NETSMART TECHNOLOGIES INC
Form 10-Q
August 10, 2005

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, 2005
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 incorporation or organization)	(I.R.S. Employer Identification Number)
3500 Sunrise Highway, Great River, NY	11739
(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 X No__

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

Yes __ No X

Number of shares of common stock outstanding as of August 3, 2005: 5,390,950

Netsmart Technologies, Inc. and Subsidiary

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Item 1. Financial Statements

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2005 Unaudited	December 31, 2004
Assets:		
Current Assets:		
Cash and Cash Equivalents	$16,359,627	$16,411,735
Accounts Receivable - Net	9,010,691	11,714,691
Costs and Estimated Profits in Excess of Interim Billings	831,057	636,985
Deferred taxes	1,030,000	1,111,000
Other Current Assets	772,305	596,253
Total Current Assets	28,003,680	30,470,664
Property and Equipment - Net	2,427,944	2,546,948
Other Assets:		
Software Development Costs - Net	3,561,024	1,132,453
Customer Lists - Net	3,183,411	2,179,237
Deferred taxes less current portion	1,074,000	1,284,000
Other Assets	104,246	93,599

Total Other Assets	7,922,681	4,689,289
Total Assets	$38,354,305	$37,706,901

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2005 (Unaudited)
Liabilities and Stockholders' Equity:	
Current Liabilities:	
Current Portion - Long Term Debt	$ 666,699
Current Portion Capital Lease Obligations	54,394
Accounts Payable	1,469,763
Accrued Expenses	1,146,917
Interim Billings in Excess of Costs and Estimated Profits	6,917,950
Deferred Revenue	1,924,311
Total Current Liabilities	12,180,034
Long Term Debt - Less current portion	--
Capital Lease Obligations - Less current portion	--
Interest Rate Swap at Fair Value	5,008
Deferred Rent Payable	475,050
Total Non Current Liabilities	480,058
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 and outstanding 5,599,531 and 5,371,607 shares at June 30, 2005 and 5,567,124 and 5,339,200 shares at December 31, 2004	55,995

Additional Paid in Capital	30,137,495
Accumulated Comprehensive loss - Interest Rate Swap	(5,008)
Accumulated Deficit	(2,781,287)
	27,407,195
Less: cost of shares of Common Stock held in treasury - 227,924 shares at June 30, 2005 and December 31, 2004	1,712,982
Total Stockholders' Equity	25,694,213
Total Liabilities and Stockholders' Equity	$ 38,354,305

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME - (Unaudited)

	Six months ended June 30		Three months June 30
	2005	2004	2005
Revenues:			
Software and Related Systems and Services:			
General	$ 8,663,661	$ 8,303,967	$ 4,422,905
Maintenance Contract Services	4,445,033	3,968,908	2,290,914
Total Software and Related Systems and Services	13,108,694	12,272,875	6,713,819
Application Service Provider Services	1,133,046	741,885	577,625
Data Center Services	946,258	997,154	467,853
Total Revenues	15,187,998	14,011,914	7,759,297
Cost of Revenues:			
Software and Related Systems and Services:			
General	4,500,663	4,552,399	2,240,336
Maintenance Contract			

Services	2,111,381	1,992,255	1,050,622
Total Software and Related Systems and Services	6,612,044	6,544,654	3,290,958
Application Service Provider Services	664,082	439,100	387,234
Data Center Services	449,624	430,692	218,881
Total Cost of Revenues	7,725,750	7,414,446	3,897,073
Gross Profit	7,462,248	6,597,468	3,862,224
Selling, General and Administrative Expenses	4,358,585	3,733,512	2,370,473
Research, Development and Maintenance	1,969,303	1,664,689	898,921
Total	6,327,888	5,398,201	3,269,394
Operating Income	1,134,360	1,199,267	592,830
Interest and Other Income	145,694	64,952	88,405
Interest and Other Expense	37,433	77,365	17,796
Income before Income Tax Expense	1,242,621	1,186,854	663,439
Income Tax Expense	430,000	369,000	214,000
Net Income	$ 812,621	$ 817,854	$ 449,439
Earnings Per Share ("EPS")of Common Stock:			
Basic EPS	$ .15	$ .15	$ .08
Weighted Average Number of Shares of Common Stock Outstanding	5,354,968	5,325,628	5,371,607
Diluted EPS	$ .15	$ .15	$ .08
Weighted Average Number of Shares of Common Stock and Common Stock Equivalents Outstanding	5,570,611	5,557,748	5,584,448

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (Unaudited)

	Six Months ended June 30, 2005	2004
Operating Activities:		
Net Income	$ 812,621	$ 817,854
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation and Amortization	853,017	781,693
Provision for Doubtful Accounts	337,000	(122,733)
Deferred Income Taxes	291,000	295,000
Changes in Assets and Liabilities:		
[Increase] Decrease in:		
Accounts Receivable	2,494,698	(869,824)
Costs and Estimated Profits in Excess of Interim Billings	(194,072)	278,782
Other Current Assets	(144,004)	123,095
Other Assets	(7,730)	14,796
Increase [Decrease] in		
Accounts Payable	(103,167)	(224,875)
Accrued Expenses	(398,210)	(277,964)
Interim Billings in Excess of Costs and Estimated Profits	(579,823)	(886,784)
Deferred Revenue	22,927	168,558
Deferred Rent Payable	19,623	272,598
Total Adjustments	2,591,259	(447,658)
Net Cash Provided by Operating Activities	3,403,880	370,196
Investing Activities:		
Acquisition of Property and Equipment	(229,501)	(1,200,633)
Capitalized Software Development	--	(117,000)
Business Acquisitions	(2,914,766)	(16,263)
Net Cash Used In Investing Activities	(3,144,267)	(1,333,896)

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (Unaudited)

	Six Months ended June 30, 2005	Six Months ended June 30, 2004
Financing Activities:		
Payment of Capitalized Lease Obligations	$ (31,588)	$ (31,052)
Net Proceeds from Stock Options Exercised	53,196	107,487
Payments of Term Loan	(333,329)	(333,330)
Net Cash Used in Financing Activities	(311,721)	(256,895)
Net (Decrease) in Cash and Cash Equivalents	(52,108)	(1,220,595)
Cash and Cash Equivalents - Beginning of Period	16,411,735	15,920,993
Cash and Cash Equivalents - End of Period	$ 16,359,627	$ 14,700,398
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 39,437	$ 79,662
Income Taxes	$ 170,063	$ 173,149

Non Cash Investing and Financing Activities:
The fair value of the interest rate swap decreased by $10,144 for the six months ended June 30, 2005. The fair value of the interest rate swap decreased by $27,447 for the six months ended June 30, 2004.

During the six months ended June 30, 2005, the Company acquired for $489,238 in cash and stock software, customer lists and other assets of ContinuedLearning LLC. The consideration consisted of $252,917 in cash plus 20,000 shares of common stock, valued at $191,400, based upon the average weighted stock price of $9.57 for the period commencing three days before and ending three days after the acquisition was agreed to and announced. The consideration also included the assumption of $44,921 for certain liabilities for services to be performed in the future.

During the six months ended June 30, 2005, the Company acquired for $3,610,682 software, customer lists and other assets of Addiction Management Systems. The consideration consisted of $2,661,849 in cash and the assumption of $948,833 for certain liabilities for services to be performed in the future.

During the six months ended June 30, 2004, the Company received 4,166 shares of its common stock in consideration for the exercise of certain stock options. The value of the shares received was $53,533, which was the market value of the common stock on the date of exercise.

During the six months ended June 30, 2004, the Company acquired for $250,000 TxM software and customer lists. The consideration consisted of $16,263 in cash and

the assumption of $233,707 for certain liabilities for services to be performed in the future.

See Notes to Condensed Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY - (UNAUDITED)

	Common Stock		Additional Paid-in Capital Common	Accumulated	Accumulated Comprehensive Loss Interest Rate	Comprehensiv
	Shares	Amount	Stock	Deficit	Swap	Income
Balance - January 1, 2005	5,567,124	$ 55,671	$29,893,223	$(3,593,908)	$(15,152)	$ --
Common Stock Issued - Exercise of Options	12,407	124	53,072	--	--	--
Change in Fair Value of Interest Rate Swap	--	--	--	--	10,144	10,144
Common Stock Issued - Business Acquisition	20,000	200	191,200	--	--	--
Net Income	--	--	--	812,621	--	812,621
						$822,765
Balance - June 30, 2005	5,599,531	$ 55,995	$30,137,495	$(2,781,287)	$(5,008)	

See Notes to Consolidated Financial Statements.

NETSMART TECHNOLOGIES, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Financial Statements

The accompanying condensed consolidated financial statements include the accounts of Netsmart Technologies, Inc. and its subsidiary (collectively, unless the context otherwise indicates, the "Company"). All intercompany balances and transactions have been eliminated in consolidation.

These unaudited, condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company's annual report on Form 10-K for the year ended December 31, 2004.

(2) Earnings 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 Mont June
	2005	2004	2005
Numerator:			
Net income	$ 812,621	$ 817,854	$ 449,439
Denominator:			
Weighted average shares	5,354,968	5,325,628	5,371,607
Effect of dilutive securities:			
Employee stock options	215,643	232,120	212,841
Denominator for diluted earnings per share-adjusted weighted average shares after assumed conversions	5,570,611	5,557,748	5,584,448

Options to purchase 9,792 shares of the Company's common stock that were outstanding as of June 30, 2005 were not included in the calculation of diluted earnings per share for the six and three months ended June 30, 2005 since such inclusion would have been antidilutive.

(3) Stock Options and Similar Equity Instruments

At June 30, 2005, the Company had three stock-based employee compensation plans. As permitted under Statement of Financial Accounting Standards ("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 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 Mont June
	2005	2004	2005
Net Income as Reported	$ 812,621	$ 817,854	$ 449,439
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effect	471,638	361,967	159,806
Pro Forma Net Income	$ 340,983	$ 455,887	$ 289,633
Basic Net Income Per Share as Reported	$ .15	$ .15	$ .08
Basic Pro Forma Net Income Per Share	$ .06	$ .09	$ .05
Diluted Net Income Per Share as Reported	$ .15	$ .15	$ .08
Diluted Pro Forma Net Income Per Share	$ .06	$ .08	$ .05

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:

Six Months Ended

	June 30, 2005	June 30, 2004
Expected Life (Years)	5	5
Interest Rate	4%	4.00%
Annual Rate of Dividends	0%	0%
Volatility	67%	68%

The weighted average fair value of options at date of grant using the fair value based method during 2005 and 2004 is estimated at $5.01 and $3.95 respectively.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS No. 123R eliminates the alternative to use APB No. 25's intrinsic value method of accounting that was provided in SFAS No 123 as originally issued. SFAS No. 123R requires entities to recognize the cost of employee services in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). That cost will be recognized over the period during

which the employee is required to provide the service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. SFAS No. 123R requires entities to initially measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of the award will be remeasured at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. The grant date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. SFAS No. 123R is effective as of the beginning of the Company's interim reporting period that begins on January 1, 2006. The transitional provisions of SFAS No. 123R will not have a material effect on the Company's consolidated financial position or results of operations as substantially all outstanding equity instruments vest on or prior to December 31, 2005. The Company will utilize the fair value method for any future instruments issued or outstanding but not vested after the implementation date.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107, "Share Based Payments" ("SAB 107"). The interpretations in SAB 107 express views of the staff regarding the interaction between SFAS 123R and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with non-employees, the transition from non-public to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123R in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123R, the modification of employee share options prior to adoption of SFAS 123R, and disclosures in Management's Discussion and Analysis subsequent to adoption of SFAS 123R.

(4) Income Taxes

The provision for income taxes for the six months ended June 30, 2005, consists of a current tax provision of $139,000 and a deferred tax provision of

approximately $291,000. The provision for income taxes for the period ended June 30, 2004, consists of a current tax provision of $74,000 and a deferred tax provision of $295,000. The deferred tax provision for the six months ended June 30, 2005 was $487,000 based upon utilization of available net operating loss carry forwards offset by a reduction in the deferred tax asset valuation allowance of $192,000. The provision for income taxes for the three months ended June 30, 2005, consists of a current tax provision of $60,000 and a deferred tax provision of approximately $154,000. The provision for income taxes for the three months ended June 30, 2004 consists of a current provision of $43,000 and a deferred tax provision of $108,000. The deferred tax provision was $248,000 based upon utilization of available net operating loss carry forwards offset by a reduction in the deferred tax asset valuation allowance of $140,000.

(5) Stockholders' Equity

During the six months ended June 30, 2005, options to purchase 12,407 shares were exercised and the Company received gross proceeds of $53,196.

On April 28, 2005, the Company acquired substantially all of the assets of Continued Learning LLC (see Acquisition footnote 8). The total purchase price of $489,238 consisted of various components of consideration including 20,000 shares of the Company's common stock valued at $191,400.

(6) Operating Segments

The Company currently classifies its operations into three business segments: (1) Software and Related Systems and Services, (2) Data Center Services and (3) Application Service Provider ("ASP") Services. Software and Related Systems and Services is the design, installation, implementation and maintenance of computer

information systems that provide comprehensive healthcare 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 involves Company personnel performing data entry and data processing services for customers. ASP Services involve Company offerings of each of its Avatar suite of products, CareNet products and InfoScribeR products on a virtual private network or internet delivery approach, thereby allowing its customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements. Intersegment sales and sales outside the United States are not material. Information concerning the Company's business segments are as follows:

	Software and Related Systems and Services	Data Center Services	App Servic S
Six Months Ended June 30, 2005			
Revenue	$13,108,694	$ 946,258	$
Income before income taxes	927,239	266,987	
Total identifiable assets at June 30, 2005	31,735,430	2,373,467	
Six Months Ended June 30, 2004			

Revenue	$12,272,875	$ 997,154	$
Income before income taxes	837,894	341,727	
Total identifiable assets at June 30, 2004	28,182,770	2,331,048	
Three Months Ended June 30, 2005			
Revenue	$ 6,713,819	$ 467,853	$
Income before income taxes	556,626	128,475	
Three Months Ended June 30, 2004			
Revenue	$ 6,292,694	$ 509,173	$
Income before income taxes	443,161	178,300	

(7) 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.

(8) Acquisitions

On April 28, 2005, the Company acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offered a comprehensive family of web-based training products and services, including its Learning Management System. The total purchase price, including acquisition costs, was $489,238 which consisted of cash of $252,917 including legal fees of $18,632 and broker fees of $10,000, 20,000 shares of the Company's common stock valued at $191,400, and assumed liabilities of $44,921. It also provides for a potential additional payment up to $250,000 if certain revenue targets are met in year one.
The Company also entered into a two year employment agreement at an annual salary of $100,000 per year with the principal of ContinuedLearning LLC, whereby the principal can receive an additional $300,000 in cash, to be accounted for as compensation expense, if certain revenue targets are met within a two year period. The cash portion of the purchase price was paid out of existing working capital.

The cost of the ContinuedLearning acquisition was allocated as follows: $404,606 to purchased software, $42,632 to customer lists,$17,000 to computer hardware, and $25,000 to a covenant not to compete. The Company is amortizing the purchased software over a six-year life, the customer lists and computer hardware over a three-year life, and the covenant not to compete over a two-year life.

On June 20, 2005, the Company acquired the assets of Addiction Management Systems, Inc ("AMS"). The total purchase price, including acquisition costs, was $3,610,682 which consisted of cash of $2,641,945 plus legal fees of $19,904 and assumed liabilities for services to be provided of $948,833.

The cost of the AMS acquisition was allocated as follows: $2,173,681 to purchased software, $1,273,921 to customer lists, $127,698 accounts receivable, $32,048 to inventory, and $3,334 to a security deposit. The Company is

amortizing the purchased software over an eight-year life and the customer lists over a ten-year life.

The results of each acquisition were included in the consolidated results of operations as of the dates of the acquisitions.

The Company accounted for both of the ContinuedLearning and AMS acquisitions pursuant to the purchase method of accounting as required under Statement of Financial Accounting Standards No. 141 "Business Combination".

(9) New Pronouncements

FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47) In March 2005, the FASB issued FIN 47, which is effective for the company on December 31, 2005. FIN 47 clarifies that the phrase "conditional asset retirement obligation," as used in FASB Statement No. 143, "Accounting for Asset Retirement Obligations" (FAS 143), refers to a legal obligation to perform an asset retirement activity for which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the company. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FAS 143 acknowledges that in some cases, sufficient information may not be available to reasonably estimate the fair value of an asset retirement obligation. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The company does not expect that adoption of FIN 47 will have a significant effect on its financial position or results of operations.

In May 2005, FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" (SFAS 154). SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle. It also requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. The statement will be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not expect the adoption of SFAS 154 to have a material effect on our consolidated financial position of results of operations.

In June 2005, the EITF reached consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements ("EITF 05-6"). EITF 05-6 provides guidance on determining the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception. The guidance in EITF 05-6 will be applied prospectively and is effective for periods beginning after June 29, 2005. EITF 05-6 is not expected to have a

material impact on the Company's unaudited interim condensed consolidated financial statements.

(10) Subsequent Events

On July 14, 2005, at the annual meeting of stockholders, the stockholders approved an increase of 400,000 in the number shares available under the Netsmart 2001 Long-Term Incentive Plan. These 400,000 additional options were granted to officers and employees on July 14, 2005 with an exercise price of

$9.85 per share for each option, which was equal to the fair market value at the date of grant, in accordance with the terms of the 2001 Long-Term Incentive Plan. The options granted vest over different periods; however, they will all be fully vested by December 31, 2005.

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

Overview

Our operations are grouped into three segments:
|X| Software and Related Systems and Services
|X| Data Center (service bureau) Services
|X| Application Service Provider Services (ASP)

Software and Related Systems and Services is the design, installation, implementation and maintenance of computer information systems that provide comprehensive healthcare 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 involves our personnel performing data entry and data processing services for customers. Application Service Provider Services involves the offering of our Avatar suite of products, our CareNet products, our InfoScribeR products and our ContinuedLearning products on a virtual private network or through an internet delivery approach, thereby allowing our customers to deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements for such services.

On April 28, 2005, we acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offered a comprehensive family of web-based training products and services, including its Learning Management System. The total purchase price, including acquisition costs, was $489,238 which consisted of cash of $252,917 including legal fees of $18,632 and brokers fees of $10,000, 20,000 shares of the Company's common stock valued at $191,400 and assumed liabilities of $44,921. It also provides for a potential additional payment of $250,000 if certain revenue targets are met in year one. We also entered into an employment agreement with the principal of ContinuedLearning LLC, whereby the principal can receive an additional $300,000 in cash, to be accounted for as compensation expense, if certain revenue targets are met. The cash portion of the purchase price was paid out of existing working capital.

On June 20, 2005, we acquired the assets of Addiction Management Systems, Inc ("AMS"). The total purchase price, including acquisition costs, was $3,610,682, which consisted of cash of $2,641,945 plus legal fees of $19,904 and assumed liabilities for services to be provided of $948,833.

Six Months Ended June 30, 2005 and 2004

Results of Operations

Our total revenue for the six months ended June 30, 2005 (the "June 2005 period") was $15,188,000, an increase of $1,176,000, or 8%, from our revenue for the six months ended June 30, 2004 (the "June 2004 period"), which was $14,012,000.

Revenue from contracts with state and local government agencies represented 48%

of revenue in the June 2005 and June 2004 periods.

Fixed price software development contracts, which include labor, licenses and

third party resale components, accounted for 33% and 35% of consolidated revenue for the June 2005 period and the June 2004 period, respectively. This decrease is the result of a decrease in Software and Related Systems and Services revenue generated from fixed price contracts and an increase in such revenue generated on an as incurred basis. Our recurring revenue components, which include our maintenance contract services, our Data Center and ASP services, accounted for 43% of our consolidated revenue for the June 2005 period compared to 41% of consolidated revenue for the June 2004 period. This increase was the result of increases in maintenance and ASP revenue. 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 costs 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.

Software and Related Systems and Services

Our Software and Related Systems and Services revenue for the June 2005 period was $13,109,000, an increase of $836,000, or 7%, from our revenue for the June 2004 period, which was $12,273,000. 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 Software and Related Systems and Services revenue was turnkey systems labor revenue, which increased $301,000 or 6% to $5,009,000 in the June 2005 period from $4,708,000 in the June 2004 period. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. The increase in turnkey systems labor revenue was primarily due to increased staff working on turnkey labor contracts. Additionally, approximately $76,000, or 25%, of the total turnkey systems labor increase was the result of a 3% increase in the average daily billing rate from the June 2005 period to the June 2004 period. Revenue from third party hardware and software increased 12% to $2,294,000 in the June 2005 period, from $2,045,000 in the June 2004 period. Sales of third party hardware and software, such as pharmacy and database software, are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our other software and related systems and services revenue. During the June 2005 period, the increase in third party hardware and software was partially the result of an increase in database software sales to two customers. License revenue decreased 5% to $989,000 in the June 2005 period, from $1,044,000 in the June 2004 period. 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. We sold and performed on fewer contracts containing license revenue in the June 2005 period than in the June 2004 period. We are actively pursuing courses of action designed to retain or increase our customer base, including offering price incentives or payment plans on a customer-by-customer basis. These price incentives with respect to our license revenue have contributed to the decrease in our license revenue. Maintenance revenue increased 12% to $4,445,000 in the June 2005 period from $3,969,000 in the June 2004 period. 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 27% to $372,000 in the June 2005 period from $507,000 in the June 2004 period. We sold and performed on fewer small turnkey contracts in the June 2005 period than in the June 2004 period. Small turnkey division sales relate to turnkey contracts that are less than $50,000 and are usually completed within one month. On June 20, 2005, we acquired AMS. AMS typically has the type of contracts included in the small turnkey division revenue.

Gross profit increased 13% to $6,497,000 in the June 2005 period from $5,728,000 in the June 2004 period. Our gross margin percentage increased to 50% in the June 2005 period from 47% in the June 2004 period. Our gross margin increased as a result of improved labor efficiency on our fixed price contracts and maintenance division. This increase was partially offset by a decrease in our license revenue.

Data Center Services (Service Bureau)

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 fee by an amount that approximates the New York urban consumer price index increase. The data center revenue decreased to $946,000 in the June 2005 period from $997,000 in the June 2004 period, representing a decrease of $51,000, or 5%. This decrease was the result of one customer discontinuing the use of our services.

Gross profit decreased 12% to $497,000 in the June 2005 period from $566,000 in the June 2004 period. Our gross margin percentage decreased to 52% in the June 2005 period from 57% in the June 2004 period. This decrease was the result of the decrease in revenue, as well as an increase in costs of approximately $19,000. The increase in costs was substantially the result of an increase in communications costs of $25,000, which was partially offset by a decrease in supplies costs of approximately $7,000.

Application Service Provider Services ("ASP")

ASP Services involves the offering of our Avatar suite of products, our CareNet products, our ContinuedLearning products and our Infoscriber products on a virtual private network or internet delivery approach, thereby allowing our customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements for such services.

ASP revenue increased to $1,133,000 in the June 2005 period from $742,000 in the June 2004 period, representing an increase of $391,000 or 53%. The components of the ASP revenue are as follows:

	June 2005 period	June 2004 period
Avatar	$ 525,000	$ 240,000
CareNet	442,000	391,000
ContinuedLearning	23,000	--
Infoscriber	143,000	111,000
Total	$1,133,000	$ 742,000

Avatar ASP revenue increased in the June 2005 period by 119% as compared to the June 2004 period. This increase was substantially the result of increased usage from our existing customer base, as well as the addition of one new customer in the June 2005 period.

CareNet revenue increased in the June 2005 period by 13% as compared to the June 2004 period. Approximately 29% of the revenue increase is associated with the original CareNet customer base acquired in June 2003, with the balance of the increase resulting from sales to new customers.

Infoscriber revenue increased in the June 2005 period by 29% as compared to the June 2004 period. This increase is the result of an increase in our client base.

On April 28, 2005, we acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offers a comprehensive family of web-based training products and services, including its Learning Management System. ContinuedLearning revenue totaled $23,000 for the June 2005 period.

Gross profit for the June 2005 period was $469,000 and for the June 2004 period was $303,000. The gross margin percentage was 41% in the June 2005 and June 2004 periods. Although revenue increased, the gross profit and gross margin

percentage did not increase proportionally due to the increased costs associated with the Continued Learning acquisition which amounted to $117,000 in the June 2005 period. These costs represent the required baseline costs to support the ContinuedLearning operation. We expect that as new revenue is added to this operation, gross profit and margins will increase accordingly.

Operating Expenses

Selling, general and administrative expenses were $4,359,000 in the June 2005 period, reflecting an increase of $625,000, or 17%, from $3,734,000 in the June 2004 period. Approximately 49% or $305,000 of this increase was related to an increase in bad debts as a result of one customer filing for bankruptcy. The remaining increases were: sales and marketing salaries and fringe benefits, which increased by $228,000; sales and marketing consulting costs, which increased by $117,000; sales conferences, which increased by $47,000; other consulting which increased by $171,000, of which $59,000 related to Sarbanes Oxley compliance efforts and $53,000 related to strategic planning efforts; and $57,000 which related to increased amortization related to the ContinuedLearning and AMS acquisitions. The cost increases were partially offset by reductions in: trade shows, which decreased by $36,000; advertising and promotion, which decreased by $60,000; investment banker fees, which decreased by $66,000; depreciation, which decreased by $69,000; accounting costs, which decreased by $40,000; and provision for bonuses, which decreased by $33,000.

We incurred research, development and maintenance expenses of $1,969,000 in the June 2005 period, an increase of 18% from $1,665,000 in the June 2004 period. During the latter part of 2004, we invested in infrastructure that is designed to improve the way we support our customers and products. This increased infrastructure costs relate to product version control, which includes design, programming, testing, documentation and quality control of our products. These efforts accounted for a substantial increase in our research, development and maintenance expenses. The increase in research, development and maintenance expense is also the result of continuing investment in product enhancement and extensions. These extensions include the development of new software modules which addresses Federal reporting requirements, as well as continued investment in core 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 $37,000 in the June 2005 period, a decrease of $40,000, or 52%, from the $77,000 in the June 2004 period. This decrease is the

result of the completion of the amortization of the financing costs associated with our loan agreement, which was amortized over a three year period, as well as reduced borrowing under our loan agreement during the June 2005 period.

Interest income was $146,000 in the June 2005 period, an increase of $81,000, or 125%, from the $65,000 in the June 2004 period. This increase is the result of maintaining higher cash balances during the June 2005 period as well as an increase in interest rates. 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 and the proceeds of the exercise of options and warrants.

We had a net operating loss tax carry forward of approximately $2.9 million at June 30, 2005. In the June 2005 period, we recorded a current income tax expense of $139,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The income tax provision was increased by a deferred tax provision of $291,000. In the June 2004 period, we recorded a current income tax expense of $74,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The income tax provision was increased by a deferred tax provision of $295,000. The deferred tax provision was $487,000 based upon utilization of available net operating loss carry forwards offset by a reduction in the deferred tax asset valuation allowance of $192,000.

As a result of the foregoing factors, in the June 2005 period we had net income

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of $813,000, or $.15 per share basic and diluted. For the June 2004 period, we had net income of $818,000, or $.15 per share basic and diluted.

Three Months Ended June 30, 2005 and 2004

Results of Operations

Our total revenue for the three months ended June 30, 2005 (the "June 2005 quarter") was $7,759,000, an increase of $570,000, or 8%, from our revenue for the three months ended June 30, 2004 (the "June 2004 quarter"), which was $7,189,000.

Revenue from contracts with state and local government agencies represented 45% of revenue in the June 2005 quarter and 48% of revenue in the June 2004 quarter. This decrease is the result of a substantial completion of one state and two county contracts.

Fixed price software development contracts, which include labor, licenses and third party resale components, accounted for 29% and 37% of consolidated revenue for the June 2005 quarter and the June 2004 quarter, respectively. This decrease is the result of a decrease in Software and Related Systems and Services revenue generated from fixed price contracts and an increase in Software and Related Systems and Services revenue generated on an as incurred basis. Our recurring revenue components, which include our maintenance contract services, our Data Center and ASP services, accounted for 43% of our consolidated revenue for the June 2005 quarter compared to 41% of consolidated revenue for the June 2004 quarter. This increase was the result of increases in maintenance and ASP revenue. 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 quarter, these contracts generally result in either costs and estimated profits in excess of billing or billing in excess of costs 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.

Software and Related Systems and Services

Our Software and Related Systems and Services revenue for the June 2005 quarter was $6,714,000, an increase of $421,000, or 7%, from our revenue for the June 2004 quarter, which was $6,293,000. 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 Software and Related Systems and Services revenue was turnkey systems labor revenue, which increased $199,000 or 8% to $2,641,000 in the June 2005 quarter from $2,442,000 in the June 2004 quarter. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. The increase in turnkey systems labor revenue was primarily due to the result of increased staff working on turnkey labor contracts. Additionally, approximately $45,000, or 23%, of the total turnkey systems labor increase was the result of a 3% increase in the average daily billing rate from the June 2005 quarter to the June 2004 quarter. Revenue from third party hardware and software increased 2% to $1,189,000 in the June 2005 quarter, from $1,164,000 in the June 2004 quarter. Sales of third party hardware and software, such as pharmacy and database software, are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our other software and related systems and services revenue. License revenue increased 18% to $487,000 in the June 2005 quarter, from $414,000 in the June 2004 quarter. 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. The increase in license revenue in the June 2005 quarter is the result of increased sales to our customer base related to customer user count increases. We are actively pursuing courses of action designed to retain

or increase our customer base, including offering price incentives or payment plans on a customer-by-customer basis. The reductions from these price incentives with respect to our license revenue have partially offset the increase in license revenue associated with sales to our customer base related to user count increases. Maintenance revenue increased 12% to $2,291,000 in the June 2005 quarter from $2,052,000 in the June 2004 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 52% to $106,000 in the June 2005 quarter from $220,000 in the June 2004 quarter. We sold and performed on fewer small turnkey contracts in the June 2005 quarter than in the June 2004 quarter. Small turnkey division sales relate to turnkey contracts that are less than $50,000 and are usually completed within one month. On June 20, 2005, we acquired AMS which typically has the type of contracts included in the small turnkey division revenue.

Gross profit increased 15% to $3,423,000 in the June 2005 quarter from $2,968,000 in the June 2004 quarter. Our gross margin percentage increased to 51% in the June 2005 quarter from 47% in the June 2004 quarter. Our gross margin increased as a result of improved labor efficiency on our fixed price contracts and maintenance division as well as an increase in our license revenue.

Data Center Services (Service Bureau)

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 fee by an amount that approximates the New York urban consumer price index increase. The data center revenue decreased to $468,000 in the June 2005 quarter from $509,000 in the June 2004 quarter, representing a decrease of $41,000, or 8%. This decrease was the result of one customer discontinuing the use of our services.

Gross profit decreased 15% to $249,000 in the June 2005 quarter from $293,000 in the June 2004 quarter. Our gross margin percentage decreased to 53% in the June 2005 quarter from 57% in the June 2004 quarter. This decrease was substantially the result of the decrease in revenue.

Application Service Provider Services ("ASP")

ASP Services involves the offering of our Avatar suite of products, our CareNet products, our ContinuedLearning products and our Infoscriber products on a virtual private network or internet delivery approach, thereby allowing our customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements for such services.

ASP revenue increased to $578,000 in the June 2005 quarter from $387,000 in the June 2004 quarter, representing an increase of $191,000 or 49%. The components of the ASP revenue are as follows:

	June 2005 period	June 2004 period
Avatar	$ 265,000	$ 127,000
CareNet	216,000	207,000
ContinuedLearning	23,000	--
Infoscriber	74,000	53,000
Total	$ 578,000	$ 387,000

Avatar ASP revenue increased in the June 2005 quarter by 109% as compared to the June 2004 quarter. This increase was substantially the result of increased usage from our existing customer base, as well as the addition of one new customer in the June 2005 quarter.

CareNet revenue increased in the June 2005 quarter by 4% as compared to the June 2004 quarter. Approximately 33% of the revenue increase is associated with the original CareNet customer base acquired in June 2003, with the balance of the increase resulting from sales to new customers.

Infoscriber revenue increased in the June 2005 quarter by 37% as compared to the June 2004 quarter. This increase is the result of an increase in our client base.

On April 28, 2005, we acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offers a comprehensive family of web-based training products and services including its Learning Management System. ContinuedLearning revenue totaled $23,000 for the June 2005 quarter.

Gross profit for the June 2005 quarter was $190,000 and for the June 2004 quarter was $174,000. The gross margin percentage was 33% in the June 2005 quarter and 45% in the June 2004 quarter. The decrease in gross margin percentage is the result of increased costs associated with the

ContinuedLearning acquisition, which amounted to $117,000 in the June 2005 quarter. These costs represent the required baseline costs to support the ContinuedLearning operation. We expect that as new revenue is added to this operation, gross profit and margins will increase accordingly.

Operating Expenses

Selling, general and administrative expenses were $2,370,000 in the June 2005 quarter, reflecting an increase of $467,000, or 25%, from $1,903,000 in the June 2004 quarter. Approximately 65% or $305,000 of this increase was related to an increase in bad debts as a result of one customer filing for bankruptcy. The remaining increases were: sales and marketing salaries and fringe benefits, which increased by $108,000; sales and marketing consulting costs, which increased by $57,000; sales conferences and trade shows, which increased by $47,000; other consulting costs, which increased by $80,000 of which $19,000 related to Sarbanes Oxley compliance efforts and $18,000 related to strategic planning efforts; legal fees, which increased by $22,000; recruitment costs, which increased by $21,000; and $45,000 which related to increased amortization related to the ContinuedLearning and AMS acquisitions. The cost increases were partially offset by reductions in: reserve for bad debts - other, which decreased by $99,000 advertising and promotion expenses which decreased by $61,000; investment banker fees, which decreased by $29,000; accounting costs which decreased by $40,000; and provision for bonuses, which decreased by $13,000.

We incurred research, development and maintenance expenses of $899,000 in the June 2005 quarter, an increase of 1% from $886,000 in the June 2004 quarter. During the latter part of 2004, we invested in infrastructure that is designed to improve the way we support our customers and products. These infrastructure costs relate to product version control, which includes design, programming, testing, documentation and quality control of our products. These research, development and maintenance expense are also the result of continuing investment in product enhancement and extensions. These extensions include the development of new software modules which addresses Federal reporting requirements, as well as continued investment in core 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 $18,000 in the June 2005 quarter, a decrease of $18,000, or 50%, from the $36,000 in the June 2004 quarter. This decrease is the result of the completion of the amortization of the financing costs associated with our loan agreement, which was amortized over a three year period, as well as reduced borrowing under our loan agreement during the June 2005 quarter.

Interest income was $88,000 in the June 2005 quarter, an increase of $55,000, or 167%, from the $33,000 in the June 2004 quarter. This increase is the result of

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maintaining higher cash balances during the June 2005 quarter as well as an increase in interest rates. 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 and the proceeds of the exercise of options and warrants.

We have a net operating loss tax carry forward of approximately $2.9 million at June 30, 2005. In the June 2005 quarter, we recorded a current income tax expense of $60,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The income tax provision was increased by a deferred tax provision of $154,000. In the June 2004 quarter, we recorded a current income tax expense of $43,000, which related to various state

and local taxes, as well as a provision for the Federal alternative minimum tax. The income tax provision was increased by a deferred tax provision of $108,000. The deferred tax provision was $248,000 based upon utilization of available net operating loss carry forwards offset by a reduction in the deferred tax asset valuation allowance of $140,000.

As a result of the foregoing factors, in the June 2005 quarter we had net income of $449,000, or $.08 per share basic and diluted. For the June 2004 quarter, we had net income of $493,000, or $.09 per share basic and diluted.

Liquidity and Capital Resources

We had working capital of approximately $15.8 million at June 30, 2005 as compared to working capital of approximately $18.2 million at December 31, 2004. This decrease of approximately $2.4 million in working capital was the result of the following: $2,915,000 for the acquisitions of ContinuedLearning and AMS, $994,000 in current liabilities assumed with respect to the acquisitions of ContinuedLearning and AMS, $260,000 for the acquisition of equipment and a decrease in the current portion of the deferred tax asset in the amount of $81,000. These decreases were partially offset by our net income, after adding back depreciation and amortization, which totaled $1,666,000 and $53,000 in net proceeds from the exercise of stock options. The remaining increase in working capital of $139,000 was due to changes in other current assets and liabilities.

In June 2001, we entered into a term loan agreement with Fleet Bank, which was subsequently acquired by the Bank of America ("B of A"). This financing provides us with a five-year term loan of $2.5 million. The current term loan bears interest at LIBOR plus 2.5%. We have entered into an interest rate swap agreement with B of A for the amount outstanding under the term loan whereby we converted our variable rate on the term loan to a fixed rate of 7.95% in order to reduce the interest rate risk associated with these borrowings. The amount outstanding at June 30, 2005 is $500,000.

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, 2005, we were in compliance with the financial covenants of the loan agreement.

On February 27, 2003, our Board of Directors authorized the purchase of up to $100,000 of our common stock at any time that the market price is less than $3.50 per share. Purchases of stock may 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 any stock repurchases from our operating cash flow. As of June 30, 2005, we have not made any stock repurchases.

We issued a note payable to Shuttle Data Systems Corporation, d/b/a Adia Information Management Corp. in connection with the acquisition of the CareNet Segment. This three year promissory note is payable in 36 equal monthly installments of principal plus interest at the prime rate plus 1%. We have made the required principal and interest payments on the note and the principal amount outstanding at June 30, 2005 is $167,000.

In the June 2004 period, we capitalized software development costs of $117,000

relating to our RAD Plus 2004 product. We did not capitalize any software development costs in the June 2005 period.

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, 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. We are continually seeking acquisitions that will add complementary products to our offerings and that will provide value for the markets we serve. Although we are in discussions with several potential acquisitions and have entered into a non-binding letter of intent related to one potential acquisition, there are no assurances that we will be able to complete that potential acquisition or any other 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 expectations.

Off-Balance Sheet Arrangements

We are not a party to any off-balance sheet arrangements.

Contractual Obligations

The following table summarizes, as of June 30, 2005, 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 ye
Long Term Debt(1)	$ 666,699	$ 666,699	$ --	$ -
Capital Lease Obligations(2)	54,394	54,394	--	-
Operating Leases(3)	6,614,184	849,897	1,543,057	1,283,9
Total Contractual Cash Obligations	$7,335,277	$1,570,990	$1,543,057	$1,283,9

(1) See Note 7 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2004, 2003 and 2002, which describes the Company's financing agreement.
(2) See Note 10 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2004, 2003 and 2002, which describes the Company's Capital Lease Obligation.
(3) See Note 12 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2004, 2003 and 2002 which describes the Company's Operating Lease Obligations.

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
Capitalized Software Development Costs
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 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 utilizing the estimated percentage-of-completion method which uses 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 and Application Service Provider revenue are recognized in the period in which the services are 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 often 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 and ends upon its availability for general release to customers. Technological

feasibility for our computer software products is generally based upon achievement of a detail program design free of high risk development issues. We capitalize only those costs directly attributable to the development of the software. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized computer software development costs require 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, development and maintenance. Activities undertaken after the products are available for general release to customers to correct errors or keep the product updated are expensed as incurred and included in research, development and maintenance. 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 bears 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.

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.

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 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.

ISSUES AND UNCERTAINTIES

This Quarterly Report on Form 10-Q contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of issues and uncertainties such as those listed below under "Risk Factors" and elsewhere in this report, which, among others, should be considered in evaluating our financial outlook.

Risk Factors

Because we are particularly dependent upon government contracts, any decrease in funding for entitlement programs could result in decreased revenue.

We market our health information systems principally to behavioral health facilities, many of which are operated by state and local government entities and include entitlement programs. During the June 2005 period, we generated 48% of our revenue from contracts that are directly or indirectly with government agencies, as compared with 48% in the June 2004 period. Government agencies

generally have the right to cancel certain contracts at their convenience. Our ability to generate business from government agencies is affected by funding for entitlement programs, and our revenue would decline if state agencies reduce this funding.

Changes in government regulation of the health care industry may adversely affect our revenue, operating expenses and profitability.

Our business is based on providing systems for behavioral and public health organizations in both the public and private sectors. The federal and state governments have adopted numerous regulations relating to the health care industry, including regulations relating to the payments to health care providers for various services, and our systems are designed to provide information based on these requirements. The adoption of new regulations can have a significant effect upon the operations of health care providers, particularly those operated by state agencies. Furthermore, changes in regulations in the health care field may force us to modify our health information systems to meet any new record-keeping or other requirements and may impose added costs on our business. If that happens, we may not be able to

generate revenues sufficient to cover the costs of developing the modifications. In addition, any failure of our systems to comply with new or amended regulations could result in reductions in our revenue and profitability.

If we are not able to take advantage of technological advances, we may not be able to remain competitive and our revenue may decline.

Our customers require software which enables them to store, retrieve and process very large quantities of data and to provide them with instantaneous communications among the various data bases. Our business requires us to take advantage of recent advances in software, computer and communications technology. This technology has been developing at rapid rates in recent years, and our future may be dependent upon our ability to use and develop or obtain rights to products utilizing such technology. New technology may develop in a manner which may make our software obsolete. Our inability to use new technology would have a significant adverse effect upon our business.

Because of our size, we may have difficulty competing with larger companies that offer similar services, which may result in decreased revenue.

Our customers in the human services market include entitlement programs, managed care organizations and specialty care facilities which have a need for access to information over a distributed data network. The software industry in general, and the health information software business in particular, are highly competitive. Other companies have the staff and resources to develop competitive systems. We may not be able to compete successfully with such competitors. The health information systems business is served by a number of major companies and a larger number of smaller companies. We believe that price competition is a significant factor in our ability to market our health information systems and services, and our inability to offer competitive pricing may impair our ability to market our system.

Because we are dependent on our management, the loss of key executive officers

could disrupt our business and our financial performance could suffer.

Our business is largely dependent upon our senior executive officers, Messrs. James L. Conway, our chief executive officer, Gerald O. Koop, our president, and Anthony F. Grisanti, our chief financial officer. Although we have employment agreements with these officers, the employment agreements do not guarantee that the officers will continue with us, and each of these officers has the right to terminate his employment with us on 90 days notice. Our agreements with Messrs. Conway and Grisanti are scheduled to expire on December 31, 2006. In addition, Mr. Koop's employment agreement is scheduled to expire on December 31, 2005, following which he is expected to continue to work with us for a six-year period pursuant to our Executive Retirement, Non-Competition & Consulting Plan dated April 1, 2004. Our business may be adversely affected if any of our key management personnel or other key employees left our employ.

If we are unable to protect our intellectual property, our competitors may gain access to our technology, which could harm our ability to successfully compete in our market.

We have no patent protection for our proprietary software. We rely on copyright protection for our software and non-disclosure and secrecy agreements with our employees and third parties to whom we disclose information. This protection does not prevent our competitors from independently developing products similar or superior to our products and technologies. To further develop our services or products, we may need to acquire licenses for intellectual property. These licenses may not be available on commercially reasonable terms, if at all. Our failure to protect our proprietary technology or to obtain appropriate licenses could have a material adverse effect on our business, operating results or financial condition. Since our business is dependent upon our proprietary products, the unauthorized use or disclosure of this information could harm our business.

We cannot guarantee that in the future, third parties will not claim that we infringed on their intellectual property. Asserting our rights or defending against third party claims could involve substantial costs and diversion of resources, which could materially and adversely affect us.

Government programs may suggest or mandate initiatives that could impact our ability to sell our products.

A major initiative being pushed by President Bush and the Department of Health and Human Services is the National Electronic Health Record. The federal government is promoting this platform and technology which is based on supplying "freeware" to any agency who desires; however, support is not supplied. This initiative does compete with the private for profit Health Information Systems vendor community.

The covenants in our loan agreement restrict our financial and operational flexibility, including our ability to complete additional acquisitions, invest in new business opportunities, pay down certain indebtedness or declare

dividends.

Our term loan agreement contains covenants that restrict, among other things, our ability to borrow money, make particular types of investments, including investments in our subsidiaries, make other restricted payments, swap or sell assets, merge or consolidate, or make acquisitions. An event of default under our loan agreement could allow the lender to declare all amounts outstanding to be immediately due and payable. We have pledged substantially all of our consolidated assets to secure the debt under our loan agreement. If the amounts outstanding under the loan agreement were accelerated, the lender could proceed against those consolidated assets. Our loan agreement also requires us to maintain specified financial ratios. Our ability to meet these financial ratios can be affected by events beyond our control, and we cannot assure you that we will meet those ratios. We also may incur future debt obligations that might subject us to restrictive covenants that could affect our financial and operational flexibility or subject us to other events of default.

We have only paid one cash dividend after getting our lender's consent and we do not anticipate paying any further cash dividends on our common stock in the foreseeable future. We presently intend to retain future earnings, if any, in order to provide funds for use in the operation and expansion of our business. Consequently, investors cannot rely on the payment of dividends to increase the value of their investment on Netsmart. In addition, we are a party to a loan agreement which prohibits us from paying cash dividends without the prior consent of our lender.

Our growth may be limited if we cannot make acquisitions.

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. To the extent that we require cash, we may have to borrow the funds or issue equity, which could dilute our earnings or the book value per share of our common stock. Our stock price may adversely affect our ability to make acquisitions for equity or to raise funds for acquisitions through the issuance of equity securities. If we fail to make any acquisitions, our future growth may be limited.

If we make any acquisitions, they may disrupt or have a negative impact on our business.

If we make acquisitions, we could have difficulty integrating the acquired company's personnel and operations with our own. In addition, the key personnel of the acquired business may not be willing to work for us, and/or our officers may exercise their rights to terminate their employment with us. We cannot predict the affect expansion may have on our core business. Regardless of whether we are successful in making an acquisition, the negotiations could disrupt our ongoing business, distract our management and employees and increase our expenses.

The employment contracts with our executive officers and provisions of Delaware law may deter or prevent a takeover attempt and may reduce the price investors might be willing to pay for our common stock.

The employment contracts between us and each of James Conway, Gerald Koop and Anthony Grisanti provide that in the event there is a change in control of Netsmart, the employee has the option to terminate his employment agreement. Upon such termination, each of Messrs. Conway, Koop and Grisanti has the right to receive a lump sum payment equal to his compensation for a forty-eight month period.

In addition, Delaware law restricts business combinations with stockholders who acquire 15% or more of a company's common stock without the consent of the company's board of directors.

These provisions could deter or prevent a takeover attempt and may also reduce the price that certain investors might be willing to pay in the future for shares of our common stock.

<u>Any issuance of preferred stock may adversely effect the voting power and equity interest of our common stock.</u>

Our certificate of incorporation gives our board of directors the right to create new series of preferred stock. As a result, the board of directors may, without stockholder approval, issue preferred stock with voting, dividend, conversion, liquidation or other rights which could adversely affect the voting power and equity interest of the holders of common stock. The preferred stock, which could be issued with the right to more than one vote per share, could be utilized as a method of discouraging, delaying or preventing a change of control. The possible impact on takeover attempts could adversely affect the price of our common stock. Although we have no present intention to issue any shares of preferred stock or to create any series of preferred stock, we may issue such shares in the future. If we issue preferred stock in a manner which dilutes the voting rights of the holders of the common stock, our listing on The Nasdaq SmallCap Market may be impaired.

<u>Shares may be issued pursuant to options which may adversely affect the market price of our common stock.</u>

We may issue stock upon the exercise of options to purchase shares of our common stock pursuant to our long term incentive plans, of which options to purchase 720,218 shares were outstanding at June 30, 2005. On July 14, 2005, the shareholders approved a 400,000 increase in the number shares available under the Netsmart 2001 Long-Term Incentive Plan. These 400,000 additional options were granted to officers and employees on July 14, 2005. The exercise of these options and the sale of the underlying shares of common stock may have an adverse effect upon the price of our stock.

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. These statements are based on current expectations, estimates and projections about our business based, in part, on 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 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 annual report for the year ended December 31, 2004, including the risks described under "Risk Factors" 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 risks related to changes in interest rates. 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 comprehensive income.

Most of our cash and cash equivalents, which are invested in money market accounts and commercial paper, are at variable rates of interest. If short-term market interest rates decrease by 10% from the levels at June 30, 2005, the effect on our net income would be a decrease of approximately $27,000 per year.

Item 4. Controls and Procedures

Evaluation and Disclosure Controls and Procedures

Based on their evaluation as of the end of the period covered by this Form 10-Q, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as required by Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, except as set forth below, our disclosure controls and procedures were effective to insure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported with the time periods specified by the SEC's rules and forms.

Changes in Internal Controls

There were no changes made in our internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Limitations on the Effectiveness of Controls

We believe that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all controls issues and instances of fraud, if any, within a company have been detected. Our disclosure controls and procedures are designed to provide a reasonable assurance of achieving their objectives and our Chief Executive

Officer and Chief Financial Officer have concluded that our controls and procedures are effective at the "reasonable assurance" level.

PART II OTHER INFORMATION

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

On July 14, 2005 we held our 2005 annual meeting of stock holders.

The following individuals were elected as directors:

Name	Votes For	Withheld
James L. Conway	4,982,667	174,049
John F. Phillips	4,938,352	218,364
Gerald O. Koop	4,889,157	267,559
Joseph G. Sicinski	4,921,867	234,849
Francis Calcagno	4,020,048	1,136,668
John S.T. Gallagher	4,921,867	234,849
Yacov Shamash	4,924,872	231,844

The following proposals were approved as follows:

	Votes For	Votes Against	Abstain
Proposal to increase the number of shares available under the Company's 2001 Long-Term Incentive Plan	2,324,944	883,949	6,360
Approval of amendments to the 2001 Long Term Incentive Plan	2,324,944	883,949	6,360
Approval of the selection of Marcum & Kliegman LLP as the Company's independent certified Accountants for 2005	5,143,871	2,745	10,100

Item 6. Exhibits

Exhibit No.	Description
10.1	Asset Purchase Agreement dated June 17, 2005 between Addiction Management Systems, Inc. and Creative Socio-Medics Corp. (incorporated by reference to Exhibit 10.1 to Form 8-K dated June 21, 2005).
10.2	2001 Long-Term Incentive Plan, as amended (incorporated by reference to Exhibit 10.1 to Form 8-K dated June 16, 2005).
10.3	Amendment No. 1 to Employment Agreement dated June 16, 2005, between the Registrant and James L. Conway (incorporated by reference to Exhibit 10.2 to Form 8-K dated June 16, 2005).
10.4	Amendment No. 1 to Employment Agreement dated June 16,

	2005 between the Registrant and Anthony F. Grisanti (incorporated by reference to Exhibit 10.3 to Form 8-K dated June 16, 2005).
10.5	Asset Purchase Agreement dated April 27, 2005 between ContinuedLearning LLC and Creative Socio-Medics Corp. (incorporated by reference to Exhibit 10.2 to Form 8-K dated April 27, 2005).

10.6	Employment Agreement dated April 27, 2005 between Netsmart Technologies, Inc. and A. Sheree Graves (incorporated by reference to Exhibit 10.2 to Form 8-K dated April 27, 2005).
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 8 U.S.C. section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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 9, 2005
/s/ Anthony F. Grisanti ------------------------- Anthony F. Grisanti	Chief Financial Officer (Principal Financial and Accounting Officer)	August 9, 2005

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