

COMPUTER PROGRAMS & SYSTEMS INC

Form 10-Q

November 08, 2010

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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, 2010.

**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)

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**Delaware**  
(State or Other Jurisdiction of

**74-3032373**  
(I.R.S. Employer

**Incorporation or Organization)**

**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 has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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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 5, 2010, there were 10,962,874 shares of the issuer's common stock outstanding.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**Form 10-Q**

**(For the three and nine months ended September 30, 2010)**

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**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements.****COMPUTER PROGRAMS AND SYSTEMS, INC.****CONDENSED BALANCE SHEETS**

	September 30, 2010 (Unaudited)	December 31, 2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,688,208	\$ 4,386,763
Investments	13,395,188	13,243,118
Accounts receivable, net of allowance for doubtful accounts of \$1,149,000 and \$759,000, respectively	24,719,064	19,472,642
Financing receivables, current portion	3,264,508	3,767,613
Inventories	1,593,305	1,703,668
Deferred tax assets	2,139,650	1,526,605
Prepaid income taxes		867,825
Prepaid expenses	844,438	705,481
<b>Total current assets</b>	<b>47,644,361</b>	<b>45,673,715</b>
Property and equipment		
Land	936,026	936,026
Maintenance equipment	4,145,141	3,819,469
Computer equipment	7,851,773	6,687,155
Leasehold improvements	3,042,211	963,211
Office furniture and equipment	2,817,543	1,516,376
Automobiles	158,042	132,926
	18,950,736	14,055,163
Less accumulated depreciation	(10,550,254)	(9,039,396)
<b>Net property and equipment</b>	<b>8,400,482</b>	<b>5,015,767</b>
Financing receivables, net of current portion	4,365,075	3,761,239
<b>Total assets</b>	<b>\$ 60,409,918</b>	<b>\$ 54,450,721</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 3,641,080	\$ 2,212,085
Deferred revenue	4,206,059	3,582,870
Accrued vacation	3,037,209	2,606,043
Income taxes payable	920,808	
Other accrued liabilities	4,222,913	2,846,349
<b>Total current liabilities</b>	<b>16,028,069</b>	<b>11,247,347</b>

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Deferred tax liabilities	824,496	512,103
Stockholders' equity:		
Common stock, par value \$0.001 per share; 30,000,000 shares authorized; 10,962,874 and 10,972,757 shares issued and outstanding	10,963	10,973
Additional paid-in capital	30,333,864	29,679,385
Accumulated other comprehensive income	85,698	100,103
Retained earnings	13,126,828	12,900,810
Total stockholders' equity	43,557,353	42,691,271
Total liabilities and stockholders' equity	\$ 60,409,918	\$ 54,450,721

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,	
	2010	2009	2010	2009
<b>Sales revenues:</b>				
System sales	\$ 17,481,708	\$ 11,577,722	\$ 42,048,829	\$ 30,915,962
Support and maintenance	14,980,612	13,957,089	43,654,969	41,610,529
Business management services	8,450,902	7,473,192	24,464,020	21,464,551
<b>Total sales revenues</b>	<b>40,913,222</b>	<b>33,008,003</b>	<b>110,167,818</b>	<b>93,991,042</b>
<b>Costs of sales:</b>				
System sales	12,591,304	9,428,060	33,777,583	25,716,423
Support and maintenance	6,160,444	5,594,986	17,619,361	15,916,323
Business management services	5,104,340	4,372,072	13,919,487	12,611,736
<b>Total costs of sales</b>	<b>23,856,088</b>	<b>19,395,118</b>	<b>65,316,431</b>	<b>54,244,482</b>
<b>Gross profit</b>	<b>17,057,134</b>	<b>13,612,885</b>	<b>44,851,387</b>	<b>39,746,560</b>
<b>Operating expenses:</b>				
Sales and marketing	3,311,060	2,297,325	8,314,560	6,625,308
General and administrative	6,067,938	5,210,398	17,645,458	15,392,763
<b>Total operating expenses</b>	<b>9,378,998</b>	<b>7,507,723</b>	<b>25,960,018</b>	<b>22,018,071</b>
<b>Operating income</b>	<b>7,678,136</b>	<b>6,105,162</b>	<b>18,891,369</b>	<b>17,728,489</b>
<b>Other income:</b>				
Interest income	221,955	218,407	512,836	690,334
<b>Total other income</b>	<b>221,955</b>	<b>218,407</b>	<b>512,836</b>	<b>690,334</b>
<b>Income before taxes</b>	<b>7,900,091</b>	<b>6,323,569</b>	<b>19,404,205</b>	<b>18,418,823</b>
<b>Income taxes</b>	<b>3,011,622</b>	<b>2,303,025</b>	<b>7,331,167</b>	<b>6,831,842</b>
<b>Net income</b>	<b>\$ 4,888,469</b>	<b>\$ 4,020,544</b>	<b>\$ 12,073,038</b>	<b>\$ 11,586,981</b>
<b>Net income per share - basic</b>	<b>\$ 0.45</b>	<b>\$ 0.37</b>	<b>\$ 1.10</b>	<b>\$ 1.06</b>
<b>Net income per share - diluted</b>	<b>\$ 0.45</b>	<b>\$ 0.37</b>	<b>\$ 1.10</b>	<b>\$ 1.06</b>
<b>Weighted average shares outstanding</b>				
Basic	10,962,874	10,972,757	10,962,874	10,947,341
Diluted	10,962,874	10,972,757	10,962,874	10,949,239
<b>Dividends declared per share</b>	<b>\$ 0.36</b>	<b>\$ 0.36</b>	<b>\$ 1.08</b>	<b>\$ 1.08</b>

See accompanying notes.



**Table of Contents****COMPUTER PROGRAMS AND SYSTEMS, INC.****CONDENSED STATEMENT OF STOCKHOLDERS EQUITY (Unaudited)**

	<b>Common Shares</b>	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Retained Earnings</b>	<b>Total Stockholders Equity</b>
Balance at December 31, 2009	10,972,757	\$ 10,973	\$ 29,679,385	\$ 100,103	\$ 12,900,810	\$ 42,691,271
Net income					12,073,038	12,073,038
Forfeiture of restricted stock	(9,883)	(10)	10			
Unrealized loss on investments available for sale, net of tax				(14,405)		(14,405)
Stock-based compensation			643,324			643,324
Income tax benefit from dividends on restricted stock			11,145			11,145
Dividends					(11,847,020)	(11,847,020)
Balance at September 30, 2010	10,962,874	\$ 10,963	\$ 30,333,864	\$ 85,698	\$ 13,126,828	\$ 43,557,353

See accompanying notes.

**Table of Contents****COMPUTER PROGRAMS AND SYSTEMS, INC.****CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)**

	<b>Nine months ended September 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Operating Activities</b>		
Net income	\$ 12,073,038	\$ 11,586,981
Adjustments to net income:		
Provision for bad debt	406,408	747,943
Deferred taxes	(278,779)	(500,558)
Stock-based compensation	643,324	689,985
Excess tax benefit from stock option exercises		(418,830)
Income tax benefit from restricted stock dividends	(11,145)	
Depreciation	1,510,858	1,294,136
Changes in operating assets and liabilities:		
Accounts receivable	(5,652,830)	(4,305,921)
Financing receivables	(100,731)	(719,003)
Inventories	(215,308)	(322,308)
Prepaid expenses	(138,958)	(260,666)
Accounts payable	1,428,995	(905,915)
Deferred revenue	623,189	(391,529)
Other liabilities	1,807,731	(495,062)
Income taxes payable	1,799,778	124,711
<b>Net cash provided by operating activities</b>	<b>13,895,570</b>	<b>6,123,964</b>
<b>Investing Activities</b>		
Purchases of property and equipment	(4,569,902)	(1,385,976)
Sales of investments		1,500,000
Purchases of investments	(188,348)	(2,897,693)
<b>Net cash used in investing activities</b>	<b>(4,758,250)</b>	<b>(2,783,669)</b>
<b>Financing Activities</b>		
Proceeds from exercise of stock options		1,303,599
Income tax benefit from restricted stock dividends	11,145	
Excess tax benefit from stock option exercises		418,830
Dividends paid	(11,847,020)	(11,817,268)
<b>Net cash used in financing activities</b>	<b>(11,835,875)</b>	<b>(10,094,839)</b>
<b>Decrease in cash and cash equivalents</b>	<b>(2,698,555)</b>	<b>(6,754,544)</b>
Cash and cash equivalents at beginning of period	4,386,763	11,744,466
<b>Cash and cash equivalents at end of period</b>	<b>\$ 1,688,208</b>	<b>\$ 4,989,922</b>
Cash paid for interest	\$	\$
Cash paid for income taxes, net of refund	\$ 5,751,143	\$ 7,207,693
Reclassification of inventory to property and equipment	\$ 325,671	\$
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 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 audited financial statements of Computer Programs and Systems, Inc. ( the Company ) for the year ended December 31, 2009 and the notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2009.

**2. REVENUE RECOGNITION**

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States of America, principally those required by the *Software* topic and *Revenue Recognition* subtopic of the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification (the Codification ) and those prescribed by the SEC.

The Company's revenue is generated from three sources:

the sale of information systems, which includes software, conversion, installation and training 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 ) services hereinafter referred to as software as a service or ( SAAS ), and internet service provider ( ISP ) services.

the provision of business management services, which includes electronic billing, statement processing, payroll processing and accounts receivable management.

The Company enters into contractual obligations to sell hardware, perpetual software licenses and conversion, installation, training and maintenance services. Revenue from hardware sales is recognized upon shipment, when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collection is probable. Revenue from the perpetual software licenses and installation and training services are recognized using the residual method. The residual method allocates an amount of the arrangement to the elements for which fair value can be determined and any remaining arrangement consideration (the residual revenue ) is then allocated to the delivered elements. The fair value of maintenance services is determined based on vendor specific objective evidence ( VSOE ) of fair value and is deferred and recognized as revenue ratably over the maintenance term. VSOE of fair value of maintenance services is determined by reference to the price the Company's customers are required to pay for the services when sold separately via renewals. The residual revenue is allocated to the perpetual license and installation and training services and is recognized over the term that the installation and training services are performed for the entire arrangement. The method of recognizing revenue for the perpetual license for the associated modules included in the arrangement and related installation and training services over the term the services are performed is on a module by module basis as the respective installation and training for each specific module is completed as this is representative of the pattern of provision of these services. The installation and training services are normally completed in three to four weeks.

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Revenue derived from maintenance contracts primarily includes revenue from software application support, hardware maintenance, continuing education and related services. Maintenance contracts are typically sold for a separate fee with initial contract periods ranging from one to seven years, with renewal for additional periods thereafter. Maintenance revenue is recognized ratably over the term of the maintenance agreement.

The Company accounts for SAAS contracts in accordance with the requirements of the *Hosting Arrangement* section under the *Software* topic and *Revenue Recognition* subtopic of the FASB Codification. The Codification states that the software element of SAAS services should not be accounted for as a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party related to the vendor to host the software. Each SAAS contract includes a system purchase and buyout clause, and this clause specifies the total amount of the system buyout.

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In addition, a clause is included in SAAS contracts which states that should the system be bought by the customer, the customer would be required to enter into a general support agreement (for post-contract support services) for the remainder of the original SAAS term. Accordingly, the Company has concluded that SAAS customers do not have the right to take possession of the system without significant penalty (i.e. the purchase price of the system), and thus SAAS revenue of the Company falls within the scope of the *Hosting Arrangement* section of the Codification. In accordance with SEC regulations, revenue is recognized when the SAAS services are performed.

Revenue for ISP and business management services are recognized in the period in which the services are performed.

**3. OTHER ACCRUED LIABILITIES**

Other accrued liabilities are comprised of the following:

	September 30, 2010	December 31, 2009
Salaries and benefits	\$ 2,399,957	\$ 1,378,473
Commissions	500,000	182,525
Self-insurance reserves	493,000	510,900
Unrecognized tax benefit	589,477	536,717
Other	240,479	237,734
	\$ 4,222,913	\$ 2,846,349

**4. INVESTMENTS**

The Company accounts for investments in accordance with FASB Codification topic, *Investments - 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 stockholders' 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, 2010:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Short term investments (cash and accrued income)	\$ 224,554	\$	\$	\$ 224,554
Obligations of U.S. Treasury, U.S. government corporations and agencies	5,664,845	18,484	983	5,682,346
Mortgage backed securities	128,662	3,050		131,712
Corporate bonds	7,236,639	121,473	1,536	7,356,576
	\$ 13,254,700	\$ 143,007	\$ 2,519	\$ 13,395,188

Shown below are the amortized cost and estimated fair value of debt securities with fixed maturities at September 30, 2010, by contract maturity date. Actual maturities may differ from contractual maturities because issuers of certain securities retain early call or prepayment rights.

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	<b>Amortized Cost</b>	<b>Fair Value</b>
Due in 2010	\$ 1,582,654	\$ 1,584,096
Due in 2011	4,362,145	4,412,165
Due in 2012	6,165,078	6,251,040
Due in 2013	1,016,161	1,016,176
Due thereafter	128,662	131,711
	\$ 13,254,700	\$ 13,395,188

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Investments were comprised of the following at December 31, 2009:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Short term investments (cash and accrued income)	\$ 311,895	\$	\$	\$ 311,895
Obligations of U.S. Treasury, U.S. government corporations and agencies	4,648,496	15,047	847	4,662,696
Mortgage backed securities	153,083	737		153,820
Corporate bonds	7,965,541	149,430	264	8,114,707
	\$ 13,079,015	\$ 165,214	\$ 1,111	\$ 13,243,118

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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 Company used the treasury stock method to calculate the impact of outstanding stock options. Potentially dilutive shares for a period are derived from outstanding stock options that have an exercise price less than the weighted average market price of our common stock during such period. The difference between basic and diluted EPS is solely attributable to stock options. There were no dilutive shares for the three and nine month periods ended September 30, 2010 or the three month period ended September 30, 2009. There were 1,898 dilutive shares for the nine month period ended September 30, 2009.

**6. INCOME TAXES**

The Company accounts for income taxes in accordance with FASB's Codification topic, *Income Taxes*. Deferred income taxes arise from the temporary differences in the recognition of income and expenses for tax purposes. A valuation allowance is established when the Company believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Deferred tax assets and liabilities are comprised of the following at September 30, 2010 and December 31, 2009:

	September 30, 2010	December 31, 2009
Deferred tax assets:		
Accounts receivable	\$ 448,093	\$ 296,194
Accrued vacation	1,184,511	1,027,065
Stock-based compensation	285,142	390,847
Other accrued liabilities	291,124	325,153
Total deferred tax assets	\$ 2,208,870	\$ 2,039,259
Deferred tax liabilities:		
Other comprehensive income	\$ 42,128	\$ 64,001
Depreciation	851,588	960,756
Total deferred tax liabilities	\$ 893,716	\$ 1,024,757

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

	2010	2009
Current provision:		
Federal	\$ 6,231,706	\$ 5,889,245
State	1,378,240	1,443,155
Deferred benefit:		
Federal	(250,186)	(449,219)
State	(28,593)	(51,339)
Total income tax provision	\$ 7,331,167	\$ 6,831,842

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 is as follows:

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	2010	2009
Income taxes at U. S. Federal statutory rate	\$ 6,787,972	\$ 6,446,588
State income tax, net of federal tax effect	867,264	886,712
Impact of tax credits	(209,274)	(468,061)
Other	(114,795)	(33,397)
<b>Total income tax provision</b>	<b>\$ 7,331,167</b>	<b>\$ 6,831,842</b>

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The federal returns for the tax years 2004, 2005, and 2006 are currently under examination by Internal Revenue Service, primarily in relation to research credits claimed on those returns by the Company. The federal returns for tax years 2007, 2008 and 2009 remain open to examination, and the tax years 2004 – 2009 remain open to other taxing jurisdictions to which the Company is subject. The Company had unrecognized tax benefits of \$589,477 related to uncertain tax positions as of September 30, 2010 under the provisions of FASB Codification topic, *Income Taxes*, which is recorded in Other accrued liabilities on the Condensed Balance Sheet. No accrued interest or penalties for such positions is recorded. The tax provision for 2010 does not currently include the impact of certain tax credits that expired on December 31, 2009. These credits are currently up for renewal in Congress, and when passed may have a significant impact to our 2010 provision for income taxes.

**7. STOCK BASED COMPENSATION**

Effective January 1, 2006, the Company adopted the provisions of FASB Codification topic, *Compensation – Stock Compensation*, which establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at the grant date based on the fair value of the award, and is recognized as an expense over the employee's requisite service period.

The following table shows total stock-based compensation expense for the three and nine months ended September 30, 2010 and 2009, included in the Condensed Statements of Income:

	Three Months Ended		Nine Months Ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Costs of sales	\$ 74,997	\$ 74,997	\$ 224,991	\$ 224,991
Operating expenses	137,499	154,998	418,333	464,994
Pre-tax stock-based compensation expense	212,496	229,995	643,324	689,985
Less: income tax effect	82,873	89,698	250,896	269,094
Net stock-based compensation expense	\$ 129,623	\$ 140,297	\$ 392,428	\$ 420,891

**2002 Stock Option Plan**

Under the Company's 2002 Stock Option Plan, as amended (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 2002 Stock Option Plan, the Company can grant either incentive or non-qualified stock options. Options to purchase common stock under the 2002 Stock Option Plan had 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 became vested as to all of the shares covered by such grant on the fifth anniversary of the grant date and expired on the seventh anniversary of the grant date. Stock options granted under the 2002 Stock Option Plan to employees other than executive officers became 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, such options became vested upon termination of employment resulting from death, disability or retirement. Such options expired on the seventh anniversary of the grant date.

Under the methodology of the Codification, 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 were granted during 2009 or the first nine months of 2010. There were no outstanding options as of December 31, 2009 or September 30, 2010.



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A summary of stock option activity under the 2002 Stock Option Plan during the nine month period ended September 30, 2009 is as follows:

	September 30, 2009	
	Shares	Exercise Price
Outstanding at beginning of year	82,608	\$ 16.50
Granted		
Exercised	(79,006)	16.50
Forfeited	(3,602)	16.50
Outstanding at end of period		\$
Exercisable at end of period		\$
Shares available for future grants under the plan at end of period		495,134

The aggregate intrinsic value (as measured by the difference between the exercise price of the option and the market value of the Company's common stock) of options exercised during the nine months ended September 30, 2009 was \$1,145,689. There were no options granted, exercised or outstanding during the nine months ended September 30, 2010. As of September 30, 2010, there were 495,134 shares available under the 2002 Stock Option Plan for future grants.

As of September 30, 2010, there was no unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 2002 Stock Option Plan.

**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 under the 2005 Restricted Stock Plan. 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 Compensation Committee of the Board of Directors approved the grant of 17,810 shares of restricted stock to 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. On January 23, 2008, the Compensation Committee of the Board of Directors approved the grant of 16,471 shares of restricted stock to the then newly named Vice President Finance and Chief Financial Officer of the Company. The grant date fair value was \$21.25 per share. The restricted stock was scheduled to vest in five equal annual installments commencing January 30, 2009, and each January 30 thereafter. On June 30, 2010, 9,883 shares of this restricted stock were forfeited, cancelled and returned to authorized and unissued shares as a result of the termination of employment of this individual on such date.

A summary of activity under the 2005 Restricted Stock Plan during the nine month periods ended September 30, 2010 and 2009 is as follows:

	Nine Months Ended September 30, 2010		Nine Months Ended September 30, 2009	
	Shares	Weighted-Average Grant-Date Fair Value	Shares	Weighted-Average Grant-Date Fair Value
Nonvested stock outstanding at beginning of year	52,920	\$ 37.41	76,086	\$ 38.11
Granted				
Forfeited	(9,883)	21.25		
Vested	(23,166)	39.71	(23,166)	39.71

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Nonvested stock outstanding at end of period	19,871	\$ 42.77	52,920	\$ 37.41
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As of September 30, 2010, there was \$278,911 of total unrecognized compensation cost related to non-vested restricted stock granted under the 2005 Restricted Stock Plan. This cost is expected to be recognized over a weighted-average period of 0.4 years.

**8. COMPREHENSIVE INCOME**

FASB Codification topic, *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, 2010 and 2009 is as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Net income as reported	\$ 4,888,469	\$ 4,020,544	\$ 12,073,038	\$ 11,586,981
Other comprehensive income:				
Unrealized loss on investments available for sale, net of taxes	(62)	(3,373)	(14,405)	(21,342)
Total comprehensive income	\$ 4,888,407	\$ 4,017,171	\$ 12,058,633	\$ 11,565,639

**Table of Contents****9. COMMITMENTS AND CONTINGENCIES**

As of September 30, 2010, the Company is contingently liable as guarantor on a lease obligation between Solis Healthcare, LP ( Solis Healthcare ), as lessee, and Winthrop Resources Corporation ( Winthrop ), as lessor. Solis Healthcare purchased a software system from the Company in the first quarter of 2008 and then entered into a sale-leaseback transaction with Winthrop. The Company provided this guarantee in order to facilitate Solis Healthcare in leasing the new system. The lease has an initial term of five years and continues from year to year thereafter until terminated. The Company is contingently liable as guarantor under the lease such that, if at any time prior to the termination of the initial term of the lease, Solis Healthcare (i) enters into bankruptcy or (ii) defaults for more than 60 days in its payments or performance under the lease, the Company will be obligated to perform under the guaranty by making the required lease payments, including late fees and penalties. The guarantee runs for the initial term of the lease; however, the maximum potential amount of future payments that the Company would be required to make to Winthrop under the guaranty is \$1,477,820, representing the remaining payments on the initial lease term as of September 30, 2010, plus any fees and costs that Winthrop incurs in collecting amounts due under the lease (including attorney's fees and costs). The Company recorded \$2,154,389, the amount billed for the new system installation, as revenue during the first quarter of 2008. Due to the contingent nature of the guaranty, the maximum amount of the guaranty is not recorded on the balance sheet; however, when necessary, reserves are recorded to cover potential losses. A liability in the amount of \$69,466, the amortized fair value of the guaranty, is recorded on the balance sheet as an other accrued liability at September 30, 2010. As of September 30, 2010, we were not aware of any conditions that would effect the payment or performance risk of the lease obligation.

Effective for the quarter ended June 30, 2009, the Company began including language in its customer license agreements, when specifically requested by a customer, that the Company's electronic health record system, when used as prescribed by the Company, will provide the customer with the means to achieve meaningful use of certified electronic health records ( EHR ) as specified in the Health Information Technology for Economic and Clinical Health Act of 2009 ( HITECH Act ), which was enacted as part of the American Recovery and Reinvestment Act of 2009 ( ARRA ). To qualify for incentive payments under ARRA, healthcare providers must demonstrate that they are meaningful users of certified EHR technology. On July 13, 2010, the Centers for Medicare & Medicaid Services ( CMS ) released final rules setting forth the requirements that healthcare providers must satisfy to become meaningful users of certified EHR technology. On the same day, the Office of the National Coordinator for Health Information Technology ( ONC ) of the Department of Health and Human Services issued a companion final rule setting forth the standards, specifications and certification criteria that EHR technology must satisfy in order to be classified as certified EHR technology. We have submitted our application for our EHR system to be certified under ARRA with The Certification Commission for Healthcare Information Technology (CCHIT<sup>sm</sup>), the leading certification authority for healthcare information systems. Our application and security attestation have been accepted and approved by CCHIT<sup>sm</sup>, and our goal is to complete the testing process and for our EHR system to be officially certified under ARRA by December 31, 2010.

From time to time, the Company is involved in routine litigation that arises in the ordinary course of business. Management does not expect this to have a material adverse effect on the Company's financial statements.

**10. FAIR VALUE**

FASB Codification topic, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value and expands financial statement disclosures about fair value measurements. Fair value is the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. The Codification does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. The Codification requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

- Level 1: Quoted market prices in active markets for identical assets or liabilities.
- Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.
- Level 3: Unobservable inputs that are not corroborated by market data.

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The fair values of the Company's available-for-sale securities are based on quoted prices in active markets for identical assets (Level 1) or evaluated prices based on a compilation of primarily observable market information or a broker-quote in a non-active market (Level 2). We generally apply fair value techniques on a non-recurring basis associated with (1) valuing potential impairment loss related to financing receivables accounted for pursuant to Codification topic, *Leases*, and (2) valuing potential impairment loss related to long-lived assets accounted for pursuant to Codification topic, *Property, Plant and Equipment*.

The following tables summarize the carrying amounts and fair values of certain assets and liabilities at September 30, 2010 and December 31, 2009: The fair value of all accrued income, U.S. Government-backed securities, U.S. Treasury securities, and mortgage-backed securities are classified as Level 2 fair values in all interim periods due to the non-active nature of these markets. Accrued income represents earnings due and payable to our investment portfolio at any point in time but not yet received.

Description	Carrying Amount at 9/30/2010	Fair Value at September 30, 2010 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities				
Short-term investments (cash and accrued income)	\$ 224,554	\$ 140,212	\$ 84,342	\$
Mortgage backed securities	131,712		131,712	
Obligations of U.S. Treasury, U.S. government corporations and agencies	5,682,346		5,682,346	
Corporate bonds	7,356,576	7,356,576		
Total available-for-sale securities	\$ 13,395,188	\$ 7,496,788	\$ 5,898,400	\$

Description	Carrying Amount at 12/31/2009	Fair Value at December 31, 2009 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities				
Short-term investments (cash and accrued income)	\$ 311,895	\$ 160,105	\$ 151,790	\$
Mortgage backed securities	153,820		153,820	
Obligations of U.S. Treasury, U.S. government corporations and agencies	4,662,696	612,537	4,050,159	
Corporate bonds	8,114,707	7,463,276	651,431	
Total available-for-sale securities	\$ 13,243,118	\$ 8,235,918	\$ 5,007,200	\$

**11. RECENT ACCOUNTING PRONOUNCEMENTS*****New Accounting Standards Adopted in 2010***

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosure*. This update provides amendments to Codification topic, *Fair Value Measurements and Disclosures*, that require new disclosures about transfers in and out of Levels 1 and 2, the reasons for the transfers as well as a reconciliation for fair value measurements using significant unobservable inputs (Level 3), and requires quantitative disclosures about the fair value measurements separately for each class of assets and liabilities. The update is

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effective for interim and annual reporting periods beginning after December 15, 2009. Adoption of this update did not have a material impact on our financial statements.

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*New Accounting Standards Yet To Be Adopted*

In October 2009, the FASB issued ASU 2009-14, *Software: Certain Revenue Arrangements That Include Software Elements*. This update addresses revenue recognition in situations where products or services are sold along with incidental software components. The update is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We do not believe this update will have a material impact on our financial statements.

In October 2009, the FASB issued ASU 2009-13, *Revenue Recognition: Multiple-Deliverable Revenue Arrangements*. This update addresses the criteria for separating consideration in multiple-element arrangements. It will require companies allocating the overall consideration to each deliverable to use an estimated selling price of individual deliverables in the arrangement in the absence of vendor-specific objective evidence or other third-party evidence of the selling price. The update is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We have not yet determined whether this update will have a material impact on our financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. This update requires improved disclosures about the credit quality of financing receivables and credit reserves held against them. The update is effective for periods ending on or after December 15, 2010. We do not believe this update will have a material impact on our financial statements but will require additional disclosures.

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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 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 other similar words and phrases. Without limiting the 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, capital expenditures 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;

the implementation of health care reform and its effects on the financial condition of our hospital customers;

government regulation of our products and customers, including the effects of the healthcare reform legislation enacted in 2010 and changes in healthcare policy affecting Medicare and Medicaid reimbursement rates and qualifying technological standards;

changes in accounting principles generally accepted in the United States of America;

general economic conditions, including changes in the financial markets that may affect the availability and cost of credit to us or our customers; and

interruptions in our power supply and/or telecommunications capabilities.



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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, 2009 and in our Quarterly Report on Form 10-Q for the period ended March 31, 2010, as filed with the Securities and Exchange Commission.

### **Background**

CPSI was founded in 1979 and specializes in delivering comprehensive healthcare information systems and related services to community hospitals and other healthcare providers. Our systems and services are designed to support the primary functional areas of a hospital and to enhance access to needed financial and clinical information. Our products and services provide solutions in key areas, including patient management, financial management, patient care and clinical, enterprise and office automation.

We sell a fully integrated, enterprise-wide financial and clinical hospital information system comprised of all necessary software, hardware, peripherals, forms and office supplies, together with comprehensive support and maintenance services. We also offer business management services, including electronic billing submissions, patient statement processing and accounts receivable management, as part of our overall information system solution. We believe that as our customer base grows, the demand for our business management services will also continue to grow, supporting further increases in recurring revenues.

Our target market includes acute care community hospitals with 300 or fewer beds and small specialty hospitals. Hospitals having 100 or fewer acute care beds comprise approximately 94% of our customers. In addition to servicing small-to-medium-sized hospitals, we provide technology services to other related entities in the healthcare industry, such as nursing homes, home health agencies and physician clinics. From our initial hospital installation in 1981, we have grown to serve more than 650 hospital customers across 47 states and the District of Columbia.

### **Management Overview**

We primarily seek revenue growth through sales of healthcare information technology systems and related services to existing and new customers within our historic target market. Our strategy has produced consistent revenue growth over the long-term, as reflected in five- and ten-year compounded annual growth rates in revenues of approximately 9.1% and 9.7%, respectively. Selling new and additional products and services back into our existing customer base is an important part of CPSI's future revenue growth. We believe that as our customer base grows, the demand for additional products and services, including business management services, will also continue to grow, supporting further increases in recurring revenues. We also expect to drive revenue growth from new product development that we may generate from our research and development activities.

In addition to revenue growth, our business model is focused on earnings growth. Once a hospital has installed our system, we continue to provide support and maintenance services to our customers on an ongoing basis. These services are typically provided by the same personnel who perform our system installations but at a reduced cost to us, and therefore at an increased gross margin. We also periodically look to increase margins through cost containment measures where appropriate.

As a result of the economic recession of 2007 to 2009 and continued economic uncertainty, hospitals have experienced reduced availability of third party credit and an overall reduction in their investment portfolios. In addition, healthcare organizations with a large dependency on Medicaid populations, such as community based hospitals, have been impacted by the challenging financial condition of many state governments and government programs. Accordingly, we recognize that prospective hospital customers often do not have the necessary capital to make investments in information technology. Additionally, in response to these challenges, hospitals have become more selective regarding where they invest capital, resulting in a focus on strategic spending that generates a return on their investment. Despite the current economic environment, we believe healthcare information technology is often viewed as more strategic to hospitals than other possible purchases because the technology offers the possibility of a quick return on investment. Information technology also plays an important role in healthcare by improving safety, efficiency and reducing cost. Additionally, we believe most hospitals recognize that they must invest in healthcare information technology to meet current and future regulatory, compliance and government reimbursement requirements.

We have experienced an increase in customers seeking financing arrangements from us over the past two years for system installations as a result of challenging economic conditions and disruptions in the credit markets. Historically, we have made financing arrangements available to customers on a case-by-case basis depending upon various aspects of the proposed contract and customer attributes. These financing arrangements include short-term payment plans, longer-term lease financing through us and our facilitating third-party financing arrangements. We intend to continue to work with prospective customers to provide for financing arrangements to purchase our systems so long as such arrangements do not adversely affect our financial position and liquidity. We believe that meeting the financial needs of community-based

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hospitals while allowing for the profitable expansion of our footprint in this market will remain both an opportunity and a challenge for us in the foreseeable future.

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We have experienced slower customer payments over the past two years, and expect this trend to continue at least through the remainder of 2010 and until the economy shows significant signs of recovery.

### **American Recovery and Reinvestment Act of 2009**

While the economic recession of 2007 to 2009 and continued economic uncertainty have impacted and could continue to impact the community hospitals that comprise our target market, we believe that the Health Information Technology for Economic and Clinical Health Act of 2009 (the HITECH Act ), which was enacted as part of the American Recovery and Reinvestment Act of 2009 ( ARRA ), will increase demand for healthcare information technology and may have a positive impact on our business prospects. ARRA includes more than \$19 billion in incentives to hospitals and other healthcare providers that implement and engage in meaningful use of certified electronic health record ( EHR ) technology prior to 2015. These incentive payments are set to begin as early as May 2011 for hospitals and other eligible healthcare providers. If an eligible healthcare provider does not begin to implement and engage in meaningful use of certified EHRs prior to 2015, then reimbursement under Medicare will begin to be reduced.

We have been focused on ensuring that we take the necessary steps to meet the needs of community hospitals to help them gain access to these incentives under ARRA. Primary among those steps is ensuring that our technology meets the ARRA s EHR certification requirements. On July 13, 2010, the Centers for Medicare & Medicaid Services ( CMS ) released final rules setting forth the requirements that healthcare providers must satisfy to become meaningful users of certified EHR technology. On the same day, the Office of the National Coordinator for Health Information Technology (the ONC ) of the Department of Health and Human Services issued a companion final rule setting forth the standards, specifications and certification criteria that EHR technology must satisfy in order to be classified as certified EHR technology. We believe that our EHR system includes the required technological and functional capabilities to be certified and meet the meaningful use objectives under ARRA. In this regard, we created a Product Development Division early in 2009 to help ensure that our technology remains on the leading edge of the development curve and can react quickly and effectively to any technical requirements that arise under ARRA. We also hired over 150 new employees during the last eighteen months so that we have a sufficient number of adequately trained and technically proficient support staff in place when our existing customers and any prospective hospital customers proceed to implement EHR technology.

The ONC has designated three organizations as Authorized Testing and Certification Bodies to certify electronic medical record providers under the ARRA program. We have submitted our EHR system for certification under ARRA to one of those bodies, the Certification Commission for Healthcare Information Technology (CCHIT<sup>sm</sup>), the leading certification authority for healthcare information systems. Our application and security attestation have been accepted by CCHIT<sup>sm</sup>, and our goal is to complete the testing process and for our EHR system to be officially certified under ARRA by December 31, 2010.

We have recently begun to experience, and expect to continue to experience in future quarters, an increase in revenue from the healthcare information technology provisions of ARRA, and we believe that, subject to the effects of the recently enacted Healthcare Reform legislation, discussed below, the long term potential of the EHR program under ARRA could be significant. The ARRA is expected to provide states with badly needed Medicare and Medicaid dollars, which should help improve the financial health of hospitals and incentivize them to make investments in information technology. Additionally, we expect that community hospitals, which rely more heavily on Medicare and Medicaid to fund their operations than larger hospitals, will be seeking to invest in any information technology applications that will increase their Medicare and Medicaid funding. We believe that our footprint among community hospitals positions us well to benefit from these incentives.

### **Health Care Reform**

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, collectively referred to as the Healthcare Legislation. This sweeping legislation implements changes to the healthcare and health insurance industries over the next several years through 2015, with the ultimate goal of requiring substantially all U.S. citizens and legal residents to have qualifying health insurance coverage by 2014 and providing the means by which it will be made available to them. We anticipate that the Healthcare Legislation will have little direct impact on our internal operations but may have a significant impact on the business of our hospital customers. We have not been able to determine at this point whether that impact will be positive, negative or neutral; however, it is likely that the Healthcare Legislation will affect hospitals differently depending upon the populations they service. Community hospitals typically service higher uninsured populations than larger urban hospitals and rely more heavily on Medicare and Medicaid for reimbursement. It remains to be seen whether the increase in the insured population for community hospitals, as well as the increase in Medicare and Medicaid reimbursements under ARRA for hospitals that implement EHR technology, will be enough to offset proposed cuts in Medicare and Medicaid reimbursements contained in the Healthcare Legislation.

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We believe healthcare initiatives will continue during the foreseeable future. If adopted, some aspects of previously proposed reforms, such as further reductions in Medicare or Medicaid payments, could adversely affect the businesses of our customers and thereby harm our business.

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**Results of Operations**

In the nine months ended September 30, 2010, we generated revenues of \$110.2 million from the sale of our products and services, as compared to \$94.0 million for the nine months ended September 30, 2009, an increase of 17.2%. Our net income for the nine months ended September 30, 2010 increased 4.2% from the first nine months of 2009, and cash flow from operations increased 126.9%.

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The following table sets forth certain items included in our results of operations for the three and nine months ended September 30, 2010 and 2009, expressed as a percentage of our total revenues for these periods (dollar amounts in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2010		2009		2010		2009	
	Amount	% Sales	Amount	% Sales	Amount	% Sales	Amount	% Sales
<b>INCOME DATA:</b>								
<b>Sales revenues:</b>								
System sales	\$ 17,482	42.7%	\$ 11,578	35.1%	\$ 42,049	38.2%	\$ 30,916	32.9%
Support and maintenance	14,980	36.6%	13,957	42.3%	43,655	39.6%	41,611	44.3%
Business management services	8,451	20.7%	7,473	22.6%	24,464	22.2%	21,464	22.8%
Total sales revenues	40,913	100.0 %	33,008	100.0%	110,168	100.0%	93,991	100.0%
<b>Costs of sales:</b>								
System sales	12,591	30.8%	9,428	28.6%	33,778	30.7%	25,716	27.4%
Support and maintenance	6,161	15.1%	5,595	17.0%	17,619	16.0%	15,916	16.9%
Business management services	5,104	12.5%	4,372	13.2%	13,919	12.6%	12,612	13.4%
Total costs of sales	23,856	58.3%	19,395	58.8%	65,316	59.3%	54,244	57.7%
Gross profit	17,057	41.7%	13,613	41.2%	44,852	40.7%	39,747	42.3%
<b>Operating expenses:</b>								
Sales and marketing	3,311	8.1%	2,297	7.0%	8,315	7.5%	6,625	7.0%
General and administrative	6,068	14.8%	5,211	15.8%	17,645	16.0%	15,393	16.4%
Total operating expenses	9,379	22.9%	7,508	22.7%	25,960	23.6%	22,018	23.4%
Operating income	7,678	18.8%	6,105	18.5%	18,892	17.1%	17,729	18.9%
<b>Other income:</b>								
Interest income	222	0.5%	219	0.7%	512	0.5%	690	0.7%
Total other income	222	0.5%	219	0.7%	512	0.5%	690	0.7%
Income before taxes	7,900	19.3%	6,324	19.2%	19,404	17.6%	18,419	19.6%
Income taxes	3,012	7.4%	2,303	7.0%	7,331	6.7%	6,832	7.3%
Net income	\$ 4,888	11.9%	\$ 4,021	12.2%	\$ 12,073	11.0%	\$ 11,587	12.3%

**Three Months Ended September 30, 2010 Compared with Three Months Ended September 30, 2009**

*Revenues.* Total revenues for the three months ended September 30, 2010 increased 23.9%, or \$7.9 million, compared to the three months ended September 30, 2009. We experienced a significant increase in new systems and add-on sales during the third quarter of 2010, as well as continued increases in our recurring revenue streams from support and maintenance and business management services.

System sales revenues increased by 51.0%, or \$5.9 million, for the comparative three month periods. Sales to existing customers accounted for 57.4% of our system sales revenue for the third quarter of 2010 compared to 63.2% for the third quarter of 2009. third quarter of 2010 compared to eleven in the third quarter of 2009.

Support and maintenance revenues increased by 7.3%, or \$1.0 million, for the comparative three month periods. This increase was attributable to an increase in recurring revenues as a result of a larger customer base and an increase in support fees for add-on business sold to existing customers.

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Business management services revenues increased by 13.1%, or \$1.0 million, for the comparative three month periods. We experienced this increase in business management services revenues as a result of growth in customer demand for insurance follow-up services and private pay collection services. We were providing our full suite of business office management services to 29 customers at September 30, 2010, compared to 26 customers at September 30, 2009.

*Costs of Sales.* Total costs of sales increased by 23.0%, or \$4.5 million, for the comparative three month periods. As a percentage of total revenues, costs of sales decreased 50 basis points to 58.3% from 58.8%.

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Cost of system sales increased by 33.6%, or \$3.2 million, for the comparative three month periods. Gross margin on system sales increased to 28.0% in the third quarter of 2010 from 18.6% in the same quarter of the prior year due to more efficient use of personnel added over the past year. Cost of equipment increased 48.8%, or \$1.1 million, and cost of software increased \$0.3 million for the comparative three month periods. Equipment and software costs increased due to a higher number of installations. Payroll and related costs increased 10.6%, or \$0.5 million, for the comparative three month periods. This increase is primarily due to salary costs of additional support personnel hired during 2009 and 2010 in anticipation of an increase in future installations stemming from the electronic medical record requirements contained in the American Recovery and Reinvestment Act of 2009 (the ARRA). We had 465 installation and support employees as of September 30, 2010 compared to 395 as of September 30, 2009. The training curve of a newly hired employee is generally 6 to 12 months, therefore sales margins have slowly improved as our new employees are more fully utilized. Travel and related costs increased 65.0%, or \$1.2 million, as a result of an increased number of installations during the quarter.

Cost of support and maintenance increased by 10.1%, or \$0.6 million, for the comparative three month periods. The gross margin on support and maintenance revenues decreased to 58.8% from 59.9% in the same quarter of the prior year. The decrease in gross margin was due to a 10.5%, or \$0.5 million, increase in payroll and related costs due to the addition of the new personnel during 2009 and 2010 to service our growing customer base.

Cost of business management services increased by 16.7%, or \$0.7 million, for the comparative three month periods. During the third quarter of 2010 we completed the transition our entire business management services division into a consolidated facility near our main campus in Mobile, Alabama. We believe this consolidation will improve workflow and operations as well as allow for future growth of our business management services division for the foreseeable future. The gross margin on business management services decreased to 39.6% compared to 41.5% in the same quarter of the prior year primarily due to higher occupancy costs related to the new facility.

*Sales and Marketing Expenses.* Sales and marketing expenses increased by 44.1%, or \$1.0 million, for the comparative three month periods. The increase is attributable to a \$0.9 million increase in commission expense, largely attributable to the increased sales of new and add-on systems. Salary expenses increased \$0.1 million from additional personnel and merit increases.

*General and Administrative Expenses.* General and administrative expenses increased by 16.5%, or \$0.9 million, for the comparative three month periods. This increase was attributable to a \$0.1 million increase in depreciation expense, a \$0.2 million increase in insurance costs, a \$0.2 million increase in professional fees incurred as a result of an internal investigation, a \$0.1 million increase in telephony expenses to support SAAS customers, and a \$0.2 million increase in costs for our national user group meeting expense which was incurred in the third quarter of 2010 but for which there was no comparable expense in the third quarter of 2009.

As a percentage of total revenues, sales and marketing expenses, and general and administrative expenses increased slightly to 22.9% for the three months ended September 30, 2010 compared to 22.7% for the three months ended September 30, 2009.

*Net Income.* Net income for the three months ended September 30, 2010 increased by 21.6%, or \$0.9 million, to \$4.9 million, or \$0.45 per diluted share, as compared with net income of \$4.0 million, or \$0.37 per diluted share, for the three months ended September 30, 2009. Net income represented 11.9% of revenue for the three months ended September 30, 2010, as compared to 12.2% of revenue for the three months ended September 30, 2009.

**Nine Months Ended September 30, 2010 Compared with Nine Months Ended September 30, 2009**

*Revenues.* Total revenues for the nine months ended September 30, 2010 increased by 17.2%, or \$16.2 million, compared to the nine months ended September 30, 2009. We have experienced a significant increase in new systems and add-on sales during the nine months ended September 31, 2010, as well as continued increases in our recurring revenue streams from support and maintenance and business management services.

System sales revenues increased by 36.0%, or \$11.1 million, for the comparative nine month periods. System sales increased in the second and third quarter of 2010 and should remain relatively strong for the remainder of the year. Sales to existing customers accounted for 62.2% of system sales revenue for the first nine months of 2010 as compared to 62.0% for the first nine months of 2009.

Support and maintenance revenues increased by 4.9%, or \$2.0 million, for the comparative nine month periods. This increase was attributable to an increase in recurring revenues as a result of a larger customer base and increased sales of add-on business to existing customers.



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Business management services revenues increased by 14.0%, or \$3.0 million, for the comparative nine month periods. We experienced an increase in business management services revenues as a result of continued growth in existing customer demand for insurance follow-up services and private pay collection services.

*Costs of Sales.* Total costs of sales increased by 20.4%, or \$11.1 million, for the comparative nine month periods. As a percentage of total revenues, costs of sales increased 160 basis points to 59.3% from 57.7%.

Cost of system sales increased by 31.3%, or \$8.1 million, for the comparative nine month periods. Cost of equipment increased by 51.0%, or \$2.9 million, and cost of software increased by 80.0%, or \$0.6 million, due to an increased number of installations. Payroll and related costs increased by 15.2%, or \$2.1 million, due to the addition of new personnel as described previously. Travel and related costs increased by 45.8%, or \$2.3 million, due to the increased number of new and add-on system installations. Gross margin on system sales increased to 19.7% in the first nine months of 2010 compared to 16.8% in the first nine months of 2009.

Cost of support and maintenance increased by 10.8%, or \$1.7 million, for the comparative nine month periods. The gross margin on support and maintenance revenues decreased to 59.6% compared to 61.8% for the same nine month period in the prior year. The decrease in gross margin was primarily due to a 14.0%, or \$1.9 million, increase in payroll and related costs due to the addition of personnel during 2009 and 2010 as described previously.

Our costs associated with business management services increased by 10.4%, or \$1.3 million, for the comparative nine month periods. This increase was caused by an increase of \$0.9 million in payroll, temporary labor and related expenses as a result of an increase in the number of employees needed to support our growing business management services operations. Occupancy and related costs also increased \$0.2 million due to the new business management services facility. The gross margin on our business management services increased 190 basis points to 43.1% for the nine month period ended September 30, 2010 from 41.2% for the comparable nine month period ended September 30, 2009 due to more efficient utilization of personnel.

*Sales and Marketing Expenses.* Sales and marketing expenses increased 25.5%, or \$1.7 million, for the comparative nine month periods due to a \$1.4 increase in commission expense due to new and add-on system sales and a \$0.3 million increase in salary and related costs.

*General and Administrative Expenses.* General and administrative expenses increased by 14.7%, or \$2.3 million, for the comparative nine month periods. This increase was attributable to a \$0.6 million increase in health insurance and related costs due to negative claims experience. Depreciation expense increased by \$0.3 million due to new facilities put into operation during the first nine months of 2010. Professional fees increased by \$0.5 million, primarily as the result of an internal investigation. Payroll and related costs increased by \$0.2 million due to salary increases as the result of merit-based increases. Telephony costs also increased \$0.2 million due to additional telephony infrastructure.

As a percentage of total revenues, sales and marketing expenses, and general and administrative expenses increased slightly to 23.6% for the nine months ended September 30, 2010 compared to from 23.4% for nine months ended September 30, 2009.

*Net Income.* Net income for the nine months ended September 30, 2010 increased by 4.1%, or \$0.5 million, to \$12.1 million, or \$1.10 per diluted share, as compared with net income of \$11.6 million, or \$1.06 per diluted share, for the nine months ended September 30, 2009. Net income represented 10.9% of revenue for the nine months ended September 30, 2010, as compared to 12.3% of revenue for the nine months ended September 30, 2009.

## **Liquidity and Capital Resources**

As of September 30, 2010, we had cash and cash equivalents of \$1.7 million, compared to \$4.4 million at December 31, 2009. Management believes that cash and investments plus cash generated from our normal operating activities should be adequate to fund our business through the remainder of 2010 and 2011. Our principal source of liquidity has been cash provided by operating activities. Cash provided by operating activities has been used primarily to fund the growth in our business and return cash to shareholders in the form of dividends. We believe that paying dividends is an effective way of providing an investment return to our stockholders and a beneficial use of our cash. However, the declaration of dividends by CPSI is subject to the discretion of our Board of Directors. Our Board of Directors will continue to take into account such matters as general business conditions, our financial results, available cash and investments and such other factors as our Board of Directors may deem relevant in determining dividend policies.

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Net cash provided by operating activities for the nine months ended September 30, 2010 was \$13.9 million, compared to \$6.1 million for the nine months ended September 30, 2009. The increase was primarily due to an increase in accounts payable, deferred revenue and other liabilities as well as income taxes payable. Our days sales outstanding for the quarter ended September 30, 2010 dropped to 54 from 56 for the year ended December 31, 2009, which reflects a slight improvement in accounts receivable status as a percentage of sales during the first nine months of 2010. However, collections are still slower than in 2008 and prior periods, and we continue to experience an increase in requests by customers for payment terms and financing arrangements as a result of the challenging economic environment and reduced availability of credit from third parties. These financing arrangements and slower collections negatively affect our short-term operating cash flow and cash available.

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Net cash used in investing activities totaled \$4.8 million for the nine months ended September 30, 2010 compared to \$2.8 million for the nine months ended September 30, 2009. We used cash for the purchase of \$4.6 million of property and equipment and the purchase of investments of \$0.2 million during the nine months ended September 30, 2010. The property and equipment purchases were primarily for the build-out of a new facility in Mobile, Alabama to house our business management services employees. The facility was complete as of September 30, 2010. The new facility should provide us with sufficient expansion space for our business management services operations for the next few years.

Net cash used in financing activities totaled \$11.8 million for the nine months ended September 30, 2010, compared to \$10.1 million for the nine months ended September 30, 2009. Net cash used in financing activities increased from the prior year due to the expiration of all options previously granted under the 2002 Stock Option Plan in May 2009, which options provided financing proceeds and income tax benefits to the Company.

We currently do not have a bank line of credit or other credit facility in place. Because we have no debt, we are not subject to contractual restrictions or other influences on our operations, such as payment demands and restrictions on the use of operating funds that are typically associated with debt. If we borrow money in the future, we will likely be subject to operating and financial covenants that could limit our ability to operate as profitably as we have in the past. Defaults under applicable loan agreements could result in the demand by lenders for immediate payment of substantial funds and substantial restrictions on expenditures, among other things. Due to current economic conditions and continued disruption of availability of financing arrangements in the capital markets, additional capital, if needed, may not be available on terms favorable to us, or at all.

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, investments and anticipated cash generated from operations will be sufficient to meet our operating requirements for at least the next 12 months.

### **Off Balance Sheet Arrangements**

Our only off-balance sheet arrangement, as defined by Item 303(a)(4) of SEC Regulation S-K, consists of our guarantee of certain lease obligations of Solis Healthcare, LP ( Solis Healthcare ) to Winthrop Resources Corporation ( Winthrop ) under a lease agreement. Solis Healthcare purchased a software system from us and then entered into a sale-leaseback transaction with Winthrop in the first quarter of 2008. We provided this guarantee in order to facilitate Solis Healthcare in leasing the new system.

The lease has an initial term of five years and continues from year to year thereafter until terminated. We are contingently liable as guarantor under the lease such that, if at any time prior to the termination of the initial term of the lease, Solis Healthcare (i) enters into bankruptcy or (ii) defaults for more than 60 days in its payments or performance under the lease, we will be obligated to perform under the guaranty by making the required lease payments, including late fees and penalties. The guaranty runs for the initial term of the lease; however, the maximum potential amount of future payments that we would be required to make to Winthrop under the guaranty is \$1,477,820, representing the remaining payments on the initial term of the lease as of September 30, 2010, plus any fees and costs that Winthrop incurs in collecting amounts due under the lease (including attorney's fees and costs). We recorded \$2,154,389, the amount billed for the new system installation, as revenue during the first quarter of 2008. Due to the contingent nature of the guaranty, the maximum amount of the guaranty is not recorded on our balance sheet; however, when necessary, we record reserves to cover potential losses. A liability in the amount of \$69,466, the amortized fair value of the guaranty, is recorded on our balance sheet as an other accrued liability at September 30, 2010. See Note 9 to the financial statements for additional information.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Our exposure to market risk relates primarily to the potential change in the value of our investment portfolio as a result of fluctuations in interest rates. The primary purpose of our investment activities is to preserve principal while maximizing the income we receive from our investments without significantly increasing risk of loss. As of September 30, 2010, our investment portfolio consisted of a variety of financial instruments, including, but not limited to, money market securities, commercial paper and high quality government and corporate obligations. It is our intent to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We do not hold financial instruments for trading or other speculative purposes. The securities in our investment portfolio are classified as available-for-sale and, consequently, are recorded on our balance sheet at fair market value with their related unrealized gain or loss reflected as a component of accumulated other comprehensive income (loss) in stockholders' equity.

Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectation due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates.

We believe that the market risk arising from our holdings of these financial instruments is minimal. Due to the conservative allocation of our investment portfolio, we do not believe that an immediate 10% increase in interest rates would have a material effect on the fair market value of our portfolio. Additionally, since we believe we have the ability to liquidate this portfolio, we do not expect our operating results or cash flows to be materially affected to any significant degree by a sudden change in market interest rates on our investment portfolio. We do not utilize derivative financial instruments to manage our interest rate risks.

The table that follows presents fair values of principal amounts and weighted average interest rates for our investment portfolio as of September 30, 2010.

	Aggregate Fair Value	Weighted Average Interest Rate
<b>Cash and Cash Equivalents:</b>		
Cash	\$ 1,688,208	
<b>Total cash and cash equivalents</b>	<b>\$ 1,688,208</b>	
<b>Short-Term Investments: (1)</b>		
Accrued Income	\$ 84,342	
Money market funds	140,212	0.25%
Obligations of the U.S. Treasury, U.S government corporations and agencies	3,056,181	2.28%
Corporate debt securities	2,715,527	4.67%
<b>Total short-term investments</b>	<b>\$ 5,996,262</b>	
<b>Long-Term Investments: (2)</b>		
Obligations of the U.S. Treasury, U.S government corporations and agencies	\$ 2,626,166	0.71%
Mortgage backed securities	131,711	5.00%
Corporate debt securities	4,641,049	4.27%
<b>Total long-term investments</b>	<b>\$ 7,398,926</b>	

(1) Reflects instruments with a contractual maturity of less than one year.

(2) Reflects instruments with a contractual maturity of one year or more.

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As of September 30, 2010, the Company had no borrowings and, therefore, is not subject to interest rate risks related to debt instruments.

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### **Item 4. Controls and Procedures.**

#### *Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that the information required to be disclosed by us in reports that 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 specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Because of the inherent limitations to the effectiveness of any system of disclosure controls and procedures, no evaluation of disclosure controls and procedures can provide absolute assurance that all control issues and instances of fraud, if any, with a company have been prevented or detected on a timely basis. Even disclosure controls and procedures determined to be effective can only provide reasonable assurance that their objectives are achieved.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) pursuant to Rule 13a-15 of the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective at the reasonable assurance level. In arriving at this conclusion, management considered the results of the internal investigation overseen by the Audit Committee of the Board of Directors into the misappropriation of certain assets of the Company by the Company's former Chief Financial Officer which was fully disclosed by the Company in its Forms 8-K that were filed with the SEC on June 16, June 30 and July 29, 2010.

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

In the course of the Company's internal investigation into the misappropriation of corporate assets by the Company's former Chief Financial Officer, certain deficiencies in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) (internal controls) were revealed. The Company has reviewed for remediation the relevant internal controls and related compliance policies and procedures, including the review, expansion and formalization of policies relating to credit card use and reimbursement procedures and the enhancement of its training of employees regarding compliance with these and other policies, and has substantially implemented as of the date of filing of this report changes to relevant internal controls. However, there were no changes in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the quarter ended September 30, 2010 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, 2009, and in Part II, Item 1A. Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K and Quarterly Report on Form 10-Q 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.



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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**  
Not applicable.

**Item 3. Defaults Upon Senior Securities.**  
Not applicable.

**Item 4. Reserved.**

**Item 5. Other Information.**  
None

**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), 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), 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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**SIGNATURES**

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

**COMPUTER PROGRAMS AND SYSTEMS, INC.**

Date: November 8, 2010

By: /s/ J. Boyd Douglas  
J. Boyd Douglas  
President and Chief Executive Officer

Date: November 8, 2010

By: /s/ David A. Dye  
David A. Dye  
Vice President - Finance and Chief Financial Officer

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**Exhibit Index**

<b>No.</b>	<b>Exhibit</b>
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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