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NETSMART TECHNOLOGIES INC

Form 10-Q

August 05, 2003

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

Form 10-Q

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

For Quarter Ended June 30, 2003
Commission File Number 0-21177

NETSMART TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

Delaware 13-3680154
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

146 Nassau Avenue, Islip, NY 11751
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (631) 968-2000

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

Yes No
--

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No
--

Number of shares of common stock outstanding as of July 23, 2003: 4,218,298
=====

Netsmart Technologies, Inc. and Subsidiary

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and December 31, 2002 1-2

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NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, ----- 2003 ----- Unaudited ----- | December 31, ----- 2002 ----- |
|--|--|--|
| Assets: | | |
| Current Assets: | | |
| Cash and Cash Equivalents | \$ 9,013,653 | \$ 7,251,740 |
| Accounts Receivable - Net | 6,615,513 | 7,058,855 |
| Costs and Estimated Profits in Excess of Interim Billings | 2,863,084 | 3,857,522 |
| Deferred taxes | 510,000 | 459,000 |
| Other Current Assets | 379,541 | 337,719 |
| | ----- | ----- |
| Total Current Assets | 19,381,791 | 18,964,836 |
| | ----- | ----- |
| Property and Equipment - Net | 643,083 | 364,306 |
| | ----- | ----- |
| Other Assets: | | |
| Software Development Costs - Net | 1,123,751 | 382,387 |
| Customer Lists - Net | 3,001,348 | 2,141,855 |
| Deferred taxes less current portion | 490,000 | 441,000 |
| Other Assets | 238,908 | 121,419 |
| | ----- | ----- |

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| | | |
|--------------------|--------------|--------------|
| Total Other Assets | 4,854,007 | 3,086,661 |
| | ----- | ----- |
| Total Assets | \$24,878,881 | \$22,415,803 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

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NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, | December 31, |
|--|------------|--------------|
| | 2003 | 2002 |
| | Unaudited | |
| | ----- | ----- |
| Liabilities and Stockholders' Equity: | | |
| Current Liabilities: | | |
| Current Portion - Long Term Debt | \$ 666,667 | \$ 500,000 |
| Current Portion Capital Lease Obligations | 64,206 | 9,886 |
| Accounts Payable | 600,422 | 1,166,145 |
| Accrued Expenses | 1,419,353 | 1,063,559 |
| Interim Billings in Excess of Costs and Estimated Profits | 7,276,886 | 5,914,970 |
| Deferred Revenue | 520,007 | 1,095,412 |
| | ----- | ----- |
| Total Current Liabilities | 10,547,541 | 9,749,972 |
| | ----- | ----- |
| Capital Lease Obligations - Less current portion | 116,346 | 1,864 |
| Long Term Debt - Less current portion | 1,333,349 | 1,250,012 |
| Interest Rate Swap at Fair Value | 91,783 | 107,713 |
| | ----- | ----- |
| Total Non Current Liabilities | 1,541,478 | 1,359,589 |
| | ----- | ----- |
| Commitments and Contingencies | | |
| Stockholders' Equity: | | |
| Preferred Stock - \$.01 Par Value, 3,000,000 Shares Authorized; None issued and outstanding | -- | -- |
| Common Stock - \$.01 Par Value; Authorized 15,000,000 Shares; Issued 4,277,933 shares at June 30, 2003 and 4,046,430 at December 31, 2002 | 42,779 | 40,464 |
| Additional Paid in Capital | 22,170,409 | 21,411,777 |
| Unearned Compensation | -- | (14,400) |
| Accumulated Comprehensive loss - Interest | | |

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| | | |
|---|--------------|--------------|
| Rate Swap | (91,783) | (107,713) |
| Accumulated Deficit | (8,583,262) | (9,375,774) |
| | ----- | ----- |
| | 13,538,143 | 11,954,354 |
| Less: cost of shares of Common Stock held in treasury - 112,539 shares at June 30, 2003 and 89,797 at December 31, 2002 | 748,281 | 648,112 |
| | ----- | ----- |
| Total Stockholders' Equity | 12,789,862 | 11,306,242 |
| | ----- | ----- |
| Total Liabilities and Stockholders' Equity | \$24,878,881 | \$22,415,803 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

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NETSMART TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME - (Unaudited)

| | Six months ended June 30, | | Three months June 30 | |
|--|------------------------------|--------------|-------------------------|-------|
| | 2003 | 2002 | 2003 | |
| | ---- | ---- | ---- | ---- |
| Revenues: | | | | |
| Software and Related Systems and Services: | | | | |
| General | \$ 8,261,681 | \$ 6,299,687 | \$ 4,314,720 | \$ |
| Maintenance Contract Services | 3,487,205 | 3,022,288 | 1,773,651 | |
| | ----- | ----- | ----- | ----- |
| Total Software and Related Systems and Services | 11,748,886 | 9,321,975 | 6,088,371 | |
| Data Center Services | 959,303 | 955,395 | 500,765 | |
| | ----- | ----- | ----- | ----- |
| Total Revenues | 12,708,189 | 10,277,370 | 6,589,136 | |
| | ----- | ----- | ----- | ----- |
| Cost of Revenues: | | | | |
| Software and Related Systems and Services: | | | | |
| General | 5,332,140 | 4,450,324 | 2,780,532 | |
| Maintenance Contract Services | 1,739,901 | 1,771,212 | 873,775 | |
| | ----- | ----- | ----- | ----- |
| Total Software and Related Systems and Services | 7,072,041 | 6,221,536 | 3,654,307 | |
| Data Center Services | 531,676 | 526,945 | 265,464 | |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|--|------------|------------|------------|----|
| Total Cost of Revenues | 7,603,717 | 6,748,481 | 3,919,771 | |
| | ----- | ----- | ----- | |
| Gross Profit | 5,104,472 | 3,528,889 | 2,669,365 | |
| | ----- | ----- | ----- | |
| Selling, General and Administrative Expenses | 3,279,724 | 2,484,522 | 1,689,141 | |
| Research and Development | 943,027 | 684,460 | 432,590 | |
| | ----- | ----- | ----- | |
| Total | 4,222,751 | 3,168,982 | 2,121,731 | |
| | ----- | ----- | ----- | |
| Income from Operations before Interest | 881,721 | 359,907 | 547,634 | |
| Interest Income | 30,628 | 20,453 | 18,325 | |
| Interest and Other Expense | 101,837 | 108,661 | 59,632 | |
| | ----- | ----- | ----- | |
| Income before Income Tax Expense (Benefit) | 810,512 | 271,699 | 506,327 | |
| Income Tax Expense (Benefit) | 18,000 | 26,000 | (15,000) | |
| | ----- | ----- | ----- | |
| Net Income | \$ 792,512 | \$ 245,699 | \$ 521,327 | \$ |
| | ===== | ===== | ===== | |
| Earnings Per Share of Common Stock: | | | | |
| Basic: | | | | |
| Net Income | \$.20 | \$.07 | \$.13 | \$ |
| | ===== | ===== | ===== | |
| Weighted Average Number of Shares of Common Stock Outstanding | 4,008,390 | 3,695,923 | 4,077,399 | |
| | ===== | ===== | ===== | |
| Diluted: | | | | |
| Net Income | \$.18 | \$.06 | \$.12 | \$ |
| | ===== | ===== | ===== | |
| Weighted Average Number of Shares of Common Stock and Common Stock Equivalents Outstanding | 4,377,111 | 4,047,746 | 4,416,714 | |
| | ===== | ===== | ===== | |

See Notes to Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (Unaudited)

Six months ended
June 30,

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| | 2003 ---- | 2002 ---- |
|--|--------------|--------------|
| Operating Activities: | | |
| Net Income | \$ 792,512 | \$ 245,699 |
| | ----- | ----- |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Depreciation and Amortization | 521,149 | 517,606 |
| Bad Debt Expense | 99,067 | 90,813 |
| Amortization of Warrants Issued for Services and Costs Related to Warrant Extension | 15,525 | 24,873 |
| Deferred Taxes | (100,000) | -- |
| Changes in Assets and Liabilities: | | |
| [Increase] Decrease in: | | |
| Accounts Receivable | 344,275 | (210,828) |
| Costs and Estimated Profits in Excess of Interim Billings | 994,438 | (384,305) |
| Other Current Assets | (41,822) | (39,413) |
| Other Assets | 22,511 | 8,004 |
| Increase [Decrease] in | | |
| Accounts Payable | (565,723) | (107,999) |
| Accrued Expenses | 348,986 | 176,575 |
| Interim Billings in Excess of Costs and Estimated Profits | 1,300,656 | 166,767 |
| Deferred Revenue | (575,405) | (266,072) |
| | ----- | ----- |
| Total Adjustments | 2,363,657 | (23,979) |
| | ----- | ----- |
| Net Cash Provided by Operating Activities | 3,156,169 | 221,720 |
| | ----- | ----- |
| Investing Activities: | | |
| Acquisition of Property and Equipment | (213,544) | (121,811) |
| Net Cost of CareNet Acquisition | (1,047,845) | -- |
| | ----- | ----- |
| Net Cash Used In Investing Activities | (1,261,389) | (121,811) |
| | ----- | ----- |

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (Unaudited)

Six months ended
June 30,

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| | ----- 2003 ---- | 2002 ---- |
|---|-----------------------|--------------|
| Financing Activities: | | |
| Payments on Capitalized Lease Obligations | \$ (14,524) | \$ (19,360) |
| Net Proceeds from Stock Options and Warrants Exercised | 131,653 | 9,550 |
| Payments on Term Loan | (249,996) | (249,996) |
| | ----- | ----- |
| Net Cash Used in Financing Activities | (132,867) | (259,806) |
| | ----- | ----- |
| Net Increase (Decrease) in Cash and Cash Equivalents | 1,761,913 | (159,897) |
| Cash and Cash Equivalents - Beginning of Period | 7,251,740 | 3,837,226 |
| | ----- | ----- |
| Cash and Cash Equivalents - End of Period | \$ 9,013,653 | \$ 3,677,329 |
| | ===== | ===== |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 103,825 | \$ 110,703 |
| Income Taxes | \$ 97,709 | \$ 14,727 |

Non Cash Investing and Financing Activities:

The fair value of the interest rate swap calculated at June 30, 2003 was \$91,783. The fair value of the interest rate swap calculated at June 30, 2002 was \$80,691. The Company acquired equipment in the amount of \$183,326 in connection with a capital lease during the six months ended June 30, 2003.

During the six months ended June 30, 2003, stock options to purchase 81,503 shares of common stock were exercised and proceeds of \$124,343 were received by the Company in payment of the exercise prices of such options, including \$100,170 paid by delivery of shares of the Company's common stock valued at the market price on the date of exercise in accordance with the cashless exercise provisions of the Company's stock option plan.

During the six months ended June 30, 2003, the Company issued 100,000 shares of common stock in connection with its acquisition of CareNet acquisition. See Note 13. These shares were valued at \$528,000 which was based upon the average stock price three days before and after the acquisition was agreed to and announced. The Company also issued a \$500,000 three-year promissory note and assumed contract obligations and vacation liabilities totaling \$68,068.

See Notes to Condensed Consolidated Financial Statements.

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For the Six Months Ended June 30, 2003

| Common Stock \$.01 Par Value Authorized | Shares | Amount |
|--|-----------|-----------|
| | ----- | ----- |
| 15,000,000 Shares | | |
| Beginning Balance - December 31, 2002 | 4,046,430 | \$ 40,464 |
| Common Stock Issued - Exercise of Options | 81,503 | 815 |
| Common Stock Issued - Exercise of Warrants | 50,000 | 500 |
| Common Stock Issued - Acquisition | 100,000 | 1,000 |
| | ----- | ----- |
| Ending Balance - June 30, 2003 | 4,277,933 | \$ 42,779 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

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NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

----- CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY - (Unaudited) -----

For the Six Months Ended June 30, 2003

| Additional Paid-In Capital Common Stock: | Shares | Amount |
|--|--------|----------------|
| | ----- | ----- |
| Beginning Balance - December 31, 2002 | | \$ 21,411,777 |
| Common Stock Issued - Exercise of Options | | 123,527 |
| Common Stock Issued - Exercise of Warrants | | 106,980 |
| Common Stock Issued - Acquisition | | 527,000 |
| Costs Related to Warrant Extension | | 1,125 |
| | | ----- |
| Ending Balance - June 30, 2003 | | \$ 22,170,409 |
| | | ===== |
| Accumulated Deficit | | |
| Beginning Balance - December 31, 2002 | | \$ (9,375,774) |
| Net Income | | 792,512 |
| | | ----- |
| Ending Balance - June 30, 2003 | | \$ (8,583,262) |
| | | ===== |
| Accumulated Comprehensive Loss - Interest Rate Swap: | | |
| Beginning Balance - December 31, 2002 | | \$ (107,713) |
| Change in Fair Value of Interest Rate Swap | | 15,930 |
| | | ----- |
| Ending Balance - June 30, 2003 | | \$ (91,783) |
| | | ===== |

Treasury Stock

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| | | | |
|--|---------|----|------------|
| Beginning Balance - December 31, 2002 | 89,797 | \$ | (648,112) |
| Treasury Shares From Cashless | | | |
| Exercise of Stock Options | 22,742 | | (100,169) |
| | ----- | | ----- |
| Ending Balance - June 30, 2003 | 112,539 | \$ | (748,281) |
| | ----- | | ----- |
| Total Stockholders' Equity | | \$ | 12,789,862 |
| | | | ===== |
| Unearned Compensation | | | |
| Beginning Balance - December 31, 2002 | | \$ | (14,400) |
| Amortization of Warrants Issued for Services | | | 14,400 |
| | | | ----- |
| Ending Balance - June 30, 2003 | | \$ | -- |
| | | | ===== |

See Notes to Condensed Consolidated Financial Statements.

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NETSMART TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) In the opinion of the Company, the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2003 and the results of its operations for the three and six months ended June 30, 2003 and 2002 and the changes in cash flows for the six months ended June 30, 2003 and 2002. The results of operations for the three and six months ended June 30, 2003 are not necessarily indicative of the results to be expected for the full year.

(2) The accounting policies followed by the Company are set forth in Notes 1 and 2 to the Company's consolidated financial statements as filed in its Form 10-K/A for the year ended December 31, 2002.

(3) Income per share - The following table sets forth the components used in the computation of basic and diluted earnings per share:

| | Six Months Ended June 30, | | Three Months Ended June | |
|----------------------------------|---------------------------|------------|-------------------------|------------|
| | 2003 | 2002 | 2003 | 2002 |
| | ----- | ----- | ----- | ----- |
| Numerator: | | | | |
| Net income | \$ 792,512 | \$ 245,699 | \$ 521,327 | \$ 142,000 |
| Denominator: | | | | |
| Weighted average shares | 4,008,390 | 3,695,923 | 4,077,399 | 3,696,000 |
| | ----- | ----- | ----- | ----- |
| Effect of dilutive securities: | | | | |
| Employee stock options | 354,722 | 351,359 | 337,527 | 358,000 |
| Stock warrants | 13,999 | 464 | 1,788 | --- |
| | ----- | ----- | ----- | ----- |
| Dilutive potential common shares | 368,721 | 351,823 | 339,315 | 358,000 |

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| | | | | |
|---|-----------|-----------|-----------|-------|
| Denominator for diluted earnings per share-adjusted weighted average shares after assumed conversions | 4,377,111 | 4,047,746 | 4,416,714 | 4,055 |
| | ===== | ===== | ===== | ===== |

(4) Stock Options and Similar Equity Instruments - At June 30, 2003, the Company had three stock-based employee compensation plans. As permitted under SFAS No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure", which amended SFAS No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation", the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangements, as defined by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees", and related interpretations including Financial Accounting Standards Board Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation", an interpretation of APB No. 25. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the

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date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation:

| | Six Months Ended June 30, | | Three Months End |
|--|---------------------------|------------|------------------|
| | 2003 | 2002 | 2003 |
| | ---- | ---- | ---- |
| Net Income as Reported | \$ 792,512 | \$ 245,699 | \$ 521,327 |
| Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effect | 298,624 | 78,093 | 162,223 |
| | ----- | ----- | ----- |
| Pro Forma Net Income | \$ 493,888 | \$ 167,606 | \$ 359,104 |
| | ===== | ===== | ===== |
| Basic Net Income Per Share as Reported | \$.20 | \$.07 | \$.13 |
| | ===== | ===== | ===== |
| Basic Pro Forma Net Income Per Share | \$.12 | \$.05 | \$.09 |
| | ===== | ===== | ===== |
| Diluted Net Income Per Share as Reported | \$.18 | \$.06 | \$.12 |
| | ===== | ===== | ===== |
| ..04 | | | |
| Diluted Pro Forma Net Income Per Share | \$.11 | \$.04 | \$.08 |
| | ===== | ===== | ===== |

The fair value of options at date of grant was estimated using the Black-Scholes fair value based method with the following weighted average assumptions:

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| | Six Months Ended | |
|--------------------------|------------------|------------------|
| | June 30, 2003 | June 30, 2002 |
| Expected Life (Years) | 5 | 5 |
| Interest Rate | 4.00% | 4.00% |
| Annual Rate of Dividends | 0% | 0% |
| Volatility | 66% | 63% |

The weighted average fair value of options at date of grant using the fair value based method during 2003 and 2002 is estimated at \$2.34 and \$1.41 respectively.

(5) Income Taxes - The provision for income taxes for the period ended June 30, 2003, reflects a deferred tax provision of approximately \$368,000 offset by a reduction in the deferred tax asset valuation allowance of the same amount. During the June 2003 period, the Company recognized an additional \$100,000 benefit from its net operating loss carry forward.

(6) On January 27, 2003, following stockholder approval of the amendment to the 2001 Plan to increase the number of shares of common stock available for issuance pursuant to the 2001 Plan, the Company granted to employees options to purchase 217,500 shares under the 2001 Plan at a price per share of \$4.93, which was the fair market value at the date of grant. On May 22, 2003, the Company granted to employees additional options to purchase 152,500 shares under the 2001 Plan at a price per share of \$4.37, which was the fair market value at the date of grant. The majority of the options granted to date under the 2001 Plan vest 50% after six months and 100% after one year.

(7) The Company currently classifies its operations into two business segments: (1) Software and Related Systems and Services and (2) Data Center Services. Software and Related Systems and Services is the design, installation, implementation and maintenance of computer information systems that provide comprehensive healthcare

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information technology solutions including billing, patient tracking and scheduling for inpatient and outpatient environments, as well as clinical documentation and medical record generation and management. Data Center Services involve Company personnel performing data entry and data processing services for customers. Intersegment sales and sales outside the United States are not material. Information concerning the Company's business segments are as follows:

| Six Months Ended June 30, 2003 | Software and Related Systems and Services | Data Center Services | Consolidat ed |
|--|---|-------------------------|------------------|
| Revenue | \$ 11,748,886 | \$ 959,303 | \$ 12,708,189 |
| Income before income taxes | 624,427 | 186,085 | 810,512 |
| Total identifiable assets at June 30, 2003 | 22,841,438 | 1,822,884 | 24,664,322 |

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Six Months Ended June 30,

2002

| | | | |
|--|--------------|------------|---------------|
| Revenue | \$ 9,321,975 | \$ 955,395 | \$ 10,277,370 |
| Income before income taxes | 124,101 | 147,598 | 271,699 |
| Total identifiable assets at June 30, 2002 | 16,292,536 | 1,618,337 | 17,910,873 |

Three Months Ended June 30,

2003

| | | | |
|----------------------------|--------------|------------|--------------|
| Revenue | \$ 6,088,371 | \$ 500,765 | \$ 6,589,136 |
| Income before income taxes | 395,263 | 111,064 | 506,327 |

Three Months Ended June 30,

2002

| | | | |
|---------------------|--------------|------------|--------------|
| Revenue | \$ 4,961,596 | \$ 485,702 | \$ 5,447,298 |
| Income before taxes | 80,174 | 80,361 | 160,535 |

(8) On February 27, 2003, the Board of Directors authorized management to purchase up to \$100,000 of the Company's common stock at any time the market price is less than \$3.50 per share. Purchases of stock will be made from time to time, depending on market conditions, in open market or in privately negotiated transactions, at prices deemed appropriate by management. There is no set time limit on the purchases. The Company expects to fund these stock repurchases from its operating cash flow. As of June 30, 2003, the Company had not made any stock repurchases.

(9) On April 7, 2003, warrants to purchase 50,000 shares were exercised and the Company received gross proceeds of \$134,500.

(10) New Accounting Pronouncements - In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections". SFAS No. 145 requires that gains and losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria in Accounting Principles Board Opinion No. 30 ("Opinion No. 30"). Applying the provisions of Opinion No. 30 will distinguish transactions that are part of an entity's recurring operations from those that are unusual and infrequent that meet the criteria for classification as an extraordinary item. The Company adopted SFAS No. 145 during the first quarter of fiscal 2003. The adoption of this standard did not have a material effect on the Company's consolidated financial position and results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses accounting and

reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)". SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of this standard did not have a material effect on the Company's consolidated financial position or results of operations.

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In November 2002, the FASB issued Interpretation No. 45, ("FIN 45") "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 requires a company, at the time it issues a guarantee, to recognize an initial liability for the fair value of obligations assumed under the guarantee and elaborates on existing disclosure requirements related to guarantees and warranties. The initial recognition requirements of FIN 45 are effective for guarantees issued or modified after December 31, 2002. The Company's adoption of the recognition requirements of FIN 45 did not have a material effect on its consolidated financial position or results of operations.

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The Company does not expect the adoption of FIN 46 to have a material effect on its consolidated financial position or results of operations.

On April 30, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends and clarifies SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities." This statement clarifies the accounting guidance on (1) derivative instruments (including certain derivative instruments embedded in other contracts) and (2) hedging activities that fall within the scope of the SFAS 133. SFAS 149 also amends certain other existing pronouncements, which will result in more consistent reporting of contracts that are derivatives in their entirety or that contain embedded derivatives that warrant separate accounting. SFAS 149 is effective (1) for contracts entered into or modified after June 30, 2003, with certain exceptions, and (2) for hedging relationships designated after June 30, 2003. The guidance is to be applied prospectively. The Company does not expect the adoption of SFAS No. 149 to have a material impact on its consolidated financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 addresses certain financial instruments that, under previous guidance, could be accounted for as equity, but now must be classified as liabilities in statements of financial position. These financial instruments include: 1) mandatorily redeemable financial instruments, 2) obligations to repurchase the issuer's equity shares by transferring assets, and 3) obligations to issue a variable number of shares. SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The Company is evaluating the impact that the adoption of SFAS No. 150 will have on its consolidated financial position or results of operations.

(11) In January 2003, warrants to purchase 448,535 shares of common stock at \$12.00 per share were extended from January 31, 2003 to April 30, 2003. In April 2003, the Company agreed to extend these same warrants from April 30, 2003 to July 31, 2003. The Company re-measured the fair value of the warrants at the

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dates of extension. No financing costs were recorded associated with the warrant extensions made in January 2003, as there was no material change in their fair value. The Company charged \$1,125 to operations related to the warrant extension made in April 2003. In July 2003, the Company agreed to extend these same warrants from July 31, 2003 to October 31, 2003. The Company re-measured the fair value of the warrants at the date of extension and will charge \$5,211 of financing costs to operations in July 2003.

(12) Reclassifications - Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform to the presentation in the current year financial statements. These reclassifications have no effect on previously reported income.

(13) On June 25, 2003, the Company acquired substantially all of the assets of the CareNet segment ("CareNet") of Shuttle Data Systems Corporation, d/b/a Adia Information Management Corp. ("Adia"), pursuant to an asset purchase agreement dated June 25, 2003, among the Company, Adia and Steven Heintz, Jr., the president and majority shareholder of Adia. The principal assets acquired were the intellectual property and customer contracts of CareNet. The total purchase price, including acquisition costs, was \$2,003,913 which consisted of 100,000 shares of common stock of the Company valued at \$528,000, \$838,740 in cash and a three-year promissory note in the principal amount of \$500,000 payable in 36 equal monthly installments of principal plus interest at the average prime rate plus 1% as defined in the note agreement. Adia has received certain piggyback registration rights with respect to these 100,000 shares. The cash portion of the purchase price was paid out of existing working capital. The Company also assumed certain contractual obligations and liabilities totaling \$68,068 and incurred \$69,105 in legal and accounting costs which are included in the purchase price.

In addition, in connection with the acquisition, the Company entered into a non-compete and non-solicitation agreement with Steven Heintz, Jr. and Jennifer Lindbert for which they were paid a fee of an aggregate \$140,000, which fee was paid in cash out of existing working capital and is included in "other assets" on the balance sheet.

The cost of the acquisition was allocated to purchased software in the amount of \$883,075, customer lists in the amount of \$1,097,138, covenant not to compete in the amount of \$140,000 and computer hardware in the amount of \$23,700. The Company is amortizing the purchased software over an eight-year life and the customer lists over a nine-year life. The covenant not to compete will be amortized over a three-year life.

The Company accounted for this acquisition pursuant to the purchase method of accounting. For accounting purposes the Company recorded the assets and related liabilities of CareNet effective as of June 30, 2003. The Company incorporated the operations of CareNet into its operations commencing July 1, 2003.

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The following unaudited proforma condensed consolidated statements of operations assumes the CareNet acquisition occurred on January 1, 2002. In the opinion of management, all adjustments necessary to present fairly such unaudited proforma statements have been made.

| | Six months ended June 30, (in 000's except Per Share Data) | |
|------------|---|----------|
| | 2003 | 2002 |
| | ---- | ---- |
| Revenue | \$13,063 | \$10,538 |
| Net Income | \$ 801 | \$ 193 |

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| | | |
|------------------------------|---------|---------|
| Net Income Per Share - Basic | \$ 0.20 | \$ 0.05 |
| Diluted | \$ 0.18 | \$ 0.05 |

(14) In July 2003, the Company's Board of Directors approved a cash dividend of \$0.10 per share of common stock. The estimated amount to be charged to surplus based upon the shares outstanding is \$421,830.

(15) In July 2003, each of the Company's President and its Chief Executive Officer exercised options for 70,000 shares of the Company's common stock by delivery of 17,096 shares of the Company's common stock valued at the market price on the date of exercise in accordance with the cashless exercise provisions of the Company's stock option plans.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Our operations are grouped into two segments:

- |X| Software and Related Systems and Services
- |X| Data Center [service bureau services]

Results of Operations

Fixed price software development contracts and licenses accounted for 47% and 42% of consolidated revenue for the six months ended June 30, 2003 and 2002, respectively. We recognize revenue for fixed price contracts using the percentage of completion method. Since the billing schedules under the contracts differ from the recognition of revenue, at the end of any period, these contracts generally result in either costs and estimated profits in excess of billing or billing in excess of cost and estimated profits. Revenue from fixed price software development contracts is determined using the percentage of completion method which is based upon the time spent by our technical personnel on a project. As a result, during the third and fourth quarters, when many of our employees are on vacation and holidays, our revenue could be affected. Our time spent on projects during the second half of the year generally ranges from 1% to 3% less than time spent on projects during the first half of the year.

Six Months Ended June 30, 2003 and 2002

Our total revenue for the six months ended June 30, 2003 (the "June 2003 period") was \$12,708,000, an increase of \$2,431,000, or 24%, from our revenue for the six months ended June 30, 2002 (the June 2002 period"), which was \$10,277,000. Revenue from contracts from government agencies represented 61% of revenue in the June 2003 period and 43% of revenue in the June 2002 period. This reflects an increase in new government contracts, particularly relating to contracts with two new county agencies.

Software and Related Systems and Services

Our Software and Related Systems and Services revenue for the June 2003 period was \$11,749,000, an increase of \$2,427,000, or 26%, from our revenue for the June 2002 period, which was \$9,322,000. Software and related systems and services revenue is comprised of turnkey systems labor revenue, revenue from sales of third party hardware and software, license revenue, maintenance revenue and revenue from small turnkey systems.

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The largest component of revenue was turnkey systems labor revenue, which increased to \$4,500,000 in the June 2003 period, from \$3,549,000 in the June 2002 period, reflecting a 27% increase. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. This increase was substantially the result of an increase in spending for information systems in the human services marketplace and our ability to provide the staff necessary to generate additional revenue. Labor rate price changes from June 2003 period to the June 2002 period resulted in a 13% increase in the average daily billing rate and accounted for approximately \$330,000, or 35%, of the total turnkey systems labor increase. Revenue from third party hardware and software increased to \$2,146,000 in the June 2003 period, from \$1,378,000 in the June 2002 period, which represents an increase of 56%. Sales of third party hardware and software are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our human services revenue. License revenue increased to \$1,245,000 in the June 2003 period, from \$912,000 in the June 2002 period, reflecting an increase of 37%. License revenue is generated as part of a sale of a human services information system pursuant to a contract or purchase order that includes delivery of the system and maintenance. This increase in license revenue was the result of an increase in spending for information systems in the human services marketplace. Maintenance revenue increased to \$3,487,000 in the June 2003 period, from \$3,022,000 in the June

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2002 period, reflecting an increase of 15%. As turnkey systems are completed, they are transitioned to the maintenance division, thereby increasing our installed base. Revenue from the sales of our small turnkey division decreased to \$371,000 in the June 2003 period, from \$461,000 in the June 2002 period, reflecting a decrease of 20%. This decrease is the result a redirection of our sales efforts to larger turnkey sales. Small turnkey division sales relate to turnkey contracts that are less than \$50,000 and are usually completed within one month.

Gross profit increased to \$4,677,000 in the June 2003 period from \$3,100,000 in the June 2002 period, reflecting an increase of 51%. Our gross margin percentage increased to 40% in the June 2003 period from 33% in the June 2002 period. Our gross margins have increased primarily as a result of increased maintenance and license revenue and, to a lesser extent, an increase in our labor revenue. Our infrastructure costs with respect to our maintenance division are substantially in place and as new maintenance revenue occurs, our gross profit margins are improved accordingly.

Data Center

Data center clients typically generate approximately the same amount of revenue each year. We bill on a transaction basis or on a fixed fee arrangement. Historically, each year, we increase the transaction or fixed fees by an amount that approximates the New York urban consumer price index increase. The data center revenue increased to \$959,000 in the June 2003 period, from \$955,000 in the June 2002 period, representing an increase of \$4,000, or less than 1%.

Gross profit remained constant at \$428,000 for the June 2003 and 2002 periods. Our gross margin percentage remained constant at 45% for the June 2003 and 2002 periods.

Operating Expenses

Selling, general and administrative expenses were \$3,280,000 in the June 2003 period, reflecting an increase of \$795,000, or 32%, from the \$2,485,000 in the

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June 2002 period. This increase was in the area of sales and marketing costs, which increased by \$269,000, primarily as a result of increases in salaries and commissions by \$250,000; an increase in general and administrative salaries, which increased by \$158,000; and provisions for bonuses, which increased by \$299,000.

We incurred product development expenses of \$943,000 in the June 2003 period, an increase of 38% from the \$684,000 in June 2002 period. The increase in product development expense is the result of continuing investment in product enhancement and extensions. These extensions include the development of new software modules including Minimum Data Set (MDS) reporting which is designed to address Federal reporting requirements and a Computerized Physician Order Entry (CPOE) module, as well as continued investment in core products including a new version of our addictions management software products. These amounts have been appropriately accounted for in accordance with SFAS No. 86, "Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed."

Interest and other expense was \$102,000 in the June 2003 period, a decrease of \$7,000, or 6%, from the \$109,000 in the June 2002 period. This decrease is the result of reduced borrowing during the June 2003 period.

Interest income was \$31,000 in the June 2003 period, an increase of \$11,000, or 55%, from \$20,000 in the June 2002 period. Interest income is generated from short-term investments made with a substantial portion of the proceeds received from the term loan, as well as cash generated from operations.

We have a net operating loss tax carry forward of approximately \$8.2 million. In the June 2003 period, we recorded a current income tax expense of \$118,000, which related to various state and local taxes, as well as a provision for the

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Federal alternative minimum tax. In addition, we recognized a partial deferred tax benefit in the amount of \$368,000, which was offset by a reduction in the deferred tax valuation allowance of the same amount. We also re-evaluated the deferred tax valuation allowance and further reduced the allowance by \$100,000. In the June 2002 period we provided for taxes in the amount of \$26,000. This provision was based upon certain state taxes.

As a result of the foregoing factors, in the June 2003 period, we had a net income of \$793,000, or \$.20 per share (basic) and \$.18 per share (diluted). For the June 2002 period, we had net income of \$246,000, or \$.07 per share (basic) and \$.06 per share (diluted).

Three Months Ended June 30, 2003 and 2002

Results of Operations

Fixed price software development contracts and licenses accounted for 46% of consolidated revenue for the three months ended June 30, 2003 (the "June 2003 quarter") and 42% of consolidated revenue for the three months ended June 30, 2002 (the "June 2002 quarter"). We recognize revenue for fixed price contracts on the estimated percentage of completion basis. Since the billing schedules under the contracts differ from the recognition of revenue, at the end of any period, these contracts generally result in either costs and estimated profits in excess of billing or billing in excess of cost and estimated profits. Revenue from fixed price software development contracts is determined using the percentage of completion method which is based upon the time spent by our technical personnel on a project. As a result, during the third and fourth quarters, when many of our employees are on vacation and holidays, our revenue could be affected. Our time spent on projects during the second half of the year

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generally ranges from 1% to 3% less than time spent on projects during the first half of the year.

Our total revenue for the June 2003 quarter was \$6,589,000, an increase of \$1,142,000, or 21%, from our revenue for the June 2002 quarter, which was \$5,447,000. Revenue from contracts from government agencies represented 61% of revenue in the June 2003 quarter and 44% of revenue in the June 2002 quarter. This reflects an increase in new government contracts, particularly relating to contracts with two new county agencies.

Software and Related Systems and Services

Our Software and Related Systems and Services revenue for the June 2003 quarter was \$6,088,000, an increase of \$1,127,000, or 23%, from our revenue for the June 2002 quarter, which was \$4,961,000. Software and related systems and services revenue is comprised of turnkey systems labor revenue, revenue from sales of third party hardware and software, license revenue, maintenance revenue and revenue from small turnkey systems.

The largest component of revenue was turnkey systems labor revenue, which increased to \$2,282,000 in the June 2003 quarter or 19%, from \$1,913,000 in the June 2002 quarter. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. This increase was substantially the result of an increase in spending for information systems in the human services marketplace and our ability to provide the staff necessary to generate additional revenue. Labor rate price changes from June 2003 quarter to the June 2002 quarter resulted in a 14% increase in the average daily billing rate and accounted for approximately \$160,000, or 43%, of the total turnkey systems labor increase. Revenue from third party hardware and software increased to \$1,167,000 in the June 2003 quarter, from \$886,000 in the June 2002 quarter, which represents an increase of 32%. Sales of third party hardware and software are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our human services revenue. License revenue increased to \$650,000 in the June 2003 quarter, from \$378,000 in the June 2002 quarter, reflecting an increase of 72%. License revenue is generated as part of a sale of a human services information system pursuant to a contract or purchase order that includes delivery of the system and maintenance. This increase in license revenue was the result of an increase in spending for information systems in the human services marketplace. Maintenance revenue increased to

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\$1,774,000 in the June 2003 quarter or 17%, from \$1,514,000 in the June 2002 quarter. As turnkey systems are completed, they are transitioned to the maintenance division, thereby increasing our installed base. Revenue from the sales of our small turnkey division decreased to \$216,000 in the June 2003 quarter, from \$271,000 in the June 2002 quarter, reflecting a decrease of 20%. This decrease is the result a redirection of our sales efforts to larger turnkey sales. Small turnkey division sales relate to turnkey contracts that are less than \$50,000 and are usually completed within one month.

Gross profit increased to \$2,434,000 in the June 2003 quarter from \$1,624,000 in the June 2002 quarter, reflecting an increase of 50%. Our gross margin percentage increased to 40% in the June 2003 quarter from 33% in the June 2002 quarter. Our gross margins have increased as a result of increased maintenance and license revenue and to a lesser extent, an increase in our labor revenue. Our infrastructure costs with respect to our maintenance division are substantially in place and as new maintenance revenue occurs, our gross profit margins are improved accordingly.

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Data Center

Data center clients typically generate approximately the same amount of revenue each year. We bill on a transaction basis or on a fixed fee arrangement. Historically, each year, we increase the transaction or fixed fees by an amount that approximates the New York urban consumer price index increase. The data center revenue increased to \$501,000 in the June 2003 quarter, from \$485,000 in the June 2002 quarter, representing an increase of \$15,000, or 3%. The increase in revenue was due to an increase in the client base.

Gross profit increased to \$235,000 in the June 2003 quarter from \$220,000 in June 2002 quarter. Our gross margin percentage increased to 47% in the June 2003 quarter from 45% in the June 2002 quarter. This increase was the result of an increase in revenue with no corresponding increase in costs.

Operating Expenses

Selling, general and administrative expenses were \$1,689,000 in the June 2003 quarter, reflecting an increase of \$408,000, or 32%, from the \$1,281,000 in the June 2002 quarter. This increase was in the area of sales and marketing costs, which increased by \$120,000, primarily as a result of increases in salaries and commissions, which increased by \$116,000; an increase in general and administrative salaries, which increased by \$51,000; and provisions for bonuses which increased by \$177,000.

We incurred product development expenses of \$433,000 in the June 2003 quarter, an increase of 22% from the \$356,000 in June 2002 quarter. The increase in product development expense is the result of continuing investment in product enhancement and extensions. These extensions include the development of new software modules including Minimum Data Set (MDS) reporting which is designed to address Federal reporting requirements and a Computerized Physician Order Entry (CPOE) module as well as continued investment in core products including a new version of our addictions management software products. These amounts have been appropriately accounted for in accordance with SFAS No. 86, "Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed."

Interest and other expense was \$60,000 in the June 2003 quarter, an increase of \$3,000, or 5%, from the \$57,000 in the June 2002 quarter. This increase was the related to interest associated with a new capitalized lease arrangement.

Interest income was \$18,000 in the June 2003 quarter, an increase of \$7,000, or 64%, from the \$11,000 in the June 2002 quarter. Interest income is generated from short-term investments made with a substantial portion of the proceeds received from the term loan, as well as cash generated from operations.

We have a net operating loss tax carry forward of approximately \$8.2 million. In the June 2003 quarter, we recorded a current income tax expense of \$85,000,

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which related to various state and local taxes as well as a provision for the Federal alternative minimum tax. In addition, we recognized a partial deferred tax benefit in the amount of \$231,000, which was offset by a reduction in the deferred tax valuation allowance of the same amount. We also reevaluated the deferred tax valuation allowance and further reduced the allowance by \$100,000. In the June 2002 quarter we provided for taxes in the amount of \$18,000. This provision was based upon certain state taxes.

As a result of the foregoing factors, in the June 2003 quarter, we had a net

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income of \$521,000, or \$.13 per share (basic) and \$.12 per share (diluted). For the June 2002 quarter, we had net income of \$143,000, or \$.04 per share basic and diluted.

Liquidity and Capital Resources

We had working capital of approximately \$8.8 million at June 30, 2003 as compared to working capital of approximately \$9.2 million at December 31, 2002. This decrease was the result of the CareNet acquisition, which utilized approximately \$979,000 of our cash. Our working capital was further reduced by the CareNet acquisition because of the current portion of the long-term debt which we recorded in the amount of \$166,000 and certain other contract obligations totaling \$68,000. This decrease in working capital was substantially offset by approximately \$813,000 as a result of our net income after adding back depreciation and amortization and partially offset by the acquisition of equipment. The remaining change in working capital was due to changes in other current assets and liabilities.

In June 2001, we entered into a revolving credit and term loan agreement with Fleet Bank ("Fleet"). This financing provides us with a five-year term loan of \$2.5 million, as well as a two year \$1.5 million revolving line of credit. The \$1.5 million line of credit expired in June 2003. The Company did not utilize this line of credit during its duration. The Company is currently exploring its options with Fleet, relating to the possible renewal of the line of credit. The term loan bears interest at LIBOR plus 2.5%. We have entered into an interest rate swap agreement with Fleet whereby we converted our variable rate on the term loan to a fixed rate of 7.95%. The proceeds of the term loan are designated for acquisitions as well as for product enhancements specific to California requirements. We have made principal payments on the \$2.5 million term loan and the amount outstanding at June 30, 2003 is \$1.5 million.

The terms of our term loan agreement require compliance with certain covenants, including maintaining a minimum net equity of \$9 million, minimum cash reserves of \$500,000, maintenance of certain financial ratios, limitations on capital expenditures and indebtedness and prohibition of the payment of cash dividends. As of June 30, 2003, we were in compliance with the financial covenants of this agreement.

On February 27, 2003, our Board of Directors authorized the purchase of up to \$100,000 of our common stock at any time the market price is less than \$3.50 per share. Purchases of stock will be made from time to time, depending on market conditions, in open market or in privately negotiated transactions, at prices deemed appropriate by management. There is no set time limit on the purchases. We expect to fund these stock repurchases from our operating cash flow. As of June 30, 2003, we have not made any stock repurchases.

We have entered into an interest rate swap agreement with Fleet Bank for the amount outstanding under the term loan agreement at 7.95% in order to reduce the interest rate risk associated with these borrowings.

On June 25, 2003, we acquired substantially all of the assets of the CareNet segment ("CareNet") of Shuttle Data Systems Corporation, d/b/a Adia Information Management Corp. ("Adia"), pursuant to an asset purchase agreement dated June 25, 2003, among the Netsmart, Adia and Steven Heintz, Jr., the president and majority shareholder of Adia. The principal assets acquired were the intellectual property and customer contracts of CareNet. The total purchase price, including acquisition costs, was \$2,003,913 which consisted of 100,000

shares of common stock valued at \$528,000, \$838,740 in cash, and a three-year

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promissory note in the principal amount of \$500,000. The cash portion of the purchase price was paid for out of existing working capital. We also assumed certain contractual obligations and liabilities totaling \$68,068 and incurred \$69,105 in legal and accounting costs which are included in the purchase price.

In addition, in connection with the acquisition, we entered into a non-compete and non-solicitation agreement with Steven Heintz, Jr. and Jennifer Lindbert for which they were paid a fee of an aggregate \$140,000, which fee was paid in cash out of existing working capital and is included in "other assets" on the balance sheet.

The cost of the acquisition was allocated to purchased software in the amount of \$883,075, customer lists in the amount of \$1,097,138, the covenant not to compete in the amount of \$140,000 and computer hardware in the amount of \$23,700. We are amortizing the purchased software over an eight-year life and the customer lists over a nine-year life. The covenant not to compete will be amortized over a three-year life.

The Company accounted for this acquisition pursuant to the purchase method of accounting. For accounting purposes the Company recorded the assets and related liabilities of CareNet effective as of June 30, 2003. The Company incorporated the operations of CareNet into its operations commencing July 1, 2003.

A part of our growth strategy is to acquire other businesses that are related to our current business. Such acquisitions may be made with cash or our securities or a combination of cash and securities. If we fail to make any acquisitions our future growth will be limited to only internal growth. As of the date of this Form 10-Q quarterly report, we did not have any agreements formal or informal or understandings with respect to any material acquisitions, and we cannot give any assurance that we will be able to complete any material acquisitions.

Based on our outstanding contracts and our continuing business, we believe that our cash flow from operations, and our cash on hand will be sufficient to enable us to fund our operations for at least the next twelve months. It is possible that we may need additional funding if we go forward with certain acquisitions or if our business does not develop as we anticipate or if our expenses, including our software development costs relating to our expansion of our product line and our marketing costs for seeking to expand the market for our products and services to include smaller clinics and facilities and sole group practitioners, exceed our expectation.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. Among other things estimates are used in accounting for allowances for bad debts, deferred income taxes, expected realizable values of assets (primarily capitalized software development costs and customer lists) and revenue recognition. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition

Impairment of Capitalized Software Development Costs

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Impairment of Customer Lists

Revenue Recognition: Revenue associated with fixed price turnkey sales consists

of the following components: licensing of software, labor associated with the

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installation and implementation of the software; and maintenance services rendered in connection with such licensing activities. Revenue from fixed price software development contracts and revenue under license agreements, which require significant modification of the software package to the customer's specifications, are recognized on the estimated percentage-of-completion method. Using the units-of-work-performed method to measure progress towards completion, revisions in cost estimates and recognition of losses on these contracts are reflected in the accounting period in which the facts become known. The complexity of the estimation process and issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our Consolidated Financial Statements. A number of internal and external factors can affect our estimates, including labor rates, utilization and efficiency variances and specification and testing requirement changes. Maintenance contract revenue is recognized on a straight-line basis over the life of the respective contract. We also derive revenue from the sale of third party hardware and software which is recognized based upon the terms of each contract. Consulting revenue is recognized when the services are rendered. Data Center revenue is recognized in the period in which the service is provided. The above sources of revenue are recognized when, persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable and collectibility is probable.

Contract terms provide for billing schedules that differ from revenue recognition and give rise to costs and estimated profits in excess of billings, and billings in excess of costs and estimated profits.

Deferred revenue represents revenue billed and collected but not yet earned.

The cost of maintenance revenue, which consists solely of staff payroll and applicable overhead, is expensed as incurred.

Capitalized Software Development Costs - Capitalization of computer software

development costs begins upon the establishment of technological feasibility. Technological feasibility for our computer software products is generally based upon achievement of a detail program design free of high risk development issues. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized computer software development costs requires considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technology. Prior to reaching technological feasibility these costs are expensed as incurred and included in research and development. Amortization of capitalized computer software development costs commences when the related products become available for general release to customers. Amortization is provided on a product by product basis. The annual amortization is the greater of the amount computed using (a) the ratio that current gross revenue for a product bear to the total of current and anticipated future gross revenue for that product or (b) the straight-line method over the remaining estimated economic life of the product. The estimated life of these products range from 3 to 8 years.

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We periodically perform reviews of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

Pursuant to Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we evaluate our long-lived assets for financial impairment, and continue to evaluate them as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable. We evaluate the recoverability of long-lived assets by measuring the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. At the time such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their fair values.

Impairment of Customer Lists - Pursuant to SFAS No. 144, "Accounting for the

Impairment or Disposal of Long-Lived Assets", we evaluate our long-lived assets for financial impairment, and continue to evaluate them as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable. We evaluate the recoverability of long-lived assets by measuring

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the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. At the time such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying amount of such assets, the assets are adjusted to their fair values.

The following table summarizes, as of June 30, 2003, our obligations and commitments to make future payments under debt, capital leases and operating leases:

| Contractual Obligations | Payments Due by Period | | | | |
|------------------------------------|------------------------|---------------------|-------------|-------------|----------------|
| | Total | Less than 1 year | 1 - 3 years | 4 - 5 years | Over 5 year |
| Long Term Debt | 2,000,016 | 666,667 | 1,333,349 | -- | -- |
| Capital Lease Obligations | 180,552 | 64,206 | 116,346 | -- | -- |
| Operating Leases | 359,213 | 291,090 | 68,123 | -- | -- |
| Total Contractual Cash Obligations | 2,539,781 | 1,021,955 | 1,517,826 | -- | -- |

Forward-Looking Statements

Statements in this Form 10-Q quarterly report may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions and may be identified by words such as "expect", "anticipate", "believe" and similar expressions. These statements are based on current expectations, estimates and projections about our business based, in part, on

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assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may, and probably will, differ materially from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those described above and those risks discussed from time to time in our Form 10-K/A for the year ended December 31, 2002 under "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in this Form 10-Q quarterly report and in other documents which we file with the Securities and Exchange Commission. In addition, such statements could be affected by risks and uncertainties related to product demand, market and customer acceptance, competition, government regulations and requirements, pricing and development difficulties, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk related to changes in interest rates. Most of our debt is at fixed rates of interest after completing an interest rate swap agreement, which effectively converted our variable rate debt into a fixed rate debt of 7.95%. Therefore, if the LIBOR rate plus 2.5% increases above 7.95%, it may have a positive effect on our net income.

Most of our invested cash and cash equivalents, which are invested in money market accounts and commercial paper, are at variable rates of interest. If

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market interest rates decrease by 10 percent from levels at June 30, 2003, the effect on our net income would be a decrease of approximately \$7,200 per year.

Item 4. Controls and Procedures

Within the 90-day period prior to the initial filing of this Form 10-Q, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as defined in Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Part II OTHER INFORMATION

Item 2. Changes in Securities

On June 25, 2003, the Company issued 100,000 shares of common stock in connection with its acquisition of substantially all of the assets of the CareNet segment of Shuttle Data Systems Corporation, d/b/a Adia Information Management Corp. ("Adia"), pursuant to an asset purchase agreement dated June 25, 2003, among the Company, Adia and Steven Heintz, Jr., the president and majority shareholder of Adia. The issuance of the foregoing securities was issued in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, as a transaction not involving a public placement based on the fact that it was an issuance of securities to one

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person and the shares were legended to prevent their transfer.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

| Exhibit No. ----- | Description ----- |
|----------------------|--|
| 99.1 | Certification of Chief Executive Officer pursuant to 8 U.S.C.ss.1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 99.2 | Certification of Chief Financial Officer pursuant to 8 U.S.C.ss.1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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Signatures

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

NETSMART TECHNOLOGIES, INC.

| | | |
|--|--|----------------|
| /s/James L. Conway ----- James L. Conway | Chief Executive Officer (Principal Executive Officer) | August 4, 2003 |
|--|--|----------------|

| | | |
|--|--|----------------|
| /s/Anthony F. Grisanti ----- Anthony F. Grisanti | Chief Financial Officer (Principal Financial and Accounting Officer) | August 4, 2003 |
|--|--|----------------|

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Index of Exhibits

| Exhibit No. ----- | Description ----- |
|----------------------|--|
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CERTIFICATIONS PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO

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SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, James L. Conway, Chief Executive Officer of Netsmart Technologies, Inc., hereby certify that the Form 10-Q of Netsmart Technologies, Inc. for the period ended June 30, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Netsmart Technologies, Inc.

/s/James L. Conway

Name: James L. Conway
Date: August 4, 2003

I, Anthony F. Grisanti, Principal Financial and Accounting Officer of Netsmart Technologies, Inc., hereby certify that the Form 10-Q of Netsmart Technologies, Inc. for the period ended June 30, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Netsmart Technologies, Inc.

/s/ Anthony F. Grisanti

Name: Anthony F. Grisanti
Date: August 4, 2003

These certifications are being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and, except to the extent required by the Sarbanes-Oxley Act, shall not be deemed to be filed as part of the periodic report described herein nor shall they be deemed filed by Netsmart Technologies, Inc. for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of the written statements required by Section 906 has been provided to Netsmart Technologies, Inc. and will be retained by Netsmart Technologies, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.