

COMPUTER SOFTWARE INNOVATIONS INC  
Form 10QSB/A  
February 14, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB/A**

(Amendment No. 3)

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(Mark One)

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

For the quarterly period ended March 31, 2005.

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

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

Commission file number \_\_\_\_\_

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**COMPUTER SOFTWARE INNOVATIONS, INC.**

(Name of Small Business Issuer in Its Charter)

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**Delaware**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**98-0216911**  
**(I.R.S. Employer**  
**Identification No.)**

**1661 East Main Street**  
**Easley, South Carolina 29640**  
**(864) 855-3900**

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

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 2,631,786 as of May 16, 2005.

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

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**EXPLANATORY NOTE**

**Restatement of Previously Issued Financial Statements**

*Amendment No. 1*

On August 16, 2005, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, concluded that the previously issued financial statements contained in our quarterly report on Form 10-QSB for the quarter ended March 31, 2005 should not be relied upon for the reasons set forth below. We restated our financial statements for such period in an Amendment No. 1 filed with the Commission on August 22, 2005 to make the necessary accounting corrections.

On February 10, 2005, we entered into a Registration Rights Agreement (the Agreement) with Barron Partners LP (Barron) in connection with the issuance of convertible preferred stock and warrants, whereby we undertook to file a registration statement registering the sale of the shares of our common stock underlying the convertible preferred stock and warrants held by Barron. Under the Agreement as in effect during the first quarter, the failure to timely effect the registration statement triggered cash liquidated damages. According to recent accounting guidance, the existence of the cash liquidated damages provisions caused Barron's warrants to be treated as a liability on our books. In connection with the filing of our first quarter Form 10-QSB, we sought to resolve this issue, and prepared our financial statements to comport with the recently issued guidance. Simultaneously, we pursued options available under the accounting guidance whereby we could amend our registration rights agreement, subject to the approval of Barron, to eliminate the liability treatment. This pursuit of alternatives resulted in significant technical discussions with several accounting, regulatory and valuation experts. In the process, additional changes were identified which we believed necessary to properly reflect the full impact of the transaction in accordance with accounting guidance.

Specifically, in Amendment No. 1, we revised the carrying value of the stock warrants as of March 31, 2005. We recorded an unrealized loss of \$3,084,921 on the warrants in other income (expense) to adjust the value of the warrants to their estimated fair value at March 31, 2005. The estimated fair value of the warrants was revised after consultation with a valuation expert, and through the use of the Black-Scholes model. This resulted in a reduction in net income and retained earnings. The reduction in retained earnings was primarily offset by increases in our warrant related liability.

*Amendment No. 2*

On November 11, 2005, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, determined that certain expenses for activities related to products and services sold totaling \$882,572 and \$620,634 for the three months periods ended March 31, 2005 and 2004, respectively, should be reclassified from operating expenses to cost of sales. Reclassifications for these items were made in this amendment.

Also in this amendment, due to further guidance, we reclassified the portion of the proceeds from the issuance of preferred stock and warrants that was allocated to the par value of preferred stock (\$7,218) from permanent equity to temporary equity.

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### *Amendment No. 3*

On February 3, 2006, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, concluded that the previously issued controls and procedures disclosure on Form 10-QSB/A for the quarter ended March 31, 2005 should be amended for the reasons set forth below.

The registration process (discussed in *Amendment 1* above) has involved significant technical discussions with several accounting, regulatory and valuation experts. In our prior Forms 10-QSB/A, we disclosed a deficiency in internal control over financial reporting related to the need for additional qualified financial and accounting personnel. This deficiency was a result of our entering into the series of transactions that resulted in public reporting of operations without personnel with public reporting experience. In the process of discussions with regulatory experts, we determined to revise our internal control disclosure to note our controls were ineffective for the reasons previously disclosed and to include more specifics as to the nature of the deficiency and our plans and timeframe for curing the deficiency.

Also, in view of this amendment, we have taken the opportunity to make certain other conforming changes to the Financial Statements. In 2005, we began reporting our operations under two operating segments and, consequently, adopted the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. As a result, the disclosures in Note 10 have been expanded to conform to the provisions of SFAS No. 131 regarding segment presentation. Finally, as a result of our recapitalization transaction effectuated on February 11, 2005 (see Note 2 to the Financial

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Statements) and discussions with regulatory experts, we have reclassified certain amounts from retained earnings to paid-in capital.

We have also updated the notes to the financial statements for two subsequent events. One is a consulting arrangement entered into by the registrant for which it is anticipated payment will be made in the form of issuance of registrant's common stock in an amount equal to 3.5% of the outstanding common and preferred stock of the registrant immediately following the February 2005 merger. We are in the process of reaching a definitive agreement with respect to the consulting arrangement. The second subsequent event was the settlement of litigation relating to the merger. See Note 5 to the Financial Statements for more information on these subsequent events.

*General*

The adjustments reflected in this amendment do not affect income from operations or cash flows.

All amounts in this quarterly report on Form 10-QSB/A have been updated, as appropriate, to reflect these restatements. We did not update this quarterly report on Form 10-QSB/A for subsequent events occurring after the filing of our original quarterly report on Form 10-QSB on May 20, 2005, except as specifically noted above.

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31,</b>
	<b>2005</b>	<b>2004</b>
<b>REVENUES</b>		
Software applications segment	\$ 986,749	\$ 1,130,771
Technology solutions segment	3,105,555	2,381,307
	<u>4,092,304</u>	<u>3,512,078</u>
Net sales and service revenue	4,092,304	3,512,078
<b>COST OF SALES</b>		
Cost of sales excluding depreciation, amortization and capitalization	506,438	275,656
Depreciation	8,026	4,957
Amortization of capitalized software costs	133,623	104,694
Capitalization of software costs	(201,261)	(139,962)
	<u>446,826</u>	<u>245,345</u>
Software applications segment	446,826	245,345
Cost of sales excluding depreciation	2,478,488	1,960,746
Depreciation	9,295	8,795
	<u>2,487,783</u>	<u>1,969,541</u>
Technology solutions segment	2,487,783	1,969,541
Total cost of sales	<u>2,934,609</u>	<u>2,214,886</u>
Gross profit	1,157,695	1,297,192
<b>OPERATING EXPENSES</b>		
Salaries and wages and benefits (excluding stock-based compensation)	602,391	693,474
Stock option compensation	631,174	
Reverse acquisition transaction costs	759,283	
Travel and mobile costs	62,226	101,424
Depreciation	12,679	16,601
Other selling, general and administrative expenses	140,231	108,522
	<u>2,207,984</u>	<u>920,021</u>
Total operating expenses	2,207,984	920,021
Operating income (loss)	(1,050,289)	377,171

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<b>OTHER INCOME (EXPENSE)</b>		
Interest income	6,022	4,266
Interest expense	(37,445)	
Gain on disposal of property and equipment	100	
Unrealized loss on financial instrument	(3,084,921)	
	<u>(3,116,244)</u>	<u>4,266</u>
Net other income (expense)		
Income (loss) before income taxes	(4,166,533)	381,437
<b>INCOME TAX EXPENSE (BENEFIT)</b>	<u>(1,717,090)</u>	<u>120,568</u>
Net income (loss)	<u><b>\$ (2,449,443)</b></u>	<u><b>\$ 260,869</b></u>
<b>BASIC EARNINGS (LOSS) PER SHARE</b>		
	<u><b>\$ (0.93)</b></u>	<u><b>\$ 0.10</b></u>
<b>DILUTED EARNINGS (LOSS) PER SHARE</b>		
	<u><b>\$ (0.93)</b></u>	<u><b>\$ 0.10</b></u>
<b>WEIGHTED AVERAGE SHARES OUTSTANDING Basic</b>		
	<u><b>2,631,786</b></u>	<u><b>2,631,786</b></u>
<b>WEIGHTED AVERAGE SHARES OUTSTANDING Diluted</b>		
	<u><b>2,631,786</b></u>	<u><b>2,640,396</b></u>

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



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

	March 31,	
	2005	December 31,
	(Unaudited)	2004
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and equivalents	\$ 1,123,576	\$ 3,656,477
Accounts receivable	2,714,285	2,362,304
Prepaid expenses	48,334	8,007
Inventories	205,792	
Taxes receivable	580,404	
Deferred income taxes	1,233,968	
	<u>          </u>	<u>          </u>
Total current assets	5,906,359	6,026,788
<b>PROPERTY AND EQUIPMENT, net</b>	141,363	143,451
<b>COMPUTER SOFTWARE COSTS, net</b>	824,426	756,788
<b>OTHER ASSETS</b>	84,300	500
	<u>          </u>	<u>          </u>
	<b>\$ 6,956,448</b>	<b>\$ 6,927,527</b>
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 1,246,474	\$ 773,825
Deferred revenue	1,185,987	1,212,898
Deferred tax liability	320,432	212,630
Taxes payable		309,753
Bank line of credit	1,500,000	
Financial instrument	8,119,953	
	<u>          </u>	<u>          </u>
Total current liabilities	12,372,846	2,509,106
	<u>          </u>	<u>          </u>
<b>SUBORDINATED NOTES PAYABLE TO SHAREHOLDERS</b>	2,250,400	
<b>PREFERRED STOCK</b> - \$0.001 par value; 15,000,000 shares authorized; 7,217,736 shares issued and outstanding	7,218	
<b>SHAREHOLDERS EQUITY (DEFICIT)</b>		
Common stock - \$0.001 par value 40,000,000 shares authorized; 2,631,786 shares issued and outstanding	2,632	2,632
Additional paid-in capital	(337,656)	77,368
Retained earnings (deficit)	(7,338,992)	4,070,451
Unearned stock compensation		267,970
	<u>          </u>	<u>          </u>
Total shareholders equity (deficit)	(7,674,016)	4,418,421
	<u>          </u>	<u>          </u>
	<b>\$ 6,956,448</b>	<b>\$ 6,927,527</b>
	<u>          </u>	<u>          </u>

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



**Table of Contents****COMPUTER SOFTWARE INNOVATIONS, INC.****CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY (DEFICIT)****(UNAUDITED)**

	Common Stock	Additional Paid-In Capital	Retained Earnings (Deficit)	Unearned Stock Compensation	Total
<b>Balances at December 31, 2004</b>	\$ 2,632	\$ 77,368	\$ 4,070,451	\$ 267,970	\$ 4,418,421
Purchase of VerticalBuyer shell		(415,024)			(415,024)
Stock option compensation				631,174	631,174
Redemption of stock options				(899,144)	(899,144)
Dividends paid			(3,460,000)		(3,460,000)
Purchase of stock from shareholders upon Merger			(5,500,000)		(5,500,000)
Net loss for three months ended March 31, 2005			(2,449,443)		(2,449,443)
<b>Balances at March 31, 2005</b>	<b>\$ 2,632</b>	<b>\$ (337,656)</b>	<b>\$ (7,338,992)</b>	<b>\$</b>	<b>\$ (7,674,016)</b>

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

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

	<b>Three Months Ended</b>	
	<b>March 31, 2005</b>	<b>March 31, 2004</b>
<b>OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (2,449,443)	\$ 260,869
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities		
Depreciation and amortization	163,623	135,047
Stock option compensation expense	631,174	
Deferred income taxes	(1,126,166)	
Gain on disposal of fixed assets	(100)	
Unrealized loss on financial instrument	3,084,921	
Changes in deferred and accrued amounts		
Accounts receivable	(351,981)	(504,303)
Inventories	(205,792)	
Prepaid expenses and other assets	(40,327)	
Accounts payable	472,649	384,453
Deferred revenue	(26,911)	(76,852)
Taxes payable (receivable)	(890,157)	(95,580)
Net cash provided by (used for) operating activities	(738,510)	103,634
<b>INVESTING ACTIVITIES</b>		
Purchase of property and equipment	(27,812)	(43,833)
Capitalization of computer software	(201,261)	(139,962)
Net cash used for investing activities	(229,073)	(183,795)
<b>FINANCING ACTIVITIES</b>		
Borrowings under line of credit	1,500,000	
Payment of debt issuance costs	(83,800)	
Proceeds from notes payable to shareholders	1,875,200	
Repayments under notes payable to shareholders	(1,500,000)	
Dividends paid	(3,460,000)	
Redemption of stock options	(899,144)	
Purchase of VerticalBuyer shell	(415,024)	
Payments for purchase of stock from shareholders	(3,624,800)	
Proceeds from issuance of preferred stock and related warrants	5,042,250	
Net cash used for financing activities	(1,565,318)	
Net decrease in cash and cash equivalents	(2,532,901)	(80,161)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>3,656,477</b>	<b>1,755,724</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 1,123,576</b>	<b>\$ 1,675,563</b>

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:**

Cash paid during the period for:

Interest

Income Taxes

\$ 299,233

\$ 216,148

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

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

***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***

***(UNAUDITED)***

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

**Description of business**

Computer Software Innovations, Inc. ( CSI, Company, we or us ) is engaged in the business of development, sales, deployment and ongoing support of proprietary software applications. The Company is also engaged in providing technology solutions through the sales and distribution of computers and accessories and through offering a wide range of technology consulting services, including network and systems integration and computer support and maintenance services. The Company currently markets its products and services to a wide variety of governmental, education and not-for-profit entities in the Southeastern United States. The majority of the Company's business is with local governmental agencies and K-12 education entities.

**Organization**

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

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

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

The series of transactions culminating in the reverse acquisition and related financing are detailed in Note 2. ACQUISITION AND MERGER.

**Basis of presentation**

The consolidated financial statements include CSI Technology Resources, Inc., a wholly-owned subsidiary. CSI Technology Resources Inc., was acquired by CSI on May 1, 2000, and became the technology services segment of CSI. This subsidiary no longer has any significant operations or accounting, as all activities are now accounted for within CSI, except that certain vendor contracts are still in the name of CSI Technology Resources, Inc. At a future date, the name on these contracts may be converted and the subsidiary deactivated, subject to a review of any tax or legal implications. The consolidated balance sheet and the related statements of operations, capital accounts and cash flows are unaudited. Intercompany balances and transactions have been eliminated. The Company uses the accrual basis of accounting. In our opinion, all adjustments (consisting of normal recurring adjustments) necessary for fair presentation of the interim financial statements have been made. The accounting and reporting policies conform to accounting principles generally accepted in the United States of America.

**Significant Accounting Issue and Subsequent Event Affecting Basis of Presentation.**

In the series of transactions referred to in Organization above and in Note 2, ACQUISITION AND MERGER, CSI issued warrants to Barron in connection with the issuance of preferred stock. The preferred stock transaction was entered into in accordance with a registration rights agreement. The agreement contains a liquidated damages clause which requires cash penalties equal to 25% of Barron's investment per annum if the Company's registration of stock does not become effective by June 11, 2005. Since the liquidated damages are payable in cash, under EITF 00-19 Accounting for Derivative Financial

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Instruments Indexed to and Potentially Settled in a Company's Own Stock, a potential obligation (referred to under EITF 00-19 as a derivative financial instrument ) exists until the registration is made effective. Accordingly, the entire proceeds of the preferred stock issuance, except for the par value, have been recorded as a liability on the balance sheet until the Company's registration statement on Form SB-2 becomes effective. Accordingly, our net shareholders' equity as a result of this treatment is reported as a deficit of \$7.7 million. In addition, the par value of the preferred stock has been recorded as temporary equity on the Company's balance sheet. (See also Note 6.)

It was not the intent by either party to the transaction (CSI or Barron) that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock issuance and warrants being recorded as a liability rather than equity. The Company is in the process of negotiating an amendment to the liquidated damages provisions of the Registration Rights Agreement to eliminate the accounting treatment of the proceeds (net of par value) as a liability. If successful, the par value of preferred stock will be reclassified from temporary to permanent equity and the liability will be reclassified to equity and, assuming continued earnings from operations, our reported shareholders' deficit would be eliminated.

We will make our best effort to complete the shares registration and renegotiate the Registration Rights Agreement. We believe it is more likely than not we will complete these changes; however, there can be no assurance we will. (See also a detailed discussion of the potential impact on liquidity and cash flows in Part I, Item 2.)

## **Disclosure regarding segments**

Prior to January 1, 2005, the Company reported as one operating segment, as the chief operating decision-maker reviewed the results of operations of the Company as a single enterprise. During the first quarter of 2005, in part because of the reverse acquisition, the Company began reporting its operations under two operating segments: the Software applications segment and the Technology solutions segment. Prior-year amounts have been reclassified to conform to the current period presentation.

## **Computer software costs**

Computer software costs consist of internal software production costs capitalized under the provisions of SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed. Costs in the research and development of new software products and enhancements are expensed as incurred. Capitalized computer software costs are amortized over the economic life of the product, generally three years, using the straight-line method.

## **Revenue recognition**

Revenue generated from products shipped is recognized when the risk and rights of ownership have passed to the customer. The Company, under certain conditions, permits its customers to return or exchange products. The provision for sales returns is recorded concurrently with revenue recognition.



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Revenues generated from service and support activities are recognized as the services are performed. Revenue generated from support service block contracts and maintenance contracts, generally collected in advance, are deferred and recognized as income when services are performed or on a straight line basis over the contractual life of the maintenance agreement. Deferred amounts are reported in deferred revenue.

The Company recognizes revenue in accordance with AICPA Statement of Position (SOP) 97-2 Software Revenue Recognition, as amended and modified by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. The Company recognizes license revenues when the product has been shipped or the access codes that allow for immediate possession of the software have been provided to the customer (collectively "delivered"), the fees are fixed or determinable, collectibility is probable and vendor-specific objective evidence (VSOE) of fair value exists to allocate the fee to the undelivered elements of the arrangement. VSOE is based on the price charged when an element is sold separately. In the case of an element not yet sold separately, the price, which does not change before the element is made generally available, is established by authorized management. If an acceptance period is required, the Company recognizes revenue upon customer acceptance or the expiration of the acceptance period after all other revenue recognition criteria under SOP 97-2 have been met. The Company's standard agreements do not contain product return rights.

### **Warranties**

The Company's suppliers generally warrant the products distributed by the Company and allow returns of defective products, including those that have been returned to the Company by its customers. The Company does not independently warrant the products it distributes; however, the Company does warrant its services with regard to products that it configures for its customers and products that it builds from components purchased from other sources. Warranty expense is not material to the Company's financial statements.

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### **Vendor programs**

The Company receives volume incentives and rebates from certain manufacturers related to sales of certain products, which are recorded as a reduction of cost of goods sold when earned. The Company also receives manufacturer reimbursement for certain promotional and marketing activities that offset expenses incurred by the Company.

### **Income taxes**

The Company uses the asset and liability method of accounting for income taxes. Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due or refundable plus deferred income tax assets and liabilities. Deferred income tax assets and liabilities are recorded to recognize the income tax effect of the temporary differences in the method of reporting various items of income and expenses for financial reporting purposes and income tax purposes. The deferred income tax assets and liabilities at the end of the year are determined using the statutory tax rates expected to be in effect when the taxes are actually due or refundable.

### **Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### **Earnings per share**

Basic earnings per share is computed by dividing net income by the weighted average number of common stock shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of common and potential common shares outstanding during the period. All share amounts have been adjusted to give effect for the reverse stock split and change in number of shares in connection with the exchange of equity interests as a result of the reverse acquisition, by including all shares issued in the transaction as outstanding in the calculations for all periods presented, except where inclusion is anti-dilutive. Potential common shares were 11,559,922 for the period ended March 31, 2005 (consisting of shares underlying the preferred stock, warrants and options of 7,217,736, 4,081,971 and 260,215, respectively). The shares underlying the outstanding warrants and options of 7,217,736 and 268,343, respectively, were outstanding for the quarter ended March 31, 2005 and are reduced by application of the treasury stock method which assumes the proceeds from the exercise of the warrants and options are used to buy back shares off the market thereby reducing the number of outstanding shares for the earnings per share calculation. Generally accepted accounting principles ( GAAP ) require that in the case of thinly traded stock, management assess, among other factors, whether the market quoted price is representative of the price which would be effective were all shares issued in connection with various transactions, which would include the issuance of significant additional shares in dilutive transactions. Following consultation with accounting and valuation experts and applying the principle of conservatism, which is a basis of the dilution calculation under GAAP, management uses the higher of a cashflow based stock value computation based on comparisons to peer public companies, or the quoted market price, on a weighted average basis, for the repurchase of shares in the diluted earnings per share calculation. Once management, in consultation with its accounting and financial experts considers the stock no longer thinly traded, management will use the quoted market price exclusively.

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The 11,559,922 potential common shares are not used in the calculation of diluted earnings per share for the period ended March 31, 2005 as the effect would be anti-dilutive. As a result of the merger, prior period per share amounts have been restated to reflect the stock split issuances and cancellation of common stock. Accordingly, the common shares outstanding for the quarterly period ended March 31, 2004 are 2,631,786. The number of shares used in the diluted earnings per share calculation for the quarterly period ended March 31, 2004 is 2,640,396 and includes the dilutive effect of options outstanding at that time. The dilutive effect of the preferred stock and warrants issued in connection with the issuance of preferred stock after the reverse merger has not been included in the diluted earnings per share calculation for the quarterly and six months periods of the prior year as these were not outstanding at the time.

### **Stock-based compensation**

The Company has stock based employee compensation plans, which are described more fully in Note 3. The Company accounts for stock based compensation using the fair value method prescribed in SFAS No. 123, Accounting for Stock Based Compensation, and related interpretations. No options or awards have been granted under the current plans. The Company accelerated the vesting and assumed the outstanding options of the predecessor plan ( fixed stock option plan ) of CSI South Carolina in connection with the reverse merger. No additional options will be issued under this fixed stock option plan. The Company has recognized compensation cost for its fixed stock option plan as all options granted under the plan had an exercise price less than the estimated market price of the underlying common stock on the date of grant.

The Company utilizes the Black-Scholes model to estimate the fair value of options granted.

**Table of Contents****Fair value of financial instruments**

The Company's financial instruments include cash equivalents, accounts receivable, accounts payable, short-term debt and other financial instruments associated with the issuance of the common stock warrants attributable to the preferred stock capital investment in the Company in February of 2005. The carrying values of cash equivalents, accounts receivable and accounts payable approximate their fair value because of the short maturity of these instruments. The carrying amount of the Company's bank borrowings under its credit facility approximate fair value because the interest rates are reset periodically to reflect current market rates.

The Company's financial instruments also include a financial instrument in which a valuation for the warrants from the Barron Partners LP preferred financing agreement contained a registration rights agreement which contained a liquidating damages provision. Accordingly, a fair-value option pricing model was used to determine the fair value of those warrants which are classified as a financial instrument in the current liabilities section of the consolidated balance sheet. (See also Note 1, Significant Accounting Issue and Subsequent Event Affecting Basis of Presentation and Note 6.)

**NOTE 2 ACQUISITION AND MERGER**

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

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

Purchase of VerticalBuyer shell company	\$ (415,024)
CSI - South Carolina redemption of options for common stock	(899,144)
Initial cash payment of portion of CSI - South Carolina \$3,460,000 dividends declared to shareholders	(960,000)
Proceeds from sale of preferred stock and warrants in merger	5,042,250
Proceeds from issuance of subordinated note to Barron	1,875,200
Payment of remaining outstanding dividends declared, from preferred stock and warrant proceeds	(2,500,000)
Payment on one of the two sets of subordinated notes (\$3,624,800) and (\$1,875,200) issued to shareholders in connection with merger	(3,624,800)
Payment of debt issuance costs for \$3,000,000 revolving credit facility	(83,800)
Initial borrowings under revolving credit facility	1,500,000
Payment on second set of shareholder and Barron's notes, from loan proceeds	(1,500,000)
	<hr/>
Net effect of merger transactions on cash, and cash used for financing activities	\$ (1,565,318)

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

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The above transactions are described in more detail below.

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

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

*Redemption of Options.* Prior to the merger, CSI South Carolina, for \$899,144, redeemed options to purchase 797,403 shares, as allowed for under a stock option plan which had provided to certain non-executive employees options to purchase 1,065,746 shares of common stock. The 797,403 shares represented 73.34% of the 1,066,538 options then outstanding. Pursuant to the plan, the option holders retained the remaining portion of their options.

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

*Name Change.* On February 10, 2005, the VBYSR changed its name from VerticalBuyer, Inc to Computer Software Innovations, Inc., referred to herein as CSI or the Company.

*Merger Agreement.* On February 10, 2005, VBYSR entered into an Agreement and Plan of Merger (the Merger Agreement) with CSI South Carolina. The Merger Agreement provided that, upon the terms and conditions set forth in the agreement, CSI South Carolina would merge into CSI, with CSI continuing as the surviving corporation. The merger and related transactions were consummated on February 11, 2005 through the exchange of the CSI South Carolina shareholders' beneficial interests in VerticalBuyer via the surrender (and cancellation) of CSI's shares in VerticalBuyer, representing 73.34% ownership of the common stock of VerticalBuyer before the merger, and an exchange of their shares in CSI South Carolina for shares in the Company representing 96% ownership in VerticalBuyer (now known as CSI) following the merger, and the issuance of notes payable to the shareholders, and cash (as detailed below).

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

Following the merger, the former majority shareholders of CSI South Carolina as a group hold 96% of the voting stock of the Company, occupy two of five board seats with the remaining three seats being filled by independent directors, and retain senior management positions of the combined company. Preferred stock issued subsequent to the merger sold to assist with the payment for shares and dividends payable to the CSI South Carolina shareholders, cannot be converted to common stock in excess of 4.99% ownership within a period of 60 days, and thus no common stock is deemed beneficially owned by the preferred stockholder pursuant to Rule 13d-3 under the Securities Exchange Act of 1934, as amended. In addition, the preferred stock has no voting rights (except under limited circumstances under Delaware law) and generally no provisions granting rights with respect to the governance of the Company. Accordingly, under SFAS No. 141 Business Combinations, the merger of CSI South Carolina into us was considered to be a reverse acquisition, whereby CSI South Carolina is considered to be the acquirer even though it is not the surviving corporation. Accordingly, the assets and liabilities of CSI South Carolina continued to be recorded at their actual cost. The assets and liabilities of VerticalBuyer would have been recorded at fair value, but no assets or liabilities existed at the time of acquisition; and, accordingly, no goodwill is recorded. Under reverse acquisition accounting, the financial statements of the surviving corporation (VerticalBuyer) are the financial statements of the acquirer (CSI South Carolina). Costs associated with the reverse acquisition are expensed as incurred. Shares issued in the transaction are shown as outstanding for all periods presented and our activities (activities of VerticalBuyer) are included only from the date of the transaction forward. Shareholders' equity of CSI-South Carolina, after giving effect for differences in par value, has been carried forward after the acquisition.

Pursuant to the Merger Agreement, in the merger and related CSI dividend transactions, the former shareholders of CSI South Carolina received, in exchange for their shares of common stock, approximately \$6.7 million of cash, subordinated notes aggregating approximately \$2.3 million to be repaid over the next fifteen months and 2,526,904 shares of common stock of the Company. The shares of VerticalBuyer's common stock previously held by CSI South Carolina, representing approximately 77 percent of VerticalBuyer's issued and outstanding capital stock, were cancelled, as was the common stock of CSI South Carolina. The remaining shareholders of VerticalBuyer retained their existing shares, subject to the 40 to 1 reverse stock split.

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*Preferred Stock Purchase Agreement.* In connection with the merger, CSI entered into a Preferred Stock Purchase Agreement dated February 10, 2005 (the Preferred Stock Agreement ) with Barron Partners LP ( Barron ), whereby CSI agreed to issue 7,217,736 shares of its newly created Series A convertible, non-voting preferred stock to Barron in exchange for payment of \$5,042,250. Each share of preferred stock is convertible into one share of common stock, subject to certain anti-dilution adjustments. The proceeds of the preferred stock issuance were used to pay the outstanding dividends as declared by CSI South Carolina and a portion of the subordinated notes. Barron has agreed, generally, not to convert at any time its preferred stock into shares of the Company common stock or exercise its warrants to purchase shares of common stock if and to the extent that Barron s beneficial ownership of CSI common stock would exceed 4.99%, without giving the Company at least 61 days advance notice.

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

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

*Warrants.* Pursuant to the Preferred Stock Agreement, Barron was issued two warrants to purchase 7,217,736 shares of CSI's common stock (the warrant shares). The respective exercise prices of the warrants are \$1.3972 and \$2.0958 per share, with each warrant exercisable for half of the total warrant shares. The terms and conditions of the warrants are identical except with respect to exercise price. Barron has agreed, generally, not to convert at any time its preferred stock into shares of the Company common stock or exercise its warrants to purchase shares of common stock if and to the extent that Barron's beneficial ownership of CSI common stock would exceed 4.99%, without giving the Company at least 61 days' advance notice.

As a result of the registration rights agreement that contained a liquidated damages clause, the Company is required to follow EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (see Note 6). In light of the required accounting treatment under EITF 00-19, the amount of proceeds allocated to the issuance of warrants (as discussed in the section entitled *Preferred Stock Purchase Agreement* immediately above) was recorded as a liability as of the date of the transaction. In addition, the difference between the amount allocated to the issuance of warrants and the market value of the warrants based on the Black-Scholes valuation method as of March 31, 2005 was recorded in the statement of operations in the line *Unrealized loss on financial instrument* in the Statement of operations and as an adjustment to the line *Financial Instrument* in our Balance Sheet, to restate the warrants to current market value as of that date. In each period thereafter, including the current quarter, the financial instrument is marked to market and changes in the value are recorded as adjustments in the Statement of Operations (see also Note 6).

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

The Barron note provides that CSI will pay to Barron \$1,875,200, with interest accruing at the prime rate plus two percent. The principal on the note must be paid in full on or before May 10, 2006. Any past due and unpaid amounts bear interest at the rate of 15% per annum until paid in full. The amount outstanding under this note totaled \$1,125,200 at March 31, 2005.

The aggregate principal sum borrowed under the notes payable by CSI to the five former shareholders of CSI - South Carolina is \$1,875,200, or \$375,040 per individual. Other than the principal amount borrowed, the terms of the notes are substantially identical to the note payable to



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Barron. Amounts outstanding under these notes totaled \$1,125,200 at March 31, 2005.

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

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

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Compensation expense related to the early redemption of stock options of \$631,174, consisting of \$899,144 cash compensation less unearned compensation expense of \$267,970 eliminated upon the redemption. Related payroll benefit costs of \$47,766, were also paid by CSI South Carolina and are included in the line item Other selling, general and administrative expenses in CSI's Consolidated Statements of Operations for the three months ended March 31, 2005.

**NOTE 3 STOCK COMPENSATION PLAN, WARRANTS AND ADDITIONAL PAID-IN-CAPITAL**

The Company assumed in the merger the stock based compensation plan of CSI- South Carolina as described below. The compensation cost that had been charged to income for the plan totaled approximately \$5,000 for the period ended March 31, 2004. No compensation cost was recorded for the period ended March 31, 2005, as all compensation cost related to the 1,006,538 options outstanding as of the beginning of the period had previously been expensed.

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

In connection with and immediately prior to the merger with VerticalBuyer, CSI South Carolina, for \$899,144, redeemed options to purchase 797,403 shares. This was allowed for under the above stock option plan which had provided to certain non-executive employees options to purchase 1,065,746 shares of common stock, representing 73.34% of the 1,006,538 options then outstanding. Compensation expense related to the early redemption of stock options was \$631,174, consisting of the \$899,144 cash payment less unearned compensation expense of \$267,970 eliminated upon the redemption. Employer FICA and medicare, and additional expenses related to this transaction totaling \$47,766, were also paid by CSI South Carolina. Pursuant to the plan, the option holders retained the remaining 268,343 options. The board of directors of the surviving corporation, CSI, at its discretion, provided that the options would be assumed and exercisable for shares of CSI common stock at the exchange ratio applicable to the five CSI South Carolina shareholders in the merger.

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

As of March 31, 2005 and 2004, options for 268,343 shares were outstanding and exercisable. The amount of options outstanding in 2004 has been restated to give effect as if the redemption in connection with the merger had occurred before the prior year period.

VerticalBuyer also had an option plan, with shares available for issuance at the time of the merger. However, all options under the plan had expired, and the plan was cancelled, on March 24, 2005. Subsequent to the end of the quarter, our board of directors approved a new plan which allows the award of stock-based compensation for the potential ownership of options, restricted stock or stock appreciation rights at the discretion of the compensation committee of the board of up to an aggregate of 1,100,000 shares. As of the filing date of this report, no awards have been granted or are outstanding under the new plan.

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In February of 2005, the Company issued 7,217,736 warrants exercisable for common stock to Barron as part of a preferred stock financing. The warrants have a term of five years. The Company used a fair-value option pricing model to value these stock warrants. Pursuant to EITF 00-19,

Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the value of these warrants has been recorded as a liability in the current liabilities section of the consolidated balance sheet until the Company has obtained an effective registration statement. Upon the effectiveness of the registration statement, the value of the shares may be recorded as additional paid-in capital.

The following tables summarize the warrants and Additional paid-in capital for the period:

(a) Warrants

The following summarizes the warrant activity for the affected periods:

<u>Detail</u>	<u>Black-Scholes</u> <u>Valuation (\$)</u>	<u>Number</u> <u>of</u> <u>Warrants</u>	<u>Exercise</u> <u>Price</u>	<u>Expiration</u>
Balance December 31, 2004				
Barron Warrant Group 1	\$ 4,511,085	3,608,868	\$ 1.3972	February 11, 2010
Barron Warrant Group 2	3,608,868	3,608,868	\$ 2.0958	February 11, 2010
Balance March 31, 2005	<u>\$ 8,119,953</u>	<u>7,217,736</u>		

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## (b) Additional paid-in-capital

Included in additional paid-in-capital are the following items:

<u>Detail</u>	
Additional paid-in capital related to common stock	\$ 77,368
Purchase of VerticalBuyer shell	(415,024)
Warrants <sup>(1)</sup>	
	<hr/>
Balance March 31, 2005	\$ (337,656)
	<hr/>

<sup>(1)</sup> Recorded in the Company's Balance Sheet as a liability under the line item "Financial instrument" due to a cash liquidated damages penalty in a Registration Rights Agreement entered into in connection with the issuance of the warrants, until such time as the registration of the shares becomes effective, or the Registration Rights Agreement is appropriately amended as discussed previously and in Note 6 "Financial Instrument" below.

**NOTE 4 LONG-TERM AND SHORT-TERM DEBT AND OFF-BALANCE SHEET INSTRUMENTS**

On March 17, 2005, CSI entered into a revolving credit facility with a financial institution. Fees for the transaction were \$83,800. The \$3,000,000 facility allows the Company to borrow up to 80% of accounts receivable balances. The total balance borrowed may not exceed \$3,000,000. Loans bear interest at Libor rate plus 0.275% (5.61% at March 31, 2005), payable monthly and mature on March 17, 2006. The facility is collateralized by substantially all the assets of the Company. Immediately upon entering into the loan agreement, the Company borrowed \$1,500,000, which remains outstanding at March 31, 2005 and was used for the payoff of a portion of the subordinated notes issued in connection with the merger. There was \$340,406 available under the facility as of March 31, 2005. Under the facility, CSI is subject to restrictive covenants, the primary terms of which restrict incurring debt, making loans, changing approved executive compensation arrangements or making distributions or investments which would violate the restrictive covenants in the loan agreement, require the achievement of a debt to EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization - a non-GAAP, financial measure which takes GAAP net income and adds back interest, taxes, depreciation and amortization) ratio of not more than 2.5:1 measured on a quarterly rolling twelve months by June 30, 2005, EBITDA of not less than \$2,000,000 by year-end 2005 and a minimum tangible net worth of \$1,500,000 including subordinated debt by year-end 2005. As of the end of the current quarter, the Company would not meet these requirements, and while management is optimistic we will meet these requirements, there can be no guarantee we will do so by the effective dates prescribed in the covenants.

During the preparation of its first quarter unaudited financial statements to be included in this Form 10-QSB, the Company determined that pursuant to EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the value of the warrants issued in conjunction with our preferred stock in February 2005 should be recorded as a current liability on our consolidated balance sheet until the Company has obtained an effective registration statement pursuant to the terms of the Registration Rights Agreement entered into with the holder of the warrants and the preferred stock at the time of issuance. This accounting treatment is explained in more detail in Part I of this report, in Item 1, in footnotes 1, 2, and 6 to our consolidated unaudited financial statements, and in Item 2. Such information is incorporated into this item by reference.

As a result of such accounting treatment for the warrants as a liability, our net worth is reduced at March 31, 2005 from a net worth of approximately \$500,000 to a deficit of \$7.7 million. When we entered into our \$3 million bank revolving credit facility on March 17, 2005, the

accounting for the warrants described above was not anticipated. As a result, the Company, as a condition to such loan arrangement, represented that it had a net worth of \$600,000 or greater, counting as equity for the purposes of such calculation subordinated indebtedness of \$2.3 million. Taking into account the new accounting treatment for the warrants, we now believe that the representation of a minimum net worth of \$600,000 made at the closing of the credit facility was not correct and that we may be in technical default under our bank credit facility as a result. The bank has granted us a waiver with respect to any such default until June 30, 2005. Pursuant to the waiver, we are obligated to achieve a minimum net worth of \$600,000 or more as of such date and at quarter end thereafter, again counting subordinated debt as equity for the purposes of such calculation. The waiver is filed as Exhibit 99.1 to this report and incorporated into this item by this reference. As discussed in Part I, Item 2, we are currently in negotiations with the holder of the preferred stock and warrants to amend the liquidated damages provisions contained in the Registration Rights Agreement in such a way as to eliminate the current accounting treatment which causes the warrants to be classified as a liability. Likewise, such accounting treatment would be eliminated upon the registration statement which is the subject of the Registration Rights Agreement becoming effective with the SEC and thereby foreclosing during the period of such effectiveness the operation of the liquidated damages provisions. Although management anticipates that through one or both of these alternatives it will be able

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to eliminate the current accounting for the warrants and comply with the requirements of the bank waiver by June 30, 2005, we can give no assurances that we will in fact successfully comply with the requirements of the bank waiver and avoid again being in default under our bank credit facility.

As of March 31, 2005, and at May 19, 2005, there were outstanding draws totaling \$1.5 million and \$800,000, respectively, under our bank credit facility. Pursuant to our agreements with the bank, upon an event of default, it may accelerate and require the repayment of all amounts under the credit facility. It may also decline to make further advances. At March 31, 2005 and May 19, 2005, \$300,000 and \$1.0 million respectively, were available for future advances under the facility.

We do not believe that any related default or adverse effect was triggered under any other material agreement of the Company as a consequence of any potential loan default under our bank credit facility described above.

The Company also has subordinated notes payable to shareholders. See Note 2.

As of March 31, 2005, for the prior reporting periods, and through the filing date, CSI had no off-balance sheet instruments.

**NOTE 5 COMMITMENTS AND CONTINGENCIES AND SUBSEQUENT EVENTS**

(a) Integrated Tek Solutions Lawsuit

On April 4, 2005, Integrated Tek Solutions, Inc. filed a lawsuit against the Company alleging breach of contract, fraud, negligent misrepresentation and promissory estoppel. The action arose out of a letter of intent pursuant to which a predecessor to the plaintiff conducted negotiations relating to a potential acquisition of CSI South Carolina's common stock. The defendants in the lawsuit included some of the Company's officers and directors. The complaint sought damages up to \$60 million in the aggregate.

On December 28, 2005, the suit was settled by all parties involved. As part of the settlement, the plaintiff released all claims against all defendants in exchange for payment of \$600,000. The Company contributed \$200,000 toward this payment with each of the five individual current and former officers of the Company contributing \$20,000. The remaining \$300,000 was paid by the other defendants in the suit. Although the Company maintained the suit was without merit, the Company believed the settlement was prudent in view of the cost of continuing litigation. None of the portion of the settlement payment made by the Company was covered by any of the Company's insurance policies.

At March 31, 2005, the lawsuit had not been filed. Accordingly, no costs related to the litigation were accrued as of March 31, 2005.

(b) United States Department of Justice Subpoena

The U.S. Department of Justice (Atlanta Antitrust Division) served Computer Software Innovations, Inc. with an April 27, 2005 subpoena *duces tecum* in Matter No. 60-514191-0017 requesting the Company's production of documents relating to the federal E-Rate program. The E-Rate Program is a government program providing funding for telecommunications, internet access and internal connections for schools that have a very high free and reduced lunch rate count. It is the Company's understanding that similar inquiries have been directed to numerous other companies associated with the E-Rate program. No allegations concerning any impropriety by the Company have been made. However, the Antitrust Division's collection of information from the hundreds of subpoenas it has issued to various E-Rate Program affiliates may eventually result in further inquiry or possible antitrust and/or related allegations. The Company has produced the requested information, and awaits direction from the Antitrust Division as to whether anything further is required of the Company. The Company intends to comply with all further direction, and management does not anticipate any allegations as a result of these inquiries.

(c) Non-employee Director Compensation

At this time, non-employee directors do not receive any cash compensation for serving on the Company's board of directors. However, it is the Company's intention to compensate the non-employee directors with awards of restricted common stock under its 2005 Incentive Compensation Plan. The awards have not yet been made, pending confirmation of final terms. However, it is anticipated that such awards would aggregate approximately 196,992 shares.

(d) Consulting Arrangement

The Company has entered into a consulting arrangement with Robert F. Steel and Kenneth A. Steel of Lamont, Illinois, for Messrs. Steel to advise the Company on the development and implementation of strategic business plans, to assist management in developing marketing and growth strategies, and to assist management in seeking out and analyzing potential acquisition opportunities. Although the parties have not yet reached or executed a definitive agreement, the general terms of the arrangement call for a term of three years. In exchange for such services, we anticipate compensating Messrs Steel in the

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form of shares of common stock, equal to approximately 3.5% in the aggregate of the outstanding common and preferred stock of the Company following the consummation of the February 2005 merger.

**NOTE 6 FINANCIAL INSTRUMENT**

In February of 2005, the Company issued 7,217,736 warrants to Barron Partners LP as part of a preferred stock financing. The warrants have a term of five years. The Company used a Black-Scholes fair-value option-pricing model to value these stock warrants. Assumptions used in calculation of the Black-Scholes model as of March 31, 2005 were an average expected life of the warrants in years of 1.0, an expected volatility of 75%, a risk-free interest rate (zero coupon U.S. Treasury Note) of 3.301%, and a dividend rate of zero percent. The average expected life was based on discussions with the warrant holder as to the potential timing of an exercise. Because the company does not have significant float, we used a 75% volatility factor based on its review of historical changes in the common stock prices of public companies which are peers or of similar size, and the discount was obtained from web postings by the U.S. Treasury. A dividend rate of zero percent was used as the company has no plans to pay dividends for the foreseeable future. Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the value of these warrants has been recorded as a liability under the heading Financial Instrument in the current liabilities section of the consolidated balance sheet until the Company has obtained an effective registration statement. Upon the effectiveness of the registration statement, the value of the shares may be recorded as additional paid-in capital. In light of the required accounting treatment under EITF 00-19, the entire portion of the proceeds of the preferred stock financing, except for the par value of the preferred stock, were allocated to warrants and recorded as a liability. The Company is also required to value the fair market price of the financial instrument as of the end of each reporting period. The Company believes the amount recorded for the financial instrument as of March 31, 2005 approximates fair value. The changes in market value (subsequent to the initial recording of the liability based on the allocation of proceeds) have been recorded as adjustments in the line Unrealized loss on financial instrument in the Statement of Operations for the period ended March 31, 2005.

The preferred stock transaction was entered into in accordance with a registration rights agreement. The agreement contains a liquidated damages clause which requires cash penalties equal to 25% of Barron's investment per annum if the Company's registration of stock does not become effective by June 11, 2005. Since the liquidated damages are payable in cash, under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock, a potential obligation (referred to under EITF 00-19 as a derivative financial instrument) exists until the registration is made effective. Accordingly, the entire proceeds of the preferred stock issuance, except for the par value, have been recorded as a liability, and the par value of the preferred stock was recorded as temporary equity on the balance sheet. Accordingly, our net shareholders' equity as a result of this treatment is reported as a deficit of \$7.7 million.

It was not the intent by either party to the transaction (CSI or Barron) that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock issuance and warrants being recorded as a liability rather than equity. The Company is in the process of negotiating an amendment to the liquidated damages provisions of the Registration Rights Agreement to eliminate the accounting treatment of the proceeds (net of par value) as a liability. If successful, the liability will be reclassified to equity and our reported shareholders' deficit will be reduced to \$1.0 million.

We will make our best effort to complete the shares registration and renegotiate the Registration Rights Agreement. We believe it is more likely than not we will complete these changes; however, there can be no assurance we will. (See also a detailed discussion of the potential impact on liquidity and cash flows in Part I, Item 2.)

**NOTE 7 SEGMENT INFORMATION**



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Prior to January 1, 2005, CSI South Carolina reported as one operating segment, as the chief operating decision-maker reviewed the results of operations of the Company as a single enterprise. Subsequent to December 31, 2004, CSI South Carolina, and as a result of the merger, CSI, began reporting its operations under two operating segments. Prior-year amounts have been reclassified to conform to the current period segment presentation. Costs related to the reverse acquisition have been excluded from segment results, as no significant operations were added in connection with the reverse acquisition.

Below is a description of the types of products and services from which each reportable segment derives its revenues:

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

### *Software applications segment*

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

**Table of Contents***Technology solutions segment*

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

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

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

There are no significant transactions between reportable segments. The total of Segment net sales and service revenue from all segments is equal to Net sales as reported in our Consolidated Income Statements. Sales and Cost of sales are included in each segment's income as reported in our Consolidated income statements. Accordingly, the total of the segments' Gross profit is equal to Gross profit in our Consolidated Income Statements. Operating expenses are allocated to segment income based on estimate of sales and administrative time spent on each segment. None of the income or loss items following Operating income in our Consolidated Statements of Operations are allocated to our segments, since they are reviewed separately by management. Certain non-recurring items (those items occurring for reasons which have not occurred in the prior 2 years and are not likely to reoccur in 2 years), stock-based compensation costs and compliance costs are generally excluded from management's analysis of profitability by segment and the Company's segment presentation. Accordingly, the total of Segment income from all segments, less non-recurring, stock-based compensation and compliance items, if any, is equal to Operating income as reported in our Consolidated Income Statements.

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

The following tables summarize information about segment profit and loss for the three month periods ended March 31, 2005 and 2004 and assets allocated to segments as of March 31, 2005 and 2004.

	<b>Software Applications</b>	<b>Technology Solutions</b>	<b>Total Company</b>
<b>Three months ended March 31, 2005:</b>			
Net sales and service revenue	\$ 986,749	\$ 3,105,555	\$ 4,092,304
Gross profit	539,923	617,772	1,157,695

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Segment income	197,489	190,445	(*)
Segment assets	2,813,220	4,143,228	6,956,448
Three months ended March 31, 2004:			
Net sales and service revenue	\$ 1,130,771	\$ 2,381,307	\$ 3,512,078
Gross profit	885,426	411,766	1,297,192
Segment income	455,848	(78,677)	(*)
Segment assets	2,022,323	2,790,101	4,812,424

\* See reconciliation below

**Table of Contents****Reconciliation of Segment income (loss) (non-GAAP measure) to operating income (loss) per Statement of Operations (GAAP measure):**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31,</b>
	<b>2005</b>	<b>2004</b>
<b>Segment income (loss):</b>		
<b>Software applications segment</b>	\$ 197,489	\$ 455,848
<b>Technology solutions segment</b>	190,445	(78,677)
<b>TOTAL SEGMENT INCOME (LOSS)</b>	387,934	377,171
<b>Less: Merger and compliance related costs</b>		
Stock option compensation from stock option redemption in connection with the merger	(631,174)	
Payroll tax expenses in Other selling, general and administrative costs related to stock option compensation from stock option redemption in connection with merger	(47,766)	
Reverse acquisition costs	(759,283)	
<b>OPERATING INCOME (LOSS) Per Statement of Operations</b>	\$ (1,050,289)	\$ 377,171

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

We are a developer of software applications and provider of technology solutions, focused primarily on the needs of organizations that employ fund accounting. Our client base consists principally of municipalities, school districts and local government organizations.

*Strategy*

Our overall business mission is to deliver innovative software applications and technology solutions backed by high-quality service and support, as we expand our client base. By providing a combined high level of service and support with excellent products, we believe we will continue to grow. A strong referral base has been key to our success and will continue to play a vital role in our growth. Our focus is on nurturing long-standing relationships with existing customers while establishing relationships with new customers.

**Organization**

Prior to January 1, 2005, the Company reported as one operating segment, as the chief operating decision-maker reviewed the results of operations of the Company as a single enterprise.

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Currently our business efforts are focused on two key operating segments: internally developed software applications and related service and support (our Software applications segment ), other technology solutions and related service and support (our Technology solutions segment ). Subsequent to December 31, 2004, the Company has begun reporting separately for its two operating segments: the Software applications segment and the Technology solutions segment. Prior-year amounts have been reclassified to conform to the current period presentation.

### *Software applications segment*

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

General (or Fund ) Ledger;

Accounts Payable;

Purchasing;

Payroll;

Personnel;

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Employee Absence/Substitutes;

Inventory;

Utility Billing; and

Other specialty modules designed for government markets.

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

Typically, sales of software and related services generate significantly higher margins than sales of hardware. Because our revenues in our software applications segment result from sales and support of software products developed for resale, and are coupled with a relatively small volume of related hardware sales (also referred to as software and related services), our software applications segment produces higher margins than our technology solutions segment. Conversely, revenues in our technology solutions segment result primarily from hardware sales, and relatively smaller amount of integration services (also referred to hardware sales and related services). Accordingly, our technology solutions segment produces lower margins than our software applications segment.

*Technology solutions segment*

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

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

Hardware/software installations;

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

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

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

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

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

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

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

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

Education technologies, including distance learning and classroom learning tools.

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

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

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

For a discussion of the results of the reported segments, see the section entitled [Segment Information](#) below.

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### **Acquisitions**

A significant reason for the merger in February 2005 was to allow for access to public capital markets as a source for funding to provide for our ability to grow through acquisitions. In addition, the merger facilitated the sale of warrants, which are a significant potential source of capital (subject to cashless exercise provisions). Our competitive markets are occupied by a number of competitors, many substantially larger than we, and with significantly greater geographic reach. We believe that to remain competitive we must take advantage of acquisition opportunities that arise that may help us achieve greater geographic presence and economies of scale, and whenever appropriate, expand our technological capabilities.

We believe our markets contain a number of attractive acquisition candidates and foresee expanding through acquisitions of one or more of the following types of organizations:

Cabling and infrastructure - CSI currently outsources cabling services;

Commercial (Fortune 100) and Commercial (Small Business) focus products and services - many of CSI's current technology solutions translate to the corporate market, especially IP telephony, IP surveillance, video conferencing and network security;

High level professional services (consulting) - this type of acquisition would enhance CSI's offering of technology planning and project management.

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

We continued to pursue acquisitions during the interim period. However, the Company has not engaged in any discussions or entered into agreements for which the likelihood of their resulting in an acquisition would be deemed by management as of the date of this report as probable outside of the merger activity discussed in the section entitled "Recent Developments" below.

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

Statements that are not reported financial results or other historical information are forward-looking statements. Forward-looking statements include, for example, statements about our business outlook, assessment of market conditions, strategies, future plans, future sales, prices for our major products, inventory levels, capital spending and tax and exchange rates. These forward-looking statements are not guarantees of future performance. These statements are based on management's expectations that involve a number of business risks and uncertainties, any of which could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. In addition to specific factors described in connection with any particular forward-looking statement, factors that could cause actual results to differ materially include, but are not limited to, those described under the caption "Cautionary Statement Regarding Forward-Looking Information" in CSI's annual reports on Form 10-KSB for the year ended December 31, 2004, and from time to time, in our other filings with the Securities and Exchange Commission. In addition, other risks could adversely affect us, as it is not possible for us to predict or assess all risks. We disclaim any



obligation to publicly update or revise any forward-looking statements even if our situation changes in the future.

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

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

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

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and liabilities in our financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

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

### *Significant Accounting Issue and Subsequent Event Affecting Basis of Presentation.*

In the series of transactions referred to in *Organization* above and in Note 2, *ACQUISITION AND MERGER*, CSI issued warrants to Barron in connection with the issuance of preferred stock. The preferred stock transaction was entered into in accordance with a registration rights agreement. The agreement contains a liquidated damages clause which requires cash penalties equal to 25% of Barron's investment per annum if the Company's registration of stock does not become effective by June 11, 2005. Since the liquidated damages are payable in cash, under EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock*, a potential obligation (referred to under EITF 00-19 as a derivative financial instrument) exists until the registration is made effective. Accordingly, the entire proceeds of the preferred stock issuance, except for the par value, have been allocated to the warrants and recorded as a liability on the balance sheet until the Company's registration statement on Form SB-2 becomes effective. Accordingly, our net shareholders' equity as a result of this treatment is reported as a deficit of \$7.7 million. (See also Note 6.)

It was not the intent by either party to the transaction (CSI or Barron) that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock issuance and warrants being recorded as a liability rather than equity. The Company is in the process of negotiating an amendment to the liquidated damages provisions of the Registration Rights Agreement to eliminate the accounting treatment of the proceeds (net of par value) as a liability. If successful, the liability will be reclassified to equity and, assuming continued earnings from operations, our reported shareholders' deficit would be eliminated.

We will make our best effort to complete the shares registration and renegotiate the Registration Rights Agreement. We believe it is more likely than not we will complete these changes; however, there can be no assurance we will.

See also the application of accounting pronouncements to the merger activity discussed in the *Recent Developments* section below.

### **Overview of Financial Performance**

Our revenues improved \$580,226 or 16.5% for the quarter compared to the same period of the prior year due to an increase in hardware sales (and related services), partially offset by a decline in software sales. The gross profit improved \$122,441 or 6.4%, primarily due to the increased volume in hardware sales and a small reduction in hardware costs, partially offset by an unfavorable change in the product mix between hardware and software. Notwithstanding the improvements in sales and gross profit, operating income declined from the prior year by \$1,427,460 or 378.5%. The decline was due to the substantial increase in our operating expenses primarily as a result of the increased compensation related to the redemption of outstanding stock options, interest and professional fees, all of which are related to the reverse acquisition discussed in the *Recent Developments* section below.

## Recent Developments

### *Merger*

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

During the first quarter of 2005, we completed a series of recapitalization transactions which began with a change in control due to the purchase of a majority of our common stock by CSI South Carolina and culminated on February 11, 2005 with the merger of CSI South Carolina into us, and our issuance of preferred stock, common stock, Warrants and certain subordinated notes, and the change of our name to Computer Software Innovations, Inc. We refer to the Company prior to such merger as VerticalBuyer. The series of transactions are detailed in Note 2. Acquisition and Merger to the Consolidated Financial Statements included with the filing of this Form 10-KSB above, and summarized below.

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### *Merger Accounting*

The Merger was accomplished through an exchange of equity interests.

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

The former majority shareholders of CSI South Carolina as a group hold 96% of the voting stock of the Company, occupy two of five board seats with the remaining three seats being filled by independent directors, and retain senior management positions of the combined company. Preferred stock granted subsequent to the transaction, sold to assist with the payment for shares and dividends payable to the CSI South Carolina shareholders, cannot be converted to common stock in excess of 4.99% ownership within a period of 60 days, and thus no common stock is deemed beneficially owned by the preferred stockholder pursuant to Rule 13d-3 under the Securities Exchange Act of 1934, as amended. In addition, the preferred stock has no voting rights (except under limited circumstances under Delaware law) and generally no provisions granting rights with respect to the governance of the Company. Accordingly, under SFAS 141 Business Combinations, the merger of CSI South Carolina into us was considered to be a reverse acquisition, whereby CSI South Carolina is considered to be the acquirer even though it is not the surviving corporation. Accordingly, the assets and liabilities of CSI South Carolina continued to be recorded at their actual cost. The assets and liabilities of VerticalBuyer would have been recorded at fair value, but no assets or liabilities existed at the time of acquisition; and, accordingly, no goodwill is recorded. Under reverse acquisition accounting, the financial statements of the surviving corporation (VerticalBuyer) are the financial statements of the acquirer (CSI South Carolina). Costs associated with the reverse acquisition are expensed as incurred. Shares issued in the transaction are shown as outstanding for all periods presented and our activities (activities of VerticalBuyer) are included only from the date of the transaction forward. Shareholders equity of CSI, after giving effect for differences in par value, has been carried forward after the acquisition.

### Summary of Merger

On January 31, 2005, CSI South Carolina purchased 77% or 13,950,000 shares of our common stock from our primary shareholder, Maximum Ventures, Inc., a New York corporation, pursuant to a stock purchase agreement. The purchase price was \$450,000, including approximately \$53,000 of that amount used to satisfy our outstanding liabilities at that time. CSI South Carolina also reimbursed Maximum for legal expenses of \$20,000. Thereafter, on the same date, our board approved a 40 to 1 reverse stock split, with fractional shares rounded up to one post-split share in order to facilitate a potential merger with CSI South Carolina, paid on February 11, 2005. Following the split, our outstanding shares of 453,598 were owned 77% or 348,750 shares by CSI South Carolina and 23% or 104,882 shares collectively by other parties.

Prior to the merger, CSI South Carolina, for \$899,144, redeemed options to purchase 797,403 shares, as allowed for under a stock option plan which had provided to certain non-executive employees options to purchase 1,065,746 shares of common stock, representing 73.34% of the 1,006,538 options then outstanding. Pursuant to the plan the option holders retained the remaining portion of their options. In connection with the merger, the surviving corporation assumed the plan and the board of directors, at their discretion, provided that the options after the merger were convertible into shares of common stock of the surviving corporation at the same ratio applicable to the five CSI South Carolina shareholders in the merger. VerticalBuyer also had a plan, with shares available for issuance at the time of the merger; however all options under the plan had expired, and the plan was cancelled on March 24, 2005. Subsequent to the end of the quarter the board approved a new plan which allows the award of stock-based compensation for the potential ownership of options, restricted stock or stock appreciation rights at the discretion of the board up to an aggregate of 1,100,000 shares. As of the filing date of this report, no awards have been granted or are outstanding under the new plan.

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

On February 10, 2005, VerticalBuyer and CSI South Carolina executed an Agreement and Plan of Merger. On February 11, 2005, CSI South Carolina merged into the Company, and in accordance with the Plan of Merger, the former shareholders of CSI South Carolina authorized the cancellation of all VerticalBuyer shares owned by CSI South Carolina and the exchange of their shares of common stock in CSI South Carolina for the following consideration:

2,526,904 shares of our common stock;

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A set of notes totaling \$3,624,800;

A set of notes totaling \$1,875,200.

Immediately following the transaction, our common stock totaled 2,631,786 shares outstanding, with the former owners of CSI South Carolina owning 96% or 2,526,904 shares and the remaining 4% or 104,882 owned collectively by other parties.

*Sale of Preferred Stock and Warrants and Use of Proceeds of Preferred Stock Sale*

Also on February 10, 2005, we entered into a Preferred Stock Purchase Agreement with Barron Partners LP. Pursuant to the agreement, on February 11, 2005, immediately following the consummation of the merger, we issued to Barron 7,217,736 shares of our newly created Series A Convertible Preferred Stock in exchange for the payment of \$5,042,250, and the issuance to Barron of two Warrants to purchase in the aggregate, 7,217,736 shares of our common stock. The exercise price of the Warrants are \$1.3792 and \$2.0958 per share, subject to anti-dilution adjustments, each Warrant exercisable for half of the total Warrant shares. The terms and conditions of the Warrants are identical except as to exercise price.

The funds from the sale of the preferred stock were used to pay off, prior to March 31, 2005, the set of notes totaling \$3,624,800 discussed above. The remaining notes of \$1,875,200 are subordinated to other non-subordinated debt of the Company and are due in full on or before May 10, 2006. Amounts outstanding under these notes totaled \$1,125,200 as of March 31, 2005.

In conjunction with the Preferred Stock Purchase Agreement, the Company also entered into a Registration Rights Agreement with Barron on February 10, 2005, whereby the Company undertook certain obligations to register the shares of common stock of the Company underlying the Warrants and shares of preferred stock to be sold to Barron pursuant to the Preferred Stock Purchase Agreement. Under the terms of the Registration Rights Agreement, the Company is obligated to file, within forty-five days following the execution of the Registration Rights Agreement, a registration statement covering the resale of the shares underlying the convertible preferred stock and Warrants issued to Barron. Barron, subject to certain conditions, may also demand the registration of all or part of such shares on a one-time basis and, pursuant to piggy-back rights, may require the Company (subject to certain carvebacks) to include such shares in certain registration statements filed by the Company. The Company is obligated to pay all expenses in connection with the registration of the shares and may be liable for liquidated damages in the event the registration of shares is not effected pursuant to the agreement between the parties. Among other events, such liquidated damages at a rate of 25% of Barron's investment per annum, would be triggered if the Company fails to file the registration statement within 45 days, cause such registration statement to become effective within 120 days or maintain the effectiveness of the registration statement, subject to certain allowances.

Since the liquidated damages are payable in cash, under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock, a potential obligation (referred to under EITF 00-19 as a derivative financial instrument) exists until the registration is made effective. Accordingly, the entire proceeds of the preferred stock issuance, except for the par value, have been allocated to the warrants and recorded as a liability on the balance sheet. Accordingly, our net shareholders' equity as a result of this treatment is reported as a deficit of \$7.7 million. In addition, the par value of the preferred stock has been recorded as temporary equity on the Company's balance sheet. (See also Note 6.)

It was not the intent by either party to the transaction (CSI or Barron) that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock issuance and warrants being recorded as a liability rather than equity. The Company is in the process of

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negotiating an amendment to the liquidated damages provisions of the Registration Rights Agreement to eliminate the accounting treatment of the proceeds (net of par value) as a liability. If successful, the liability will be reclassified to equity and, assuming continued earnings from operations, our reported shareholders' deficit would be eliminated.

We will make our best effort to complete the shares registration and renegotiate the Registration Rights Agreement. We believe it is more likely than not we will complete these changes; however, there can be no assurance we will. (See also a detailed discussion of the potential impact on liquidity and cash flows in Part I, Item 2.)

### *Outstanding Shares Following Recapitalization*

As a result of our stock split, and merger, we have approximately 2.6 million shares of common stock outstanding. As a result of the issuance of the preferred stock and warrants, on a diluted basis, assuming the conversion of the preferred stock and exercise of outstanding warrants and options, approximately 17.3 million shares of common stock are outstanding.

**Table of Contents****Consolidated Results of Operations**

	Three Months Ended		
	March 31,	March 31,	Increase
	2005	2004	(Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 4,092,304	\$ 3,512,078	\$ 580,226
<b>GROSS PROFIT</b>	1,157,695	1,297,192	(139,497)
<b>OPERATING INCOME (LOSS)</b>	(1,050,289)	377,171	(1,427,460)
<b>SIGNIFICANT ITEMS THAT INCREASED (DECREASED) OPERATING INCOME</b>			
Gross Profit:			
Sales			\$ 580,226
Salaries, wages and benefits			(254,120)
Purchased components			(457,785)
Other miscellaneous			(7,818)
			(139,497)
Operating Expenses:			
Salaries, wages and benefits			91,083
Reverse acquisition costs			(759,283)
Stock option compensation			(631,174)
Other SG&A expenses			11,411
			\$ (1,427,460)

**Three months ended March 31, 2005, versus three months ended March 31, 2004****Sales**

Total sales in the first quarter of 2005 increased \$580,226 in comparison with the first quarter of 2004. This net increase includes a \$724,248 increase in hardware sales and services through the technology solutions segment and a \$144,022 decrease in software sales and services through the software solutions segment. The increase in the technology solutions segment came from both increases in hardware sales and related engineering support services. The decline in the software solutions segment was due to a decrease in new software sales from a temporary reduction in sales staff and a deferral of some installations into the second quarter from first quarter software installations.

**Gross Profit**

Gross profit in the first quarter of 2005 decreased \$139,497 in comparison with the first quarter of 2004. The gross margin percentage was 28.3% in 2005 versus 36.9% in 2004. The decrease in margin is attributed to an unfavorable change in product mix. Hardware (Technology solutions segment) sales, with relatively low margins increased during the quarter while software (Software applications segment) sales, our



highest margin products, decreased. (For reasons for changes in sales mix, see the Sales section above.) Salaries, wages and benefits also increased due to the addition of a .Net (pronounced dot-net) Microsoft SQL (application programming language and database conversion) team to the Software applications segment. While this team's work is primarily capitalized, the capitalization was substantially offset by depreciation of prior capitalized cost (netted in other miscellaneous) and the net result was an overall increase in expenses related to development.

### **Operating Expenses**

Operating expenses increased \$1,287,963 in the first quarter of 2005 compared to the first quarter of 2004. The above table analyzes the major items that account for this increase. The majority of the increase is reflected in two non-recurring costs associated with the merger and recapitalization of CSI. Following is a brief explanation of these items and the related impact on Other selling, general and administrative (SG&A) expenses. A decrease in Salaries, wages and benefits partially offset these increases. The decrease in Salaries, wages and benefits was due to the absence in the current year of executive level bonuses paid in the prior year.

*Reverse acquisition costs* included \$275,000 in commissions paid to a third-party broker, Liberty Company, LLC for their assistance in the preferred stock sale and warrant issuance. No commission was paid to Barron, the investment group which purchased the preferred stock and received the warrants. The remaining \$485,283 consisted of merger related fees paid principally for legal and accounting services.

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*Stock option compensation* represents cost incurred to redeem certain stock options held by key management employees of CSI in connection with the merger. In August, 2000, CSI approved and implemented an equity incentive plan pursuant to which eight non-executive employees were granted options to purchase 1,065,746 shares of common stock of CSI, of which 59,208 had been previously cancelled and 1,006,538 were outstanding as of December 31, 2004. Immediately prior to the merger, CSI cancelled options to purchase 797,403 shares and paid the option holders \$899,144 as compensation for the cancellation, and reduced unearned stock compensation for the redemption by \$267,970, for net compensation expense of \$631,174 during the period. Employer FICA and medicare, additional expenses related to this transaction totaling \$47,766, were also paid by CSI and are included in Other selling, general and administrative expenses.

**Segment information**

Prior to January 1, 2005, the Company reported as one operating segment, as the chief operating decision-maker reviewed the results of operations of the Company as a single enterprise. Subsequent to December 31, 2004, the Company began reporting its operations under two operating segments. Prior-year amounts have been reclassified to conform to the current period segment presentation.

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

*Software applications segment*

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

	<b>Three Months Ended</b>		
	<b>March 31,</b>	<b>March 31,</b>	<b>Increase</b>
	<b>2005</b>	<b>2004</b>	<b>(Decrease)</b>
<b>NET SALES AND SERVICE REVENUE</b>	\$ 986,749	\$ 1,130,771	\$ (144,022)
<b>GROSS PROFIT</b>	539,923	885,426	(345,503)
<b>SEGMENT INCOME (LOSS)</b>	197,489	455,848	(258,359)
<b>SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME</b>			
Gross Profit:			
Sales			\$ (144,022)
Salaries, wages and benefits			(178,587)
Other miscellaneous			(22,894)
			(345,503)
Operating Expenses:			
Salaries, wages and benefits			73,002
Other miscellaneous			14,142
			\$ (258,359)

Sales decreased primarily due to lower software sales, partially offset by an increase in service revenues. The lower software sales were due to a temporary reduction in sales staff and a deferral of software installations into the second quarter of first quarter purchase orders.

Salaries, wages and benefits increased primarily due to the addition of the .Net Microsoft SQL (application programming language and database conversion) team. The increase in salaries and wages in cost of sales was partially offset by a decline of salaries and wages in operating expenses due to the absence in the current year of executive level bonuses paid in the prior year.

**Table of Contents***Technology solutions segment*

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

	Three Months Ended		
	March 31, 2005	March 31, 2004	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 3,105,555	\$ 2,381,307	\$ 724,248
<b>GROSS PROFIT</b>	617,772	411,766	206,006
<b>SEGMENT INCOME (LOSS)</b>	190,445	(78,677)	269,122
<b>SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME</b>			
Gross Profit:			
Sales			\$ 724,248
Purchased components			(402,397)
Salaries, wages and benefits			(75,553)
Other miscellaneous			(40,292)
			206,006
Operating Expenses:			
Salaries, wages and benefits			21,404
Other miscellaneous			41,712
			\$ 269,122

Sales, Purchased components and Salaries, wages and benefits increased primarily due to additional hardware and related engineering services sold and related additional wages incurred. The increase in salaries and wages in cost of sales was partially offset by a decline of salaries and wages in operating expenses due to the absence in the current year of executive level bonuses paid in the prior year.

The following tables summarize the segment information discussed above to the consolidated amounts reported and previously discussed. The table also presents the segment assets information. Increases in segment assets came primarily from an increase in deferred tax assets in connection with the recording of the financial instrument related to the issuance of the warrants in connection with the reverse merger (approximately \$1.2 million), and taxes receivable as a result of the loss recorded from the impact of legal and stock redemption related expenses related to the reverse merger. In the prior year the company had a current tax payable of approximately \$100,000 versus a current tax receivable of \$500,000 in the current year. For a discussion of the accounting for the warrants see Critical Accounting Policies and Estimates - *Significant Accounting Issue and Subsequent Event Affecting Basis of Presentation* above.

The following tables reconcile information about segment profit and loss for the three month periods ended March 31, 2005 and 2004 and assets allocated to segments as of March 31, 2005 and 2004.

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	<b>Software</b>	<b>Technology</b>	<b>Total</b>
	<b>Applications</b>	<b>Solutions</b>	<b>Company</b>
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Three months ended March 31, 2005:</b>			
Net sales and service revenue	\$ 986,749	\$ 3,105,555	\$ 4,092,304
Gross profit	539,923	617,772	1,157,695
Segment income	197,489	190,445	(*)
Segment assets	2,813,220	4,143,228	6,956,448
<b>Three months ended March 31, 2004:</b>			
Net sales and service revenue	\$ 1,130,771	\$ 2,381,307	\$ 3,512,078
Gross profit	885,426	411,766	1,297,192
Segment income	455,848	(78,677)	(*)
Segment assets	2,022,323	2,790,101	4,812,424

\* See reconciliation below

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

Certain non-recurring items (those items occurring for reasons which have not occurred in the prior 2 years and are not likely to reoccur in 2 years) and compliance costs are generally excluded from management's analysis of profitability by segment and the Company's segment presentation. The following reconciliation presents separately those costs related to the merger and compliance costs, which have not been included in the analysis of segment income. Detailed discussions related to the merger costs have been previously discussed under Summary of Merger Transactions. In addition, due to the public reporting requirements, we have incurred significant compliance-related professional and legal costs. These costs were not incurred in the prior years because CSI-South Carolina was not a reporting company at that time.

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31,</b>
	<b>2005</b>	<b>2004</b>
<b>Segment income (loss):</b>		
<b>Software applications segment</b>	\$ 197,489	\$ 455,848
<b>Technology solutions segment</b>	190,445	(78,677)
<b>TOTAL SEGMENT INCOME (LOSS)</b>	<b>387,934</b>	<b>377,171</b>
<b>Less: Merger and compliance related costs</b>		
Stock option compensation from stock option redemption in connection with the merger	(631,174)	
Payroll tax expenses in Other selling, general and administrative costs related to stock option compensation from stock option redemption in connection with merger	(47,766)	
Reverse acquisition costs	(759,283)	
<b>OPERATING INCOME (LOSS) Per Statement of Operations</b>	<b>\$ (1,050,289)</b>	<b>\$ 377,171</b>

**Interest and other income and expenses**

Interest expense increased \$37,445 in the first quarter of 2005 compared to the first quarter of 2004 due to the addition of borrowing in connection with the reverse acquisition. As of March 31, 2005, we had outstanding draws of \$1,500,000 under our bank credit facility bearing interest at 5.61% (Libor plus 0.275%). We also had outstanding subordinated notes payable to Barron and the five former CSI-South Carolina shareholders totaling \$2,250,400 and bearing interest at 7.5% (the Prime Rate as reported by Bank of America plus 2%). The Company had no funded debt at March 31, 2004.

Unrealized loss on warrants increased \$3,084,921, due to an increase in the market value of the warrants based on the Black-Scholes valuation method. For a discussion of the accounting for the warrants see Critical Accounting Policies and Estimates - *Significant Accounting Issue and Subsequent Event Affecting Basis of Presentation* above. No loss on warrants was recorded in 2004 as no warrants were outstanding at that time.

**Income Taxes**

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Income taxes decreased in the first quarter of 2005 compared to the first quarter of 2004 due to the loss resulting from the expenses related to the reverse acquisition activity.

### **Liquidity and Capital Resources**

Cash declined from \$3,656,477 at December 31, 2004 to \$1,123,576 at March 31, 2005, due primarily to the merger related activity during the quarter, which is detailed in Note 2 to the Consolidated Financial Statements and which has been summarized earlier in management's discussions above and are summarized again in the table below.

#### *Cash from Operating Activities*

Cash used for operating activities totaled (\$738,510) in the first three months of 2005 compared to cash provided by operating activities of \$103,634 in the first three months of 2004. The decrease, (\$842,144), is due primarily to the legal and professional fees, stock option compensation and taxes related to the reverse acquisition. Without the effect of the reverse acquisition related transactions, cash provided by operating activities in the first three months of 2005 which would have been \$361,650, or \$258,016 ahead of the prior year. The financial statement category most significantly impacting cash from

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operating activities was net income. Net income declined due to the merger related fees as discussed previously in the Overview of Financial Performance section above.

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

Increases in the consolidated balance sheet line items for accounts receivable and accounts payable were a result of the increased hardware sales and related purchases previously discussed. Increased hardware demand and timing of sales also resulted in an increase in inventories. The change in taxes from a payable balance to a receivable balance is the result of the tax refund provided for the loss incurred in the current quarter due to the costs related to the merger transaction.

*Cash from Investing Activities*

Cash used for investing activities totaled \$229,073 in the first three months of 2005 compared to \$183,795 in the first three months of 2004. The increase of \$45,278 is due primarily to the continued investment in development in the .Net version of CSI's major software modules, and is reflected in the increase in computer software costs, net in the consolidated balance sheet.

*Cash from Financing Activities*

Cash used for financing activities netted to \$1,565,318 in the first three months of 2005 compared to no financing needs or repayments in the first three months of 2004. The increase of \$1,565,318 is due entirely to activities related to the reverse acquisition, which have been summarized earlier in management's discussions above and in Note 2 to the Consolidated Financial Statements. Changes in the balance sheet line items for other assets (from deferred financing fees), bank line of credit, subordinated notes payable to shareholders and shareholders' equity (deficit) are all a result of the merger related transactions detailed in Note 2 above and in the consolidated statement of changes in shareholders' equity (deficit).

In addition to the changes related to the merger transaction, the following additional significant non-cash changes impacted the balance sheet. The Financial instrument (warrants) increased significantly from the initial allocation of proceeds from the preferred stock and warrants issuance and an increase in the market value of the warrants.

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

Purchase of VerticalBuyer shell company	\$ (415,024) <sup>(1)</sup>
CSI - South Carolina redemption of options for common stock	(899,144)
Initial cash payment of portion of CSI - South Carolina \$3,460,000 dividends declared to shareholders	(960,000)
Proceeds from sale of preferred stock and warrants in merger	5,042,250
Proceeds from issuance of subordinated note to Barron	1,875,200



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Payment of remaining outstanding dividends declared, from preferred stock and warrant proceeds	(2,500,000)
Payment on one of the two sets of subordinated notes (\$3,624,800) and (\$1,875,200) issued to shareholders in connection with merger	(3,624,800)
Payment of debt issuance costs for \$3,000,000 revolving credit facility	(83,800)
Initial borrowings under revolving credit facility	1,500,000
Payment on second set of shareholder and Barron's notes from loan proceeds	(1,500,000)
	(1,565,318)
<b>Net effect of merger transactions on cash, and cash used for financing activities</b>	<b>\$ (1,565,318)</b>

- (1) Consists of \$450,000 aggregate agreed-upon purchase price (including approximately \$5,000 used to satisfy outstanding liabilities of VerticalBuyer) and an additional \$20,000 paid to Maximum Ventures to offset its legal and accounting expenses, net of the \$50,000 contribution by Barron and a \$5,000 allowance to help defray our legal and professional expenses.

In addition to the cash used for financing activities related to the merger, the Company incurred approximately \$700,000 in legal and professional fees which were expensed and are included in the discussion of cash used for operating activities above.

### Credit Arrangements

During the quarter, in order to support the activities of the reverse acquisition, the Company entered into a \$3,000,000 line of credit facility whereby the Company can borrow up to 80% of accounts receivables balances, not to exceed the total facility limit of \$3,000,000. Loans bear interest at Libor rate plus 0.275%, (5.61% at March 31, 2005), payable monthly and mature on March 17, 2006. Immediately upon entering into the loan agreement, the Company borrowed \$1,500,000 which was used

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for the paydown of a portion of the subordinated notes issued in connection with the merger. There was \$340,406 available under the facility as of March 31, 2005. Under the facility CSI is subject to restrictive covenants, the primary terms of which restrict incurring debt, making loans, changing approved executive compensation arrangements or making distributions or investments which would violate the restrictive covenants in the loan agreement, require the achievement of debt to EBITDA ratio of not more than 2.5:1 measured on a quarterly rolling twelve months by June 30, 2005, EBITDA of not less than \$2,000,000 by year-end 2005 and a minimum tangible net worth of \$1,500,000 including subordinated debt by year-end 2005. As of the end of the current quarter, the Company would not meet these requirements, and while management is optimistic we will meet these requirements, there can be no guarantee we will do so by the effective dates prescribed in the covenants. Were the Company not to meet its covenants, it could be forced to seek a temporary waiver or other financing. The Company also has significant commitments under the notes payable to the original five shareholders of CSI South Carolina and Barron, as a result of the reverse acquisition, totaling \$2,250,400, which will be due and payable in May of 2006.

During the preparation of its first quarter unaudited financial statements to be included in this Form 10-QSB, the Company determined that pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the value of the warrants issued in conjunction with our preferred stock in February 2005 should be recorded as a current liability on our consolidated balance sheet until the Company has obtained an effective registration statement pursuant to the terms of the Registration Rights Agreement entered into with the holder of the warrants and the preferred stock at the time of issuance. This accounting treatment is explained in more detail in Part I of this report, in Item 1 in footnotes 1, 2, and 6 to our consolidated unaudited financial statements, and in Item 2. Such information is incorporated into this item by reference.

As a result of such accounting treatment for the warrants as a liability, our net worth is reduced at March 31, 2005 from a net worth of approximately \$500,000 to a deficit of \$7.7 million. When we entered into our \$3.0 million bank revolving credit facility on March 17, 2005, the accounting for the warrants described above was not anticipated. As a result, the Company, as a condition to such loan arrangement, represented that it had a net worth of \$600,000 or greater, counting as equity for the purposes of such calculation subordinated indebtedness of \$2.3 million. Taking into account the new accounting treatment for the warrants, we now believe that the representation of a minimum net worth of \$600,000 made at the closing of the credit facility was not correct and that we may be in technical default under our bank credit facility. The bank has granted us a waiver with respect to any such default until June 30, 2005. Pursuant to the waiver, we are obligated to achieve a minimum net worth of \$600,000 or more as of such date and at quarter end thereafter, again counting subordinated debt as equity for the purposes of such calculation. The waiver is filed as Exhibit 99.1 to this report and incorporated into this item by this reference. As discussed in Part I, Item 2, we are currently in negotiations with the holder of the preferred stock and warrants to amend the liquidated damages provisions contained in the Registration Rights Agreement in such a way as to eliminate the current accounting treatment which causes the warrants to be classified as a liability. Likewise, such accounting treatment would be eliminated upon the registration statement which is the subject of the Registration Rights Agreement becoming effective with the SEC and thereby foreclosing during the period of such effectiveness the operation of the liquidated damages provisions. Although management anticipates that through one or both of these alternatives it will be able to eliminate the current accounting for the warrants and comply with the requirements of the bank waiver by June 30, 2005, we can give no assurances that we will in fact successfully comply with the requirements of the bank waiver and avoid being in default under our bank credit facility.

As of March 31, 2005, and at May 19, 2005, there were outstanding draws totaling \$1.5 million and \$800,000, respectively, under our bank credit facility. Pursuant to our agreements with the bank, upon an event of default, it may accelerate and require the repayment of all amounts under the credit facility. It may also decline to make further advances. At March 31, 2005 and May 19, 2005, \$300,000 and \$1.0 million respectively, were available for future advances under the facility.

We do not believe that any related default or adverse effect was triggered under any other material agreement of the Company as a consequence of any potential loan default under our bank credit facility described above.

### ***Future Capital Needs and Resources.***

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Since inception, and prior to the merger, the Company has funded its operations through cash flow from operations.

Ongoing capital resources depend on a variety of factors, including our existing cash balance, the cash flow generated from our operations and external financial sources that may be available. As of December 31, 2004, our capital resources included \$3.7 million of cash, which was impacted by the merger and related transactions described above. As a result, at March 31, 2005 our cash balance totaled approximately \$1.1 million. Our ability to generate sufficient operating cash flow is dependent upon, among other things:

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

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the amount of operating expenses required to provide our services;

the cost of acquiring and retaining customers; and

our ability to continue to grow our customer base.

*Customer support billings.* We historically bill a significant portion of our service contracts late in the second quarter of the year. Historically this amount has exceeded \$2,000,000. While revenue for service contracts is deferred over the life of the contract (typically over a year) significant cash is generated in the third quarter as a result of the service payments being billed and collected as payment for the entire future year's service.

*Bank Credit Facility.* In the coming year, we will also rely on our \$3.0 million line of credit facility whereby the Company can borrow up to 80% of its receivable balance, not to exceed the total facility limit of \$3.0 million. As of March 31, 2005, our facility allows for borrowing up to \$1.8 million (based on adjustments for eligible receivables) of which \$1.5 million is outstanding at March 31, 2005. (See also our discussions regarding default and waiver of loan covenants under "Credit Arrangements" above.)

*Short Term Capital Requirements.* We currently anticipate that our capital needs will principally consist of \$800,000 for software development and \$120,000 for capital expenditures.

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

*Potential Capital Inflow from Warrants Exercise.* A significant amount of cash and capital for the Company would be generated by the exercise by Barron of its common stock Warrants. The exercise of Warrant A, with an exercise price of \$1.3972, would generate approximately \$5 million. The exercise of Warrant B, with an exercise price of \$2.0958, would generate approximately \$7.6 million. The exercise of the Warrants is in the sole discretion of Barron, subject to the restrictions in the preferred stock and the Warrants prohibiting Barron from beneficially holding greater than 4.99% of our outstanding common stock, at any time, which prohibition can be waived by Barron upon 61 days notice. Although we presume any decision by Barron to exercise the warrants or any portion would depend upon our stock price, results of operations and the long term outlook for the development of our business, among other things, we cannot predict if and when Barron may exercise the Warrants. Accordingly, there can be no assurance that Barron will exercise the Warrants and that we will receive any resulting capital.

The warrants may be exercised on a cashless basis, in which case the Company would receive no cash proceeds. However, Barron is prohibited from electing a cashless exercise until February 11, 2006, and is thereafter prohibited so long as there is an effective registration statement with respect to the shares underlying the warrants. Accordingly, it will be important in the future for us to maintain the effectiveness of the registration statement covering the warrant shares in order to assure the receipt of equity capital from the exercise of the warrants. In addition, our failure to maintain the effectiveness of such a registration statement would subject the Company to liquidated damages mandated by the Registration Rights Agreement in an amount equal to 25% per annum of the \$5,042,250 purchase price of the Series A convertible non-voting preferred stock. The payment of such liquidated damages over an extended period of time would have a substantial and adverse impact on the cash flows and capital resources of the Company.

*Adequacy of Liquidity and Capital Resources.* Based on the foregoing, our management believes that our cash flow from operations and existing bank credit facility will be adequate to fund our short term liquidity and capital needs. We believe that our current business plan for the organic growth of our business will not require any additional external funding and that we will be able to operate and grow our business while servicing our debt obligations. As previously noted, any acquisition would be dependent upon additional funding sources.

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

cash and cash equivalents on hand or available to our operations of \$1.1 million at March 31, 2005;

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expected cash flow from operations;

the anticipated level of capital expenditures of \$120,000;

software development costs of \$800,000; and

our scheduled debt service.

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

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

the commercial success of our operations;

the volatility and demand of the capital markets; and

the future market prices of our securities.

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

**Recent Accounting Pronouncements**

In January 2003, the FASB issued FASB Interpretation (FIN) 46 (revised 2003), *Consolidation of Variable Interest Entities*. FIN 46(R) defines a variable interest entity (VIE) as a corporation, partnership, trust, or any other legal structure that does not have equity investors with a controlling financial interest or has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46(R) requires consolidation of a VIE by the primary beneficiary of the assets, liabilities, and results of activities. FIN 46(R) also requires certain disclosures by all holders of a significant variable interest in a VIE that are not the primary beneficiary. In January 2005, we adopted FIN 46(R). As we have not held during the current period, or hold currently any significant variable interests in a VIE, the adoption of FIN 46(R) has not had a material effect on the financial statements.

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In December 2004, the FASB published SFAS No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured on the fair value of the equity or liability instruments issued. This Statement is the result of a two-year effort to respond to requests from investors and many others that the FASB improve the accounting for share-based payment arrangements with employees. Statement 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock issued to Employees*. SFAS No. 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Although those disclosures helped to mitigate the problems associated with accounting under Opinion 25, many investors and other users of financial statements said that the failure to include employee compensation costs in the income statement impaired the transparency, comparability, and credibility of financial statements. Public Entities filing as small business issuers will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after December 15, 2005 (the fourth quarter of fiscal 2005 for the Company). In January 2005, we adopted the provisions of SFAS No. 123 (R). As our only active stock plan was already being accounted for using the fair value method prescribed in SFAS No. 123, *Accounting for Stock Based Compensation*, and related interpretations, including the recognition of compensation cost at the time of grant in the financial statements, and we were not using the disclosure only provisions of SFAS No. 123, the adoption of SFAS No. 123(R) has not had a material impact on the financial statements.

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### **Item 3. Controls and Procedures.**

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

Our chief executive officer and chief financial officer evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rule 15d-15e under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of March 31, 2005. Based upon such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of such period, the Company's disclosure controls and procedures were ineffective due to a significant deficiency in our internal controls over the application of existing accounting principles to new public reporting disclosures and particularly related to the application of GAAP to new transactions. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the Chief Financial Officer in consultation with the Chief Executive Officer and the audit committee of the board of directors determined the Company still lacked sufficient internal resources to insure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis, following its inception of reporting as a public company and hiring of its first Chief Financial Officer with SEC reporting experience. Accordingly, it was also determined until such time as we had sufficient resources, we would be unable to declare our disclosure controls with regard to new public reporting disclosures effective.

#### *Deficiency Related to Qualified Financial and Accounting Personnel*

In March 2005, the Public Company Accounting Oversight Board, or PCAOB, defined a significant deficiency as a deficiency that results in more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected, or that a company will be unable to comply with laws and regulations, which includes the timely filing of required reports with the Securities and Exchange Commission. As a result of this new standard, our management noted in our most recent review a significant deficiency. Prior to February 11, 2005, we were a public shell with virtually no operations and had limited need for staff with highly technical accounting and public reporting expertise. In addition, our predecessor, Computer Software Innovations, Inc., a South Carolina corporation (CSI South Carolina) was a private company and likewise had no need for staff with technical accounting and public reporting expertise. In the period covered by this report, we entered into a complex merger and resumed public reporting of significant operations. Due to the time required to source, attract, negotiate and hire personnel with the necessary experience, we remained as of March 31, 2005 without sufficient public reporting or technical expertise to resolve non-routine or complex accounting matters and public reporting requirements such as we encountered in the merger with CSI South Carolina. It was not until May 6, 2005 that we were able to hire a chief financial officer with prior public reporting experience who is accustomed to dealing with more complex accounting matters. As a result, we were unable to file our first quarterly report on Form 10-QSB for 2005 by its initial due date and were forced to utilize a filing extension, with which we complied.

We are working with the chief financial officer to enlist the resources necessary to assist in the handling of complex non-routine accounting issues and to meet public disclosure requirements in a timely fashion. Following consultation with the Company's audit committee and board of directors, the chief financial officer has received authority to engage outside accounting experts to support management in their review, interpretation, and implementation of significant changes in accounting and regulatory reporting requirements. The purpose is to provide additional technical resources (other than our independent auditors) to whom we may direct complex accounting issues for review, particularly in situations where the accounting treatment is unclear or extremely complex. While continuous improvements will be made in 2005 and beyond, based on our CFO's experience and with an increase in staff, we expect we will receive additional suggestions for improvement in controls during the process of implementing the Sarbanes-Oxley Act, will be implementing recommendations throughout the process and are unsure we will be able to entirely eliminate any possibility of a significant deficiency until we have completed this process. Even so, due to the increasing number and complexity of pronouncements, emerging issues and releases, we expect there will always be some risk related to financial disclosures, albeit mitigated following implementation of the Sarbanes-Oxley Act requirements, which we anticipate will be completed in 2007.



*August 2005 Restatement of Financial Statements*

On August 16, 2005, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, concluded that the previously issued financial statements contained in our quarterly report on Form 10-QSB for the quarter ended March 31, 2005 should not be relied upon for the reasons set forth below. On August 22, 2005, we restated these financial statements to make the necessary accounting corrections in an Amendment No. 1 to our March 31, 2005 Form 10-QSB. The decision to restate was made with the concurrence of our independent registered accounting firm.

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On February 10, 2005, we entered into a Registration Rights Agreement (the Agreement) with Barron Partners LP (Barron) in connection with the issuance of convertible preferred stock and warrants, whereby we undertook to file a registration statement registering the sale of the shares of our common stock underlying the convertible preferred stock and warrants held by Barron. Under the agreement as in effect during the first quarter, the failure to timely effect the registration statement triggered cash liquidated damages. According to recent accounting guidance, the existence of the cash liquidated damages provisions caused Barron's warrants to be treated as a liability on our books. In connection with the filing of our first quarter Form 10-QSB, we sought to resolve this issue, and prepared our financial statements to comport with the recently issued guidance. Simultaneously, we pursued options available under the recent accounting guidance whereby we could amend our registration rights agreement, subject to the approval of Barron, to eliminate the liability treatment. This pursuit of alternatives resulted in significant technical discussions with several accounting, regulatory and valuation experts. In the process, additional changes were identified which we believed necessary to properly reflect the full impact of the transaction in accordance with accounting guidance.

Specifically, in Amendment No. 1 to this report, we revised the carrying value of the stock warrants as of March 31, 2005. We recorded an unrealized loss of \$3,084,921 on the warrants in other income (expense) to adjust the value of the warrants to their estimated fair value at March 31, 2005. The estimated fair value of the warrants was revised after consultation with a valuation expert, and through the use of the Black-Scholes model. This resulted in a reduction in net income and retained earnings. The reduction in retained earnings was primarily offset by increases in our warrant related liability. The adjustments reflected in Amendment No. 1 did not affect income from operations or cash flows.

### *November 2005 Restatement of Financial Statements*

On November 11, 2005, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, concluded that the previously issued financial statements contained in our amended quarterly report on Forms 10-QSB for the quarter ended March 31, 2005 should not be relied upon for the reasons set forth below and that we would need to restate the financial statements to make necessary accounting corrections. The decision to restate was made with the concurrence of our independent registered public accounting firm.

In the process of reviewing our financial statements in comparison to accounting pronouncements and the disclosures of other entities, our chief financial officer identified that certain reclassifications were necessary to properly meet the disclosure requirements under generally accepted accounting principles. Primarily, certain items recorded in selling, general and administrative costs, including certain salaries and expenses and the amortization of capitalized software development costs, should have been recorded as components of cost of sales. Traditionally, the Company had only recorded the cost of purchased components as a part of cost of sales.

Also in the restatement, due to further guidance, we reclassified the portion of the proceeds from the issuance of preferred stock and warrants that was allocated to the par value of preferred stock (\$7,218) from permanent equity to temporary equity.

### *February 2006 Restatement of Financial Statements*

On February 3, 2006, our chief executive officer and chief financial officer, in consultation with the audit committee of the board of directors, concluded that the previously issued controls and procedures disclosure on Form 10-QSB/A for the quarter ended March 31, 2005 should be amended for the reasons set forth below.

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The registration process has involved significant technical discussions with several accounting, regulatory and valuation experts. In our prior Form 10-QSB/A we disclosed a deficiency in internal control over financial reporting related to the need for additional qualified financial and accounting personnel. This deficiency was a result of our entering into the series of transaction that resulted in public reporting of operations without personnel with public reporting experience. In the process of discussions with regulatory experts, we determined to revise our internal control disclosure to note our controls were ineffective for the reasons previously disclosed and to include more specifics as to the nature of the deficiency and our plans and timeframe for curing the deficiency.

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Also, in view of this amendment, we have taken the opportunity to make certain other conforming changes to the Financial Statements. In 2005, we began reporting our operations under two operating segments and, consequently, adopted the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. As a result, the disclosures in Note 10 have been expanded to conform to the provisions of SFAS No. 131 regarding segment presentation. Finally, as a result of our recapitalization transaction effectuated on February 11, 2005 (see Note 2 to the Financial Statements) and discussions with regulatory experts we have reclassified certain amounts from retained earnings to paid-in capital.

We have also updated the notes to the financial statements for two subsequent events. One is a consulting arrangement entered into by the registrant for which it is anticipated payment will be made in the form of issuance of registrant's common stock in an amount equal to 3.5% of the outstanding common and preferred stock of the registrant immediately following the February 2005 merger. We are in the process of reaching a definitive agreement with respect to the consulting arrangement. The second subsequent event was the settlement of litigation relating to the merger. See Note 5 to the Financial Statements for more information on these subsequent events.

### *General*

The adjustments reflected in the restated financial statements do not affect net income or cash flows.

As a result of the need to restate our financial statements for the quarter ended March 31, 2005, we have again amended our Form 10-QSB for that period. Furthermore, we have restated our assessment of the effectiveness of our controls and procedures for the first quarter.

### *Changes in Internal Control over Financial Reporting*

Other than as stated above, there were no other changes in the Company's internal control over financial reporting that occurred during the period ended March 31, 2005, that have materially affected and are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

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

#### Integrated Tek Solutions Lawsuit

As previously disclosed in a Current Report on Form 8-K dated April 22, 2005 and in our quarterly report on Form 10-QSB for the quarter ended March 31, 2005, on April 4, 2005, Integrated Tek Solutions, Inc. filed a lawsuit against us in the Supreme Court of the State of New York, County of New York, alleging breach of contract, fraud, negligent misrepresentation and promissory estoppel. We received notice of the suit on April 14, 2005. The action arose out of a letter of intent pursuant to which a predecessor to the plaintiff, Yasup, LLC, and a predecessor to us,

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Computer Software Innovations, Inc., a South Carolina corporation ( CSI South Carolina ) conducted negotiations relating to a potential acquisition of CSI South Carolina s capital stock by Yasup, LLC.

Subsequent to the filing of our Form 10-QSB for the first quarter, we received an Amended Complaint on June 3, 2005, which added several new defendants. Some of our officers and directors were named as individual defendants in the suit. These included Nancy K. Hedrick, CEO and Director; Joe G. Black, former CFO; Thomas P. Clinton, Vice President of Sales and Director; Beverly N. Hawkins, Secretary and Vice President of Support Services; and William J. Buchanan, Treasurer and Vice President of Engineering. Ms. Hedrick and Ms. Hawkins and Messrs. Black, Clinton and Buchanan were also officers, directors and the shareholders of CSI South Carolina. Other defendants in the suit were Alan Marrullier, The Geneva Companies, Inc., Capital Access Group LLC, Barron Partners LP, Liberty Capital LLC, Andrew Worden, Philip Seifert, Ned Gelband and Lee Haskin, against whom allegations of tortious interference with contractual relations, aiding and abetting a fraud, and breach of contract were asserted. The Amended Complaint sought damages up to \$60 million in total.

Several of our officers and directors were named as individual defendants in the lawsuit. Accordingly, the potential existed for conflicts of interest between those officers and directors and the Company. In order to avoid potential conflicts of interest that may arise, the board of directors felt that it was in our best interest to create a special litigation committee comprised of outside directors who were not named in the lawsuit, namely Anthony H. Sobel, Thomas V. Butta and Shaya Phillips. The special litigation committee, formed on July 8, 2005, was delegated the authority to manage the litigation. Furthermore, the special litigation committee retained independent counsel to represent it with respect to the Integrated Tek Solutions, Inc. matter.

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On August 15, 2005, we filed and served responsive pleadings consisting of a Verified Answer, Defendants' First Request for Production and Deposition Subpoenas. Other parties had pending motions.

In connection with August 15, 2002 and February 6, 2003 agreements between CSI - South Carolina and The Geneva Companies, Inc., we undertook the defense of The Geneva Companies, Inc. and Alan Marullier in the New York litigation effective October 28, 2005. The defense involved additional expense to us, although such expense was not significant. Our special litigation committee monitored this relationship in order to take appropriate action if a conflict developed.

As explained above, we undertook the defense of our officers and directors individually named in the lawsuit. We also advanced expenses to them. In accordance with Delaware law, those officers and directors executed an Undertaking and Affirmation pursuant to which the officers and directors agreed to repay any expenses advanced or indemnification paid with respect to the lawsuit if it is ultimately determined that the advancement of expenses or indemnification was improper under Delaware law.

On December 28, 2005, the suit was settled by all parties involved. As part of the settlement, the plaintiff released all claims against all defendants in exchange for payment of \$600,000. The Company contributed \$200,000 toward this payment with each of the five individual current and former officers of the Company contributing \$20,000 each. The remaining \$300,000 was paid by the other defendants in the suit. Although the Company maintained the suit was without merit, the Company believed the settlement to be prudent in view of the cost of continuing litigation. None of the portion of the settlement payment made by the Company was covered by any of the Company's insurance policies.

**Item 6. Exhibits**

**Exhibit**

<b>Number</b>	<b>Description</b>
31.1	Statement of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Statement of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a).
32.1	Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.
99.1	Waiver letter agreement between the Company and RBC Centura Bank dated May 19, 2005 (previously filed in the Computer Software Innovations, Inc. Form 10-QSB filed on May 20, 2005).

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**SIGNATURES**

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

COMPUTER SOFTWARE INNOVATIONS, INC.

Date: February 14, 2006

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

Date: February 14, 2006

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

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