COMPUTER SOFTWARE INNOVATIONS INC
Form 10KSB
March 30, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

OR

¨ 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: **000-51758**

COMPUTER SOFTWARE INNOVATIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**98-0216911**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1661 East Main Street, Easley, SC	**29640**
(Address of principal executive offices)	(Zip Code)

(864) 855-3900

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $0.001 per share

Check whether the issuer is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes [ ] No [**x**]

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [**x**] No [ ]

Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [**x**]

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

State issuer s revenues for its most recent fiscal year. $24,286,724

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of a specified date within the past 60 days. $748,865, based on the average bid and asked price of $2.98 on March 17, 2006.

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date.

Class	Outstanding at March 17, 2006
Common Stock, $0.001 par value per share	3,270,680 shares

DOCUMENTS INCORPORATED BY REFERENCE

None

Transitional Small Business Disclosure Format (check one): Yes [ ] No [**x**]

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PART I

Item 1. Description of Business.
A. Introduction

Unless the context requires otherwise, (1) Computer Software Innovations, Inc., CSI, we, our, us and the Company refer to the combined business of Computer Software Innovations, Inc., a Delaware corporation formerly known as VerticalBuyer, Inc., and its subsidiary, CSI Technology Resources, Inc., a South Carolina corporation; (2) VerticalBuyer refers to the Company prior to the merger; and (3) CSI South Carolina refers to Computer Software Innovations, Inc., a South Carolina corporation, prior to the merger.

We develop software and provide hardware-based technology solutions. Our internally developed software consists of fund accounting based financial management software and standards-based lesson planning software. Our primary software product, fund accounting based financial management software, is developed for those entities that track expenditures and investments by fund, or by source and purpose of the funding. Our fund accounting software is used primarily by public sector and not-for-profit entities. In September 2005, we acquired a standards-based lesson planning software product that we have since named curriculator The software is designed to allow teachers to create lesson plans that are tied to a state s curriculum standards. These lesson plans may be reviewed by administrators and a report generated to determine the standards that have been met or need to be met. We also provide a wide range of technology solutions, including hardware and design, engineering, installation, training and ongoing support and maintenance. Our solutions include computers, networking, security, IP telephony and distance learning and video communication.

Our operations are those of our predecessor, Computer Software Innovations, Inc., a South Carolina corporation organized in 1990. The history and development of CSI South Carolina is described in C. History and Development of CSI South Carolina. Our current business operations are described in B. Overview and elsewhere in this Description of Business.

Prior to February 10, 2005, the Company was known as VerticalBuyer, Inc. Prior to our merger with CSI South Carolina on February 11, 2005, we were a public shell corporation, having conducted no business operations since September 2001. A brief history of VerticalBuyer, Inc. is presented in Q. VerticalBuyer, Inc.

In the first quarter of 2005, we concluded a series of recapitalization transactions. On January 31, 2005, a change in control of the Company occurred as a result of the purchase of a majority of our common stock by CSI South Carolina. On February 11, 2005, CSI South Carolina merged into us, and we issued preferred stock, common stock, warrants and certain subordinated notes. In connection with the merger, we changed our name to Computer Software Innovations, Inc. We refer to the Company prior to the merger as VerticalBuyer.

The merger of CSI South Carolina into us is accounted for as a reverse acquisition, with CSI South Carolina being designated for accounting purposes as the acquirer, and the surviving corporation, VerticalBuyer, Inc., being designated for accounting purposes as the acquiree. Under reverse acquisition accounting, the financial statements of the surviving corporation (VerticalBuyer) are the financial statements of the acquirer (CSI South Carolina). Accordingly, reported prior year financial results are those of CSI South Carolina, not VerticalBuyer. The activities of VerticalBuyer are included only from the date of the transaction forward. Shareholders equity of CSI South Carolina, after giving effect for differences in par value, has been carried forward after the acquisition, and prior year per share amounts have been restated to account for the additional stock issued as a result of the merger.

The merger and related transactions are described in E. The Merger and Recapitalization, and under Item 6 Management s Discussion and Analysis or Plan of Operation B. Reverse Merger and Investment by Barron Partners LP.

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Our principal executive offices are located at 1661 East Main Street, Easley, South Carolina 29640. Our telephone number at that location is (864) 855-3900.

We maintain an Internet website at www.csi-plus.com. Certain pertinent information about our business, products and services and recent developments is posted on our website. The information on our website does not constitute a part of this report.

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended, and we file annual, quarterly and current reports and other information with the Securities and Exchange Commission (the SEC). You may read and copy any document that we file at the SEC s public reference room facility located at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The SEC maintains an Internet site at http://www.sec.gov that contains reports and other information regarding issuers, including us, that file documents with the SEC electronically through the SEC s electronic data gathering, analysis and retrieval system known as EDGAR.

Our common stock is traded in the over-the-counter market under the symbol CSWI.OB Trade information is reported on the OTC Bulletin Board.

B. Overview

We develop software and provide hardware-based technology solutions. Our internally developed software is sold and supported through our software applications segment. We monitor our business as two segments, but take advantage of cross-selling and integration opportunities. We provide hardware-based technology solutions through our technology solutions segment. By strategically combining our fund accounting software with our ability to integrate computer and other hardware, we have been successful in providing a variety of technological solutions to over 300 clients located in South Carolina, North Carolina and Georgia. We are pursuing a national presence with a primary, initial focus on the southeast region of the United States.

Software Applications Segment

Our software applications segment develops accounting and administrative software applications that are designed for organizations that employ fund accounting. These organizations include our primary target market: municipalities, school districts and local governments. Our software provides a wide range of functionality to handle public sector and not-for-profit accounting requirements including receipt and tracking of funds, application of purchases, payables, investments and expenditures by fund, and production of financial and informational reports. The software is written in modules which can be sold separately or as a fully-integrated package so that information keyed in one module will be updated electronically into other modules to minimize keying and improve productivity. In addition to the modules covering general accounting functions, specialty modules are also available. The software modules include:

General (or Fund) Ledger;

Accounts Payable;

Purchasing;

Payroll;

Personnel;

Employee Absence/Substitutes;

Inventory;

Utility Billing; and

Other specialty modules designed for government markets.

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More detailed information concerning the modules noted above and additional specialty modules is presented in G. Product and Services.

We also provide standards-based lesson planning software that we have recently renamed curriculator This software is designed to allow teachers to create lesson plans that tie to a state s curriculum standards. Lesson plans may then be reviewed by school administrators and reports generated to determine if standards have been met. Additional information concerning the standards based learning planning software is presented in G. Product and Services.

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

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

Technology Solutions Segment

Our technology solutions segment has a staff of certified systems engineers capable of providing a broad range of technology solutions to our clients. Certified systems engineers are computer professionals who have passed a test indicating specialized knowledge in the design, planning and implementation of specific computer based technology. These solutions can include, among other capabilities, planning, installation and management of computer, telephone, wireless, video conference, security monitoring and distance and classroom learning projects. Through this segment we also provide subsequent support and maintenance of equipment and systems.

In addition, we provide network integration solutions as a value added reseller (selling equipment purchased from vendors to which we have added our engineering services) of computer hardware and engineering services. These technologies include, but are not limited to:

- technology planning (developing plans to purchase or upgrade computers, telephone equipment, cabling and software);
- hardware/software sales and installation;
- system and network integration (combining different computer programs, processes and hardware such that they operate and communicate seamlessly as a tight-knit system.);
- wide area networking (linking a group of two or more computer systems over a large geographic area, usually by telephone lines or the internet);
- wireless networking (linking a group of two or more computer systems by radio waves);
- IP Telephony and IP Surveillance (sending voice calls and surveillance across the internet using internet protocol (IP), a standard method for capturing information in packets);
- project management (overseeing installation of computers, telephone equipment, cabling and software);

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

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

education technologies, including distance learning and classroom learning tools.

In addition to our engineers, our technology solutions segment includes a staff of sales persons, project managers and product specialists. Our technology solutions segment also purchases and resells products from a variety of manufacturers such as Hewlett Packard, Cisco, Microsoft, Novell, Promethean, Tandberg and DIVR, and supports the software applications segment.

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

The chart below shows revenues by business segment for the years ended December 31, 2005 and 2004.

($ in thousands)	**Year Ended December 31, 2005**	**Year Ended December 31, 2004**
Revenues		
Software applications segment	$ 4,148	$ 4,676
Technology solutions segment	20,139	17,805
Revenues	$ 24,287	$ 22,481
Gross Profit		
Software applications segment	$ 2,367	$ 3,063
Technology solutions segment	4,179	4,006
Gross Profit	$ 6,546	$ 7,069
Gross Margin		
Software applications segment	57.1%	65.5%
Technology solutions segment	20.8%	22.5%
Gross Margin	27.0%	31.4%

C. History and Development of CSI South Carolina

Initial Development

Our current business operations are those of CSI South Carolina. CSI South Carolina was incorporated under the name of Compu-Software, Inc. as a South Carolina corporation on January 12, 1990, and founded by Joe G. Black, our former interim Chief Financial Officer; Nancy K. Hedrick, our Chief Executive Officer and Director; and Beverly N. Hawkins, our Secretary and Vice President of Product Development. Ms. Hedrick and Ms. Hawkins previously worked for Data Management, Inc. (DMI), and while employed by DMI, they developed a software program for an accounting system designed for the local government and the kindergarten through high school (K-12) education sector. Ms. Hedrick and Ms. Hawkins left DMI to work for Holliday Business Service, Inc. (HBS) and shortly thereafter, in February of 1989, DMI sold the accounting system software to HBS. HBS created a division of the company for this accounting system named Compusoft. In January of 1990, Ms. Hawkins and Ms. Hedrick left HBS to create CSI South Carolina under the name of Compu-Software, Inc. In connection with the establishment of the new company, HSB sold the rights to the CompuSoft software to CSI South Carolina (Compu-Software, Inc., which subsequently changed its name to Computer Software Innovations, Inc.).

Mr. Black, a former partner with HBS, recognized the value of the software targeted at a potentially attractive niche market, and teamed up with Ms. Hedrick and Ms. Hawkins in their formation of Compu-

Software, Inc. The marketing of the accounting software and supporting the developing client base was the core business of CSI South Carolina from its incorporation until 1999. Beginning with a small, established client base, CSI South Carolina was profitable near inception. During this nine year period, it grew from the original two employees (Ms. Hedrick and Ms. Hawkins), fifteen clients and modest revenues to approximately thirteen employees, a client base of more than 70 customers, and revenues of more than a million dollars.

In early 1999, the original principals were joined by Thomas P. Clinton, our Vice President of Sales and Director; and William J. Buchanan, our Treasurer and Vice President of Delivery and Support. Messrs. Buchanan and Clinton had been employees of another value added reseller and for many years had worked closely with CSI South Carolina to provide hardware network support to its clients. When their former employer began to de-emphasize the K-12 education market, Messrs. Buchanan and Clinton elected to join CSI South Carolina. CSI Technology Resources, Inc. was formed as a wholly-owned subsidiary of CSI South Carolina to be a value added reseller of computer hardware and network integration services. A value added reseller is a business that resells computers and other technology hardware or software coupled with value adding solutions such as installation services, software, customization and project management.

The addition of the technology sector provided an additional revenue source from the existing client base and new contacts. The result was an increase in revenues from approximately $2 million in 1999 to revenues of approximately $24 million for the fiscal year ended 2005.

By 2000, CSI Technology Resources, Inc. ceased to operate or be accounted for as a separate organization. Accordingly, Ms. Hedrick, Ms. Hawkins and Messrs. Black, Clinton and Buchanan became equal shareholders in CSI South Carolina. Each principal managed a specific area of the business (i.e., sales, technical support services, product development, engineering and administration-finance). The business has continued to operate in a similar manner following its reverse merger with VerticalBuyer.

Events Leading Up to 2005 Restructuring

In 2001, Joe Black, one of the owners and the Chief Financial Officer of CSI South Carolina at the time, announced to the other four owners that he expected to retire within three years. He also indicated that he might want to cash out all or a portion of his interest in CSI South Carolina at the time of his retirement. The five owners of CSI South Carolina began to plan for the approaching retirement of Mr. Black and for the possible disposition of his shares of stock in connection with his retirement. The owners decided to look for financing and considered the possibility of selling stock from each owner in CSI South Carolina to an investor, as well as positioning CSI South Carolina for growth. CSI South Carolina interviewed a few investment banking firms in 2001 and 2002, including The Geneva Companies, Inc. (Geneva), an affiliate of Citigroup, Inc. Management selected Geneva and engaged it to advise CSI South Carolina and the five principals on valuation and financing strategies. Geneva directed the process of locating potential strategic or financial partners for CSI South Carolina.

CSI South Carolina spoke with several interested parties from 2003 into 2004, but no firm prospects emerged until early 2004. Ultimately, CSI South Carolina and its owners signed a letter of intent on May 10, 2004 to sell the stock of CSI South Carolina to Yasup, LLC of New York, New York, which CSI South Carolina management believed to be affiliated with a larger company in CSI South Carolina s industry. Pursuant to the letter of intent, CSI South Carolina began providing information and materials concerning its business to Yasup, LLC. Subsequently, on July 19, 2004, CSI South Carolina and its owners signed a revised letter of intent with Yasup, LLC for the sale of CSI South Carolina. This letter of intent provided that it would terminate if a definitive agreement was not executed within 90 days, or by October 17, 2004.

Over the next several months, the owners of CSI South Carolina negotiated with Yasup, LLC concerning the acquisition. During these negotiations, Yasup, LLC indicated that several companies had evaluated possible financing for the acquisition, but none committed funds. Ultimately, the parties could not come to terms by the termination date of the letter of intent or afterwards, and the proposed acquisition was abandoned.

Through its financial adviser, Liberty Company, LLC (Liberty), Barron Partners LP, a Delaware limited partnership (Barron), became aware that CSI South Carolina was seeking to restructure. After the July 19, 2004 letter of intent with Yasup, LLC had terminated, Barron approached the owners of CSI South Carolina through Geneva about financing possibilities. On December 2, 2004, CSI South Carolina and Barron executed a letter of intent by which Barron proposed to buy common stock from the CSI South Carolina owners and acquire other rights in CSI South Carolina (or another company into which CSI South Carolina would merge) after the transaction.

Barron is a micro-cap fund, limited by its organizational documents to investments in companies that are public entities, so the transaction required the merger of CSI South Carolina into a public company that was already reporting to the SEC prior to the investment by Barron. In order to accomplish this, Barron and CSI South Carolina determined that the most effective alternative was for CSI South Carolina to merge into a publicly held inactive shell corporation. In addition, our shareholders believed that converting CSI South Carolina into a publicly held entity would provide the Company in the long term with access to public capital markets that could provide funds for future strategic growth. A public market for the Company s stock would also provide the five shareholders with liquidity for their equity investment in the recapitalized Company.

Barron searched for a publicly held inactive shell corporation, eventually identifying VerticalBuyer, Inc., a Delaware corporation, 77% of the common stock of which was held by Maximum Ventures, Inc. (Maximum Ventures), a New York corporation. VerticalBuyer, which is described in more detail under Q. VerticalBuyer, Inc. below, had formerly been engaged in the development of internet sites and had ceased all operations in September 2001. Maximum Ventures purchased its interest in VerticalBuyer on March 12, 2004.

CSI South Carolina and Barron originally envisioned that Barron would acquire the inactive shell corporation required to facilitate the contemplated investment by Barron. In December 2004, Barron entered into negotiations with Maximum Ventures for the shares held by it in VerticalBuyer, and advanced $50,000 as an advisory fee, to be credited against the purchase price. However, subsequent to these initial negotiations by Barron with Maximum Ventures, Barron was advised that its organizational documents would not permit it to acquire a corporation with substantially no assets. Accordingly, CSI South Carolina and Barron agreed that CSI South Carolina would acquire a controlling interest in VerticalBuyer.

In December 2004 and January 2005, CSI South Carolina performed legal and financial due diligence on VerticalBuyer, completed negotiations with Maximum Ventures for the purchase of its stockholdings in the inactive corporation and finalized a stock purchase agreement. On January 28, 2005, CSI South Carolina and Barron entered into a second amendment to their letter of intent. In addition to extending Barron s exclusive due diligence period until February 28, 2005, CSI South Carolina also agreed that it would not sell or otherwise dispose of any of the shares of VerticalBuyer s common stock it was to purchase without the prior written consent of Barron, other than as a part of the transactions contemplated by the letter of intent. In addition, Barron agreed to purchase from CSI South Carolina all of such VerticalBuyer stock, at the same price at which it was to be purchased from Maximum Ventures, in the event that the closing of the transactions contemplated by the letter of intent were not consummated by February 28, 2005. The parties contemplated that any exercise of such right by Barron would have been accomplished through an assignee of Barron.

On January 31, 2005, CSI South Carolina and Maximum Ventures entered into a stock purchase agreement and CSI South Carolina concurrently purchased all of the 13,950,000 shares of the common stock of VerticalBuyer from Maximum Ventures. CSI South Carolina s acquisition of a majority interest in VerticalBuyer from Maximum Ventures is described in more detail under E. The Merger and Recapitalization Description of Merger and Related Investment Transactions Purchase of Majority Interest of VerticalBuyer by CSI South Carolina.

Upon the consummation of the stock purchase transaction with Maximum Ventures, VerticalBuyer became a 77% owned subsidiary of CSI South Carolina. Officers of CSI South Carolina were appointed as officers of

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VerticalBuyer as follows: Nancy K. Hedrick, President and CEO; Joe G. Black, Interim CFO; William J. Buchanan, Treasurer; and Beverly N. Hawkins, Secretary. Effective upon the closing of the Maximum Ventures transaction, the following persons, who had no previous association with VerticalBuyer or CSI South Carolina, were appointed to the board of directors: Anthony H. Sobel, Thomas V. Butta and Shaya Phillips. Prior to Barron, CSI South Carolina or VerticalBuyer entering into any definitive agreements, the management of CSI South Carolina was having difficulty in identifying and securing independent director candidates that it thought would add value to the Company. Accordingly, management solicited advice from Barron regarding potential independent director candidates. Barron introduced Messrs. Sobel, Butta and Phillips. Mr. Sobel, who had no prior business or investment ties to Barron, has experience in the management and financing of emerging enterprises. Mr. Sobel is the chief executive officer of Montana Metal Products, L.L.C., a precision sheet metal fabrication and machining company. Robert F. Steel, a consultant to us who is also an investor in Barron, is an investor with Mr. Sobel in Montana Metal Products. Messrs. Butta and Phillips were introduced to CSI South Carolina because of their experience in technology and software-based businesses. Mr. Butta, who subsequently resigned as a director on February 22, 2006, is President and Vice Chairman of the board of directors of a21, Inc., a concern in which Barron invested. Mr. Phillips previously served as chief operating officer and chief technology officer of Global Broadband, Inc., a concern in which Barron years earlier had invested. Mr. Phillips has consulted on a limited basis for Barron with respect to technology investments.

On February 10, 2005, CSI South Carolina and VerticalBuyer, its then 77% owned subsidiary, entered into the Agreement and Plan of Merger. The agreement provided that CSI South Carolina would merge into VerticalBuyer, with VerticalBuyer being the surviving corporation. As a result, CSI South Carolina would in effect become a publicly held company reporting to the SEC. Also on February 10, 2005, CSI South Carolina and Barron entered into definitive agreements for a preferred stock investment in VerticalBuyer following its merger with CSI South Carolina. The merger and other transactions contemplated by the Barron letter of intent and definitive agreements were consummated February 11, 2005 and are described in more detail in E. The Merger and Recapitalization below.

D. Subsidiaries

Our consolidated financial statements continue to include CSI Technology Resources, Inc. as a wholly-owned subsidiary. However, this subsidiary no longer has any significant operations or separate accounting. Its former operations are now accounted for within CSI, except that CSI Technology Resources, Inc. is still named in certain contracts. At a future date, these contracts may be transferred to the parent and the subsidiary deactivated, subject to a review of any tax and legal consequences.

We have no other subsidiaries.

E. The Merger and Recapitalization

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

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

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Merger Accounting

The merger was accomplished through an exchange of equity interests.

Under Statement of Financial Accounting Standards (SFAS) No. 141 Business Combinations, the merger of CSI South Carolina into VerticalBuyer was considered to be a reverse acquisition, whereby CSI South Carolina is considered to be the acquirer. Accordingly, the assets and liabilities of CSI South Carolina continued to be recorded at their actual cost. VerticalBuyer had no assets or liabilities at the time of acquisition. Under reverse acquisition accounting, the financial statements of the surviving corporation (VerticalBuyer) are the financial statements of the acquirer (CSI South Carolina). Costs associated with the reverse acquisition are required to be expensed as incurred. Shares issued in the transaction are shown in our financial statements as outstanding for all periods presented and the activities of the surviving company (VerticalBuyer) are included only from the date of the transaction forward. Shareholders equity of CSI South Carolina, after giving effect for differences in par value, has been carried forward after the acquisition.

The accounting treatment for the merger is discussed in more detail in Item 6, Management s Discussion and Analysis or Plan of Operation B. Reverse Merger and Investment by Barron Partners LP and in Note 2, Acquisition and Merger to our audited consolidated financial statements as of December 31, 2005, included as part of this annual report.

Summary of Merger and Related Investment Transactions

The significant merger related activity, on a cash basis, in the order it occurred is as follows:

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

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

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

The above transactions are described in more detail below under Description of Merger and Related Investment Transactions. Our financial analysis of these transactions is discussed in Item 6, Management s Discussion and Analysis or Plan of Operation.

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Description of Merger and Related Investment Transactions

Purchase of Majority Interest of VerticalBuyer by CSI South Carolina

On January 31, 2005, CSI South Carolina purchased 13,950,000 shares of the common stock, $0.001 par value, of VerticalBuyer from Maximum Ventures pursuant to a Stock Purchase Agreement. The shares purchased by CSI South Carolina represented approximately 77% of VerticalBuyer s outstanding common stock. The purchase price was $450,000, with approximately $53,000 of that amount going to satisfy the outstanding liabilities of VerticalBuyer at that time. CSI South Carolina also reimbursed Maximum Ventures for legal expenses of $20,000. The purchase price was reduced by a $5,000 allowance from Maximum Ventures to defray a portion of the estimated costs of preparation of tax returns for 2001, 2002, 2003 and 2004 and accountant fees for the 2004 audit. CSI South Carolina also received credit for the $50,000 pre-paid advisory fee previously paid by Barron to Maximum Ventures as earnest money. As a part of its preferred stock investment in the Company, Barron contributed the $50,000 prepayment for the Company s benefit to help defray transaction legal expenses. There were no finder s fees or other monetary consideration paid in connection with the Stock Purchase Agreement and the purchase of the VerticalBuyer shares.

The purpose of the purchase of the VerticalBuyer shares was the procurement of a publicly held inactive shell corporation into which CSI South Carolina could merge and itself become a publicly held corporation reporting to the SEC. The reasons for utilizing a shell corporation are described in more detail under C. History and Development of CSI South Carolina Events Leading Up to 2005 Restructuring.

In connection with CSI South Carolina s purchase of the VerticalBuyer shares owned by Maximum Ventures, Mr. Abraham Mirman resigned as president, CEO and sole director of VerticalBuyer and Mr. Chris Kern resigned as its CFO. Messrs. Mirman and Kern also served as president and vice president, respectively, of Maximum Ventures. Anthony H. Sobel, Thomas V. Butta and Shaya Phillips were appointed as directors of VerticalBuyer. The board of directors appointed new officers of VerticalBuyer, who were also officers of CSI South Carolina. These were Nancy K. Hedrick, President and CEO; Joe G. Black, interim CFO; Beverly N. Hawkins, Secretary; and William J. Buchanan, Treasurer. The officer and director appointments were ratified by CSI South Carolina, as majority stockholder, acting by non-unanimous written consent on January 31, 2005.

Pursuant to a Stock Purchase Agreement between CSI South Carolina and Maximum Ventures dated January 31, 2005, CSI South Carolina and Maximum Ventures made certain representations and warranties, including representations and warranties by Maximum Ventures with respect to VerticalBuyer. In particular, Maximum Ventures made representations and warranties with respect to: (1) VerticalBuyer s due organization, valid existence and good standing under Delaware law; (2) the authorized and outstanding common and preferred stock of VerticalBuyer; (3) the absence of any outstanding options, warrants or convertible securities; (4) the absence of any obligation to file a registration statement with respect to common or preferred shares of VerticalBuyer; (5) the absence of any legal proceedings pending or threatened against VerticalBuyer or any of its properties or any of its officers or directors; (6) all tax returns being properly filed, except for income tax returns for years 2001 through 2004; (7) VerticalBuyer being current in its reporting obligations under the Securities Exchange Act of 1934; (8) the absence of any liens or encumbrances on the common stock to be transferred pursuant to the Stock Purchase Agreement, except for certain restrictions on transfer; (9) Maximum Ventures having the legal right to consummate the transactions contemplated by the Stock Purchase Agreement; (10) VerticalBuyer s compliance with, and absence of any violation by it of, laws and regulations; (11) the identity of the director, officers and employees of VerticalBuyer; (12) the identity of all existing creditors and claims (totaling approximately $53,000); (13) the accuracy of the books and records; (14) the exemption from the registration requirements of the Securities Act of 1933 for the stock sale; and (15) the absence, to Maximum Venture s knowledge, of any material misstatement or of a material fact or omission to state a material fact contained in VerticalBuyer s filings with the SEC, and the absence of any material adverse change from the facts set forth in VerticalBuyer s Form 10-KSB for the fiscal year ended December 31, 2003. The filing deficiency with respect to income tax returns VerticalBuyer failed to file between 2001 and 2004 has been remedied. In view of VerticalBuyer having ceased operations during this period and reporting no income, the cost of remediating these filing deficiencies was not material.

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The parties also agreed to indemnify each other generally for any breaches of any of their respective representations, warranties and covenants. In the case of Maximum Ventures, indemnification liability is capped at $450,000. CSI South Carolina and Maximum Ventures also gave further assurances that they would cooperate in the future to carry out the purposes of the Stock Purchase Agreement, including the preparation and filing of future reports of VerticalBuyer with the SEC.

Reverse Stock Split

On January 31, 2005, the board of directors of VerticalBuyer approved a reverse stock split in order to facilitate a potential merger with CSI South Carolina. In the reverse stock split, every 40 shares of VerticalBuyer s common stock issued and outstanding on the record date, February 10, 2005, were converted and combined into one share of post-split shares. The reverse split was effected pursuant to an amendment to our certificate of incorporation and was paid on February 11, 2005. No fractional shares were issued nor any cash paid in lieu thereof. Rather, all fractional shares were rounded up to the next highest number of post-split shares and the same issued to any beneficial holder of such pre-split shares which would have resulted in fractional shares. Accordingly, each beneficial holder of our common stock received at least one post-split share and no stockholders were eliminated. Pursuant to the amendment to our certificate of incorporation effecting the reverse stock split, the number of authorized and preferred shares remained unchanged at 50,000,000 and 5,000,000, respectively. Continental Stock Transfer & Trust Company, New York, New York, our transfer agent, served as exchange agent for the reverse split.

On January 31, 2005, following the board s approval of the reverse stock split, CSI South Carolina, acting as majority stockholder, approved by non-unanimous written consent the reverse split and the related amendment to our certificate of incorporation.

Par Value

In connection with the January 31, 2005 approval of the reverse stock split, the board of directors of VerticalBuyer also approved the elimination of par value of all shares of our authorized common and preferred stock. Such change was likewise approved on January 31, 2004 by CSI South Carolina, as majority stockholder acting by non-unanimous written consent. Subsequently, on February 9, 2005, the board decided it was in the best interest of VerticalBuyer and more economical to retain par value of $0.001 for all of our authorized common and preferred stock. This decision was made prior to the filing of the amendment to our certificate of incorporation and accordingly, the par value of our common and preferred stock has not changed. CSI South Carolina as majority stockholder acting by non-unanimous written consent, also approved the subsequent retention of par value on February 9, 2005.

Name Change

On February 4, 2005, the board of directors of VerticalBuyer approved the change of our name from VerticalBuyer, Inc. to Computer Software Innovations, Inc. The board also approved an amendment to our certificate of incorporation effecting such change. Following the board s approval of the name change on February 4, 2005, CSI South Carolina, acting as majority stockholder by non-unanimous written consent, also approved the name change.

The change of our name to Computer Software Innovations, Inc. became effective on February 10, 2005, concurrently with the reverse stock split, upon the filing of an amendment to our certificate of incorporation.

CSI South Carolina Redemption of Options

Prior to the merger on February 9, 2005, CSI South Carolina redeemed stock options for 6,234 (738,195, as restated in our consolidated financial statements) shares of its common stock in exchange for $899,144 cash. Under CSI South Carolina s stock option plan, certain non-executive employees had been granted stock options

for an aggregate of 9,000 (1,065,746, as restated in our consolidated financial statements) shares of CSI South Carolina common stock. The redeemed options represented 73.34% of then outstanding options for 8,500 (1,006,538, as restated in our consolidated financial statements) shares. Pursuant to the plan, the option holders retained the remaining portion of their options. In connection with the merger, the surviving corporation assumed such options, which after the merger became exercisable for shares of common stock of the surviving corporation at the share ratio applicable to shares of CSI South Carolina common stock cancelled in the merger. Following the merger, the remaining options were exercisable for 268,343 shares of the Company s common stock.

The redemption by CSI South Carolina of the options was contemplated by the parties to the Merger Agreement between CSI South Carolina and VerticalBuyer, and the preferred stock purchase agreement between Barron and the Company relating to Barron s preferred stock investment in the merged Company. The option redemption was a condition to both agreements. The purpose of the redemption was to permit the option holders, consisting of non-executive employees of CSI South Carolina whom management believed to have contributed to the success of that company, to participate with the five shareholders in the cash consideration received by the shareholders in the merger.

For additional discussion of the redemption of the CSI South Carolina options and other option plans of the Company, see Item 6, Management s Discussion and Analysis or Plan of Operation B. Reverse Merger and Investment by Barron Partners LP Summary of Merger Transactions.

CSI South Carolina Dividends

Prior to the merger on February 11, 2005, CSI South Carolina declared dividends to its five shareholders totaling $3,460,000. Those shareholders were: Nancy K. Hedrick, Joe G. Black, Beverly N. Hawkins, Thomas P. Clinton and William J. Buchanan. Of this amount, $960,000 was paid in cash and $2.5 million recorded as subordinated dividend notes payable to each shareholder. These notes were repaid immediately following the merger from the proceeds of the issuance of the preferred stock and the approximately $1.9 million subordinated loan from Barron.

The dividends were contemplated by the parties to the Merger Agreement (CSI South Carolina and VerticalBuyer) and the Preferred Stock Purchase Agreement (Barron and VerticalBuyer), and were conditions in such agreements to the consummation of the merger and Barron s preferred stock investment. The dividends resulted from the desire of the five shareholders of CSI South Carolina to withdraw a substantial amount of cash which had accumulated in CSI South Carolina prior to the sale of their stock in the merger.

The Merger

At a meeting on February 4, 2005, the board of directors of VerticalBuyer considered and approved the potential merger of CSI South Carolina into VerticalBuyer and a related merger agreement. The board had previously discussed such merger at its January 31, 2005 meeting and in meetings with legal and other advisors.

On February 10, 2005, VerticalBuyer and CSI South Carolina executed the Agreement and Plan of Merger. On February 11, 2005, CSI South Carolina merged into VerticalBuyer, with VerticalBuyer continuing as the surviving corporation. In the merger, the former stockholders of CSI South Carolina received, in exchange for their shares of CSI South Carolina common stock, two sets of notes totaling $3,624,800 and $1,875,200, respectively, and 2,526,905 shares of our common stock. Such consideration was in addition to the pre-merger dividend by CSI South Carolina. The set of notes totaling $3,624,800 was repaid to the former CSI South Carolina shareholders immediately following the merger from the proceeds of the preferred stock and the $1,875,200 subordinated note issued to Barron, as described under Sale of Preferred Stock and Warrants below. Subordinated notes payable to the former shareholders of CSI South Carolina totaling $1,875,200 remained outstanding following the merger. Amounts outstanding under these notes totaled $1,125,200 as of December 31, 2005. The terms of the subordinated notes are described more fully under Subordinated Notes below.

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The shares of the common stock of VerticalBuyer previously held by CSI South Carolina, representing approximately 77% of VerticalBuyer s issued and outstanding capital stock, were cancelled in the merger. The remaining stockholders of VerticalBuyer retained their existing shares, subject to the 40 to 1 reverse stock split. Such minority stockholders had appraisal rights as provided in accordance with Delaware law, whereby they could elect to have their shares repurchased by the surviving corporation. No minority stockholders elected to exercise their appraisal rights.

As a result of the reverse stock split and merger, immediately following the merger the Company had approximately 2.6 million shares of common stock outstanding. As a result of the issuance of the preferred stock and warrants (discussed in Sale of Preferred Stock and Warrants below), on a diluted basis, assuming the conversion of the preferred stock and exercise of outstanding warrants and options, approximately 17.3 million shares of common stock were outstanding.

Pursuant to the Agreement and Plan of Merger, a new board of directors was constituted and new officers appointed. See Item 9 for information on our officers and directors.

In accordance with the Agreement and Plan of Merger, upon the consummation of the merger, the certificate of incorporation and the bylaws of the Company were each amended and restated.

Sale of Preferred Stock and Warrants

At its meeting on February 4, 2005, VerticalBuyer s board, in connection with the merger, approved the issuance and sale of shares of its preferred stock and common stock warrants to Barron in exchange for the payment of $5,042,250 pursuant to the terms of a Preferred Stock Purchase Agreement. Pursuant to the agreement, Barron also agreed to lend an additional $1.9 million, in the form of a subordinated note on the same terms as the subordinated notes payable to the former CSI South Carolina shareholders in the merger. Later, on February 4, 2005, CSI South Carolina, acting as majority stockholder by non-unanimous written consent, ratified the board s approval of the transactions with Barron.

On February 10, 2005, VerticalBuyer entered into the Preferred Stock Purchase Agreement with Barron. Pursuant to the agreement, on February 11, 2005, immediately following the consummation of the merger, we issued to Barron 7,217,736 shares of our newly created Series A Convertible Preferred Stock in exchange for the payment of $5,042,250. Barron was also issued two warrants to purchase in the aggregate 7,217,736 shares of our common stock. The preferred stock is convertible into common stock on a one-for-one basis. The exercise prices of the warrants are $1.3972 and $2.0958 per share. Each warrant is exercisable for half of the total warrant shares. The terms and conditions of the warrants are identical except with respect to exercise price.

Both the conversion of the preferred stock and the exercise of the warrants are subject to restrictions on ownership that limit Barron s beneficial ownership of our common stock. Initially, Barron was generally prohibited from beneficially owning greater than 4.99% of our common stock, and such restriction could be waived by Barron upon 61 days prior notice. It was the intention of the Company and Barron that the preferred stockholder never acquire greater than 4.99% of the Company s common stock and never be deemed an affiliate or control person under federal securities laws. For avoidance of doubt, Barron and we agreed to remove the 61 day waiver provision and to impose a non-waivable beneficial ownership cap of 4.9%. These agreements were implemented on November 7, 2005. Pursuant to the terms of the Certificate of Designation governing the preferred stock and the warrants, the ownership cap may not be amended or waived without the approval of the common stockholders of the Company, excluding for such vote all shares held by the holders of preferred stock and warrants (including Barron) and any directors, officers or other affiliates of the Company.

As of March 17, 2006, Barron had not exercised any portion of the warrants. The warrants provide that they may be exercised on a cashless basis after February 11, 2006 if there were no registration statement effective permitting the resale of the common stock underlying the warrants. In such event, we would receive no proceeds

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from their exercise. However, our Form SB-2 registration statement covering the warrant shares was declared effective by the SEC on February 14, 2006. So long as we maintain the effectiveness of a registration statement for the resale of the shares underlying the warrants, the warrant holder is prohibited from utilizing a cashless exercise.

The terms of the Series A Convertible Preferred Stock are contained in the Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock, which is part of our charter and filed with the Secretary of State of Delaware. Disclosure on the provisions of the Certificate of Designation is contained in Certificate of Designation. The holder of the preferred stock also possesses rights pursuant to the Preferred Stock Purchase Agreement, which is discussed in Preferred Stock Purchase Agreement below. Other provisions of the warrants are discussed in Warrants below.

Registration Rights Agreement

In conjunction with the Preferred Stock Purchase Agreement, the Company also entered into a Registration Rights Agreement with Barron on February 10, 2005, whereby we agreed to register the shares of common stock underlying the preferred stock and warrants to be sold to Barron. Under the initial terms of the Registration Rights Agreement, the Company was obligated to file, within 45 days following the execution of the Registration Rights Agreement, a registration statement covering the resale of the shares. The agreement also obligated us to use our best efforts to cause the registration statement to be declared effective by the SEC within 120 days following the closing date of the registration rights agreement (February 11, 2005) or generally such earlier date as permitted by the SEC. Barron could have also demanded the registration of all or part of such shares on a one-time basis and, pursuant to piggy-back rights, require us (subject to carveback by a managing underwriter) to include such shares in certain registration statements we may file. We are obligated to pay all expenses in connection with the registration of the shares and may be liable for liquidated damages in the event the registration of shares is not maintained pursuant to the agreement.

Under the terms of the initial Registration Rights Agreement, liquidated damages would be triggered if we failed (i) to file the registration statement within 45 days from February 11, 2005, (ii) to cause such registration statement to become effective within 120 days from February 10, 2005, or (iii) to maintain the effectiveness of the registration statement. These requirements are subject to certain allowances: 45 Amendment Days during any 12-month period to allow the Company to file post-effective amendments to reflect a fundamental change in the information set forth in the registration statement, and Black-out Periods of not more than ten trading days per year in our discretion, during which liquidated damages would not be paid.

Under the initial terms of the Registration Rights Agreement with Barron, the liquidated damages were payable in cash at a rate of 25% per annum on Barron s initial preferred stock and warrant investment of $5,042,250. Because the liquidated damages were payable in cash, under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company s Own Stock a potential obligation (referred to under EITF 00-19 as a derivative financial instrument) existed until the registration became effective. Accordingly, the entire proceeds of the preferred stock issuance except for the par value were allocated to the warrants and recorded as a liability. Additional information on this accounting treatment is presented in Note 8, Preferred Stock and Related Warrants to our audited consolidated financial statements as of December 31, 2005, included as part of this annual report.

It was not the intent of either CSI or Barron that the Registration Rights Agreement result in the majority of the proceeds from the preferred stock and warrant issuance being recorded as a liability rather than equity. In response, on November 7, 2005, CSI and Barron entered into an amendment to the Registration Rights Agreement that eliminated cash liquidated damages and replaced them with liquidated damages in the form of additional shares of Series A Convertible Preferred Stock. Accordingly, the fair value of the warrants at that date was reclassified to equity as additional paid-in capital. Pursuant to the amendment, 2,472 shares of preferred stock will be issued to Barron for each day when liquidated damages are triggered. The maximum number of

shares that could be issued as of March 17, 2006 was 815,760. The amendment also resolved a conflict in the initial Registration Rights Agreement whereby some time periods for registration and liquidated damages were determined with respect to the date of the agreement (February 10, 2005) while others utilized the closing date of the agreement (February 11, 2005). Under the amended agreement, all such periods are determined in relation to February 11, 2005.

Prior to the execution of the amendment, Barron agreed to waive any liquidated damages through November 30, 2005 pursuant to a waiver dated September 30, 2005. Barron had also waived liquidated damages on three prior occasions. In exchange, during the fourth quarter of 2005 we paid Barron $50,000 and agreed to cause the registration statement to become effective under the Registration Rights Agreement on or before November 30, 2005. We entered into a fifth waiver extending the required effectiveness date until January 31, 2006 and a sixth waiver extending the required effectiveness date until February 28, 2006. Our registration statement was declared effective by the SEC on February 14, 2006. We would again be subject to the payment of liquidated damages, in the form of 2,472 preferred shares per day through February 11, 2007, if we do not maintain the effectiveness of the registration statement, subject to allowances for Amendment Days or Black-Out Periods.

Subordinated Notes

On February 11, 2005, the Company also issued six subordinated promissory notes payable, respectively, to Barron and the five former shareholders of CSI South Carolina: Nancy K. Hedrick, Joe G. Black, Beverly N. Hawkins, Thomas P. Clinton and William J. Buchanan. The five notes payable to the former CSI South Carolina shareholders were issued pursuant to the Agreement and Plan of Merger and constituted a portion of the shareholders consideration in the merger. The note payable to Barron, issued pursuant to the Preferred Stock Purchase Agreement, evidences a subordinated loan to the Company in connection with Barron s investment in the preferred stock. All such notes rank equally in right of payment in the event of bankruptcy or liquidation of the Company, or similar events, and are subordinated in right of payment to all other non-subordinated debt of the Company. Payments of principal and interest may be paid as agreed under such subordinated notes, so long as, generally, we are not in default under any of our senior indebtedness.

The Barron note provides that the Company will repay to Barron $1,875,200, with interest accruing at an annual rate of the prime rate plus 2%. We must pay the principal on the note in full on or before May 10, 2006. Any past due and unpaid amounts bear interest at the rate of 15% per annum until paid in full. At December 31, 2005, $1,125,200 was outstanding under the Barron subordinated note.

The aggregate principal sum borrowed under the notes payable to the five former shareholders of CSI South Carolina is $1,875,200, or $375,040 per individual. Other than the principal amount borrowed, the terms of the notes are substantially identical to the note payable to Barron. On December 31, 2005, the aggregate outstanding balance on the five shareholder subordinated notes was $1,125,200.

We anticipate repaying the subordinated notes from the proceeds from the exercise of the warrants and cash generated by operations. The repayment of the subordinated notes is discussed further in Item 6, Management s Discussion and Analysis or Plan of Operation F. Liquidity and Capital Resources.

Preferred Stock Purchase Agreement

Barron invested in our preferred stock and warrants pursuant to the Preferred Stock Purchase Agreement. It contains certain rights of the holders of the preferred stock and certain limitations on us in addition to those contained in the Certificate of Designation. In addition to the customary representations, warranties and other provisions, the Preferred Stock Purchase Agreement:

required Barron, as the investor in the preferred stock, to make a subordinated loan to the Company in the amount of approximately $1.9 million. Barron s loan was funded with cash at closing and was substantially utilized to fund the merger consideration;

required the five former shareholders of CSI South Carolina, collectively, to make subordinated loans totaling approximately $1.9 million. The loans by the former CSI South Carolina shareholders were funded by merger consideration which otherwise would have been payable in cash;

provided that Barron waived reimbursement of certain prepaid expenses in the amount of $81,726.50, so as to provide the Company with funds to apply toward its legal expenses relating to the sale of the preferred stock and related transactions. This amount included the $50,000 prepayment by Barron to Maximum Ventures relating to the purchase of a majority of VerticalBuyer s common stock, as well as $31,726.50 advanced by Barron to its financial adviser, Liberty Company LLC to reimburse expenses related to finding and initially investigating the VerticalBuyer shell corporation;

provided for the delivery of the two warrants;

required that the merger be consummated immediately prior to the sale of the preferred stock and the warrants;

required the execution and continued effectiveness of the Registration Rights Agreement;

requires us to reserve shares of common stock underlying the preferred stock and warrants;

obligates us to continue to report to the Commission under Section 15(d) of the Securities Exchange Act of 1934, as amended, or register under Section 12(b) or (g) thereunder;

prohibits us from issuing any shares of our preferred stock for a period of three years, which preferred stock is convertible into shares of our common stock other than on a conversion ratio that is fixed, with certain exceptions;

prohibits us for a period of three years from issuing any convertible debt;

prohibits us for a period of three years from entering into any transactions that have reset features that result in additional shares being issued;

required us within 90 days to employ a chief financial officer who has experience with public companies, and provides for liquidated damages for our failure to comply. On May 6, 2005, we employed David B. Dechant as our chief financial officer, in fulfillment of this provision. Biographical information on Mr. Dechant is presented in Item 9;

requires us to use the proceeds from the sale of the preferred stock and the warrants for working capital and the repayment of certain notes related to the merger;

provides that, until such time as all of the preferred stock shall have been converted into common stock, Barron and the five former shareholders of CSI South Carolina, Inc. will have the right to participate in any subsequent funding by the Company on a pro rata basis at 80% of the offering price;

- prohibits any insiders, including all of our officers and directors, from selling any shareholdings for a period of two years;

- for two years, prohibits any employment and consulting contracts from containing any provisions for the following: bonuses not related directly to increases in earnings; any car allowances not approved by the unanimous vote of the board of directors; any anti-dilution or reverse split provisions for shares, options or warrants; any deferred compensation, any unreasonable compensation or benefit clauses; or any termination clauses paying over 18 months of salary; and

- prohibits any variable rate or other transaction whereby a purchaser of securities is granted the right to receive additional shares based upon future transactions of the Company on terms more favorable than those granted to such investor in the investor s current offering.

On November 7, 2005, Barron and the Company amended the Preferred Stock Purchase Agreement. The amendment reflected changes in the warrants and the Certificate of Designation in connection with the parties agreements to make the beneficial ownership limitation on preferred stockholders and warrants holders (including Barron) non-waivable. For a discussion of the amendments relating to the beneficial ownership cap, see Sale of Preferred Stock and Warrants.

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Certificate of Designation

The terms of the Series A Convertible Preferred Sock are governed by an Amended and Restated Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock filed with the Delaware Secretary of State on November 7, 2005, which we refer to as the Certificate of Designation. The Certificate of Designation authorizes the issuance of up to 8,300,472 shares of Series A Convertible Preferred Stock. The preferred stock is convertible into shares of our common stock on a one-for-one basis at the election of the holder. There are no redemption provisions.

Significant features of the Certificate of Designation include:

- A holder of preferred stock (including Barron) is prohibited from converting any shares of the preferred stock if such conversion would result in it beneficially owning greater than 4.9% of our common stock. The only exception to the beneficial ownership limitation is in the event of a change in control, whereby all of the preferred stock would be automatically converted;

- Provides that the beneficial ownership limitation may only be amended or waived with the unanimous consent of the Series A Convertible Preferred stockholder(s) and a majority of the non-affiliated holders of outstanding common stock (excluding as affiliated holders all holders of the Series A Preferred Stock or the related warrants);

- Provides that the preferred stockholder may elect liquidation treatment and recover its investment in the preferred stock under certain stock transfer or business combination transactions (for example, in the event of a tender offer or compulsory share exchange.)

- No dividends are payable with respect to the Series A Convertible Preferred Stock or upon liquidation of the Company;

- The Series A Convertible Preferred Stock generally has no voting rights; and

- Upon liquidation of the Company, the preferred stockholders are entitled to be paid out of the assets of the Company an amount equal to $0.6986 per share before any distributions are made to common stockholders.

Warrants

Pursuant to the terms of a Preferred Stock Purchase Agreement with Barron, we issued to Barron two warrants to purchase 7,217,736 shares of our common stock. The respective exercise prices of the warrants are $1.3972 and $2.0958 per share, with each warrant exercisable for half of such shares**.** The terms and conditions of the warrants are identical except with respect to the exercise price.

Initially, Barron was subject to the same waivable beneficial ownership limitation as it was with the preferred stock. For the same reason the preferred stock was amended, the warrants were amended on November 7, 2005 to impose a non-waivable beneficial ownership limitation of 4.9%. This limitation applies to any subsequent holder of the warrants of the Company currently held by Barron. Currently, Barron may not exercise its warrants to purchase shares of common stock if and to the extent Barron s beneficial ownership of our common stock would exceed 4.9%. The 4.9% beneficial ownership limitation is not applicable in the event of a change in control, which is defined as (i) our consolidation or merger with or into another company or entity in which we are not the surviving entity, or (ii) the sale of all or substantially all of our assets to another company or entity not controlled by our then existing stockholders in a transaction or series of transactions. We are obligated to give the holder of the warrant 30 days notice prior to a change in control. The beneficial ownership limitation may only be waived or amended with the consent of the holder of the warrant and the consent of the non-affiliate holders of a majority of the shares of our outstanding common stock.

The warrants provide that they may be exercised on a cashless basis after February 11, 2006 if there were no registration statement effective permitting the resale of the common stock underlying the warrants. However, our

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Form SB-2 registration statement covering the warrant shares was declared effective by the SEC on February 14, 2006. So long as we maintain the effectiveness of a registration statement for the shares underlying the warrants, the warrant holder is prohibited from utilizing a cashless exercise.

The number of shares of common stock underlying the warrants and the exercise price of the warrants will be adjusted to reflect any stock splits, stock dividends, recapitalizations, or similar events. The warrants will also be adjusted in the event of any reorganization, consolidation, merger, or similar event in which we are not the surviving corporation. Such adjustment will entitle the holder of the warrant to receive, after the effective date of any such merger, consolidation, etc., such stock or property as the holder would have been entitled to receive on the effective date had he exercised the warrant immediately prior to the effective date.

No fractional shares will be issued upon the conversion of the warrants. Instead, any fractional amounts are to be settled in cash or by rounding up each fractional share to the next whole number.

Summary of Consideration Received by Participants in Merger and Related Transactions

Five Former Shareholders of CSI South Carolina

In the merger and related transactions, the five former shareholders of CSI South Carolina received consideration in the form of cash, subordinated notes and common stock in the surviving Company. The net consideration received by the five former CSI South Carolina shareholders as of the closing on February 11, 2005 of the dividend, merger and related investment transactions, is summarized below.

Pre-merger Dividend

CSI *South Carolina dividends*. These dividends were declared by CSI South Carolina on February 9, 2005. Of the total, $960,000 was paid in cash prior to the merger on February 9, and $2.5 million in a subordinated note, which note was repaid in cash at the closing on February 11, 2005. The dividends that were paid to the five former shareholders of CSI South Carolina were paid to remove accumulated cash in CSI South Carolina. The dividends did not constitute consideration for the sale of their shares in CSI South Carolina. Although a condition to the merger and investment by Barron, the dividends were effected independently of such subsequent transactions. Absent the merger and recapitalization, it was anticipated that the five shareholders of CSI South Carolina would have distributed excess cash out of CSI South Carolina upon the imminent retirement of Joe G. Black.	$ 3,460,000

Merger

In the merger, the five shareholders of CSI South Carolina tendered their shares of common stock (being all of the issued and outstanding capital stock of CSI South Carolina), which was cancelled, in exchange for the following consideration:	
(a) *Merger cash (gross)*. The five shareholders received subordinated notes totaling $3,624,800, which were repaid in cash later on the day of closing upon the receipt of investment proceeds from Barron. Net merger cash received by the shareholders totaled $3,212,015, after the payment from their merger proceeds of the fee to The Geneva Companies, Inc. totaling $412,785.	$ 3,624,800
(b) *Merger subordinated notes*. These subordinated notes were received in the merger on February 11, 2005. They mature on May 10, 2006. As of December 31, 2005, the aggregate outstanding balance of these notes was $1,125,200.	1,875,200
	5,500,000
Less: advisory fee paid to The Geneva Companies, Inc. by the five shareholders	(412,785)
Net non-equity consideration received by former CSI South Carolina shareholders in the merger	$ 5,087,215

(c) *2,526,905 shares of the surviving Company s common stock (estimated value)*. This estimate, as of the closing, is based on the price per share of $0.6986 paid by Barron for the preferred stock and issuance of warrants. These shares represented approximately 26% of the Company s common stock at the time, assuming conversion into common of all of the preferred stock held by Barron. The shares received were not registered under federal and state securities laws, and therefore were restricted as to resale. Also, pursuant to the Preferred Stock Purchase Agreement, the five former CSI South Carolina shareholders are restricted for two years from selling any of such shares. The estimate is based on the arms length transaction with Barron and represents the parties per share value of stock received in the transaction.	1,765,295
Estimate of total consideration received by five former CSI South Carolina shareholders in the merger	$ 6,852,510
Total consideration received by five former CSI South Carolina shareholders from pre-merger dividends and in the merger	$ 10,312,510

On February 11, 2005, four of the five former CSI South Carolina shareholders entered into employment agreements with the Company. These were Nancy K. Hedrick, President and Chief Executive Officer; Thomas P. Clinton, Vice President of Sales; William J. Buchanan, Vice President of Delivery and Support; and Beverly N. Hawkins, Vice President of Product Development. The employment agreements provide for compensation at a rate of $185,000 a year, plus such bonuses and raises as the board of directors may determine. Each agreement is for a term of three years, and is described in more detail under Item 10 Executive Compensation.

The remaining former CSI South Carolina shareholder, Joe G. Black, served as our interim Chief Financial Officer from the closing on February 11, 2005 until May 5, 2005. We entered into a consulting agreement with Mr. Black to provide financial and accounting consulting services to us with compensation at $75 an hour. The consulting agreement has an initial term of one year and is described in more detail under Item 12, Certain Relationships and Related Transactions.

Fees Paid to Financial Advisors

CSI South Carolina and the five former shareholders, as discussed in C. History and Development of CSI South Carolina Events Leading Up to 2005 Restructuring, retained The Geneva Companies, Inc. as their financial advisor. On February 11, 2005, upon the consummation of the merger and related transactions, Geneva received a commission of $412,785. The commission was paid by the five former shareholders.

Barron s financial advisor and finder for its preferred stock investment in the Company was Liberty Company, LLC. Liberty was paid a fee of $275,000 upon the consummation of the merger and related transactions on February 11, 2005, which fee was based on a percentage of Barron s investment. Pursuant to the terms of the Preferred Stock Purchase Agreement, Liberty s fees were paid by the Company. In addition, in March 2005, pursuant to the Preferred Stock Purchase Agreement, Liberty was paid an additional $83,800 in fees by the Company upon the closing of its $3.0 million credit facility with RBC Centura Bank, again pursuant to its finder arrangement with Barron. The Company has been informed by a representative of Liberty that Liberty is a registered broker-dealer.

Maximum Ventures, Inc. was paid a financial advisory fee of $50,000 by Barron on or about December 2004. The payment essentially constituted earnest money, which was to be offset against the $450,000 purchase price. The prepaid advisory fee so reduced the $450,000 purchase price for the shares of VerticalBuyer purchased from Maximum Ventures by CSI South Carolina, pursuant to the Stock Purchase Agreement between CSI South Carolina and Maximum Ventures. Pursuant to the Preferred Stock Purchase Agreement, Barron waived reimbursement of the $50,000 paid to Maximum Ventures.

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No other brokerage, advisory or other fees were paid or payable by the Company, the five former CSI South Carolina shareholders, Barron, or other parties to the merger, the preferred stock investment, loan or related transactions.

Barron Partners LP

On February 11, 2005, Barron invested and loaned the following monies to the Company:

Preferred stock and warrants	$ 5,042,250.00
Subordinated note	$ 1,875,200.00
Contribution, per Preferred Stock Purchase Agreement, for Company s costs and legal fees	$ 81,726.50(1)
Total investment/loan by Barron	$ 6,999,176.50

(1) Includes the waiver of the Company s obligation to repay $50,000 earnest money paid by Barron to Maximum Ventures, as well as $31,726.50 paid by Barron to its financial advisor to reimburse it for out-of-pocket costs incurred in finding and investigating the VerticalBuyer shell corporation.

Barron received no fees or other compensation with respect to the acquisition of the VerticalBuyer shares by CSI South Carolina, the merger of CSI South Carolina into VerticalBuyer, its preferred stock, warrant and subordinated debt investments in the Company or any related transactions. Barron did not act as a broker-dealer with respect to these transactions. Barron s activities related solely to its purpose of investment for its own account. Barron s involvement in the procurement of VerticalBuyer related only its use as a vehicle to facilitate an investment in CSI South Carolina, or another such private company should the CSI South Carolina transaction not have been successfully completed.

F. Our Niche in the Governmental and Educational Technology Market

There are approximately 3,100 counties (according to the U.S. Dept. of Census), 36,000 cities and towns (according to the National League of Cities) and more than 14,000 school districts (according to the National Center for Education Statistics) in the United States. Each of these organizations is a potential candidate for an integrated financial management system as well as for various technology services and products. Since many local governments are moving toward outsourcing of information technology services, even more opportunities are available for our services. In 2005, the sale of software, hardware and services to non-educational governmental organizations accounted for approximately 35% of our total sales.

IDC, a subsidiary of International Data Group, Inc. (the parent company of IDG News Service), projected in May 2002 that U.S. public schools would substantially increase their information technology-related expenditures as technology and traditional education resources become interwoven. IDC projected that information technology spending for K-12 schools would reach $9.5 billion by 2006. IDC estimated that computer hardware would account for just over a quarter of district technology budgets.

Our customer base is discussed in more detail under K. Customers below.

G. Products and Services

CSI Fund Accounting Software

We provide the CSI Fund Accounting Software (CSI Accounting+*Plus*) to a variety of clients in an integrated financial management system. We generate revenue from the CSI Accounting+*Plus* as outlined below. Each of these sources of revenue is described in the remainder of this section.

Sales of software licenses to new clients;

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Sales of new/additional modules to existing clients;

Installation of software;

Data conversion from legacy systems;

End user training;

Guaranteed service agreements; and

Sales of third party products to enhance functionality of CSI Accounting+Plus.

Prior to 1999, our proprietary fund accounting system was a DOS-based product. DOS, or Disk Operating System, was the personal computer operating software used widely before the release of Microsoft s Windows software. In July 1999, we released a Windows® based version of the system as CSI Accounting+*Plus*. This product was written with Microsoft s Visual FoxPro® database, a relational database, and utilizes Crystal Reports®, an industry standard report generator. Over the next four years, approximately 120 software clients upgraded from the DOS based system to the new product. For our clients, this upgrade process included data conversion, installation and training on the new system and, in many cases, a hardware upgrade. The CSI Accounting+*Plus* system has also been installed in approximately 100 new clients during the period from 1999 to 2005. In addition to software sales, we offer ongoing customer support for the accounting software. This support is provided under a guaranteed service agreement, providing the client with phone support, online user assistance and routine updates to the software.

While we continue to market the Visual FoxPro version, the CSI Accounting+*Plus* system is currently being rewritten with Microsoft s .Net (pronounced dot-net) and SQL (pronounced sequel and standing for Structured Query Language) database technologies. This new version will provide improved performance, scalability, more flexible data access and native data-tagging (XML or Extensible Mark-up Language) web support. SQL and .Net have become the industry standards for software development, and XML has become an industry standard for data tagging and retrieval. We anticipate that the first components of this new version will be available for release by the third quarter of 2006. At that time, we plan to begin upgrading existing clients to the new version and begin marketing this version to new clients. The current CSI product contains the functionality required by our clients but moving to the SQL and .Net platform will allow us to be more competitive on both a regional and national level.

A new software service option called Service +*Plus* has also been developed. This plan will provide the normal coverage of a guaranteed service agreement but will also include version protection: clients will get new major releases of the software without additional fees. Service+*Plus* will also provide clients free attendance to webinars (seminars which may be attended remotely by use of the internet), free user conference attendance, one free Crystal Reports training class each year, disaster recovery (off-site data storage) and discounts on additional software modules, training and engineering services.

We have a close business relationship with AIG Technology, Inc. (AIG) to enhance the functionality of our accounting software. AIG is a developer of document workflow systems. Through this relationship, we offer our clients enhanced printing, faxing and emailing capabilities (Doc e Serve), document imaging (Doc e Scan) and the routing of documents across the web for distribution and approval (Doc e Fill). CSI markets the AIG product line and receives a commission for the sales of these products and services. The commissions have not constituted a significant part of our revenues. However, the ability to offer enhancements improves our competitive position.

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The CSI Accounting+*Plus* software suite is designed as a modular solution. The modules are sold separately to enable customers to pick and choose only those modules that are needed to provide desired functionality. The modules in the software suite are shown in the following table:

Accounting Modules	**Specialty Modules**
Accounts Payable	Audit Reporting
Accounts Receivable	Claims Reimbursement
Budget Preparation	Food Service Reporting
Check Reconciliation	Inventory
Cost Allocation	Pupil Activity Accounting
Fixed Assets	Warehouse Requisitions
Fund Ledger	
Payroll	
Purchasing	
System Manager	
Payroll / Personnel Support Modules	**Municipal Modules**
Absent Employee Tracking	Business License
Applicant Tracking	Cash Collections
Available Substitutes	Construction Permits
Insurance and Benefits	Utility Billing
Personnel	

Our development team writes and maintains the CSI Accounting+*Plus* modules. The support of these modules includes routine enhancements, governmentally required changes (e.g., Form W-2 format changes) and problem fixes. We provide updates to the CSI system through our website.

Standards Based Lesson Planner

In September 2005, we acquired a standards based lesson planning software product from Eric Levitt of Carolina Education Services. We have renamed this software curriculator The software is designed to allow teachers to create lesson plans that are tied to a state s curriculum standards. These lesson plans may then be reviewed by school administrators and a report generated to determine the standards that have been met or need to be met. This is particularly important as school systems develop higher accountability standards. In addition, the federal legislation of No Child Left Behind Act has focused greater attention on schools adequate yearly progress (AYP), and meeting curriculum standards is an important component of these measurements. Standards based lesson planning software allows a school to document its compliance with the curriculum standards as a component of its compliance with the No Child Left Behind Act legislation.

We have converted this product to a Microsoft SQL database and internet-based product and are marketing it as curriculator™ standards based lesson planner.

We believe the addition of this product, while not yet material, may provide significant additional revenue in the future as we are able to offer an additional product to our existing school-based customers. We believe it may also provide a source of additional contacts and referrals. The gross profit received from each sale of this product may be significantly less than that of our traditional fund accounting software. As a result, we intend to use telesales as a cost effective method of generating additional contacts and may use the Internet as the primary medium for demonstrations and software delivery, in order to minimize selling and delivery costs.

Hardware Sales and Related Support Services

Our technology solutions segment provides network system solutions to more than 200 governmental organizations in South Carolina, North Carolina and Georgia. This segment provides professional network

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integration services as well as network computing solutions to our customers. We strive to deliver high-quality hardware, software and related professional services to help our customers plan, acquire, implement, manage and upgrade their organizations information systems.

We have established associations with some of the largest vendors in the industry, and with others whom we believe offer innovative products. We believe that strong industry relationships will further enhance our competitive position. We have developed and maintain the following vendor relationships:

Our primary focuses in the technology solutions segment include IP (internet packet-based) telephony, wireless, system security and routing/switching. We have a strategic relationship with **Cisco Systems, Inc.,** (Cisco) a worldwide leader in networking for the Internet and technology innovation, whereby Cisco provides the hardware necessary to implement these systems. We purchase the majority of our Cisco equipment through Ingram Micro. Ingram Micro is a multi-national distributor of technology hardware. Although we are an indirect reseller of Cisco products, we periodically work closely with Cisco representatives, particularly on large sales. This relationship occasionally produces customer leads and referrals. We also encourage our employees to pursue Cisco technical certifications, as such certifications as well as the achievement of certain sales volumes of Cisco products can make us eligible for certain incentives periodically offered by Cisco. We also participate in certain state contract pricing frameworks that Cisco has established with public entities. Purchases from Ingram Micro are made on an individual purchase order basis. We have no formal agreements with Ingram Micro.

We deploy desktops, notebook computers, personal devices and file servers in a variety of client network environments. We have a strategic relationship with **Hewlett Packard** (HP **),** who produces technology solutions that span information technology infrastructure, personal computing and access devices, global services and imaging and printing for consumers, enterprises and small and medium business. We provide professional services to deploy these devices. Our relationship with HP consists primarily of the purchase of computers and printer equipment for resale. We purchase these products on an individual purchase order basis under a standard, nonexclusive reseller agreement. In addition to purchases directly from HP, we have arms-length business relationships with certain customers whereby the customers have elected to name us as their authorized HP representative. As the named representative, and as an incentive for the customer to approve us as the named representative, we provide various forms of assistance which can include assisting the customer in identifying the specific HP products that will meet its needs, summarizing and processing orders on behalf of the customer with HP, and providing certain support and HP authorized repair and maintenance for which we are separately compensated by HP. To provide these services, some of our personnel have received training and certifications from HP. As the named representative of HP, we assist the customers in placing their orders directly with, and we receive commissions from HP, rather than acting as the purchaser and reseller of HP s products. Due to the volume of business we do with HP, we also work very closely with HP representatives and receive support which may include special quantity or other pricing in competitive situations with products from other manufacturers, and may receive customer leads or referrals from time to time.

Our focus on the K-12 sector has led to our developing relationships with vendors who specialize in technologies for the classroom. **Promethean** Collaborative Classroom Solutions offer what we consider to be the industry-leading solution for transforming the classroom into an interactive learning environment. Using Promethean s ActivBoards, students are able to use a stylus on a special electronic white board to interact with computer projected images. The computer reacts to the stylus activity and projects the results. By having an exclusive sales arrangement to market Promethean ActivBoards in North Carolina and South Carolina, we believe we are able to maintain gross margins higher than most hardware products. In addition to selling the ActivBoards, we offer installation services, end user training and market complementary products (e.g., projectors, PC Tablets) to be used with the boards for the collaborative classroom.

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In keeping with our focus on IP-based systems, we also have a business relationship with DIVR **(Digital Image Viewing and Retrieval) Systems, Inc.,** providing IP-based surveillance solutions to the industry. With growing demand and governmental initiatives to provide security solutions, we believe the DIVR Systems technologies represent significant opportunity. In November 2003, J.P. Freeman & Co. a market research firm that follows the security industry, forecast that the overall video surveillance market would reach $3 billion per year by 2007.

In order to offer visual communication equipment to our clients and prospective clients in order to allow video conferencing, administrative communications, home bound learning and professional development, we have developed a business relationship with **Tandberg.** In the education environment, Tandberg provides worldwide access to people, places and experiences without time or travel constraints. Through the public sector and business environment, Tandberg offers solutions in providing more efficient and effective training to employees, saving travel, time and money. Tandberg solutions include cameras, monitors, videophones and software.

Our relationships with Promethean, DIVR and Tandberg are established through standard reseller agreements. These agreements make us eligible to resell products on a generally non-exclusive basis, many in specifically authorized geographic regions, and make us eligible, from time to time, for periodic promotions, special offers and manufacturing standard volume discounts and rebates, when offered. Occasionally we may request special pricing for large volume deals, particularly in competitive situations, which may be approved on a case by case basis. Due to our sales and marketing success on behalf of vendors, we have been asked from time to time to represent products in new geographic regions. As we expand we will exploit these opportunities as they come available and as we have the financial justification for the physical presence to do so.

In addition to the above relationships, we also have developed relationships with Microsoft, Novell, Packeteer, Symantec, and Citrix, which are on similar terms with those of Promethean, DIVR and Tandberg. We also have one additional vendor, Synnex. Our purchases from Synnex, like those from Ingram Micro have equaled more than 10% of our annual purchase volume. Synnex is a distributor of technology hardware. We have no formal agreement with Synnex and purchase technology accessories on a purchase order by purchase order basis. The products purchased from Synnex are readily available through other vendors.

Our technical services include the following:

Consulting Services

- Project Management
- Deployment Management
- Procurement Management
- Product Evaluation Management
- Outsourcing Management
- Bid Management

Network Services

Network Needs Analysis

Network System Design

Network System Integration

Network System Implementation

Network System Maintenance

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Convergence Services

Integration Needs Analysis

Integration Design

Integration Implementation

Integration Maintenance

Support Services

Hardware Support

Network Support

Convergence Support

Network Operating Systems Support

Collaboration Systems Support

H. Strategy

In addition to our sales of software applications, technology solutions and related support and maintenance services, we provide technology consulting, including network and systems integration services as a part of our solutions sales efforts. These services also generate a significant amount of revenue from the sale of computer hardware equipment. Our marketing strategy is to provide a suite of software products coupled with full service integration of the hardware solutions that support those products and other back-office functions.

By providing a client the ability to call one solution provider and circumvent the difficulties that often arise when dealing with multiple vendors, we believe we are able to achieve higher long-term client satisfaction and a competitive advantage in the marketplace. Repeat business from our existing customer base has been key to our success and we expect it will continue to play a vital role in our growth. Over the past ten years we have retained more than 90% of our software customers.

Software

Fund Accounting Software

New Product Development

We continue to market the primary CSI software applications, which contain the functionality required by our clients. However, we are in the process of rewriting these applications using the latest Microsoft application programming tools and current Microsoft data storage and retrieval technologies. The new release will allow us to expand more easily into additional states. We will continue to expand our product offerings to meet the needs of our clients both in the current version and in the new version.

Service+Plus

Our new service offering provides version protection for major releases of the software without additional fees, free attendance to seminars accessed remotely by use of the internet, free user conference attendance and disaster recovery (off-site data storage).

Hosted Services (ASP)

We are beginning to offer an ASP (Application Service Provider or CSI hosted) solution to new clients whereby they can access the software on CSI servers and run it remotely over the internet at a fixed monthly cost. Under this business model, the client can forego the significant up-front investment required to purchase computer hardware and install the software at their location.

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Reseller Model

In order to move into new regions and states, we are pursuing a reseller model in those areas where it will be the most expedient way to introduce our primary software application. There are often information technology organizations established in an area that have the sales staff in place to market our products.

Lesson Planning Software

New Product Acquisition

In September 2005, we acquired a standards based lesson planning software product, which we have renamed curriculator The software product, potential customer list, install base and all related rights purchased did not constitute a material addition to the business. This software is designed to allow teachers to create lesson plans that are tied to a state s curriculum standards. These lesson plans may then be reviewed by school administrators and reports may be generated to determine the standards that have been met or need to be met. This is particularly important as school systems develop higher accountability standards. In addition, the federal No Child Left Behind Act legislation has focused greater attention on schools adequate yearly progress (AYP) and meeting curriculum standards is an important component of these measurements. Standards based lesson planning software allows a school to document its compliance with the curriculum standards as a component of its compliance with the No Child Left Behind Act legislation.

Product Enhancement

We will be rewriting the lesson planning software to be web-enabled. In addition, we will be building in curriculum standards for all states.

Market Penetration

Addressing No Child Left Behind Act requirements and meeting state curriculum standards are issues for educators in every state. We plan to use telemarketing, our web presence, attendance at educational trade shows and direct mail campaigns to introduce and sell our lesson planning software nationally. Our initial efforts will be focused on the southeastern states.

Technology

Expansion of Offerings

We are continually seeking new hardware offerings to present to our clients. Our spending on research and development is generally insignificant. As old technologies expire and new technologies emerge we work to stay a short distance behind the new product curve, adopting primarily those solutions that are proven in the marketplace. As a reseller with more than 300 public sector clients and internal technical personnel, we are periodically approached by vendors and manufacturers to expand into new territories or represent new or additional products. We also pursue these opportunities. For example, new product opportunities we evaluate could include additional products in the following market spaces in which we are already engaging: storage solutions, database technologies such as standardized data-tagging (XML or Extensible Mark-up Language) applications for improved data retrieval, internet based audio and video distribution (equipment used to broadcast audio and video communications), metropolitan wireless (city-wide wireless public internet access and city-wide wireless network access by city employees) and additional service capabilities. As with our other hardware-based solutions, we plan to enter into reseller arrangements with equipment and solutions providers or manufacturers who already have experience and can provide installation, support, equipment warranties and technical training to our personnel to offer additional solutions to our existing client base and new customers. Except for internally developed software or acquired products, we enter new areas as a reseller as opportunities arise and customer needs present themselves. This approach allows us to mitigate the risk a product will not have sufficient demand or profitability. By doing this, we forego the investment in inventory a manufacturer or large distributor would

have to commit to a new product. We are already proposing solutions involving some of these areas, including metropolitan wireless networking for small towns and housing communities, although they do not yet represent a significant portion of our business. We typically do not commit significant resources to them unless we achieve reasonable profitability on the initial opportunities. Periodically, certain products introduced at a new client site, in response to a client s specific needs or requests and to maintain or improve the client relationship, never become a significant portion of our business. Other products become significant contributors to profitability and we add them as a standard offering to our client base.

Managed Services and Guaranteed Service Agreements

In addition to guaranteed service agreements on our software products, we will be offering guaranteed service agreements on many of our hardware offerings. Guaranteed service agreements allow us to increase our recurring revenue.

Geographic Expansion

We are pursuing a national presence with a primary, initial focus on the southeastern region of the United States.

Generally, our technology offerings require hands-on implementation and support. In order to expand into new geographic territories, we must find qualified personnel in an area to service our business. The need for hands-on implementation and support may also require investment in additional physical offices and other overhead. We believe our approach is conservative. Our strategy is to limit the number of new target areas until they become cash flow positive before expanding into additional ones. Accordingly, we intend to expand the geographic reach of our technology offerings from our primary client locations of South Carolina, North Carolina and Georgia to surrounding states methodically over time. We may, however, accelerate expansion if we find complementary businesses in other regions that we are able to acquire. Until such time as we are able to find appropriate acquisitions, our geographic reach for the technology solutions segment is likely to be limited to the southeast for the next several years. Our marketing efforts to expand into new territories may include telemarketing, attendance at trade shows, and direct mail in addition to personal contact.

We are able to deliver software applications, demonstrations and training over the internet and deliver support by internet or phone. Accordingly, for our software applications segment, we plan to expand our geographic reach to a national level more quickly than for our technology solutions segment. Software marketing efforts may include attendance at national trade shows and national telemarketing, direct mail and web advertising. Because our lesson planning software product is less complex than our accounting software, it is likely we will focus our efforts on that product first while looking for any opportunities to sell the accounting software that may arise in the process.

Growth Through Acquisitions

One significant reason for our entering into the merger and recapitalization transaction in February 2005 was to allow us to access public capital markets as a source of funding to permit us to grow through acquisitions. In addition, the merger transaction facilitated the sale of warrants, the exercise of which (absent a cashless exercise) represents a significant potential source of capital. Our competitive markets are occupied by a number of competitors, many substantially larger than we, and with significantly greater geographic reach. We believe that to remain competitive, we need to take advantage of acquisition opportunities that arise which may help us achieve greater geographic presence and economies of scale. We may also utilize acquisitions to whenever appropriate expand our technological capabilities and product offerings. While we may use a portion of any cash proceeds to pay down debt on an interim basis, we intend to use any additional liquidity and/or availability of assets generated by the paydown and remaining proceeds to fund acquisitions. Additionally, we are in the process of engaging a consultant to assist us with acquisitions, including identifying potential acquisition opportunities.

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

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

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

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

- Cabling and infrastructure contractors. We currently outsource cabling services.

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

Following the merger in February 2005, we have pursued and entered into preliminary discussions with various acquisition candidates. However, the Company has not entered into agreements or understandings for any acquisitions which management deems material.

I. Sales, Marketing and Distribution

We market our products and services through direct sales throughout North Carolina, South Carolina and Georgia. We are currently expanding our direct sales to cover the southeastern United States. Our in-house sales staff provides lead generation and support to the direct sales team.

We have twelve outside sales persons, including a Vice-President of Sales and a Sales Manager, and six additional employees on our inside sales staff. In line with our expansion plans described under H. Strategy, we plan to expand both of these teams in 2006. Other employees are involved in selling on a daily basis. Engineers and trainers have excellent opportunities to sell additional products and services to clients while delivering services.

We have a Chief Technology Officer who helps to determine which technology products will be marketed. A staff member also provides marketing services and coordinates vendor relations. Our marketing efforts include participation in various trade shows (for municipalities, counties and education), road shows to showcase various products and services, and mailings to target specific products and services.

Our inside sales staff provides leads to the outside staff and also produces proposals to be delivered to prospects and clients. In 2004, the software inside sales staff began making outbound calls to pre-qualify leads for the outside sales staff. This has proven successful and we intend to expand these calls by both the software and the technology inside sales teams.

Our outside sales personnel call on existing and prospective clients. Due to our wide range of product and service offerings and rapidly changing technology, we believe there are sales opportunities within the existing client base. Recurring sales account for a significant part of our overall revenue. Our sales teams are segmented by geography and also product lines (technology and software). Depending on the product or service being offered, we may call upon an information technology director, city manager, director of finance, director of operations, utility manager or curriculum coordinator.

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J. Key Suppliers

On February 19, 2006, CSI renewed its Cisco Premier certified partner status pursuant to its Indirect Channel Partner Agreement with Cisco Systems, Inc. The renewal is effective through March 11, 2007. The agreement grants us a limited, nonexclusive, revocable license to receive from authorized distributors and distribute to end users both those Cisco products made available to the authorized distributors and Cisco s proprietary rights in those products. The prices we pay for the Cisco products are set by the authorized distributors. In 2005, sales of Cisco products accounted for 38% of our sales revenue. In 2004, that number was 33%.

Pursuant to a Hewlett Packard U.S. Business Development Partner Agreement, we were appointed a Business Development Partner for the purchase and resale or sublicense of Hewlett Packard s products, services and support. In this capacity, we will purchase Hewlett Packard s products, services and support from authorized distributors and resell them to end users. The agreement was originally effective until May 31, 2005, and we received notification that it has been extended in its current form until May 31, 2006. The prices we pay for Hewlett Packard products, services and support are set by the authorized distributors. Sales of Hewlett Packard products accounted for 8% of gross sales revenues in 2005 and 17% in 2004. In addition, we received commissions on customer orders of Hewlett Packard products of $930,814 (4% of 2005 gross sales) in 2005 and $1,061,705 (5% of 2004 gross sales) in 2004. See Note 1 to our audited consolidated financial statements, which are included in this annual report, captioned Computer Hardware Sales Revenues for further information regarding the accounting related to Hewlett Packard hardware sales.

K. Customers

Our customers are predominantly educational institutions (K-12 and higher education), municipalities, non-profit organizations and other local governments. We sold services and products to more than 300 customers during 2005. Eleven customers constituted approximately 50% of the 2005 gross revenues, but no customer constituted more than 20% of gross revenues. One of our customers accounted for at least 10% of our revenues in 2005, the Greenville County, South Carolina school district. Due to the nature of the large technology projects we install, it is not unusual for a relatively small number of customers to account for the majority of sales. Many of these customers have ongoing projects extending across several years.

2005 Revenues by Market Type		**2005 Revenues by State**	
Sector	**%**	**State**	**%**
Private	6	Georgia	8
Public Education	82	North Carolina	18
Public Government	12	South Carolina	70
		Other	4

L. Competition

The market for the services that we provide is highly competitive, includes a large number of competitors, and is subject to rapid change. Our primary competitors include participants from a variety of market segments, including publicly and privately held firms, systems and consulting and implementation firms, application software firms and service groups of computer equipment companies. Competition is generally based on quality of products and customer support, timeliness, cost of services, relevant targeted expertise and return on investment.

In the fund accounting software market, there are a handful of national companies and many regional companies that have carved a niche in their region much as CSI has done in the southeast. On a national level these include divisions of Tyler Technologies, particularly MUNIS and INCODE, and divisions of Sungard Data Systems, Sungard Bi-Tech and Sungard Pentamation.

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The hardware and technology services market tends to have more regional rather than national competitors. In some cases hardware vendors, such as Hewlett Packard, offer engineering services that are in direct competition with our engineering services. On a national level, Pomeroy IT Solutions is the primary competitor in the IT products and services market.

We were recognized by *VAR Business Magazine* as one of the top 500 network integration companies in the United States (the VAR Business 500) in 2004 and 2005. Additionally, in 2005 we were recognized by *VAR Business Magazine* as one of the top 100 network integration companies serving the government sector (the Government VAR 100). The bases for this recognition were growth measures in revenues and client base. We were also one of three finalists for the Educational Solution Provider of the Year award also presented by *VAR Business Magazine*.

There is a disadvantage to this recognition in that we are now highly visible as potential competition for those with whom we compete for business. Virtually all of the companies listed on the VAR Business 500 and Government VAR 100 are competitors or potential competitors of ours. The VAR Business 500 and Government VAR 100 lists include IBM Global Services, EDS, Lockheed Martin IT, Accenture and Computer Sciences, to name a few. Most of the companies are significantly larger than we are, and some may enter our market space should they choose to do so. While we believe we will be able to continue to compete effectively in the future, there is no guarantee we will be able to do so or achieve any future recognition.

As CSI begins to market its products and services nationally, we will continue to compete with the same national companies and will be faced with additional regional competitors in the new markets we enter.

We believe a primary strategic advantage of CSI is combining the sale of our fund accounting software with network integration and hardware sales and services. We believe that providing one-stop shopping with a single point of contact is a material benefit to our clients and that this has been a key factor in our successful penetration of the educational and governmental software and technology markets in South Carolina, North Carolina and Georgia. Although competitors exist in these markets, we believe very few organizations offer the blend of services and products that is available through CSI. We are expanding into surrounding states with the goal of leveraging this strategic advantage in new areas.

Customer Service

Our historical growth has been, in large part, due to the high level of repeat business from our existing client base. This is evidenced by a greater than 95% client retention rate by our software applications segment and significant recurring sales opportunities to this client base through our technology solutions segment. We believe clients continue to utilize our products and services due to our focus on customer service, attention to detail and regular follow-up. We strive to have technical and customer service staff members available to address swiftly the needs, questions or concerns of clients. Specifically, our software customer service includes user conferences, a support desk access and a website, which offers documentation and downloadable upgrades.

Ability to Carry Out a Broad Range of Projects of Varying Scope

We strive to be agile and adaptable in fulfilling the technology needs of our clients, traits which are instilled in our corporate culture. We have managed multi-million dollar, multi-year projects for our clients, as well as requests for projects of a much smaller scale. We believe that our clients appreciate our range and flexibility in meeting their technology requirements.

Long-term Relationships With Clients

A large percentage of revenue continues to flow from our existing client base. The preservation of these client relationships is a high priority of our management team. We believe the longevity of these relationships evidences a high degree of customer satisfaction.

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Seamless Implementation of Software and Hardware

Because of our dual capabilities with respect to providing both software and integration services, we believe that we are able to coordinate the implementation of software and hardware, minimizing disruption to our client s day-to-day operations.

Diversification of Products and Service

Our products and services can address the needs of many departments within a city, county or educational facility. We offer a wide variety of services and products, including financial software, workflow management solutions, network integration products and services, specialized classroom technologies, IP telephony and IP surveillance, distance learning technology and wireless solutions.

M. Intellectual Property

We develop new software as part of our business activities. The software products we develop are generally works made for hire, prepared by our employees within the scope of their employment and with copyright ownership vesting in the Company pursuant to the Copyright Act. We routinely license software to our customers through unwritten, implied nonexclusive licenses, the terms of which are commensurate with our copyright protection in the software. Licenses for our products are ordinarily on a site license or user-based license basis. Generally, implied licenses are created by law when an express, written agreement does not exist between the parties. An implied license provides certain rights to the licensee, and typically such rights would be those the copyright owner would have given to the licensee as customarily given in the industry for similar types of software products. Other than password protection of the software for preventing unauthorized access to the software and/or the company receiving actual knowledge of a violation of its licenses, we have no formal methods in place for monitoring compliance with our licenses. Our software is generally entitled to receive copyright protection automatically, by operation of law, upon its creation. Copyright protection provides protection against unauthorized copies and derivative versions of the software being made. Copyright protection may also provide protection against the unauthorized distribution, public performance and display of the software. We typically do not assign our copyrights in our software to our customers. We have not, however, pursued registration of copyrights for our software under the Copyright Act nor have we pursued obtaining patents on the software we develop. In 2005, we applied for trademark protection of TECHNOLOGY OUTFITTERS and CURRICULATOR with the United States Patent and Trademark Office.

The length of such implied licenses of our software are generally coextensive with the length of the applicable copyright term provided for by federal law. Currently, the term for copyright protection is the life of the author of the software, plus 70 years. For software works that are made for hire (as defined by the Copyright Act), the length of the copyright term is 95 years from the first publication.

Enforcement of the implied licenses on our software would be primarily on copyright infringement grounds and/or on common law principles pertaining to implied licenses. Violations of copyrights on our software could include, among other things, unauthorized distribution of our software, and unauthorized derivative works being made of our software (such as by reverse engineering), each of the foregoing being rights uniquely held by the copyright owner.

N. Software Development

In 2004, we spent and capitalized $559,847 on software development; in 2005 we spent and capitalized $709,972. Our software development efforts focus on the implementation of known technological capabilities applied to common business processes to enhance our existing products. Historically, we have spent no material efforts on technological innovation for which the feasibility has been unknown. These software development amounts were accounted for as deferred software development costs and are amortized over the economic life of the related product (generally three years).

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O. Government Regulations

Procurement Regulations

We are subject to certain laws, regulations, policies and procedures governing the procurement by local governmental units of goods and services generally. These vary by jurisdiction, and there is a wide variance in the policies and procedures with which we must comply among our clients. For example, some governmental units require that we strictly comply with a request for proposal, some of our projects are subject to bid, and in others, the official handling procurement has considerable discretion. We have integrated compliance with these governmental procurement requirements into our sales process. As a result, the sales cycle associated with our products tends to be complex and lengthy. Factors contributing to the length and complexity of the sales cycle are the potential need to provide written responses to product demonstrations, customizing software to meet a particular customer s needs and the integration of our products with third party products.

Also, the governmental entities that comprise our customer base generally have the ability to terminate a contract from convenience, typically on a year-to-year basis. This right could adversely impact us, particularly in the case of technology solution projects we may be performing or ongoing service agreements that we may have in place. Although the potential for termination of a governmental customer for convenience exists, we have never had a customer terminate a contract in this manner.

Impact of Regulations on Maintenance of our Software

With respect to our software products, compliance with existing and future and government regulations is a potential cost to CSI. Upon certain changes in law, we may be required to review the construction and content of our software to determine what impact, if any, the changes will have on the underlying rules tables in, and the operation of, our software. For example, our CSI Accounting+*Plus* system has to be modified as the federal and state governments change reporting requirements. Modifications for Form W-2, Form 1099, various health and retirement reporting and payroll tax table updates are a few examples of the changes that may need to be made.

If a regulatory change does impact our software, modification will need to be made at a cost and burden to CSI. In an extreme case, the software may be required to be rewritten entirely. This cost may potentially be passed on to customers in the form of product updates and product service agreements, but in certain circumstances we will absorb the costs entirely. For example, if we have a support agreement with a customer for a software product serviced, but no longer sold, by CSI, then our cost for updating the software may not be fully recoverable from the customer, but instead may be limited by the terms of the support agreement.

Federal E-Rate Program

Because we participate in the federal E-Rate Program, we are subject to the rules and regulations of that program. These rules and regulations are continually reviewed and modified and we must stay current with these changes. The risk factor entitled *A significant portion of our revenue stems from sales to schools receiving funding through the E-Rate Program. A loss of such funding could have a material adverse impact on our revenues and financial condition* contains additional information about the E-Rate program. Approximately 10% of our 2004 and 20% of our 2005 revenues, respectively, were generated from the E-Rate program. The Company and its customers compete for federal funds with many other entities and projects. As a result the revenue we receive from the federal E-Rate Program can be volatile.

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P. Employees

As of December 31, 2005, we had 99 full-time employees and six part-time employees. Our relationship with our employees is good. Many employees have worked at CSI for more than five years, some more than ten years. Full-time staff are assigned to the following areas:

Administration/Finance	13
Technical/Support Services/Training	24
Software Product Development	17
Engineering Services/Project Management	24
Sales/Sales Support	21

Q. VerticalBuyer, Inc.

Incorporated in Delaware on September 24, 1999, we were known as VerticalBuyer, Inc. until the February 10, 2005 reverse stock split, reverse acquisition and name change described in E. The Merger and Recapitalization. Presented below is a brief history of VerticalBuyer, Inc. prior to the reverse acquisition and name change.

On March 1, 2000, VerticalBuyer issued 14,250,000 shares of common stock to shareholders of Lightseek Ltd. in exchange for all of the outstanding common stock of Lightseek Ltd. On February 15, 2001, Lightseek Ltd. acquired all the outstanding common stock of the Litech Ltd. Lightseek was principally engaged in the development of internet sites designed to take advantage of business to business e-commerce opportunities in the global commercial electrical and lighting market. Litech was a specialist designer in the manufacture of fiber optic lighting application for the entertainment, commercial and retail market. In September, 2001, VerticalBuyer discontinued the operations of both Lightseek Ltd. and Litech Ltd.

VerticalBuyer was seeking to specialize in the creation of internet based news sites dedicated to specific industries. Lightseek was the first website developed for the commercial lighting industry. Subsequently, other lighting sites were also tested, including an auction site for the global market. After the discontinuation of operations in September 2001, and prior to assuming the business operations of CSI South Carolina, VerticalBuyer conducted no business operations of any kind.

On March 12, 2004, Maximum Ventures purchased approximately 13,950,000 of VerticalBuyer s outstanding shares from then controlling shareholders, Leslie Kent and Timothy Rosen. Such shares represented approximately 80% of VerticalBuyer s then outstanding shares of common stock. The purchase price was $150,000. Maximum Ventures is a New York corporation located at 1175 Walt Whitman Road, Suite 100, Melville, NY 11747.

On October 22, 2004, Mr. Kent and Mr. Rosen resigned from the board of directors of the company and the board consisted of affiliates of Maximum Ventures until Maximum Ventures sold its interest in VerticalBuyer to CSI South Carolina on January 31, 2005. The Maximum Ventures CSI-South Carolina transaction is described in E. The Merger and Recapitalization Description of Merger and Related Investment Transactions Purchase of Majority Interest of VerticalBuyer, Inc. by CSI South Carolina. During the time that Maximum Ventures held its interest in VerticalBuyer, VerticalBuyer s board of directors and management made all filings, including past due reports, necessary to bring VerticalBuyer into compliance with the periodic reporting requirements of the Securities and Exchange Act of 1934, as amended.

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R. Risk Factors

Risk Factors Relating to Our Company

Our customers are predominantly educational institutions, municipalities, non-profit organizations, and other local governments. Negative trends in governmental spending patterns or failure to appropriate funds for our contracts, whether due to budgetary constraints or otherwise may have an adverse impact on sales revenues.

Approximately 90% of our revenues are generated from sales of software and services to county and city governments and school districts. We expect that sales to public sector customers will continue to account for substantially all of our revenues in the future. Many of these contracts are subject to annual review and renewal by the local governments, and may be terminated at any time on short notice. Our dependence on county and city governments and school districts for the sales of our products and services renders our revenue position particularly susceptible to downturns in revenues as a result of changes in governmental spending patterns and the contract award process.

Because we must comply with governmental procurement regulations and undergo governmental approval processes, the sales cycle associated with our products is typically complex and lengthy. This puts us at risk of having to incur significant sales expenses with no assurance that a sale will be consummated and revenues received. Future regulations could increase the magnitude of this risk.

For each contract with a public sector customer, we are typically subject to a procurement process, which can include a competitive bid process and governmental acceptance reviews. The process is often onerous and can include a detailed written response addressing, among other things, the design of software that addresses customer-specified needs, the integration of our products with third-party products and product demonstrations. Future laws and regulations could increase the demands and costs of this process. There is a risk that we could expend significant funds and management resources in complying with the procurement and governmental review rules, only to ultimately fail to close the sale. The procurement process can also be subject to political influences, award protests initiated by unsuccessful bidders and changes in budgets or appropriations which are beyond our control. Reacting or responding to any such influences or protests may involve considerable expense and delay, and may result in termination, reduction or modification of the awarded contract. Our failure to consummate sales after incurring significant expenses to comply with lengthy procurement processes would reduce our profitability and adversely affect our financial condition.

Changes in governmental procurement regulations may increase our costs, and non-compliance could negatively impact our ability to compete.

Government organizations require compliance with various legal and other special considerations in the procurement process. The adoption of new or modified procurement regulations could harm us by increasing the costs of competing for sales or by impacting our ability to perform government contracts. Any violation, intentional or otherwise, of these regulations could result in fines and/or debarment from award of additional government contracts, which could negatively affect our profitability and harm our business reputation.

Compliance with procurement processes and regulations may require us to disclose trade secrets or other confidential business information, which may place us at a competitive disadvantage.

We may, depending on the particular procurement, be required to disclose trade secrets and commercially sensitive information to the governmental entity making the procurement in order to place a bid or respond to a request for proposal. While mechanisms may be in place for protecting such information, disclosure could occur through a Freedom of Information Act release, thereby potentially compromising our confidential information.

Governmental contracts may contain terms not contained in typical private sector sales contracts that may be unfavorable to us. These terms may have the effect of raising our compliance costs or interrupting our revenue stream, either or both of which could negatively impact our income position.

Governmental contracts may contain terms that could adversely impact our sales revenues or increase our costs of doing business. Such terms may include profit limitations and rights of a particular governmental agency to terminate a contract for convenience or if funds are unavailable. We have never had a customer terminate a contract in this manner, although we can give no assurances this will not occur in the future. Also, in some cases we may be subject to liquidated damages for defective products and/or delays or interruptions caused by systems failures. Payments under some public sector contracts are subject to achieving implementation milestones and we could in the future have differences with customers as to whether milestones have been achieved.

Modifying our software products to comply with existing and future governmental regulations may increase our operating costs and have a negative impact on our profitability.

From time to time, it may be necessary to revise and update our software products to comply with changes in laws relating to the subject matter with which our software deals. For, example we may have to revise our CSI Accounting +*Plus* software to comply with changes in reporting requirements. Examples of such changes include modifications for Form W-2, Form 1099 and various health and retirement reporting and payroll tax table updates. The extent of any required revisions will depend upon the nature of the change in law. It is possible that in some cases, the costs of compliance may be passed on to the customer, but in other cases, we may be forced to absorb some or all of the costs. Any absorption of compliance costs would have an adverse impact on profits.

Most of our maintenance agreements are for a term of one year. If our customers do not renew their annual maintenance and support agreements for our products and services, or if they do not renew them on terms that are favorable to us, the reduction in revenues would have an adverse impact on our financial condition.

As the end of the term of a maintenance agreement approaches, we seek to renew the agreement with the customer. Revenues related to support and maintenance agreements, which are renewed annually, represented 6% of our total revenue for the 2005 fiscal year and 9% of our total revenue for the 2004 fiscal year. Due to this characteristic of our business, if our customers chose not to renew their maintenance and support agreements with us on terms beneficial to us, our business, operating results and financial condition could be harmed.

We derive a material portion of our revenue from the sale of our Accounting+Plus software. We believe that the use by our customers of our software also gives us a competitive advantage in our providing system integration services, including the sale of hardware, to these customers. Reduced acceptance of our Accounting+Plus software and upgrades of such software could have a direct and indirect adverse impact on our revenues.

We derive a material amount of our revenue from the sale of our Accounting+*Plus* software and related services, and revenue from this product and related services is expected to remain a material component of our revenue for the foreseeable future. For the 2005 and 2004 fiscal years, software sales and related revenues accounted for approximately 6.1% and 12.6% of our total revenues, respectively**.** Because we generally grant non-exclusive licenses to our products on a perpetual basis and deliver new versions and enhancements to customers who purchase annual maintenance and support, our future license, services and maintenance revenue are substantially dependent on sales to new customers. In addition, if demand for our Accounting+*Plus* software declines, we believe we would lose a competitive advantage in providing system integration services, and our technology segment revenues could also decline.

We encounter long sales cycles, particularly for our largest customers, which could have an adverse effect on the size, timing and predictability of our revenue and sales.

Potential customers, particularly large clients, generally commit significant resources to an evaluation of available software and require us to expend substantial time, effort and money educating them as to the value of our software and services. Sales of our core software products to these larger customers often require an extensive education and marketing effort.

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We could expend significant funds and management resources during the sales cycle and ultimately fail to close the sale. Our core software product sales cycle averages approximately three months for sales to existing customers and from three to nine months for sales to new customers and large organizations. Our sales cycle for all of our products and services is subject to significant risks and delays over which we have little or no control, including:

- our customers budgetary constraints;
- the timing of our clients budget cycles and approval processes;
- our clients willingness to replace their current methods or software solutions;
- our need to educate potential customers about the uses and benefits of our products and services;
- the timing and expiration of our clients current outsourcing agreements for similar services; and
- the governmental procurement risk described elsewhere in Risk Factors.

If we are unsuccessful in closing sales after expending significant funds and management resources or if we experience delays as discussed above, it could have a material adverse effect on the size, timing and predictability of our revenue.

We are dependent on strategic relationships with our vendors, and our business would be materially and adversely affected if we were to lose our existing, or fail to gain additional, strategic relationships.

The segment of our business that includes hardware sales and related support services is dependent upon the strong relationships that have been established with our vendors. We purchase equipment from these vendors and add our engineering services to provide a total solution to the customer. Without the vendor products, we would lose the margin on the hardware sale as well as the margin provided by our engineering services.

These relationships could be terminated if we fail to:

- maintain adequate certified systems engineers (computer professionals who have passed a test indicating specialized knowledge in the design, planning and implementation of specific computer-based technology) and staff that can implement and support the vendors products;
- receive satisfactory feedback from our customers; or
- pay for purchased equipment and services on a timely basis.

Our failure to compete successfully could cause our revenue or market share to decline.

Our market is fragmented, competitive and rapidly evolving, and there are limited barriers to entry for some aspects of this market. Our software applications segment has three primary sources of competition:

- software developers offering integrated specialized products designed to address specific needs of governmental organizations;

- custom-developed products created either internally or outsourced to custom service providers; and

- software developers offering general products not designed to address specific needs of governmental organizations.

Our technology solutions segment is subject to competition by both regional and national technology solutions providers including those listed by *VAR Business Magazine* as the top 500 network integration companies in the United States.

The companies with which we compete, and other potential competitors, may have greater financial, technical and marketing resources and generate greater revenue and better name recognition than we do. If one or more of our competitors or potential competitors were to merge or form a strategic relationship with another of

our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively. For example, a large diversified software enterprise, such as Microsoft, Oracle or PeopleSoft, could decide to enter the market directly, including through acquisitions, or large hardware and technology solutions providers, such as IBM Global Services, EDS and Lockheed Martin IT could have a negative impact on our ability to compete in the technology solutions market.

Loss of significant clients could hurt our business by reducing our revenues and profitability.

Our success depends substantially upon retaining our significant clients. Generally, we may lose clients due to conversion to a competing service provider. We cannot guarantee that we will be able to retain long-term relationships or secure renewals of short-term relationships with our significant clients in the future. Our top ten clients constituted approximately 40% of our revenue for the 2005 and 2004 fiscal years. The loss of a significant portion or all of these clients would have a material adverse effect on our profitability and financial condition.

We may not be able to manage our future growth efficiently or profitably. Increased demands on our human resources and infrastructure due to planned expansion, if not accompanied by increases in revenues, could negatively impact our profitability.

We have experienced significant personnel and infrastructure growth since our inception, and are continuing this expansion to address potential market opportunities. For example, we are expanding the size of our outside and inside sales staff, adding a telesales department and increasing our marketing and product development efforts to support a broader geographic reach and expanded product offerings. If these increases in personnel do not produce the intended growth in revenues, there can be no assurance that we will maintain profitability. Additionally, an increase in revenues will result in increased demands on our maintenance and support services professionals in order to maintain service quality. If we are unable to address sufficiently these additional demands on our personnel, operations, systems, procedures and resources, our profitability and growth might suffer.

In conjunction with the addition of a telesales department, we plan to establish a call center to broaden our support offerings for technology hardware sold, including IP telephony products. Establishment of such a call center will require a large initial investment. We hope that having an established call center dedicated to the support of technology products sold will facilitate an increase in sales of service contracts in connection with equipment sales and in turn, increase our sales revenue. Additionally, we hope that the establishment of a centralized call center will increase our efficiency in responding to customer service issues by increasing the amount of support provided remotely, improving response time, and reducing the need to divert engineers in the field from other projects. Failure to realize increased sales revenues and increased efficiency, combined with the cost to establish a call center, would have a negative impact on our profitability.

Because competition for highly qualified personnel is intense, we may not be able to attract and retain the employees we need to support our planned growth.

To execute our plans for continuing growth, we will need to increase the size, and maintain the quality of, our sales force, software development staff and our professional services organization. To meet our objectives, we must attract and retain highly qualified personnel with specialized skill sets focused on the educational and local government market. Competition for qualified personnel can be intense, and we might not be successful in attracting and retaining them. The pool of qualified personnel with experience working with or selling to nonprofit organizations is limited overall and specifically in Easley, South Carolina, where our principal office is located. Our ability to maintain and expand our sales, product development and professional services teams will depend on our ability to recruit, train and retain top quality people with advanced skills who understand selling to, and the specific needs of, educational institutions and local governments. For these reasons, we have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications for our business. In addition, it takes time

for our new sales and services personnel to become productive, particularly with respect to obtaining and supporting major customer accounts. In particular, we plan to continue to increase the number of services personnel to attempt to meet the needs of our customers and potential new customers. In addition to hiring services personnel to meet our needs, we might also engage additional third-party consultants as contractors, which could have a negative impact on our earnings. If we are unable to hire or retain qualified personnel, if newly hired personnel fail to develop the necessary skills or if they reach productivity slower than anticipated, it would be more difficult for us to sell our products and services, and we could experience a shortfall in revenue or earnings, and not achieve our planned growth.

As a result of the relatively low margins associated with the sale of hardware, our technology solutions segment produces substantially lower gross margins than our software applications segment. Our overall gross profit margin may be adversely affected if revenues of our technology solutions segment rise as a percentage of total revenues. In turn, this could result in reduced net income.

For the fiscal years ended December 31, 2005 and 2004, our software applications segment reported gross margins of 57.1% and 65.5%, respectively. In contrast, our technology solutions segment for such periods reported gross margins of 20.8% and 22.5%. Accordingly, an increase in hardware and related sales in our technology solutions segment relative to software revenues in our software applications segment could harm our overall gross margin. A shift in our product mix toward lower margin products would adversely affect our overall profitability if increases in volume of lower margin products did not offset the effect of changes in product mix. A decline in margins may also be received negatively by investors. Since establishing our technology solutions business in 1999, we have seen a continual increase in the amount of hardware we have been able to sell. Hardware pricing is highly competitive and product life-cycles can be short. We have recently been able to benefit from identifying, selling and implementing new products (for example, IP telephony and classroom learning tools) with higher margins as a result of selling such products before what we believe to be the midpoint of their life-cycles. As market penetration and competition increase for these products, margins and sales of these products may decline. As current hardware-based products mature, there can be no assurance that we will identify new products with equal margins or opportunities for greater volume to replace existing products.

If our products fail to perform properly due to undetected errors or similar problems, or fail to comply with government regulations, our business could suffer, and we could become subject to product or general liability or errors and omissions claims. Such claims could be time-consuming and costly. Furthermore, any negligence or misconduct on the part of our consultants could result in financial or other damages to our customers, for which they may bring claims against us.

Complex software such as ours often contains undetected errors or bugs. Software errors are frequently found after introduction of new software or enhancements to existing software. We continually introduce new products and new versions of our products. If we detect any errors before we ship a product, we might have to delay product shipment for an extended period of time while we address the problem. We might not discover software errors that affect our new or current products or enhancements until after they are deployed, and we may need to provide enhancements to correct such errors. Therefore, it is possible that, despite testing by us, errors may occur in our software. These errors, as well as any negligence or misconduct on the part of our consultants, could result in:

- harm to our reputation;
- lost sales;
- delays in commercial release of our software;
- product liability, general liability or errors and omissions claims;
- delays in, or loss of, market acceptance of our products;
- license terminations or renegotiations; and

unexpected expenses and diversion of resources to remedy errors.

Furthermore, our customers may use our software together with products from other companies. As a result, when problems occur, it might be difficult to identify the source of the problem. Even when our software does not cause these problems, the existence of these errors might cause us to incur significant costs, divert the attention of our technical personnel from our product development efforts, impact our reputation and cause significant customer relations problems.

Our failure to obtain or integrate third-party technologies could delay the development of our software and increase our costs.

We intend to continue licensing technologies from third parties, including applications used in our research and development activities and technologies which are integrated into our products. These technologies may not continue to be available to us on commercially reasonable terms or at all. Our inability to obtain any of these licenses could delay product development until equivalent technology can be identified, licensed and integrated. This inability in turn would harm our business and operating results. Our use of third-party technologies exposes us to increased risks, including, but not limited to, risks associated with the integration of new technology into our products, the diversion of our resources from development of our own proprietary technology and our inability to generate revenue from licensed technology sufficient to offset associated acquisition and maintenance costs.

Our success depends on our ability to respond quickly to changing technology, and we believe that we must develop new software programs and services utilizing modern technology in order to maintain our competitive position and profitability.

The market for our products and services is characterized by rapid technological change, evolving industry standards in computer hardware and software technology, changes in customer requirements and frequent new product introductions and enhancements. The introduction of products embodying new technologies and the emergence of new industry standards can cause customers to delay their purchasing decisions and render existing products obsolete and unmarketable. The life cycles of our software products are difficult to estimate. As a result, our future success will depend, in part, upon our ability to continue to enhance existing products and to develop and introduce in a timely manner new products with technological developments that satisfy customer requirements and achieve market acceptance. We may not be able to successfully identify new product opportunities and develop and bring new products to market in a timely and cost-effective manner. In addition, products, capabilities or technologies developed by others could render our products or technologies obsolete or noncompetitive or shorten product life cycles. If we are unable to develop on a timely and cost-effective basis new software products or enhancements to existing products or if new products or enhancements do not achieve market acceptance, we may not be able to compete effectively or maintain or grow our revenues.

As a result of the complexities inherent in software development, and in particular development for multi-platform environments, and the broad functionality and performance demanded by our customers, major new product enhancements and new products can require long development and testing periods before they are released commercially. We have on occasion experienced delays in the scheduled introduction of new and enhanced products, and future delays could increase costs and delay revenues.

We have made significant investments in software development and our growth plans are premised in part on generating substantial revenue from new product introductions and future enhancements to existing products. New product introductions and enhancements involve significant risks. For example, delays in new product introductions and enhancements, or less-than-anticipated market acceptance, are possible and would have an adverse effect on our revenue and earnings. We cannot be certain that our new products or enhancements will meet customer performance needs or expectations when shipped or that they will be free of significant software defects or bugs. If they do not meet customer needs or expectations, for whatever reason, upgrading or enhancing these products could be costly and time consuming.

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In addition, the selling price of software products tends to decline significantly over the life of the product. If we are unable to offset any reductions in the selling prices of our products by introducing new products at higher prices or by reducing our costs, our revenue, gross margin and operating results would be adversely affected.

Advances in technology can require retraining and additional certifications for existing personnel or hiring of more qualified personnel. The most significant portion of our investment in software development is related to labor. If our personnel are unable to keep up with changing technologies or we are unable to attract, hire, and retain personnel having the qualifications needed to engineer, manage and implement technological advances, our competitive position may erode, with an adverse effect on our revenues and profitability.

If the security of our software is breached, we could suffer significant costs and damage to our reputation.

Fundamental to the use of our products is the secure collection, storage and transmission of confidential information. Third parties may attempt to breach our security or that of our customers and their databases. We may be liable to our customers for any breach in such security, and any breach could harm our customers, our business and our reputation. Any imposition of liability, particularly liability that is not covered by insurance or is in excess of insurance coverage, could harm our reputation, our business and our operating results. Also, computers, including those that utilize our software, are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions. Such disruptions could lead to interruptions, delays or loss, of data and we may be required to expend significant capital and other resources to protect further against security breaches or to rectify problems caused by any security breach.

Future acquisitions could prove difficult to integrate, disrupt our business, dilute stockholder value and strain our resources.

One significant reason for our entering into the merger and recapitalization transaction in February 2005 was to allow us to access public capital markets as a source of funding to permit us to grow through acquisitions. In addition, the merger transaction facilitated the sale of warrants, the exercise of which (absent a cashless exercise) represents a significant potential source of capital. Our competitive markets are occupied by a number of competitors, many substantially larger than we, and with significantly greater geographic reach. We believe that to remain competitive, we need to take advantage of acquisition opportunities that arise which may help us achieve greater geographic presence and economies of scale. We may also utilize acquisitions to, whenever appropriate, expand our technological capabilities and product offerings. While we may use a portion of any cash proceeds to pay down debt on an interim basis, we intend to use any additional liquidity and/or availability of assets generated by the paydown and remaining proceeds to fund acquisitions. Additionally, we are in the process of engaging a consultant to assist us with acquisitions, including identifying potential acquisition opportunities. Pursuant to this strategic plan, we intend to acquire companies, products, services and/or technologies that we feel could complement or expand our existing business operations, augment our market coverage, enhance our technical capabilities, provide us with important customer contacts or otherwise offer growth opportunities. Acquisitions and investments involve numerous risks, including:

- improper valuation of the acquired business;
- difficulties in integrating operations, corporate cultures, technologies, services, accounting and personnel;
- difficulties in supporting and transitioning customers of acquired companies;
- diversion of financial and management resources from existing operations;
- risks of entering new sectors of the educational and governmental market;
- potential loss of key employees;

inability to generate sufficient revenue to offset acquisition or investment costs; and

consumption of significant capital and cash flow to the detriment of other business opportunities and needs.

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Acquisitions also frequently result in recording of goodwill and other intangible assets, which are subject to potential impairments in the future that could harm our operating results. In addition, if we finance acquisitions by issuing equity securities or securities convertible into equity securities, our existing stockholders could be diluted, which, in turn, could affect the market price of our stock. Moreover, we might finance an acquisition with debt, resulting in higher leverage and interest costs. As a result, if we fail to evaluate and execute acquisitions or investments properly, we might not achieve the anticipated benefits of any such acquisition, and we may incur costs in excess of what we anticipate.

There can be no assurance suitable acquisition candidates will be available, that we will be able to procure adequate financing, that we will be able to successfully purchase or profitably manage acquired companies, that future acquisitions will further the successful implementation of our overall strategy or that acquisitions ultimately will produce returns that justify the investment. In addition, we may compete for acquisition and expansion opportunities with companies that have significantly greater resources than we do.

Following our merger in February 2005, we have pursued and entered into preliminary discussions with various acquisition candidates. However, we have not entered into agreements or understandings for any acquisition which management deems material.

Our ability to raise capital in the future may be limited and our failure to raise capital when needed could prevent us from executing our growth strategy.

The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on many factors, including:

- market acceptance of our products and services;
- the need to adapt to changing technologies and technical requirements;
- the existence of opportunities for expansion; and
- access to and availability of sufficient management, technical, marketing and financial personnel.

If our capital resources are not sufficient to satisfy our liquidity needs, we may seek to sell additional equity or obtain other financing. We have not made arrangements to obtain additional financing. We may not be able to obtain additional financing, if required, in amounts or on terms acceptable to us, or at all.

Under certain circumstances, holders of warrants to purchase shares of our common stock may be able to exercise those warrants pursuant to a cashless exercise. A cashless exercise may adversely impact our business strategy.

The terms of the warrants held by Barron permit the cashless exercise of the warrants under certain circumstances. A cashless exercise would not result in capital inflow to the Company, which may hinder the implementation of our business strategy, one element of which is to expand through acquisition.

We currently do not have any pending or issued patents, but we rely upon trademark, copyright and trade secret laws to protect our proprietary intellectual property rights, which might not provide us with adequate protection. The loss or compromising of our rights in our intellectual property could adversely affect our competitive position and raise our costs.

Our success and ability to compete depend to a significant degree upon the protection of our software and other proprietary technology rights. We might not be successful in protecting our proprietary technology, and our proprietary rights might not provide us with a meaningful competitive advantage. To protect our proprietary technology, we rely on a combination of trademark, copyright and trade secret laws, as well as nondisclosure agreements. Each of these affords only limited protection. Moreover, we have no patent protection for Accounting+*Plus* software, which is one of our core products. Any inability to protect our intellectual property rights could seriously harm our competitive position, operating results and financial condition.

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In addition, the laws of some foreign countries do not protect our proprietary rights in our products to the same extent as do the laws of the United States. Despite the measures taken by us, it may be possible for a third party to copy or otherwise obtain and use our proprietary technology and information without authorization. Policing unauthorized use of our products is difficult, and litigation could become necessary in the future to enforce our intellectual property rights. Any litigation could be time consuming and expensive to prosecute or resolve, result in substantial diversion of management attention and resources, and materially harm our business, financial condition and results of operations.

Because we generally do not have written software licenses, we must rely primarily on implied licenses and copyrights to protect our software. The enforcement of implied licenses and copyrights may be time-consuming and costly.

Enforcement of the implied licenses on our software would be primarily based on copyright infringement grounds and/or on common law principles pertaining to implied licenses. Proving a breach of contract relating to a violation of an implied license may be difficult. Violations of copyrights on our software could include, among other things, unauthorized copies of the software being made, unauthorized distribution of our software, and unauthorized derivative works being made of our software (such as by reverse engineering). While each of the foregoing rights are held by a copyright owner, copyright infringement may be difficult to prove, whereas a violation of an express license may be more readily provable and may provide additional rights and remedies than available through copyright protection. Therefore, we may have to expend significant time and financial resources should the need to enforce an implied license or copyright arise.

Claims that we infringe upon third parties intellectual property rights could be costly to defend or settle.

Litigation regarding intellectual property rights is not unusual in the software industry. We expect that software products and services may be increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segments overlaps. We may from time to time encounter disputes over rights and obligations concerning intellectual property. Although we believe that our intellectual property rights are sufficient to allow us to market our software without incurring liability to third parties, third parties may nevertheless bring claims of infringement against us. Such claims may be with or without merit. Any litigation to defend against claims of infringement or invalidity could result in substantial costs and diversion of resources. Furthermore, a party making such a claim could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from selling or servicing our software. Our business, results of operations and financial condition could be harmed if any of these events occurred.

In addition, we have agreed, and will likely agree in the future, to indemnify certain of our customers against certain claims that our software infringes upon the intellectual property rights of others. We could incur substantial costs in defending ourselves and our customers against infringement claims. In the event of a claim of infringement, we and our customers might be required to obtain one or more licenses from third parties. We, or our customers, might be unable to obtain necessary licenses from third parties at a reasonable cost, if at all. Defense of any lawsuit or failure to obtain any such required licenses could harm our business, operating results and financial condition.

Increasing government regulation of electronic commerce could reduce our revenues and increase our costs.

We are subject not only to regulations applicable to businesses generally but also to laws and regulations directly applicable to electronic commerce. We deliver marketing, shareholder and customer information, product demonstrations, new software and software updates, technical support and training over the internet. We also sell services whereby a customer may access and use our software to load and manage their organization s data over the internet. Although there are currently relatively few laws and regulations governing electronic commerce, state, federal and foreign governments may adopt laws and regulations applicable to our business.

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Any such legislation or regulation could increase our operating costs as we are forced to comply, or increase the operating costs to our customers**.** In any such event, customers may decide not to use our products and services. Any new laws or regulations in the following areas could cause us to incur new compliance expenses, or otherwise adversely affect our business:

- user security and privacy;
- the pricing and taxation of internet use or goods and services offered or provided via the internet;
- the online distribution of specific material, content or services over the internet; and
- the content of websites or other internet marketing abilities (e.g., do not call (do not contact) registry requirements).

A significant portion of our revenues stem from sales to schools receiving funding through the E-Rate Program. A loss of such funding could have a material adverse impact on our revenues and financial condition.

We participate in the E-Rate Program, a government program providing funding for telecommunications, internet access and internal connections for schools that have a very high free and reduced lunch rate count. Schools and school districts that have developed an approved technology plan may receive funds to implement the plan. Service providers may sell to such schools and districts through an open and competitive bidding process. We have received funding through the E-Rate program since 2001, routinely representing 10% to 20% of our total revenues. The Schools and Libraries Division of the Universal Service Administrative Company, which administers the program, may conduct audits with respect to previous funding years. If the Schools and Libraries Division were to find that either we or the school to which we have made sales did not comply with the rules and regulations of the program, previous funding may have to be repaid and we could be barred from future bidding under the program. To date, we have not had to repay any money received in connection with the program, nor have we been cited for any material violation of program guidelines.

We received a subpoena from the United States Department of Justice on April 27, 2005, requesting our production of documents relating to the E-Rate Program. It is our understanding that similar inquiries have been directed to numerous other companies associated with the program. No allegations concerning impropriety by the Company have been made. Department of Justice Antitrust Division counsel has confirmed, as of March 17, 2006, that we have complied with all requests for information required by the subpoena, that nothing further is required of the Company at this time, and that the Company is a witness only. Although we do not believe that the investigation will impact our participation in the E-Rate Program, we can give no such assurances.

The requirements of being a public company, particularly the requirement to report financial results publicly and on a quarterly basis and compliance requirements under Sarbanes-Oxley will increase our administrative costs and may reduce our profitability in future periods in comparison to our reported historical results of operations and may distract management from business operations.

As a public company, we are subject to a number of additional requirements, including the reporting requirements of the Securities Exchange Act of 1934, as amended, and the Sarbanes-Oxley Act of 2002. The Securities Exchange Act requires, among other things, that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and internal controls for financial reporting.

Prior to February 11, 2005 we were a public shell with virtually no operations and had limited staff with highly technical accounting and public reporting expertise. We also had no requirement to report earnings quarterly or to any external persons or entities. In the first quarter of 2005, we entered into a complex merger and began public reporting of significant operations. Considerable additional effort is required to maintain and improve the effectiveness of disclosure controls and procedures and internal controls over financial reporting to meet the demands of a public reporting environment. Particularly, substantial additional resources are required in

light of Section 404 of the Sarbanes-Oxley Act and the related regulations regarding our required assessment of our internal controls over financial reporting and our independent registered public accounting firm s audit of that assessment beginning with our fiscal 2007 Annual Report on Form 10-KSB. These requirements have made it necessary for us to hire additional and more technical personnel, engage external resources and will increase our administrative costs and may reduce our profitability in future periods in comparison to our reported historical results.

Significant management oversight will also be necessary in light of these requirements. As a result, our management s attention might be diverted from other business concerns, which could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our inability to attract and retain qualified resources and effect adequate management over these areas in a timely fashion might adversely impact our compliance with Section 404. Any failure to comply with Section 404 as required may harm our financial position, reduce investor confidence, cause a decline in the market price for our common stock and subject us to costly litigation.

Failure to comply with certain standards has resulted in a conclusion there is a significant deficiency in our internal controls over financial reporting, and management may be unable to declare its controls over financial reporting effective until its implementation of the Sarbanes-Oxley Act which it anticipates completing in fiscal year 2007.

Since commencing the public reporting of significant operations following our reverse merger, we have identified a deficiency in our internal controls which constituted a significant deficiency, and have led to the conclusion that our disclosure controls are ineffective for the reasons described below.

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

Due to the time required to source, attract, negotiate and hire personnel with the necessary experience, we remained for several months without sufficient public reporting or technical expertise to resolve non-routine or complex accounting matters and public reporting requirements such as we encountered in the merger with CSI South Carolina, Inc. This resulted in our filing extensions and amending financial reports. Adjustments did not impact cash flows, but an adjustment related to the valuation of our warrants, following a determination they constituted a derivative financial instrument subject to complex accounting treatment, did impact our reported net income. The adjustments reflected a significant deficiency in our internal controls over the application of existing accounting principles to new public reporting disclosures and particularly related to the application of GAAP to new transactions. All necessary adjustments from the amendments to our previously issued financial results have been made in the financial information contained in this registration statement.

It was not until May 6, 2005 that we hired a chief financial officer with prior public reporting experience who is accustomed to dealing with more complex accounting matters. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the CFO in consultation with the CEO and the audit committee of the board of directors determined the Company, following its inception of reporting as a public company and hiring of its first CFO with SEC reporting experience, still lacked sufficient internal resources to insure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis. Accordingly, it was also determined until such time as we have sufficient resources, we would be unable to declare our disclosure controls with regard to new public reporting disclosures effective.

We continue to work with the chief financial officer to enlist the resources necessary to assist in the handling of complex non-routine accounting issues and to meet public disclosure requirements in a timely

fashion. Following consultation with the Company s Audit Committee and board of directors, the chief financial officer received authority to engage outside accounting experts to support management in their review, interpretation, and implementation of new disclosures and significant changes in accounting and regulatory reporting requirements, and engaged a resource in January 2006 to assist. The purpose is to provide additional technical resources (other than our independent auditors) to whom we may direct complex accounting issues for review, particularly in situations where the accounting treatment is unclear or extremely complex. In addition, in January 2006, we hired an additional staff person with public accounting and reporting experience.

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

We may discover and report additional weaknesses in our internal controls. Reporting deficiencies could harm our financial position, reduce investor confidence, cause a decline in the market price for our common stock and subject us to costly litigation.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our results of operations could be misstated and our reputation may be harmed. Historically, we may not have maintained a system of internal controls that was adequate for a public company, and in preparing the financial statements included in this prospectus we placed only limited reliance on our historical internal control structure. This limited reliance is not sufficient to meet the standards under Section 404 of the Sarbanes-Oxley Act, with which we must comply beginning with our fiscal 2007 Annual Report on Form 10-KSB. We have undertaken the task of documenting our controls in preparation for the additional review, evaluation and testing requirements under Section 404 under the direction of our chief financial officer, who has prior experience in this area. We have also engaged external resources to assist with our documentation, implementation and testing of internal control and financial reporting control requirements under the Sarbanes-Oxley Act and hired an additional staff person with experience in this area,

While continuous improvements in internal controls will be made into 2006 and 2007 either separately or in connection with the implementation of the Sarbanes-Oxley Act, based on our CFO s experience, with an increase in staff and the work of external resources, we expect we will receive additional suggestions for improvement in controls and will be implementing recommendations throughout the process. In this process we may identify and be required to report deficiencies in our internal controls that individually or collectively constitute material weaknesses.

The Public Company Accounting Oversight Board (PCAOB) has defined a material weakness as a significant control deficiency, or combination of deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A material weakness does not necessarily mean that a material misstatement has occurred or will occur, but that it could occur.

We are unsure we will be able to mitigate the possibility of significant deficiencies, including those that would constitute material weaknesses until we have completed the Sarbanes Oxley Act implementation process. Even so, we cannot assure you that the measures we have taken to date or these measures will ensure that we will be able to implement and maintain adequate controls over our financial processes and reporting to prevent any failure or deficiency. Any deficiencies or failures in internal controls or reporting of deficiencies or failures could harm the financial position of our business, reduce investor confidence, cause a decline in the market price for our common stock, and subject us to costly litigation.

Our management has limited experience in managing a public company, which could hamper our ability to function effectively as a public company.

Our management team has historically operated our business as a privately-owned corporation. Except for our chief financial officer, hired May 6, 2005, the individuals who now constitute our management have never had responsibility for managing a publicly-traded company. In particular, management is inexperienced in utilizing sophisticated forecasting or long term historical analysis of data that may be used for projecting future operating and financial results with a significant degree of consistency and accuracy. Due to the limited number of our personnel with experience with publicly-traded companies, any unexpected departure of our chief financial officer could result in our inability to comply fully with accounting pronouncements and public filing requirements on a timely basis. If we are unable to comply, our financial condition could be adversely affected.

In addition, although we are in the process of updating our systems and processes to public company standards, such systems and processes in many aspects still reflect those of a non-public corporation. As a result, we cannot assure you that we will be able to execute our business strategy as a public company. You should be especially cautious in drawing conclusions about the ability of our management team to provide guidance or other forward looking information regarding our operating or financial results with a reasonable degree of consistency and accuracy.

The development and enhancement of our software requires significant capital expenditures that we may not be able to make if we were to experience significant revenue reductions. Our failure or delay in developing and enhancing our software could seriously erode our competitive position.

Software technology is characterized by rapid technological change and evolving industry standards that require continuous development and enhancements to our software applications. Significant resources, primarily in the form of salaries and benefits, are required to keep up with these changes. We are in the process of rewriting our software applications to take advantage of current technologies. If we were to experience significant revenue reductions, our ability to implement these changes could be delayed or eliminated, eroding our competitive position and adversely affecting our revenues and financial condition.

We may not be able to repay both our bank credit facility which matures in May 2006 and our subordinated notes which mature in May 2006. Any failure to repay the credit facility or the notes, or in the alternative to secure a renewal or refinancing of the credit facility, would have a material adverse effect on our liquidity position and our ability to fund operations.

Our bank credit facility matures on May 1, 2006. Management believes that cash flow from operations may not be sufficient to repay both our $3.0 million bank credit facility in full on such date and the subordinated promissory notes payable to shareholders in an aggregate amount of $2.3 million which are due May 10, 2006. Management anticipates renewing the bank credit facility prior to its expiration date. In the alternative, we would attempt to refinance the credit facility with another lender. Although management currently believes that its existing lender will agree to a renewal of the facility, there can be no assurance that our bank will in fact agree to a renewal or that replacement financing could be procured by us on favorable terms. Without the existing credit facility or a replacement, management also believes that our ability to fund working capital and support additional sales growth could be adversely affected. If we were unable to repay the subordinated notes, there can be no assurance as to what adverse collection actions the subordinated noteholders might take, whether the noteholders would agree to an extension and on what terms, and the impact such a default might otherwise have on our other creditors and our financial condition.

We depend on key management and may not be able to retain those executives or recruit additional qualified personnel.

We believe that our future success will be due, in part, to the continued services of our senior management team. This team historically has been and we anticipate for the foreseeable future will continue to be relatively small. Our company was built by the five former shareholders of CSI South Carolina who were largely

responsible for our growth over the past 15 years. All of these founders of the Company now serve as our executive officers, with the exception of our former CFO, Joe G. Black, now retired. Each of the remaining four CSI South Carolina founders have garnered significant technical expertise in both our products and the requirements of our client base. They have also developed relationships with our clients that we believe are valuable. The four CSI South Carolina founders continue to manage specific areas of the business: sales, engineering, technical support and product development. They have been responsible for the technical development of our products and solutions and the creation of our business strategy. Because we are now a public company, we must also retain a chief financial officer with requisite technical expertise to handle the requirements of public company reporting and compliance. Our ability to implement our business plan is dependent on the retention of these executives who have specific, differentiated skills. Losing the services of one or more members of our management team could adversely affect our business and expansion plans.

Our certificate of incorporation limits the liability of our directors, which may bar stockholder actions and recovery against the directors for misconduct.

We have adopted provisions in our Amended and Restated Certificate of Incorporation that eliminate to the fullest extent permissible under Delaware law the liability of our directors for monetary damages for breach of fiduciary of duty as a director. While it may limit stockholder actions against the directors of the Company for various acts of malfeasance, the provision is designed to ensure the ability of our directors to exercise their best business judgment in managing the Company s affairs, subject to their continuing fiduciary duties of loyalty to the Company and its stockholders. Absent such a limitation, their judgment could be unreasonably impeded by exposure to potentially high personal costs or other uncertainties of litigation.

Our certificate of incorporation and bylaws provide for the indemnification of management, which in certain circumstances could serve to circumvent the recovery by stockholders in legal actions.

Our Amended and Restated Certificate of Incorporation and Amended and Restated Bylaws, to the fullest extent permitted by Delaware law, provide, generally, that the Company will indemnify, including the advancement of expenses, any director, officer, employee or agent of the Company who is, or is threatened to be made, a party to any action, suit or proceeding by reason of the fact he was acting as a director, officer, employee or agent of the Company. Any advancement of expenses is subject to the indemnified person undertaking to repay any advanced expenses later deemed to be improper. Such indemnification would cover the cost of attorneys fees as well as any judgment, fine or amount paid in settlement of such action provided that the indemnified party meets certain standards of conduct necessary for indemnification under applicable law and the provisions of the Amended and Restated Bylaws. Such indemnity may or may not be covered by officer and director liability insurance and could result in expense to the Company even if such person is not successful in the action. This provision is designed to protect such persons against the costs of litigation that may result from his or her actions on our behalf.

Risk Factors Relating to Our Common Stock

Our quarterly financial results fluctuate and may be difficult to forecast. If our future results are below either any guidance we may issue or the expectations of public market analysts and investors, the price of our common stock may decline.

Our quarterly revenue and results of operations are difficult to forecast. We have experienced, and expect to continue to experience, fluctuations in revenue and operating results from quarter to quarter. As a result, we believe that quarter-to-quarter comparisons of our revenue and operating results are not necessarily meaningful and that such comparisons might not be accurate indicators of future performance. The reasons for these fluctuations include but are not limited to:

- the size and timing of sales of our software, including the relatively long sales cycles associated with many of our large software sales;

- budget and spending decisions by our customers;
- market acceptance of new products we release;
- the amount and timing of operating costs related to the expansion of our business, operations and infrastructure;
- changes in our pricing policies or our competitors pricing policies;
- seasonality in our revenue;
- general economic conditions; and
- costs related to acquisitions of technologies or businesses.

Certain of our costs and expenses are based on our expectations of future revenue and are, to a large extent, fixed in the short term. These include: our software development costs, certain other overhead costs in costs of sales and the majority of our general and administrative expenses. If revenue falls below our expectations in a quarter and we are not able to quickly reduce our expenses in response, our operating results for that quarter could be adversely affected. It is possible that in some future quarter our operating results may be below either any guidance we may issue or the expectations of public market analysts and investors and, as a result, the price of our common stock may fall.

Our common stock is currently a penny stock, and the market for it is limited. Accordingly, we cannot assure that an adequate market will develop for our common stock or what the market price of our common stock will be.

Our common stock is currently traded in the over-the-counter market and is quoted on the OTC Bulletin Board. As of the date of this report, only approximately 104,881 shares were available for trading in the over-the-counter market. As a result, the liquidity of our common stock is limited, not only in the number of shares that are bought and sold, but also through delays in the timing of transactions and the lack of coverage by security analysts and the news media of our company.

In addition, because our stock is quoted on the OTC Bulletin Board, our common stock is subject to certain rules and regulations relating to a penny stock. A penny stock is generally defined as any equity security that has a price of less than $5.00 per share and that is not listed or approved for listing on a national securities exchange or an automated quotation system sponsored by a registered national securities exchange. Being a penny stock generally means that any broker who wants to trade in our shares (other than with established customers and certain institutional investors) must comply with certain sales practice requirements, including delivery to the prospective purchaser of the penny stock a disclosure statement describing the penny stock market and associated risks. In addition, broker/dealers must take certain steps prior to selling a penny stock, which steps include:

- obtaining financial and investment information from the investor;
- obtaining a written suitability questionnaire and purchase agreement signed by the investor; and
- providing the investor a written identification of the shares being offering and the quantity of the shares.

If these penny stock rules are not followed by the broker/dealer, the investor has no obligation to purchase the shares. The application of these comprehensive rules will make it more difficult for broker/dealers to sell our common stock, and as a practical matter, these requirements may mean that brokers will be less likely to make recommendations on our shares to their general customers. As a result, for as long as our common stock is quoted on the OTC Bulletin Board and subject to the penny stock rules, our stockholders may have difficulty selling their shares in the

secondary trading market. In addition, prices per share of our common stock may be lower than might otherwise prevail if our common stock were quoted on the Nasdaq Stock Market or traded on a national securities exchange, such as the New York Stock Exchange or the American Stock Exchange. This lack of liquidity may also make it more difficult to raise capital in the future through the sale of equity securities.

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The price of our common stock might be volatile.

Our stock price has been and may continue to be volatile, making an investment in our company risky. In the first quarter of 2005, the high quote was $7.00 and the low was $0.02. In the second quarter of 2005, the high quote was $4.01 and the low was $1.25. In the third quarter of 2005, the high quote was $2.25 and the low was $1.25. In the fourth quarter of 2005, the high quote was $3.00 and the low was $1.31. In the first quarter of 2006 (through March 15), the high quote was $3.00 and low was $2.10.

In recent years, technology stocks have experienced high levels of volatility and significant declines in value from their historic highs. The trading price of our common stock may fluctuate substantially. The price of the common stock that will prevail in the market might be higher or lower than the price you pay, depending on many factors, some of which are beyond our control and may not be related to our operating performance. The fluctuations could cause you to lose part or all of your investment in our shares of common stock. Those factors that could cause fluctuations in the trading price of our common stock include the following:

- price and volume fluctuations in the overall stock market from time to time;
- significant volatility in the market price and trading volume of software and technology companies;
- actual or anticipated changes in our earnings or fluctuations in our operating results or in the expectations of securities analysts;
- economic conditions and trends in general and in the software and information technology industries;
- major catastrophic events, including terrorist activities, which could reduce or divert funding from, and technology spending by, our core customer base of municipal governments and educational institutions;
- changes in our pricing policies or the pricing policies of our customers;
- changes in the estimation of the future size and growth of our market; or
- departures of key personnel.

In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has often been brought against that company. Due to the potential volatility of our stock price, we might be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management s attention and resources from our business.

Holders of the Series A Convertible Preferred Stock have certain rights which are superior to those of the common stockholders. These rights may adversely affect the liquidity and value of your investment.

The superior rights of the preferred stock include:

- If we are liquidated, our preferred stockholders have priority on the distribution of assets up to their original investment value of $0.6986 per share. If any assets remain after the preferred stockholders receive their entitlement, then the remaining assets will be distributed on a pro rata basis to the common stockholders.

In the event of a change in control of our company or the occurrence of certain other transactions including, but not limited to, a tender offer, exchange offer or compulsory share exchange, holders of Series A Convertible Preferred Stock are entitled to treat such a transaction as a liquidation and recover their original investment in our company.

While the preferred stock is outstanding, we are not permitted to pay dividends on our common stock. This restriction means we are unlikely to pay dividends to our common stockholders in the foreseeable future.

In the future, if we were to offer shares of common stock to the public for cash, the holder of Series A Convertible Preferred Stock and the five former shareholders of CSI South Carolina would have the right to participate pro rata in such an offering at 80% of the offering price. We do not currently contemplate such an offering.

The Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock permits the preferred stockholders to demand the return of their original investment under certain circumstances, which could hinder a stock transfer or business combination transaction beneficial to stockholders.

The preferred stockholders have the ability to elect to treat a change in control and certain other fundamental transactions as a liquidation and to be repaid their original investment under these circumstances. These transactions include a tender offer, an exchange offer, or a compulsory share exchange. The ability of the preferred stockholders to elect liquidation treatment could hinder or even prevent an acquisition transaction that might be beneficial to our common stockholders.

The raising of additional capital in the future may dilute your ownership in our company.

We may need to raise additional funds through public or private debt or equity financings in order to:

- take advantage of opportunities, including more rapid expansion;
- acquire complementary businesses or technologies;
- develop new services and products; or
- respond to competitive pressures.

Any additional capital raised through the sale of equity may dilute your ownership percentage in our company.

We could issue additional shares of common stock, which might dilute the book value of our common stock.

We have a total of 40,000,000 authorized shares of common stock, of which 3,270,680 shares were issued and outstanding as of March 17, 2006. Our board of directors has the authority, without action or vote of our stockholders in most cases, to issue all or a part of any authorized but unissued shares of our common stock. Such stock issuances may be made at a price that reflects a discount from the then-current trading price of our common stock. Of our 40,000,000 authorized shares, we have reserved for issuance 15,518,208 shares of common stock relating to outstanding warrants, options and convertible preferred stock. An additional 1,100,000 shares of our common stock are reserved for issuance under our 2005 Incentive Compensation Plan. Also, we anticipate that we may issue common stock in acquisitions in which we anticipate engaging pursuant to our business strategy. Any issuances relating to the foregoing would dilute your percentage ownership interests, which would have the effect of reducing your influence on matters on which our stockholders vote. They might also dilute the tangible book value per share of our common stock. In addition, the Series A Convertible Preferred stockholder and the five former shareholders of CSI South Carolina have the right, so long as any of the Series A Convertible Preferred stock is still outstanding, to participate in any funding by the Company (including a sale of common stock) on a pro rata basis at 80% of the offering price, which right if exercised might dilute our net tangible book value per share. Further, Barron has the right under certain circumstances to effect a cashless exercise of the warrants, which would dilute the tangible book value per share of our common stock.

Because we intend to retain any earnings to finance the development of our business, we may never pay cash dividends. Furthermore, the terms of both the Series A Convertible Preferred Stock and our bank loan documents currently prohibit the payment of cash dividends.

We have not paid cash dividends, except for the one-time cash dividend paid by CSI South Carolina, our predecessor, prior to the February 2005 merger and sale of preferred stock. Our bank loan documents now

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prohibit the payment of cash dividends, as do the terms of our Series A Convertible Preferred Stock. Regardless of these restrictions, we do not anticipate paying cash dividends on our common stock in the foreseeable future, but instead intend to retain any earnings to finance the development of our business.

Availability of significant amounts of common stock for sale in the future, or the perception that such sales could occur, could cause the market price of our common stock to drop.

A substantial number of shares of our common stock may be issued and subsequently sold upon the exercise of the two common stock warrants and the conversion of Series A Convertible Preferred Stock held by Barron. As of March 17, 2006, the number of such shares totaled 15,251,232 (including 815,760 shares issuable upon the conversion of preferred stock potentially issuable as liquidated damages under the Registration Rights Agreement). In addition, officers and other affiliates of our company held 2,526,905 shares of common stock, which have not been registered under the Securities Act of 1933, as amended, and are accordingly subject to the resale restrictions under such Act and Rule 144 thereunder. Under the Preferred Stock Purchase Agreement with Barron, shares held by insiders of the Company may not be sold until February 10, 2007. There were also outstanding options to purchase approximately 268,343 shares of our common stock. Additionally, we may issue up to 1,100,000 shares of common stock pursuant to our 2005 Computer Software Innovations, Inc. Incentive Compensation Plan. As of March 17, 2006, outside directors and consultants of the Company had been awarded an aggregate of 508,894 shares of common stock pursuant to the Plan as compensation for their services. This amount included 16,416 shares awarded to Thomas V. Butta, who subsequently resigned on February 22, 2006. The sale of any or all of these shares could have an adverse impact on the price of our common stock, as could the sale or issuance of additional shares of common stock in the future in connection with acquisitions or otherwise.

Insiders currently hold a significant percentage of our stock and could limit your ability to influence the outcome of key transactions, including a change of control, which could adversely affect the market price of our stock.

As of March 17, 2006 approximately 92% or 2,526,905 shares of our common stock were held by the former CSI South Carolina shareholders, four of whom are currently executive officers. Non-executive officers of the Company also held options to purchase approximately 268,343 shares. Further, our independent directors and consultants to the Company hold 492,478 shares of common stock (restricted stock in the case of the directors) that were granted under our 2005 Incentive Compensation Plan, which plan provides for the award of a total of 1,100,000 shares to employees, directors and consultants. All of these facts have the potential of solidifying control of the Company with insiders, and would likely limit the ability of any minority stockholders to influence the outcome of key decisions, including elections of directors.

Item 2. om">

Total liabilities	449,177	75,355	26,331		550,863
Total equity	432,550	849,890	18,275	(868,165)	432,550
Total liabilities and equity	$ 881,727	$ 925,245	$ 44,606	$ (868,165)	$ 983,413

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Operations

Three Months Ended September 30, 2013

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Revenue before provision for doubtful accounts	$	$ 179,560	$ 11,014	$	$ 190,574
Provision for doubtful accounts		(5,660)	(212)		(5,872)
Revenue		173,900	10,802		184,702
Salaries, wages and benefits	1,331	98,166	4,292		103,789
Professional fees		7,954	1,002		8,956
Supplies		9,170	636		9,806
Rents and leases		2,394	262		2,656
Other operating expenses		19,896	2,449		22,345
Depreciation and amortization		4,072	342		4,414
Interest expense, net	8,542		923		9,465
Transaction-related expenses		984			984
Total expenses	9,873	142,636	9,906		162,415
(Loss) income from continuing operations before income taxes	(9,873)	31,264	896		22,287
Equity in earnings of subsidiaries	21,087			(21,087)	
(Benefit from) provision for income taxes	(3,150)	10,680	211		7,741
Income (loss) from continuing operations	14,364	20,584	685	(21,087)	14,546
Loss from discontinued operations, net of income taxes		(182)			(182)
Net income (loss)	$ 14,364	$ 20,402	$ 685	$ (21,087)	$ 14,364

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Operations

Three Months Ended September 30, 2012

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Revenue before provision for doubtful accounts	$	$ 104,618	$	$	$ 104,618
Provision for doubtful accounts		(1,502)			(1,502)
Revenue		103,116			103,116
Salaries, wages and benefits	521	59,367			59,888
Professional fees		4,690			4,690
Supplies		4,831			4,831
Rents and leases		1,775			1,775
Other operating expenses		11,380			11,380
Depreciation and amortization		2,076			2,076
Interest expense, net	7,433				7,433
Transaction-related expenses		732			732
Total expenses	7,954	84,851			92,805
(Loss) income from continuing operations before income taxes	(7,954)	18,265			10,311
Equity in earnings of subsidiaries	11,532			(11,532)	
(Benefit from) provision for income taxes	(2,872)	6,595			3,723
Income (loss) from continuing operations	6,450	11,670		(11,532)	6,588
Loss from discontinued operations, net of income taxes		(138)			(138)
Net income (loss)	$ 6,450	$ 11,532	$	$ (11,532)	$ 6,450

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Operations

Nine Months Ended September 30, 2013

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Revenue before provision for doubtful accounts	$	$ 516,467	$ 22,763	$	$ 539,230
Provision for doubtful accounts		(14,932)	(889)		(15,821)
Revenue		501,535	21,874		523,409
Salaries, wages and benefits	3,744	285,760	9,400		298,904
Professional fees		25,447	1,847		27,294
Supplies		26,718	1,299		28,017
Rents and leases		6,872	505		7,377
Other operating expenses		53,922	5,502		59,424
Depreciation and amortization		11,379	869		12,248
Interest expense, net	25,570		2,102		27,672
Debt extinguishment costs	9,350				9,350
Transaction-related expenses		3,813			3,813
Total expenses	38,664	413,911	21,524		474,099
(Loss) income from continuing operations before income taxes	(38,664)	87,624	350		49,310
Equity in earnings of subsidiaries	54,340			(54,340)	
(Benefit from) provision for income taxes	(14,623)	33,143	(81)		18,439
Income (loss) from continuing operations	30,299	54,481	431	(54,340)	30,871
Loss from discontinued operations, net of income taxes		(572)			(572)
Net income (loss)	$ 30,299	$ 53,909	$ 431	$ (54,340)	$ 30,299

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Operations

Nine Months Ended September 30, 2012

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Revenue before provision for doubtful accounts	$	$ 298,638	$	$	$ 298,638
Provision for doubtful accounts		(5,429)			(5,429)
Revenue		293,209			293,209
Salaries, wages and benefits	1,691	171,899			173,590
Professional fees		13,521			13,521
Supplies		14,148			14,148
Rents and leases		6,244			6,244
Other operating expenses		30,768			30,768
Depreciation and amortization		5,332			5,332
Interest expense, net	22,186				22,186
Transaction-related expenses		2,097			2,097
Total expenses	23,877	244,009			267,886
(Loss) income from continuing operations before income taxes	(23,877)	49,200			25,323
Equity in earnings of subsidiaries	31,139			(31,139)	
(Benefit from) provision for income taxes	(8,776)	18,083			9,307
Income (loss) from continuing operations	16,038	31,117		(31,139)	16,016
Income from discontinued operations, net of income taxes		22			22
Net income (loss)	$ 16,038	$ 31,139	$	$ (31,139)	$ 16,038

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Cash Flows

Nine Months Ended September 30, 2013

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Operating activities:					
Net income (loss)	$ 30,299	$ 53,909	$ 431	$ (54,340)	$ 30,299
Adjustments to reconcile net income (loss) to net cash provided by (used in) continuing operating activities:					
Depreciation and amortization		11,379	869		12,248
Amortization of debt issuance costs	1,686				1,686
Equity-based compensation expense	3,744				3,744
Deferred income tax expense	(70)	10,797	(182)		10,545
Loss from discontinued operations, net of taxes		572			572
Debt extinguishment costs	9,350				9,350
Other		16			16
Change in operating assets and liabilities, net of effect of acquisitions:					
Equity in earnings of subsidiaries	54,340			(54,340)	
Accounts receivable, net		(18,920)	542		(18,378)
Other current assets		(5,638)	(19)		(5,657)
Other assets		(1,676)			(1,676)
Accounts payable and other accrued liabilities		2,763	(167)		2,596
Accrued salaries and benefits		(3,660)	193		(3,467)
Other liabilities		7,693	(4,155)		3,538
Net cash provided by (used in) continuing operating activities	99,349	57,235	(2,488)	(108,680)	45,416
Net cash used in discontinued operating activities		(541)			(541)
Net cash provided by (used in) operating activities	99,349	56,694	(2,488)	(108,680)	44,875
Investing activities:					
Cash paid for acquisitions, net of cash acquired		(135,605)			(135,605)

Cash paid for capital expenditures		(50,378)	(300)		(50,678)
Cash paid for real estate acquisitions		(4,676)			(4,676)
Other		(1,088)			(1,088)
Net cash used in investing activities		(191,747)	(300)		(192,047)
Financing activities:					
Borrowings on long-term debt	150,000				150,000
Net increase in revolving credit facility	19,500				19,500
Principal payments on long-term debt	(5,625)				(5,625)
Repayment of long-term debt	(52,500)				(52,500)
Payment of debt issuance costs	(4,307)				(4,307)
Payment of premium on note redemption	(6,759)				(6,759)
Proceeds from stock option exercises	233				233
Excess tax benefit from equity awards	1,265				1,265
Cash (used in) provided by intercompany activity	(201,156)	85,746	8,046	107,364	
Net cash (used in) provided by financing activities	(99,349)	85,746	8,046	107,364	101,807
Net (decrease) increase in cash and cash equivalents		(49,307)	5,258	(1,316)	(45,365)
Cash and cash equivalents at beginning of the period		49,307	92		49,399
Cash and cash equivalents at end of the period	$	$	$ 5,350	$ (1,316)	$ 4,034

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Acadia Healthcare Company, Inc.

Condensed Consolidating Statement of Cash Flows

Nine Months Ended September 30, 2012

(In thousands)

	Parent	Combined Subsidiary Guarantors	Combined Subsidiary Non-Guarantors	Consolidating Adjustments	Total Consolidated Amounts
Operating activities:					
Net income (loss)	$ 16,038	$ 31,139	$	$ (31,139)	$ 16,038
Adjustments to reconcile net income (loss) to net cash provided by (used in) continuing operating activities:					
Depreciation and amortization		5,332			5,332
Amortization of debt issuance costs	1,869				1,869
Equity-based compensation expense	1,691				1,691
Deferred income tax expense	(439)	8,577			8,138
Loss from discontinued operations, net of taxes		(22)			(22)
Other		(9)			(9)
Change in operating assets and liabilities, net of effect of acquisitions:					
Equity in earnings of subsidiaries	31,139			(31,139)	
Accounts receivable, net		(13,597)			(13,597)
Other current assets		(3,677)			(3,677)
Other assets		1,029			1,029
Accounts payable and other accrued liabilities		4,817			4,817
Accrued salaries and benefits		527			527
Other liabilities		1,527			1,527
Net cash provided by (used in) continuing operating activities	50,298	35,643		(62,278)	23,663
Net cash used in discontinued operating activities		(328)			(328)
Net cash provided by (used in) operating activities	50,298	35,315		(62,278)	23,335
Investing activities:					
Cash paid for acquisitions, net of cash acquired		(165,981)			(165,981)
Cash paid for capital expenditures		(14,511)			(14,511)
Cash paid for real estate acquisitions		(50,745)			(50,745)
Other		1,231			1,231

Net cash used in investing activities		(230,006)			(230,006)
Financing activities:					
Borrowings on long-term debt	25,000				25,000
Principal payments on long-term debt	(6,000)				(6,000)
Payment of debt issuance costs	(1,197)				(1,197)
Issuance of common stock	138,954				138,954
Proceeds from stock option exercises	515				515
Cash (used in) provided by intercompany activity	(207,570)	145,292		62,278	
Net cash (used in) provided by financing activities	(50,298)	145,292		62,278	157,272
Net decrease in cash and cash equivalents		(49,399)			(49,399)
Cash and cash equivalents at beginning of the period		61,118			61,118
Cash and cash equivalents at end of the period	$	$ 11,719	$	$	$ 11,719

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include any statements that address future results or occurrences. In some cases you can identify forward-looking statements by terminology such as may, might, will, would, should, could or the negative thereof. Generally, the words anticipate, believe, continue, expect, i estimate, project, plan and similar expressions identify forward-looking statements. In particular, statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance contained are forward-looking statements.

We have based these forward-looking statements on our current expectations, assumptions, estimates and projections. While we believe these expectations, assumptions, estimates and projections are reasonable, such forward-looking statements are only predictions and involve known and unknown risks, uncertainties and other factors, many of which are outside of our control, which could cause our actual results, performance or achievements to differ materially from any results, performance or achievements expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, but are not limited to:

negative media coverage relating to patient incidents, which could adversely affect the price of our common stock and result in incremental regulatory burdens and governmental investigations;

the impact of payments received from the government and third-party payors on our revenues and results of operations;

our significant indebtedness, our ability to meet our debt obligations, and ability to incur substantially more debt;

our future cash flow and earnings;

our restrictive covenants, which may restrict our business and financing activities;

our ability to make payments on our financing arrangements;

the impact of the economic and employment conditions in the United States on our business and future results of operations;

compliance with laws and government regulations;

the impact of claims brought against our facilities;

the impact of governmental investigations, regulatory actions and whistleblower lawsuits;

the impact of recent healthcare reform;

the impact of our highly competitive industry on patient volumes;

the impact of the trend by insurance companies and managed care organizations entering into sole source contracts;

the impact of recruitment and retention of quality psychiatrists and other physicians on our performance;

the impact of competition for staffing on our labor costs and profitability;

our dependence on key management personnel, key executives and our local facility management personnel;

our acquisition strategy, which exposes us to a variety of operational and financial risk;

difficulties in successfully integrating the operations of acquired facilities or realizing the potential benefits and synergies of these acquisitions;

the impact of state efforts to regulate the construction or expansion of healthcare facilities on our ability to operate and expand our operations;

our potential inability to extend leases at expiration;

the impact of controls designed to reduce inpatient services on our revenues;

the impact of different interpretations of accounting principles on our results of operations or financial condition;

the impact of environmental, health and safety laws and regulations, especially in states where we have concentrated operations;

the impact of an increase in uninsured and underinsured patients or the deterioration in the collectability of the accounts of such patients on our results of operations;

the risk of a cyber-security incident and any resulting violation of HIPAA, breach of privacy or other negative impact;

the impact of legislative and regulatory initiatives relating to privacy and security of patient health information and standards for electronic transactions;

failure to maintain effective internal control over financial reporting;

the impact of fluctuations in our operating results, quarter to quarter earnings and other factors on the price of our common stock;

the impact of our sponsor s rights over certain company matters;

the impact of the trend for insurance companies and managed care organizations to enter into sole source contracts on our ability to obtain patients; and

those risks and uncertainties described from time to time in our filings with the Securities and Exchange Commission.

Given these risks and uncertainties, you are cautioned not to place undue reliance on such forward-looking statements. These risks and uncertainties may cause our actual future results to be materially different than those expressed in our forward-looking statements. These forward-looking statements are made only as of the date of this Quarterly Report on Form 10-Q. We do not undertake and specifically decline any obligation to update any such statements or to publicly announce the results of any revisions to any such statements to reflect future events or developments.

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Overview

Our business strategy is to acquire and develop inpatient behavioral healthcare facilities and improve our operating results within our inpatient facilities and our other behavioral healthcare operations. We strive to improve the operating results of our facilities by providing high quality services, expanding referral networks and marketing initiatives while meeting the increased demand for behavioral healthcare services through expansion of our current locations as well as developing new services within existing locations. At September 30, 2013, we operated 47 behavioral healthcare facilities with approximately 3,900 licensed beds in 21 states and Puerto Rico. During the nine months ended September 30, 2013, we acquired four facilities with an aggregate of 488 licensed beds and a 75-bed facility under construction, which opened on October 1, 2013. We also added 195 beds to our existing facilities and opened a 60-bed facility during the nine months ended September 30, 2013 and opened a 42-bed facility in October 2013. We expect to add over 300 total beds during 2013 (exclusive of acquisitions).

We are the leading publicly traded pure-play provider of inpatient behavioral healthcare services based upon number of licensed beds in the United States. Management believes that the Company s recent acquisitions position the Company as a leading platform in a highly fragmented industry under the direction of an experienced management team that has significant industry expertise. Management expects to take advantage of several strategies that are more accessible as a result of our increased size and geographic scale, including continuing a national marketing strategy to attract new patients and referral sources, increasing our volume of out-of-state referrals, providing a broader range of services to new and existing patients and clients and selectively pursuing opportunities to expand our facility and bed count.

Acquisitions

On October 1, 2013, we completed the acquisition of the assets of Longleaf, an inpatient psychiatric facility with 68 licensed beds located in Alexandria, Louisiana, for cash consideration of $8.5 million.

On August 1, 2013, we completed the acquisition of The Refuge, an inpatient psychiatric facility near Ocala, Florida, licensed for 87 beds, for cash consideration of $14.1 million.

On May 1, 2013, we completed the acquisition of two facilities from United Medical Corporation, including San Juan Capestrano Hospital in San Juan, Puerto Rico, which is licensed for 108 beds and has a certificate of need for 100 additional beds, and a 75-bed inpatient behavioral healthcare hospital in Tampa, Florida, which opened on October 1, 2013, for cash consideration of $99.4 million.

On January 31, 2013, we completed the acquisition of Delta, a facility with 243 licensed beds located in Memphis, Tennessee with the majority of operating beds dedicated to inpatient psychiatric patients, for cash consideration of $23.1 million.

On January 1, 2013, we completed the acquisition of the assets of Greenleaf, an inpatient psychiatric facility with 50 licensed beds located in Valdosta, Georgia, for cash consideration of $6.3 million.

On December 31, 2012, we completed the acquisition of BCA and AmiCare. On November 11, 2012, we purchased 100% of the membership interests of Park Royal. On August 31, 2012, we completed the acquisition of the assets of Timberline Knolls. On March 1, 2012, we completed the acquisition of the Haven Facilities.

Revenue

Our revenue is primarily derived from services rendered to patients for inpatient psychiatric and substance abuse care, outpatient psychiatric care and adolescent residential treatment. We receive payments from the following sources for services rendered in our facilities: (i) state governments under their respective Medicaid and other programs; (ii) commercial insurers; (iii) the federal government under the Medicare program administered by the Centers for Medicare and Medicaid Services; and (iv) individual patients and clients. Revenue is recorded in the period in which services are provided at established billing rates less contractual adjustments based on amounts reimbursable by Medicare or Medicaid under provisions of cost or prospective reimbursement formulas or amounts due from other third-party payors at contractually determined rates.

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The following table presents revenue by payor type and as a percentage of revenue before provision for doubtful accounts for the three and nine months ended September 30, 2013 and 2012 (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Self-Pay	$ 7,994	4.2%	$ 2,482	2.4%	$ 16,444	3.0%	$ 5,376	1.8%
Commercial	47,309	24.8%	24,984	23.9%	135,703	25.2%	65,570	22.0%
Medicare	44,160	23.2%	12,492	11.9%	115,461	21.4%	33,351	11.2%
Medicaid	87,573	45.9%	63,256	60.5%	259,963	48.2%	186,750	62.5%
Other	3,538	1.9%	1,404	1.3%	11,659	2.2%	7,591	2.5%
Revenue before provision for doubtful accounts	190,574	100.0%	104,618	100.0%	539,230	100.0%	298,638	100.0%
Provision for doubtful accounts	(5,872)		(1,502)		(15,821)		(5,429)	
Revenue	$ 184,702		$ 103,116		$ 523,409		$ 293,209	

The following tables present a summary of our aging of accounts receivable as of September 30, 2013 and December 31, 2012:

September 30, 2013

	Current	30-90 Days	90-150 Days	>150 Days	Total
Self-Pay	1.2%	2.6%	2.4%	3.8%	10.0%
Commercial	14.6%	6.7%	2.1%	2.4%	25.8%
Medicare	17.9%	7.5%	2.3%	3.1%	30.8%
Medicaid	23.2%	6.1%	1.6%	2.5%	33.4%
Total	56.9%	22.9%	8.4%	11.8%	100.0%

December 31, 2012

	Current	30-90 Days	90-150 Days	>150 Days	Total
Self-Pay	1.3%	2.2%	2.2%	3.5%	9.2%
Commercial	16.2%	6.5%	2.4%	3.1%	28.2%
Medicare	14.4%	2.0%	0.6%	0.9%	17.9%
Medicaid	26.6%	10.2%	3.8%	4.1%	44.7%
Total	58.5%	20.9%	9.0%	11.6%	100.0%

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Results of Operations

The following table illustrates our consolidated results of operations from continuing operations for the respective periods shown (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Revenue before provision for doubtful accounts	$ 190,574		$ 104,618		$ 539,230		$ 298,638	
Provision for doubtful accounts	(5,872)		(1,502)		(15,821)		(5,429)	
Revenue	184,702	100.0%	103,116	100.0%	523,409	100.0%	293,209	100.0%
Salaries, wages and benefits	103,789	56.2%	59,888	58.1%	298,904	57.1%	173,590	59.2%
Professional fees	8,956	4.9%	4,690	4.6%	27,294	5.2%	13,521	4.6%
Supplies	9,806	5.3%	4,831	4.7%	28,017	5.4%	14,148	4.8%
Rents and leases	2,656	1.4%	1,775	1.7%	7,377	1.4%	6,244	2.2%
Other operating expenses	22,345	12.1%	11,380	11.0%	59,424	11.4%	30,768	10.5%
Depreciation and amortization	4,414	2.4%	2,076	2.0%	12,248	2.3%	5,332	1.8%
Interest expense	9,465	5.1%	7,433	7.2%	27,672	5.3%	22,186	7.6%
Debt extinguishment costs		%		%	9,350	1.8%		%
Transaction-related expenses	984	0.5%	732	0.7%	3,813	0.7%	2,097	0.7%
Total expenses	162,415	87.9%	92,805	90.0%	474,099	90.6%	267,886	91.4%
Income from continuing operations before income taxes	22,287	12.1%	10,311	10.0%	49,310	9.4%	25,323	8.6%
Provision for income taxes	7,741	4.2%	3,723	3.6%	18,439	3.5%	9,307	3.2%
Income from continuing operations	$ 14,546	7.9%	$ 6,588	6.4%	$ 30,871	5.9%	$ 16,016	5.4%

Three months ended September 30, 2013 compared to the three months ended September 30, 2012

Revenue before provision for doubtful accounts. Revenue before provision for doubtful accounts increased $86.0 million, or 82.2%, to $190.6 million for the three months ended September 30, 2013 from $104.6 million for the three

months ended September 30, 2012. The increase related primarily to revenue generated during the three months ended September 30, 2013 from Timberline Knolls acquired on August 31, 2012, Park Royal acquired on November 11, 2012, BCA and AmiCare acquired on December 31, 2012, Greenleaf acquired on January 1, 2013, Delta acquired on January 31, 2013, the UMC Facilities acquired on May 1, 2013 and The Refuge acquired on August 1, 2013 (collectively the Third and Fourth Quarter 2012 and 2013 Acquisitions), which were not included in our results for periods prior to the acquisitions. Same-facility revenue before provision for doubtful accounts increased by $10.7 million, or 10.5%, for the three months ended September 30, 2013 compared to the three months ended September 30, 2012, resulting from same-facility growth in patient days of 8.4% and same-facility revenue per day of 1.4%.

Provision for doubtful accounts. The provision for doubtful accounts was $5.9 million for the three months ended September 30, 2013, or 3.1% of revenue before provision for doubtful accounts, compared to $1.5 million for the three months ended September 30, 2012, or 1.4% of revenue before provision for doubtful accounts. The increase as a percentage of revenue related primarily to the changes in our payor mix from the Third and Fourth Quarter 2012 and 2013 Acquisitions. The same-facility provision for doubtful accounts was $2.3 million for the three months ended September 30, 2013, or 2.0% of revenue before provision for doubtful accounts, compared to $1.4 million for the three months ended September 30, 2012, or 1.4% of revenue before provision for doubtful accounts.

Salaries, wages and benefits. Salaries, wages and benefits (SWB) expense was $103.8 million for the three months ended September 30, 2013 compared to $59.9 million for the three months ended September 30, 2012, an increase of $43.9 million. SWB expense included $1.3 million and $0.5 million of equity-based compensation expense for the three months ended September 30, 2013 and 2012, respectively. Excluding equity-based compensation expense, SWB expense was $102.5 million, or 55.5% of revenue, for the three months ended September 30, 2013, compared to $59.4 million, or 57.6% of revenue, for the three months ended September 30, 2012. The $43.1 million increase in SWB expense, excluding equity-based compensation expense, was primarily attributable to the hiring of additional employees in connection with the Third and Fourth Quarter 2012 and 2013 Acquisitions. The decrease in SWB expense, excluding equity-based compensation expense, as a percentage of revenue was primarily the result of lower SWB expense incurred by Timberline Knolls acquired on August 31, 2012 and BCA acquired on December 31, 2012. Same-facility SWB expense was $59.7 million for the three months ended September 30, 2013, or 54.2% of revenue, compared to $53.8 million for the three months ended September 30, 2012, or 53.7% of revenue.

Professional fees. Professional fees were $9.0 million for the three months ended September 30, 2013, or 4.9% of revenue, compared to $4.7 million for the three months ended September 30, 2012, or 4.6% of revenue. The increase in professional fees as a percentage of revenue was primarily attributable to higher professional fees incurred by the facilities acquired in our Third and Fourth Quarter 2012 and 2013 Acquisitions, which had higher professional fees as a percentage of revenue than our existing facilities. Same-facility professional fees were $3.6 million for the three months ended September 30, 2013, or 3.3% of revenue, compared to $3.4 million, for the three months ended September 30, 2012, or 3.4% of revenue.

Supplies. Supplies expense was $9.8 million for the three months ended September 30, 2013, or 5.3% of revenue, compared to $4.8 million for the three months ended September 30, 2012, or 4.7% of revenue. The $5.0 million increase in supplies expense was primarily attributable to the Third and Fourth Quarter 2012 and 2013 Acquisitions, which had higher supplies expense as a percentage of revenue than our existing facilities. Same-facility supplies expense was $5.1 million for the three months ended September 30, 2013, or 4.7% of revenue, compared to $4.7 million for the three months ended September 30, 2012, or 4.7% of revenue.

Rents and leases. Rents and leases were $2.7 million for the three months ended September 30, 2013, or 1.4% of revenue, compared to $1.8 million for the three months ended September 30, 2012, or 1.7% of revenue. The decrease in rents and leases as a percentage of revenue was primarily attributable to the purchase of six facilities during 2012 that were previously leased. Same-facility rents and leases were $1.6 million for the three months ended September 30, 2013, or 1.4% of revenue, compared to $1.7 million for the three months ended September 30, 2012, or 1.7% of revenue.

Other operating expenses. Other operating expenses consisted primarily of purchased services, utilities, insurance, travel and repairs and maintenance expenses. Other operating expenses were $22.3 million for the three months ended September 30, 2013, or 12.1% of revenue, compared to $11.4 million for the three months ended September 30, 2012, or 11.0% of revenue. The increase in other operating expenses as a percentage of revenue was primarily attributable to higher other operating expenses incurred by the facilities acquired in our Third and Fourth Quarter 2012 and 2013 Acquisitions, which had higher other operating expenses as a percentage of revenue than our existing facilities. Same-facility other operating expenses were $12.3 million for the three months ended September 30, 2013, or 11.2% of revenue, compared to $10.8 million for the three months ended September 30, 2012, or 10.8% of revenue.

Depreciation and amortization. Depreciation and amortization expense was $4.4 million for the three months ended September 30, 2013, or 2.4% of revenue, compared to $2.1 million for the three months ended September 30, 2012, or 2.0% of revenue. The increase in depreciation and amortization was attributable to depreciation associated with real estate purchases of $53.2 million and capital expenditures during 2012 and real estate acquired as part of the Third and Fourth Quarter 2012 and 2013 Acquisitions.

Interest expense. Interest expense was $9.5 million for the three months ended September 30, 2013 compared to $7.4 million for the three months ended September 30, 2012. The increase in interest expense was primarily a result of increased borrowings under the Amended and Restated Senior Credit Facility and the issuance of the 6.125% Senior Notes offset by a reduction related to the redemption of $52.5 million of the 12.875% Senior Notes on March 12, 2013.

Transaction-related expenses. Transaction-related expenses were $1.0 million for the three months ended September 30, 2013 compared to $0.7 million for the three months ended September 30, 2012. Transaction-related expenses represent costs incurred in the respective periods, primarily related to the 2012 and 2013 Acquisitions, as summarized below (in thousands):

	Three Months Ended September 30,	
	2013	2012
Legal, accounting and other fees	$ 841	$ 629
Severance and contract termination costs	143	103
	$ 984	$ 732

Provision for income taxes. For the three months ended September 30, 2013, the provision for income taxes was $7.7 million, reflecting an effective tax rate of 34.7%, compared to $3.7 million, reflecting an effective tax rate of 36.1%, for the same period of 2012. The decrease in the tax rate for the three months ended September 30, 2013 is primarily attributable to the filing of the 2012 calendar year tax returns as well as certain state tax planning initiatives.

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Nine months ended September 30, 2013 compared to the nine months ended September 30, 2012

Revenue before provision for doubtful accounts. Revenue before provision for doubtful accounts increased $240.6 million, or 80.6%, to $539.2 million for the nine months ended September 30, 2013 from $298.6 million for the nine months ended September 30, 2012. The increase related primarily to revenue generated during the nine months ended September 30, 2013 from the Haven Facilities acquired on March 1, 2012, Timberline Knolls acquired on August 31, 2012, Park Royal acquired on November 11, 2012, BCA and AmiCare acquired on December 31, 2012, Greenleaf acquired on January 1, 2013, Delta acquired on January 31, 2013, the UMC Facilities acquired on May 1, 2013 and The Refuge acquired on August 1, 2013 (collectively the 2012 and 2013 Acquisitions). Same-facility revenue before provision for doubtful accounts increased by $31.1 million, or 10.7%, for the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012, resulting from same-facility growth in patient days of 9.3% and same-facility revenue per day of 1.1%.

Provision for doubtful accounts. The provision for doubtful accounts was $15.8 million for the nine months ended September 30, 2013, or 2.9% of revenue before provision for doubtful accounts, compared to $5.4 million for the nine months ended September 30, 2012, or 1.8% of revenue before provision for doubtful accounts. The increase as a percentage of revenue related primarily to the changes in our payor mix from the 2012 and 2013 Acquisitions. The same-facility provision for doubtful accounts was $6.5 million for the nine months ended September 30, 2013, or 2.0% of revenue before provision for doubtful accounts, compared to $5.3 million for the nine months ended September 30, 2012, or 1.8% of revenue before provision for doubtful accounts.

Salaries, wages and benefits. SWB expense was $298.9 million for the nine months ended September 30, 2013 compared to $173.6 million for the nine months ended September 30, 2012, an increase of $125.3 million. SWB expense included $3.7 million and $1.7 million of equity-based compensation expense for the nine months ended September 30, 2013 and 2012, respectively. Excluding equity-based compensation expense, SWB expense was $295.2 million, or 56.4% of revenue, for the nine months ended September 30, 2013, compared to $171.9 million, or 58.6% of revenue, for the nine months ended September 30, 2012. The $123.3 million increase in SWB expense, excluding equity-based compensation expense, was primarily attributable to the hiring of additional employees in connection with the 2012 and 2013 Acquisitions. The decrease in SWB expense, excluding equity-based compensation expense, as a percentage of revenue was primarily the result of lower SWB expense incurred by the Haven Facilities acquired on March 1, 2012, Timberline Knolls acquired on August 31, 2012 and BCA acquired on December 31, 2012. Same-facility SWB expense was $170.1 million for the nine months ended September 30, 2013, or 54.0% of revenue, compared to $157.0 million for the nine months ended September 30, 2012, or 55.0% of revenue.

Professional fees. Professional fees were $27.3 million for the nine months ended September 30, 2013, or 5.2% of revenue, compared to $13.5 million for the nine months ended September 30, 2012, or 4.6% of revenue. The increase in professional fees as a percentage of revenue was primarily attributable to higher professional fees incurred by the facilities acquired in our 2012 and 2013 Acquisitions, which had higher professional fees as a percentage of revenue than our existing facilities. Same-facility professional fees were $10.5 million for the nine months ended September 30, 2013, or 3.3% of revenue, compared to $10.2 million, for the nine months ended September 30, 2012, or 3.6% of revenue.

Supplies. Supplies expense was $28.0 million for the nine months ended September 30, 2013, or 5.4% of revenue, compared to $14.1 million for the nine months ended September 30, 2012, or 4.8% of revenue. The $13.9 million increase in supplies expense was primarily attributable to the 2012 and 2013 Acquisitions, which had higher supplies expense as a percentage of revenue than our existing facilities. Same-facility supplies expense was $14.8 million for the nine months ended September 30, 2013, or 4.7% of revenue, compared to $13.7 million for the nine months ended September 30, 2012, or 4.8% of revenue.

Rents and leases. Rents and leases were $7.4 million for the nine months ended September 30, 2013, or 1.4% of revenue, compared to $6.2 million for the nine months ended September 30, 2012, or 2.2% of revenue. The decrease in rents and leases as a percentage of revenue was primarily attributable to the purchase of six facilities during 2012 that were previously leased. Same-facility rents and leases were $4.4 million for the nine months ended September 30, 2013, or 1.4% of revenue, compared to $5.9 million for the nine months ended September 30, 2012, or 2.1% of revenue.

Other operating expenses. Other operating expenses consisted primarily of purchased services, utilities, insurance, travel and repairs and maintenance expenses. Other operating expenses were $59.4 million for the nine months ended September 30, 2013, or 11.4% of revenue, compared to $30.8 million for the nine months ended September 30, 2012, or 10.5% of revenue. The increase in other operating expenses as a percentage of revenue was primarily attributable to higher other operating expenses incurred by the facilities acquired in our 2012 and 2013 Acquisitions, which had higher other operating expenses as a percentage of revenue than our existing facilities. Same-facility other operating expenses were $32.8 million for the nine months ended September 30, 2013, or 10.4% of revenue, compared to $29.5 million for the nine months ended September 30, 2012, or 10.3% of revenue.

Depreciation and amortization. Depreciation and amortization expense was $12.2 million for the nine months ended September 30, 2013, or 2.3% of revenue, compared to $5.3 million for the nine months ended September 30, 2012, or 1.8% of revenue. The increase in depreciation and amortization was attributable to depreciation associated with real estate purchases of $53.2 million and capital expenditures during 2012 and real estate acquired as part of the 2012 and 2013 Acquisitions.

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Interest expense. Interest expense was $27.7 million for the nine months ended September 30, 2013 compared to $22.2 million for the nine months ended September 30, 2012. The increase in interest expense was primarily a result of increased borrowings under the Amended and Restated Senior Credit Facility and the issuance of the 6.125% Senior Notes offset by a reduction related to the redemption of $52.5 million of the 12.875% Senior Notes on March 12, 2013.

Debt extinguishment costs. Debt extinguishment costs for the nine months ended September 30, 2013 represent $6.8 million of cash charges and $2.6 million of noncash charges recorded in connection with the redemption of $52.5 million of the 12.875% Senior Notes on March 12, 2013.

Transaction-related expenses. Transaction-related expenses were $3.8 million for the nine months ended September 30, 2013 compared to $2.1 million for the nine months ended September 30, 2012. Transaction-related expenses represent costs incurred in the respective periods, primarily related to the 2012 and 2013 Acquisitions, as summarized below (in thousands):

	Nine Months Ended September 30,	
	2013	**2012**
Legal, accounting and other fees	$ 2,644	$ 1,958
Severance and contract termination costs	1,169	139
	$ 3,813	$ 2,097

Provision for income taxes. For the nine months ended September 30, 2013, the provision for income taxes was $18.4 million, reflecting an effective tax rate of 37.4%, compared to $9.3 million, reflecting an effective tax rate of 36.8%, for the same period of 2012. The increase in the tax rate for the nine months ended September 30, 2013 is primarily attributable to the impact of additional state taxes associated with the Company s expansions and acquisitions.

Liquidity and Capital Resources

Cash provided by continuing operating activities for the nine months ended September 30, 2013 was $45.4 million compared to $23.7 million for the nine months ended September 30, 2012. The increase in cash provided by continuing operating activities was primarily attributable to cash provided by continuing operating activities from the 2012 and 2013 Acquisitions and the growth in same-facility operations. Days sales outstanding (DSO) as of September 30, 2013 was 46 compared to 39 as of December 31, 2012. The increase in DSO was primarily attributable to longer collection periods at our facilities acquired during 2013. As of September 30, 2013 and December 31, 2012, we had working capital of $41.6 million and $69.1 million, respectively.

Cash used in investing activities for the nine months ended September 30, 2013 was $192.0 million compared to $230.0 million for the nine months ended September 30, 2012. Cash used in investing activities for the nine months ended September 30, 2013 primarily consisted of $135.6 million of cash paid for acquisitions. Cash paid for capital expenditures for the nine months ended September 30, 2013 was $50.7 million, consisting of $11.0 million of routine capital expenditures and $39.7 million of expansion capital expenditures. We define expansion capital expenditures as those that increase the capacity of our facilities or otherwise enhance revenue. Routine or maintenance capital expenditures were 2.1% of revenue for the nine months ended September 30, 2013. Cash paid for real estate

acquisitions was $4.7 million for the nine months ended September 30, 2013. Cash used in investing activities for the nine months ended September 30, 2012 consisted primarily of cash paid for acquisitions of $166.0 million, cash paid for capital expenditures of $14.5 million and cash paid for real estate acquisitions of $50.7 million.

Cash provided by financing activities for the nine months ended September 30, 2013 was $101.8 million compared to $157.3 million for the nine months ended September 30, 2012. Cash provided by financing activities for the nine months ended September 30, 2013 primarily consisted of long-term debt borrowings of $150.0 million in connection with the issuance of the 6.125% Senior Notes, a net increase in revolving credit facility of $19.5 million, an excess tax benefit from equity awards of $1.3 million and proceeds from stock option exercises of $0.2 million, partially offset by repayment of long-term debt of $52.5 million, payment of premium on note redemption of $6.8 million, principal payments on long-term debt of $5.6 million and payment of debt issuance costs of $4.3 million. Cash provided by financing activities for the nine months ended September 30, 2012 primarily consisted of borrowings on long-term debt of $25.0 million, proceeds from the issuance of common stock of $139.0 million and proceeds from stock option exercises of $0.5 million, partially offset by principal payments on long-term debt of $6.0 million and payment of debt issuance costs of $1.2 million.

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Amended and Restated Senior Credit Facility

The Company entered into the Senior Secured Credit Facility, administered by Bank of America, N.A., on April 1, 2011. The Senior Secured Credit Facility initially included $135.0 million of term loans and a revolving line of credit of $30.0 million.

On March 1, 2012, the Company amended the Senior Secured Credit Facility to provide an incremental $25.0 million of term loans and increase the revolving line of credit by $45.0 million, from $30.0 million to $75.0 million. We used the incremental term loans of $25.0 million and a $5.0 million borrowing under the revolving line of credit to partially fund the acquisition of the Haven Facilities on March 1, 2012.

On December 31, 2012, the Company amended and restated the Senior Secured Credit Facility to provide a revolving line of credit of $100.0 million and term loans of $300.0 million, which resulted in debt proceeds of $151.1 million. We used $151.1 million of the term loans partially to fund the acquisition of BCA and AmiCare on December 31, 2012.

On March 11, 2013, the Company entered into a Consent and First Amendment to the Amended and Restated Senior Credit Facility. The First Amendment modified the definition of Consolidated EBITDA to permit the add-back for financial covenant purposes of certain fees and expenses related to the redemption of the Company s 12.875% Senior Notes. In addition, the First Amendment amended the definitions of Consolidated Leverage Ratio and Consolidated Senior Leverage Ratio to permit the Company to test indebtedness on a basis net of cash or cash equivalents on hand for financial covenant purposes.

On June 28, 2013, the Company entered into the Second Amendment to the Amended and Restated Senior Credit Facility. The Second Amendment modified certain of the restrictive covenants contained therein to permit the Company to increase the amount of miscellaneous investments it may make, as well as to permit the Company to incur increased amounts of purchase money indebtedness in order to finance certain long-term capital leases.

On September 30, 2013, the Company entered into the Third Amendment to the Amended and Restated Senior Credit Facility. The Third Amendment modified certain of the restrictive covenants contained therein to permit the incurrence by the Company of increased amounts of miscellaneous types of liens and indebtedness to facilitate its consummation of the acquisition of Longleaf.

The Company had $80.1 million of availability under the revolving line of credit as of September 30, 2013. Borrowings under the revolving line of credit are subject to customary conditions precedent to borrowing. The amended term loans require quarterly principal payments of $1.9 million for September 30, 2013 to December 31, 2013, $3.8 million for March 31, 2014 to December 31, 2014, $5.6 million for March 31, 2015 to December 31, 2015, $7.5 million for March 31, 2016 to December 31, 2016, and $9.4 million for March 31, 2017 to September 30, 2017, with the remaining principal balance due on the maturity date of December 31, 2017. The Amended and Restated Senior Credit Facility also provides for a $50.0 million incremental credit facility, subject to customary conditions precedent to borrowing.

Borrowings under the Amended and Restated Senior Credit Facility are guaranteed by each of the Company s domestic subsidiaries (other than Park Royal) and are secured by a lien on substantially all of the assets of the Company and its domestic subsidiaries (other than Park Royal). Borrowings under the Amended and Restated Senior Credit Facility bear interest at a rate tied to the Company s consolidated leverage ratio (defined as consolidated funded debt to consolidated EBITDA, in each case as defined in the Amended and Restated Senior Credit Facility). The Applicable Rate (as defined in the Amended and Restated Senior Credit Facility) for borrowings under the Amended

and Restated Senior Credit Facility was 3.25% for Eurodollar Rate Loans (as defined in the Amended and Restated Senior Credit Facility) and 2.25% for Base Rate Loans (as defined in the Amended and Restated Senior Credit Facility) at September 30, 2013. Eurodollar Rate Loans bear interest at the Applicable Rate plus the Eurodollar Rate (as defined in the Amended and Restated Senior Credit Facility) (based upon the British Bankers Association LIBOR Rate (as defined in the Amended and Restated Senior Credit Facility) prior to commencement of the interest rate period). Base Rate Loans bear interest at the Applicable Rate plus the highest of (i) the federal funds rate plus 1/2 of 1.0%, (ii) the prime rate and (iii) the Eurodollar Rate plus 1.0%. As of September 30, 2013, borrowings under the Senior Secured Credit Facility bore interest at a rate of 3.25%. In addition, the Company is required to pay a commitment fee on undrawn amounts under the revolving line of credit. The Company paid a commitment fee of 0.50% for undrawn amounts for the period from December 31, 2012 through September 30, 2013.

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The interest rates and the commitment fee on unused commitments related to the Amended and Restated Senior Credit Facility are based upon the following pricing tiers:

Pricing Tier	Consolidated Leverage Ratio	Eurodollar Rate Loans	Base Rate Loans	Commitment Fee
1	<3.5:1.0	2.75%	1.75%	0.40%
2	³3.5:1.0 but <4.0:1.0	3.00%	2.00%	0.45%
3	³4.0:1.0 but <4.5:1.0	3.25%	2.25%	0.50%
4	³4.50:1.0	3.50%	2.50%	0.50%

The Amended and Restated Senior Credit Facility requires the Company and its subsidiaries to comply with customary affirmative, negative and financial covenants. A breach of any of the restrictions or covenants in our debt agreements could cause a cross-default under other debt agreements. We may be required to pay all of our indebtedness immediately if we default on any of the numerous financial or other restrictive covenants contained in any of our material debt agreements. Set forth below is a brief description of such covenants, all of which are subject to customary exceptions, materiality thresholds and qualifications:

a) the affirmative covenants include the following: (i) delivery of financial statements and other customary financial information; (ii) notices of events of default and other material events; (iii) maintenance of existence, ability to conduct business, properties, insurance and books and records; (iv) payment of taxes; (v) lender inspection rights; (vi) compliance with laws; (vii) use of proceeds; (viii) further assurances; and (ix) additional collateral and guarantor requirements.

b) the negative covenants include limitations on the following: (i) liens; (ii) debt (including guaranties); (iii) investments; (iv) fundamental changes (including mergers, consolidations and liquidations); (v) dispositions; (vi) sale leasebacks; (vii) affiliate transactions and the payment of management fees; (viii) burdensome agreements; (ix) restricted payments; (x) use of proceeds; (xi) ownership of subsidiaries; (xii) changes to line of business; (xiii) changes to organizational documents, legal name, state of formation, form of entity and fiscal year; (xiv) capital expenditures (not to exceed 10.0% of total revenues of the Company and its subsidiaries); (xv) prepayment or redemption of certain senior unsecured debt; and (xvi) amendments to certain material agreements. The Company is generally not permitted to issue dividends or distributions other than with respect to the following: (w) certain tax distributions; (x) the repurchase of equity held by employees, officers or directors upon the occurrence of death, disability or termination subject to cap of $500,000 in any fiscal year and compliance with certain other conditions; (y) in the form of capital stock; and (z) scheduled payments of deferred purchase price, working capital adjustments and similar payments pursuant to the merger agreement or any permitted acquisition.

c) The financial covenants include maintenance of the following:

the fixed charge coverage ratio may not be less than 1.25:1.00 as of the end of any fiscal quarter, commencing with the fiscal quarter ending March 31, 2013;

the consolidated leverage ratio may not be greater than the amount set forth below as of the date opposite such ratio:

Fiscal Quarter Ending	Maximum Consolidated Leverage Ratio
September 30, 2013	5.25:1.0
December 31, 2013	5.00:1.0
March 31, 2014	4.75:1.0
June 30, 2014	4.75:1.0
September 30, 2014	4.75:1.0
December 31, 2014	4.50:1.0
March 31, 2015	4.50:1.0
June 30, 2015	4.50:1.0
September 30, 2015	4.50:1.0
December 31, 2015 and each fiscal quarter ending thereafter	4.00:1.0

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The consolidated senior secured leverage ratio may not be greater than the amount set forth below as of the date opposite such ratio:

Fiscal Quarter Ending	Maximum Consolidated Senior Secured Leverage Ratio
September 30, 2013	3.50:1.0
December 31, 2013 September 30, 2014	3.25:1.0
December 31, 2014 and each fiscal quarter ending thereafter	3.00:1.0

As of September 30, 2013, the Company was in compliance with all of the above covenants.

12.875% Senior Notes due 2018

On November 1, 2011, we issued $150.0 million of 12.875% Senior Notes due 2018 at 98.323% of the aggregate principal amount of $150.0 million, a discount of $2.5 million. The notes bear interest at a rate of 12.875% per annum. We pay interest on the notes semi-annually, in arrears, on November 1 and May 1 of each year.

The indenture governing the 12.875% Senior Notes contains covenants that, among other things, limit our ability to: (i) incur or guarantee additional debt or issue certain preferred stock; (ii) pay dividends on our equity interests or redeem, repurchase or retire our equity interests or subordinated debt; (iii) transfer or sell assets; (iv) make certain investments; (v) incur certain liens; (vi) restrict our subsidiaries ability to pay dividends or make other payments to the Company; (vii) engage in certain transactions with our affiliates; and (viii) merge or consolidate with other companies or transfer all or substantially all of the Company s assets.

The 12.875% Senior Notes issued by the Company are guaranteed by each of our domestic subsidiaries (other than Park Royal), all of which are wholly-owned subsidiaries. The guarantees are full and unconditional and joint and several and the Company, as the parent issuer of the 12.875% Senior Notes, has no independent assets or operations.

On March 12, 2013, we redeemed $52.5 million of the 12.875% Senior Notes using a portion of the net proceeds of our December 2012 equity offering pursuant to the provision in the indenture permitting an optional redemption with equity proceeds of up to 35% of the principal amount of 12.875% Senior Notes. The 12.875% Senior Notes were redeemed at a redemption price of 112.875% of the principal amount thereof plus accrued and unpaid interest to, but not including, the redemption date in accordance with the provisions of the indenture governing the 12.875% Senior Notes. As part of the redemption of 35% of the 12.875% Senior Notes, the Company recorded a debt extinguishment charge of $9.4 million, including the premium and write-off of deferred financing costs, which was recorded in debt extinguishment costs in the condensed consolidated statements of operations.

6.125% Senior Notes Due 2021

On March 12, 2013, we issued $150.0 million of 6.125% Senior Notes due 2021. The 6.125% Senior Notes mature on March 15, 2021 and bear interest at a rate of 6.125% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, beginning on September 15, 2013.

The indenture governing the 6.125% Senior Notes contains covenants that, among other things, limit the Company s ability and the ability of its restricted subsidiaries to: (i) pay dividends, redeem stock or make other distributions or

investments; (ii) incur additional debt or issue certain preferred stock; (iii) transfer or sell assets; (iv) engage in certain transactions with affiliates; (v) create restrictions on dividends or other payments by the restricted subsidiaries; (vi) merge, consolidate or sell substantially all of the Company s assets; and (vii) create liens on assets.

The 6.125% Senior Notes issued by the Company are guaranteed by each of our domestic subsidiaries (other than Park Royal), all of which are wholly-owned subsidiaries. The guarantees are full and unconditional and joint and several and the Company, as the parent issuer of the 6.125% Senior Notes, has no independent assets or operations.

We may redeem the 6.125% Senior Notes at our option, in whole or part, at any time prior to March 15, 2016, at a price equal to 100% of the principal amount of the 6.125% Senior Notes redeemed, plus accrued and unpaid interest to the redemption date and plus an applicable premium. We may redeem the 6.125% Senior Notes, in whole or in part, on or after March 15, 2016, at the redemption prices set forth in the indenture governing the 6.125% Senior Notes plus accrued and unpaid interest to the redemption date. At any time on or before March 15, 2016, we may elect to redeem up to 35% of the aggregate principal amount of the 6.125% Senior Notes at a redemption price equal to 106.125% of the principal amount thereof, plus accrued and unpaid interest to the redemption date, with the net proceeds of one or more equity offerings.

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9.0% and 9.5% Revenue Bonds

On November 11, 2012, in connection with the acquisition of Park Royal, we assumed debt of $23.0 million. The fair market value of the debt assumed was $25.6 million and resulted in a debt premium balance being recorded as of the acquisition date. The debt consisted of $7.5 million and $15.5 million of Lee County (Florida) Industrial Development Authority Healthcare Facilities Revenue Bonds, Series 2010 with stated interest rates of 9.0% and 9.5%, respectively. The 9.0% bonds in the amount of $7.5 million have a maturity date of December 1, 2030 and require yearly principal payments beginning in 2013. The 9.5% bonds in the amount of $15.5 million have a maturity date of December 1, 2040 and require yearly principal payments beginning in 2031. The principal payments establish a bond-sinking fund to be held with the trustee and shall be sufficient to redeem the principal amounts of the 9.0% and 9.5% Revenue Bonds on their respective maturity dates. The bond premium amount of $2.6 million is amortized as a reduction of interest expense over the life of the 9.0% and 9.5% Revenue Bonds using the effective interest method.

Contractual Obligations

The following table presents a summary of contractual obligations as of September 30, 2013 (dollars in thousands):

	Payments Due by Period				
	Less Than 1 Year	**1-3 Years**	**3-5 Years**	**More Than 5 Years**	**Total**
Long-term debt (a)	$ 40,531	$ 111,212	$ 301,111	$ 358,792	$ 811,646
Operating leases	7,927	12,429	7,551	21,383	49,290
Purchase and other obligations (b)	5,281	2,562	3,080		10,923
Total obligations and commitments	$ 53,739	$ 126,203	$ 311,742	$ 380,175	$ 871,859

(a) Amounts include required principal and interest payments. The projected interest payments reflect an interest rate of 3.25% per annum for our variable-rate debt based on the rate in place as of September 30, 2013.

(b) Amounts relate to purchase obligations, including capital lease payments and contingent payments of up to $7.0 million related to the acquisition of Park Royal in November 2012 that we may make depending upon achievements of certain financial targets over the four-year period ending December 31, 2016.

Off-Balance Sheet Arrangements

As of September 30, 2013, we had standby letters of credit outstanding of $0.4 million related to security for the payment of claims as required by our workers compensation insurance program.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our interest expense is sensitive to changes in market interest rates. With respect to our interest-bearing liabilities, our long-term debt outstanding at September 30, 2013 was composed of $271.4 million of fixed-rate debt and $313.9 million of variable-rate debt with interest based on LIBOR plus an applicable margin. A hypothetical 10% increase in interest rates would decrease our net income and cash flows by $0.6 million on an annual basis based upon our borrowing level at September 30, 2013.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, our management conducted an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

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Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the three months ended September 30, 2013 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

We are, from time to time, subject to various claims and legal actions that arise in the ordinary course of our business, including claims for damages for personal injuries, medical malpractice, breach of contract, tort and employment related claims. In these actions, plaintiffs request a variety of damages, including, in some instances, punitive and other types of damages that may not be covered by insurance. In the opinion of management, we are not currently a party to any proceeding that would 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, an investor should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2012. The risks, as described in the Company s Annual Report on Form 10-K for the year ended December 31, 2012, are not the only risks facing the Company. Additional risks and uncertainties not currently known to management or that management currently deems immaterial also may materially, adversely affect the Company s business, financial condition, operating results or cash flows.

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

During the three months ended September 30, 2013, the Company withheld shares of Company common stock to satisfy employee tax withholding obligations payable upon the vesting of restricted stock, as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 July 31		$		
August 1 August 31	961	38.10		
September 1 September 30				
Total	961			

Item 6. Exhibits

Exhibit No.

Exhibit No.	Exhibit Description
3.1	Amended and Restated Certificate of Incorporation, as filed on October 28, 2011 with the Secretary of State of the State of Delaware (1).
3.2	Amended and Restated Bylaws of Acadia Healthcare Company, Inc. (1).
10.1*	Third Amendment, dated as of September 30, 2013, to the Amended and Restated Credit Facility, dated December 31, 2012, by and among Bank of America, N.A. (Administrative Agent, Swing Line Lender and L/C Issuer) and Acadia Healthcare Company, Inc., the guarantors listed on the signature pages thereto, and the lenders listed on the signature pages thereto.
31.1*	Certification of the Chief Executive Officer of Acadia Healthcare Company, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of the Chief Financial Officer of Acadia Healthcare Company, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32*	Certification of Chief Executive Officer and Chief Financial Officer of Acadia Healthcare Company, Inc. pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document.
101.SCH**	XBRL Taxonomy Extension Schema Document.
101.CAL**	XBRL Taxonomy Calculation Linkbase Document.
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(1) Incorporated by reference to exhibits filed with Acadia Healthcare Company, Inc. s Current Report on Form 8-K filed November 1, 2011 (File No. 001-35331).

* Filed herewith.

** The XBRL related information in Exhibit 101 to this quarterly report on Form 10-Q shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

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SIGNATURES

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

Acadia Healthcare Company, Inc.

By: /s/ David M. Duckworth

David M. Duckworth

Chief Financial Officer

Dated: October 30, 2013

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