Incentive Compensation Plan, as of June 30, 2006. The Company accounts for stock based compensation using the fair value method prescribed in SFAS No. 123 (revised 2004), Share-Based Payment, and related interpretations. The Company utilizes the Black-Scholes model to estimate the fair value of the shares granted.

In 2005, the Company assumed the stock based employee compensation plan of CSI- South Carolina as a result of the merger as described below.

At the time of the merger, the CSI South Carolina plan provided for the granting of options to purchase common stock, with a maximum term of ten years, at the option price on the date of grant. Management determined at the time of grant whether options vested immediately or at the end of a three year vesting period. Under the plan, employees had been granted options for 1,065,746 shares, of which 59,208 options were cancelled and 1,006,538 were outstanding under the plan at the time of merger.

In connection with and immediately prior to the merger with VerticalBuyer, CSI South Carolina redeemed options to purchase 797,403 shares for \$899,144 pursuant to the terms of the plan. Under such plan, certain non-executive employees had been awarded options to purchase 1,065,746 shares of common stock. The 797,403 non-executive employees options redeemed represented 73.34% of the 1,006,538 options outstanding at the time of the merger. Compensation expense related to the early redemption of stock options was \$631,174, consisting of the \$899,144 cash payment less unearned compensation expense of \$267,970 eliminated upon the redemption. Employer FICA and Medicare, and additional expenses related to this transaction totaling \$47,766, were also paid by CSI South Carolina. Pursuant to the plan, the option holders retained the remaining 268,343 options. The board of directors of the surviving corporation, CSI, at its discretion, provided that the options would be assumed and exercisable for shares of CSI common stock at the exchange ratio applicable to the five CSI South Carolina shareholders in the merger. No additional options will be issued under this fixed stock option plan.

The fair value of options was estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants in 2003: dividend rate of zero percent for all years, risk-free interest rate of 4.8 percent, expected lives of 10 years, and volatility of 0.35 percent.

VerticalBuyer also had an option plan, with shares available for issuance at the time of the merger. However, all options under the plan had expired, and the plan was cancelled on March 24, 2005. Subsequent to the end of the first quarter 2006, our board of directors approved a new plan for the award of stock-based compensation to employees, directors and consultants as described below. The new plan provides for the award of options, restricted stock or stock appreciation rights at the discretion of the compensation committee of the board of up to an aggregate of 1,100,000 shares.

*Stock options assumed in reverse merger*

| Detail | Number of | Weighted | Expiration |
|--------|-----------|----------|------------|
|        | Options   | Average  |            |

Exercise

|                                   |         | <b>Price</b> |                  |
|-----------------------------------|---------|--------------|------------------|
| Options assumed in reverse merger | 268,343 | \$ 0.12      | November 1, 2012 |

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**Non-employee Compensation**

On February 21, 2006, the Compensation Committee of the Board of Directors and the full Board of Directors approved awards of Company common stock for the Company's outside directors under the Company's 2005 Incentive Compensation Plan (the Plan). Directors receiving awards under the Plan were Anthony H. Sobel, Chairman; Shaya Phillips; and Thomas V. Butta. Mr. Sobel was granted 98,496 shares, while Messrs. Phillips and Butta were granted 49,248 shares each. One-third of the award vested immediately upon approval. An additional one-third vested on February 28, 2006, with the final one-third to vest on February 28, 2007. Except in the event of a change in control of the Company, the directors may not sell any shares awarded to them prior to March 1, 2007. If a director's service terminates prior to a vesting date, all unvested shares will be forfeited, subject to exception in the discretion of the Board. As a result of his subsequent resignation as a director discussed below, Mr. Butta forfeited 32,832 shares.

Thomas V. Butta resigned from the Company's Board of Directors effective February 22, 2006. His resignation was not the result of any disagreement relating to the Company's operations, policies or practices. Rather, Mr. Butta resigned in order to devote his full attention to his responsibilities at an unaffiliated company of which he is the Chief Executive Officer. Mr. Butta served on the Board's Audit and Compensation Committees.

On March 2, 2006, the Company entered into a Letter of Engagement dated February 27, 2006 and individual restricted stock agreements with Robert F. Steel and Kenneth A. Steel, Jr. (the Consultants). The purpose of the agreements was to formally set forth the terms and conditions under which the Consultants have been providing and will continue to provide consulting services to the Company through February 10, 2008. Under the terms of the Letter of Engagement, the Consultants are to advise the Company on the development and implementation of strategic business plans, to assist management in developing marketing and growth strategies, and to assist management in seeking out and analyzing potential acquisition opportunities. The agreement requires the Consultants to provide such consulting services until February 10, 2008. In return, the Company agreed to issue 172,367 shares of its common stock to each of the Consultants. The stock awards were granted pursuant to the Company's 2005 Incentive Compensation Plan. The Company will also reimburse the Consultants for reasonable travel and other expenses incurred by the Consultants in furtherance of the objectives of the agreements. The agreements contain customary confidentiality and non-competition provisions. The agreements also require the Consultants, if they are terminated for cause prior to the earlier to occur of February 28, 2007 or a change in control of the Company, to return one-third of the Stock Awards at the time of termination.

In addition, on June 20, 2006, the Board elected Jeffery A. Bryson to fill the vacancy on the Board created by the February 22, 2006 resignation of Mr. Butta. Mr. Bryson serves on the Company's Audit and Compensation Committees and he is Chairman of the Audit Committee. In connection with his election to the Board of Directors on June 20, 2006, the Board approved the award to Mr. Bryson of 23,350 shares of common stock under the Company's 2005 Incentive Compensation Plan. Such shares are registered pursuant to the Company's Form S-8 registration statement filed with the Securities and Exchange Commission on January 27, 2006. Under the terms of the award, 11,675 shares vested immediately upon Mr. Bryson's election to the Board and the remaining shares will vest at the conclusion of the 2007 Annual Meeting of Stockholders of the Company if Mr. Bryson is reelected to the Board for a successive term at such meeting.

Total stock compensation issued in 2006 was \$893,845, of which \$613,954 was recorded in the first quarter 2006 upon issuing of the stock awards following the reaching of a definitive agreement as to the terms of compensation for the services performed to date and to be performed, and \$81,258 was earned in second quarter 2006, leaving \$198,633 as unearned stock compensation at June 30, 2006.

On July 10, 2006, the Company entered into an Investor Relations Consulting Agreement (the Agreement) with Alliance Advisors, LLC (Alliance). The purpose of the Agreement is for Alliance to assist the Company in the development of the Company's investor relations and corporate communications program. Under the terms of the Agreement, Alliance will assist the Company for a period of twelve months in developing and implementing an investor relations and corporate communications strategy. In exchange for Alliance's services, the Company will pay Alliance \$6,500 a month in cash for the first six months of the Agreement. At the end of six months, either party to the Agreement will have the option of terminating the Agreement. If the Agreement continues for an additional six months, then the monthly payment will increase to \$7,250. In addition to the cash compensation just described, the Company issued to Alliance sixty thousand (60,000) shares of restricted common stock in the third quarter of 2006. If Alliance does not complete the full one-year term of the Agreement, a pro rata portion of fifty-four thousand (54,000) shares must be returned to the Company. In addition to the cash compensation, it is anticipated that the Company will record non-cash stock-based compensation of approximately \$40,000 per quarter over the subsequent four quarters related to this agreement.

**Table of Contents****NOTE 5 LONG-TERM AND SHORT-TERM DEBT AND OFF-BALANCE SHEET INSTRUMENTS**

On February 14, 2006, the Company entered into an agreement with RBC Centura Bank ( RBC ) for a 42 month term loan of \$400,000 at a fixed interest rate 7.5% per annum. The facility is collateralized by substantially all of the assets of the Company. The purpose of the loan was to finance capital expenditures long term and improve its availability under its bank credit facility for working capital purposes. Upon any default by the Company on the promissory note, the bank may accrue interest on the promissory note at a rate of 18% per annum, subject to any maximum rate imposed by applicable law. Further, upon default by the Company, the bank may declare the entire unpaid principal balance on the promissory note and all accrued unpaid interest on the promissory note immediately due. For the quarter ended June 30, 2006, the Company paid \$9,609 of interest and \$26,327 of principal on the loan. The Company paid \$12,130 of interest and \$34,572 of principal on the loan for the six months ended June 30, 2006.

On March 17, 2005, CSI entered into a revolving credit facility with RBC. Fees for the transaction were \$83,800. The facility allows the Company to borrow up to 80% of accounts receivable balances. The total balance borrowed may not exceed the facility limit. Outstanding amounts under the facility bear interest at Libor rate plus 0.275% (7.86% at June 30, 2006), payable monthly and originally matured on May 1, 2006. The maturity date was extended several times. Most recently, on July 14, 2006, the Company and RBC Centura Bank executed a modification agreement extending the maturity date of the facility from July 15, 2006 to July 15, 2007. The modification agreement increased the principal amount of the facility from the original \$3.0 million to \$3.5 million. The reason for the increase in principal was to support increasing working capital requirements of the Company. Please see Item 2. Management's Discussion and Analysis or Plan of Operation under Credit Arrangements for further discussion of the revolving credit facility.

The facility is collateralized by substantially all the assets of the Company. Immediately upon entering into the loan agreement, the Company borrowed \$1,500,000, which was used for the paydown of a portion of the subordinated notes issued in connection with the merger. There was \$1,842,000 outstanding and \$1,658,000 available under the facility as of June 30, 2006. Under the facility, CSI is subject to restrictive covenants, the primary terms of which restrict incurring debt, making loans, changing approved executive compensation arrangements or making distributions or investments which would violate the restrictive covenants in the loan agreement. The agreement with our lender also requires the achievement of a debt to EBITDA ( Earnings Before Interest Taxes, Depreciation and Amortization a non-GAAP, financial measure which takes GAAP net income and adds back in interest, taxes, depreciation and amortization), as defined, ratio of not more than 2.5:1 measured as of fiscal year end; a debt service coverage of 1.2:1.0 as measured at fiscal year end (EBITDA, as defined, divided by current maturities of long-term debt plus interest payments); EBITDA, as defined, of not less than \$2,000,000 by year-end 2005; and a minimum tangible net worth, as defined, of \$1,500,000 including subordinated debt by year-end 2005. Pursuant to our agreements with the bank, upon an event of default, it may accelerate and require the repayment of all amounts under the credit facility. It may also decline to make further advance. As of June 30, 2006, management believes the Company is in compliance with all such covenants.

The Company also has subordinated notes payable to shareholders related to the reverse merger (See Note 3).

As of June 30, 2006, for the prior reporting periods, and through the filing date, CSI had no off-balance sheet instruments.

**NOTE 6 PREFERRED STOCK AND RELATED WARRANTS**

On February 10, 2005, the Company entered into the Preferred Stock Purchase Agreement with Barron. Pursuant to the agreement, on February 11, 2005, immediately following the consummation of the merger, the Company issued to Barron 7,217,736 shares of its newly created Series A Convertible Preferred Stock in exchange for the payment of \$5,042,250. Barron was also issued two warrants to purchase in the aggregate 7,217,736 shares of the Company's common stock. The preferred stock is convertible into common stock on a one-for-one basis. The warrants are exercisable for 3,608,868 shares at a price of \$1.3972 per share and 3,608,868 shares at a price of \$2.0958 per share. The terms and conditions of the warrants are identical, including the expiration date of February 11, 2010, except with respect to exercise price.

Both the conversion of the preferred stock and the exercise of the warrants are subject to restrictions on ownership that limit Barron's beneficial ownership of common stock. Initially, Barron was generally prohibited from beneficially owning greater than 4.9% of common stock, and such restriction could be waived by Barron upon 61 days prior notice. It was the intention of the Company and Barron that the preferred stockholder never acquire greater than 4.9% of the Company's common stock and never be deemed an affiliate or control person under federal securities laws. For avoidance of doubt, Barron and the Company agreed to remove the 61 day waiver provision and to impose a non-waiveable beneficial ownership cap of 4.9%. These agreements were implemented on November 7, 2005.

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The warrants may be exercised on a cashless basis. In such event, the Company would receive no proceeds from their exercise. However, a warrant holder (including Barron) may not effect a cashless exercise prior to February 11, 2006. Also, so long as the Company maintains an effective registration statement for the shares underlying the warrants, a warrant holder is prohibited from utilizing a cashless exercise. The Company's registration statement was considered effective on February 14, 2006. Barron did not invoke a cashless exercise.

GAAP requires that in the case of thinly traded stock, management assess, among other factors, whether the market quoted price is representative of the price which would be effective were all shares issued in connection with various transactions, which would include having significant additional shares and liquidity in the market. Following consultation with accounting and valuation experts, management used a cash flow based stock value computation based on comparisons to peer public companies and the market value of their shares near the date of the Company's preferred stock and warrant transaction. The Company used these comparables to calculate a per share market value of its shares as a public company with significant stock liquidity (the Adjusted Market Value).

The Adjusted Market Value of the shares has been used in the Black-Scholes calculation for valuing the warrants. Because the registration rights agreement contained a clause whereby liquidated damages were payable in cash, the warrants were initially considered a liability under derivative accounting (see further discussion below). The principles used under SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity require that the proceeds be allocated first to the liability portion of an instrument based on its fair market value and the remaining proceeds assigned to the equity portion. As the fair market value of the warrants exceeded the proceeds from the preferred shares and warrants offering, no proceeds, except for the par value of \$7,218, were allocated to the preferred stock.

### **Registration Rights Agreement**

In conjunction with the Preferred Stock Purchase Agreement, the Company also entered into a Registration Rights Agreement with Barron on February 10, 2005, whereby the Company agreed to register the shares of common stock underlying the preferred stock and warrants to be sold to Barron. Under the initial terms of the Registration Rights Agreement, the Company was obligated to file, within 45 days following the execution of the Registration Rights Agreement, a registration statement covering the resale of the shares. The agreement also obligated the Company to use its best efforts to cause the registration statement to be declared effective by the SEC within 120 days following the closing date of the registration rights agreement (February 11, 2005) or generally such earlier date as permitted by the SEC. Barron may also demand the registration of all or part of such shares on a one-time basis and, pursuant to piggy-back rights, may require the Company (subject to carveback by a managing underwriter) to include such shares in certain registration statements it may file. The Company is obligated to pay all expenses in connection with the registration of the shares and may be liable for liquidated damages in the event the registration of shares does not remain effective pursuant to the agreement.

Under the terms of the initial Registration Rights Agreement, liquidated damages were triggered if the Company failed (i) to file the registration statement within 45 days from February 11, 2005, (ii) to cause such registration statement to become effective within 120 days from February 10, 2005, or (iii) to maintain the effectiveness of the registration statement. These requirements were subject to certain allowances: 45 Amendment Days during any 12-month period to allow the Company to file post-effective amendments to reflect a fundamental change in the information set forth in the registration statement, and Black-out Periods of not more than ten trading days per year in the Company's discretion, during which liquidated damages would not be paid.

Under the initial terms of the Registration Rights Agreement with Barron, the liquidated damages were payable in cash at a rate of 25% per annum on Barron's initial preferred stock and warrant investment of \$5,042,250. Because the liquidated damages were payable in cash, under Emerging Issues Task Force (EITF) 00-19 Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock a potential obligation (referred to under EITF 00-19 as a derivative financial instrument) existed until the registration became effective. On November 7, 2005 the Registration Rights Agreement was amended to eliminate the treatment of the warrants as a derivative financial instrument (see further discussion below).

### **Warrants**

As a result of the registration rights agreement containing a clause whereby liquidated damages were payable in cash, the Company was required to follow EITF 00-19. In light of the required accounting treatment under EITF 00-19, the amount of proceeds allocated to the issuance of warrants (\$5,035,032, representing all the proceeds with the exception of the \$7,218 par value allocated to preferred stock) was recorded as a liability as of the date of the transaction. In addition, the difference between the amount allocated to the issuance of warrants and the fair market value of the warrants based on the Black-





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Scholes valuation method at reporting dates was recorded in the statement of operations as an unrealized gain (loss) on financial instrument-warrant liability and as an adjustment to the financial instrument-warrant liability on the Company's balance sheet, to restate the warrants to fair market value as of that date. In each period up to November 7, 2005, the date of the amendment to the registration rights agreement, whereby the cash liquidated damages provision was converted to damages payable by the issuance of a set number of preferred shares, the financial instrument was marked to market and changes in the value were recorded as adjustments in the statement of operations.

It was not the intent of either CSI or Barron that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock and warrant issuance being recorded as a liability rather than equity. In response, on November 7, 2005, CSI and Barron entered into an amendment to the Registration Rights Agreement that eliminated cash liquidated damages and replaced them with liquidated damages in the form of additional shares of Series A Convertible Preferred Stock. Pursuant to the amendment, 2,472 shares of preferred stock will be issued to Barron for each day when liquidated damages are triggered until February 11, 2007, when this damages agreement expires. The maximum number of shares that could be issued was 561,144 as of June 30, 2006. Because the amendment to the Registration Rights Agreement changes the liquidated damages penalty from settlement in cash to settlement in a set number of shares which is unaffected by changes in the share market price, in accordance with EITF 00-19, as of the amendment date, the fair value of the warrants was reclassified from a liability to permanent equity as additional paid-in capital. The fair value at that date, based on the Black-Scholes valuation method, was \$5,449,392. The difference between this fair value and the amount allocated to the warrants at issuance (\$5,035,032) totaling \$414,360 was recorded as an unrealized loss on warrants to purchase common stock in the accompanying statement of operations for the year ended December 31, 2005. Please see the table below for the complete fluctuations of gains and losses associated with the warrants in 2005.

|                                       | Ending Market Value @                    |  |                | Quarterly<br>(Loss) / Gain |
|---------------------------------------|--|--|----------------|----------------------------|
|                                       | Warrant<br>Group1<br>3,608,868<br>shares | Warrant<br>Group2<br>3,608,868<br>shares | Total<br>Value |                            |
| <b>Book Value at Grant Date</b>       | \$ 2,761,147                             | \$ 2,273,885                             | \$ 5,035,032   |                            |
| March 31, 2005                        | 4,511,085                                | 3,608,868                                | 8,119,953      | \$ (3,084,921)             |
| June 30, 2005                         | 4,619,352                                | 3,608,868                                | 8,228,220      | (108,267)                  |
| September 30, 2005                    | 3,969,756                                | 3,067,538                                | 7,037,294      | 1,190,926                  |
| November 7, 2005                      | 3,356,249                                | 2,093,143                                | 5,449,392      | 1,587,902                  |
| <b>2005 Fiscal Year (Loss) / Gain</b> |  |  |                | \$ (414,360)               |

Prior to the execution of the amendment, Barron agreed to waive any liquidated damages through November 30, 2005 pursuant to a waiver dated September 30, 2005. Barron had also waived liquidated damages on three prior occasions. In exchange, during the fourth quarter of 2005 the Company paid Barron \$50,000, which was expensed, and agreed to cause the registration statement to become effective under the Registration Rights Agreement on or before November 30, 2005. After that date, the Company entered into two additional waivers extending the required effectiveness date initially until January 31, 2006 and finally, February 28, 2006. The Company's registration statement was considered effective on February 14, 2006.

**NOTE 7 COMMITMENTS AND CONTINGENCIES****Operating leases**

The Company leases certain facilities and equipment under various operating leases. At June 30, 2006, future minimum lease payments under non-cancelable leases were:

|            |           |
|------------|-----------|
| 2006       | \$ 67,344 |
| 2007       | 134,688   |
| 2008       | 138,432   |
| 2009       | 143,433   |
| 2010       | 146,556   |
| Thereafter | 36,795    |

|       |            |
|-------|------------|
| Total | \$ 667,248 |
|-------|------------|

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The Company entered into a new operating lease with Chuck Yeager Real Estate on November 30, 2005, related to the lease of premises at 900 Block, 900 East Main Street, Easley, SC, Suite T. The term of this lease is five years, beginning on April 1, 2006 and ending on March 31, 2011. Total rent due under this lease is \$700,920, due on the first of each month in escalating monthly payments. The commitments under this lease are included in the future payments in the table above. If at any time the Company terminates the lease the lessor may recover from the Company all damages approximately resulting from the termination, including the cost of recovering the premises and the worth of the balance of the lease over the reasonable rental value of the premises for the remainder of the lease term, which shall be due immediately. The Company does not anticipate terminating the lease at any time prior to the natural termination of the lease.

### **NOTE 8 SEGMENT INFORMATION**

CSI is organized into the two reportable segments: software applications and technology solutions. Below is a description of the types of products and services from which each reportable segment derives its revenues.

#### *Software applications segment*

Through our software applications segment, we report the results of the development, sales, and deployment and provision of ongoing support of our software applications, fund accounting based financial management software and standards based lesson planning software.

#### *Technology solutions segment*

Through our technology solutions segment, we report the results of the technology solutions products through the sales and distribution of computers and accessories and the wide range of technology consulting services, including network and systems integration and computer support and maintenance services, that we provide.

#### **Factors management used to identify our segments:**

CSI's reportable segments are analyzed separately because of the differences in margin routinely generated by the major products within each group, and the differences in which sales and investment decisions may be made to evaluate existing or potential new products. Through its software applications segment, the Company develops, sells, deploys and provides ongoing support of software applications. Through its technology solutions segment, the Company provides technology solutions through the sale and distribution of computers and accessories and offers a wide range of technology consulting services, including network and systems integration and computer support and maintenance service.

There are no significant transactions between reportable segments. The total of Segment net sales and service revenue from all segments is equal to Net sales as reported in our Consolidated Statements of Operations. Sales and Cost of sales are included in each segment's income as reported in our Consolidated Statements of Operations. Accordingly, the total of the segments' Gross profit is equal to Gross profit in our Consolidated Income Statements. Operating expenses are allocated to segment income based on estimates of sales and administrative time spent on each segment. None of the income or loss items following Operating income (loss) in our Consolidated Statements of Operations are allocated to our segments, since they are reviewed separately by management. Certain non-recurring items (generally those items occurring for reasons which have not occurred in the prior two years and are not likely to reoccur in two years) and compliance and governance costs are generally excluded from management's analysis of profitability by segment and the Company's segment presentation. Accordingly, the total of Segment income from all segments, less certain non-recurring and compliance and governance items, if any, is equal to Operating income (loss) as reported in our Consolidated Statements of Operations.

The total of Segment assets for all segments is equal to Total Assets as reported in our Consolidated Balance Sheets. The Company allocates shared assets related to liquidity (e.g. cash, accounts receivable and inventory) based on each segment's percent of revenues to total consolidated revenues. Capitalized computer software costs are allocated to the software segment. Fixed assets, net, are allocated on the same basis as operating expenses (or by time spent on each segment, as discussed above), since support equipment usage is generally tied to time utilized. All other assets are generally allocated on the same basis.

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The following tables summarize information about segment profit and loss for the quarters and six months periods ended June 30, 2006 and 2005 and assets allocated to segments as of June 30, 2006 and 2005.

|  | Software<br>Applications | Technology<br>Solutions | Total<br>Company |
|--|--------------------------|-------------------------|------------------|
| <b>Quarter ended June 30, 2006:</b>    |                          |                         |                  |
| Net sales and service revenue          | \$ 1,446,005             | \$ 10,718,231           | \$ 12,164,236    |
| Gross profit                           | 936,873                  | 1,438,238               | 2,375,111        |
| Segment income                         | 340,385                  | 679,071                 | (*)              |
| Segment assets                         | 3,368,260                | 9,106,778               | 12,475,038       |
| <b>Quarter ended June 30, 2005:</b>    |                          |                         |                  |
| Net sales and service revenue          | \$ 1,142,039             | \$ 6,156,389            | \$ 7,298,428     |
| Gross profit                           | 640,637                  | 1,897,234               | 2,537,871        |
| Segment income                         | 145,768                  | 1,130,352               | (*)              |
| Segment assets                         | 2,464,276                | 5,951,094               | 8,415,370        |
| <b>Six months ended June 30, 2006:</b> |                          |                         |                  |
| Net sales and service revenue          | \$ 2,550,077             | \$ 14,456,562           | \$ 17,006,639    |
| Gross profit                           | 1,579,056                | 2,299,661               | 3,878,717        |
| Segment income                         | 510,795                  | 940,055                 | (*)              |
| Segment assets                         | 3,252,626                | 8,881,307               | 12,133,933       |
| <b>Six months ended June 30, 2005:</b> |                          |                         |                  |
| Net sales and service revenue          | \$ 2,128,788             | \$ 9,261,944            | \$ 11,390,732    |
| Gross profit                           | 1,180,560                | 2,515,006               | 3,695,566        |
| Segment income                         | 343,257                  | 1,520,797               | (*)              |
| Segment assets                         | 2,464,276                | 5,951,094               | 8,415,370        |

\* See reconciliation below

**Reconciliation of Segment income (non-GAAP measure) to operating income per consolidated Statements of Operations (GAAP measure):**

|   | Quarter Ended<br>June 30, |              |
|---|---------------------------|--------------|
|   | 2006                      | 2005         |
| <b>Segment income:</b>  |                           |              |
| Software applications segment                                     | \$ 340,385                | \$ 145,768   |
| Technology solutions segment                                      | 679,071                   | 1,330,352    |
| <b>TOTAL SEGMENT INCOME</b>                                       | 1,019,456                 | 1,476,120    |
| <b>Less: Merger and compliance costs</b>                          |                           |              |
| Stock based compensation  | (81,258)                  |              |
| Professional and legal compliance and litigation related costs    | (86,034)                  | (220,303)    |
| <b>OPERATING INCOME Per consolidated Statements of Operations</b> | \$ 852,164                | \$ 1,255,817 |



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|   | Six Months Ended |            |
|---|------------------|------------|
|   | June 30,         | June 30,   |
|   | 2006             | 2005       |
| <b>Segment income:</b>  |                  |            |
| <b>Software applications segment</b>  | \$ 510,795       | \$ 343,257 |
| <b>Technology solutions segment</b>   | 940,055          | 1,520,797  |
| <b>TOTAL SEGMENT INCOME</b>   | 1,450,850        | 1,864,054  |
| <b>Less: Merger and compliance related costs</b>  |                  |            |
| Stock based compensation  | (695,212)        | (631,174)  |
| Payroll tax expenses in Other selling, general and administrative costs related to stock option compensation from stock option redemption in connection with merger |                  | (47,766)   |
| Reverse acquisition costs   |                  | (759,283)  |
| Professional and legal compliance costs   | (430,888)        | (220,303)  |
| <b>OPERATING INCOME Per Statement of Operations</b>   | \$ 324,750       | \$ 205,528 |

**Item 2. Management's Discussion and Analysis or Plan of Operation.****Introduction**

Unless the context requires otherwise, (1) Computer Software Innovations, Inc., CSI, we, our, us and the Company refer to the consolidated combined business of Computer Software Innovations, Inc., a Delaware corporation formerly known as VerticalBuyer, Inc., and its subsidiary, CSI Technology Resources, Inc., a South Carolina corporation; (2) VerticalBuyer refers to the Company prior to the merger; and (3) CSI South Carolina refers to Computer Software Innovations, Inc., a South Carolina corporation, prior to the merger. The merger refers to the merger of CSI South Carolina into VerticalBuyer on February 11, 2005, as more particularly described under 2005 Reverse merger below.

**Overview**

We are a developer of software applications and a provider of technology solutions, focused primarily on the needs of organizations that employ fund accounting. Our client base consists principally of municipalities, school districts and local government organizations, although we continue to increase the amount of products and services we provide to corporate and other non-governmental entities. We offer a wide variety of software and hardware based solutions and related support and maintenance services, which are discussed in more detail under Organization below.

*Strategy*

In addition to our sales of software applications, technology solutions and related support and maintenance services, we provide technology consulting, including network and systems integration services, as a part of our solutions sales efforts. These services also generate a significant amount of revenue by increasing demand for computer hardware equipment that we sell. Our marketing strategy is to provide a suite of software products coupled with full service integration of the hardware solutions that support those products and other back-office functions, and to provide ongoing technical support, monitoring and maintenance services to support the clients continuing needs. We also market our hardware solutions and ability to provide a wide level of services and support independent from our software solutions which, when marketed to a fund accounting based organization, may also lead to future software sales and integration services.

By providing a client the ability to call one solution provider and circumvent the difficulties that often arise when dealing with multiple vendors, we believe we are able to achieve high long-term client satisfaction and a competitive advantage in the marketplace. Repeat business from our existing customer base has been key to our success and we expect it will continue to play a vital role in our growth. Over the past ten years we have retained more than 90% of our software customers. Our focus is on nurturing long-standing relationships with existing customers while establishing relationships with new customers. For more information on our strategy, see our latest annual report filed on Form 10-KSB.

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### **2005 Reverse merger**

We were previously known as VerticalBuyer, Inc. until entering into a merger transaction with CSI South Carolina in February 2005. Incorporated in Delaware on September 24, 1999, VerticalBuyer ceased business operations of any kind in September 2001. Prior to assuming the business operations of CSI South Carolina in the February 2005 merger, VerticalBuyer was a shell corporation without material assets or liabilities.

In the first quarter of 2005, we completed a series of recapitalization transactions which began January 31, 2005 with a change in control due to the purchase of a majority of our common stock by Computer Software Innovations, Inc., a South Carolina corporation ( CSI South Carolina). These culminated on February 11, 2005 with the merger of CSI South Carolina into the Company, and our issuance of preferred stock, common stock, common stock warrants and certain subordinated notes, and the change of our name to Computer Software Innovations, Inc. We refer to the Company prior to such merger as VerticalBuyer, and Computer Software Innovations, Inc. prior to such merger as CSI South Carolina. As we were a shell corporation with virtually no assets or operations and due to other considerations under reverse merger accounting, CSI South Carolina was considered the acquirer and VerticalBuyer the acquiree. As a result, our prior operations for reporting purposes became those of CSI South Carolina. The recapitalization transactions, along with further discussion regarding merger accounting and merger summary, are discussed in Note 2 to the interim financial statements and are also discussed in further detail in our most recent filing of our audited financial statements on Form 10-KSB.

### **Current Challenges and Opportunities of our Business, and Forward-Looking Information**

#### *Processes and Procedures*

Because of our focus on the public sector, many sales opportunities are subject to our having to comply with government bid requirements and other formal proposal processes. Complying with such requirements and processes can result in a significant investment of time and effort that may or may not result in a sale. We have been implementing procedures to make the bid and sales process more efficient and believe these types of improvements will aid in our ability to maintain competitiveness in the marketplace. We will also look for additional process improvement opportunities as we move through the process of documenting controls and procedures in order to comply with the Sarbanes-Oxley Act legislation. However, this process is primarily compliance-driven and will be costly, while cost-saving opportunities as a result of this process, if any, may be limited.

Prior to February 11, 2005, we were a public shell with virtually no operations and CSI South Carolina was a private company with limited complex accounting issues. As a result, neither we nor CSI South Carolina had need for staff with technical accounting and public reporting expertise. In the first quarter of 2005, we entered into a complex merger and began public reporting of significant operations.

Due to the time required to source, attract, negotiate and hire personnel with the necessary experience, we remained for several months without sufficient public reporting or technical expertise to resolve non-routine or complex accounting matters and public reporting requirements such as we encountered in the merger. On May 6, 2005 we hired a chief financial officer with prior public reporting experience who is accustomed to dealing with more complex accounting matters. Deficiencies, which constituted a material weakness, arose as a result of the delay in hiring our CFO and our general shortage of experienced internal technical personnel and resulted in our filing of extensions and amendments of certain quarterly reports during the fiscal year ended 2005. The amendments included the reclassification of certain costs including salaries and capitalized software costs from selling, general and administrative expenses to cost of sales, and the reclassification of proceeds and recording of gains and losses related to our issuance of preferred stock and warrants. All necessary adjustments to 2005 financial results were made to the financial information contained herein.

The adjustments were identified primarily as a result of our CFO's reviews in connection with correspondence related to our filing of a Form SB-2 registration Statement on March 28, 2005 and our subsequent filing of a second, replacement Form SB-2 on November 21, 2005 (the Form SB-2), and in review of generally accepted accounting principles ( GAAP ) and information in other Company filings, by our CFO and external auditors in consultation with our Audit Committee. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the CFO in consultation with the CEO and the audit committee of the board of directors determined that the Company, following its inception of reporting as a public company and hiring of its first CFO with SEC reporting experience, still lacked sufficient internal resources to insure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis.

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To address this deficiency, in January 2006, we hired an additional staff person with public accounting and reporting experience and established a relationship with outside accounting experts to support management in their review, interpretation and implementation of new disclosures and significant changes in accounting and regulatory reporting requirements.

Even so, due to the increasing number and complexity of pronouncements, emerging issues and releases, we expect there will continue to be some risk related to financial disclosures, albeit mitigated following implementation of the Sarbanes-Oxley Act requirements. The process of identifying risk areas and implementing financial disclosure controls required under the Sarbanes-Oxley Act may result in the identification of areas where we may need additional resources. Accordingly, we have also determined that until such time as we complete this process, we may be unable to declare our controls with regard to new public reporting disclosures effective. This process has begun and we anticipate it will be completed in 2007. This process may also result in the identification and possible reporting of additional deficiencies.

We have moved forward with our initial work surrounding the implementation of the Sarbanes-Oxley Act. This has included an assessment of risk in financial reporting and the creation of a documentation and evaluation framework for a significant portion of our business, under consultation with an independent public accounting firm. We have budgeted \$200,000 for compliance work by external parties related to the Sarbanes-Oxley Act for the fiscal year 2006 and to thereafter complete a portion of testing. In the first six months we spent approximately \$100,000 on external resources to support this initial effort. We plan to use the established framework to perform much of the documentation and initial evaluation effort with internal staff over the next quarter or two to minimize our costs, while still moving forward in our effort to improve our internal controls work, and to avoid additional third-party costs while we monitor the SEC's reaction to the recommendations of the Advisory Committee. In the second quarter we used internal staff and an intern resource to continue our Sarbanes-Oxley compliance work. We will likely use some external resources in the third and fourth quarters. At this time, we plan to stay within our budget in 2006 for this work.

### *Establishment of a Telesales Department*

We intend to utilize telesales as a method of marketing our lower price point (considered by us to be fundable at the school level) standards based lesson planning software. We also believe telesales will be beneficial in promoting and providing leads for potential sales of our other products. We have not previously had a formal telesales department, and while we had engaged a consultant with significant experience in this area to help with the effort, the establishment of this area will entail some up front investment. We plan to use existing personnel to manage the telesales department, but intend to initially hire two or three additional employees to focus primarily on telesales. We also expect the telesales department to assist in the identification and qualifying of additional sales opportunities for the fund accounting software. We expect, but cannot guarantee, that these efforts will generate sufficient revenues to avoid any negative impact on profitability. We hired one individual in the first quarter of 2006 who has had some success generating leads for our fund accounting software and hired an additional person in the second quarter to identify additional opportunities for fund accounting in support of our geographic expansion efforts. We will likely hire additional sales and support staff as we identify geographic territories with good potential. We also hired an individual with both sales and classroom experience to support our standards based lesson planner in the second quarter of 2006. This individual will likely generate leads by phone, but also participate in other marketing and sales efforts including product demonstrations both via the internet and by visit to client sites.

### *Software Modifications Required by Geographic Expansion*

We have achieved the most significant penetration in the tri-state area of South Carolina, North Carolina and Georgia. We are now accelerating our efforts to move into surrounding states. To do so, we may also have to modify our existing fund accounting programs to accommodate differences in state laws, regulations and taxation. We anticipate needing to make additional investment in software development to accomplish this. However, we plan to make the changes when we have firm orders in an area in an attempt to maximize and achieve a return on investment as quickly as possible. As we are currently converting our programs to the Microsoft .Net programming and SQL database language, but do not yet have all modules ready for release, some of these changes may be required in both our current and .Net platforms until 2007, when we anticipate all modules will be converted. The costs of such changes may offset the positive impact from expanding our geographic reach in 2006.

### *Conversion of our Accounting+Plus software to Microsoft .Net Programming and SQL Database Language*

We have already completed the conversion of the majority of our core accounting modules. The completed modules are in formal beta installations; however, the changes we are having to make as a result of the formal beta use have been limited, and we are prepared to install the completed modules in any entities which do not have an immediate need for other



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integrated modules not yet converted. In addition, the completed modules have the functionality necessary to handle school activity funds, such as student clubs, organizations and athletics. Many school activity personnel use packages independent of the school's accounting packages, which may be cumbersome, or lack functionality. Accordingly, we are beginning to look for sales opportunities of the completed modules now, marketed as our School Activity solution. And if the school later adopts our full accounting suite, the process of integration will be relatively seamless. We anticipate completing additional modules in 2006, and as previously noted under Software Modifications Required by Geographic Expansion above, we anticipate completing the remaining modules throughout 2007.

### *Maintaining Margins*

In 2005, we continued to experience a significant increase in IP telephony sales, historically one of our higher margin product lines in the technology segment. Among these transactions were continued sales of IP Telephony products to one of our largest customers (Greenville County Schools) which encompasses all schools in a fairly large school district. IP Telephony sales increased sales to that customer to 14% of our revenues in 2005, and represented more than 90% of the revenues from this customer in that year. The challenge going forward will be to match large opportunities or increase the number of smaller opportunities. We have increased and reorganized our sales force in an effort to increase the probability of achieving consistent and increasing performance in this product niche in future periods. To date in 2006 IP Telephony hardware sales have held steady, but in general and in engineering services have not experienced the significant growth of the past year.

In the first half of 2006, we experienced a significant increase in sales of interactive whiteboard solutions and to a lesser degree the amount we charge for related engineering services. Both product lines, IP Telephony and interactive whiteboard solutions, have become subject to increased competition as more product manufacturers have recognized product potential and have entered these markets. Our challenge going forward is to continue to search for new and innovative, and initially higher margin, products to augment those that become mature, as well as continuing our focus on higher margin engineering services and software. While we cannot predict success in achieving these goals, we have taken and are taking actions to do so, including expanding our geographic reach, increasing the size of and reorganizing our sales force to focus on more products backed by product specialists, adding telemarketing efforts, improving our sales tools, and identifying additional product and service areas. We are focused on increasing margins, but ultimately we are looking to increase profits by leveraging existing and an increasing number of customer relationships and taking advantage of cross-sell opportunities with a variety of products and services. We will focus primarily on those customers for which we can provide ongoing support and higher margin integration and other engineering services.

### *Continued Improvement of Support Solutions*

Historically, our software applications segment has been the most effective in providing support solutions. Going forward, we are increasing the level of support offerings available through our technology solutions segment from primarily warranty-based services to include additional support offerings. Such offerings may include additional telephone-based troubleshooting and support, real time monitoring and other proactive service offerings and guaranteed response times for customer needs. We have begun introducing additional services, including support for our interactive whiteboard solutions; however, increases in revenues have not yet exceeded our investment in this area. See further discussion below.

### *Investment in Support and Telesales Efforts*

Over the next year we will be making an investment (estimated to be as much as \$500,000, of which less than \$100,000 was spent in the first six months of 2006), consisting primarily of increased salaries and wages to support the additional technical support services and telesales efforts. Based on our past experience with prospecting and technical support agreements, we expect the additional revenue generated from the sales of technical support contracts and additional sales opportunities uncovered by telesales efforts for the fund accounting software and the new curriculum standards based lesson planner software will be sufficient to offset our investment within approximately one year, but we can give no assurances such additional services will be profitable collectively, particularly in the short-term. In addition, effective January 1, 2006 we reorganized our sales force. Previously, our primary sales personnel were assigned to either sell products in our software applications segment or in our technology solutions segment, but not both. We had potentially two persons, a software specialist and a technology specialist, calling on every organization, many times talking to different people within the same organization, and no opportunity for a single salesperson to be in touch with all of the needs of the organization. Due to an increase in the experience and quality of our sales personnel, and our ongoing efforts to educate them about our product offerings, our sales personnel are now able to maximize their contacts by discussing both software and technology in each visit to the customer. As a result, we have been able to reduce the size of salespersons' territories and allow them to reduce drive time, freeing them up to make more calls, sell across a broader range of solutions and identify additional opportunities. We back the sales personnel with product specialists and engineering support as necessary. We believe this realignment has

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improved the effectiveness of our sales force and will translate into deeper customer penetration and relationships. We anticipate greater sales and reduced costs per salesperson over time as more opportunities are identified and closed; however, we are unable to estimate the financial impact of these changes.

### *Expanded Market Opportunities*

With the acquisition and web development of the curricularator standards based lesson planner product, the Company is now positioned with a product offering that provides a link between school administration and the classroom. Principals, in addition to monitoring their financial condition using our fund accounting software in their administrative role, are also able to track the progress of teaching against state standards using the curricularator product. Lesson plans can now be reviewed, monitored and commented on electronically for content coverage and resource usage. The curricularator product provides a link between the administrative oversight function and the technology solutions we provide for the classroom, including our interactive white board offering. We plan to capitalize on these cross-selling opportunities. In addition to increasing our cross selling opportunities, the curricularator product puts us in a position to feasibly consider acquisitions that may be in the classroom content or curriculum results reporting market space. However, we cannot predict the financial impact, if any, this link will create. Any acquisition we would make in the expanded market space would require us to identify and retain product experts in the acquired entity, as we do not currently have significant expertise in the content or curriculum-related market spaces. In the first quarter, we experienced a significant increase in interest in our curricularator product, and completed a few additional installations. Although we are hopeful this product will become a significant revenue generator over the long-term, we did not experience a significant impact on revenues in the first half of this year.

### *Re-branding*

In the process of moving toward a national presence, we have established a new brand for CSI: *CSI Technology Outfitters Computers. Software. Innovations.* We have noted that in some cases software customers have not been aware of the breadth of our technology offerings, while technology customers have not been aware of the extent of our software offerings. While at this time we do not plan to change our corporate name, Computer Software Innovations, Inc., we believe a reemphasis of the term Computers, following it with a period ( . ) distinguishes the technology portion of our business from the software offerings. We have trademarked *Technology Outfitters* to connote our ability to outfit organizations with which we work for a variety of environments. We are redesigning our website to match this theme and are creating a brochure which presents a wider range of offerings, which can be communicated quickly in summary form. We believe these efforts will increase the recognition and value of the CSI name over time and enhance our presence as a preferred provider in our markets. We spent approximately \$150,000 on marketing, including our re-branding efforts, in the first six months of 2006 compared to approximately \$12,000 in the first six months of 2005.

### *Developing Customer Relationships in New Regions*

As we move forward with our growth strategy, we anticipate expanding into new geographic regions. We have achieved the most significant penetration in the tri-state area of South Carolina, North Carolina and Georgia. We are now accelerating our efforts to move into surrounding states. While expanding geographic markets provides a good opportunity to extend existing customer bases and increase revenue, breaking into a new market can prove difficult. There are several obstacles to successfully entering new geographic markets, including limited market knowledge or relationships, little brand awareness, and no established presence or regional client references. Initial penetration will be slow but should accelerate over time. While we have a sales and marketing strategy to address these obstacles, there is no exact manner to predict how much time the customer relationships will take to build and the rate at which new market penetration can be accomplished.

To support the expansion process we plan to hire additional sales personnel to help penetrate new geographic regions, which could represent a \$200,000 to \$300,000 investment and could potentially be made before year end 2006. While management believes this is a prudent investment which should result in significant long-term increases in revenue, there may be a short-term negative impact on earnings initially. Due to the length of our typical software sales closing cycle, six to twelve months, and the varying size of deals, we cannot predict the time to recovery on this investment.

### *Challenges to Technology and Software Budgets*

While federal, state and local funding was slightly decreased in 2006 over 2005, and technology and software budgets have been challenged during the last few years, we have sensed a steady improvement in the discretionary funds that are available to our potential clients. These discretionary funds coupled with our clients desire to utilize those funds to improve or implement technology and software tools into their individual environments have provided for growth of our business. We acknowledge that changes in funding could improve or strain technology budgets even further.



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### **Earnings Guidance**

#### *Certain Costs Related to Going Public in 2005*

In 2005, we incurred substantial costs related to our efforts to take CSI's operations public by way of the reverse merger, totaling more than \$2.8 million (pre-tax). These costs included the following:

merger fees totaling \$759,283, of which \$275,000 were paid to a third-party broker and the remainder were paid primarily for legal and accounting fees;

the redemption of stock options held by certain managers of CSI - South Carolina for \$631,174 considered compensation, and \$47,766 of payroll tax related costs;

legal and professional fees totaling \$437,013, expended in 2005 related to our efforts to register the underlying common shares of the preferred stock and warrants (which registration was declared effective on February 14, 2006);

litigation costs of \$343,063 and settlement costs to the company of \$200,000 to settle litigation related to the merger (which, in the opinion of management and its counsel, was unfounded, but settled to avoid further legal costs); and

non-cash loss of \$414,360 on warrants due to the accounting treatment of the warrants under a liquidated damages penalty payable in cash, until such time as the liquidated damages penalty was renegotiated for payment in a set number of preferred shares on November 7, 2005.

At this time, we do not anticipate incurring any further litigation or reverse merger costs. We expect the costs of registering Barron's shares in 2006 will be substantially reduced from that which was incurred in 2005. Also, we do not expect to incur any costs related to option redemptions, except potentially in connection with an acquisition to grow our business. As discussed above, we do expect to incur some costs to implement the Sarbanes-Oxley Act legislation. As of June 30, 2006, we had incurred approximately \$100,000 related to Sarbanes-Oxley work. As a result of the related changes noted, we estimate our ongoing professional and legal fees to aggregate approximately \$600,000 for the 2006 fiscal year, of which approximately \$430,000 was incurred in the first six months of 2006.

Also in connection with becoming a public company, we recruited independent, non-employee directors. We also engaged consultants to assist us with strategic planning and acquisitions. Definitive agreements were reached regarding the independent directors and consultants compensation in the first and second quarters of 2006. The Compensation Committee of the Board of Directors board approved stock awards, granting the non-employee directors and consultants approximately 500,000 shares. Accordingly, we recorded non-cash expense for directors and consultants' fees in the first six months of 2006 totaling approximately \$695,000. See Note 4 to our interim financial statements, "Stock Based Compensation," for further discussion.

#### *Warrant accounting*

In the first six months of 2006, we experienced a significant increase in net income driven by the recording of warrant losses of more than \$3 million dollars in the first and second quarters of 2005, which did not recur in 2006 due to a renegotiation of the warrant related registration rights agreement in November 2005. For the six months ended June 30 2005, there was an approximate loss of \$3,193,000 related to the warrants. The first and second quarter increases in net income in 2006 compared to 2005 will likely be offset in the third and fourth quarters of 2006 since the loss in the first and second quarters of 2005 was substantially offset by gains recorded in the third and fourth quarters of 2005, prior to the renegotiation of the registration rights agreement.

#### *E-Rate Program*

We have experienced an improvement in our success under contracts related to the E-Rate program.

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The E-Rate program assists both schools and libraries in the United States to obtain affordable telecommunications and internet infrastructure and access. The program provides federally subsidized funding based on the level of poverty and the urban/rural status of the population served and ranges from 20% to 90% of the costs of eligible services. The Company has

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participated in this program in the past, typically winning total contract awards in the \$4 to \$5 million dollar range during the last several years. In late 2005, as a result of our additional investments in software and personnel, we improved our ability to respond to proposals under the program. As a result, for the annual fall 2005 to spring 2006 E-Rate window, we have been awarded more than \$15 million in contracts.

Not all of these contracts become fully funded, and projects and related funding can span multiple years. Typically, we have experienced a 25% to 30% funding rate of awarded contracts. Accordingly, we cannot project the impact of our E-Rate efforts on future periods. Revenues linked to the E-Rate program ranged from 10% to nearly 20% of our total revenues from 2004 through 2005.

### *Engagement of Investor Relations Firm*

On July 10, 2006, the Company entered into an Investor Relations Consulting Agreement (the Agreement) with Alliance Advisors, LLC (Alliance). The purpose of the Agreement is for Alliance to assist the Company in the development of the Company's investor relations and corporate communications program. Under the terms of the Agreement, Alliance will assist the Company for a period of twelve months in developing and implementing an investor relations and corporate communications strategy. The Company anticipates recording approximately \$20,000 in cash and \$40,000 in non-cash stock based compensation per quarter for the next four quarters in connection with this agreement.

### *Additional Investments which May Impact Earnings in the Short Term*

In addition to the items mentioned above, we expect that our investments in expanding our telesales team, increasing our technical support offerings and hiring additional sales personnel to support our geographic expansion efforts may impact earnings negatively in the short term. While we would expect to cover these investments over no more than four to six quarters, we are unable to estimate the portion of these investments which will be covered in the short term. For further discussions see the Current Challenges and Opportunities of our Business, and Forward-Looking Information section above.

## **Organization**

Our business efforts are focused on two key operating segments: internally developed software applications and related service and support (our Software applications segment), other technology solutions and related service and support (our Technology solutions segment).

### *Software applications segment*

Our Software applications segment develops accounting and administrative software applications that are designed for organizations that employ fund accounting. These organizations are primarily municipalities, school districts and local governments. Specific software modules include:

General (or Fund) Ledger;

Accounts Payable;

Purchasing;

Payroll;

Personnel;

Employee Absence/Substitutes;

Inventory;

Utility Billing; and

Other specialty modules designed for government markets.

Our Software applications segment includes a staff of software developers, implementers, trainers, sales personnel and applications support specialists focused primarily on the development, sales, deployment and support of our in-house software products. From time-to-time they also provide support for the Technology solutions segment.

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As in other competitive software businesses, the sales and support of software products developed for resale, coupled with few related hardware sales, support higher margins in the Software applications segment (also referenced as software and related services). The sales of the Technology solutions segment (also referenced as hardware sales and related services) are typically at lower margins, due to the amount of hardware, a traditionally low margin product, included in these sales.

### *Technology solutions segment*

Our technology solutions segment has a staff of certified engineers capable of providing a broad range of technology solutions to our client base, including, but not limited to:

Technology planning (developing plans to purchase or upgrade computers, telephone equipment, cabling and software);

Hardware/software installations;

Cabling (installation of wiring and wireless devices to link computer networks and telephones);

System integration (installation of computers and configuration of software to enable systems to communicate with and understand each other);

Wide area networking (linking a group of two or more computer systems over a large geographic area, usually by telephone lines or the internet);

Wireless networking (linking a group of two or more computer systems by radio waves);

IP telephony and IP surveillance (sending voice calls and surveillance across the internet using internet protocol (IP), a standard method for capturing information in packets);

Project management (overseeing installation of computers, telephone equipment, cabling and software);

Support and maintenance (using Novell, Microsoft, Cisco and Citrix certified engineers and other personnel to fix problems);

System monitoring (proactively monitoring computers and software to detect problems);

Education technologies, including distance learning and classroom learning tools.

In addition to our engineers, our technology solutions segment includes a staff of sales persons, project managers and product specialists. Our technology solutions segment also purchases and resells products from a variety of manufacturers including but not limited to Hewlett Packard, Cisco, Microsoft, Novell, Promethean, Tandberg and DIVR, and supports the Software applications segment, as needed.

The combination of traditionally low margin sales of hardware with the sales of services results in a much lower margin for the Technology services segment when compared to the Software applications segment.



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We believe the combined efforts of our technology solutions segment with that of our Software applications segment provide CSI with a competitive advantage in the education and government markets.

For a discussion of the results of the reported segments, see the section entitled "Segment Information" below.

### **Acquisitions**

We believe that to remain competitive, we need to take advantage of acquisition opportunities that arise which may help us achieve greater geographic presence and economies of scale. We may also utilize acquisitions to whenever appropriate expand our technological capabilities and product offerings. While we may use a portion of any cash proceeds to pay down debt on an interim basis, we intend to use any additional liquidity and/or availability of assets generated by the paydown and remaining proceeds to fund acquisitions. Additionally, we are in the process of engaging a consultant to assist us with acquisitions, including identifying potential acquisition opportunities. We believe our markets contain a number of attractive acquisition candidates. We foresee expanding through acquisitions of one or more of the following types of technology organizations:

Developers and resellers of complementary software, such as time and attendance, workflow management, tax appraisals and assessment, education, court and law enforcement related products.

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Organizations focused on providing products and solutions to commercial large company (Fortune 100) and small business (SMB) accounts. Many of our current technology solutions translate to the corporate market, especially IP telephony, IP surveillance, video conferencing and network security.

Consulting firms providing high level professional services. We believe this type of acquisition would enhance our offering of technology planning and project management.

Cabling and infrastructure contractors. We currently outsource cabling services.

Our business strategy provides that we will examine the potential acquisition of companies and businesses within our industry. In determining a suitable acquisition candidate, we will carefully analyze a target's potential to add to and complement our product mix, expand our existing revenue base, improve our margins, expand our geographic coverage, strengthen our management team and, above all, improve stockholder returns. We are unable to predict the nature, size or timing of any acquisition. We can give no assurance that we will reach agreement or procure the financial resources necessary to fund any acquisition, or that we will be able to successfully integrate or improve returns as a result of any such acquisition.

During the interim period, we have continued to pursue and enter into preliminary discussions with various acquisition candidates. However, the Company has not entered into agreements or understandings for any acquisitions which management deems material.

### **Cautionary Statement Regarding Forward-Looking Information**

Certain information contained in this report includes forward-looking statements that involve substantial risk and uncertainties. Any statement in this report and in the documents incorporated by reference into this report that is not a statement of a historical fact constitutes a forward-looking statement. Among other things, these statements relate to our financial condition, results of operations and business. When used in this report, these forward-looking statements are generally identified by the words or phrases may, expect, anticipate, plan, believe, seek, estimate, or words of similar import. These forward-looking statements are not guarantees of future performance. These statements are based on management's expectations that involve a number of business risks, uncertainties and other factors that may cause the actual results, performance or achievements to differ materially from those expressed or implied by the forward-looking statements. Many factors are beyond our ability to control or predict. You are accordingly cautioned not to place undue reliance on such forward-looking statements, which speak only as of the date that we make them. We do not undertake to update any forward-looking statement that may be made from time to time by or on our behalf. We have attempted to identify, in context, some of the factors that we currently believe may cause actual future experience and results to differ from our current expectations regarding the relevant matter or subject area. The operations and results of our software and systems integration businesses also may be subject to the effects of other risks and uncertainties, including, but not limited to:

a reduction in anticipated sales;

an inability to perform customer contracts at anticipated cost levels;

our ability to otherwise meet the operating goals established by our business plan;

market acceptance of our new software, technology and services offerings;

an economic downturn; and

changes in the competitive market place and/or customer requirements.

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For a discussion of factors that may cause actual results to differ materially from forward-looking statements, see our Annual Report on Form 10-KSB for the year ended December 31, 2005, and other reports periodically filed with or furnished to the Securities and Exchange Commission.

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### **Critical Accounting Policies and Estimates**

The following discussion and analysis provides information that we believe is useful in understanding our operating results, cash flows and financial condition on our unaudited Consolidated Financial Statements included in this quarterly report. Our significant accounting policies are described in Note 1 to the Consolidated Financial Statements in CSI's annual report on Form 10-KSB. CSI's critical accounting policies and estimates are described under the caption "Critical Accounting Policies and Estimates" in CSI's annual report on Form 10-KSB.

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates, assumptions and judgments and rely on projections of future results of operations and cash flows. We base our estimates and assumptions on historical data and other assumptions that we believe are reasonable under the circumstances. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities in our financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

Our judgments are based on our assessment as to the effect certain estimates, assumptions of future trends or events may have on the financial condition and results of operations reported in our Consolidated Financial Statements. It is important that the reader of our financial statements understand that actual results could differ materially from these estimates, assumptions, projections and judgments.

### **Overview of Financial Performance**

Our revenues improved approximately \$4.9 million or 66.7% for the 2006 second quarter compared to the same period of the prior year due to increases in both technology solutions and software applications sales. For the six month period ended June 30, 2006 our revenues increased by approximately \$5.6 million, or 49.3%, compared to the same period in the prior year.

The gross profit for the quarter decreased by \$162,760 or 6.4%, and for the six months improved by \$183,152, or 5.0%. The gross margin percentage was 19.5% and 34.8% for the quarters ended June 30, 2006 and 2005, respectively. The overall decrease in margin for the quarter was attributed to a decline in hardware margins, partially offset by improvements in the software margins. The improvement in software margins for the quarter came from an increase in new software sales and related services, while costs remained flat over the prior year. Total personal computer sales both as reseller and agent declined slightly resulting in decreased gross profit from reduced commissions. The decrease in margins for the quarter on the hardware side also came from increased competitive pressure in the market place for hardware in general, partially offset by a slight improvement in gross profit from engineering services.

The increase in gross profit for the six months ended June 30, 2006 was attributed to the increase in both software and hardware gross profits driven by the corresponding increases in revenues of both segments in the first quarter, partially offset by a decline in gross profit of 6.4% in the second quarter of 2006. The overall decrease in margin percentage can be attributed to the decrease in hardware margins due to reduced computer systems commissions and increased competition in the hardware space partially offset by sales of higher margin engineering services and the improvement in software margins resulting from the increase in new software sales and support coupled with a decrease in the number of implementations requiring purchased third party software components for the first quarter of 2006.

Operating income declined from the year ago quarter by \$403,653 or 32.1% and for the six months improved by \$119,222, or 58.0%. The decrease in the second quarter was largely attributed to the decrease in gross profit, coupled with slight increases in operating expenses. The improvement over the six month period was primarily attributed to the non-recurrence in 2006 of expenses in 2005 related to the reverse merger. An increase in gross profit of the software applications segment, partially offset by lower hardware margins and slight increases in operating expenses for the same period of time also contributed to the increase. Further analysis of financial performance is discussed below in subsequent sections of this report.

**Table of Contents****Consolidated Results of Operations for three months ended June 30, 2006 versus three months ended June 30, 2005**

The following table and discussion sets forth the change in sales and the major items impacting the change in operating income for the three month period ended June 30, 2006 compared to the three month period ended June 30, 2005.

|                                      | Three Months Ended |              |              |
|--------------------------------------|--------------------|--------------|--------------|
|                                      | June 30,           | June 30,     | Increase     |
|                                      | 2006               | 2005         | (Decrease)   |
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 12,164,236      | \$ 7,298,428 | \$ 4,865,808 |
| <b>GROSS PROFIT</b>                  | 2,375,111          | 2,537,871    | (162,760)    |
| <b>OPERATING INCOME</b>              | 852,164            | 1,255,817    | (403,653)    |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) OPERATING INCOME**

|   |  |  |              |
|---|--|--|--------------|
| <b>Gross Profit:</b>  |  |  |              |
| Sales   |  |  | \$ 4,865,808 |
| Cost of sales excluding depreciation, amortization and capitalization |  |  | (5,192,743)  |
| Depreciation and Amortization   |  |  | (117,828)    |
| Capitalization of Software Costs                                      |  |  | 282,003      |
|   |  |  | (162,760)    |
| <b>Operating Expenses:</b>  |  |  |              |
| Salaries, wages and benefits  |  |  | (120,850)    |
| Reverse acquisition costs   |  |  |              |
| Stock based compensation  |  |  | (81,258)     |
| Professional and legal compliance and litigation related costs        |  |  | 134,269      |
| Marketing costs   |  |  | (59,952)     |
| Travel and mobile costs   |  |  | (59,647)     |
| Depreciation  |  |  | (26,741)     |
| Other SG&A expenses   |  |  | (26,714)     |
|   |  |  | \$ (403,653) |

**Revenue**

Total sales in the second quarter of 2006 increased \$4,865,808 in comparison with the second quarter of 2005. This net increase includes a \$4,561,842 increase in hardware sales and services through the technology solutions segment and a \$303,966 increase in software sales and services through the software solutions segment.

The increase in the technology solutions segment for the second quarter came from increases in hardware product sales, hardware support services, and related engineering support services, partially offset by a decline in hardware commissions. The increase in hardware product revenues was related to large technology sales of primarily computers systems and related peripherals, representing approximately 60% of the total increase. In connection with these sales, CSI purchased the hardware, acting as reseller rather than agent. Depending on the circumstances, which may include funding, financing costs, deal size, bid or other sales processes and considerations, CSI acts as agent on computer systems sales, in which case no cost is associated with the sale, and the only revenue recognized is the commissions from the vendor.

The increase in the software solutions segment was due to increases in software support agreement revenues, new client software sales, and software service revenues. New client software sales increased 31.4% in the second quarter of 2006, over the second quarter 2005. Software service revenues showed improvement due to a number of training projects being completed in the second quarter of 2006, and revenues related to support agreement services showed steady growth in second quarter 2006 revenues over second quarter 2005 due to the addition of new software customers since the second quarter of the prior year.

**Gross Profit**

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Gross profit in the second quarter of 2006 decreased \$162,760, or 6.4%, in comparison with the second quarter of 2005. The gross margin percentage was 19.5% and 34.8% for the quarters ended June 30, 2006 and 2005, respectively. The overall decrease in gross profit can be attributed to improvements in the software gross profit of approximately 46%, more than offset by a decline in hardware gross profit of 24%. The improvement in software margins came from an increase in new software sales and related services, while costs remained flat over the prior year. Total personal computer sales both as reseller and agent declined resulting in decreased gross profit from reduced commissions. The decrease in margins on the hardware side also came from increased competition in the hardware market partially offset by more profitable engineering services.

### **Operating Expenses**

Operating expenses increased \$240,893, or 18.8%, in the second quarter of 2006 compared to the second quarter of 2005. The above table analyzes the major items that account for this increase. The majority of the increase, approximately \$121,000, was related to increased salaries, wages and benefits primarily due to the increase in sales force. Following is a brief explanation of the other operating expenses and the related impact in the second quarter.

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*Reverse acquisition costs* decreased to zero in the second quarter 2006, as reverse acquisition costs were incurred and expensed in connection with the completion of the reverse merger in 2005.

*Stock based compensation* represents costs in connection with the issuance of stock awards to non-employee directors and outside consultants in 2006 and the redemption of options in 2005. Subsequent to the end of the first quarter 2005, our board of directors approved a new plan for the award of stock-based compensation to employees, directors and consultants. The new plan provides for the award of options, restricted stock or stock appreciation rights at the discretion of the compensation committee of the board of up to an aggregate of 1,100,000 shares. In February and March of 2006, the compensation committee of the board of directors reached a definitive agreement as to the terms surrounding compensation related to the reverse merger, and awarded our outside directors 196,992 shares of common stock and awarded outside consultants 344,734 shares of common stock under our 2005 Incentive Compensation Plan. Additionally in June 2006 Jeff Bryson was elected to our Board of Directors and awarded 23,350 shares of common stock under our 2005 Incentive Compensation Plan. \$81,258 was recorded as stock based compensation in the second quarter 2006. No stock based compensation was recorded in the second quarter of the prior year.

*Professional and legal compliance and litigation related costs* decreased in second quarter 2006, over second quarter 2005 by \$134,269. A significant amount of this decrease was related to reduced registration costs and litigation expenses related to the reverse merger, partially offset by increased costs associated with ongoing compliance, primarily the costs associated with the issuance of our first formal annual report and proxy during the second quarter. While the costs associated with the reverse merger and registration are likely to decrease in future periods, we anticipate that the audit fees and Sarbanes-Oxley related costs will continue.

*Marketing costs* increased due to the establishment of a new brand for CSI: *CSI Technology Outfitters* Computers. Software. Innovations. We are using *Technology Outfitters* to connote our ability to outfit organizations with a variety of technology and software solutions. We have also redesigned our website to match this theme and created a brochure which presents a wider range of offerings that can be communicated quickly in summary form. We spent \$59,952 on marketing, including our re-branding efforts in, the second quarter of 2006, while there were no marketing costs in the second quarter of 2005.

*Travel and mobile costs* increased in second quarter 2006 over second quarter 2005 by \$59,647. These costs increased due to increased fuel costs in 2006 and increased travel requirements of senior management.

*Depreciation expense* increased as a result of increased capitalized costs related to the relocation of our corporate headquarters late in 2005 and early in 2006 being depreciated in the second quarter of 2006.

*Other SG&A expenses* increased primarily as a result of increased non-compliance related professional fees including expenses related to sales consulting, market research, and trademark activities.

**Operating Income**

Operating income declined from the year ago quarter by \$403,653 or 32.1%. The decrease in the second quarter was largely attributed to the decrease in gross profit, coupled with increases in operating expenses. The decrease in gross profit was attributed to improvements in the software gross profit, more than offset by a decline in hardware gross profit, while operating expenses increased across various accounts as discussed above.

**Segment information**

CSI is organized into the two segments: software applications and technology solutions.

*Software applications segment*

Through our Software applications segment, we develop, sell, deploy and provide ongoing support of proprietary software applications.

|                                      | Three Months Ended |                  |                        |
|--------------------------------------|--------------------|------------------|------------------------|
|                                      | June 30,<br>2006   | June 30,<br>2005 | Increase<br>(Decrease) |
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 1,446,005       | \$ 1,142,039     | \$ 303,966             |

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|                              |         |         |         |
|------------------------------|---------|---------|---------|
| <b>GROSS PROFIT</b>          | 936,873 | 640,637 | 296,236 |
| <b>SEGMENT INCOME (LOSS)</b> | 340,385 | 145,768 | 194,617 |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME**

|   |  |  |            |
|---|--|--|------------|
| <b>Gross Profit:</b>  |  |  |            |
| Sales   |  |  | \$ 303,966 |
| Cost of sales excluding depreciation, amortization and capitalization |  |  | (191,835)  |
| Depreciation and Amortization   |  |  | (97,898)   |
| Capitalization of Software Costs                                      |  |  | 282,003    |
|   |  |  | 296,236    |
| <b>Operating Expenses:</b>  |  |  |            |
| Salaries, wages and benefits  |  |  | (17,696)   |
| Other SG&A expenses   |  |  | (83,923)   |
|   |  |  | \$ 194,617 |



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Sales improved by \$303,966, or 26.6%, primarily due to increases in revenue from new client software sales, software service revenues and software support agreements. As a result of the increase in new client software sales, more software services were rendered in the second quarter of 2006 over 2005, therefore increasing software service revenue. In addition to the increases from new client software sales and the accompanying services, software support agreement revenues increased as existing clients expanded their software support agreements and new clients were added.

The cost of sales excluding depreciation, amortization and capitalization increased primarily due to an increase in salaries and wages resulting from the addition of the .Net Microsoft SQL (application programming language and database conversion) team throughout 2005 and the addition of software services staff in 2006. In addition to salaries and wages, the increase was related to an increase in purchased third party software components, as installations in second quarter 2006 required more purchased components than in the year-ago quarter, which was offset by a decrease in travel and mobile costs associated with software services. The increase in deferred software costs and amortization are associated with the increased costs and subsequent amortization of costs associated with our standards based lesson planning software, curriculumator and our application delivery solution, DeliveryPoint and conversion of our integrated financial management software, CSI+, to .Net and SQL. The increase in salaries and wages in operating expenses was related to an increase in sales and pre-sales salaries, as well as bonuses. Other SG&A expenses increased primarily as a result of increased non-compliance related professional fees including expenses related to sales consulting, market research, and trademark activities, as well as increased marketing costs associated with the re-branding of CSI's products and services.

*Technology solutions segment*

Through our Technology solutions segment, we provide technology solutions through the sales and distribution of computer based technologies and accessories and offer a wide range of technology hardware and consulting services, including network and systems integration and computer support and maintenance services.

|                                      | <b>Three Months Ended</b> |                          |                                |
|--------------------------------------|---------------------------|--------------------------|--------------------------------|
|                                      | <b>June 30,<br/>2006</b>  | <b>June 30,<br/>2005</b> | <b>Increase<br/>(Decrease)</b> |
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 10,718,231             | \$ 6,156,389             | \$ 4,561,842                   |
| <b>GROSS PROFIT</b>                  | 1,438,238                 | 1,897,234                | (458,996)                      |
| <b>SEGMENT INCOME</b>                | 679,071                   | 1,130,352                | (451,281)                      |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME**

## Gross Profit:

|                                      |              |
|--------------------------------------|--------------|
| Sales                                | \$ 4,561,842 |
| Cost of sales excluding depreciation | (5,000,908)  |
| Depreciation                         | (19,930)     |

(458,996)

## Operating Expenses:

|                              |           |
|------------------------------|-----------|
| Salaries, wages and benefits | (103,154) |
| Other SG&A expenses          | 110,869   |

\$ (451,281)

Hardware sales increased over second quarter 2005 by \$4,561,842, or 74.1%, due to increases in new hardware sales, support agreement revenues and third party service agreement revenues, partially offset by a decrease in hardware commissions. The increase in new hardware sales and decrease in hardware commissions is attributed to large dollar sales of computer systems and peripherals, where CSI purchased the hardware and acted as reseller rather than agent. Depending on the circumstances, which may include funding, financing costs, deal size, bid or other sales processes and considerations, CSI acts as agent on computer system sales in which case the only revenue recorded is the commissions. The results from these deals are partially

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seen in the increase in hardware sales and resulting increase in the costs of purchased components. Total personal computer sales both as reseller and agent declined, resulting in decreased gross profit from reduced commissions. The net impact on gross profit is approximately the same whether we act as reseller or agent. Increased competition in the hardware markets in general affected pricing, which impacted margins. The increases were partially offset by higher margin engineering services. The significant increase in cost of sales excluding depreciation is the result of the previously mentioned deals, as well as increases in salaries related to technical delivery and travel and mobile costs.

The increase in salaries and wages in operating expenses was related to an increase in sales and pre-sales salaries, as well as increased bonuses. Other SG&A expenses decreased as a result of reduced travel costs, offset by increased non-compliance related professional fees including expenses related to sales consulting, market research, and trademark activities, as well as increased marketing costs associated with the re-branding of CSI's products and services.

The following tables summarize information about segment profit and loss for the quarters ended June 30, 2006 and 2005 and assets allocated to segments as of June 30, 2006 and 2005.

|                                     | Software<br>Applications | Technology<br>Solutions | Total<br>Company |
|-------------------------------------|--------------------------|-------------------------|------------------|
| <b>Quarter ended June 30, 2006:</b> |                          |                         |                  |
| Net sales and service revenue       | \$ 1,446,005             | \$ 10,718,231           | \$ 12,164,236    |
| Gross profit                        | 936,873                  | 1,438,238               | 2,375,111        |
| Segment income                      | 340,385                  | 679,071                 | (*)              |
| Segment assets                      | 3,368,260                | 9,106,778               | 12,475,038       |
| <b>Quarter ended June 30, 2005:</b> |                          |                         |                  |
| Net sales and service revenue       | \$ 1,142,039             | \$ 6,156,389            | \$ 7,298,428     |
| Gross profit                        | 640,637                  | 1,897,234               | 2,537,871        |
| Segment income                      | 145,768                  | 1,130,352               | (*)              |
| Segment assets                      | 2,464,276                | 5,951,094               | 8,415,370        |

\* See reconciliation below

**Reconciliation of Segment income (non-GAAP measure) to operating income per consolidated Statements of Operations (GAAP measure):**

|   | Quarter Ended |              |
|---|---------------|--------------|
|   | June 30,      | June 30,     |
|   | 2006          | 2005         |
| <b>Segment income:</b>  |               |              |
| <b>Software applications segment</b>                              | \$ 340,385    | \$ 145,768   |
| <b>Technology solutions segment</b>                               | 679,071       | 1,330,352    |
| <b>TOTAL SEGMENT INCOME</b>                                       | 1,019,456     | 1,476,120    |
| <b>Less: Merger and compliance costs</b>                          |               |              |
| Stock based compensation  | (81,258)      |              |
| Professional and legal compliance and litigation related costs    | (86,034)      | (220,303)    |
| <b>OPERATING INCOME Per consolidated Statements of Operations</b> | \$ 852,164    | \$ 1,255,817 |
| <b>Interest and Other Income and Expenses</b>                     |               |              |

Interest expense increased approximately \$19,000 in the second quarter of 2006 compared to the second quarter of 2005 due to the additional interest costs incurred related to the RBC notes payable and additional interest paid to the five original shareholders and Barron as a penalty for being in default on the notes payable associated with the reverse merger transactions. A material decrease in other income and expenses occurred

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related to the unrealized loss on warrants recorded in 2005 which did not recur in 2006. In the second quarter of 2005, CSI recognized a non-cash loss related to the accounting for the warrants of approximately \$108,000 (\$65,000 net of tax) due to a decrease in the market value of the warrants based on the Black-Scholes valuation method. While this item does not have a significant impact on the second quarter 2006, the warrant loss in the first quarter of 2005 and gains in the third and fourth quarters of 2005 will have significant effect on comparability in the third and fourth quarters of 2006. As a result, CSI's net income to be reported in the third and fourth quarters of 2006 will likely be significantly below that of the prior year taking into consideration the non-cash gains recorded in 2005 associated with the warrants.

**Table of Contents****Income Taxes**

Income taxes decreased by \$233,195, or 48.4%, in the second quarter of 2006 compared to the first quarter of 2005 due to the tax impact of the decline in gross profit of approximately \$162,000 and the decrease in operating income of approximately \$377,000 and reduction of other expenses as a result of having no loss associated with the warrants in 2006.

**Net Income and Earnings per Share**

Net income decreased \$80,766, or 13.7%, to \$507,824 for second quarter 2006, as a result of the reduction in hardware margins partially offset by the increase in software margins, the absence of reverse acquisition costs, the reduction of professional and legal compliance and litigation costs, the increased operating expenses, and the absence of the unrealized loss on the warrants.

Basic earnings per share declined from earnings per share of \$0.22 in the second quarter 2005, to earnings per share of \$0.15 in the second quarter of 2006, while diluted earnings per share remained constant at \$0.05 for both the 2006 and 2005 second quarters. This unfavorable decline resulted from the downward pressure on margins and increased operating expenses, partially offset by the absence of the \$108,267 unrealized loss on warrants as previously discussed. The additional preferred stock, warrants and employee held options issued in connection with the merger in February 2005 were included in the calculation of diluted earnings per share for second quarter 2005 and 2006. See Note 2 to the financial statements for additional discussion surrounding the calculation of earnings per share.

**Consolidated Results of Operations for six months ended June 30, 2006 versus six months ended June 30, 2005**

The following table and discussion sets forth the change in sales and the major items impacting the change in operating income for the six month period ended June 30, 2006 compared to the six month period ended June 30, 2005.

|                                      | June 30,<br>2006 | Six Months Ended<br>June 30,<br>2005 | Increase<br>(Decrease) |
|--------------------------------------|------------------|--------------------------------------|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 17,006,639    | \$ 11,390,732                        | \$ 5,615,907           |
| <b>GROSS PROFIT</b>                  | 3,878,717        | 3,695,566                            | 183,151                |
| <b>OPERATING INCOME</b>              | 324,750          | 205,528                              | 119,222                |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) OPERATING INCOME**

|   |  |  |              |
|---|--|--|--------------|
| <b>Gross Profit:</b>  |  |  |              |
| Sales   |  |  | \$ 5,615,907 |
| Cost of sales excluding depreciation, amortization and capitalization |  |  | (5,537,380)  |
| Depreciation and Amortization   |  |  | (157,893)    |
| Capitalization of Software Costs                                      |  |  | 262,517      |
|   |  |  | 183,151      |
| <b>Operating Expenses:</b>  |  |  |              |
| Salaries, wages and benefits  |  |  | (289,674)    |
| Reverse acquisition costs   |  |  | 759,283      |
| Stock based compensation  |  |  | (64,038)     |
| Professional and legal compliance and litigation related costs        |  |  | (210,585)    |
| Marketing costs   |  |  | (149,856)    |
| Travel and mobile costs   |  |  | (79,866)     |
| Depreciation  |  |  | (49,173)     |
| Other SG&A expenses   |  |  | 19,980       |
|   |  |  | \$ 119,222   |



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**Table of Contents****Revenue**

Our revenues for the first six months of 2006 were \$17,006,639, \$5,615,907 or 49.3% higher than the first six months of 2005. The change resulted from the increase in sales for the first quarter of \$750,100 over the same prior year period coupled with a \$4,865,808 increase in the second quarter. Technology solutions segment sales of internet-protocol based telephony equipment, instructional hardware, computer systems and printing and fax machines increased substantially through the first and second quarters. In addition, increases in engineering service revenues, technology support revenues and third party service agreement revenues contributed to the increase but were partially offset by a decrease in hardware commission revenues. The increase in the hardware product revenues was related to large computer system sales which occurred in the second quarter of 2006. In connection with these sales, CSI purchased the hardware and acted as reseller rather than agent.

The increase in the software solutions segment sales was due to increases in software support agreement revenues and new client software sales in the first and second quarter of 2006. New client software sales increased in both the first and second quarters of 2006, compared to the same quarters in 2005. Related software service revenues were down in the first quarter but recovered in the second due to a number of training projects being completed. Additionally, revenues related to support agreement services showed steady growth due to additions of new software sales since the prior year quarter and the movement of some existing clients to enhanced support offerings.

**Gross Profit**

Gross profit was \$3,878,717 for the first six months of 2006, an increase of \$183,151 or 5.0% over the same period of the prior year. The gross margin percentage was 22.8% for the first six months of 2006 versus 32.4% for the same period of 2005. The increase in gross profit was attributed to the increase in both software and hardware gross profits driven by the corresponding increases in revenues of both segments in the first quarter, partially offset by a decline in gross profit of 6.4% in the second quarter of 2006. The overall decrease in margin can be attributed to the decrease in hardware margins due to increasing competitive pressures in the hardware space in general, and decreased hardware commissions, partially offset by more profitable engineering services in the second quarter 2006, and the improvement in software margins resulting from the increase in new software sales and support coupled with a decrease in the number of implementations requiring purchased third party software components for the first quarter of 2006.

In late 2005, CSI increased the number of software sales personnel and in early 2006 restructured the sale force from a single segment (software or technology) product focus to a combined effort, supported by product specialists. As a result, in first six months of 2006 salaries, wages and benefits related to product development, software delivery and training services increased by approximately \$174,004, or 23.6%. Hardware salaries and wages remained relatively flat, showing a slight decrease of 3.1%. The results from the large technology deals that occurred in 2006 are partially seen in the increase in new hardware sales and hardware cost of sales. The net impact on gross profit is approximately the same whether we acts as reseller or agent for these larger deals. In total, total personal computer sales both as reseller and agent declined, resulting in decreased gross profit from reduced commissions. In addition, increases in competition in developing hardware lines, primarily classroom based solutions, also had a negative impact on margin.

**Operating Expenses**

Operating expenses were \$3,553,967 for the first six months of 2006, an increase of \$63,929 or 1.8% over the same period of the prior year. The above table analyzes the major items that account for this increase. The majority of the increase is reflected in the \$289,674 increase in salaries and wages, the \$210,585 increase in legal and professional compliance and litigation costs, and the \$149,856 increase in marketing costs, all of which were partially offset by the absence of reverse acquisition costs in 2006. The increase in salaries, wages and benefits was primarily due to the increase in the sales and pre-sales staff and increased administrative staff hired in the second quarter of 2006. Following is a brief explanation of the other operating expenses and the related impact in the second quarter.

*Reverse acquisition costs* decreased to zero in the first six months of 2006, as reverse acquisition costs were incurred and expensed in connection with the completion of the reverse merger in 2005.

*Stock based compensation* represents costs in connection with the issuance of stock awards to non-employee directors and outside consultants in 2006 and the redemption of options in 2005. Subsequent to the end of the first quarter 2005, our board of directors approved a new plan for the award of stock-based compensation to employees, directors and consultants. The new plan provides for the award of options, restricted stock or stock appreciation rights at the discretion of the compensation committee of the board of up to an aggregate of 1,100,000 shares. In February and March of 2006, the compensation committee of the board of directors reached a definitive agreement as to the terms surrounding compensation related to the reverse merger, and awarded our outside directors 196,992 shares of common stock and awarded outside consultants 344,734



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shares of common stock under our 2005 Incentive Compensation Plan. Additionally in June 2006 Jeff Bryson was elected to our Board of Directors and awarded 23,350 shares of common stock under our 2005 Incentive Compensation Plan. Under the terms of the award, 11,675 shares vested immediately upon election and the remaining shares will vest at the conclusion of the 2007 Annual Meeting of Stockholders. The total stock compensation issued in 2006 was \$893,845, of which \$613,954 was earned in 2005 and the first quarter 2006 and \$81,258 was earned in second quarter 2006, leaving \$198,633 as unearned stock compensation at June 30, 2006.

*Professional and legal compliance and litigation related costs* increased in the first half of 2006, over the first half of 2005 by \$210,585 due to the costs associated with operating as a public company, partially offset by reduced registration costs and litigation expenses. A significant amount of these costs were related to audit fees, initial Sarbanes-Oxley implementation costs, and costs related to effecting registration of securities related to the reverse merger in the first quarter of 2006. While the costs associated with the reverse merger are likely to decrease in future periods, the Company anticipates that the audit fees and Sarbanes-Oxley related costs will continue. The Company cannot quantify how much professional and legal compliance and litigation related costs will be in future periods as it is unable to project events which may impact these amounts. However, the company has budgeted approximately \$600,000 for these costs in 2006.

*Marketing costs* increased due to the establishment of a new brand for CSI: *CSI Technology Outfitters* Computers. Software. Innovations. We are using *Technology Outfitters* to connote our ability to outfit organizations with a variety of technology and software solutions. We have also redesigned our website to match this theme and created a brochure which presents a wider range of offerings that can be communicated quickly in summary form. We spent a total of \$149,856 on marketing, including our re-branding efforts in the first and second quarter of 2006, while there were no such marketing costs in the first and second quarter of 2005.

*Travel and mobile costs* increased in the first half of 2006 over the first half of 2005 by \$79,866. These costs increased due to increased sales staff, increases in fuel costs and increased travel requirements of senior management.

*Depreciation expense* increased as a result of increased capitalized costs related to the relocation of our corporate headquarters late in 2005 and early in 2006 being depreciated in the first half of 2006.

*Other SG&A expenses* decreased as a result of reduced travel costs, offset by increased non-compliance related professional fees including expenses related to sales consulting, market research, and trademark activities, as well as increased marketing costs associated with the re-branding of CSI's products and services.

**Operating Income**

Operating income for the six months ended June 30, 2006 was \$324,750, an increase of \$119,222 or 58.0% compared to the same period of the prior year. This increase in operating income is the result of the \$522,877 improvement in the first quarter 2006, partially offset by the decrease of \$403,653 in the second quarter 2006. The overall 2006 improvement was due to increased sales and improved software margins, partially offset by increases in: our operating expenses primarily as a result of increases in salaries, wages and benefits; professional and legal compliance costs; marketing costs; travel and mobile costs; and depreciation and amortization. Further analysis of financial performance is discussed below in subsequent sections of the report.

**Segment information***Software applications segment*

|                                      | Six Months Ended |              |            |
|--------------------------------------|------------------|--------------|------------|
|                                      | June 30,         | June 30,     | Increase   |
|                                      | 2006             | 2005         | (Decrease) |
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 2,550,077     | \$ 2,128,788 | \$ 421,289 |
| <b>GROSS PROFIT</b>                  | 1,579,056        | 1,180,560    | 398,496    |
| <b>SEGMENT INCOME</b>                | 510,795          | 343,257      | 167,538    |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME**

Gross Profit



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|   |            |
|---|------------|
| Sales   | \$ 421,289 |
| Cost of sales excluding depreciation, amortization and capitalization | (159,652)  |
| Depreciation and Amortization   | (125,658)  |
| Capitalization of Software Costs                                      | 262,517    |
|   | 398,496    |
| Operating Expenses  |            |
| Salaries, wages and benefits  | (78,107)   |
| Other SG&A expenses   | (152,851)  |
|   | \$ 167,538 |

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Software applications segment sales increased by \$421,289, or 19.8%, primarily due to increases in new client software sales and software support agreement revenues. Software service revenues were down in the first quarter but recovered in the second due to a number of training projects being completed.

Cost of sales excluding depreciation, amortization and capitalization increased in the first half of 2006 by \$159,652, or 15.9%, over the first half of 2005. This increase was the result of increased salaries and wages due to the addition of the .Net Microsoft SQL (application programming language and database conversion) team throughout 2005, and increased travel and mobile costs, the total of which was somewhat offset by a decrease in costs associated with purchased components related to software, as the installations in the first quarter of 2006 did not require significant purchased third party software components. The increase in deferred software costs and amortization are associated with the increased costs and subsequent amortization of costs associated with our standards based lesson planning software, curricular and our application delivery solution, DeliveryPoint, and conversion of our integrated financial management software, CSI+, to .Net SQL. The increase in salaries and wages in operating expenses was related to an increase in sales and pre-sales salaries, as well as increased bonus. Other SG&A expenses increased by \$152,851, or 83.7%, as the result of increased non-compliance related professional fees including expenses related to sales consulting, market research, and trademark activities, as well as increased marketing costs associated with the re-branding of CSI's products and services.

*Technology solutions segment*

|                                      | Six Months Ended |              |              |
|--------------------------------------|------------------|--------------|--------------|
|                                      | June 30,         | June 30,     | Increase     |
|                                      | 2006             | 2005         | (Decrease)   |
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 14,456,562    | \$ 9,261,944 | \$ 5,194,618 |
| <b>GROSS PROFIT</b>                  | 2,299,661        | 2,515,006    | (215,345)    |
| <b>SEGMENT INCOME</b>                | 940,055          | 1,520,797    | (580,742)    |

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME**

|                                      |  |  |              |
|--------------------------------------|--|--|--------------|
| Gross Profit                         |  |  |              |
| Sales                                |  |  | \$ 5,194,618 |
| Cost of sales excluding depreciation |  |  | (5,377,728)  |
| Depreciation                         |  |  | (32,235)     |
|                                      |  |  | (215,345)    |
| Operating Expenses                   |  |  |              |
| Salaries, wages and benefits         |  |  | (163,799)    |
| Other SG&A expenses                  |  |  | (201,598)    |
|                                      |  |  | \$ (580,742) |

Technology solutions segment sales increased by \$5,194,618, or 56.1% in the first six months of 2006 over the same period in 2005. Sales of internet-protocol based telephony equipment, instructional hardware, computer systems and printing and fax machines increased substantially through the first and second quarters. In addition, increases in engineering service revenues, technology support agreement revenues and third party service agreement revenues contributed to the increase but were partially offset by a decrease in commission revenues. The increase in the hardware product revenues was related to large dollar computer system sales which occurred in the second quarter of 2006. In connection with these sales, CSI purchased the hardware and acted as reseller rather than agent. The significant increase in cost of sales excluding depreciation is the result of the sales of computer systems as reseller rather than agent, representing approximately 97% of the increase, with the remaining increase due to increases in salaries related to technical delivery and travel and mobile costs.

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The increase in salaries and wages in operating expenses of \$163,799, or 21.3%, was related to the increase in the sales and pre-sales staff and increased administrative staff hired in the second quarter of 2006, while the increase in other SG&A expenses of \$201,598, or 89.5%, related to increases in marketing expense, travel and mobile costs and depreciation.

The following tables summarize information about segment profit and loss for the six month periods ended June 30, 2006 and 2005 and assets allocated to segments as of June 30, 2006 and 2005.

|  | Software<br>Applications | Technology<br>Solutions | Total<br>Company |
|--|--------------------------|-------------------------|------------------|
| <b>Six months ended June 30, 2006:</b> |                          |                         |                  |
| Net sales and service revenue          | \$ 2,550,077             | \$ 14,456,562           | \$ 17,006,639    |
| Gross profit                           | 1,579,056                | 2,299,661               | 3,878,717        |
| Segment income                         | 510,795                  | 940,055                 | (*)              |
| Segment assets                         | 3,368,260                | 9,106,778               | 12,475,038       |
| <b>Six months ended June 30, 2005:</b> |                          |                         |                  |
| Net sales and service revenue          | \$ 2,128,788             | \$ 9,261,944            | \$ 11,390,732    |
| Gross profit                           | 1,180,560                | 2,515,006               | 3,695,566        |
| Segment income                         | 343,257                  | 1,520,797               | (*)              |
| Segment assets                         | 2,464,276                | 5,951,094               | 8,415,370        |

\* See reconciliation below

**Reconciliation of Segment income (non-GAAP measure) to operating income per consolidated Statements of Operations (GAAP measure):**

|   | Six Months Ended<br>June 30,<br>2006 | Six Months Ended<br>June 30,<br>2005 |
|---|--------------------------------------|--------------------------------------|
| <b>Segment income:</b>  |                                      |                                      |
| <b>Software applications segment</b>  | \$ 510,795                           | \$ 343,257                           |
| <b>Technology solutions segment</b>   | 940,055                              | 1,520,797                            |
| <b>TOTAL SEGMENT INCOME</b>   | 1,450,850                            | 1,864,054                            |
| <b>Less: Merger and compliance related costs</b>  |                                      |                                      |
| Stock based compensation  | (695,212)                            | (631,174)                            |
| Payroll tax expenses in Other selling, general and administrative costs related to stock option compensation from stock option redemption in connection with merger |                                      | (47,766)                             |
| Reverse acquisition costs   |                                      | (759,283)                            |
| Professional and legal compliance costs   | (430,888)                            | (220,303)                            |
| <b>OPERATING INCOME Per Statement of Operations</b>   | \$ 324,750                           | \$ 205,528                           |
| <b>Interest and other income and expenses</b>   |                                      |                                      |

Interest income decreased by approximately \$3,000 due to the Company only receiving interest on overnight invested funds related to the RBC line of credit in 2006, while the Company received interest income from approximately \$3 million held in a money market account for the first portion of the first quarter in 2005. Interest expense increased \$98,755 in the first six months of 2006 compared to the first six months of 2005 due to the additional interest costs incurred related to the RBC notes payable and additional interest paid to the five original shareholders and Barron on the notes payable associated with the reverse merger transactions. A material decrease in other income and expenses occurred related to the unrealized loss on warrants recorded in 2005 which did not recur in 2006. In the first half of 2005, we recognized a non-cash loss related to the accounting for the warrants of approximately \$3.2 million (\$1.9 million net of tax) due to a decrease in the market value of the warrants

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based on the Black-Scholes valuation method. Accordingly, the six month 2006 improvement is significant in comparison to the loss in the prior year's first quarter; however, the warrant loss in the first six months of 2005 was offset by significant gains in the third and fourth quarters of 2005. As a result, CSI's net income to be reported in the third and fourth quarters of 2006 will likely be significantly below that of the prior year taking into consideration the non-cash gains recorded in the 2005 third and fourth quarters associated with the warrants.

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**Table of Contents****Income Taxes**

Income taxes increased by approximately \$1.2 million, or 103.5%, in the first six months of 2006 compared to the first six months of 2005 due to the tax impact of the increase in gross profit of approximately \$183,000 and the increase in operating income of approximately \$119,000. However, the most significant impact on the change in income taxes was related to the absence in 2006 of the tax effect of the \$3.2 million dollar loss associated with the warrants in 2005.

**Net Income (Loss) and EPS**

The net loss of \$1,860,853 in the first six months of 2005 improved by \$1,939,145, or 104.2%, compared to net income of \$78,292 for first six months of 2006, primarily as a result of the increase in operating income and the absence of the unrealized loss on the warrants which occurred in 2005 period.

Basic earnings per share improved from a loss per share of \$0.71 in the first six months of 2005, to earnings per share of \$0.03 in the first six months of 2006. Diluted earnings per share also improved from the \$0.71 loss per share in the first six months of 2005 to earnings per share of \$0.01 in the first six months of 2006. These improvements resulted primarily from the increased operating income and the absence of the \$3.2 million unrealized loss on warrants as previously discussed. Diluted earnings per share were the same as basic earnings per share for the six months ended June 30, 2005, as their effect, due to losses being reported in the period was anti-dilutive. Due to being anti-dilutive, the additional preferred stock, warrants and employee held options issued in connection with the merger in February 2005 were not included in the calculation of diluted earnings per share for the six months ended June 30, 2005, but were not anti-dilutive and included for the six months ended June 30, 2006. See Note 2 to the financial statements for additional discussion surrounding the calculation of earnings per share. Also see comments regarding net income to be reported for the third and fourth quarters in the Interest and other income and expenses section above.

**Liquidity and Capital Resources**

Cash increased from \$0 at December 31, 2005 to \$334,310 at June 30, 2006, due primarily to net income of \$94,546 adjusted for non-cash items and changes in current asset and liabilities account balances of \$960,549 and financing activities of \$506,428, offset by cash used for investing activities of \$1,132,667.

*Cash from Operating Activities*

Cash provided by operating activities totaled \$960,549 in the first six months of 2006 compared to cash used for operating activities of \$1,221,807 in the first six months of 2005. The increase of \$2,182,356 in 2006 is due primarily to the increase in net income, the increase in depreciation and amortization, and the increase in deferred income taxes, offset against the absence of the loss related to the warrant, the increases in deferred revenue and changes in the current assets and liabilities balances as noted below.

Changes since year end to balance sheet items related to operating activities are as follows:

Increases in the consolidated balance sheet line items for accounts receivable and accounts payable were due to the large technology deals, which occurred in the second quarter of 2006, where we acted as reseller rather than agent, and therefore recorded significant amounts due from clients and due to vendors supplying the product sold related to these deals. Increased hardware demand and timing of sales also resulted in an increase in inventories. The increase in deferred revenue is in connection with a significant increase in support agreements previously discussed, which are deferred over the life of the agreement. The increase in the taxes receivable balance is the result of the tax refund, provided for by the loss incurred in the first quarter due to the costs related to stock compensation costs and professional and legal compliance and litigation costs and to some extent a shift between current and deferred taxes for temporary items including the the payment in 2006 of certain 2005 year end accruals.

*Cash from Investing Activities*

Cash used for investing activities totaled \$1,132,667 in the first six months of 2006 compared to \$420,352 in the first six months of 2005. The increase of \$712,315 is due primarily to the continued investment in development of the .Net version of CSI's major software modules, the investment in curricularator software and increased purchases of property and equipment related to the relocation of the corporate headquarters in the first quarter of 2006.



**Table of Contents***Cash from Financing Activities*

Cash provided by financing activities netted to \$506,428 in the first six months of 2006 compared to cash used of \$2,014,318 in the first six months of 2005. The increase of \$2,520,746 is due primarily to the absence of activities related to the reverse acquisition in 2005.

**Credit Arrangements**

During the first quarter of 2005, in order to support the activities of the reverse acquisition, the Company entered into a \$3,000,000 line of credit facility whereby the Company can borrow up to 80% of accounts receivable balances, not to exceed the total facility limit of \$3,000,000. In the first quarter of 2006, this facility was renewed with an increased limit of \$3.5 million. Eligible accounts receivable balances essentially include all of our trade accounts receivable except, in most cases, for those accounts which are more than 90 days past due. Certain other accounts are excluded from eligibility for borrowing including: (i) such accounts due from affiliates; (ii) accounts which we have determined to be of doubtful collectibility; and (iii) accounts due from any one of our customers if such accounts constitute more than 20% of the total eligible accounts. Immediately upon entering into the loan agreement in 2005, the Company borrowed \$1,500,000 which was used for the paydown of a portion of the subordinated notes issued in connection with the merger. The loans bear interest at Libor plus 0.275%, (7.86% at June 30, 2006), payable monthly. The original facility matured on July 15, 2006, following short-term extensions to align the renewal period to follow the Company's annual reporting and meeting time frames. On July 14, 2006, the Company executed a modification agreement extending the maturity date of the facility from July 15, 2006 to July 15, 2007. The modification agreement also increased the principal amount of the facility from \$3.0 million to \$3.5 million. The reason for the increase in principal is to support increasing working capital requirements of the Company.

Prior to the execution of the modification agreement, the maturity date of the facility was extended on two prior occasions. The first extension extended the maturity date from March 1, 2006 to May 1, 2006. The second extension extended the maturity date from May 1, 2006 to July 15, 2006. Both extensions were disclosed on Current Reports on Form 8-K filed on March 1, 2006 and May 3, 2006, respectively. Other than as altered by the modification agreement, the obligations under the credit facility remained unchanged.

Loans under the facility are secured by a first priority lien on all of our personal property to the lender, including all accounts, equipment, inventory, contract rights and intangibles. Under the facility, CSI is subject to restrictive covenants, the primary terms of which restrict incurring debt, making loans, changing approved executive compensation arrangements or making distributions or investments which would violate the restrictive covenants in the loan agreement. The agreement with our lender also requires the achievement of a debt to EBITDA ratio of not more than 2.5:1 measured as of fiscal year end; a debt service coverage of 1.2:1.0 as measured at fiscal year end (measured as EBITDA, as defined, divided by current maturities of long-term debt plus interest payments); EBITDA of not less than \$2,000,000; and a minimum tangible net worth of \$1,500,000 (including subordinated debt). EBITDA is defined as earnings before income taxes, depreciation and amortization, but provides for the elimination of certain special expenses that would not typically reflect the Company's operating income (or income from operations), including (i) unrealized gain (loss) on warrants; (ii) legal and professional fees; (iii) expenses of securities compliance; and (iv) stock option compensation. As of June 30, 2006, the Company believes it had complied with the covenants.

As of June 30, 2006 there was \$1,842,000 of outstanding draws under our bank credit facility, and \$1,658,000 was available under the facility.

The Company also has significant commitments under the subordinated notes payable to the original five shareholders of CSI - South Carolina and Barron, as a result of the reverse acquisition, totaling \$2,250,400, which were due and payable on May 10, 2006. The Company failed to pay the subordinated notes at maturity, and such notes were in default. Interest not paid quarterly and any principal not paid by the due date accrue interest at 15% until paid. Any potential cross-default under our bank credit facilities relating to the nonpayment of the subordinated notes has been waived by our bank lender through July 15, 2007. We have agreed with our bank to cure the default under the subordinated notes by that date if and when any such action might be deemed necessary based on discussions with the subordinate note holders, and pursuant to the terms of our bank credit facilities, to obtain the consent of the bank to any modification of the terms of the subordinated notes.

Although adequate availability existed under our bank credit facility to repay in full the subordinated notes on the May 10, 2006 maturity date, neither we nor the note holders believed it to be in our best interests. First, we believed that draws under the credit facility to repay the subordinated notes may have left inadequate availability to support our working capital needs for the remainder of the year. Secondly, and more importantly, the subordinated debt is counted as equity in the calculations

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of the minimum tangible net worth requirement with the bank. Utilization on May 10, 2006 of the bank credit facility to repay the subordinated notes would probably place us in violation of the minimum tangible net worth covenant at the next covenant test date of December 31, 2006. Looking forward, we believe it is unlikely that we will be able to generate sufficient net income during 2006 so as to permit repayment of the subordinated notes with draws under the line of credit this fiscal year and still maintain compliance with the minimum tangible net worth covenant.

The Company currently plans to use the first \$2,250,400 of warrant proceeds, if and when available, to repay the subordinated debt, unless other arrangements, such as an extension of the due date or conversion of some or all of the notes payable to equity were agreed to by the subordinated debt holders or changes in financing were effected such as those that might occur in connection with an acquisition. Although the registration statement registering the resale of the warrant shares was declared effective by the SEC on February 14, 2006, and Barron has communicated an interest in selling some of the shares underlying the warrants, we cannot predict when Barron may exercise the warrants and we will receive proceeds with which to repay the subordinated notes. Also, it should be noted that Barron may procure saleable common shares by first converting its preferred stock, thereby deferring its exercise of the two warrants. We would receive no proceeds from a conversion of the preferred stock.

We are currently in negotiations with the subordinated noteholders to extend the maturity of the notes. Such negotiations have also included consideration of the conversion of all or a portion of the subordinated notes to an equity security. Although we are optimistic that a successful resolution of the repayment of the subordinated notes will be obtained, and the default under such notes cured within the waiver period provided by the bank, we can give no assurances that such a resolution will in fact occur. Although the terms of the notes subordinate the rights of the holders to those of senior lenders including the bank and generally prohibit the Company from making any payments on the subordinated notes until the repayment of senior debt, the holders of the subordinated notes could potentially accelerate such debt following nonpayment by the Company at maturity. Although this would not have any direct effect on the Company, it may trigger a default under our bank line of credit. Despite what we believe to be our good relations with our bank, we are unable to predict whether our bank lender would grant another waiver under such circumstances. If our bank did not grant such a waiver, we could be forced to obtain an alternative source of financing. We can give no assurances that replacement financing would be available on acceptable terms, or at all. Also, it may be possible for the subordinated noteholders to bring legal action with respect to the subordinated notes, the adverse consequences of which we are unable to evaluate. However, as indicated above, we have discussed with the subordinated noteholders a delay in payment on the notes and alternatives including extending the maturity date. We do not anticipate any of such noteholders taking any action detrimental to the Company. It should be noted that five of the subordinated noteholders are currently significant stockholders of the Company, and four of these are executive officers of the Company. The sixth subordinated noteholder, Barron, holds all of the Company's preferred stock.

***Future Capital Needs and Resources***

Since inception, and prior to the merger, the Company had funded its operations through cash flow from operations. However, as a result of the recapitalization in connection with the reverse merger the Company has chosen to utilize a line of credit facility and term loan to assist in the financing of future costs.

Ongoing capital resources depend on a variety of factors, including our existing cash balance, the cash flow generated from our operations and external financial sources that may be available. As of December 31, 2004, our capital resources included \$3.7 million of cash, which was impacted by the merger and related transactions as described in Note 3 of the interim financial statements. As a result, at December 31, 2005 our cash balance was zero, and we were funding our operations through the use of our \$3 million line of credit. As of June 30, 2006, the Company plans to continue using the line of credit (now \$3.5 million) to fund operations, while using the \$400,000 term loan to support capital expenditures. In light of the additional capital needs incurred in connection with the relocation of our main offices, and to provide additional working capital availability under our line of credit, we may seek to increase our term borrowings to \$1,000,000. Our ability to generate sufficient operating cash flow is dependent upon, among other things:

the amount of revenue we are able to generate and collect from our customers;

the amount of operating expenses required to provide our services;

the cost of acquiring and retaining customers; and



our ability to continue to grow our customer base.

**Table of Contents*****Factors Affecting Capital Needs and Resources***

Set forth below are factors which management believes could have a significant impact on our future cash and capital needs and resources.

*Customer support billings.* We historically bill a significant portion of our service contracts late in the second quarter of the year. Historically this amount has exceeded \$2,000,000. While revenue for service contracts is deferred over the life of the contract (typically over a year) significant cash is generated in the third quarter as a result of the service payments being billed and collected as payment for the entire future year's service. The Company borrows through its line of credit based on availability tied to its receivables. Cash collections are first used to pay down the line of credit. Thereafter, funds are available to be borrowed again based on our receivables position and line of credit limit as detailed below. Only if the line of credit was paid down and working capital needs met, would we have significant cash on our balance sheet.

*Burden of Professional and Legal Compliance Costs.* For the six months ended June 30, 2006, professional and legal compliance and litigation costs, excluding stock-based (non-cash) compensation, totaled \$430,888. These related primarily to compliance costs for the Company's transition to a public company, as well as legal and accounting costs for the registration of shares pursuant to the registration rights agreement. Management anticipates that the current level of expenses should abate following the effectiveness of the Company's registration statement with the Securities and Exchange Commission on February 14, 2006. Although the Company is hopeful that costs related to supplementing the registration statement for updated financial and other information will be minimal, there can be no assurances that this will in fact be the case and cost savings realized. Also, the compliance costs associated with public company status are significant.

*Bank Credit Facility.* Absent a significant cash inflow from the cash exercise of the warrants or otherwise, for the foreseeable future, we will rely on our \$3.5 million line of credit facility whereby the Company can borrow up to 80% of its receivable balance, not to exceed the total facility limit of \$3.5 million. As of June 30, 2006, our facility allowed for borrowing up to \$3.5 million (based on adjustments for eligible receivables) of which there was \$1,842,000 of outstanding draws under our bank credit facility, and \$1,658,000 was available under the facility for additional loan advances.

Management believed that cash flow from operations was not sufficient to repay both the bank credit facility in full as of its July 2006 maturity and the subordinated promissory notes payable to shareholders in an aggregate amount of \$2.3 million which were due May 10, 2006, without risk to its ability to fund working capital requirements and meet debt covenants. Management renewed the bank credit facility prior to its expiration date. On July 14, 2006, the Company and RBC Centura Bank executed a modification agreement extending the maturity date of the facility from July 15, 2006 to July 15, 2007. The modification agreement also increased the principal amount of the facility from \$3.0 million to \$3.5 million. The reason for the increase in principal is to support increasing working capital requirements of the Company.

*Subordinated Promissory Notes.* At June 30, 2006, subordinated promissory notes payable to shareholders totaled approximately \$2.3 million. As described above, we failed to repay the subordinated promissory notes upon their maturity on May 10, 2006. From discussions with the holders of the subordinated notes, we anticipate that they will cooperate with the Company in formulating a new repayment schedule or other resolution. Such notes are also subordinated to our senior debt, and we believe the ability of the subordinated debt holders to have direct recourse against the Company is currently limited. However, the holders of the subordinated notes may take actions that could adversely affect the Company, including acting to accelerate the subordinated debt, thereby potentially triggering a default under our credit facility with our bank. Such noteholders also may take legal or other adverse collection actions against the Company. For further discussion regarding the subordinated notes please see [Bank Credit Facility](#) above.

*Short Term Capital Requirements.* We currently anticipate that our capital needs for 2006 will principally consist of \$1.2 million for software development and \$660,000 for capital expenditures. These amounts will be funded through cashflow from operations, our line of credit or an increase in our term debt to \$1,000,000.

*Acquisitions.* We are examining the potential acquisition of companies and businesses within our industry. We are unable to predict the nature, size or timing of any such acquisition, and accordingly are unable to estimate the capital resources which may be required. Any acquisition would be subject to our utilizing sources in addition to those described above. These alternative sources could include the issuance of our common stock or other securities in an acquisition, seller financing, and bank and other third party financing, among other things. We can give no assurance that, should the opportunity for a suitable acquisition arise, we will be able to procure the financial resources necessary to fund any such acquisition or that we will otherwise be able to conclude and successfully integrate any acquisition.

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*Potential Capital Inflow from Warrants Exercise.* A significant amount of cash and capital for the Company would be generated by the exercise by Barron of its common stock warrants. The exercise of Warrant A, with an exercise price of \$1.3972, would generate approximately \$5 million. The exercise of Warrant B, with an exercise price of \$2.0958, would generate approximately \$7.6 million. The complete exercise of the warrants is in the sole discretion of Barron, subject to the restrictions in the preferred stock and the warrants prohibiting Barron from beneficially holding greater than 4.9% of our outstanding common stock, at any time. Although we presume any decision by Barron to exercise the warrants or any portion would depend upon our stock price, results of operations and the long term outlook for the development of our business, among other things, we cannot predict if and when Barron may exercise the warrants. Accordingly, there can be no assurance that Barron will exercise the Warrants and that we will receive any resulting capital.

The warrants may be exercised on a cashless basis, in which case the Company would receive no cash proceeds. However, Barron was prohibited from electing a cashless exercise until February 11, 2006, and going forward, is prohibited so long as there is an effective registration statement with respect to the shares underlying the warrants. Accordingly, it will be important in the future for us to maintain the effectiveness of the registration statement covering the warrant shares in order to assure the receipt of equity capital from the exercise of the warrants. Our registration statement was declared effective on February 14, 2006. Barron did not invoke the cashless exercise provision.

*Long Term Debt Financing.* On February 14, 2006, the Company entered into an agreement with RBC for a 42 month term loan of \$400,000 at a fixed interest rate 7.5% per annum. The facility is collateralized by substantially all of the assets of the Company. The purpose of the loan was to finance capital expenditures long term and improve availability under our bank credit facility for working capital purposes. Upon any default by the Company on the promissory note, the bank may accrue interest on the promissory note at a rate of 18% per annum, subject to any maximum rate imposed by applicable law. Further, upon default by the Company, the bank may declare the entire unpaid principal balance on the promissory note and all accrued unpaid interest on the promissory note immediately due. As of June 30, 2006 the Company had paid \$5,971 of interest and \$26,327 of principal related to the loan.

*Adequacy of Liquidity and Capital Resources.* Based on the foregoing, our management believes that our cash flow from operations and existing bank credit facility will be adequate to fund our short term liquidity and capital needs, so long as we are able to successfully negotiate an extension or other satisfactory restructuring of our subordinated debt. We believe that our current business plan for the organic growth of our business will not require any additional external funding, except for a possible increase in our credit line facility which we believe is obtainable with increased sales and receivables supporting the facility, and that we will be able to operate and grow our business while servicing our debt obligations. As previously noted, any acquisition would be dependent upon additional funding sources.

In making our assessments of a fully-funded business plan, we have considered:

cash and cash equivalents on hand or available to our operations of \$334,000 at June 30, 2006;

expected cash flow from operations;

the anticipated level of capital expenditures of \$600,000;

software development costs of \$1.2 million; and

our scheduled debt service.

If our business plans change, including as a result of changes in our products or technology, or if we decide to expand into additional markets, or if economic conditions in any of our markets generally arise and have a material effect on the cash flow or profitability of our business, or if we have a negative outcome related to the debt covenants and are unable to obtain a waiver, or are unable to successfully restructure our subordinated debt, then the anticipated cash needs of our business as well as the conclusions presented herein as to the adequacy of available sources of cash and timing of our ability to generate net income could change significantly. A decision not to exercise Warrants or a cashless exercise of the Warrants could result in the necessity to pursue other funding.

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Any of these events or circumstances could involve significant additional funding needs in excess of the identified current available sources, and could require us to raise additional capital to meet these needs. However, our ability to seek additional capital, if necessary, is subject to a variety of additional factors that we cannot presently predict with certainty, including:

the commercial success of our operations;

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the volatility and demand of the capital markets; and

the future market prices of our securities.

There is no guarantee CSI could obtain access to additional funding or at reasonable rates. The failure of CSI to meet covenant requirements, raise capital through the exercise of the Warrants or find or obtain other funding at reasonable rates, could have a negative impact on the business.

**Recently Issued Accounting Pronouncements**

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and disclosure of financial information by the Company.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe that the adoption of SFAS No. 155 will have a material impact on its financial position, results of operations and cash flows.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This Statement amends FASB No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract; requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; permits an entity to choose its subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities; at its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value; and requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt SFAS No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. The Company does not believe the adoption of SFAS No. 156 will have a material impact on its financial position, results of operations and cash flows.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations and cash flows.

**Item 3. Controls and Procedures.**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods required by the Securities and Exchange Commission, including, without limitation, those controls and procedures designed to insure that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosures.

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15e and 15d-15e under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. In March 2005, the Public Company Accounting Oversight Board, or PCAOB, defined a significant deficiency as a deficiency that results in more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected, or that a company will be unable to comply with laws and regulations, which includes the timely filing of required reports with the Securities and Exchange Commission. Based upon evaluation under this standard, our Chief Executive Officer and

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Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were ineffective due to a significant deficiency in our internal controls over the application of existing accounting principles to new public reporting disclosures and particularly related to the application of GAAP to new transactions. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the CFO in consultation with the CEO and the audit committee of the board of directors determined the Company still lacked sufficient internal resources to ensure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis, following its inception of reporting as a public company and hiring of its first CFO with SEC reporting experience. Prior to February 11, 2005, we were a public shell with virtually no operations and had limited need for staff with highly technical accounting and public reporting expertise. In addition, our predecessor, Computer Software Innovations, Inc., a South Carolina corporation (CSI - South Carolina) was a private company and likewise had no need for staff with technical accounting and public reporting expertise. In the first quarter of 2005, we entered into a complex merger and resumed public reporting of significant operations. It was not until May 6, 2005 that we hired a chief financial officer with prior public reporting experience who is accustomed to dealing with more complex accounting matters. As a result, we were unable to file without utilizing extensions and had to amend certain of our financial reports for 2004 and 2005. We re-filed these documents as amended on February 14, 2006.

It was determined that this deficiency would be addressed both through the hiring or engaging of additional resources and implementation of the Sarbanes-Oxley Act requirements, since this implementation could result in identification of additional areas where we may need technical resources. In January 2006 we hired an additional person with public reporting experience and engaged outside technical resources. However, based on our CFO's experience and with an increase in staff, we expect we will receive additional suggestions for improvement in controls during the process of implementing the Sarbanes-Oxley Act. We will be implementing recommendations throughout the process and are unsure of whether we will be able to entirely eliminate any possibility of a significant deficiency until we have completed this process. Even so, due to the increasing number and complexity of pronouncements, emerging issues and releases, we expect there will always be some risk related to financial disclosures, albeit mitigated following implementation of the Sarbanes-Oxley Act requirements, which we anticipate will be completed in 2007.

As discussed above, we also maintain a system of internal accounting controls that is designed to provide assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and properly recorded. Other than as described above in this item, there were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of it that occurred during our last fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

None.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

### **Item 3. Defaults Upon Senior Securities.**

None.

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

(a) Our Annual Meeting of Stockholders was held on Wednesday, May 10, 2006.

(b) Not applicable.

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- (c) The common stockholders voted for the election of four (4) directors to serve for terms of one (1) year each, expiring on the date of the Annual Meeting of Stockholders in 2007 or until their successors are duly elected and qualified. The results of the voting in these elections are set forth below.

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| Nominee           | Votes     |          |
|-------------------|-----------|----------|
|                   | Votes For | Withheld |
| Anthony H. Sobel  | 527,229   | 142      |
| Nancy K. Hedrick  | 527,325   | 46       |
| Thomas P. Clinton | 527,225   | 146      |
| Shaya Phillips    | 527,228   | 143      |

**Item 5. Other Information.***(a) Entry into Material Definitive Agreement - RBC Centura Bank Waiver Letter*

On May 12, 2006, the Company and RBC Centura Bank (the Bank) entered into a letter agreement whereby the Bank agreed to waive a potential cross-default in the loan documents governing the Company's \$3,000,000 credit facility as well as its \$400,000 term loan with the Bank. The potential cross-default arises out of the Company not paying the remaining \$2,250,400 of principal owing on its subordinated debt held by stockholders at the debt maturity on May 10, 2006. Although the Company is in default on its subordinated debt, such debt has not been accelerated by the holders. In order to give the Company time to negotiate an extension of the maturity date of the subordinated debt, which comprises six promissory notes, the Bank agreed to waive until June 12, 2006 any potential default on the credit facility and the term loan that may have been triggered by the default on the subordinated debt. The waiver was disclosed in the Company's Form 10-QSB for the quarter ended March 31, 2006 filed on May 15, 2006. By way of a letter agreement dated August 10, 2006, the waiver was extended, effective as of June 12, 2006, until July 15, 2007. The August 10, 2006 letter agreement is filed as **Exhibit 10.1** to this report and is incorporated herein by reference.

*(b) Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant*

The credit arrangement with RBC Centura Bank is a facility under which the Company may borrow, repay and then reborrow. Advances and repayments under the credit facility occur daily, reflecting cash receipts and the Company's working capital needs. The amount outstanding under the Note as of the date of this Report is \$1,845,000. Set forth below is the outstanding balance as of specific dates since July 11, 2006. The balances presented reflect aggregate advances and paydowns which the Company deems material, or significant. Such information through July 11, 2006 was previously disclosed by the Company pursuant to a Form 8-K dated July 14, 2006.

| Date          | Loan Balance |
|---------------|--------------|
| July 12, 2006 | 1,139,000    |
| July 18, 2006 | -0-          |
| July 20, 2006 | 619,000      |
| July 26, 2006 | 184,000      |
| July 31, 2006 | 721,000      |

*(c) Other Events**Risk Factor Update*

The risk factor in our Annual Report on Form 10-KSB captioned ***We may not be able to repay both our bank credit facility which matures in May 2006 and our subordinated notes which mature in May 2006. Any failure to repay the credit facility or the notes, or in the alternative to secure a renewal or refinancing of the credit facility, would have a material adverse effect on our liquidity position and our ability to fund operations.*** is hereby updated as follows:

***We may not be able to repay both our bank credit facility which matures in July 2007, and our subordinated notes which matured in May 2006 and as to which we are currently in default. Any failure to repay the credit facility or the notes, or in the alternative to secure a renewal or refinancing of the credit facility, and to obtain an extension or other restructuring of the subordinated notes, could have a material adverse effect on our liquidity position and our ability to fund operations.***

On July 14, 2006, the Company and RBC Centura Bank executed a modification agreement extending the maturity date of the facility from July 15, 2006 to July 15, 2007. The modification agreement also increased the





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principal amount of the facility from \$3.0 million to \$3.5 million. The reason for the increase in principal is to support increasing working capital requirements of the Company. The bank has also waived until July 15, 2007 any potential default under its facility related to the Company's failure to repay its subordinated notes in the amount of \$2.3 million which were due in full on May 10, 2006.

Although the Company possessed adequate availability on the May 10, 2006 due date of the subordinated notes to repay them, management believed that cash flow from operations and bank facility availability following such a drawdown might not be sufficient to fund ongoing working capital needs and would not be sufficient to comply with the bank's financial covenants. Accordingly, in consultation with its board of directors, senior debt holders, and the holders of these notes, the Company determined it was not in the best interest of all parties to pay these notes at maturity, and the subordinated notes remain due and payable. Absent an exercise of the warrants held by Barron, we believe we may not have financial resources from operating cash flow or otherwise sufficient to repay the subordinated notes or meet financial covenant requirements in the short-term and, depending on other working capital needs, which may include working capital to support entities that may be acquired, for the foreseeable future.

We anticipate the successful negotiation of a maturity date extension or other restructuring of our subordinated debt with the holders of our subordinated debt, through a refinancing, for example, in combination with the financing of a future acquisition, or through the sale of warrants by Barron. The notes are subordinated to our senior debt, and we believe the ability of the subordinated debt holders to have direct recourse against the Company is currently limited. However, if we are unable to negotiate an extension, restructuring, refinancing, or receive adequate proceeds from the sale of any warrants by Barron, or we are unable to repay the subordinated notes at the end of any extension period, there can be no assurance as to what adverse collection actions the subordinated noteholders might take, whether the noteholders would agree to an additional extension or restructuring and on what terms, and the impact such default might otherwise have on our other creditors and our financial condition.

Likewise, we anticipate renewing our bank credit facility prior to its July 15, 2007 maturity, as management believes that cash flow from operations may not be sufficient to repay the facility at maturity in July 2007 and fund working capital growth. In the alternative, we would attempt to refinance the facility with another lender. Although management currently believes that its existing lender will renew the facility in 2007, there can be no assurance that our board will in fact do so or that replacement financing could be obtained by us on favorable terms. Our failure to resolve our default under, or otherwise restructure, our subordinated debt could adversely affect our ability to renew our existing bank credit facility or procure a replacement. Without such a credit facility, management recognizes that our ability to fund working capital and sufficient additional sales growth could be adversely affected.

In addition to the above update, the following risk is a new item and supplements those risk factors contained in our 2005 Annual Report on Form 10-KSB.:

***We face a number of obstacles in implementing our strategic expansion into new geographic markets. Overcoming these obstacles will require an expenditure of material financial resources and significant efforts by management and other employees. Our failure to succeed in our efforts to penetrate these new markets in a timely fashion could adversely affect our profits and margins and our revenue growth.***

As we move forward with our growth strategy, we anticipate expanding into new geographic regions. We have achieved the most significant penetration in the tri-state area of South Carolina, North Carolina and Georgia. We are now accelerating our efforts to move into surrounding states. While expanding geographic markets provides a good opportunity to extend existing customer bases and increase revenue, breaking into a new market can prove difficult. There are several obstacles to successfully entering new geographic markets, including limited market knowledge or relationships, little brand awareness, and no established presence or regional client references. Initial penetration will be slow but should accelerate over time. While we have a sales and marketing strategy to address these obstacles, there is no exact manner to predict how much time the customer relationships will take to build and the rate at which new market penetration can be accomplished.

To support the expansion process we plan to hire additional sales personnel to help penetrate new geographic regions, which could represent a \$200,000 to \$300,000 investment and could potentially be made before year end 2006. While management believes this is a prudent investment, there may be a short-term negative impact on earnings initially. Due to the length of our typical software sales closing cycle, six to twelve months, coupled with the occasional quick close and the varying size of deals, we cannot predict the time to recovery on this investment.

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**Item 6. Exhibits.**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.1                      | Letter Agreement by and between the Company and RBC Centura Bank dated August 10, 2006.*   |
| 10.2                      | Restricted Stock Agreement by and between the Company and Jeffery A. Bryson dated June 20, 2006.*  |
| 10.3                      | Reseller Agreement by and between the Company and Promethean, Inc. dated April 18, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed April 24, 2006).                              |
| 10.4                      | IDS Branded Reseller Agreement by and between the Company and Information Delivery Systems, LLC dated April 18, 2006 (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed April 24, 2006). |
| 10.5                      | Change in Terms Agreement by and between the Company and RBC Centura Bank dated April 24, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed May 3, 2006).                          |
| 10.6                      | Business Loan Agreement by and between the Company and RBC Centura Bank dated April 24, 2006 (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed May 3, 2006).                            |
| 10.7                      | Investor Relations Consulting Agreement by and between the Company and Alliance Advisors, LLC dated July 10, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed July 14, 2006).     |
| 10.8                      | Modification Agreement by and between the Company and RBC Centura Bank dated July 14, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed July 19, 2006).                            |
| 31.1                      | Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.*  |
| 31.2                      | Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.*  |
| 32.1                      | Statement of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. §1350.*   |

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\* Filed herewith

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**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

COMPUTER SOFTWARE INNOVATIONS, INC.

Date: August 14, 2006

By: /s/ Nancy K. Hedrick  
Nancy K. Hedrick  
President and Chief Executive Officer

Date: August 14, 2006

By: /s/ David B. Dechant  
David B. Dechant  
Chief Financial Officer