

COMPUTER PROGRAMS & SYSTEMS INC

Form 10-Q

November 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

For the quarterly period ended September 30, 2006.

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.**

For the transition period from _____ to _____.

Commission file number: 000-49796

COMPUTER PROGRAMS AND SYSTEMS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

74-3032373
(I.R.S. Employer Identification No.)

6600 Wall Street, Mobile, Alabama
(Address of Principal Executive Offices)

36695
(Zip Code)

(251) 639-8100
(Registrant's Telephone Number, Including Area Code)

N/A

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of November 2, 2006, there were 10,754,978 shares of the issuer's common stock outstanding.

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Form 10-Q
(For the period ended September 30, 2006)
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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements.

COMPUTER PROGRAMS AND SYSTEMS, INC.
CONDENSED BALANCE SHEETS

	September 30, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 9,090,385	\$ 11,669,690
Investments	10,573,345	10,231,446
Accounts receivable, net of allowance for doubtful accounts of \$904,000 and \$704,000 respectively	13,875,397	12,413,797
Financing receivables, current portion	1,727,464	1,168,472
Inventories	1,836,126	1,988,184
Deferred tax assets	1,752,421	1,200,637
Prepaid income taxes	52,479	268,321
Prepaid expenses	256,220	265,128
Total current assets	39,163,837	39,205,675
Property and equipment		
Land	936,026	936,026
Maintenance equipment	4,227,037	3,674,200
Computer equipment	6,161,804	5,690,497
Office furniture and equipment	1,863,717	1,626,940
Automobiles	111,394	111,394
	13,299,978	12,039,057
Less accumulated depreciation	(7,115,287)	(5,866,020)
Net property and equipment	6,184,691	6,173,037
Financing receivables	1,845,432	1,605,226
Total assets	\$ 47,193,960	\$ 46,983,938
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 1,384,245	\$ 2,051,195
Deferred revenue	2,896,896	3,285,678
Accrued vacation	2,135,626	1,875,365
Other accrued liabilities	2,203,427	2,685,231
Total current liabilities	8,620,194	9,897,469
Deferred tax liabilities	649,827	698,320

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Stockholders' equity:

Common stock, par value \$0.001 per share; 30,000,000 shares authorized; 10,754,978 and 10,624,901 shares issued and outstanding	10,755	10,625
Additional paid-in capital	22,038,546	20,576,268
Deferred compensation		(72,305)
Accumulated other comprehensive loss	(59,938)	(67,979)
Retained earnings	15,934,576	15,941,540
 Total stockholders' equity	 37,923,939	 36,388,149
 Total liabilities and stockholders' equity	 \$ 47,193,960	 \$ 46,983,938

See accompanying notes.

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COMPUTER PROGRAMS AND SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME (Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Sales revenues:				
System sales	\$ 10,917,361	\$ 12,479,787	\$ 38,648,480	\$ 37,778,628
Support and maintenance	11,763,808	10,981,951	34,360,914	31,688,357
Outsourcing	4,588,978	3,538,715	12,782,847	10,900,497
Total sales revenues	27,270,147	27,000,453	85,792,241	80,367,482
Costs of sales:				
System sales	8,400,956	8,510,674	25,677,480	24,932,499
Support and maintenance	4,960,047	4,863,889	14,908,447	14,101,808
Outsourcing	2,567,496	2,168,685	7,250,184	6,255,241
Total costs of sales	15,928,499	15,543,248	47,836,111	45,289,548
Gross profit	11,341,648	11,457,205	37,956,130	35,077,934
Operating expenses:				
Sales and marketing	2,164,373	1,911,066	6,505,997	5,520,423
General and administrative	4,220,919	3,838,777	13,613,004	13,070,778
Total operating expenses	6,385,292	5,749,843	20,119,001	18,591,201
Operating income	4,956,356	5,707,362	17,837,129	16,486,733
Other income (expense):				
Interest income	308,864	176,779	829,623	431,214
Miscellaneous income				5,306
Total other income	308,864	176,779	829,623	436,520
Income before taxes	5,265,220	5,884,141	18,666,752	16,923,253
Income taxes	1,841,040	2,318,937	7,064,523	6,714,735
Net income	\$ 3,424,180	\$ 3,565,204	\$ 11,602,229	\$ 10,208,518
Net income per share basic	\$ 0.32	\$ 0.34	\$ 1.08	\$ 0.97
Net income per share diluted	\$ 0.32	\$ 0.33	\$ 1.07	\$ 0.96

Weighted average shares outstanding				
Basic	10,752,518	10,603,781	10,736,745	10,540,817
Diluted	10,824,529	10,695,570	10,820,201	10,628,017
Dividends declared per share	\$ 0.36	\$ 0.22	\$ 1.08	\$ 0.66

See accompanying notes.

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COMPUTER PROGRAMS AND SYSTEMS, INC.
CONDENSED STATEMENT OF STOCKHOLDERS EQUITY (Unaudited)

	Common Shares	Common Stock	Additional Paid-in Capital	Deferred Compensation	Accumulated Other Comprehensive Loss	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2005	10,624,901	\$10,625	\$20,576,268	\$(72,305)	\$(67,979)	\$ 15,941,540	\$ 36,388,149
Net Income						11,602,229	11,602,229
Issuance of common stock	153,376	154	314,487				314,641
Forfeiture of restricted stock	(23,299)	(24)	24				
Unrealized loss on available for sales investments, net of tax of \$4,817					8,041		8,041
Share-based compensation			1,020,316				1,020,316
Dividends						(11,609,193)	(11,609,193)
Income tax benefit from stock option exercise			199,756				199,756
Adoption of SFAS No. 123R			(72,305)	72,305			
Balance at September 30, 2006	10,754,978	\$10,755	\$22,038,546	\$	\$(59,938)	\$ 15,934,576	\$ 37,923,939

See accompanying notes.

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COMPUTER PROGRAMS AND SYSTEMS, INC.
CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine months ended September 30,	
	2006	2005
Operating Activities		
Net income	\$ 11,602,229	\$ 10,208,518
Adjustments to net income:		
Provision for bad debt	(148,250)	759,505
Deferred taxes	(605,094)	(161,386)
Stock based compensation	1,020,316	38,280
Excess tax benefit from stock based compensation	(199,756)	882,921
Depreciation	1,449,738	1,289,046
Changes in operating assets and liabilities:		
Accounts receivable	(1,313,350)	(1,967,029)
Financing receivables	(799,198)	(579,679)
Inventories	152,058	(331,455)
Prepaid expenses	8,908	(3,335)
Accounts payable	(666,950)	735,222
Deferred revenue	(388,782)	817,368
Other liabilities	(221,543)	(171,970)
Income taxes payable	415,598	312,819
Net cash provided by operating activities	10,305,924	11,828,825
Investing Activities		
Purchases of property and equipment	(329,041)	(1,766,989)
Purchases of investments	(1,461,392)	(8,261,664)
Net cash used in investing activities	(1,790,433)	(10,028,653)
Financing Activities		
Proceeds from exercise of stock options, net	314,641	1,950,861
Excess tax benefit from stock based compensation	199,756	
Dividends paid	(11,609,193)	(6,948,134)
Net cash used in financing activities	(11,094,796)	(4,997,273)
Decrease in cash and cash equivalents	(2,579,305)	(3,197,101)
Cash and cash equivalents at beginning of period	11,669,690	13,785,377
Cash and cash equivalents at end of period	\$ 9,090,385	\$ 10,588,276
Cash paid for income taxes	\$ 7,254,019	\$ 5,691,906
See accompanying notes.		

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**COMPUTER PROGRAMS AND SYSTEMS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

1. BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and include all adjustments that, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments are considered of a normal recurring nature. Quarterly results of operations are not necessarily indicative of annual results.

Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These unaudited condensed financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2005 and the notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

2. REVENUE RECOGNITION

The Company's revenue is generated from three sources:

the sale of information systems, which includes software, conversion and installation services, hardware, peripherals, forms and supplies.

the provision of system support services, which includes software application support, hardware maintenance, continuing education, application service provider (ASP) products, and internet service provider (ISP) products.

the provision of outsourcing services, which includes electronic billing, statement processing, and business office outsourcing.

Depending upon the terms of the contract, revenue is recognized in accordance with SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, as amended by SAB No. 104, *Revenue Recognition*, and the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition*, which states that revenue should be recognized when persuasive evidence of an agreement exists, the product or service has been delivered, fees and prices are fixed and determinable, collectibility is probable, and when all other significant obligations have been fulfilled.

License revenue in connection with license agreements for proprietary software is recognized upon delivery of the software, providing collection is considered probable, the fee is fixed or determinable, there is evidence of an arrangement, and vendor specific objective evidence (VSOE) exists with respect to any undelivered elements of the arrangement. For multiple-element arrangements, the Company recognizes revenue under the residual method as permitted by the American Institute of Certified Public Accountants Statement of Position (SOP) 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, whereby (1) the total fair value of the undelivered elements, as indicated by VSOE, is deferred and subsequently recognized in accordance with SOP 97-2 and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Revenue derived from maintenance contracts primarily includes software application support, hardware maintenance, continuing education and related services. Maintenance contracts are typically sold for a separate fee with initial contractual periods ranging from one to three years with renewal for additional periods thereafter. Maintenance revenue is recognized ratably over the term of the maintenance agreement. In situations where all or a portion of the maintenance fee is bundled with the license fee, VSOE for maintenance is determined based on prices when sold separately.

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Revenue for hardware is recognized under SAB No. 104. Under SAB No. 104, revenue is recognized provided that persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable, and collectibility is reasonably assured. For hardware, delivery is considered to have occurred upon shipment provided that risk of loss has been transferred to the customer.

Revenue for ISP, ASP, and outsourcing services are recognized in the period in which the services are performed.

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Other accrued liabilities are comprised of the following:

	September 30, 2006	December 31, 2005
Salaries and benefits	\$ 1,327,619	\$ 1,920,861
Commissions	309,744	306,704
Self-insurance reserves	365,600	380,600
Other	200,464	77,066
	\$ 2,203,427	\$ 2,685,231

4. INVESTMENTS

The Company accounts for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, investments are classified as available-for-sale securities and are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholder's equity. The Company's management determines the appropriate classifications of investments in fixed maturity securities at the time of acquisition and re-evaluates the classifications at each balance sheet date. The Company's investments in fixed maturity securities are classified as available-for-sale.

Investments are comprised of the following at September 30, 2006:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Short term investments	\$ 236,186	\$	\$	\$ 236,186
Obligations of U.S. Treasury, U.S. government corporation and agencies	4,497,948	19,388	27,514	4,489,822
Mortgaged backed securities	428,854		8,904	419,950
Municipal obligations	800,000			800,000
Corporate bonds	4,686,103	10,293	69,009	4,627,387
	\$ 10,649,091	\$ 29,681	\$ 105,427	\$ 10,573,345

Shown below are the amortized cost and estimated fair value of securities with fixed maturities at September 30, 2006, by contract maturity date. Actual maturities may differ from contractual maturities because issuers of certain securities retain early call or prepayment rights.

	Amortized Cost	Fair Value
Due in 2006	\$ 2,799,004	\$ 2,750,593
Due in 2007	3,290,670	3,280,277
Due in 2008	2,498,776	2,489,478
Due in 2009 and thereafter	1,824,455	1,816,811
	\$ 10,412,905	\$ 10,337,159

5. NET INCOME PER SHARE

The Company presents both basic and diluted earnings per share (EPS) amounts. Basic EPS is calculated by dividing net income by the weighted average number of common shares outstanding during the period presented. Diluted EPS amounts are based upon the weighted average number of common and common equivalent shares outstanding during the period presented. The difference between basic and diluted EPS is solely attributable to stock options. The Company uses the treasury stock method to calculate the impact of outstanding stock options. For the three and nine month periods ended September 30, 2006, these dilutive shares were 72,011 and 83,456 respectively. For the three and nine month periods ended September 30, 2005, these dilutive shares were 91,789 and 87,200 respectively.

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The Company accounts for income taxes using the liability method in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Deferred income taxes arise from the temporary differences in the recognition of income and expenses for tax purposes. Deferred tax assets and liabilities are comprised of the following:

	September 30, 2006	December 31, 2005
Deferred tax assets:		
Accounts receivable	\$ 352,468	\$ 274,520
Accrued vacation	832,894	731,392
Stock compensation	383,002	
Other accrued liabilities	145,415	151,266
Unrealized loss on investments	38,642	43,459
Total deferred tax assets	\$ 1,752,421	\$ 1,200,637
Deferred tax liabilities:		
Deferred compensation	\$ 13,270	\$ 28,199
Depreciation	636,557	670,121
Total deferred tax liabilities	649,827	698,320
Net deferred tax asset	\$ 1,102,594	\$ 502,317

Significant components of the Company's income tax provision for the nine months ended September 30 are as follows:

	2006	2005
Current provision:		
Federal	\$ 6,319,348	\$ 5,683,021
State	1,350,269	1,193,100
Deferred provision:		
Federal	(543,033)	(144,761)
State	(62,061)	(16,625)
Total income tax provision	\$ 7,064,523	\$ 6,714,735

The difference between income taxes at the U. S. federal statutory income tax rate of 35% and those reported in the condensed statements of income for the nine months ended September 30 are as follows:

	2006	2005
Income taxes at U. S. Federal statutory rate	\$ 6,533,013	\$ 5,923,139

State income tax, net of federal tax effect	841,750	755,463
Other	(310,240)	36,133
Total income tax provision	\$ 7,064,523	\$ 6,714,735

7. STOCK BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share Based Payment* (SFAS No. 123R). SFAS No. 123R establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date based on the fair value of the award, and is recognized as an expense over the employee's requisite service period. The Company previously applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations and provided pro forma disclosures of SFAS No. 123, *Accounting for Stock Based Compensation*. The Company elected to adopt the modified prospective application method as provided by SFAS No. 123R, and, accordingly, prior periods are not restated for the effects of SFAS No. 123R. The Company recorded compensation costs as the requisite service rendered for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption and any awards issued, modified, repurchased, or cancelled after the effective date of SFAS 123R.

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The following table shows total stock-based compensation expense for the three and nine months ended September 30, 2006, included in the Condensed Statement of Income:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Costs of sales	\$ 152,736	\$ 434,823
Operating expenses	203,125	585,493
Pre-tax stock-based compensation expense	355,861	1,020,316
Less: income tax effect	124,445	386,190
Net stock-based compensation expense	\$ 231,416	\$ 634,126
Basic and diluted per share impact	\$ 0.02	\$ 0.06

Prior to adopting SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123R requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting SFAS 123R, \$199,756 of excess tax benefits for the nine months ended September 30, 2006 have been classified as a financing cash inflow.

2002 Stock Option Plan

Under the 2002 Stock Option Plan, the Company has authorized the issuance of equity-based awards for up to 865,333 shares of common stock to provide additional incentive to employees and officers. Pursuant to the plan, the Company can grant either incentive or non-qualified stock options. Options to purchase common stock under the 2002 Stock Option Plan have been granted to Company employees with an exercise price equal to the fair market value of the underlying shares on the date of grant.

Stock options granted under the 2002 Stock Option Plan to executive officers of the Company become vested as to all of the shares covered by such grant on the fifth anniversary of the grant date and expire on the seventh anniversary of the grant date. Stock options granted under the 2002 Stock Option Plan to employees other than executive officers become vested as to 50% of the shares covered by the option grant on the third anniversary of the grant date and as to 100% of such shares on the fifth anniversary of the grant date. In addition, options become vested upon termination of employment resulting from death, disability or retirement. Such options expire on the seventh anniversary of the grant date.

Under the methodology of SFAS No. 123, the fair value of the Company's stock options was estimated at the date of grant using the Black-Scholes option pricing model. The multiple option approach was used, with assumptions for expected option life of 5 years and 44% expected volatility for the market price of the Company's stock in 2002. An estimated dividend yield of 3% was used. The risk-free rate of return was determined to be 2.79% in 2002. No options have been granted in 2006 and no options were granted in 2005, 2004 or 2003.

As required under SFAS 123R, the reported net income and earnings per share for the three and nine months ended September 30, 2005 have been presented to reflect the impact had the Company been required to include the amortization of the Black-Scholes option value as an expense. The pro forma amounts are as follows:

Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
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Net income as reported	\$	3,565,204	\$	10,208,518
Add: Stock-based compensation expense, net of tax, included in reported net income		7,785		23,352
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of tax		(64,137)		(192,408)
Pro forma net income	\$	3,508,852	\$	10,039,462
Basic income per share as reported	\$	0.34	\$	0.97
Diluted income per share as reported	\$	0.33	\$	0.96
Pro forma basic income per share	\$	0.33	\$	0.95
Pro forma diluted income per share	\$	0.33	\$	0.94

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A summary of stock option activity under the plan during the nine month period ended September 30, 2006 is as follows:

	Shares	Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	251,519	\$ 16.50		
Granted				
Exercised	(19,068)	16.50		
Forfeited	(7,616)	16.50		
Outstanding at end of period	224,835	\$ 16.50	2.75	\$ 3,658,065
Exercisable at end of period	36,919	\$ 16.50	2.75	\$ 600,672
Shares available for future grants under the plan at end of period		484,529		

The aggregate intrinsic value in the above table represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading date of the third quarter of 2006 and the exercise price, multiplied by the number of options.) The amount of aggregate intrinsic value will change based on the fair market value of the Company's stock.

The aggregate intrinsic value of options exercised during the quarters ended September 30, 2006 and September 30, 2005 was \$87,672 and \$195,487 respectively. The aggregate intrinsic value of options exercised during the nine months ended September 30, 2006 and September 30, 2005 was \$506,865 and \$2,255,151 respectively.

As of September 30, 2006, there was \$230,410 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the existing stock option plan. This cost is expected to be recognized over a weighted-average period of 1.0 year.

2005 Restricted Stock Plan

On January 27, 2006, the Compensation Committee of the Board of Directors approved the grant of 116,498 shares of restricted stock, effective January 30, 2006, to certain executive officers of the Company. The grant date fair value was \$42.91 per share. The restricted stock vests in five equal annual installments commencing on the first anniversary of the date of grant.

On May 17, 2006, the Company's CEO, David A. Dye, resigned his position as CEO. Upon resignation, 23,299 shares of restricted stock which had been granted to him under the 2005 Restricted Stock Plan were forfeited. The forfeiture of these shares resulted in the reversal of previously recognized stock compensation expense of \$51,076.

On May 17, 2006, the Compensation Committee of the Board of Directors approved the grant of 17,810 shares of restricted stock, effective May 17, 2006, to the Michael Jones, the newly named Chief Operating Officer of the Company. The grant date fair value was \$42.11 per share. The restricted stock vests in five equal annual installments commencing January 30, 2007, and each January 30 thereafter.

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested stock outstanding at beginning of year		\$

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Granted	134,308		42.81
Vested			
Forfeited	23,299		42.91
Nonvested stock outstanding at end of period	111,009	\$	42.79

As of September 30, 2006, there was \$4,133,045 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 2005 Restricted Stock Plan. This cost is expected to be recognized over a weighted-average period of 4.3 years.

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On May 17, 2002, Kenny Muscat, one of the Company's directors and a principal stockholder sold 66,667 shares of common stock to J. Boyd Douglas, Jr., one of the Company's directors and its current Chief Executive Officer (CEO), for a price of \$13.20 per share. The share price was determined by an independent valuation of the fair market value of the shares. A promissory note was delivered for the entire purchase price. The promissory note bears interest at the applicable rate for federal income tax purposes, and the entire principal balance is due five years after the date of the stock sale. As a part of the same transaction, Mr. Muscat also transferred to Mr. Douglas 19,333 shares of common stock for \$1.00. These shares are subject to a mandatory transfer obligation under which Mr. Douglas will be required to transfer the shares back to Mr. Muscat in the event Mr. Douglas' employment with the Company terminates for certain reasons prior to the fifth anniversary of the transaction date. The mandatory transfer obligation lapses as to 20% of the shares on each anniversary of the transaction date over the five year restriction period.

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested stock outstanding at beginning of year	5,478	\$ 13.20
Granted		
Vested	2,901	13.20
Forfeited		
Nonvested stock outstanding at end of period	2,577	\$ 13.20

As of September 30, 2006, there was \$34,016 of total unrecognized compensation cost related to the unexpired portion of the mandatory transfer obligation. This cost is expected to be recognized over a weighted-average period of 0.67 years.

8. COMPREHENSIVE INCOME

Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income*, requires the disclosure of certain revenue, expenses, gains and losses that are excluded from net income in accordance with accounting principles generally accepted in the United States of America. Total comprehensive income for the three and nine months ended September 30, 2006 and 2005 are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net income as reported	\$ 3,424,180	\$ 3,565,204	\$ 11,602,229	\$ 10,208,518
Other comprehensive income:				
Unrealized (loss) gain on investments, net of taxes	21,093	(28,930)	8,041	(55,354)
Total comprehensive income	\$ 3,445,273	\$ 3,536,274	\$ 11,610,270	\$ 10,153,164

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9. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 requires a company to determine whether it is more likely than not that a tax position will be sustained upon examination based upon the technical merits of the position. If the more-likely-than-not threshold is met, a company must measure the tax position to determine the amount to recognize in the financial statements. FIN 48 is effective for the Company beginning January 1, 2007. The Company is currently evaluating FIN 48 and the potential impact on its financial statements has not been determined.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 was issued to provide consistency between how registrants quantify financial statement misstatements.

Historically, there have been two widely-used methods for quantifying the effects of financial statement misstatements. These methods are referred to as the roll-over and iron curtain method. The roll-over method quantifies the amount by which the current year income statement is misstated. Exclusive reliance on an income statement approach can result in the accumulation of errors on the balance sheet that may not have been material to any individual income statement, but which may misstate one or more balance sheet accounts. The iron curtain method quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on a balance sheet approach can result in disregarding the effects of errors in the current year income statement that results from the correction of an error existing in previously issued financial statements. We currently use the roll-over method for quantifying identified financial statement misstatements.

SAB 108 established an approach that requires quantification of financial statement misstatements based on the effects of the misstatement on each of the company's financial statements and the related financial statement disclosures. This approach is commonly referred to as the dual approach because it requires quantification of errors under both the roll-over and iron curtain methods.

SAB 108 allows registrants to initially apply the dual approach either by (1) retroactively adjusting prior financial statements as if the dual approach had always been used or by (2) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of this cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose.

We will initially apply SAB 108 using the cumulative effect transition method in connection with the preparation of our annual financial statements for the year ending December 31, 2006. The Company is currently evaluating SAB 108 and the potential impact on its financial statements has not been determined.

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

You should read the following discussion and analysis of our financial condition and results of operations together with the unaudited condensed financial statements and related notes appearing elsewhere herein.

This discussion and analysis contains forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements can be identified generally by the use of forward-looking terminology and words such as expects, anticipates, estimates, believes, predicts, intends, plans, potential, may, continue, should, will and words of comparable meaning. Without limiting generality of the preceding statement, all statements in this report relating to estimated and projected earnings, margins, costs, expenditures, cash flows, growth rates and future financial results are forward-looking statements. We caution investors that any such forward-looking statements are only predictions and are not guarantees of future performance. Certain risks, uncertainties and other factors may cause actual results to differ materially from those projected in the forward-looking statements. Such factors may include:

overall business and economic conditions affecting the healthcare industry;

saturation of our target market and hospital consolidations;

changes in customer purchasing priorities and demand for information technology systems;

competition with companies that have greater financial, technical and marketing resources than we have;

failure to develop new technology and products in response to market demands;

fluctuations in quarterly financial performance due to, among other factors, timing of customer installations;

failure of our products to function properly resulting in claims for medical losses;

government regulation of our products and customers, including changes in healthcare policy affecting Medicare reimbursement rates; and

interruptions in our power supply and/or telecommunications capabilities.

Additional information concerning these and other factors which could cause differences between forward-looking statements and future actual results is discussed under the heading Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

Overview

We are a healthcare information technology company that designs, develops, markets, installs and supports computerized information technology systems to meet the unique demands of small and midsize hospitals. Our target market includes acute care community hospitals with 300 or fewer beds and small specialty hospitals. We are a single-source vendor providing comprehensive software and hardware products, complemented by data conversion, complete installation and extensive support. Our fully integrated, enterprise-wide system automates the management of clinical and financial data across the primary functional areas of a hospital. In addition, we provide services that enable our customers to outsource certain data-related business processes which we can perform more efficiently. We believe our products and services enhance hospital performance in the critical areas of clinical care, revenue cycle management, cost control and regulatory compliance. From our initial hospital installation in 1981, we have grown to serve more than 600 hospital customers across 46 states and the District of Columbia. In the three months ended September 30, 2006, we generated revenues of \$27.3 million from the sale of our products and services.

Results of Operations

Three Months Ended September 30, 2006 Compared with Three Months Ended September 30, 2005

Revenues. Total revenues increased by 1.0%, or \$0.3 million, to \$27.3 million for the three months ended September 30, 2006, from \$27.0 million for the three months ended September 30, 2005.

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System sales revenues decreased by 12.5%, or \$1.6 million, to \$10.9 million for the three months ended September 30, 2006, from \$12.5 million for the three months ended September 30, 2005. This decrease was primarily due to a decrease in sales of systems to new customers.

Support and maintenance revenues increased by 7.1%, or \$0.7 million, to \$11.7 million for the three months ended September 30, 2006, from \$11.0 million for the three months ended September 30, 2005. This increase was attributable to an increase in recurring revenues as a result of a larger customer base.

Outsourcing revenues increased by 29.7%, or \$1.1 million, to \$4.6 million for the three months ended September 30, 2006, from \$3.5 million for the three months ended September 30, 2005. We experienced an increase in outsourcing revenues as a result of continued growth in existing customer demand for electronic billing and business office outsourcing services. We were providing business office outsourcing services to forty-five customers at September 30, 2006 and twenty customers at September 30, 2005.

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Costs of Sales. Total costs of sales increased by 2.5%, or \$0.4 million, to \$16.0 million for the three months ended September 30, 2006, from \$15.5 million for the three months ended September 30, 2005. As a percentage of total revenues, costs of sales increased to 58.4% for the three months ended September 30, 2006 from 57.6% for the three months ended September 30, 2005.

Cost of system sales decreased by 1.3%, or \$0.1 million, to \$8.4 million for the three months ended September 30, 2006, from \$8.5 million for the three months ended September 30, 2005. The gross margin on system sales decreased to 23.0% for the three months ended September 30, 2006, from 31.8% for the three months ended September 30, 2005. The decrease in sales of new systems resulted in the decreased gross margin percentage since many of the expenses are fixed in nature.

Cost of support and maintenance increased by 2.0%, or \$0.1 million, to \$5.0 million for the three months ended September 30, 2006, from \$4.9 million for the three months ended September 30, 2005. This increase was caused primarily by an increase in payroll related expenses as a result of salary increases and an increase in the number of employees. The gross margin on support and maintenance revenues increased to 57.8% for the three months ended September 30, 2006, compared to 55.7% for the three months ended September 30, 2005. The increase in gross margin was primarily due to the addition of new customers coupled with a proportionately smaller increase in support personnel.

Our costs associated with outsourcing services increased by 18.4%, or \$0.4 million, to \$2.6 million for the three months ended September 30, 2006, from \$2.2 million for the three months ended September 30, 2005. This increase was caused primarily by an increase of \$0.3 million in payroll related expenses as a result of an increase in the number of employees needed to support our growing business office outsourcing operations and electronic billing operations. Postage expense related to our statement outsourcing business also increased \$0.1 million due to an increase in volume.

Sales and Marketing Expenses. Sales and marketing expenses increased by 13.3%, or \$0.3 million, to \$2.2 million for the three months ended September 30, 2006, from \$1.9 million for the three months ended September 30, 2005. The increase was attributable to an increase in salary expense of \$0.3 million as a result of an increase in the number of personnel in sales and marketing.

General and Administrative Expenses. General and administrative expenses increased by 10.0%, or \$0.4 million, to \$4.2 million for the three months ended September 30, 2006, from \$3.8 million for the three months ended September 30, 2005. Stock compensation expense which resulted from the adoption of SFAS 123R was \$0.2 million for the quarter ended September 30, 2006 as compared to \$0.0 in the prior year period. Group health insurance expense increased \$0.2 million due to an increase in the number of covered employees.

As a percentage of total revenues, sales and marketing expenses and general and administrative expenses increased to 23.5% for the three months ended September 30, 2006 from 21.3% for three months ended September 30, 2005.

Net Income. Net income for the three months ended September 30, 2006 decreased by 4.0%, or \$0.1 million, to \$3.4 million, or \$0.32 per diluted share, as compared with net income of \$3.6 million, or \$0.33 per diluted share, for the three months ended September 30, 2005. Net income represents 12.6% of revenue for the three months ended September 30, 2006, as compared to 13.2% of revenue for the three months ended September 30, 2005.

Nine Months Ended September 30, 2006 Compared with Nine Months Ended September 30, 2005

Revenues. Total revenues increased by 6.7%, or \$5.4 million, to \$85.8 million for the nine months ended September 30, 2006, from \$80.4 million for the nine months ended September 30, 2005.

System sales revenues increased by 2.3%, or \$0.9 million, to \$38.6 million for the nine months ended September 30, 2006, from \$37.8 million for the nine months ended September 30, 2005. This increase was primarily due to an increase in the number of new system installations as well as an increase in the sale of add-on business to existing customers.

Support and maintenance revenues increased by 8.4%, or \$2.7 million, to \$34.4 million for the nine months ended September 30, 2006, from \$31.7 million for the nine months ended September 30, 2005. This increase was attributable to an increase in recurring revenues as a result of a larger customer base.

Outsourcing revenues increased by 17.3%, or \$1.9 million, to \$12.8 million for the nine months ended September 30, 2006, from \$10.9 million for the nine months ended September 30, 2005. We experienced an increase

in outsourcing revenues as a result of continued growth in customer demand for electronic billing, statement processing, and business office outsourcing services.

Costs of Sales. Total costs of sales increased by 5.6%, or \$2.5 million, to \$47.8 million for the nine months ended September 30, 2006, from \$45.3 million for the nine months ended September 30, 2005. As a percentage of total revenues, costs of sales decreased to 55.8% for the nine months ended September 30, 2006, from 56.3% for the nine months ended September 30, 2005. The size of our average new installation contract increased. We also experienced an increase in the number of new system installations which produced a higher profit margin.

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Cost of system sales increased by 3.0%, or \$0.7 million, to \$25.7 million for the nine months ended September 30, 2006, from \$24.9 million for the nine months ended September 30, 2005. Payroll related expenses increased \$0.6 million as a result of salary increases and an increase in the number of employees. Stock compensation expense which resulted from the adoption of SFAS 123R was \$0.4 million for the nine months ended September 30, 2006, as compared to \$0.0 in the prior year period. Cost of equipment increased \$0.2 million as a result of an increase in equipment sales. These increases in expense were offset by a decrease in travel related expense of \$0.5 million. The gross margin on system sales decreased to 33.6% for the nine months ended September 30, 2006, from 34.0% for the nine months ended September 30, 2005.

Cost of support and maintenance increased by 5.7%, or \$0.8 million, to \$14.9 million for the nine months ended September 30, 2006, from \$14.1 million for the nine months ended September 30, 2005. This increase was caused primarily by an increase in payroll related expenses as a result of salary increases and an increase in the number of employees. The gross margin on support and maintenance revenues increased to 56.6% for the nine months ended September 30, 2006, compared to 55.5% for the nine months ended September 30, 2005.

Our costs associated with outsourcing services increased by 15.9%, or \$1.0 million, to \$7.3 million for the nine months ended September 30, 2006, from \$6.3 million for the nine months ended September 30, 2005. This increase was caused primarily by an increase of \$0.7 million in payroll related expenses as a result of an increase in the number of employees needed to support our growing business office outsourcing operations and electronic billing operations. Postage expense related to our statement outsourcing business also increased \$0.3 million due to an increase in volume.

Sales and Marketing Expenses. Sales and marketing expenses increased by 17.9%, or \$1.0 million, to \$6.5 million for the nine months ended September 30, 2006, from \$5.5 million for the nine months ended September 30, 2005. The increase was partly attributable to an increase in salary expense of \$0.6 million as a result of an increase in the number of personnel in sales and marketing. Stock compensation expense which resulted from the adoption of SFAS 123R was \$0.2 million for the nine months ended September 30, 2006, as compared to \$0.0 in the prior year period. Travel expense also increased \$0.2 million.

General and Administrative Expenses. General and administrative expenses increased 4.1%, or \$0.5 million, to \$13.6 million for the nine months ended September 30, 2006, from \$13.1 million for the nine months ended September 30, 2005. Stock compensation expense which resulted from the adoption of SFAS 123R was \$0.4 million for the nine months ended September 30, 2006 as compared to \$0.0 in the prior year period. Group health insurance expense increased \$0.3 million and depreciation increased \$0.1 million. Payroll related expenses also increased \$0.2 million. These increases in expense were offset by a decrease in bad debt expense of \$0.6 million.

As a percentage of total revenues, sales and marketing expenses and general and administrative expenses increased to 23.5% for the nine months ended September 30, 2006, from 23.2% for nine months ended September 30, 2005.

Net Income. Net income for the nine months ended September 30, 2006 increased by 13.7%, or \$1.4 million, to \$11.6 million, or \$1.07 per diluted share, as compared with net income of \$10.2 million, or \$0.96 per diluted share, for the nine months ended September 30, 2005. Net income represents 13.5% of revenue for the nine months ended September 30, 2006, as compared to 12.6% of revenue for the nine months ended September 30, 2005. This increase in net income is attributable to an increase in the number of new system installations and also an increase in the average installation size, as described above.

Liquidity and Capital Resources

At September 30, 2006, we had cash and cash equivalents of \$9.1 million, compared with \$10.6 million at September 30, 2005. Net cash provided by operating activities for the nine months ended September 30, 2006 was \$10.3 million, compared to \$11.8 million for the nine months ended September 30, 2005. The decrease was primarily due to an increase in accounts receivable, financing receivables and provision for bad debt. The temporary suspension of reimbursement to hospitals by Medicare in September 2006 resulted in a decrease in collections from our customers.

Net cash used in investing activities totaled \$1.8 million for the nine months ended September 30, 2006, compared to \$10.0 million for the nine months ended September 30, 2005. We used cash primarily for the purchase of property and equipment. In 2005, we used cash primarily for the purchase of \$8.3 million in investments which are classified as

available for sale.

Net cash used in financing activities totaled \$11.1 million for the nine months ended September 30, 2006, compared to \$5.0 million for the nine months ended September 30, 2005. We paid dividends of \$11.6 million to our shareholders in the nine months ended September 30, 2006 compared to \$6.9 million in the nine months ended September 30, 2005.

We currently do not have a bank line of credit or other credit facility in place. Our future capital requirements will depend upon a number of factors, including the rate of growth of our sales, cash collections from our customers and our future investments in fixed assets. We believe that our available cash and cash equivalents and anticipated cash generated from operations will be sufficient to meet our operating requirements for the next 12 months.

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Off Balance Sheet Arrangements

We are not currently a party to any material off-balance sheet arrangement as defined in Item 303 of Regulation S-K.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

We currently do not use derivative financial instruments. Cash and cash equivalents consist of highly liquid financial instruments, primarily cash, money market funds and short term U.S. Government obligations, purchased with an original maturity of three months or less. Interest income on our income statement is included in Other Income.

As of September 30, 2006, the Company had no borrowings and is, therefore, not subject to interest rate risks related to debt instruments.

Item 4. Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company that is required to be included in our periodic SEC filings. There have not been any changes in the Company's internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II
OTHER INFORMATION**

Item 1. Legal Proceedings.

From time to time, we are involved in routine litigation that arises in the ordinary course of business. We are not currently involved in any litigation that we believe could reasonably be expected to have a material adverse effect on our business, financial condition, or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

(a) None.

(b) None.

(c) None.

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None

Item 5. Other Information.

None.

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Item 6. Exhibits

- 3.1 Certificate of Incorporation (filed as Exhibit 3.4 to CPSI's Registration Statement on Form S-1 (Registration No. 333-84726) and incorporated herein by reference)
- 3.2 Bylaws (filed as Exhibit 3.6 to CPSI's Registration Statement on Form S-1 (Registration No. 333-84726) and incorporated herein by reference)
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURE

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

**COMPUTER PROGRAMS AND SYSTEMS,
INC.**

Date: November 8, 2006

By: /s/ J. Boyd Douglas

J. Boyd Douglas
President and Chief Executive Officer

Date: November 8, 2006

By: /s/ M. Stephen Walker

M. Stephen Walker
Vice President Finance and
Chief Financial Officer

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Exhibit Index

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