

COMPUTER SOFTWARE INNOVATIONS INC  
Form 10QSB  
November 13, 2007  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-QSB**

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(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2007.

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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

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**COMPUTER SOFTWARE INNOVATIONS, INC.**

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

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**Delaware**  
(State or Other Jurisdiction of

Incorporation or Organization)

**98-0216911**  
(I.R.S. Employer

Identification No.)

**900 East Main Street, Suite T**

**Easley, South Carolina 29640**

**(864) 855-3900**

(Address and Telephone Number of Principal Executive Offices)

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

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 4,698,970 as of November 13, 2007.

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

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**Table of Contents**

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

***TABLE OF CONTENTS***

	<b>PAGE NUMBER</b>
<b><u>PART I - FINANCIAL INFORMATION</u></b>	3
Item 1. <u>Financial Statements</u>	3
<u>Consolidated Statements of Operations for the Three Months and Nine Months Ended September 30, 2007 and 2006</u>	3
<u>Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006</u>	4
<u>Consolidated Statement of Changes in Shareholders' Equity (Deficit) for the Nine Months Ended September 30, 2007</u>	5
<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2007 and 2006</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
Item 2. <u>Management's Discussion and Analysis or Plan of Operation</u>	20
Item 3. <u>Controls and Procedures</u>	49
<b><u>PART II - OTHER INFORMATION</u></b>	50
Item 3. <u>Defaults Under Senior Securities</u>	50
Item 5. <u>Other Information</u>	51
Item 6. <u>Exhibits</u>	51
<b><u>SIGNATURES</u></b>	53
<b><u>EXHIBIT INDEX</u></b>	54

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

	Three Months Ended		Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2007	2006	2007	2006
<b>REVENUES</b>				
Software applications segment	\$ 2,633,513	\$ 1,448,180	\$ 8,167,675	\$ 3,998,257
Technology solutions segment	12,718,474	5,679,357	35,937,339	18,673,381
Net sales and service revenue	15,351,987	7,127,537	44,105,014	22,671,638
<b>COST OF SALES</b>				
<i>Software applications segment</i>				
Cost of sales excluding depreciation, amortization and capitalization	1,391,169	709,770	4,471,764	1,875,339
Depreciation	15,121	12,903	46,040	50,282
Amortization of capitalized software costs	287,238	171,457	785,560	529,123
Capitalization of software costs	(278,137)	(337,712)	(713,991)	(927,303)
Total Software applications segment cost of sales	1,415,391	556,418	4,589,373	1,527,441
<i>Technology solutions segment</i>				
Cost of sales excluding depreciation	10,867,366	4,879,467	29,846,606	15,703,770
Depreciation	22,682	20,954	66,416	69,423
Total technology solutions segment cost of sales	10,890,048	4,900,421	29,913,022	15,773,193
Total cost of sales	12,305,439	5,456,839	34,502,395	17,300,634
Gross profit	3,046,548	1,670,698	9,602,619	5,371,004
<b>OPERATING EXPENSES</b>				
Salaries, wages and benefits (excluding stock-based compensation)	1,337,936	847,916	3,825,515	2,510,737
Stock based compensation	1,496	179,937	92,308	875,148
Reverse merger costs		960		64,129
Acquisition costs		21,709	8,636	38,273
Professional and legal compliance and litigation costs	80,059	72,368	499,276	434,023
Sales consulting fees	68,054		164,054	
Marketing costs	28,242	33,509	101,554	124,639
Travel and mobile costs	158,850	97,711	450,386	330,726
Depreciation and amortization	94,195	49,291	274,943	124,822
Other selling, general and administrative expenses	234,706	180,905	732,474	535,774
Total operating expenses	2,003,538	1,484,306	6,149,146	5,038,271
Operating income	1,043,010	186,392	3,453,473	332,733
<b>OTHER INCOME (EXPENSE)</b>				

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Interest income	9,850	101	12,613	3,101
Interest expense	(133,298)	(105,867)	(419,353)	(294,844)
Amortization of loan fees				(17,458)
Loss on disposal of asset			(1,218)	
Net other income (expense)	(123,448)	(105,766)	(407,958)	(309,201)
Income before income taxes	919,562	80,626	3,045,515	23,532
<b>INCOME TAX EXPENSE</b>	228,780	119,789	1,166,769	91,437
<b>NET INCOME (LOSS)</b>	<b>\$ 690,782</b>	<b>\$ (39,163)</b>	<b>\$ 1,878,746</b>	<b>\$ (67,905)</b>
<b>BASIC EARNINGS (LOSS) PER SHARE</b>	<b>\$ 0.19</b>	<b>\$ (0.01)</b>	<b>\$ 0.53</b>	<b>\$ (0.02)</b>
<b>DILUTED EARNINGS (LOSS) PER SHARE</b>	<b>\$ 0.05</b>	<b>\$ (0.01)</b>	<b>\$ 0.14</b>	<b>\$ (0.02)</b>
<b>WEIGHTED AVERAGE SHARES OUTSTANDING:</b>				
<b>Basic</b>	<b>3,572,503</b>	<b>3,413,541</b>	<b>3,535,607</b>	<b>3,196,662</b>
<b>Diluted</b>	<b>13,257,601</b>	<b>3,413,541</b>	<b>13,251,489</b>	<b>3,196,662</b>

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

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

	September 30,	
	2007	December 31,
	(Unaudited)	2006
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$	\$
Accounts receivable, net	8,700,754	3,828,190
Inventories	1,125,895	2,569,382
Prepaid expenses	83,838	56,174
Taxes receivable		43,651
Total current assets	9,910,487	6,497,397
<b>PROPERTY AND EQUIPMENT, net</b>	1,309,845	771,472
<b>COMPUTER SOFTWARE COSTS, net</b>	2,115,099	1,505,458
<b>DEFERRED TAX ASSET</b>	56,232	366,476
<b>GOODWILL</b>	1,480,587	
<b>OTHER ASSETS</b>	1,603,990	318,884
Total assets	<b>\$ 16,476,240</b>	<b>\$ 9,459,687</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 4,449,719	\$ 3,995,021
Deferred revenue	3,660,810	2,079,492
Deferred tax liability	249,960	373,960
Income taxes payable	146,475	
Current portion of notes payable	277,702	109,274
Current portion of bank line of credit		551,000
Subordinated notes payable to shareholders	2,250,400	2,250,400
Total current liabilities	11,035,066	9,359,147
<b>NOTES PAYABLE, less current portion</b>	836,368	204,680
<b>BANK LINE OF CREDIT</b>	2,646,000	
Total liabilities	<b>14,517,434</b>	<b>9,563,827</b>
<b>SHAREHOLDERS EQUITY (DEFICIT)</b>		
Preferred stock - \$0.001 par value; 15,000,000 shares authorized; 6,859,736 and 7,012,736 shares issued and outstanding, respectively	6,860	7,013
Common stock - \$0.001 par value; 40,000,000 shares authorized; 3,765,170 and 3,429,030 shares issued and outstanding, respectively	3,765	3,429
Additional paid-in capital	6,631,659	6,473,342
Accumulated deficit	(4,647,027)	(6,525,773)
Unearned stock compensation	(36,451)	(62,151)
Total shareholders equity (deficit)	1,958,806	(104,140)

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Total liabilities and shareholders' equity (deficit)	\$ 16,476,240	\$ 9,459,687
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The accompanying notes are an integral part of these financial statements.

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

	Common Stock	Preferred Stock	Additional Paid-In Capital	Accumulated Deficit	Unearned Stock Compensation	Total
<b>Balances at December 31, 2006</b>	<b>\$ 3,429</b>	<b>\$ 7,013</b>	<b>\$ 6,473,342</b>	<b>\$ (6,525,773)</b>	<b>\$ (62,151)</b>	<b>\$ (104,140)</b>
Barron's conversion of preferred stock into common stock	153	(153)				
Barron's exercise of warrant to purchase common stock	120		83,880			84,000
Exercise of stock options	63		7,829			7,892
Stock based compensation			66,608		25,700	92,308
Net income for Nine months ended September 30, 2007				1,878,746		1,878,746
<b>Balances at September 30, 2007</b>	<b>\$ 3,765</b>	<b>\$ 6,860</b>	<b>\$ 6,631,659</b>	<b>\$ (4,647,027)</b>	<b>\$ (36,451)</b>	<b>\$ 1,958,806</b>

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



**Table of Contents**

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

	Nine Months Ended	
	September 30,	September 30,
	2007	2006
<b>OPERATING ACTIVITIES</b>		
Net Income (loss)	\$ 1,878,746	\$ (67,905)
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation and amortization	1,172,959	791,108
Stock based compensation expense, net	92,308	875,148
Deferred income tax expense	152,493	(145,132)
Loss on disposal of fixed assets	1,218	
Changes in deferred and accrued amounts net of effects from purchase of McAleer Computer Associates, Inc.		
Accounts receivable	(4,872,564)	917,670
Inventories	1,443,487	(36,432)
Prepaid expenses and other assets	76,123	(16,993)
Accounts payable	454,698	(848,592)
Deferred revenue	1,581,318	796,030
Income taxes payable (receivable)	190,126	192,918
<b>Net cash provided by operating activities</b>	<b>2,170,912</b>	<b>2,457,820</b>
<b>INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(223,000)	(594,195)
Capitalization of computer software	(785,201)	(927,303)
Purchase of computer software		(68,325)
Trademarks	(200)	(161,967)
Payment for purchase of McAleer Computer Associates, Inc.	(4,149,519)	
<b>Net cash used for investing activities</b>	<b>(5,157,920)</b>	<b>(1,751,790)</b>
<b>FINANCING ACTIVITIES</b>		
Net borrowings (repayments) under line of credit	2,095,000	(1,046,000)
Borrowings under notes payable	1,011,046	400,000
Repayments of notes payable	(210,930)	(60,030)
Proceeds from exercise of stock options and warrants	91,892	
<b>Net cash provided by (used for) financing activities</b>	<b>2,987,008</b>	<b>(706,030)</b>
<b>Net change in cash and cash equivalents</b>		
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>		
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$</b>	<b>\$</b>
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Interest	\$ 309,781	\$ 403,894

Income Taxes	\$ 824,150	\$ 43,651
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The accompanying notes are an integral part of these financial statements.

**Table of Contents**

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

***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***

***(UNAUDITED)***

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

**Organization**

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

In the first quarter of 2005, we concluded a series of recapitalization transactions. 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 Computer Software Innovations, Inc., a South Carolina corporation (CSI South Carolina) founded in 1989. 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 was 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). The activities of VerticalBuyer are included only from the date of the transaction forward. Shareholders' equity of CSI-South Carolina, cumulative since its founding in 1989 and after giving effect for differences in par value, has been carried forward after the acquisition.

The reverse merger and related transactions are described in further detail in our Annual Report on Form 10-KSB for the year ended December 31, 2006.

In accordance with our business strategy, on January 2, 2007, we purchased substantially all of the assets and business operations of McAleer Computer Associates, Inc. (McAleer). The total price for the assets acquired was \$4,050,000. Details on the acquisition are described in Note 3 McAleer Acquisition.

**Description of business**

The Company is engaged in the business of development and sales of internally developed software, sales and distribution of computers, network and communications hardware and accessories, as well as interactive collaborative classroom technologies and other hardware based solutions.

The Company's internally developed software consists of fund accounting based financial management software and standards-based lesson planning software. The Company's 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. The fund accounting software is used primarily by public sector and not-for-profit entities. The Company's standards-based lesson planning 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. The lesson plans can be stored, shared, and retrieved for collaboration, editing and future use.

In connection with its hardware-based solutions, the Company provides a wide range of technology products and services including hardware and design, engineering, installation, training and ongoing support and maintenance. Technology solutions include computers, networking, security, IP telephony, interactive whiteboard solutions and integrated accessories, distance learning and video communication. The Company currently markets its products and services primarily to a wide variety of education and local government agencies, and not-for-profit entities in the southeastern United States. The majority of the Company's business is with K-12 (kindergarten through grade 12) public education and local government entities.



**Table of Contents****Basis of presentation**

Our consolidated financial statements include CSI Technology Resources, Inc., a wholly-owned subsidiary. Intercompany balances and transactions have been eliminated. We use the accrual basis of accounting.

We employ accounting principles generally accepted in the United States ( generally accepted accounting principles or GAAP ). GAAP requires us to make estimates, assumptions and judgments and rely on projections of future results of operations and cash flows. Those estimates, assumptions, judgments and projections are based on our assessment of future trends or events and the impact that those trends or events could have on our results of operations as reported in our financial statements, and are an integral part of our financial statements. We base our estimates, assumptions, and judgments on historical data and other assumptions, which include knowledge and experience with regard to past and current events and assumptions about future trends or events that we believe are reasonable under the circumstances. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities in our financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates, assumptions, projections and judgments.

Certain accounting policies, methods and estimates are particularly sensitive because of their significance to the financial statements and of the possibility that future events affecting them may differ markedly from management's current judgments.

The interim consolidated balance sheet and the related consolidated statements of operations, changes in shareholders' equity (deficit) and cash flows are unaudited. In our opinion, all adjustments (consisting of normal recurring adjustments) necessary for fair presentation of the interim financial statements have been made. The results of the three month or nine month periods ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the consolidated financial statements, critical accounting policies, significant accounting policies and the notes to the consolidated financial statements included in our most recent Annual Report on Form 10-KSB.

Certain prior period amounts have been reclassified to conform to the current presentation.

**NOTE 2 EARNINGS (LOSS) PER SHARE**

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common stock shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common and potential common shares outstanding during the period following application of the treasury stock method. The table below presents the weighted average shares outstanding for the three and nine month periods ended September 30, 2007 and 2006, both prior to and after application of the treasury stock method.

	For the Three Months Ended September 30, 2007		For the Nine Months Ended September 30, 2006	
<b>Weighted Average Shares Outstanding Prior to Application of the Treasury Stock</b>				
<b>Method</b>				
Common stock	3,572,503	3,413,541	3,535,607	3,196,662
Preferred stock	6,928,595	7,012,736	6,948,762	7,060,886
Warrants	7,213,823	7,217,736	7,216,417	7,217,736
Options	282,924	268,343	292,293	268,343
Total Weighted Average Shares Outstanding	17,997,845	17,912,356	17,993,079	17,743,627
<b>Weighted Average Shares Outstanding After Application of the Treasury Stock</b>				
<b>Method</b>				
Common stock	3,572,503	3,413,541	3,535,607	3,196,662
Preferred stock	6,928,595	7,012,736	6,948,762	7,060,886
Warrants	2,530,875	1,539,459	2,532,547	1,539,459
Options	225,628	253,625	234,573	253,625
Total Weighted Average Shares Outstanding treasury stock method	13,257,601	12,219,361	13,251,489	12,050,632

GAAP requires that in the case of thinly traded stock, management assess, among other factors, whether the market quoted price is representative of the price that would be effective were all shares issued in connection with various transactions, which would include the

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issuance of significant additional shares in dilutive transactions. Following consultation with accounting and valuation experts and applying the principle of conservatism, which is a basis of the dilution calculation under GAAP, management uses the higher of an income statement performance and cash flow indicator based stock value computation based on comparisons to peer public companies, or the quoted market price, on a weighted average basis, for the repurchase of shares under the treasury stock method in the diluted earnings (loss) per share calculation. Once management, in consultation with its accounting and financial experts, considers the stock no longer thinly traded, management will use the quoted market price exclusively.

**Table of Contents**

The potential common shares were used in the calculation of diluted earnings per share for the three months and nine months ended September 30, 2007, but were not used in the calculation of diluted loss per share for the three or nine month periods ended September 30, 2006 as the effect was anti-dilutive due to the net loss reported for the periods.

**NOTE 3 MCALEER ACQUISITION**

On January 2, 2007, the Company consummated its previously announced acquisition of the business operations of McAleer. The transaction was structured as a purchase of substantially all of the assets of McAleer.

The total price for the purchased assets was \$4,050,000, of which \$3,525,000 was paid in cash at closing. The balance of \$525,000 was to be paid pursuant to a promissory note to the owner, William McAleer, in twenty quarterly installments of principal in the amount of \$26,250, plus interest in arrears at the LIBOR rate, beginning March 31, 2007. The note was secured by a first mortgage on the real property of McAleer conveyed in the acquisition, consisting of the office building located in Mobile, Alabama from which the Mobile personnel operate. The Company assumed no liabilities of McAleer, other than certain operating leases and obligations under ongoing customer contracts. On February 8, 2007, the Company repaid the note to William McAleer by financing the real estate through a mortgage note with its bank in the amount of \$486,000 (the terms of which are discussed below under Note 5 Long-term and Short-term Debt, Including Related Party Transaction and Off-Balance Sheet Instruments), and a draw against its revolving credit facility for the remaining balance. Expenses for the acquisition, in the amount of \$266,837, consisted of legal and professional fees, travel costs, stock compensation costs and various other expenses related to the acquisition transaction. These expenses have been capitalized and allocated to goodwill. The Company engaged an independent party to provide assistance with customary valuations, analysis and allocation of the purchase price, which resulted in an allocation to goodwill. For the purposes of recording assets by segment, the acquired assets, including goodwill, are reported under the Software applications segment. The Company expects all goodwill will be deductible for tax purposes, and has an indefinite life for book purposes. The deferred tax liability arises from a difference in the agreed to price for the building asset (tax basis) and the purchase price allocation (book basis included in property and equipment and based on appraisal). Research and development assets acquired in the purchase were not material.

The allocation of the purchase price, including capitalized acquisition expense is as follows (liabilities assumed as parts of the purchase price were not deemed material):

Property and equipment	\$ 615,000
Computer software	610,000
Goodwill	1,480,587
Other intangible assets	1,645,000
Deferred tax liability	(33,750)
 Total assets purchase price	 \$ 4,316,837

The detail of computer software, other intangible assets and goodwill and their useful lives are as follows:

Asset	Value	Effective Useful Life
Computer software	\$ 610,000	4 years
Trade name	70,000	3 years
Covenants not-to-compete	75,000	5 years
Customer contracts and related relationships	1,500,000	20 years
 Other intangible assets	 \$ 1,645,000	
 Total computer software and other intangible assets	 \$ 2,255,000	 13.3 years *
 Goodwill	 \$ 1,480,587	 indefinite

\* weighted average



**Table of Contents**

The Company funded the acquisition in part with advances of approximately \$2.1 million under its credit facilities with its bank. The Company also utilized approximately \$1.3 million in cash from McAleer as, pursuant to the asset purchase agreement, service contract revenue with respect to 2007 services which was received by McAleer in 2006 prior to the closing was segregated for the Company's account. Initially the owner assumed a \$525,000 note secured by the real estate for the remainder of the purchase price, which was subsequently refinanced, and the Company incurred expenses which were capitalized as a part of the transaction.

Sources of funds used in the transaction (net of subsequent refinancing activities) are as follows:

Proceeds from increase in long-term note payable secured by property and equipment (at time of purchase)	\$ 486,046
Proceeds from long-term note payable secured by real estate (for refinance of McAleer note)	486,000
Receipts on billings for McAleer 2007 support agreements earmarked for CSI	1,280,000
Draw on revolving credit facility (escrow payment at time of signing of definitive agreement)	100,000
Draw on revolving credit facility (at time of purchase (including \$12,378 for acquisition related expenses))	1,671,332
Draw on revolving credit facility (for refinance of McAleer note)	39,000
Payments of acquisition related expenses (funded from revolving credit facility)	254,459
 Subtotal of funds from revolving loan	 2,064,791
 Total purchase price	 \$ 4,316,837

Under Statement of Financial Accounting Standards ( SFAS ) No. 141, Business Combinations, acquisition expenses incurred as of the initiation date by the acquiring company that are direct costs of the acquisition, as determined by the principles of accounting for the acquisition of an asset, should be allocated to identified assets acquired and liabilities assumed, with unallocated amounts being recorded as goodwill. The guidance further defines the initiation date as the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer. In addition, direct costs are further defined as out-of-pocket or incremental costs directly related to a business combination such as a finder's fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals. Guidance further dictates that internal costs associated with a business combination (whether one-time costs or recurring in nature) should be expensed as incurred. Under this guidance, the initiation date of this acquisition was September 20, 2006, the date the Company filed the Form 8-K with the SEC setting forth our intent to acquire McAleer and formally communicating to our shareholders the major terms of the potential acquisition agreement.

In consideration of the requirements of SFAS No. 141, the Company identified expenses incurred that were directly related to the acquisition of McAleer, and capitalized those expenses as appropriate. Upon completion of the acquisition, the purchase price and other direct costs were allocated to identifiable assets or liabilities, with all unallocated amounts classified as goodwill, subject to SFAS No. 142, Goodwill and Other Intangible Assets. As of September 30, 2007, the Company has incurred approximately \$300,000 in acquisition related costs, of which approximately \$267,000 were direct costs of the acquisition of McAleer and were therefore capitalized.

**Pro Forma Financial Information**

The following unaudited pro forma statement of operations data for the three months and nine months ended September 30, 2006 gives effect to our acquisition of McAleer as if the acquisition had occurred on January 1, 2006. Our historical financial information has been derived from our unaudited financial statements included in this report. Historical financial information for McAleer has been derived from the unaudited financial statements of McAleer as of September 30, 2006.

The following unaudited pro forma financial information reflects our accounting for the acquisition of McAleer using the purchase method of accounting. Under the purchase method of accounting, the purchase price that we paid is allocated to the assets acquired, both tangible and intangible, and liabilities that we assumed based upon fair values. Any excess in the purchase price over the fair values of assets and liabilities is recorded as goodwill, which does not require amortization, but is periodically evaluated for impairments. The following unaudited pro forma financial statements data reflects our best estimates of the impact had the transaction occurred on January 1, 2006 based on the best available data, including the final allocation of purchase price using external third-party valuation experts as noted above.

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The unaudited pro forma financial information is not necessarily indicative of the financial condition or results of operations that we would have achieved had the acquisition occurred on the dates referred to above. In addition, unaudited pro forma operating information is not necessarily indicative of the results of operations that we may achieve following the consummation of the acquisition.

**Table of Contents**

We have not disclosed pro forma results for 2007 as actual results reported in our consolidated statements of operations are the same as those that would be reported on a pro forma basis. Since the acquisition was agreed to close effective January 1, 2007, and was only closed on January 2, 2007 to accommodate the banks' holiday, the financial statements for the period ended September 30, 2007 as disclosed in the consolidated statements of operations are indicative of the pro forma results for that period and no further disclosure is necessary.

*Proforma Income Statement Data for the Three and Nine Months Ended September 30, 2006*

	<b>For the Three Months ended</b>			
	<b>September 30, 2006</b>			
	<b>CSI</b>	<b>McAleer</b>	<b>Adjustments</b>	<b>Proforma Combined</b>
Revenues	\$ 7,127,537	\$ 972,490	\$	\$ 8,100,027
Net income (loss)	(39,163)	(6,053)	(165,721) <sup>(1)(2)</sup>	(210,937)
Earnings (loss) per share	(0.01)			(0.06)
Weighted average shares outstanding	3,413,541			3,413,541

  

	<b>For the Nine Months ended</b>			
	<b>September 30, 2006</b>			
	<b>CSI</b>	<b>McAleer</b>	<b>Adjustments</b>	<b>Proforma Combined</b>
Revenues	\$ 22,671,638	\$ 3,034,103	\$	\$ 25,705,741
Net income (loss)	(67,905)	269,888	(311,485) <sup>(1)(2)</sup>	(109,502)
Earnings (loss) per share	(0.02)			(0.03)
Weighted average shares outstanding	3,196,662			3,196,662

(1) Net income is net of pro forma adjustment for C-corporation taxes.

(2) Net income is adjusted for the pro forma additional depreciation of property and equipment and the amortization of intangibles over the useful lives noted above following the write-up of the assets to their fair values (in accordance with the purchase price allocation detailed above) and the pro forma additional interest expense related to financing used to fund the acquisition.

**NOTE 4 STOCK-BASED COMPENSATION**

The Company has a stock based compensation plan, the 2005 Incentive Compensation Plan (the Plan). The Company accounts for stock based compensation using the fair value method prescribed in SFAS No. 123R, Share-Based Payment, and related interpretations, which the Company adopted in 2006 using the modified prospective method. The Company utilizes the Black-Scholes model to estimate the fair value of the shares granted.

In 2005, the Company assumed the stock based employee compensation plan of CSI- South Carolina as a result of the reverse merger. In addition, the Company granted 70,000 of new options under the Plan in the first quarter of 2007 at an exercise price of \$0.85 per share, as a result of the McAleer acquisition which closed on January 2, 2007. The fair value of stock-based compensation was estimated at the grant date for each issuance using the Black-Scholes option-pricing model with the following weighted-average assumptions. The assumptions in 2007 relate to the options issued in 2007, reflected in the tables below. The assumptions in 2006 relate to the non-employee compensation issued in 2006, which is discussed under Non-employee Compensation below.

*Assumptions used in calculation of fair value***For the Period Ended****September 30,**

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	2007	2006
Expected term (in years)	10	10
Expected volatility	153%	35%
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	4.7%	4.8%

*Stock options*

Detail	Number of Options	Weighted Average Exercise		Expiration
		Price		
Options assumed in reverse merger	268,343	\$	0.12	November 1, 2012
Options granted in McAleer acquisition	70,000	\$	0.85	January 2, 2017

**Table of Contents**

The following table summarizes option activity under the plans for the first nine months of 2007:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
<b>Stock Options</b>				
Outstanding at December 31, 2006	268,343	\$ 0.12		
Granted	70,000	0.85		
Cancelled				
Exercised	(63,140)	0.13		
Forfeited/expired				
Outstanding at September 30, 2007	275,203	\$ 0.31	6.15	\$ 287,242
Exercisable at September 30, 2007	205,203	\$ 0.12	5.09	\$ 252,242

The aggregate intrinsic value represents the difference between the Company's closing stock price of \$1.35 as of September 30, 2007 and the exercise price multiplied by the number of options outstanding as of that date.

As of September 30, 2007 there remained \$36,451 of unrecognized compensation cost related to non-vested stock options which is expected to be recognized over a weighted-average period of approximately two years.

**Non-employee Compensation**

On February 21, 2006, the Compensation Committee of the Board of Directors and the full Board of Directors approved awards of Company common stock for the Company's outside directors under the Company's 2005 Incentive Compensation Plan (the Plan). Directors receiving awards under the Plan were Anthony H. Sobel, Chairman; Shaya Phillips; and Thomas V. Butta. Mr. Sobel was granted 98,496 shares, while Messrs. Phillips and Butta were granted 49,248 shares each. One-third of the awards vested immediately upon approval. An additional one-third vested on February 28, 2006, with the final one-third to vesting on February 28, 2007. Except in the event of a change in control of the Company, the directors could not sell any shares awarded to them prior to March 1, 2007. If a director's service terminated prior to a vesting date, all unvested shares would be forfeited, subject to exception in the discretion of the Board. As a result of his subsequent resignation as a director discussed below, Mr. Butta forfeited 32,832 shares.

Thomas V. Butta resigned from the Company's Board of Directors effective February 22, 2006. His resignation was not the result of any disagreement relating to the Company's operations, policies or practices. Rather, Mr. Butta resigned in order to devote his full attention to his responsibilities with an unaffiliated company of which he is the Chief Executive Officer. Mr. Butta served on the Board's Audit and Compensation Committees.

On March 2, 2006, the Company entered into a Letter of Engagement dated February 27, 2006 and individual restricted stock agreements with Robert F. Steel and Kenneth A. Steel, Jr. (the Consultants). The purpose of the agreements was to formally set forth the terms and conditions under which the Consultants had been providing and will continue to provide consulting services to the Company through February 10, 2008. Under the terms of the Letter of Engagement, the Consultants are to advise the Company on the development and implementation of strategic business plans, to assist management in developing marketing and growth strategies, and to assist management in seeking out and analyzing potential acquisition opportunities. The agreement requires the Consultants to provide such consulting services until February 10, 2008. In return, the Company agreed to issue 172,367 shares of its common stock to each of the Consultants. The stock awards were granted pursuant to the Company's 2005 Incentive Compensation Plan. The Company will also reimburse the Consultants for reasonable travel and other expenses incurred by the Consultants in furtherance of the agreements. The agreements contain customary confidentiality and non-competition provisions. The agreements also required the Consultants, if they were terminated for cause prior to the earlier to occur of February 28, 2007 or a change in control of the Company, to return one-third of the Stock Awards at the time of termination.

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**Table of Contents**

On June 20, 2006, the Board elected Jeffery A. Bryson to fill the vacancy on the Board created by the February 22, 2006 resignation of Mr. Butta. Mr. Bryson serves on the Company's Audit and Compensation Committees and he is Chairman of the Audit Committee. In connection with his election to the Board of Directors on June 20, 2006, the Board approved the award to Mr. Bryson of 23,350 shares of common stock under the Company's 2005 Incentive Compensation Plan. Under the terms of the award, 11,675 shares vested immediately upon Mr. Bryson's election to the Board and the remaining shares vested at the conclusion of the 2007 Annual Meeting of Stockholders of the Company when Mr. Bryson was reelected to the Board for a successive term at such meeting.

On July 10, 2006, the Company entered into an Investor Relations Consulting Agreement (the "Agreement") with Alliance Advisors, LLC ("Alliance"). The purpose of the Agreement is for Alliance to assist the Company in the development of the Company's investor relations and corporate communications program. Under the terms of the Agreement, Alliance will assist the Company for up to a period of twelve months in developing and implementing an investor relations and corporate communications strategy. In exchange for Alliance's services, the Company paid Alliance \$6,500 per month for the first nine months of the Agreement. At the end of nine months, either party to the Agreement had the option of terminating the Agreement, but agreed to extend the Agreement for an additional nine months, with a monthly payment of \$7,250. In addition to the cash compensation just described, the Company issued to Alliance sixty thousand (60,000) shares of restricted common stock in the third quarter of 2006.

No additional non-employee based stock awards were granted in the first nine months of 2007.

Total stock based compensation in the third quarter of 2007 was \$1,496, all of which related to the stock options granted as a result of the McAleer acquisition. Total stock based compensation for the first nine months of 2007 was \$92,308, of which \$30,157 related to the stock options granted as a result of the McAleer acquisition, and \$62,151 related to non-employee stock compensation discussed above.

**NOTE 5 LONG-TERM AND SHORT-TERM DEBT, INCLUDING RELATED PARTY TRANSACTIONS, AND OFF-BALANCE SHEET INSTRUMENTS**

*Senior Debt*

In 2005, in order to support the activities of the reverse acquisition, the Company entered into a line of credit facility with a bank whereby the Company could borrow up to 80% of accounts receivable balances, not to exceed the total facility limit of \$3.0 million. In the first quarter of 2006 and in January 2007, the facility was renewed and the limit increased to \$3.5 million and \$5.5 million, respectively. The primary purpose of these modifications was to increase the amount of the credit facilities to provide for expanding working capital and other credit needs, including funding the acquisition of substantially all of the assets and business operations of McAleer (see Note 3) in early 2007. In May 2007, the Company extended the maturity date of the facility until September 15, 2007, and on September 14, 2007 once again extended the maturity date until June 30, 2009 and increased the limit to \$7.0 million, as further discussed below.

Eligible accounts receivable balances essentially include all of our trade accounts receivable except, in most cases, those accounts which are more than 90 days past due. Certain other accounts are excluded from eligibility for borrowing including: (i) accounts due from affiliates; (ii) accounts which we have determined to be of doubtful collectibility; and (iii) accounts due from any one of our customers if such accounts constitute more than 20% of the total eligible accounts. The loans bear interest at Libor plus 2.50%, (7.62% at September 30, 2007), payable monthly.

The loans under the revolving credit facility and the equipment facility, as well as all other obligations owed by the Company to the bank, are secured by a first priority security interest in substantially all of the Company's assets. Also, the Company is required to comply with certain covenants, including: providing periodic financial statements to the bank, compliance with SEC reporting requirements, allowing the bank to inspect its secured assets, the Company maintaining its assets in good operating condition and maintaining sufficient insurance. Also, the Company is required to comply with certain financial covenants. The first financial covenant is a Debt Service Coverage Ratio, which is measured at the end of each year beginning December 31, 2007. This ratio is calculated by adding certain nonrecurring special items to EBITDA, and then dividing by current maturities of long term debt plus interest expense. For the purposes of the amended loan agreement, EBITDA means the total of (i) net income from continuing operations (excluding extraordinary gains or losses), and to the extent deducted in determining net income (ii) interest expense, (iii) income taxes, and (iv) depreciation, depletion and amortization expenses. The Company is required to maintain a Debt Service Coverage Ratio of not less than 1.2 to 1.0. The second financial ratio is Funded Debt to EBITDA, which is also measured annually beginning December 31, 2007. A ratio of not greater than 2.5 to 1.0 is required. For the purposes of the ratio, Funded Debt generally means all obligations for borrowed money or for the deferred purchase price of property, and all capitalized lease obligations. The Company complied with these covenants at December 31, 2006, as required by the now expired agreements, and anticipates continued compliance under the most recent and effective agreements as the required ratios and calculations remained unchanged.



## Table of Contents

The amended loan agreement also contains certain restrictive covenants. These include general prohibitions on: (i) disposing of property other than in the ordinary course of business; the Company changing its business; a change in control of the Company; mergers, acquisitions and the creation of new subsidiaries; the incurring of new indebtedness; the creation of new encumbrances or liens; investments, other than certain permitted investments in liquid investment grade paper; and the Company making loans, including loans to officers. Also, the amended loan agreement prohibits the Company from making any distributions (including any dividends on its common stock), or making any repurchases or redemptions of its capital stock, except to the extent there is no event of default either before or after any such distribution, repurchase or redemption. The bank may accelerate the Company's obligations under the amended loan agreement and the related promissory notes upon an event of default under the amended loan agreement. Events of default generally include the Company failing to make payments of principal or interest when due; defaults under loan covenants, subject to periods during which the Company may cure in certain cases; the Company becoming insolvent or being subject to certain bankruptcy proceedings, subject to certain time periods; and the occurrence of a material adverse change in the Company's business or financial condition. Upon an acceleration of the bank's loans to the Company, the bank, among other remedies, would have recourse to substantially all of the Company's assets through its security interest.

On September 14, 2007, the Company entered into agreements with the bank renewing the line of credit facility. The terms of the agreements previously entered into were amended as follows:

the principal amount of the facility was increased from \$5.5 million to \$7.0 million;

the maturity date was extended from September 15, 2007 until June 30, 2009;

permissible purposes of the funds borrowed under the revolving facility were expanded to include funding short-term working capital and general corporate purposes of the Company;

the definition of the borrowing base was expanded to include 50% of eligible inventory (with a maximum borrowing ability against eligible inventory of \$1,000,000), in addition to 80% of eligible accounts and;

the requirement that the Company provide an unaudited consolidated balance sheet and a statement of income, cash flow and retained earnings within 25 days after the end of each calendar month was amended to require these reports within 45 days after the end of each quarter (beginning with the quarter ended September 30, 2007).

Other than the amendments noted above, the obligations and provisions of the facility remain unchanged. The modifications also memorialized certain previously granted waivers to the restrictive covenants and requirements contained in the agreements with the bank. The bank granted waivers permitting us to enter into the acquisition of McAleer, including the use of bank credit facility advances to fund such acquisition, and incurring mortgage indebtedness to McAleer as a part of the purchase of McAleer's real estate. The bank also waived any cross-default relating to the subordinated notes payable to certain stockholders, which the Company did not repay at their May 2006 maturity.

There were \$2.6 million and \$0.6 million of outstanding draws under the facility as of September 30, 2007 and December 31, 2006, respectively.

On February 14, 2006 the Company entered into an agreement with its bank for a 42 month term loan of \$400,000 at a fixed interest rate of 7.5% per annum. The facility is collateralized by substantially all of the assets of the Company. The purpose of the term loan was to finance 2005 capital expenditures and improve its availability under its bank credit facility for working capital purposes.

On January 2, 2007, the Company entered into agreements with the bank modifying its credit facilities, as previously discussed above, and its equipment note was increased from \$400,000 to \$800,000. The equipment note matures January 1, 2010.



**Table of Contents**

The amount outstanding on the notes payable at September 30, 2007 was \$1,114,070. Scheduled principal payments under the Company's notes payable for the years ended are presented below:

2007	\$ 66,417
2008	283,187
2009	306,235
2010	458,231
<b>Total Principal Payments</b>	<b>\$ 1,114,070</b>

*Subordinated Debt*

The Company has subordinated notes payable to shareholders with amounts outstanding totaling \$2,250,400 at both September 30, 2007 and December 31, 2006. Although the Company possessed adequate availability on the May 9, 2006 due date to repay the subordinated notes, management believed that cash flow from operations and remaining availability under the bank facility following such a draw would not be sufficient to fund ongoing working capital needs. The Company also anticipated that such a refunding of the subordinated notes with bank debt would have caused the Company to fail to comply with equity related covenants with the bank, given that the subordinated notes are treated as equity for such ratios. Accordingly, after consultation with the bank and the holders of the subordinated notes, the Company determined it was not in the best interest of all stakeholders to pay the notes at maturity, and the subordinated notes remain due and payable.

Since the Company failed to pay the subordinated notes at maturity such notes are in default. Interest not paid quarterly and any principal not paid by the due date accrue interest at 15% until paid. Any potential cross-default under our bank credit facilities relating to the nonpayment of the subordinated notes has been waived by our bank lender. Pursuant to the terms of our bank credit facilities, we have also agreed to obtain the consent of the bank to any modification of the terms of the subordinated notes.

The Company's subordinated note holders have cooperated with us in the deferral of payment on the subordinated notes. After discussion with the subordinated note holders, we did not pay the quarterly interest payments that were due on either January 1, 2007 or April 1, 2007 until May 18, 2007. We made the decision to defer these payments in a conservative effort to preserve cash flow anticipating the potential impact on liquidity of borrowings as a result of the McAleer acquisition. As of September 30, 2007 the Company has paid in full all interest and interest penalty payments due to the subordinated note holders, but may defer future interest payments should such deferral be required. Depending on cash flow and liquidity, management will also consider and may make some payments toward reduction of the principal.

The Company anticipates the continued cooperation of the note holders and the ultimate successful negotiation of a maturity date extension or other restructuring of its subordinated debt with the holders. The subordinated notes may, for example, be refinanced as part of the financing of future acquisitions, or repaid from the proceeds of the exercise of warrants by Barron. However, the Company can give no assurance that it will be able to successfully restructure, extend or refund the subordinated notes, and that the note holders will continue to cooperate. The notes are subordinated to the Company's senior bank debt, and management believes the ability of the note holders to have direct recourse against us is limited. However, the Company can give no assurances as to what adverse collection actions the subordinated note holders might take, and the impact such actions and default might otherwise have on its other creditors and its financial condition. The Company does not anticipate any of the note holders taking any action which would be detrimental, as five of the subordinated note holders are currently significant stockholders of the Company and the sixth note holder, Barron, holds all of the Company's preferred stock.

*Off Balance Sheet Instruments*

As of September 30, 2007, for the prior reporting periods, and through the filing date, CSI had no off-balance sheet instruments except for certain operating leases discussed in Note 7.

**NOTE 6 PREFERRED STOCK AND RELATED WARRANTS AND RETAINED EARNINGS (ACCUMULATED DEFICIT)**

On February 11, 2005, pursuant to the terms of a Preferred Stock Purchase Agreement with Barron Partners LP, we issued to Barron two common stock purchase warrants to purchase a total of 7,217,736 shares of our common stock. The respective exercise prices of the warrants were \$1.3972 and \$2.0958 per share, with each warrant exercisable for 3,608,868 shares. On



**Table of Contents**

December 29, 2006, we agreed to a re-pricing of a portion of the warrants in a Warrant Amendment and Exchange Agreement between the Company and Barron. The first warrant was amended and divided into two warrants, one for 1,608,868 shares of common stock at an exercise price of \$0.70 per share and another for 2,000,000 shares of common stock at the original exercise price of \$1.3972 per share. The second warrant was likewise amended and divided into two warrants, one for 1,608,868 shares of common stock at an exercise price of \$0.85 per share and another for 2,000,000 shares of common stock at the original exercise price of \$2.0958 per share.

Warrant exercises may be accomplished in one or a series of transactions, subject to a 4.9% beneficial ownership restriction. The terms and conditions of the warrants are identical except with respect to the exercise price.

The warrants may be exercised on a cashless basis. In such event, the Company would receive no proceeds from their exercise. However, a warrant holder (including Barron) could not effect a cashless exercise prior to February 11, 2006. Also, so long as the Company maintains an effective registration statement for the shares underlying the warrants, a warrant holder is prohibited from utilizing a cashless exercise. The Company's registration statement was declared effective on February 14, 2006 and an updating amendment was declared effective on May 14, 2007.

Activity related to the common stock purchase warrants for the three and nine month periods ended September 30, 2007 and outstanding balances is as follows:

*Common Stock Purchase Warrants*

	<b>Warrant A1</b>	<b>Warrant A2</b>	<b>Warrant B1</b>	<b>Warrant B2</b>
Exercise Price	\$ 1.3972	\$ 0.70	\$ 2.0958	\$ 0.85
Expiration Date	2/10/2010	2/10/2010	2/10/2010	2/10/2010

*Warrant related activity for the three and nine months ended September 30, 2007*

	<b>Warrant A1</b>	<b>Warrant A2</b>	<b>Warrant B1</b>	<b>Warrant B2</b>
Outstanding at December 31, 2006	2,000,000	1,608,868	2,000,000	1,608,868
Exercised third quarter 2007		120,000		
Outstanding at September 30, 2007	2,000,000	1,488,868	2,000,000	1,608,868

**Registration Rights Agreement**

In conjunction with the Preferred Stock Purchase Agreement, the Company entered into a Registration Rights Agreement with Barron on February 10, 2005, whereby the Company agreed to register the shares of common stock underlying the preferred stock and warrants to be sold to Barron. Barron may also demand the registration of all or part of such shares on a one-time basis and, pursuant to piggy-back rights, may require the Company (subject to carve back by a managing underwriter) to include such shares in certain registration statements it may file. The Company is obligated to pay all expenses in connection with the registration of the shares and, prior to February 11, 2007, was liable for liquidated damages in the event the registration of shares did not remain effective pursuant to the Registration Rights Agreement.

On December 29, 2006, the Registration Rights Agreement was amended to, among other things, eliminate liquidated damages. The Company's obligation to maintain an effective registration statement was also extended by one year until February 11, 2009.

**Warrants**

As a result of the Registration Rights Agreement containing a clause whereby liquidated damages were payable in cash, the Company was required to follow Emerging Issues Task Force (EITF) 00-19. In light of the required accounting treatment under EITF 00-19, the amount of proceeds allocated to the issuance of warrants (\$5,035,032, representing all the proceeds with the exception of the \$7,218 par value allocated to preferred stock) was recorded as a liability as of the date of the transaction. In addition, the difference between the amount allocated to the issuance of warrants and the fair market value of the warrants based on the Black-Scholes valuation method at reporting dates was recorded in the statement of operations as an unrealized gain (loss) on financial instrument-warrant liability and as an adjustment to the financial instrument-warrant liability on the Company's balance sheet, to restate the warrants to fair market value as of that date. In each period up to

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November 7, 2005, the date of the amendment to the Registration Rights Agreement, whereby the cash liquidated damages provision was converted to damages payable by the issuance of a set number of preferred shares, the financial instrument was marked to market and changes in the value were recorded as adjustments in the statement of operations. These adjustments resulted in the Company reporting a significant accumulated deficit where otherwise it would have reported retained earnings.

**Table of Contents**

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. Pursuant to the amendment, 2,472 shares of preferred stock would have been issued to Barron for each day when liquidated damages were triggered until February 11, 2007, when this damages provision expired. Because the amendment to the Registration Rights Agreement changed the liquidated damages penalty from settlement in cash to settlement in a set number of shares which is unaffected by changes in the share market price, in accordance with EITF 00-19, as of the amendment date, the fair value of the warrants was reclassified from a liability to permanent equity as additional paid-in capital rather than as a potential offset to the accumulated deficit which would not have existed if the initial accounting for the warrants had been as paid in capital instead of as a liability. The fair value at that date, based on the Black-Scholes valuation method, was \$5,449,392. The difference between this fair value and the amount allocated to the warrants at issuance (\$5,035,032), or \$414,360, was recorded as an unrealized loss on warrants to purchase common stock in the statement of operations for the year ended December 31, 2005.

Prior to the execution of the amendment to the Registration Rights Agreement, 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 the Company paid Barron \$50,000, which was expensed, and agreed to cause the registration statement to become effective under the Registration Rights Agreement on or before November 30, 2005. After that date, the Company entered into two additional waivers extending the required effectiveness date initially until January 31, 2006 and finally, February 28, 2006. The Company's registration statement was declared effective on February 14, 2006.

On September 11, 2006, the Company notified Barron of the need to refrain from selling under the Company's then effective registration statement, and accordingly, to refrain from utilizing the prospectus relating to the primary registration statement until amendments could be filed with the SEC and declared effective. This notification was the result of the proposed acquisition by the Company of substantially all of the assets of McAleer.

The Company filed a post-effective amendment with the SEC on January 29, 2007. We filed another such amendment on March 14, 2007, which was declared effective on that date. However, absent an amendment or waiver of the Registration Rights Agreement, the Company would have been required to issue to Barron 2,472 shares of preferred stock for each day the liquidated damages are triggered until February 11, 2007, when the damages provision expired. As a part of the agreement on December 29, 2006 to re-price the warrants, Barron waived liquidated damages through February 11, 2007, when the liquidated provisions of the Registration Rights Agreement expired. Also, Barron and the Company agreed to extend the effective term of the Registration Rights Agreement by one year.

On September 28, 2007, Barron exercised its Common Stock Purchase Warrant A-2 for 120,000 shares of our common stock. The conversion price was \$.70 per share. The aggregate proceeds resulting from this transaction were \$84,000. In October 2007, Barron exercised additional warrants to purchase 933,800 shares of common stock which is further discussed in Note 9 Subsequent Event below.

**NOTE 7 COMMITMENTS AND CONTINGENCIES****Operating Leases**

The Company leases certain facilities and equipment under various operating leases. At September 30, 2007, future minimum lease payments under non-cancelable leases were:

2007	\$ 40,728
2008	138,432
2009	143,433
2010	146,556
2011	36,795
Total	\$ 505,944

**Table of Contents**

The Company entered into a new operating lease with Chuck Yeager Real Estate on November 30, 2005, related to the lease of premises at 900 East Main Street, Suite T, Easley, SC. The term of this lease is five years, beginning on April 1, 2006 and ending on March 31, 2011. Total rent due under this lease is \$700,920, due on the first of each month in escalating monthly payments. The remaining commitments under this lease are included in the future payments in the table above. If at any time the Company terminates the lease the lessor may recover from the Company all damages proximately resulting from the termination, including the cost of recovering the premises and the worth of the balance of the lease over the reasonable rental value of the premises for the remainder of the lease term, which shall be due immediately. The Company does not anticipate terminating the lease at any time prior to its expiration. On June 20, 2007 the Company and Chuck Yeager Real Estate amended the operating lease agreement, originally entered into on November 30, 2005, to include an additional 12,544 square feet of warehouse space. The lease of the additional warehouse space was the result of carrying additional inventory and increased monthly rent by approximately \$2,400. While the lease on the additional space was scheduled to expire on August 31, 2007, the Company extended the lease until December 31, 2007, at which time we may choose to extend the lease once again.

**Purchase Commitment**

On April 18, 2006, we entered into a Reseller Agreement with Promethean, Inc., pursuant to which we were granted the exclusive right to market and resell certain Promethean products in North Carolina and South Carolina. The Reseller Agreement expired in accordance with its terms on December 31, 2006. Subsequently, the parties continued operating under the terms of the expired Reseller Agreement. In March of 2007, the parties engaged in negotiations for a new agreement.

On or about May 4, 2007, the parties were successful in agreeing on the terms of an interim agreement to be effective beginning May 1, 2007, renewable quarterly. In exchange for purchasing an initial minimum amount of Promethean product aggregating approximately \$3.2 million, per quarter, we receive standardized pricing for the products. We believe that the arrangement preserves our previous exclusive reseller status in the North and South Carolina markets. The terms of the agreement have not been memorialized in a formal written contract.

**NOTE 8 SEGMENT INFORMATION**

CSI is organized into two reportable segments: Software applications and Technology solutions. Below is a description of the types of products and services from which each reportable segment derives its revenues.

*Software applications segment*

Through our Software applications segment, we report the results of the development, sales, deployment and provision of ongoing support of our software applications, fund accounting based financial management software, and standards based lesson planning software.

*Technology solutions segment*

Through our Technology solutions segment, we report the results of the technology solutions products through the sales and distribution of computers, network and communication based hardware, and accessories, including interactive classroom solutions and a wide range of technology consulting services, including network and systems integration and computer support and maintenance services.

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

CSI's reportable segments are analyzed separately because of the differences in margin routinely generated by the major products within each group, and the differences in sales and investment decisions made to evaluate existing or potential new products.

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



**Table of Contents**

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

The following tables summarize information about segment income for the quarters and nine month periods ended September 30, 2007 and 2006; and assets allocated to segments as of September 30, 2007 and 2006.

<i>Amounts in thousands</i>	Technology		Total
	Software Applications	Solutions	Company
<b>Quarter ended September 30, 2007:</b>			
Net sales and service revenue	\$ 2,634	\$ 12,718	\$ 15,352
Gross profit	1,219	1,828	3,047
Segment income	169	955	(*)
Segment assets	7,265	9,211	16,476
<b>Quarter ended September 30, 2006:</b>			
Net sales and service revenue	\$ 1,448	\$ 5,679	\$ 7,127
Gross profit	892	779	1,671
Segment income	360	102	(*)
Segment assets	3,002	4,832	7,834
<b>Nine months ended September 30, 2007:</b>			
Net sales and service revenue	\$ 8,168	\$ 35,937	\$ 44,105
Gross profit	3,579	6,024	9,603
Segment income	547	3,506	(*)
Segment assets	7,265	9,211	16,476
<b>Nine months ended September 30, 2006:</b>			
Net sales and service revenue	\$ 3,998	\$ 18,673	\$ 22,671
Gross profit	2,471	2,900	5,371
Segment income	875	869	(*)
Segment assets	3,002	4,832	7,834

\* See reconciliation below

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

<i>Amounts in thousands</i>	Quarter Ended	
	September 30, 2007	September 30, 2006
<b>Segment income:</b>		
Software applications segment	\$ 169	\$ 360
Technology solutions segment	955	102
<b>TOTAL SEGMENT INCOME</b>	1,124	462
<b>Less: Merger and compliance costs</b>		
Stock based compensation	(1)	(180)



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Reverse acquisition expenses			(1)
Acquisition expenses			(22)
Professional and legal compliance and litigation related costs	(80)		(72)
<b>OPERATING INCOME Per consolidated Statements of Operations</b>	\$ 1,043	\$	187

**Table of Contents**

<i>Amounts in thousands</i>	Nine Months Ended	
	September 30,	September 30,
	2007	2006
<b>Segment income:</b>		
<b>Software applications segment</b>	\$ 547	\$ 875
<b>Technology solutions segment</b>	3,506	869
<b>TOTAL SEGMENT INCOME</b>	4,053	1,744
<b>Less: Merger and compliance related costs</b>		
Stock based compensation	(92)	(875)
Reverse acquisition expenses		(64)
Acquisition expenses	(9)	(38)
Professional and legal compliance costs	(499)	(434)
<b>OPERATING INCOME Per Statement of Operations</b>	<b>\$ 3,453</b>	<b>\$ 333</b>

**NOTE 9 SUBSEQUENT EVENT****Exercise of warrants**

In October 2007, on five separate occasions, Barron exercised its Common Stock Purchase Warrant A-2 to purchase a total of 933,800 shares of common stock, which resulted in aggregate proceeds to the Company of \$653,660. All of the warrants exercised in October were issued as part of a recapitalization of the Company in the first quarter of 2005 and at the exercise price of \$.70 per share.

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

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

We develop software applications and provide technology solutions, focused primarily on the needs of organizations that employ fund accounting. Fund accounting is used by those entities that track expenditures and investments by fund, or by source and purpose of the funding (e.g., funds provided by government or grant sources), and is utilized primarily by public sector and not-for-profit entities. Our client base consists principally of municipalities, school districts and local government organizations. Our clients also include public libraries, disabilities boards and other non-governmental clients.

**Organization**

Our business efforts are focused on 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).

*Software applications segment*

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

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General (or Fund ) Ledger;

Accounts Payable;

Purchasing;

Payroll;

Personnel;

Employee Absence/Substitutes;

Inventory;

Utility Billing; and

Other specialty modules designed for government markets.

## **Table of Contents**

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

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

### *Technology solutions segment*

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

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

Hardware/software installations;

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

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

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

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

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

Project management (overseeing installation of computers, telephone equipment, interactive white-board equipment, cabling and software);

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

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

Education technologies (distance learning and classroom learning tools including interactive white board solutions).

In addition to our engineers, our Technology solutions segment includes a staff of sales persons, project managers and product specialists. Our Technology solutions segment also purchases and resells products from a variety of manufacturers including but not limited to Hewlett Packard,

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Cisco, Microsoft, Novell, Promethean, Tandberg and DIVR, and supports the Software applications segment, as needed.

The combination of traditionally low margin sales of hardware with the sales of services results in a much lower margin for the Technology solutions segment when compared to the Software applications segment. Gross margins for the Software applications segment were 53.1% for the 2006 fiscal year, while margins for the Technology solutions segment were 15.8% for the same period. Gross margins for the Software applications segment were 46.3% and 43.8% for the quarter and nine month periods ended September 30, 2007, while margins for our Technology solutions segment were 14.4% and 16.8% for the same periods. Gross margins for the Software applications segment were 61.6% and 61.8% for the quarter and nine month periods ended September 30, 2006, while margins for the Technology solutions segment were 13.7% and 15.5% for the same periods.

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

For a discussion of the results of the reported segments, see the two Segment information sections under I. Financial Performance below.

### **Strategy**

While we report the business as two segments and use such information for analysis and decision making purposes, we also operate the business collectively, taking advantage of cross-selling opportunities. As a part of our software applications and technology solutions sales efforts we provide systems and software networking and integration services. These services also generate a significant amount of revenue by increasing demand for the computer hardware equipment we sell.

Our marketing strategy is to provide a suite of software products coupled with full service integration of the hardware solutions that support those products and other back-office functions, and to provide ongoing technical support, monitoring and maintenance services to support the clients' continuing needs. We also market our hardware solutions and ability to

## **Table of Contents**

provide a wide level of services and support independent from our software solutions, which when marketed to a fund accounting based organization may also lead to future software sales and integration services. By providing a client the ability to call one solution provider and circumvent the difficulties that often arise when dealing with multiple vendors, we believe we are able to achieve high long-term client satisfaction and a competitive advantage in the marketplace. Repeat business from and increased account penetration through added products and services within our existing customer base has been key to our success and we expect it will continue to play a vital role in our growth. Our focus is on nurturing long-standing relationships with existing customers while establishing relationships with new customers. Over the past ten years we have retained more than 90% of our financial management software customers, and many have become technology solutions customers. Some of our customers who first purchased technology solutions and services have subsequently become financial management software customers.

Our long-term strategy is to pursue a national presence. Our primary, initial focus has been on the southeast region of the United States. As a result of our recent acquisition of McAleer Computer Associates, Inc. ( McAleer ) discussed below, we have expanded our reach into the southeastern states significantly and are beginning to look at other areas of the United States as well.

By strategically combining our internally developed software applications with our ability to integrate computer, networking and other hardware solutions, we have been successful in providing software and hardware solutions to over 400 clients located in the tri-state area of South Carolina, North Carolina and Georgia.

Prior to January 2, 2007, we supported our operations principally out of our physical location in Easley, South Carolina. On January 2, 2007, we acquired the operations, in an asset purchase acquisition, of McAleer. McAleer, an Alabama corporation based in Mobile, Alabama, is primarily a provider of financial management software to the K-12 education market. It has been in operation for over twenty-five years. The acquisition of McAleer strengthens CSI's current operations with the addition of an office in Mobile, Alabama, from which CSI will be able to deliver expanded software, technology and service offerings to a broader geographic area and the local government (city and county) markets. The addition of McAleer brings on more than 160 additional fund accounting customers in the K-12 education sector, with a geographic presence in five states not previously served by CSI: Alabama, Mississippi, Louisiana, Tennessee and Florida. Like CSI, McAleer also has customers in Georgia and South Carolina. In contrast to CSI, McAleer has not historically focused on the local government market or provided as broad a range of technology solutions. CSI has the opportunity to increase sales to those specific markets and the new regions that McAleer serves. McAleer and the acquisition is discussed in more detail below under B. Acquisition of McAleer Computer Associates, Inc.

The products and services previously offered by McAleer are now products and services of CSI. However, in order to differentiate, we will refer to the products and services offered by McAleer prior to the acquisition, and from which continued service and support will be offered from the Mobile, Alabama office subsequent to the acquisition, as McAleer or CSI-Mobile products and services. All other products and services of CSI referred to are those offered by CSI prior to the acquisition of McAleer, and for which CSI continues to provide the development, support and services primarily out of its Easley, South Carolina headquarters.

For more information on our strategy, see our latest annual report filed on Form 10-KSB.

## **Acquisitions**

We believe that to remain competitive, we need to take advantage of acquisition opportunities that arise which may help us achieve greater geographic presence and economies of scale. We may also utilize acquisitions to, when appropriate, expand our technological capabilities and product offerings. While we may use a portion of any cash proceeds generated by operations or obtained from capital sources to pay down debt on an interim basis, we intend to use any additional liquidity and/or availability from those sources or related pay downs to fund acquisitions. Additionally, we have engaged a consultant to assist us with acquisitions, including identifying potential acquisition opportunities. We believe our markets contain a number of attractive acquisition candidates. We foresee expanding through acquisitions of one or more of the following types of software and 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.

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.



**Table of Contents**

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.

As previously disclosed, on January 2, 2007 we acquired the business operations of McAleer. We believe the acquisition of this leading provider of fund accounting based financial management software in Alabama fits within our acquisition strategy. McAleer and the acquisition transaction are discussed in more detail below under B. Acquisition of McAleer Computer Associates, Inc.

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. We continue to pursue and enter into preliminary discussions with various acquisition candidates. However, except for the McAleer acquisition, the Company has not entered into agreements or understandings for any other acquisitions which management deems material.

**B. Acquisition of McAleer Computer Associates, Inc.**

On January 2, 2007, we consummated our previously announced acquisition of the business operations of McAleer. The transaction was structured as a purchase of substantially all of the assets of McAleer.

McAleer is the leading provider of fund accounting based financial management software, its major product, for the K-12 sector of the education market in the state of Alabama and has a presence in five other states. The acquisition expands our reach from our three primary state markets to an eight-state footprint in the southeast. We believe the acquisition constitutes a major move in implementing our strategy of geographic expansion, with the ultimate goal of achieving a national presence. We also believe McAleer has a strong management team and a reputation for delivering quality customer service from its location in Mobile, Alabama. We plan to utilize the existing McAleer staff to continue to service McAleer's existing clients from the offices in Mobile. We anticipate that we will be able to capitalize on the new Mobile location by delivering expanded technology and service offerings to the broader geographic area and the local government (city and county) markets. In contrast to our strategy, McAleer has not historically focused on the local government market or provided as broad a range of technology solutions.

The total price for the purchased assets was \$4,050,000, of which \$3,525,000 was paid in cash at closing. The balance of \$525,000 was paid pursuant to a promissory note payable in twenty quarterly installments of principal in the amount of \$26,250, plus interest in arrears at the LIBOR rate, beginning March 31, 2007. In February 2007, we refinanced the \$525,000 note payable with \$486,000 in proceeds from a new real estate note with our bank and a draw on our revolver for the remaining amount. The new note is payable monthly based on a 7.85% interest rate and a 15 year amortization with a balloon payment due at the end of year three. The original \$525,000 note was and the new \$486,000 note is secured by a first mortgage on the real property of McAleer conveyed in the acquisition, consisting of the office building located in Mobile, Alabama from which our Mobile personnel operate. We assumed no liabilities of McAleer, other than certain leases and obligations of McAleer under ongoing customer contracts.

Expenses for the acquisition, in the amount of \$266,837, consisted of legal and professional fees and travel costs and various other expenses related to the acquisition transaction. These expenses have been capitalized and allocated to goodwill. We engaged an independent party to provide assistance with customary evaluations, analysis and allocation of the purchase price, which resulted in an allocation to goodwill. For the purposes of recording assets by segment, the acquired assets, including goodwill will be reported under the Software applications segment. The Company expects all goodwill will be deductible for tax purposes, and has an indefinite life for book purposes. The Deferred tax liability arises from a difference in the agreed to price for the building asset (tax basis) and the purchase price allocation (book basis included in Property and equipment and based on appraisal). Research and development assets acquired in the purchase were not material.

The allocation of the purchase price, including capitalized acquisition expenses, is as follows (other liabilities assumed in the purchase were not deemed material):

Property and equipment	\$ 615,000
Computer software	610,000
Goodwill	1,480,587
Intangible assets	1,645,000
Deferred tax liability	(33,750)

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Total assets purchase and purchase price

\$ 4,316,837

**Table of Contents**

The detail of Computer software, other Intangible assets and Goodwill and their useful lives are as follows:

Asset	Value	Effective Useful Life
Computer software	\$ 610,000	4 years
Trade name	70,000	3 years
Covenants not-to-compete	75,000	5 years
Customer contracts and related relationships	1,500,000	20 years
Other intangible assets	\$ 1,645,000	
Total computer software and other intangible assets	\$ 2,255,000	13.3 years*
Goodwill	\$ 1,480,587	indefinite

\* weighted average

We funded the acquisition in part with advances of approximately \$2.1 million under our modified credit facilities with our bank. We also utilized approximately \$1.3 million in cash from McAleer as, pursuant to the asset purchase agreement, service contract revenue with respect to 2007 for which cash was received by McAleer in 2006 prior to the closing was segregated for our account. Initially the owner assumed a \$525,000 note secured by the real estate for the remainder of the purchase price, which was subsequently refinanced, and the Company incurred expenses which were capitalized as a part of the transaction.

Sources of funds used in the transaction, including subsequent refinance activities and related expenses are as follows:

Proceeds from increase in long-term note payable secured by property and equipment (at time of purchase)	\$ 486,046
Proceeds from long-term note payable secured by real estate (for refinance of McAleer note)	486,000
Receipts on billings for McAleer 2007 support agreements earmarked for CSI	1,280,000
Draw on revolving credit facility (escrow payment at time of signing of definitive agreement)	100,000
Draw on revolving credit facility (at time of purchase including \$12,378 for acquisition related expenses)	1,671,332
Draw on revolving credit facility (for refinance of McAleer note)	39,000
Payments of acquisition related expenses (funded from revolving credit facility)	254,459
Subtotal of funds from revolving loan	2,064,791
Total purchase price	\$ 4,316,837

It is anticipated that McAleer will add additional revenues of approximately \$5.0 million in 2007 to our Software applications segment. As of September 30, 2007, McAleer had contributed approximately \$3.6 million in additional revenues. McAleer is in the process of upgrading approximately 60% of its customers to the latest major release of the McAleer fund accounting system. These increases provide additional revenue due to the increased pricing structure to reflect the enhancements in the latest major release. Accordingly, while not estimable, we anticipate an ongoing improvement in our recurring revenues through this upgrade process.

Due to the increased depreciation and amortization of intangible assets based on the purchase price allocation, and financing costs of the transaction, it is not anticipated that McAleer will add a significant amount to earnings in 2007. However, it was anticipated the McAleer acquisition would be cash flow positive and the acquisition would impact the Company's EBITDA and Adjusted EBITDA calculations by more than \$500,000 for the year 2007. As of September 30, 2007, the McAleer acquisition contribution was on track to exceed this anticipated amount.

For results of operations for the period of this filing, see Note 3 to our unaudited consolidated financial statements dated September 30, 2007 included in this report.

**C. Recent Developments**

**Modification of Bank Credit Facilities**

In 2005, in order to support the activities of the reverse acquisition, the Company entered into a line of credit facility with a bank whereby the Company could borrow up to 80% of accounts receivable balances, not to exceed the total facility limit of \$3.0 million. In the first quarter of 2006 and in January 2007, the facility was renewed and the limit increased to \$3.5 million

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**Table of Contents**

and \$5.5 million, respectively. The primary purpose of these modifications was to increase the amount of the credit facilities to provide for expanding working capital and other credit needs, including funding the acquisition of substantially all of the assets and business operations of McAleer (see Note 3) in early 2007. In May 2007, the Company extended the maturity date of the facility until September 15, 2007, and on September 14, 2007 once again extended the maturity date until June 30, 2009 and increased the limit to \$7.0 million, as further discussed below.

Eligible accounts receivable balances essentially include all of our trade accounts receivable except, in most cases, those accounts which are more than 90 days past due. Certain other accounts are excluded from eligibility for borrowing including: (i) accounts due from affiliates; (ii) accounts which we have determined to be of doubtful collectibility; and (iii) accounts due from any one of our customers if such accounts constitute more than 20% of the total eligible accounts. The loans bear interest at Libor plus 2.50%, (7.62% at September 30, 2007), payable monthly.

The loans under the revolving credit facility and the equipment facility, as well as all other obligations owed by the Company to the bank, are secured by a first priority security interest in substantially all of the Company's assets. Also, the Company is required to comply with certain covenants, including: providing periodic financial statements to the bank, compliance with SEC reporting requirements, allowing the bank to inspect its secured assets, the Company maintaining its assets in good operating condition and maintaining sufficient insurance. Also, the Company is required to comply with certain financial covenants. The first financial covenant is a Debt Service Coverage Ratio, which is measured at the end of each year beginning December 31, 2007. This ratio is calculated by adding certain nonrecurring special items to EBITDA, and then dividing by current maturities of long term debt plus interest expense. For the purposes of the amended loan agreement, EBITDA means the total of (i) net income from continuing operations (excluding extraordinary gains or losses), and to the extent deducted in determining net income (ii) interest expense, (iii) income taxes, and (iv) depreciation, depletion and amortization expenses. The Company is required to maintain a Debt Service Coverage Ratio of not less than 1.2 to 1.0. The second financial ratio is Funded Debt to EBITDA, which is also measured annually beginning December 31, 2007. A ratio of not greater than 2.5 to 1.0 is required. For the purposes of the ratio, Funded Debt generally means all obligations for borrowed money or for the deferred purchase price of property, and all capitalized lease obligations. The Company complied with these covenants at December 31, 2006, as required by the now expired agreements, and anticipates continued compliance under the most recent and effective agreements as the required ratios and calculations remained unchanged.

The amended loan agreement also contains certain restrictive covenants. These include general prohibitions on: (i) disposing of property other than in the ordinary course of business; the Company changing its business; a change in control of the Company; mergers, acquisitions and the creation of new subsidiaries; the incurring of new indebtedness; the creation of new encumbrances or liens; investments, other than certain permitted investments in liquid investment grade paper; and the Company making loans, including loans to officers. Also, the amended loan agreement prohibits the Company from making any distributions (including any dividends on its common stock), or making any repurchases or redemptions of its capital stock, except to the extent there is no event of default either before or after any such distribution, repurchase or redemption. The bank may accelerate the Company's obligations under the amended loan agreement and the related promissory notes upon an event of default under the amended loan agreement. Events of default generally include the Company failing to make payments of principal or interest when due; defaults under loan covenants, subject to periods during which the Company may cure in certain cases; the Company becoming insolvent or being subject to certain bankruptcy proceedings, subject to certain time periods; and the occurrence of a material adverse change in the Company's business or financial condition. Upon an acceleration of the bank's loans to the Company, the bank, among other remedies, would have recourse to substantially all of the Company's assets through its security interest.

On September 14, 2007, the Company entered into agreements with the bank renewing the line of credit facility. The terms of the agreements previously entered into were amended as follows:

the principal amount of the facility was increased from \$5.5 million to \$7.0 million;

the maturity date was extended from September 15, 2007 until June 30, 2009;

permissible purposes of the funds borrowed under the revolving facility were expanded to include funding short-term working capital and general corporate purposes of the Company;

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the definition of the borrowing base was expanded to include 50% of eligible inventory (with a maximum borrowing ability against eligible inventory of \$1,000,000), in addition to 80% of eligible accounts and;

the requirement that the Company provide an unaudited consolidated balance sheet and a statement of income, cash flow and retained earnings within 25 days after the end of each calendar month was amended to require these reports within 45 days after the end of each quarter (beginning with the quarter ended September 30, 2007).

## **Table of Contents**

Other than the amendments noted above, the obligations and provisions of the facility remain unchanged. The modifications also memorialized certain previously granted waivers to the restrictive covenants and requirements contained in the agreements with the bank. The bank granted waivers permitting us to enter into the acquisition of McAleer, including the use of bank credit facility advances to fund such acquisition, and incurring mortgage indebtedness to McAleer as a part of the purchase of McAleer's real estate. The bank also waived any cross-default relating to the subordinated notes payable to certain stockholders, which the Company did not repay at their May 2006 maturity.

There were \$2.6 million and \$0.6 million of outstanding draws under the facility as of September 30, 2007 and December 31, 2006, respectively.

### **Exercise of Warrants**

On September 29, 2007, Barron exercised its Common Stock Purchase Warrant A-2 to purchase a total of 120,000 shares of common stock, which resulted in aggregate proceeds to the Company of \$84,000. In October 2007, on five separate occasions, Barron exercised the warrant to purchase a total of 933,800 shares of common stock, which resulted in aggregate proceeds to the Company of \$653,660. All of the warrant exercises were effectuated as part of a recapitalization of the Company in the first quarter of 2005 and at the exercise price of \$.70 per share. Among other options, we may repay a portion of the subordinated notes with a portion of such proceeds while retaining a portion for working capital or other expansion opportunities.

### **D. Updates to Current Challenges and Opportunities of our Business**

#### **Introduction**

Set forth below are updates to certain challenges and opportunities of our business previously addressed in our most recent Form 10-KSB.

#### **Sarbanes-Oxley Compliance**

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 a 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. It was some time before we hired personnel with public reporting experience and began updating our procedures to comply with the Sarbanes-Oxley Act. In the process of reviewing and improving our controls and processes, we have identified and reported errors in our financial reporting.

In August 2007, the Security and Exchange Commission ( SEC ) amended Rule 1-02 of Regulation S-X [17 CFR 210.1-02(a)(4)] by adding a new paragraph to define both the terms material weakness and significant deficiency. Under the new guidance, a material weakness shall be defined as, a deficiency, or combination of deficiencies, in internal control over financial reporting ( ICFR ) such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis. The new guidance further defines significant deficiency as, a deficiency or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting. As defined in this new standard, our management identified certain significant deficiencies in our internal controls over financial reporting in our most recent review of our internal control environment.

While there are currently internal controls and procedures in place that relate to financial reporting and the prevention and detection of material misstatements, these controls have not met the required documentation and effectiveness requirements under the Sarbanes-Oxley Act ( SOX ), and therefore, management cannot certify that these controls are correctly implemented. As a result, it is management's opinion that while the lack of documentation does not warrant a material weakness, it would represent a significant deficiency in the financial reporting process. Therefore, in order to become compliant with the requirements of SOX, management has invested in certain software and human capital resources to ensure the controls currently in place are formally documented, properly monitored and regularly tested to ensure their proper implementation and effectiveness on improving the financial reporting process.

In addition to completing the documentation and review of our control environment specifically for SOX compliance, we are taking the following additional actions to improve internal controls in 2007. In the third quarter of 2006, we purchased software for approximately \$50,000 which will allow us to automate our monitoring of our controls to assure they are executed as designed. We believe this will provide the most cost effective solution to meet the requirements of the Sarbanes-Oxley Act. The entering of controls into the system and the monitoring of those controls began toward the end of the second quarter of 2007 and will continue throughout the remainder of 2007. In fourth quarter 2006, for an undisclosed amount (due





## **Table of Contents**

to agreement with the vendor), we also purchased a financial reporting, planning and consolidation system which was not installed until first quarter 2007, and is not yet fully implemented. This system will eliminate the use of complex spreadsheets used in the roll-up of financial information for both internal and external reporting and improve the timeliness of our financial close and reporting cycle. It will also provide more time for personnel to focus on analysis and review of financial information and controls surrounding those activities which must be performed late in the financial closing and regulatory filing cycles. The system also establishes a framework to automate the consolidation of acquired entities, which the Company believes is critical to support the acquisition portion of its growth strategy. This system has been installed and will be implemented throughout the remainder of 2007.

In the second quarter of 2007, we hired an additional employee with public reporting and Sarbanes-Oxley experience. This employee began in late May 2007, and in the late second and through the third quarter assisted us with documenting a significant additional amount of the processes and controls related to financial reporting and disclosure and has been instrumental in developing documentation within the monitoring and compliance software, as previously discussed above. This work did not include any significant changes to our control environment as of September 30, 2007, but we do expect changes by year end. With the addition of this resource, we are confident that the implementation of required controls and procedures will occur in time sufficient for the proper testing and verification to take place prior to management issuing their certification as to the effectiveness of any such controls and procedures.

Even with these changes, 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. We anticipate that such risks will be mitigated following full implementation of the Sarbanes-Oxley Act requirements in 2007 which, based on our plans includes the implementation of the systems and automation of controls monitoring described above. The process of identifying risk areas and implementing financial disclosure controls and internal controls over financial reporting 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 effective. This process has begun and we anticipate it will be completed in 2007. This process may also result in the identification and possible reporting of additional deficiencies.

We have moved forward with our initial work surrounding the implementation of the Sarbanes-Oxley Act and have budgeted \$200,000 for compliance work by external parties related to the Sarbanes-Oxley Act for the fiscal year 2007. In 2006, we spent approximately \$120,000 on external resources and approximately \$80,000 in capital expenditures (for systems described above) to support this initial effort. We used the framework established with the assistance of external resources to perform much of the documentation and initial evaluation effort with internal staff in the third and fourth quarters of 2006 and first through third quarters of 2007 and plan to continue the use of internal staff over the remainder of 2007, in an effort to minimize our third party costs, while still moving forward in our effort to improve our internal controls. However, we plan to also use external resources for further documentation and assistance with controls implementation and compliance in the fourth quarter of 2007, to meet the 2007 implementation deadline.

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

We have already completed the conversion of the majority of our core accounting modules, with the personnel module still in progress. The completed modules are in formal beta installations. However, the changes resulting from the formal beta use have been limited. We are prepared to install and have installed some of the completed modules in select entities which do not have an immediate need for other integrated modules not yet converted. In addition, the completed modules have the functionality necessary to handle school activity funds, such as student clubs, organizations and athletics. Typically payroll is not needed to support school activity funds. Many school activity personnel use packages independent of the school's accounting packages, which may be cumbersome, or lack functionality. Accordingly, we are beginning to look for sales opportunities of the completed modules now, marketed as our School Activity solution. If the school later adopts our full accounting suite, the process of integration will be relatively seamless. We anticipate completing the personnel and certain additional modules adequate to support such installations over the remainder of 2007, and anticipate completing most if not all of the remaining modules throughout 2008.

## **Maintaining Margins**

In 2006, we experienced a significant increase in sales of interactive whiteboard solutions and to a lesser degree the amount we charge for related engineering services. Both product lines, IP Telephony and interactive whiteboard solutions, have become subject to increased competition as more product manufacturers have recognized product potential and have entered these markets. In order to maintain and improve our margins, we need to continue to search for new and innovative, and initially higher margin, products to augment those that become mature. We also intend to continue our focus on higher margin engineering services and software. While we cannot predict success in achieving these goals, we have taken and are



## **Table of Contents**

taking actions to do so. These include expanding our geographic reach, increasing the size of and reorganizing our sales force to focus on more products backed by product specialists, adding telemarketing efforts, improving our sales tools, and identifying additional product and service areas.

In 2007, we have seen some margin improvement due to our efforts to obtain improved pricing from vendors and an increase in sales of higher margin engineering services. We are focused on increasing margins, but ultimately we are looking to increase profits by leveraging existing and an increasing number of customer relationships by taking advantage of cross-sell opportunities with a variety of products and services. We will continue to emphasize opportunities with those customers for whom we can provide ongoing support and higher margin integration and other engineering services.

Additionally in 2007, we experienced a significant increase in sales of interactive whiteboards products and related engineering services. A considerable percentage of the 2007 increase related to a select number of large projects, initiated by school districts, involving the implementation of the interactive whiteboard technologies. Due to the size and nature of these projects, we were able to achieve certain economies of scale that resulted in improved margins and increased gross profits. The challenge in 2008 and future periods will be securing similar large opportunities or a greater number of smaller implementations. We have therefore developed a strategy focused on both large opportunities and a greater number of smaller opportunities, which includes focusing certain members of our sales team's efforts specifically on the interactive whiteboard solution product line in an effort to increase market penetration and continue the growth of interactive whiteboard sales.

### **Investment in Support and Telesales Efforts**

In 2006, we originally estimated making an investment of as much as \$500,000 to bolster our technical support services and telesales efforts. The investment consisted primarily of increased salaries and wages, and less than \$180,000 was spent in 2006. At September 30, 2007 we had not made any significant additional investments in these areas, but expect these investments to increase in late 2007 and into 2008 as we hire additional resources. Based on our past experience with prospecting and technical support agreements, we expect the additional revenue generated from the sales of technical support contracts and additional sales opportunities uncovered by telesales efforts for the fund accounting software and the new curriculum standards based lesson planner software will be sufficient to offset our investment within approximately one year. However, we can give no assurances such additional services will be profitable collectively, particularly in the short-term.

### **E. Financial Impact of Certain Developments**

#### **E-Rate Program**

We experienced an improvement in 2006 in our success in winning proposal awards for projects related to the E-Rate program. However, this success did not ultimately translate into increased revenues due to the reduced rate of funding approvals for projects we have won, compared to our experience in prior years.

The E-Rate program assists both schools and libraries in the United States to obtain affordable telecommunications and internet infrastructure and access. The program provides federally subsidized funding based on the level of poverty and the urban/rural status of the population served. The funding ranges from 20% to 90% of the costs of eligible services. The Company has participated in this program in the past, typically winning total contract awards in the \$4,000,000 to \$5,000,000 range during the last several years. In late 2005, as a result of our additional investments in software and personnel, we improved our ability to respond to proposals under the program. As a result, for the annual fall 2005 to spring 2006 E-Rate window, we were awarded more than \$17 million in contracts and for the annual fall 2006 and spring 2007 E-Rate window, we were awarded more than \$24 million in contracts.

Not all of these contracts become fully funded, and projects and related funding can span multiple years. Typically, we have experienced a 20% to 45% funding rate of awarded contracts. Accordingly, we cannot project the impact of our E-Rate efforts on future periods. Revenues linked to the E-Rate program ranged from 10% to nearly 25% of our total revenues from 2004 through 2005. In 2006, revenues linked to the E-Rate program constituted 9% of our total revenues. Although we saw some revenues related to E-Rate in 2006, we did not see significant funding in comparison to projects funded in 2005. We began to receive notification of funding in late 2006 and early 2007. Thus far in 2007, we have received notification that approximately \$6.1 million or 35.9% of the \$17 million in projects we proposed for the fall 2005 / spring 2006 application cycle received funding and \$3.5 million or 14.6% of the \$24 million in projects we proposed for the fall 2006 / spring 2007 application cycle received funding. In the second quarter of 2007, we received notification that the E-Rate program received authorization from the federal government to use certain funds not utilized in prior years to fund more recently submitted projects. The completion of projects may span multiple years and is dependent on the customers having available sufficient resources to provide their share of matching funds to receive the E-Rate program's portion. Accordingly, we cannot predict the impact of such funding awards, if any, on our 2007 revenues, or the possibility

of any additional revenues resulting from the release of prior year funds to the E-Rate program.

## **Table of Contents**

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

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

### **Professional Fees**

We expect to incur some costs to implement the Sarbanes-Oxley Act legislation and have budgeted \$200,000 in 2007 for this work. As of December 31, 2006, we had incurred approximately \$118,000 of expenses related to Sarbanes-Oxley work and \$50,000 and an undisclosed amount (due to a confidentiality agreement with the vendor) of capital expenditures for internal controls and financial reporting software, respectively, in support of our Sarbanes-Oxley efforts. For the nine months ended September 30, 2007, we incurred approximately \$67,000 in costs related to our Sarbanes-Oxley efforts. In the first nine months of 2006, such spending was approximately \$100,000. Our professional and legal compliance related costs were approximately \$609,000 for the 2006 fiscal year, of which approximately \$228,000 was related to services relating to registration statement amendments. The remainder of professional fees related to public company reporting, other regulatory compliance and the Sarbanes-Oxley work.

### **Stock Based Compensation**

In connection with becoming a public company, we recruited independent, non-employee directors. We also engaged consultants to assist us with strategic planning and acquisitions. Definitive agreements were reached regarding the independent directors and consultants compensation in the first and second quarters of 2006. The Compensation Committee of the Board of Directors board approved stock awards, granting the non-employee directors and consultants approximately 500,000 shares. We recorded non-cash expense for directors and consultants fees in the 2006 totaling approximately \$970,000. Stock-based compensation is significantly reduced in 2007 compared to 2006, primarily due to reduced stock compensation paid to consultants. See Note 4, Stock Based Compensation, for further discussion.

### **Forward-Looking Statements**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Among other things, these statements relate to our financial condition, results of operations and future business plans, operations, opportunities and prospects. In addition, we and our representatives may from time to time make written or oral forward-looking statements, including statements contained in other filings with the Securities and Exchange Commission and in our reports to stockholders. These forward-looking statements are generally identified by the words or phrases may, could, should, expect, anticipate, plan, believe, seek, estimate, predict, project or words of similar import. These forward-looking statements are based upon our current knowledge, assumptions about future events and involve risks and uncertainties that could cause our actual results, performance or achievements to be materially different from any anticipated results, prospects, performance or achievements expressed or implied by such forward-looking statements. These forward-looking statements are not guarantees of future performance. Many factors are beyond our ability to control or predict. You are accordingly cautioned not to place undue reliance on such forward-looking statements, which speak only as of the date that we make them. We do not undertake to update any forward-looking statement that may be made from time to time by or on our behalf.

In our most recent Form 10-KSB, we have included risk factors and uncertainties that might cause differences between anticipated and actual future results. We have attempted to identify, in context, some of the factors that we currently believe may cause actual future experience and results to differ from our current expectations regarding the relevant matter or subject area. The operations and results of our software and systems integration businesses also may be subject to the effects of other risks and uncertainties, including, but not limited to:

a reduction in anticipated sales;

an inability to perform customer contracts at anticipated cost levels;

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

## **Table of Contents**

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

an economic downturn; and

changes in the competitive marketplace and/or customer requirements.

## **F. Critical Accounting Policies and Estimates**

### **Basis of Presentation**

Our consolidated financial statements include CSI Technology Resources, Inc., a wholly-owned subsidiary. We use the accrual basis of accounting.

We employ accounting principles generally accepted in the United States ( generally accepted accounting principles or GAAP ). GAAP requires us to make estimates, assumptions and judgments and rely on projections of future results of operations and cash flows. Those estimates, assumptions, judgments and projections are an integral part of the financial statements. We base our estimates and assumptions on historical data and other assumptions, which include knowledge and experience with regard to past and current events and assumptions about future events that we believe are reasonable under the circumstances. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities in our financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

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

Certain accounting policies, methods and estimates are particularly sensitive because of their significance to the financial statements and of the possibility that future events affecting them may differ markedly from management's current judgments. For a description of our significant accounting policies, see Note 1 contained in the explanatory notes to our unaudited consolidated financial statements as of and for the three and nine months ended September 30, 2007 included as part of this report. The most critical accounting policies that have a significant impact on the results we report in our consolidated financial statements are discussed below.

### **Revenue Recognition**

#### *Software License Revenues*

Software revenues consist principally of fees for licenses of our CSI Accounting+Plus software product, service and training. We recognize all software revenue using the residual method in accordance with Statement of Position ( SOP ) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, and Software Revenue Recognition with Respect to Certain Transactions. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of the vendor specific fair value of one or more undelivered elements does not exist, revenues are deferred and recognized when delivery of those elements occurs or when fair value can be established. Company-specific objective evidence of fair value of maintenance and other services is based on our customary pricing for such maintenance and/or services when sold separately. At the outset of the arrangement with the customer, we defer revenue for the fair value of its undelivered elements (e.g., maintenance, consulting and training) and recognize revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (i.e., software product) when the basic criteria in SOP 97-2 have been met. If such evidence of fair value for each undelivered element of the arrangement does not exist, we defer all revenue from the arrangement until such time that evidence of fair value does exist or until all elements of the arrangement are delivered.

Under SOP 97-2, revenue attributable to an element in a customer arrangement is recognized when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, (iv) collectibility is probable and (v) the arrangement does not require services that are essential to the functionality of the software.

Persuasive evidence of an arrangement exists. We determine that persuasive evidence of an arrangement exists with respect to a customer when we have a written contract, which is signed by both us and the customer, or a purchase order from the customer when the customer has previously executed a standard license arrangement with us.

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Delivery has occurred. Our software may be either physically or electronically delivered to the customer. We determine that delivery has occurred upon shipment of the software pursuant to the billing terms of the agreement or when the software is made available to the customer through electronic delivery.



## **Table of Contents**

The fee is fixed or determinable. If at the outset of the customer engagement we determine that the fee is not fixed or determinable, we recognize revenue when the fee becomes due and payable.

Collectibility is probable. We determine whether collectibility is probable on a case-by-case basis. When assessing probability of collection, we consider the number of years in business, history of collection, and product acceptance for each customer. We typically sell to customers for whom there is a history of successful collection. However, collection cannot be assured.

We allocate revenue on software arrangements involving multiple elements to each element based on the relative fair value of each element. Our determination of the fair value of each element in multiple-element arrangements is based on vendor-specific objective evidence ( VSOE ). We align our assessment of VSOE for each element to the price charged when the same element is sold separately. We have analyzed all of the elements included in our multiple-element arrangements and determined that we have sufficient VSOE to allocate revenue to the maintenance, support and professional services components of our perpetual license arrangements. We sell our professional services separately, and have established VSOE for professional services on that basis. VSOE for maintenance and support is determined based upon the customer's annual renewal rates for these elements. Accordingly, assuming that all other revenue recognition criteria are met, we recognize revenue from perpetual licenses upon delivery using the residual method in accordance with SOP 98-9.

Our software products are fully functional upon delivery and implementation and do not require any significant modification or alteration of products for customer use.

We expense all manufacturing, packaging and distribution costs associated with software license sales as cost of license revenues.

### *Computer Hardware Sales Revenues*

Revenue related to hardware sales is recognized when: (a) we have a written sales agreement; (b) delivery has occurred; (c) the price is fixed or determinable; (d) collectibility is reasonably assured; (e) the product delivered is standard product with historically demonstrated acceptance; and (f) there is no unique customer acceptance provision or payment tied to acceptance or an undelivered element significant to the functionality of the system. Generally, payment terms are net 30 days from shipment. When sales to a customer involve multiple elements, revenue is recognized on the delivered element provided that (1) the undelivered element is a standard product, (2) there is a history of acceptance on the product with the customer and (3) the undelivered element is not essential to the customer's application. Revenue related to spare parts is recognized on shipment. Shipping and handling charges to customers are included in revenues. Shipping and handling costs incurred by the Company are included in cost of sales.

Technology revenues are generated primarily from the sale of hardware. In accordance with Emerging Issues Task Force ( EITF ) 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, we record revenues as net when we serve as an agent. In these circumstances, our supplier pays a commission to us but acts as the primary obligor in a transaction and we record only the commission in revenues. We record revenues as gross (generally cost of merchandise plus margin) when we serve as a principal whereby we act as the primary obligor in a transaction, have the latitude for establishing pricing and retain all the credit risk associated with such transaction.

### *Long-term Payment Arrangements*

Our primary customer base consists of local government and education entities whose source of funding (local taxes and federal funding) is generally assured; accordingly the risk of uncollectibility is lower than that of businesses selling primarily to non-government entities. The Company has an ongoing practice of providing financing for certain purchases under notes receivable or long term leases typically ranging from 3 to 5 years, subject to review of its exposure under such facilities and cash flow availability or needs at the time of such purchases. Such amounts have not constituted a significant portion of its account balances, and the Company has historically never experienced a default under such arrangements. The Company recognizes revenue under these arrangements when the criteria noted under Software License Revenues and Computer Hardware Sales Revenues above is met, in accordance with SOP 97-2, as amended by SOP 98-9.

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## **Table of Contents**

### *Service/Support Revenues*

Services revenues consist of professional services and maintenance fees from software and hardware maintenance agreements. Maintenance agreements are typically priced based on a percentage of the product license fee or hardware cost and has a one-year term, renewable annually. Services provided to customers under maintenance agreements may include technical product support and unspecified software upgrades. Revenue related to maintenance and service contracts is recognized ratably over the duration of the contracts. Deferred revenues from advanced payments for maintenance agreements are recognized ratably over the term of the agreement, which is typically one year.

### **Computer Software Costs and Amortization**

Computer software costs consist of internal software production costs and purchased software costs capitalized under the provisions of SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed.

Costs in the research and development of new software products where the technological feasibility is unknown and enhancements which do not prolong the life or otherwise increase its value are expensed as incurred. Capitalized computer software costs are amortized over the economic life of the product, generally three years, using the straight-line method. Our software development efforts focus on the implementation of known technological capabilities applied to common business processes to enhance our existing products. Historically, to date, through our Software applications segment, we have spent no material efforts on technological innovation for which the feasibility has been unknown.

### **Income Taxes**

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

### **Related Party Transactions and Off-Balance Sheet Arrangements**

We have not entered into any significant transactions with related parties other than the issuance of subordinated debt to certain executive officers and shareholders described in Note 5 to our unaudited financial statements for the three and nine months ended September 30, 2007 and under H. Liquidity and Capital Resources Credit Arrangements below. We do not use off-balance-sheet arrangements with unconsolidated related parties, nor do we use other forms of off-balance-sheet arrangements such as research and development arrangements.

### **G. Recent Accounting Pronouncements**

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

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting ( SFAS ) No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. FAS 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest only-strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after January 1, 2007. The Company does not believe that the adoption of SFAS No. 155 will have a material impact on its financial position, results of operations or cash flows.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force ( EITF ) Issue No. 06-3, How Tax Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) ( EITF 06-3 ). EITF 06-3 requires disclosure of the method of accounting for the applicable



**Table of Contents**

assessed taxes and the amount of assessed taxes that are included in revenues if they are accounted for under the gross method. EITF 06-3 is effective for fiscal years ending on or after December 15, 2006; however, since the Company presents revenues net of any taxes collected from customers, no additional disclosures will be required.

In July 2006, the FASB issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in enterprises' financial statements in accordance with FASB Statement No. 109,

Accounting for Income Taxes . FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 on January 1, 2007 did not have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This standard does not require any new fair value measurements, but rather eliminates inconsistencies found in various prior pronouncements. SFAS No. 157 is effective for the Company on January 1, 2008 and will not impact the Company's accounting measurements but it is expected to result in some additional disclosures.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 requires public companies to quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement as material, when all relevant quantitative and qualitative factors are considered. The guidance in SAB 108 is effective for fiscal years ending on or after November 15, 2006. The adoption of SAB 108 did not have a material impact on the Company's consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument-by-instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS 115, available-for-sale and held-to-maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS 159 is effective for the Company on January 1, 2008. The Company is currently analyzing the fair value option that is permitted, but not required, under SFAS 159.

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

**H. Financial Performance****Overview**

Our revenues increased \$8.2 million or 115.4% for the third quarter of 2007 compared to the same period of the prior year. The revenue increase resulted from an increase in technology sales primarily interactive whiteboard solutions, internet-telephony and other infrastructure products and services and the addition of sales from the January 2, 2007 acquisition of the McAleer operations ( McAleer, or CSI-Mobile ). Of the \$8.2 million third quarter 2007 revenue increase, increased technology sales contributed \$7.0 million, the new CSI-Mobile operations contributed \$1.1 million, and the CSI-Easley software operations (operations ongoing before the acquisition and supported principally from our Easley location) contributed \$0.1 million. Revenues for the nine month period ended September 30, 2007 increased \$21.4 million or 94.5% compared with the same period in the prior year, primarily due to the increased revenue generated from sales of interactive whiteboard solutions, internet-telephony and other infrastructure products and services and the additional software revenue resulting from the McAleer operations. Of the \$21.4 million increase in revenues for the nine months, increased technology sales contributed \$17.2 million, the addition of the CSI-Mobile operations added \$3.5 million, and the remaining \$0.7 million resulted from increased CSI-Easley software operations revenues.



**Table of Contents**

Gross profit for the third quarter of 2007 improved by \$1.4 million or 82.4%. The improvement primarily reflects the \$1.1 million improvement due to the increased volume and margin from the Technology solutions segment, and \$0.4 million from the addition of software related revenues generated by the acquired CSI-Mobile operations. These improvements were partially offset by a decrease in CSI-Easley software gross profit of \$0.1 million resulting from increased amortization expense and additional costs related to supporting two versions of our fund accounting software during our development of the latest release. Gross profit for the nine month period ended September 30, 2007 increased by \$4.2 million or 78.8%. The improvement primarily reflects the \$3.1 million improvement due to the increased volume and margin from the Technology solutions segment, and \$1.3 million from the addition of software related revenues generated by the acquired CSI-Mobile operations. These improvements were partially offset by a decrease in CSI-Easley software gross profit of \$0.2 million resulting from increased amortization expense and additional costs related to supporting two versions of our fund accounting software during our development of the latest release.

Operating income for the third quarter of 2007 improved over the same period in the prior year by \$0.9 million or 459.6%, as a result of the improvements in gross profit and a decrease in operating expenses as a percentage of sales. Operating income for the first nine months of 2007 improved over the same period in the prior year by \$3.1 million or 937.9%. This increase resulted from the improvement in gross profit and decrease in operating expenses as a percentage of sales. Further analysis of financial performance, including additional segment information, is discussed below in subsequent sections of the report.

**Consolidated Results of Operations for the Three Months Ended September 30, 2007 and 2006**

	Three Months Ended		Increase
	September 30,	September 30,	
<i>Amounts in thousands</i>	2007	2006	(Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 15,352	\$ 7,127	\$ 8,225
<b>GROSS PROFIT</b>	3,047	1,671	1,376
<b>OPERATING INCOME</b>	1,043	187	856

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

<b>Gross Profit:</b>			
Sales			\$ 8,225
Cost of sales excluding depreciation, amortization and capitalization			(6,669)
Depreciation and Amortization			(120)
Capitalization of Software Costs			(60)
			1,376
<b>Operating Expenses:</b>			
Salaries, wages and benefits			(490)
Reverse merger costs			1
Acquisition expenses			22
Stock based compensation			178
Professional and legal compliance and litigation related costs			(8)
Sales Consulting expenses			(68)
Marketing costs			5
Travel and mobile costs			(61)
Depreciation and amortization			(45)
Other SG&A expenses			(54)
			\$ 856

**Revenues**

Total revenues in the third quarter of 2007 increased \$8.2 million in comparison with the third quarter of 2006. This net increase included a \$7.0 million increase in hardware sales and services through the Technology solutions segment and a \$1.2 million increase in software sales and services through the Software applications segment. The increase in the Technology solutions segment came from increases primarily in sales of interactive whiteboard solutions and internet-telephony and other infrastructure products and services. The increase in the Software applications

segment was primarily due to the acquisition of the CSI-Mobile operations, which added \$1.1 million in software revenues. Increased software support agreement revenues from CSI-Easley contributed the remaining \$0.1 million increase.

**Table of Contents****Gross Profit**

Gross profit in the third quarter of 2007 increased \$1.4 million in comparison with the third quarter of 2006. The increases in both software and hardware gross profits were driven by the corresponding increases in revenues of both segments. Segment revenue increases included the addition of revenues from CSI-Mobile operations and improvements in the technology gross margin. The overall gross margin for the quarter was 19.8% in 2007 versus 23.4% in 2006. The margin change was primarily driven by the addition of CSI-McAleeer with traditionally lower margins in its software segment compared to that of CSI-Easley and a decline in the CSI Easley software gross margin. The decrease in CSI-Easley software gross margin resulted from increased amortization of capitalized investment in software and increased costs related to the support of two versions of our fund accounting software during development of the latest release. These declines were partially offset by improvements in our margins for interactive whiteboard solutions, as well as for our engineering services. While our technology gross margin continued to be up over the prior year, the amount of the increase was lower than the improvement we experienced in the second quarter of 2007 due to substantial interactive whiteboard projects, which had higher margins resulting from the greater economies of scale.

**Operating Expenses**

Operating expenses increased approximately \$519,000, or 35.0%, in the third quarter of 2007 compared to the third quarter of 2006. The above table analyzes the major items that account for this increase. The majority of the increase, approximately \$490,000, is reflected in increased salaries, wages and benefits. Travel and mobile, depreciation and amortization, and other selling, general and administrative expenses increased as well. These areas all increased as a result of the addition of CSI-Mobile to our operations. CSI-Easley salaries, wages and benefits and sales consulting fees increased due to increased sales activities. Salaries, wages and benefits also increased due to a bonus accrual made in anticipation of meeting bonus targets at year end. These increases were partially offset by the decrease in stock-based compensation costs associated with the 2005 reverse merger, which applied primarily to services for which compensation vested in 2006 and for which no additional awards were granted in 2007. This reduction was partially offset by a small amount of stock-based compensation issued in connection with the acquisition of CSI-Mobile.

**Segment information**

CSI is organized into the two segments: Software applications and Technology solutions.

*Software applications segment*

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

<i>Amounts in thousands</i>	<b>Three Months Ended</b>		
	<b>September 30, 2007</b>	<b>September 30, 2006</b>	<b>Increase (Decrease)</b>
<b>NET SALES AND SERVICE REVENUE</b>	\$ 2,634	\$ 1,448	\$ 1,186
<b>GROSS PROFIT</b>	1,219	892	327
<b>SEGMENT INCOME (LOSS)</b>	169	360	(191)

**SIGNIFICANT ITEMS THAT INCREASED (DECREASED) SEGMENT INCOME****Gross Profit:**

Sales	\$ 1,186
Cost of sales excluding depreciation, amortization and capitalization	(681)
Depreciation and Amortization	(118)
Capitalization of Software Costs	(60)

327

**Operating Expenses:**

Salaries, wages and benefits	(366)
Other SG&A expenses	(152)

\$ (191)





**Table of Contents**

Revenues improved by \$1.2 million, or 81.9%. Of the first quarter 2007 revenue increase, \$1.1 million reflects the acquisition of CSI-Mobile operations and \$0.1 million is attributed to an increase in recurring software support revenues and new software sales from CSI-Easley.

Cost of sales increased primarily from the addition of the CSI-Mobile operations, increased amortization expense and increased salaries, wages and benefits related to support of the .Net Microsoft SQL (application programming language and database) conversion effort. Increased costs of third-party products also contributed to the increase in software cost of sales. These increased costs also impacted Software applications segment gross margin. The margin for the third quarter of 2007 was 46.3% compared to 61.6% in the prior year's third quarter due to the increased costs discussed above. With CSI-Mobile having lower margins, and CSI-Easley experiencing increased amortization, support, development and third party costs, the rate of increase in gross profit was 36.7% compared to an increase in revenues of 81.9%.

Operating expenses increased primarily from the additional operating expenses related to McAleer operations, increased sales efforts and a bonus accrual made in anticipation of meeting a Company-wide profitability target by year end. The segment experienced a decrease in operating income of 52.9% to \$169,000 due to the increased operating costs previously discussed.

*Technology solutions segment*

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

<i>Amounts in thousands</i>	September 30, 2007	Three Months Ended September 30, 2006	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 12,718	\$ 5,679	\$ 7,039
<b>GROSS PROFIT</b>	1,828	779	1,049
<b>SEGMENT INCOME (LOSS)</b>	955	102	853

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

## Gross Profit:

Sales	\$ 7,039
Cost of sales excluding depreciation	(5,988)
Depreciation	(2)
	1,049

## Operating Expenses:

Salaries, wages and benefits	(124)
Other SG&A expenses	(72)

	\$ 853
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Hardware revenues increased over third quarter 2006 by \$7.0 million, or 123.9%. The increase in new hardware sales was attributed to significant sales of interactive whiteboard systems, as well as increased sales associated with infrastructure products and related engineering services.

Costs of Technology solutions segment sales increased significantly due to the significant sales increase. However, a shift in product mix to higher margin infrastructure products and engineering services, as well as improvements in interactive whiteboard solutions and related services margins resulted in an increase in the margin from 13.7% in the prior year's third quarter to 14.4% in the third quarter of 2007. The shift also resulted in a more significant rate of increase in gross profit (134.7%) than sales (123.9%).

The increase in segment salaries and wages, and sales consulting fees in operating expenses, was related primarily to increased sales efforts and a bonus accrual as previously discussed. While segment operating costs increased, the increase was at a lower rate than sales resulting in a 84.5% increase in segment operating income compared to a 134.7% increase in gross profit.



**Table of Contents**

The following tables summarize information about segment profit for the quarters ended September 30, 2007 and 2006

<i>Amounts in thousands</i>	Software Applications	Technology Solutions	Total Company
Quarter ended September 30, 2007:			
Net sales and service revenue	\$ 2,634	\$ 12,718	\$ 15,352
Gross profit	1,219	1,828	3,047
Segment income	169	955	(*)
Segment assets	7,265	9,211	16,476
Quarter ended September 30, 2006:			
Net sales and service revenue	\$ 1,448	\$ 5,679	\$ 7,127
Gross profit	892	779	1,671
Segment income	360	102	(*)
Segment assets	3,002	4,832	7,834

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

<i>Amounts in thousands</i>	Quarter Ended	
	September 30, 2007	September 30, 2006
<b>Segment income:</b>		
Software applications segment	\$ 169	\$ 360
Technology solutions segment	955	102
<b>TOTAL SEGMENT INCOME</b>	<b>1,124</b>	<b>462</b>
<b>Less: Merger and compliance costs</b>		
Stock based compensation	(1)	(180)
Reverse merger costs		(1)
Acquisition expenses		(22)
Professional and legal compliance and litigation related costs	(80)	(72)
<b>OPERATING INCOME Per consolidated Statements of Operations</b>	<b>\$ 1,043</b>	<b>\$ 187</b>
<b>Interest and Other Income and Expenses</b>		

Interest expense increased in the third quarter of 2007 compared to the third quarter of 2006 by \$27,000, or 25.9%, due to the financing of the McAleer acquisition.

**Income Taxes**

Income taxes increased by \$109,000 or 91.0%, in the third quarter of 2007 compared to the third quarter of 2006 due to the tax impact of the increase in operating income. While taxes increased, the estimate of the Company's effective tax rate was substantially less than that of the prior year and also was a reduction from the prior quarter's year-to-date rate. The tax rate reduction was due to changes in estimates related to non-deductible items, including prior year warrant losses and ongoing registration related costs.

**Net Income (Loss) and Earnings (Loss) per Share**

The Company reported net income in the third quarter of 2007 of \$691,000, an increase of \$730,000 or 1863.9%, compared to the net loss of \$39,000 for the third quarter of 2006. Significantly increased profits resulted from the addition of CSI-Mobile operations and increases in technology gross profit, partially offset by increases in interest costs and income taxes.

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Basic earnings per share improved from a loss per share of \$0.01 in the third quarter 2006, to basic earnings per share of \$0.19 in the third quarter of 2007. Diluted earnings per share also increased from a loss of \$0.01 in the third quarter of 2006 to \$0.05 in the third quarter of 2007.

**Table of Contents****Consolidated Results of Operations for the Nine Months Ended September 30, 2007 and 2006**

	September 30,	Nine Months Ended September 30,	Increase
	2007	2006	(Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 44,105	\$ 22,672	\$ 21,433
<b>GROSS PROFIT</b>	9,603	5,371	4,232
<b>OPERATING INCOME</b>	3,453	333	3,120

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

<b>Gross Profit:</b>			
Sales			\$ 21,433
Cost of sales excluding depreciation, amortization and capitalization			(16,739)
Depreciation and Amortization			(249)
Capitalization of Software Costs			(213)
			4,232
<b>Operating Expenses:</b>			
Salaries, wages and benefits			(1,315)
Reverse merger costs			64
Acquisition expenses			30
Stock based compensation			783
Professional and legal compliance and litigation related costs			(65)
Sales Consulting expenses			(164)
Marketing costs			23
Travel and mobile costs			(120)
Depreciation and amortization			(150)
Other SG&A expenses			(198)
			\$ 3,120

**Revenues**

Total revenues in the first nine months of 2007 increased \$21.4 million or 94.5% in comparison with the first nine months of 2006. This increase included a \$17.2 million increase in hardware sales and services through the Technology solutions segment and a \$4.2 million increase in software sales and services through the Software applications segment. The increase in the Technology solutions segment came from increases primarily in sales of interactive whiteboard solutions and internet telephony and other infrastructure products and services. The increase in the Software applications segment was primarily due to the acquisition of the CSI-Mobile operations, which added \$3.5 million in software revenues, and increased software support agreement revenues. New software sales from CSI-Easley contributed the remaining \$0.7 million of the increase.

**Gross Profit**

Gross profit in the first nine months of 2007 increased \$4.2 million or 78.8% in comparison with the first nine months of 2006. The increase in both software and hardware gross profits were driven by the corresponding increases in revenues of both segments, including \$1.1 million from the addition of revenues from CSI-Mobile operations and \$3.1 million in improvements of technology profits. While gross profit improved, the gross margin decreased from 23.7% in 2006, to 21.8% in 2007. The change in gross margin was the primarily due to increased amortization expense; higher costs related to third party provided products; increased salaries, wages and benefits related to the support for the .Net Microsoft SQL (application programming language and database) conversion effort; and the addition of CSI-Mobile operations. CSI Mobile has historically shown lower margins than CSI-Easley software operations. These decreases were partially offset by improvements in the interactive whiteboard solution margins, and increased sales of higher margin internet telephony and other infrastructure products and related engineering services.

**Operating Expenses**

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Operating expenses increased approximately \$1.1 million or 22.0%, in the first nine months of 2007 compared to the first nine months of 2006. The above table analyzes the major items that account for this increase. The majority of the increase, approximately \$1.3 million, is reflected in salaries, wages and benefits. Travel and mobile, depreciation and amortization, and other selling, general and administrative expenses also added to the increase. These areas all increased as a result of the addition of CSI-Mobile to our operations. CSI-Easley salaries, wages and benefits and sales consulting fees increased due to

**Table of Contents**

increased sales activities. Salaries, wages and benefits also increased due to a bonus accrual made in anticipation of meeting the bonus target at year end. These increases were partially offset by the decrease in stock-based compensation costs associated with the 2005 reverse merger, which applied primarily to services for which compensation vested in 2006 and for which no additional awards were granted significantly impacting 2007. The overall increases were also partially offset by the absence of reverse merger costs and reduced acquisition expenses. In addition to these reductions, marketing expenses also decreased as a majority of the expenses associated with our re-branding efforts as CSI Technology Outfitters were effected in 2006.

**Segment information**

CSI is organized into the two segments: Software applications and Technology solutions.

*Software applications segment*

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

	September 30, 2007	Nine Months Ended September 30, 2006	Increase (Decrease)
<b>NET SALES AND SERVICE REVENUE</b>	\$ 8,168	\$ 3,998	\$ 4,170
<b>GROSS PROFIT</b>	3,579	2,471	1,108
<b>SEGMENT INCOME</b>	547	875	(328)

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

## Gross Profit:

Sales	\$ 4,170
Cost of sales excluding depreciation, amortization and capitalization	(2,596)
Depreciation and Amortization	(253)
Capitalization of Software Costs	(213)
	1,108
Operating Expenses:	
Salaries, wages and benefits	(1,004)
Other SG&A expenses	(432)
	\$ (328)

Revenues improved by \$4.2 million, or 104.3%. The revenue increase for Software applications was due primarily to an increase of \$3.5 million related to CSI-Mobile operations, and also from an increase of \$0.7 million in recurring software support revenues and new software sales from CSI-Easley.

Cost of sales increased primarily from the addition of the CSI-Mobile operations and increased costs of third-party provided products and services. Cost of sales also increased from increased salaries, wages and benefits in cost of sales due to increased support for the .Net Microsoft SQL (application programming language and database) conversion effort, and also in the areas of delivery, training and support to provide for the increasing number of installations. Third party software and component costs also increased due to the increase in these sales. While salary and wage costs related to development are generally capitalized, the amortization of previously capitalized costs increased from the increased development efforts previously expended. Software applications gross margin for the first nine months of 2007 was 43.8% compared to 61.8% in the first nine months of the prior year due to the increased costs discussed above. With CSI-Mobile having lower margins, and increased development and third party costs for CSI-Easley, the rate of increase in gross profit was 44.8% compared to an increase in revenues of 104.3%.

Operating expenses increased primarily due to the additional operating expenses with the addition of the acquired McAleer operations, increased sales efforts and related travel and mobile expenses, and an increased bonus accrual. The segment experienced a decrease in operating income of 37.4% to \$547,000 due to the increased operating costs previously discussed.





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

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

	Nine Months Ended		Increase (Decrease)
	September 30, 2007	September 30, 2006	
<b>NET SALES AND SERVICE REVENUE</b>	\$ 35,937	\$ 18,673	\$ 17,264
<b>GROSS PROFIT</b>	6,024	2,900	3,124
<b>SEGMENT INCOME</b>	3,506	869	2,637

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

<b>Gross Profit:</b>			
Sales			\$ 17,264
Cost of sales excluding depreciation			(14,143)
Depreciation			3
			3,124
<b>Operating Expenses:</b>			
Salaries, wages and benefits			(311)
Other SG&A expenses			(176)
			\$ 2,637

Hardware revenues in the first nine months of 2007 increased over the first nine months of 2006 by \$17.3 million, or 92.5%. The increase in new hardware sales was attributed to significant sales of interactive whiteboard solutions and increased sales of internet telephony and other infrastructure products and engineering services.

Cost of sales increased as a result of the significant increase in sales. However, a shift in product mix to higher margin infrastructure products and engineering services, coupled with improved interactive whiteboard solution margins resulted in an increase in the margin from 15.5% in the prior year's first nine months to 16.8% in the first nine months of 2007. The shift also resulted in a more significant rate of increase in gross profit (107.7%) than sales (92.5%).

The increase in salaries and wages, and travel and mobile costs in operating expenses was related primarily to an increase in the number of sales staff. Salaries and wages also increased due to the accrual of a bonus in anticipation of achieving the necessary profitability target by year end. Equipment for increased sales staff and increased ongoing costs related to the new facilities was the primary driver of increases in depreciation and amortization and other selling, general and administrative expenses. Marketing expenses declined as the primary effort in re-branding and related costs were incurred in the prior year. While operating costs increased, the increase was at a lower rate than sales, resulting in a 303.5% increase in segment operating income compared to the 107.7% increase in gross profit.

The following tables summarize information about segment profit and loss for the nine months ended September 30, 2007 and 2006 and assets allocated to segments as of September 30, 2007 and 2006.

The changes in segment assets came primarily from the following:

Segment assets in the Software applications segment increased primarily from the asset purchase of McAleer. This included an increase in property, plant and equipment, computer software, goodwill and intangible assets.

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Also, capitalized software costs for the Software applications segment increased from the investment in the conversion of the fund accounting software to the Microsoft .Net and SQL platform.

Segment assets in the Technology solutions segment increased primarily in accounts receivable and inventories due to the increase in sales and a commitment to purchase interactive whiteboard solutions inventory from Promethean to secure better pricing.

**Table of Contents**

	Software Applications	Technology Solutions	Total Company
Nine months ended September 30, 2007:			
Net sales and service revenue	\$ 8,168	\$ 35,937	\$ 44,105
Gross profit	3,579	6,024	9,603
Segment income	547	3,506	(*)
Segment assets	7,265	9,211	16,476
Nine months ended September 30, 2006:			
Net sales and service revenue	\$ 3,998	\$ 18,673	\$ 22,671
Gross profit	2,471	2,900	5,371
Segment income	875	869	(*)
Segment assets	3,002	4,832	7,834

<i>Amounts in thousands</i>	Nine Months Ended	
	September 30, 2007	September 30, 2006
<b>Segment income:</b>		
Software applications segment	\$ 547	\$ 875
Technology solutions segment	3,506	869
<b>TOTAL SEGMENT INCOME</b>	4,053	1,744
<b>Less: Merger and compliance related costs</b>		
Stock based compensation	(92)	(875)
Reverse merger costs		(64)
Acquisition expenses	(9)	(38)
Professional and legal compliance costs	(499)	(434)
<b>OPERATING INCOME Per Statement of Operations</b>	\$ 3,453	\$ 333
<b>Interest and Other Income and Expenses</b>		

Interest expense increased in the first nine months of 2007 compared to the first nine months of 2006 by \$125,000, or 42.2%, due to the financing of the McAleer acquisition.

**Income Taxes**

Income taxes increased by \$1.1 million or 1176.0%, in the first nine months of 2007 compared to the first nine months of 2006, due to the tax impact of the increase in operating income.

**Net Income (Loss) and Earnings (Loss) per Share**

The Company reported net income in the first nine months of 2007 of \$1.9 million, an increase of \$1.9 million, or 2866.7%, compared to the net loss of \$68,000 for the first nine months of 2006. The significant increase in year to date net income resulted from CSI-Mobile operations, increases in our technology sales and margins, and reductions in operating costs as a percent of sales.

Basic and diluted earnings per share improved from a loss per share of \$0.02 in the first nine months of 2006, to basic earnings per share of \$0.53 and diluted earnings per share of \$0.14 in the first nine months of 2007. This improvement resulted from the changes in net income discussed above. Diluted earnings per share were the same as basic earnings per share for the first nine months of the prior year. The additional preferred stock, warrants and employee held options issued in connection with the merger in February 2006 were not included in the calculation of diluted earnings (loss) per share for 2006, as their effect, due to losses being reported in that period being anti-dilutive.

**I. Liquidity and Capital Resources**

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Our strategic plan includes the expansion of the Company both organically and through acquisitions. Due to the long-term nature of investments in acquisitions and other financial needs to support organic growth, including working capital, we expect our long-term and working capital needs to periodically exceed the short-term fluctuations in cash flow from operations. Accordingly, we use debt and equity vehicles in addition to cash flow from operations to fund our growth and working capital needs. Currently our funds for working capital are provided under our \$7.0 million revolving line of credit.

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## **Table of Contents**

### **Events Impacting Liquidity and Capital Resources**

#### *Increase in Bank Credit Facilities*

##### Line of Credit

On September 14, 2007, we entered into agreements with our senior lender, RBC Centura Bank. The primary purpose was to increase the amount of our credit facilities in order to provide for our expanding working capital and other credit needs. Specifically, the Company's revolving facility was increased from \$5.5 million to \$7.0 million. The revolving facility is priced at one month LIBOR plus 2.5% and expires on June 30, 2009. Availability under the revolving facility is determined pursuant to a borrowing base equal to 80% of the Company's eligible accounts receivable and 50% of the Company's eligible inventory up to \$1,000,000. The revolving facility and our equipment facility are secured by substantially all of our assets. Previously, in January 2007 the line, which was originally established in connection with our reverse merger in 2005, was increased to support the McAleer acquisition. The modification of the bank credit facility is described in more detail under Note 5 to our unaudited consolidated financial statements dated September 30, 2007.

##### Real estate note

As a part of amended loan arrangements in 2006, the bank also committed to extend mortgage financing to be used to pay off the \$525,000 indebtedness incurred by the Company to William McAleer in the acquisition of real estate in Mobile, Alabama as a part of the McAleer acquisition. The Company utilized \$486,000 of such financing (90% of the building's appraised value) and a \$39,000 draw on its line of credit to repay the \$525,000 note payable to William McAleer in February 2007. The new real estate loan bears interest at 7.85% and is payable on a 15 year amortization with a balloon payment due at the end of year three.

##### Equipment note

As a part of amended loan arrangements in 2006, the bank committed to increase its equipment note to assist with the financing of the McAleer acquisition. Previously the note was established at \$400,000. Pursuant to the January 2007 modification to the bank's credit facilities, the February 2006 equipment loan was modified, increasing it to \$800,000. The equipment note bears interest at 7.85% per annum. Principal and interest is payable in 36 consecutive monthly payments of principal and interest of \$25,015 continuing until January 1, 2010. The new equipment note refunded the February 2006 equipment loan balance at December 31, 2006 of \$313,954, with an additional \$486,046 being advanced at the January 2, 2007 closing. The additional proceeds represented a reimbursement to the Company for capital expenditures incurred during 2006, and were used to help fund the McAleer acquisition.

Our credit facility with RBC Centura Bank and the recent facility amendments are discussed in more detail in the notes to the unaudited consolidated financial statements for the period ended September 30, 2007 and under **B. Recent Developments** **Modification of Bank Credit Facilities** above.

#### *Acquisition of McAleer*

On January 2, 2007, we consummated the acquisition of substantially all of the assets and business operations of McAleer. McAleer and the acquisition transaction is discussed in more detail under **B. Acquisition of McAleer Computer Associates, Inc.**

The purchase price was \$4,050,000, of which \$3,525,000 was paid in cash at closing, funded from:

\$1.6 million advance under our bank line of credit facility (increased at the time from \$3.5 million to \$5.5 million)

\$0.5 million increase in our equipment note (increased from \$300,000 balance to \$800,000)

\$1.3 million in cash from McAleer from service contract revenue related to 2007 services to be provided, collected in 2006 and retained on our behalf as per the asset purchase agreement

\$525,000 to be paid pursuant to a promissory note in 20 quarterly installments of principal in the amount of \$26,250 plus interest in arrears at the LIBOR rate, beginning March 31, 2007. (This amount was refinanced with the real estate note and a small draw on our credit facilities in February 2007, as discussed under Increase in Bank Credit Facilities above).

Acquisition expenses were \$267,000 for legal and professional fees, travel costs and various other related expenses. The expenses were capitalized and allocated to goodwill.

## **Table of Contents**

We assumed no liabilities of McAleer, other than certain leases and obligations of McAleer under ongoing customer contracts.

Our utilization of draws under our bank revolver to fund a large portion of the purchase price of the McAleer acquisition has reduced our availability under the facility. Increased working capital requirements as a result of anticipated sales growth, as well as the addition of working capital requirements associated with our McAleer operations, could put pressure on the adequacy of our bank revolving credit facility. Accordingly, on an ongoing basis, we evaluate our needs and additional opportunities to increase our borrowing facilities, and consider other funding options, as discussed below under Future Capital Needs and Resources.

### **Cash Flows**

#### *Cash from Operating Activities*

Cash provided by operating activities totaled \$2.2 million in the first nine months of 2007 compared to cash provided by operating activities of \$2.5 million in the first nine months of 2006. The decrease, \$0.3 million, was due primarily to increases in accounts receivable funding the increased sales generated by our Technology solutions segment. The decrease was partially offset by increases in operating cash flow from the reduction of inventory (\$1.4 million) since year end 2006 and increase in deferred revenues (\$1.6 million) primarily related to the acquisition of McAleer. Accounts payable also increased by \$0.5 million, as a result of increased purchases on terms to support sales.

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

Increases in the consolidated balance sheet line items for accounts receivable were a result of the substantial increase in sales in the first nine months of 2007. The decrease in inventory was due to the sales of interactive whiteboard products that were in stock at year end waiting on a backordered component and moved out in early 2007. Accounts payable increased due to the increased purchases to support sales. Deferred revenue increased primarily as a result of billings related to software support agreements and additionally from technology projects which were begun in the first nine months of 2007, but a portion of which is pre-billed until the projects are fully delivered.

#### *Cash from Investing Activities*

Cash used for investing activities totaled \$5.2 million in the first nine months of 2007 compared to \$1.8 million in the first nine months of 2006. The increase of \$3.4 million was due primarily to the acquisition of McAleer. On the balance sheet, since year end 2006, property and equipment, capitalized software costs, goodwill and other assets all increased most significantly as a result of the acquisition of substantially all the assets of McAleer and related purchase price allocation to the assets and recording of the additions in our financials.

#### *Cash from Financing Activities*

Cash provided by financing activities netted to \$3.0 million in the first nine months of 2007 compared to net cash used for financing activities of \$0.7 million in the first nine months of 2006. The increase in cash provided of \$3.7 million is due to the additional borrowings used to finance the McAleer acquisition.

### **Non-GAAP Financial Measures: EBITDA and Adjusted EBITDA**

#### *Quarters and Nine Month Periods Ended September 30, 2007 and 2006*

EBITDA increased 231.5% or \$1.1 million to \$1.5 million for the quarter ended September 30, 2007 compared to EBITDA of \$0.4 million reported for the same period in 2006. The EBITDA increase was primarily due to the increase in net income, after adding back related tax effects of such increases, over the prior year. Increases in interest, depreciation and amortization over the prior year also impacted the calculation. Adjusted (financing) EBITDA for the quarter ended September 30, 2007 increased by 135.2% or \$0.9 million to \$1.5 million compared to \$0.6 million for the prior year. The Adjusted EBITDA increase was also driven primarily by the increase in net income and depreciation and amortization over the prior year. The rate of increase in Adjusted EBITDA was lower than that of EBITDA as it excludes the non-cash item stock-based compensation and reverse acquisition costs, which declined \$0.2 million in the first quarter of 2007 compared to the amount incurred in the same period of the prior year.

EBITDA increased 318.3% or \$3.5 million to \$4.6 million for the nine months ended September 30, 2007 compared to EBITDA of \$1.1 million reported for the same period in 2006. The EBITDA increase was primarily due to the increase in net income over the prior year after adding back the related tax effects of those increases in net income. Increases in interest and





## **Table of Contents**

depreciation and amortization over the prior year also impacted the calculation. Adjusted (financing) EBITDA for the nine months ended September 30, 2007 increased by 130.7% or \$2.7 million to \$4.7 million compared to \$2.0 million for the prior year. The Adjusted EBITDA increase was also driven primarily by the increase in net income and depreciation and amortization over the prior year. The rate of increase in Adjusted EBITDA was lower than that of EBITDA as it excludes the non-cash item stock-based compensation and reverse acquisition costs, which declined \$0.8 million in the first nine months of 2007 compared to the amount incurred in the same period of the prior year.

### *Explanation and Reconciliation of EBITDA and Adjusted EBITDA*

EBITDA is a non-GAAP financial measure used by management, lenders and certain investors as a supplemental measure in the evaluation of some aspects of a corporation's financial position and core operating performance. Investors sometimes use EBITDA as it allows for some level of comparability of profitability trends between those businesses differing as to capital structure and capital intensity by removing the impacts of depreciation and amortization. EBITDA also does not include changes in major working capital items such as receivables, inventory and payables, which can also indicate a significant need for, or source of, cash. Since decisions regarding capital investment and financing and changes in working capital components can have a significant impact on cash flow, EBITDA is not a good indicator of a business's cash flows. We use EBITDA for evaluating the relative underlying performance of the Company's core operations and for planning purposes, including a review of this indicator and discussion of potential targets in the preparation of annual operating budgets. We calculate EBITDA by adjusting net income or loss to exclude net interest expense, income tax expense or benefit, depreciation and amortization, thus the term Earnings Before Interest, Taxes, Depreciation and Amortization and the acronym EBITDA.

EBITDA is presented as additional information because management believes it to be a useful supplemental analytic measure of financial performance of our core business, and as it is frequently requested by sophisticated investors. However, management recognizes it is no substitute for GAAP measures and should not be relied upon as an indicator of financial performance separate from GAAP measures (as discussed further below).

Adjusted EBITDA or Financing EBITDA is a non-GAAP financial measure used in our calculation and determination of compliance with debt covenants related to our bank credit facilities. Adjusted EBITDA is also used as a representation as to how EBITDA might be adjusted by potential lenders for financing decisions and our ability to service debt. However, such decisions would not exclude those other items impacting cash flow which are excluded from EBITDA, as noted above. Adjusted EBITDA is defined as net income or loss adjusted for net interest expense, income tax expense or benefit, depreciation, amortization, and also certain additional items allowed to be excluded from our debt covenant calculation including other non-cash items such as operating non-cash compensation expense (such as stock-based compensation), and the Company's initial reorganization or restructuring related costs, unrealized gain or loss on financial instrument (non-cash related) and gain or loss on the disposal of fixed assets. While we evaluate the Company's performance against debt covenants on this basis, investors should not presume the excluded items to be one-time costs. If the Company were to enter into additional capital transactions, for example, in connection with a significant acquisition or merger, similar costs could reoccur. In addition, the ongoing impact of those costs would be considered in, and potential financings based on, projections of future operating performance which would include the impact of financing such costs.

We believe the presentation of Adjusted EBITDA is important as an indicator of our ability to obtain additional financing for the business, not only for working capital purposes, but particularly as acquisitions are anticipated as a part of our growth strategy. Accordingly, a significant part of our success may rely on our ability to finance acquisitions.

When evaluating EBITDA and Adjusted EBITDA, investors should consider, among other things, increasing and decreasing trends in both measures and how they compare to levels of debt and interest expense, ongoing investing activities, other financing activities and changes in working capital needs. Moreover, these measures should not be construed as alternatives to net income (as an indicator of operating performance) or cash flows (as a measure of liquidity) as determined in accordance with GAAP.

While some investors use EBITDA to compare between companies with different investment and capital structures, all companies do not calculate EBITDA or Adjusted EBITDA in the same manner. Accordingly, the EBITDA and Adjusted EBITDA measures presented below may not be comparable to similarly titled measures of other companies.

**Table of Contents**

A reconciliation of Net Income reported under GAAP to EBITDA and Adjusted (Financing) EBITDA is provided below:

<i>Amounts in thousands</i>	Quarter Ended		Nine Months Ended	
	September 30, 2007	2006	September 30, 2007	2006
<b>Reconciliation of Net income (loss) per GAAP to EBITDA and Adjusted (Financing) EBITDA:</b>				
Net income (loss) per GAAP	\$ 691	\$ (39)	\$ 1,879	\$ (68)
<i>Adjustments:</i>				
Income tax expense	229	120	1,167	91
Interest expense, net	123	106	407	292
Amortization of loan fees				17
Depreciation and amortization of fixed assets and trademarks	132	83	387	245
Amortization of software development costs	287	171	786	529
<b>EBITDA</b>	<b>\$ 1,462</b>	<b>\$ 441</b>	<b>\$ 4,626</b>	<b>\$ 1,106</b>
<i>Adjustments to EBITDA to exclude those items in loan covenant calculations:</i>				
Stock based compensation (non-cash portion)	1	180	92	875
Reverse acquisition costs		1		64
<b>Adjusted (Financing) EBITDA</b>	<b>\$ 1,463</b>	<b>\$ 622</b>	<b>\$ 4,718</b>	<b>\$ 2,045</b>

**Future Capital Needs and Resources***Credit Facilities*

Prior to our going public through reverse merger, we funded operations through cash flow from operations. Substantially all of our cash was distributed to the founders in exchange for distributing ownership. Accordingly, we now use primarily our working capital facility and term loans to fund our operations. See *Increase in Bank Credit Facilities* above and Note 5 to our unaudited consolidated financial statements dated September 30, 2007 for details of recent activity under and terms of these facilities.

Our current credit facilities consist of:

\$7.0 million revolving line of credit, of which \$1.0 million was drawn and \$4.7 million available October 25, 2007, which bears interest at Libor plus 2.5% and which matures June 30, 2009.

\$800,000 equipment note, of which approximately \$0.62 million was outstanding at October 25, 2007, which bears interest at 7.85%, and has a three year amortization maturing in January 2010.

\$486,000 real estate note, of which approximately \$0.47 million was outstanding at October 25, 2007, which bears interest at 7.85%, and has a payment based on a 15 year amortization with a balloon payment due in January 2010.

\$2.3 million in subordinated notes to Barron Partners and the five founding shareholders, of which \$2.3 million remained outstanding at October 25, 2007. (In order to conserve capital and borrowing capacity, we refrained from repaying the \$2.3 million in subordinated notes upon their maturity in May 2006. The noteholders have cooperated with our deferral of repayment, which is discussed in more detail below.)

*Future Capital Needs*

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

Ongoing capital resources depend on a variety of factors, including:

\$4.7 million available to our operations at October 25, 2007, under our \$7.0 million line of credit;

expected cash flow from operations;

inventory purchase commitments of \$3.2 million;

burden of professional and legal compliance costs;

the anticipated level of capital expenditures for 2007 of \$600,000;

software development costs of approximately \$1.2 million;

our scheduled debt service;

continued cooperation as to the deferral of payment on our subordinated debt;

the McAleer and potential future acquisitions; and

potential capital inflow from warrants exercise and the possibility warrant exercises and related proceeds may not be fully realized. The above items are described in more detail below.

## Table of Contents

*Adequacy of Liquidity and Capital Resources.* Based on management's assessment giving consideration to the above items, including the availability under our line of credit facility, management anticipates that our cash flow from operations and our existing bank credit facilities will be adequate to fund our short term liquidity and capital needs for operations over the next twelve months. However, we used significant availability under our facilities to fund the McAleer acquisition in January 2007, and increased our working capital requirements as a result of the addition of the McAleer operations. Accordingly, (i) further increased working capital requirements as a result of anticipated sales growth significantly beyond our expectations, (ii) cash flows lower than anticipated without a corresponding decline in working capital requirements and (iii) either of the above in combination with the addition of funding needs and working capital requirements associated with our McAleer acquisition, could put pressure on the adequacy of our bank revolving and other credit facilities.

We continuously consider and pursue other financing options which could include mezzanine financing or other capitalization alternatives. These options are under consideration, and could provide longer-term financing to match our long-term capital needs. Such needs would include providing longer term financing for the recent acquisition of McAleer, potentially supporting additional acquisition activities, and increased working capital. Our evaluation of potential long-term funding sources has also included exercise of the warrants held by Barron. Encouraging the earlier exercise of the warrants, as well as encouraging an earlier increase in the float of our stock, entered into our decision to reduce the pricing on a portion of the warrants in the fourth quarter 2006. Depending on cash flow from current operations, should we find longer-term funding unnecessary, we may not take advantage of such options, thereby paying down debt and minimizing any potential for dilution from any additional raise of capital.

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

the commercial success of our operations;

the volatility and demand of the capital markets; and

the future market prices of our securities.

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

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

*Credit Facilities.* Absent a significant cash inflow from the cash exercise of the warrants or otherwise, and in light of our growth and acquisition strategy, for the foreseeable future we will rely on a line of credit and borrowing facilities.

We are unsure that cash flow from operations will be sufficient to repay our line of credit facility at maturity and adequately fund our growing working capital needs. In the alternative, we would attempt to refinance the credit facility with another lender. Although management currently believes that our existing lender will agree to a renewal of the facility, there can be no assurance that our bank will in fact do so or that replacement financing could be procured by us on favorable terms or at all. Further, any failure to resolve our default under or otherwise restructure the subordinated notes, or to maintain the cooperation of the holders of such notes, could negatively impact our ability to renew our existing bank credit facility or procure a replacement. Without such a credit facility, we believe that our ability to fund our business operations, including providing sufficient working capital to fund sales growth, could be adversely affected.

*Expected cash flow from operations.* In addition to financing sources, our operating cash flow is a significant source for us to meet our future capital needs. Our ability to generate sufficient operating cash flow is dependent upon, among other things:

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

the amount of operating expenses required to provide our services;

the cost of acquiring and retaining customers; and

our ability to continue to grow our customer base.

Over the 2006 year, the Company experienced significant improvement in its cash flow from operations compared to the prior year. More than \$800,000 of expense recorded in the 2006 year related to non-cash, stock based compensation compared to only \$400,000 in non-cash expenses (related to the loss on the warrants) in the prior year, and the Company did

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**Table of Contents**

not incur the significant costs related to the reverse merger, including litigation costs. As a result, 2006 cash flow from operations improved by more than \$2 million over 2005. This improvement placed the Company in a position to fund the purchase of McAleer with the increase in its revolving credit facility, but without significant new types of debt or equity. While not anticipated, the use of short-term funding for the acquisition could place some pressure on us in the short-term. However, we bill the largest portion of our annual service agreements for our software segment toward the end of the third quarter. These funds are collected primarily in the third and third quarters. The addition of the McAleer acquisition adds another large portion of similar billings at the end of the fourth quarter, which is collected primarily in the fourth and first quarters. Additionally, our projections as to the acquisition of McAleer were that it would be cash flow positive, including the costs of financing. Our cash flow from operations remained over \$2.0 million in the first nine months of 2007 as in the first nine months of 2006. As a result, we see risk associated with the costs of the acquisition as being in the near-term and continuing improvements in our cash position long-term. This assessment does not take into account additional capital related to additional acquisitions, and it assumes our ongoing ability to secure asset-based financing to fund our growth. Our primary reasons for pursuing other financing and equity capital are to reduce short-term risk, if any, to fund acquisitions, and to repay our subordinated notes (potentially as part of funding an acquisition).

*Purchase Commitments.* The majority of our purchase commitments are based on firm purchase orders. However, from time to time we commit to purchase product in advance of customer commitments and as inventory to obtain volume pricing discounts or operational efficiencies. Currently we have purchase order commitments, renewable quarterly, to Promethean, one of our major suppliers, for interactive whiteboard inventory of \$3.2 million. We have no other significant purchase commitments based on estimates of customer demand that significantly exceed customer commitments. If actual customer demand were to differ significantly either in timing or volume from the purchase commitments, this could strain our available working capital resources. While management anticipates its purchase commitments will not differ significantly from its estimates of customer demand, there can be no assurance that this will in fact be the case.

*Burden of Professional and Legal Compliance Costs.* For the nine month period ended September 30, 2007, professional and legal compliance and litigation costs, excluding stock-based (non-cash) compensation, totaled \$499,000. These related primarily to compliance costs related to operating as a public company, as well as legal and accounting costs for the registration of shares pursuant to the registration rights agreement. Management anticipates that the current level of expenses should continue and could increase somewhat in the fourth quarter as the Company wraps up its initial implementation of the controls related to the Sarbanes-Oxley Act, and due to the continued registration of shares commitment through 2009. Although the Company is hopeful that costs related to supplementing the registration statement for updated financial and other information will be minimal, there can be no assurances that this will in fact be the case and cost savings realized. Management anticipates that some cost efficiencies may be realized as CSI gains experience as a reporting company and management seeks to manage compliance costs.

*Short Term Capital Requirements.* We currently anticipate that our capital needs for 2007 will principally consist of \$1.2 million for software development and \$600,000 for capital expenditures. As of September 30, 2007 we had capitalized approximately \$785,000 of software development costs and \$223,000 in capital expenditures. We plan to fund these amounts through cash flow from operations, our line of credit or other financing options discussed above.

*Subordinated Promissory Notes.* At September 30, 2007, subordinated promissory notes payable to shareholders totaled approximately \$2.3 million. Although we possessed adequate availability on the May 9, 2006 due date to repay the subordinated notes, management believed that cash flow from operations and remaining availability under the bank facility following such a drawdown would not be sufficient to fund ongoing working capital needs. We also anticipated that such a refunding of the subordinated notes with bank debt would have caused us to fail to comply with equity related covenants with the bank, given that the subordinated notes are treated as equity for such ratios. Accordingly, after consultation with the bank and the holders of the subordinated notes, we determined it was not in the best interest of all stakeholders to pay the notes at maturity, and the subordinated notes remain due and payable. We pay a default interest rate of 15% both on the principal balance and any interest not paid quarterly. From time to time we have deferred the payment of interest to preserve working capital. Specifically, we took this action in the first and second quarters of 2007 as a precautionary measure considering the cash requirement needed for the acquisition of the McAleer operations. No interest was in arrears as of September 30, 2007.

Our subordinated noteholders have cooperated with us in the deferral of payment on the subordinated notes. We anticipate the continued cooperation of the noteholders and the ultimate resolution with future payments or other restructuring of our subordinated debt. Looking forward, considering our growth and acquisition strategy, we believe it unlikely that we will be able to generate sufficient operating cash flow so as to permit repayment of the subordinated notes with draws under the revolving credit facility. Instead, we believe the subordinated notes will more likely be restructured or repaid from long term capital sources. The subordinated notes may, for example, be refinanced as part of the financing of future acquisitions, or repaid from the proceeds of the exercise of warrants by Barron. However, we can give no assurance that we will be able to

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**Table of Contents**

successfully restructure, extend or repay the subordinated notes, or that the noteholders will continue to cooperate. Our bank lender has likewise consented with respect to the subordinated notes and has granted a waiver relating to their nonpayment. The notes are subordinated to our senior bank debt, and we believe the ability of the noteholders to have direct recourse against us is limited. However, the holders of the subordinated notes may take actions that could adversely affect the Company, including acting to accelerate the subordinated debt, thereby potentially triggering a default under our credit facility with our bank. Such noteholders also may take legal or other adverse collection actions against the Company. We can therefore give no assurances as to what adverse collection actions the subordinated noteholders might take, and the impact such actions and default might otherwise have on our other creditors and our financial condition. However, we do not anticipate any of the noteholders taking any action detrimental to us. It should be noted that five of the subordinated noteholders are currently significant stockholders of the Company, and four of these are executive officers. The sixth noteholder, Barron, holds all our preferred stock.

In September 2007, Barron exercised warrants for which the Company received proceeds of \$84,000. Additionally, subsequent to September 30, 2007, and through October 25, 2007 Barron exercised additional warrants the proceeds from which amounted to an additional \$654,000. Among other options, we may repay a portion of the subordinated notes with a portion of such proceeds while retaining a portion for working capital or other expansion opportunities. We may pay a portion or the balance of subordinated note amounts outstanding from future warrant proceeds.

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

As previously discussed, we acquired McAleeer on January 2, 2007. We believe the acquisition of this leading provider of fund accounting based financial management software in Alabama fits within our acquisition strategy. We anticipate that the acquisition of McAleeer will provide several benefits as discussed in B. Acquisition of McAleeer Computer Associates, Inc. A large portion of the cash consideration for the acquisition was funded by draws under our bank revolving credit facility, thereby reducing our availability under the facility to support working capital needs. Also, it is expected that the acquisition of McAleeer, like most acquisitions by the Company of other operating businesses, will increase the working capital needs of the Company. While our line of credit may be sufficient, its adequacy may be strained by our increased working capital and other needs as a result of acquisition activity. We continue to pursue other opportunities for increasing funds available to us in light of the potentially greater capital needs of a larger organization. A number of options, as discussed above, are under consideration, and could provide longer-term financing to match the longer-term nature of an acquisition related investment.

*Potential Capital Inflow from Warrants Exercise.* A significant amount of cash and capital for the Company would be generated by the exercise by Barron of its common stock warrants. The exercise of our warrants with an exercise price of \$0.70 would generate approximately \$1.1 million. The exercise of our warrants priced at \$0.85 would generate approximately \$1.3 million. The exercise of our warrants priced at \$1.3972 would generate approximately \$2.8 million. The exercise of our warrants with a price of \$2.0958 would generate approximately \$4.2 million.

In September 2007, Barron exercised warrants for 120,000 shares of common stock of the warrants priced at \$0.70 each, for which the company received proceeds of \$84,000. Additionally, subsequent to September 30, 2007, and through October 25, 2007 Barron exercised additional warrants priced at \$0.70 for 933,800 shares of commons stock, the proceeds from which amounted to an additional \$654,000. This leaves warrants of approximately 0.5 million shares of common stock representing proceeds of approximately \$400,000 remaining from those priced at \$0.70 each. Among other options, we may repay a portion of the subordinated notes with a portion of such proceeds while retaining a portion for working capital or other expansion opportunities.

The complete exercise of the warrants is in the sole discretion of Barron, subject to the restrictions in the preferred stock and the warrants prohibiting Barron from beneficially holding greater than 4.9% of our outstanding common stock at any time. Although we presume any decision by Barron to further exercise the warrants or any portion would depend upon our stock price, results of operations and the long term outlook for the development of our business, among other things, we cannot predict if and when Barron may exercise the warrants. Accordingly, there can be no assurance that Barron will exercise additional warrants and that we will receive any resulting capital.



## **Table of Contents**

The warrants may be exercised on a cashless basis, in which case the Company would receive no cash proceeds. However, Barron is prohibited from electing a cashless exercise so long as there is an effective registration statement with respect to the shares underlying the warrants. Accordingly, it will be important for us to maintain the effectiveness of the registration statement covering the warrant shares in order to assure the receipt of equity capital from the exercise of the warrants. Our registration statement was declared effective on February 14, 2006 and an updating amendment was likewise declared effective on May 14, 2007. Barron has not invoked the cashless exercise provision.

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

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

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as such item is defined in Rules 13a-13e and 15-d-15e under the Exchange Act) as of the end of the period covered by this report. Based upon such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of such period, the Company's disclosure controls and procedures were ineffective due to a significant deficiency related to financial reporting. The significant deficiency in our controls related to financial reporting was determined to exist on August 16, 2005, at which time the CFO in consultation with the CEO and the audit committee of the board of directors determined the Company still lacked sufficient internal resources to ensure compliance with new emerging issues, or to fully review its compliance in all areas of financial disclosure on a timely basis, following its inception of reporting as a public company and hiring its first CFO with SEC reporting experience. Accordingly, it was also determined until such time as we had sufficient resources and potentially until we completed our work related to meeting the requirements of the Sarbanes-Oxley Act, no later than the fiscal year ended 2007, we would be unable to declare our disclosure controls with regard to public reporting effective.

In August 2007, the Security and Exchange Commission (SEC) amended Rule 1-02 of Regulation S-X [17 CFR 210.1-02(a)(4)] by adding a new paragraph to define both the terms material weakness and significant deficiency. Under the new guidance, a material weakness is defined as a deficiency, or combination of deficiencies, in internal control over financial reporting (ICFR) such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis. The new guidance further defines significant deficiency as, a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting. As defined in this new standard, our management identified certain significant deficiencies in our internal controls over financial reporting in our most recent review of our internal control environment.

While there are currently internal controls and procedures in place that relate to financial reporting and the prevention and detection of material misstatements, these controls have not met the required documentation and effectiveness requirements under the Sarbanes-Oxley Act (SOX), and therefore, management cannot certify that these controls are correctly implemented. As a result, it is management's opinion that while the lack of documentation does not warrant a material weakness, it would represent a significant deficiency in the financial reporting process. Therefore, in order to become compliant with the requirements of SOX, management has invested in certain software and human capital resources to ensure the controls currently in place are formally documented, properly monitored and regularly tested to ensure their proper implementation and effectiveness on improving the financial reporting process.

In addition to completing the documentation and review of our control environment specifically for SOX compliance, we are taking the following additional actions to improve internal controls in 2007. In the third quarter of 2006, we purchased software for approximately \$50,000 which will allow us to automate our monitoring of our controls to assure they are executed as designed. We believe this will provide the most cost effective solution to meet the requirements of the Sarbanes-Oxley Act. The entering of controls into the system and the monitoring of those controls began towards the end of the second quarter of 2007 and will continue throughout the remainder of 2007. In fourth quarter 2006, for an undisclosed amount (due to agreement with the vendor), we also purchased a financial reporting, planning and consolidation system which was not installed until first quarter 2007, and is not yet fully implemented. This system will eliminate the use of complex spreadsheets used in the roll-up of financial information for both internal and external reporting and improve the timeliness of our financial close and reporting cycle. It will also provide more time for personnel to focus on analysis and review of financial information and controls surrounding those activities which must be performed late in the financial closing and regulatory filing cycles. The system also establishes a framework to automate the consolidation of acquired entities, which the Company believes is critical to support the acquisition portion of its growth strategy. This system has been installed and will be implemented throughout the remainder of 2007.



**Table of Contents**

Specifically, in the second quarter of 2007, we hired an additional employee with public reporting and Sarbanes-Oxley experience. This employee began in late May 2007, and in the late second and through the third quarter, assisted us with documenting a significant additional amount of the processes and controls related to financial reporting and disclosure, and has been instrumental in developing documentation within the monitoring and compliance software, as previously discussed above. This work did not include any significant changes to our control environment as of September 30, 2007, but we do expect changes by year end. With the addition of this resource, we are confident that the implementation of required controls and procedures will occur in time sufficient for the proper testing and verification to take place prior to management issuing their certification as to the effectiveness of any such controls and procedures.

Even with these changes, 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. We anticipate that such risks will be mitigated following full implementation of the Sarbanes-Oxley Act requirements in 2007 which, based on our plans includes the implementation of the systems and automation of controls monitoring described above. The process of identifying risk areas and implementing financial disclosure controls and internal controls over financial reporting 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 effective. This process has begun and we anticipate it will be completed in 2007. This process may also result in the identification and possible reporting of additional deficiencies.

As discussed above, we also maintain a system of internal accounting controls that is designed to provide assurance that assets are safeguarded and the transactions are executed in accordance with management's authorization and properly recorded. Other than the deficiency related to completing our work in connection with documentation of controls and process level improvements, as noted above, there were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2007 that materially, or are reasonably likely to materially, affect the Company's internal control over financial reporting.

**PART II OTHER INFORMATION****Item 3. Defaults Under Senior Securities**

In its February 11, 2005 reverse acquisition and recapitalization, the Company issued a total of \$2,250,400 in principal amount of subordinated notes. Half of such amount is payable in a note to Barron Partners LP, and the other half is payable in five equal notes to the five former shareholders of CSI - South Carolina. Four of these former shareholders are executive officers or directors of the Company: Nancy K. Hedrick, President, CEO and director; Thomas P. Clinton, Senior Vice President of Strategic Relationships and director; Beverly N. Hawkins, Secretary and Senior Vice President of Product Development; and William J. Buchanan, our Senior Vice President of Delivery and Support. One of the former CSI - South Carolina shareholders, Joe Black, is the former interim chief financial officer of the Company. All of such shareholders are substantial stockholders of the Company.

The subordinated notes were due and payable on May 10, 2006. The Company declined to pay the subordinated notes at maturity, putting such notes in default, as previously reported. Interest not paid quarterly and any principal not paid by the due date accrues interest at 15% until paid. Although we possessed adequate availability on the May 10, 2006 due date to repay the subordinated notes, management believed that cash flow from operations and remaining availability under the bank facility following such a drawdown would not be sufficient to fund ongoing working capital needs at that time. We also anticipated that such a refunding of the subordinated notes with bank debt would have caused us to fail to comply with equity related covenants with the bank, given that the subordinated notes are treated as equity for such ratios. Accordingly, after consultation with the bank and the holders of the subordinated notes, we determined that it was not in the best interest of all stakeholders to pay the notes at maturity, and the subordinated notes remain due and payable.

The Company's subordinated note holders have cooperated with us in the deferral of payment on the subordinated notes. After discussion with the subordinated note holders, we did not pay the quarterly interest payments that were due on either January 1, 2007 or April 1, 2007 until May 18, 2007. We made the decision to defer these payments in a conservative effort to preserve cash flow anticipating the potential impact on liquidity of borrowings as a result of the McAleer acquisition. As of October 25, 2007 the Company has paid in full all interest and interest penalty payments due to the subordinated note holders, but may defer future interest payments should such deferral be required. Depending on cash flow and liquidity, management will also consider and may make some payments toward reduction of the principal.

**Table of Contents**

The Company anticipates the continued cooperation of the note holders and the ultimate successful negotiation of a maturity date extension or other restructuring of its subordinated debt with the holders. The subordinated notes may, for example, be refinanced as part of the financing of future acquisitions, or repaid from the proceeds of the exercise of warrants by Barron. However, the Company can give no assurance that it will be able to successfully restructure, extend or refund the subordinated notes, and that the note holders will continue to cooperate. The notes are subordinated to the Company's senior bank debt, and management believes the ability of the note holders to have direct recourse against us is limited. However, the Company can give no assurances as to what adverse collection actions the subordinated note holders might take, and the impact such actions and default might otherwise have on its other creditors and its financial condition. The Company does not anticipate any of the note holders taking any action which would be detrimental, as five of the subordinated note holders are currently significant stockholders of the Company, four of whom are executive officers. The sixth note holder, Barron, holds all of the Company's preferred stock.

**Item 5. Other Information.**  
**Entry into a Material Definitive Agreement**

*Renewal of Agreement with Cisco Systems, Inc.*

On March 18, 2005, the Company was re-certified as a Cisco Premier certified partner pursuant to an Indirect Channel Partner Agreement between the Company and Cisco Systems, Inc. The re-certification was effective through September 30, 2007. On March 2, 2007, the Company was notified electronically that such certification had been renewed effective January 29, 2007 through March 26, 2008.

*Renewal of Hewlett Packard Agreement*

Pursuant to a Hewlett Packard US Business Development Partner Agreement, the Company was appointed a Business Development Partner for the purchase and resale or sublicense of Hewlett Packard's products, services and support. The agreement was originally effective until March 31, 2005 and was subsequently extended until June 30, 2007. On November 8, 2007, the Company was notified electronically that the agreement had been renewed through May 31, 2009.

**Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant**

Our revolving credit arrangement with RBC Centura Bank is a facility under which we may borrow, repay and then re-borrow. Advances and repayments under the credit facility occur daily, reflecting cash receipts and the Company's working capital needs. Set forth below is the outstanding balance as of specific dates through October 25, 2007. The balances presented reflect aggregate advances and pay downs which the Company deems material, or significant. Such information through September 10, 2007 was previously disclosed in our Form 8-K dated September 10, 2007.

<b>Date</b>	<b>Loan Balance</b>
September 11, 2007	2,176,000
September 13, 2007	3,545,000
September 19, 2007	2,225,000
September 28, 2007	2,646,000
October 24, 2007	1,178,000
October 25, 2007	1,041,000

**Table of Contents**

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
10.1	Amended and Restated Loan and Security Agreement between the Company and RBC Centura Bank dated September 14, 2007, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed September 14, 2007.
10.2	Amended and Restated Commercial Promissory Note between the Company and RBC Centura Bank dated September 14, 2007, incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed September 14, 2007.
10.3	Commitment Letter between the Company and RBC Centura Bank dated September 10, 2007, incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed September 14, 2007.
10.4	Notification of March 2, 2007 of renewal of Indirect Channel Partner Agreement between the Company and Cisco Systems, Inc. dated January 9, 2006.
10.5	Notification of November 8, 2007 of renewal of H.P. US Business Development Partner Agreement between the Company and Hewlett-Packard, Inc. effective through May 31, 2005.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32	Statement of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.

**Table of Contents**

**SIGNATURES**

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

COMPUTER SOFTWARE INNOVATIONS, INC.

Date: November 13, 2007

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

Date: November 13, 2007

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

**Table of Contents**

**EXHIBIT INDEX**

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