

COMPUTER SOFTWARE INNOVATIONS INC  
Form 10QSB/A  
March 30, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB/A**

(Amendment No. 2)

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(Mark One)

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

For the quarterly period ended June 30, 2006.

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

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

Commission file number 000-51758

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**COMPUTER SOFTWARE INNOVATIONS, INC.**

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

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Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

900 East Main Street, Suite T  
Easley, South Carolina 29640

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

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(864) 855-3900

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

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

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

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

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

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

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**EXPLANATORY NOTE**

Computer Software Innovations, Inc. (the Company) is filing this Form 10-QSB/A (Amendment No. 2) to amend and expand certain discussions relating to changes in the relevant periods in our internal control over financial reporting. Specifically, we have revised and added disclosure in Item 2. Management's Discussion and Analysis or Plan of Operation Current Challenges and Opportunities of our Business, and Forward-Looking Information Processes and Procedures, and in Item 3. Controls and Procedures.

On October 30, 2006, we filed an amendment No. 1 to our original Form 10-QSB for the periods ended June 30, 2006, in order to restate relevant financial statements. We have not updated 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 August 14, 2006, except for certain disclosures relating to such restatement and post-filing developments relating to internal controls over financial reporting and disclosure controls and procedures.

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

#### **Introduction**

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

#### **Overview**

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

#### *Strategy*

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

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

#### **2005 Reverse merger**

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

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

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

#### *Processes and Procedures*

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

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

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

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

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

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

Our latest assessment of our controls has identified that a deficiency remains as to having sufficient resources to fully review our compliance with all areas of financial disclosure on a timely basis. We are a small public company and our resources available to dedicate to any administrative areas of the business, including compliance, have been limited. Based on our CFO's experience, we have determined it will be necessary to automate our review process. Automation is required to cost-effectively address the deficiency with regard to our inability to adequately review and document compliance with all controls and procedures to assure all are performed consistently and on a timely basis. Without an automated process, a series of multiple checklists for various processes and master checklists to assure the multiple checklists and related steps are completed by various levels of review and reviewers, is required. Such a process is tedious and requires significant effort and resources. It can become particularly difficult when a technical or complex issue or the necessity for additional analytic review requires extra research time or attention within the timeframe allowed to produce and file financial information and



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disclosures. In addition to cost-effectively improving the internal consistency of the execution and monitoring of controls and processes on a timely basis, we believe automation will significantly reduce the time, effort and cost required for our external auditors to audit the controls and processes. Accordingly, in the first six months of 2006 we have spent our time focused on documentation of existing controls pending the completion of our evaluation of options for automating existing controls and their review. We have chosen this course rather than focusing on looking specifically for areas for enhancements, particularly as we may not have sufficient resources to cost-effectively assure that any proposed enhancements are executed. Also, any such proposed enhancements may be rendered unnecessary with automation. We expect to complete our evaluation of automation options and select a solution in late 2006 or early 2007.

We have moved forward with our initial work surrounding the implementation of the Sarbanes-Oxley Act. This has included an assessment of risk in financial reporting and the creation of a documentation and evaluation framework for a significant portion of our business, under consultation with an independent public accounting firm. This review has not identified any other areas of significant deficiency other than as to our ability to document and review for consistent execution of financial disclosure controls, except as to those previously remediated as noted above and in our prior filings. We have budgeted \$200,000 for compliance work by external parties related to the Sarbanes-Oxley Act for the fiscal year 2006 and to thereafter complete a portion of testing. In the first six months we spent approximately \$100,000 on external resources to support this initial effort. We plan to use the established framework to perform much of the documentation and initial evaluation effort with internal staff over the next quarter or two to minimize our costs, while still moving forward in our effort to improve our internal controls work, and to avoid additional third-party costs while we monitor the SEC's reaction to the recommendations of the Advisory Committee. In the second quarter we used internal staff and an intern resource to continue our Sarbanes-Oxley compliance work. We will likely use some external resources in the third and fourth quarters. At this time, we plan to stay within our budget in 2006 for this work.

Based on our initial review of options for automation, we anticipate that the amount of spending on automation in 2006 will fit within the remaining \$100,000 in our budget. However, a portion may be spent as capital expenditures for the purchase and implementation of software rather than as expense. With the support of automation, we anticipate spending approximately the same amount (\$200,000) in 2007 to address our deficiency with regard to sufficient, timely review of our compliance and complete our implementation of the Sarbanes-Oxley Act requirements.

### *Establishment of a Telesales Department*

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

### *Software Modifications Required by Geographic Expansion*

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



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

We have already completed the conversion of the majority of our core accounting modules. The completed modules are in formal beta installations; however, the changes we are having to make as a result of the formal beta use have been limited, and we are prepared to install the completed modules in any entities which do not have an immediate need for other integrated modules not yet converted. In addition, the completed modules have the functionality necessary to handle school activity funds, such as student clubs, organizations and athletics. Many school activity personnel use packages independent of the school's accounting packages, which may be cumbersome, or lack functionality. Accordingly, we are beginning to look for sales opportunities of the completed modules now, marketed as our School Activity solution. And if the school later adopts our full accounting suite, the process of integration will be relatively seamless. We anticipate completing additional modules in 2006, and as previously noted under Software Modifications Required by Geographic Expansion above, we anticipate completing the remaining modules throughout 2007.

### *Maintaining Margins*

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

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

### *Continued Improvement of Support Solutions*

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

### *Investment in Support and Telesales Efforts*

Over the next year we will be making an investment (estimated to be as much as \$500,000, of which less than \$100,000 was spent in the first six months of 2006), consisting primarily of increased salaries and wages to support the additional technical support services and telesales efforts. Based on our past experience with prospecting and technical support agreements, we expect the additional revenue generated from the sales of technical support contracts and additional sales opportunities uncovered by telesales efforts for the fund accounting software and the new curriculum standards based lesson planner software will be sufficient to offset our investment within approximately one year, but we can give no assurances such additional services will be profitable collectively, particularly in the short-term. In addition, effective January 1, 2006 we reorganized our sales force. Previously, our primary sales personnel were assigned to either sell products in our software applications segment or in our technology solutions segment, but not both. We had potentially two persons, a software specialist and a technology specialist, calling on every organization, many times talking to different people within the same

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organization, and no opportunity for a single salesperson to be in touch with all of the needs of the organization. Due to an increase in the experience and quality of our sales personnel, and our ongoing efforts to educate them about our product offerings, our sales personnel are now able to maximize their contacts by discussing both software and technology in each visit to the customer. As a result, we have been able to reduce the size of salespersons' territories and allow them to reduce drive time, freeing them up to make more calls, sell across a broader range of solutions and identify additional opportunities. We back the sales personnel with product specialists and engineering support as necessary. We believe this realignment has improved the effectiveness of our sales force and will translate into deeper customer penetration and relationships. We anticipate greater sales and reduced costs per salesperson over time as more opportunities are identified and closed; however, we are unable to estimate the financial impact of these changes.

### *Expanded Market Opportunities*

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

### *Re-branding*

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

### *Developing Customer Relationships in New Regions*

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

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

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### *Challenges to Technology and Software Budgets*

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

## **Earnings Guidance**

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

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

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

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

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

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

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

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

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

### *Warrant accounting*

In the first six months of 2006, we experienced a significant increase in net income driven by the recording of warrant losses of more than \$3 million dollars in the first and second quarters of 2005, which did not recur in 2006 due to a renegotiation of the warrant related registration

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rights agreement in November 2005. For the six months ended June 30 2005, there was an approximate loss of \$3,193,000 related to the warrants. The first and second quarter increases in net income in 2006 compared to 2005 will likely be offset in the third and fourth quarters of 2006 since the loss in the first and second quarters of 2005 was substantially offset by gains recorded in the third and fourth quarters of 2005, prior to the renegotiation of the registration rights agreement.

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### *E-Rate Program*

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

The E-Rate program assists both schools and libraries in the United States to obtain affordable telecommunications and internet infrastructure and access. The program provides federally subsidized funding based on the level of poverty and the urban/rural status of the population served and ranges from 20% to 90% of the costs of eligible services. The Company has participated in this program in the past, typically winning total contract awards in the \$4 to \$5 million dollar range during the last several years. In late 2005, as a result of our additional investments in software and personnel, we improved our ability to respond to proposals under the program. As a result, for the annual fall 2005 to spring 2006 E-Rate window, we have been awarded more than \$15 million in contracts.

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

### *Engagement of Investor Relations Firm*

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

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

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

## **Organization**

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

### *Software applications segment*

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

General (or Fund) Ledger;

Accounts Payable;

Purchasing;

Payroll;

Personnel;

Employee Absence/Substitutes;

Inventory;

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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.

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

*Technology solutions segment*

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

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

Hardware/software installations;

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

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

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

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

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

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

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

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

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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.

### **Acquisitions**

We believe that to remain competitive, we need to take advantage of acquisition opportunities that arise which may help us achieve greater geographic presence and economies of scale. We may also utilize acquisitions to whenever appropriate expand our technological capabilities and product offerings. While we may use a portion of any cash proceeds to pay down debt on an interim basis, we intend to use any additional liquidity and/or availability of assets generated by the paydown and



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remaining proceeds to fund acquisitions. Additionally, we are in the process of engaging a consultant to assist us with acquisitions, including identifying potential acquisition opportunities. We believe our markets contain a number of attractive acquisition candidates. We foresee expanding through acquisitions of one or more of the following types of technology organizations:

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

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

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

Cabling and infrastructure contractors. We currently outsource cabling services.

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

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

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

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

a reduction in anticipated sales;

an inability to perform customer contracts at anticipated cost levels;

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

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

an economic downturn; and

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

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

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

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

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

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

### **Overview of Financial Performance**

Our revenues improved approximately \$3.4 million or 46.6% for the 2006 second quarter compared to the same period of the prior year due to increases in both technology solutions and software applications sales. For the six month period ended June 30, 2006 our revenues increased by approximately \$4.2 million, or 36.5%, compared to the same period in the prior year.

The gross profit for the quarter decreased by \$341,171 or 13.4%, and for the six months improved by \$4,741, or 0.1%. The gross margin percentage was 20.5% and 34.8% for the quarters ended June 30, 2006 and 2005, respectively. The gross margin percentage was 23.8% and 32.4% for the six months ended June 30, 2006 and 2005, respectively. The overall decrease in margin for the quarter was attributed to a decline in hardware margins, partially offset by improvements in the software margins. The improvement in software margins for the quarter came from an increase in new software sales and related services, while costs remained flat over the prior year. Total personal computer sales both as reseller and agent declined slightly resulting in decreased gross profit from reduced commissions. The decrease in margins for the quarter on the hardware side also came from increased competitive pressure in the market place for hardware in general, partially offset by a slight improvement in gross profit from engineering services.

The increase in gross profit for the six months ended June 30, 2006 was attributed to the increase in both software and hardware gross profits driven by the corresponding increases in revenues of both segments in the first quarter, substantially offset by a decline in gross profit of 13.4% in the second quarter of 2006. The overall decrease in margin percentage can be attributed to the decrease in hardware margins due to reduced computer systems commissions and increased competition in the hardware space. These factors were partially offset by sales of higher margin engineering services and the improvement in software margins resulting from the increase in new software sales and support coupled with a decrease in the number of implementations requiring purchased third party software components for the first quarter of 2006.

Operating income declined from the year ago quarter by \$582,065 or 46.4% and declined for the six months by \$59,188, or 28.8%. The decrease in the second quarter was largely attributed to the decrease in gross profit, coupled with slight increases across various operating expenses. The decline over the six month period was primarily attributed to increased operating salaries, professional and legal and compliance costs and increases in various other operating expenses, offset by the non-recurrence in 2006 of expenses in 2005 related to the reverse merger. An increase in gross profit of the software applications segment was substantially offset by lower hardware margins and slight increases in operating expenses for the same period of time. Further analysis of financial performance is discussed below in subsequent sections of this report.

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

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



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	Three Months Ended		
	June 30, 2006	June 30, 2005	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 10,701,697	\$ 7,298,428	\$ 3,403,269
<b>GROSS PROFIT</b>	2,196,700	2,537,871	(341,171)
<b>OPERATING INCOME</b>	673,752	1,255,817	(582,065)

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

<b>Gross Profit:</b>			
Sales			\$ 3,403,269
Cost of sales excluding depreciation, amortization and capitalization			(3,908,615)
Depreciation and Amortization			(117,828)
Capitalization of Software Costs			282,003
			(341,171)
<b>Operating Expenses:</b>			
Salaries, wages and benefits			(120,850)
Reverse acquisition costs			
Stock based compensation			(81,258)
Professional and legal compliance and litigation related costs			132,095
Marketing costs			(59,952)
Travel and mobile costs			(59,647)
Depreciation			(26,741)
Other SG&A expenses			(24,541)
			\$ (582,065)

**Revenue**

Total sales in the second quarter of 2006 increased \$3,403,269 in comparison with the second quarter of 2005. This net increase includes a \$3,099,303 increase in hardware sales and services through the technology solutions segment and a \$303,966 increase in software sales and services through the software solutions segment.

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

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

**Gross Profit**

Gross profit in the second quarter of 2006 decreased \$341,171, or 13.4%, in comparison with the second quarter of 2005. The gross margin percentage was 20.5% and 34.8% for the quarters ended June 30, 2006 and 2005, respectively. The overall decrease in gross profit can be attributed to a decline in hardware gross profit of 33.6%, offset in part by improvements in the software gross profit of approximately 46.2%. Total personal computer sales both as reseller and agent declined, resulting in decreased gross profit from reduced commissions. The decrease in margins on the hardware side also came from increased competition in the hardware market partially offset by more profitable engineering services. The improvement in software margins came from an increase in new software sales and related services, while costs remained flat over the prior year.



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### **Operating Expenses**

Operating expenses increased \$240,894, or 18.8%, in the second quarter of 2006 compared to the second quarter of 2005. The above table analyzes the major items that account for this increase. The majority of the increase, approximately \$121,000, was related to increased salaries, wages and benefits primarily due to the increase in sales force. Following is a brief explanation of the other operating expenses and the related impact in the second quarter.

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

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

*Professional and legal compliance and litigation related costs* decreased in second quarter 2006, over second quarter 2005 by \$132,095. A significant amount of this decrease was related to reduced registration costs and litigation expenses related to the reverse merger, partially offset by increased costs associated with ongoing compliance, primarily the costs associated with the issuance of our first formal annual report and proxy during the second quarter. While the costs associated with the reverse merger and registration are likely to decrease in future periods, we anticipate that the audit fees and Sarbanes-Oxley related costs will continue.

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

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

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

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

### **Operating Income**

Operating income declined from the year ago quarter by \$582,065 or 46.4%. The decrease in the second quarter was largely attributed to the decrease in gross profit, coupled with increases in operating expenses. The decrease in gross profit was attributed to a decline in hardware gross profit, offset by improvements in the software gross profit, while operating expenses increased across various accounts as discussed above.

**Table of Contents****Segment information**

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

*Software applications segment*

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

	Three Months Ended		
	June 30, 2006	June 30, 2005	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 1,446,005	\$ 1,142,039	\$ 303,966
<b>GROSS PROFIT</b>	936,873	640,637	296,236
<b>SEGMENT INCOME (LOSS)</b>	341,341	145,768	195,573

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

<b>Gross Profit:</b>			
Sales			\$ 303,966
Cost of sales excluding depreciation, amortization and capitalization			(191,835)
Depreciation and Amortization			(97,898)
Capitalization of Software Costs			282,003
			296,236
<b>Operating Expenses:</b>			
Salaries, wages and benefits			(17,696)
Other SG&A expenses			(82,967)
			\$ 195,573

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

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

*Technology solutions segment*

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





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	Three Months Ended		
	June 30, 2006	June 30, 2005	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 9,255,692	\$ 6,156,389	\$ 3,099,303
<b>GROSS PROFIT</b>	1,259,827	1,897,234	(637,407)
<b>SEGMENT INCOME</b>	501,877	1,330,352	(828,475)

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

Gross Profit:		
Sales		\$ 3,099,303
Cost of sales excluding depreciation		(3,716,780)
Depreciation		(19,930)
		(637,407)
Operating Expenses:		
Salaries, wages and benefits		(200,674)
Other SG&A expenses		9,606
		\$ (828,475)

Hardware sales increased over second quarter 2005 by \$3,099,303, or 50.3%, due to increases in new hardware sales, support agreement revenues and third party service agreement revenues, partially offset by a decrease in hardware commissions. The increase in new hardware sales and decrease in hardware commissions is attributed to large dollar sales of computer systems and peripherals, where CSI purchased the hardware and acted as reseller rather than agent. Depending on the circumstances, which may include funding, financing costs, deal size, bid or other sales processes and considerations, CSI acts as agent on computer system sales in which case the only revenue recorded is the commissions. The results from these deals are partially seen in the increase in hardware sales and resulting increase in the costs of purchased components. Total personal computer sales both as reseller and agent declined, resulting in decreased gross profit from reduced commissions. The net impact on gross profit is approximately the same whether we act as reseller or agent. Increased competition in the hardware markets in general affected pricing, which impacted margins. The increases were partially offset by higher margin engineering services. The significant increase in cost of sales excluding depreciation is the result of the previously mentioned deals, as well as increases in salaries related to technical delivery and travel and mobile costs.

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

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

	Software	Technology	Total
	Applications	Solutions	Company
Quarter ended June 30, 2006:			
Net sales and service revenue	\$ 1,446,005	\$ 9,255,692	\$ 10,701,697
Gross profit	936,873	1,259,827	2,196,700
Segment income	341,341	501,877	(*)
Segment assets	3,252,591	7,831,272	11,083,863
Quarter ended June 30, 2005:			
Net sales and service revenue	\$ 1,142,039	\$ 6,156,389	\$ 7,298,428
Gross profit	640,637	1,897,234	2,537,871
Segment income	145,768	1,330,352	(*)
Segment assets	2,464,276	5,951,094	8,415,370

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\* See reconciliation below

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

	Quarter Ended	
	June 30, 2006	June 30, 2005
<b>Segment income:</b>		
<b>Software applications segment</b>	\$ 341,341	\$ 145,768
<b>Technology solutions segment</b>	501,877	1,330,352
<b>TOTAL SEGMENT INCOME</b>	843,218	1,476,120
<b>Less: Merger and compliance costs</b>		
Stock based compensation	(81,258)	
Professional and legal compliance and litigation related costs	(88,208)	(220,303)
<b>OPERATING INCOME Per consolidated Statements of Operations</b>	<b>\$ 673,752</b>	<b>\$ 1,255,817</b>
<b>Interest and Other Income and Expenses</b>		

Interest expense increased approximately \$19,000 in the second quarter of 2006 compared to the second quarter of 2005 due to the additional interest costs incurred related to the RBC notes payable and additional interest paid to the five original shareholders and Barron as a penalty for being in default on the notes payable associated with the reverse merger transactions. A material decrease in other income and expenses occurred related to the unrealized loss on warrants recorded in 2005 which did not recur in 2006. In the second quarter of 2005, CSI recognized a non-cash loss related to the accounting for the warrants of approximately \$108,000 (\$65,000 net of tax) due to a decrease in the market value of the warrants based on the Black-Scholes valuation method. While this item does not have a significant impact on the second quarter 2006, the warrant loss in the first quarter of 2005 and gains in the third and fourth quarters of 2005 will have significant effect on comparability in the third and fourth quarters of 2006. As a result, CSI's net income to be reported in the third and fourth quarters of 2006 will likely be significantly below that of the prior year taking into consideration the non-cash gains recorded in 2005 associated with the warrants.

**Income Taxes**

Income taxes decreased by \$304,559, or 63.2%, in the second quarter of 2006 compared to the second quarter of 2005. The decrease was due to the tax impact of the decline in gross profit of approximately \$341,000 and the decrease in operating income of approximately \$582,000, partially offset by a reduction of other expenses as a result of having no loss associated with the warrants in 2006.

**Net Income and Earnings per Share**

Net income decreased \$187,814, or 32.0%, to \$400,776 for second quarter 2006. The decrease in net income resulted from the reduction in hardware margins and increased operating expenses, which were partially offset by the increase in software margins, the absence of reverse acquisition costs, the reduction in professional and legal compliance and litigation costs and the absence of the unrealized loss on the warrants.

Basic earnings per share declined from \$0.22 in the second quarter 2005 to \$0.12 in the second quarter of 2006, while diluted earnings per share declined slightly, from \$.05 per share in second quarter 2005 to \$0.04 per share in 2006. This unfavorable decline resulted from the downward pressure on margins and increased operating expenses, partially offset by the absence of the \$108,267 unrealized loss on warrants as previously discussed. The additional preferred stock, warrants and employee held options issued in connection with the merger in February 2005 were included in the calculation of diluted earnings per share for second quarter 2005 and 2006. See Note 2 to the financial statements for additional discussion surrounding the calculation of earnings per share.

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

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



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	June 30,	Six Months Ended June 30,	Increase
	2006	2005	(Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 15,544,101	\$ 11,390,732	\$ 4,153,369
<b>GROSS PROFIT</b>	3,700,307	3,695,566	4,741
<b>OPERATING INCOME</b>	146,340	205,528	(59,188)

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

## Gross Profit:

Sales			\$ 4,153,369
Cost of sales excluding depreciation, amortization and capitalization			(4,253,252)
Depreciation and Amortization			(157,893)
Capitalization of Software Costs			262,517

4,741

## Operating Expenses:

Salaries, wages and benefits			(289,674)
Reverse acquisition costs			759,283
Stock based compensation			(64,038)
Professional and legal compliance and litigation related costs			(210,585)
Marketing costs			(149,856)
Travel and mobile costs			(79,866)
Depreciation			(49,173)
Other SG&A expenses			19,980

\$ (59,188)

**Revenue**

Our revenues for the first six months of 2006 were \$15,544,101, \$4,153,369 or 36.5% higher than the first six months of 2005. The change resulted from the increase in sales for the first quarter of \$750,100 over the prior year period coupled with a \$3,403,269 increase in the second quarter. Technology solutions segment sales of internet-protocol based telephony equipment, instructional hardware, computer systems and printing and fax machines increased substantially through the first and second quarters. In addition, increases in engineering service revenues, technology support revenues and third party service agreement revenues contributed to the increase but were partially offset by a decrease in hardware commission revenues. The increase in the hardware product revenues was related to large computer system sales which occurred in the second quarter of 2006. In connection with these sales, CSI purchased the hardware and acted as reseller rather than agent.

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

**Gross Profit**

Gross profit was \$3,700,307 for the first six months of 2006, an increase of \$4,741 or 0.13% over the same period of the prior year. The gross margin was 23.8% for the first six months of 2006 versus 32.4% for the same period of 2005. The increase in gross profit was attributed to the increase in both software and hardware gross profits driven by the corresponding increases in revenues of both segments in the first quarter, partially offset by a decline in gross profit of 13.4% in the second quarter of 2006. The overall decrease in margin can be attributed to the decrease in hardware margins due to increasing competitive pressures in the hardware space in general, and decreased hardware commissions. These decreases were offset in part by more profitable engineering services in the second quarter 2006 and the improvement in software margins resulting from the increase in new software sales and support coupled with a decrease in the number of implementations requiring purchased third party software components for the first quarter of 2006.



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

### **Operating Expenses**

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

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

*Stock based compensation* represents costs in connection with the issuance of stock awards to non-employee directors and outside consultants in 2006 and the redemption of options in 2005. Subsequent to the end of the first quarter 2005, our board of directors approved a new plan for the award of stock-based compensation to employees, directors and consultants. The new plan provides for the award of options, restricted stock or stock appreciation rights at the discretion of the compensation committee of the board of up to an aggregate of 1,100,000 shares. In February and March of 2006, the compensation committee of the board of directors reached a definitive agreement as to the terms surrounding compensation related to the reverse merger, and awarded our outside directors 196,992 shares of common stock and awarded outside consultants 344,734 shares of common stock under our 2005 Incentive Compensation Plan. Additionally in June 2006 Jeff Bryson was elected to our Board of Directors and awarded 23,350 shares of common stock under our 2005 Incentive Compensation Plan. Under the terms of the award, 11,675 shares vested immediately upon election and the remaining shares will vest at the conclusion of the 2007 Annual Meeting of Stockholders. The total stock compensation issued in 2006 was \$893,845, of which \$613,954 was earned in 2005 and the first quarter 2006 and \$81,258 was earned in second quarter 2006, leaving \$198,633 as unearned stock compensation at June 30, 2006.

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

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

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

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



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

**Operating Income**

Operating income for the six months ended June 30, 2006 was \$146,340, a decrease of \$59,188 or 28.8% compared to the same period of the prior year. This decrease in operating income was the result of the \$522,877 improvement in the first quarter of 2006 being more than offset by the decrease of \$582,065 in the second quarter of 2006. The overall first half 2006 decline was due to increased sales and improved software margins, offset by reduced hardware margins and increases in: our operating expenses primarily as a result of increases in salaries, wages and benefits; professional and legal compliance costs; marketing costs; travel and mobile costs; and depreciation and amortization.

**Segment information***Software applications segment*

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

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

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

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

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



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

	Six Months Ended		
	June 30,	June 30,	Increase
	2006	2005	(Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 12,994,024	\$ 9,261,944	\$ 3,732,080
<b>GROSS PROFIT</b>	2,121,251	2,515,006	(393,755)
<b>SEGMENT INCOME</b>	761,645	1,520,797	(759,152)

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

Gross Profit			
Sales			\$ 3,732,080
Cost of sales excluding depreciation			(4,093,600)
Depreciation			(32,235)
			(393,755)
Operating Expenses			
Salaries, wages and benefits			(163,799)
Other SG&A expenses			(201,598)
			\$ (759,152)

Technology solutions segment sales increased by \$3,732,080, or 40.3% in the first six months of 2006 over the same period in 2005. Sales of internet-protocol based telephony equipment, instructional hardware, computer systems and printing and fax machines increased substantially through the first and second quarters. In addition, increases in engineering service revenues, technology support agreement revenues and third party service agreement revenues contributed to the increase but were partially offset by a decrease in commission revenues. The increase in the hardware product revenues was related to large dollar computer system sales which occurred in the second quarter of 2006. In connection with these sales, CSI purchased the hardware and acted as reseller rather than agent. The significant increase in cost of sales, excluding depreciation, was primarily the result of the sales of computer systems as reseller rather than agent. Such sales represented approximately 70% of the increase, with the remainder due to increases in salaries related to technical delivery and travel and mobile costs.

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

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

	Software Applications	Technology Solutions	Total Company
Six months ended June 30, 2006:			
Net sales and service revenue	\$ 2,550,077	\$ 12,994,024	\$ 15,544,101
Gross profit	1,579,056	2,121,251	3,700,307
Segment income	510,795	761,645	(*)
Segment assets	3,252,591	7,831,272	11,083,863
Six months ended June 30, 2005:			
Net sales and service revenue	\$ 2,128,788	\$ 9,261,944	\$ 11,390,732
Gross profit	1,180,560	2,515,006	3,695,566
Segment income	343,257	1,520,797	(*)
Segment assets	2,464,276	5,951,094	8,415,370

\* See reconciliation below

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

	Six Months Ended	
	June 30,	June 30,
	2006	2005
<b>Segment income:</b>		
<b>Software applications segment</b>	\$ 510,795	\$ 343,257
<b>Technology solutions segment</b>	761,645	1,520,797
<b>TOTAL SEGMENT INCOME</b>	1,272,440	1,864,054
<b>Less: Merger and compliance related costs</b>		
Stock based compensation	(695,212)	(631,174)
Payroll tax expenses in Other selling, general and administrative costs related to stock option compensation from stock option redemption in connection with merger		(47,766)
Reverse acquisition costs		(759,283)
Professional and legal compliance costs	(430,888)	(220,303)
<b>OPERATING INCOME Per Statement of Operations</b>	<b>\$ 146,340</b>	<b>\$ 205,528</b>
<b>Interest and other income and expenses</b>		

Interest income decreased by approximately \$3,000 due to the Company only receiving interest on overnight invested funds related to the RBC line of credit in 2006, while the Company received interest income from approximately \$3 million held in a money market account for the first portion of the first quarter in 2005. Interest expense increased \$98,755 in the first six months of 2006 compared to the first six months of 2005 due to the additional interest costs incurred related to the RBC notes payable and additional interest paid to the five original shareholders and Barron on the notes payable associated with the reverse merger transactions. A material decrease in other income and expenses occurred related to the unrealized loss on warrants recorded in 2005 which did not recur in 2006. In the first half of 2005, we recognized a non-cash loss related to the accounting for the warrants of approximately \$3.2 million (\$1.9 million net of tax) due to a decrease in the market value of the warrants based on the Black-Scholes valuation method. Accordingly, the six month 2006 improvement is significant in comparison to the loss in the prior year's first quarter; however, the warrant loss in the first six months of 2005 was offset by significant gains in the third and fourth quarters of 2005. As a result, CSI's net income to be reported in the third and fourth quarters of 2006 will likely be significantly below that of the prior year taking into consideration the non-cash gains recorded in the 2005 third and fourth quarters associated with the warrants.

**Income Taxes**

Income taxes increased by approximately \$1.2 million, or 97.7%, in the first six months of 2006 compared to the first six months of 2005. The increase was due to the reduction in operating income and more significantly, the absence in 2006 of the tax effect, approximately \$1.3 million, of the \$3.2 million loss associated with the warrants in 2005.

**Net Income (Loss) and EPS**

The net loss of \$1,860,853 in the first six months of 2005 improved by \$1,832,099, or 98.5%, compared to the net loss of \$28,754 for first six months of 2006. The reduced loss was due primarily to the absence of the unrealized loss on the warrants which occurred in 2005, coupled with the slight increase in gross profit and decrease in operating income.

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

**Liquidity and Capital Resources**

Cash increased from \$0 at December 31, 2005 to \$334,310 at June 30, 2006, due primarily to changes in current asset and liability account balances of \$960,549 and financing activities of \$506,428, offset by the net loss of \$28,754 adjusted for non-cash items, and cash used for investing activities of \$1,132,667.

*Cash from Operating Activities*

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

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

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

*Cash from Investing Activities*

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

*Cash from Financing Activities*

Cash provided by financing activities netted to \$506,428 in the first six months of 2006 compared to cash used of \$2,014,318 in the first six months of 2005. The increase of \$2,520,746 is due primarily to the absence of activities related to the reverse acquisition in 2005 and the incurrence of a \$400,000 term loan with RBC Centura bank in 2006.

**Credit Arrangements**

During the first quarter of 2005, in order to support the activities of the reverse acquisition, the Company entered into a \$3,000,000 line of credit facility whereby the Company can borrow up to 80% of accounts receivables balances, not to exceed the total facility limit of \$3,000,000. In the first quarter of 2006, this facility was renewed with an increased limit of \$3.5 million. Eligible accounts receivable balances essentially include all of our trade accounts receivable except, in most cases, for those accounts which are more than 90 days past due. Certain other accounts are excluded from eligibility for borrowing including: (i) such accounts due from affiliates; (ii) accounts which we have determined to be of doubtful collectibility; and (iii) accounts due from any one of our customers if such accounts constitute more than 20% of the total eligible accounts. Immediately upon entering into the loan agreement in 2005, the Company borrowed \$1,500,000 which was used for the paydown of a

portion of the subordinated notes issued in connection with the merger. The loans bear interest at

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Libor plus 2.75%, (7.86% at June 30, 2006), payable monthly. The original facility matured on July 15, 2006, following short-term extensions to align the renewal period to follow the Company's annual reporting and meeting time frames. On July 14, 2006, the Company executed a modification agreement extending the maturity date of the facility from July 15, 2006 to July 15, 2007. The modification agreement also increased the principal amount of the facility from \$3.0 million to \$3.5 million. The reason for the increase in principal is to support increasing working capital requirements of the Company.

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

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

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

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

Although adequate availability existed under our bank credit facility to repay in full the subordinated notes on the May 10, 2006 maturity date, neither we nor the note holders believed it to be in our best interests. First, we believed that draws under the credit facility to repay the subordinated notes may have left inadequate availability to support our working capital needs for the remainder of the year. Secondly, and more importantly, the subordinated debt is counted as equity in the calculations of the minimum tangible net worth requirement with the bank. Utilization on May 10, 2006 of the bank credit facility to repay the subordinated notes would probably place us in violation of the minimum tangible net worth covenant at the next covenant test date of December 31, 2006. Looking forward, we believe it is unlikely that we will be able to generate sufficient net income during 2006 so as to permit repayment of the subordinated notes with draws under the line of credit this fiscal year and still maintain compliance with the minimum tangible net worth covenant.

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

We are currently in negotiations with the subordinated noteholders to extend the maturity of the notes. Such negotiations have also included consideration of the conversion of all or a portion of the subordinated notes to an equity security.



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

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

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

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

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

the amount of operating expenses required to provide our services;

the cost of acquiring and retaining customers; and

our ability to continue to grow our customer base.

### ***Factors Affecting Capital Needs and Resources***

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

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

**Burden of Professional and Legal Compliance Costs.** For the six months ended June 30, 2006, professional and legal compliance and litigation costs, excluding stock-based (non-cash) compensation, totaled \$430,888. These related primarily to compliance costs for the Company's transition to a public company, as well as legal and accounting costs for the registration of shares pursuant to the registration rights agreement.

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Management anticipates that the current level of expenses should abate following the effectiveness of the Company's registration statement with the Securities and Exchange Commission on February 14, 2006. Although the Company is hopeful that costs related to supplementing the registration statement for updated financial and other information will be minimal, there can be no assurances that this will in fact be the case and cost savings realized. Also, the compliance costs associated with public company status are significant.

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

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

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

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

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

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

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

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



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

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

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

expected cash flow from operations;

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

software development costs of \$1.2 million; and

our scheduled debt service.

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

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.

## **Recently Issued Accounting Pronouncements**

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

## Edgar Filing: COMPUTER SOFTWARE INNOVATIONS INC - Form 10QSB/A

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

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This Statement amends FASB No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing

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

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

**Item 3. Controls and Procedures.**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods required by the Securities and Exchange Commission, including, without limitation, those controls and procedures designed to insure that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosures. Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15e and 15d-15e under the Exchange Act) as of the end of the period covered by this report. This evaluation was subsequently modified due to the refinement of the analysis of the items described below. Based on and as of the date of such evaluation, as modified, these officers concluded that our disclosure controls and procedures were not effective for the reasons described in the following paragraphs.

In March 2005, the Public Company Accounting Oversight Board, or PCAOB, defined a significant deficiency as a deficiency that results in more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected, or that a company will be unable to comply with laws and regulations, which includes the timely filing of required reports with the Securities and Exchange Commission. Based upon evaluation under this standard, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were ineffective due to a significant deficiency in our internal controls over the application of existing accounting principles to new public reporting disclosures and particularly related to the application of generally accepted accounting principles to new transactions. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the CFO in consultation with the CEO and the audit committee of the board of directors determined the Company still lacked sufficient internal resources to ensure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis, following its inception of reporting as a public company and hiring of its first CFO with SEC reporting experience. Prior to February 11, 2005, we were a public shell with virtually no operations and had limited need for staff with highly technical accounting and public reporting expertise. In addition, our predecessor, Computer Software Innovations, Inc., a South Carolina corporation (CSI - South Carolina) was a private company and likewise had no need for staff with technical accounting and public reporting expertise. In the first quarter of 2005, we entered into a complex merger and resumed public reporting of significant operations. It was not until May 6, 2005 that we hired a chief financial officer with prior public reporting experience who is accustomed to dealing with more complex accounting matters. As a result, we were unable to file without utilizing extensions and, as previously disclosed, had to amend certain of our financial reports for 2004 and 2005.

We determined that the deficiencies mentioned above would be addressed both through the hiring or engaging of additional resources and implementation of the Sarbanes-Oxley Act requirements, since this implementation could result in identification of additional areas where we may need technical resources. In January 2006 we hired an additional person with public reporting experience and engaged outside technical resources. However, based on our CFO's experience and with an increase in staff, we expect we will receive additional suggestions for improvement in controls during the process of implementing the Sarbanes-Oxley Act. We will be implementing recommendations throughout the process and are unsure of

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whether we will be able to entirely eliminate any possibility of a significant deficiency until we have completed this process. Even so, due to the increasing number and complexity of pronouncements, emerging issues and releases, we expect there will always be some risk related to financial disclosures, albeit mitigated following implementation of the Sarbanes-Oxley Act requirements, which we anticipate will be completed in 2007.

While we hired an additional person and engaged outside technical resources beginning in the first quarter of 2006 to mitigate the risk more complex and highly technical accounting matters would go inadequately addressed, the deficiency remains as to having sufficient resources to fully review our compliance with all areas of financial disclosure on a timely basis. We are a small public company and our resources available to dedicate to any administrative areas of the business, including compliance, are limited. Based on the CFO's experience we have determined it will be necessary to automate our review process to cost-effectively implement the review and documentation of compliance with controls and procedures in order to address the deficiency that we have inadequate resources to do so timely. In addition, such automation will significantly reduce the amount of time, effort and cost needed to test our compliance with our controls and procedures. Accordingly, in the first six months we have spent our time focused on documentation of existing controls pending the completion of our evaluation of options for automating existing controls rather than making significant enhancements for which we may not have sufficient resources to assure are executed. During the documentation process we have not yet identified any other areas of significant deficiency other than as to our ability to document and review for consistent execution of financial disclosure controls, except as to those previously remediated as noted in our prior filings, and as remediated with the increase in our review of calculations for significant amounts in reports as discussed above. For 2006, we budgeted approximately \$200,000 for spending on Sarbanes-Oxley related compliance efforts. In the first six months of 2006 we spent approximately \$100,000 on these efforts. Based on our initial review of options for automation, we anticipate that the amount of spending on automation in 2006 will fit within the remaining \$100,000 in our budget; albeit a portion may be spent as capital expenditures for the purchase and implementation of software rather than as expense. With the support of automation, we anticipate spending approximately the same amount (\$200,000) in 2007 to address our deficiency with regard to sufficient, timely review of our compliance and complete our implementation of the Sarbanes-Oxley Act requirements.

As discussed above, we maintain a system of internal accounting controls that is designed to provide assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and properly recorded. On September 12, 2006, the Audit Committee of our Board of Directors, in consultation with our Chief Financial Officer and Chief Executive Officer, concluded that the previously issued financial statements contained in our quarterly report on Form 10-QSB for the quarter and six months ended June 30, 2006 should not be relied upon due to an error in a transactional report which was used to accrue sales and the associated costs of goods sold in June of 2006. The error occurred despite indiscriminate sample testing of the report calculations during the review process, and corroborative inquiry as to the validity of related operational activity. To mitigate the risk of a similar error occurring in the future, we have implemented a policy to increase report testing including random sampling and a more detailed review of all large dollar amounts. The error was identified, albeit subsequent to the filing of the Form 10-QSB, due to recent improvements surrounding the reporting process which were proposed by the CFO and Board of Directors based on their experience with reporting in other companies. These changes in reporting, although primarily operationally driven, also relate to the Company's continued focus on internal controls. The event described above and its financial impact were previously disclosed in our Form 8-K which was filed with the Securities and Exchange Commission on September 18, 2006.

As a result of the error identified through our review, we have restated our financial statements as of and for the three and six months ended June 30, 2006, as set forth in this report, in order to correct the error in the period in which it originated. The decision to restate was made with the concurrence of Elliott Davis, LLC, our independent registered public accounting firm.

Other than the change in the policy to increase report testing, as described above in this item, and as a result of our decision to focus on documentation and delay the focus on and implementation of systems changes until and in connection with the implementation of automation to support efficient documentation of compliance with existing or improved controls, there were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of such controls that occurred during the three and six month periods ended June 30, 2006 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 6. Exhibits.**

**Exhibit**

**Number Description**

10.1\* Letter Agreement by and between the Company and RBC Centura Bank dated August 10, 2006.





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

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\* Previously filed.

\*\* Filed herewith.

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**SIGNATURES**

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

COMPUTER SOFTWARE INNOVATIONS, INC.

Date: March 30, 2007

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

Date: March 30, 2007

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

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