CERNER CORP /MO/
Form 10-Q
November 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from _____ to _____

Commission File Number 0-15386

CERNER CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	43-1196944
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2800 Rockcreek Parkway
North Kansas City, Missouri 64117
(816) 201-1024
(Address of Principal Executive Offices, including zip code;
registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) with the Commission, and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

There were 78,138,892 shares of Common Stock, $.01 par value, outstanding at October 28, 2006.

CERNER CORPORATION AND SUBSIDIARIES
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Part I. Financial Information
Item 1. Financial Statements

CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Current Assets:		
Cash and cash equivalents	$ 139,363	$ 113,057
Short-term investments	148,080	161,230
Receivables, net	351,616	316,965
Inventory	18,108	9,585
Prepaid expenses and other	51,341	42,685
Deferred income taxes	7,832	8,109
Total current assets	716,340	651,631
Property and equipment, net	331,785	292,608
Software development costs, net	186,758	172,548
Goodwill, net	127,576	116,142
Intangible assets, net	56,574	60,448
Other assets	13,933	10,252
Total Assets	$ 1,432,966	$ 1,303,629
Liabilities and Shareholders Equity		
Current Liabilities:		
Accounts payable	$ 54,720	$ 65,377
Current installments of long-term debt	19,285	28,743
Deferred revenue	89,561	79,890
Accrued payroll and tax withholdings	74,138	66,002
Other accrued expenses	43,596	20,078
Total current liabilities	281,300	260,090
Long-term debt	190,343	194,265
Deferred income taxes	73,359	72,922
Deferred revenue	16,188	14,533
Minority owners equity interest in subsidiaries	1,286	1,286
Shareholders Equity:		

Common stock, $.01 par value, 150,000,000 shares authorized, 78,081,321 shares issued at September 30, 2006 and 77,011,464 issued at December 31, 2005	781	770
Additional paid-in capital	368,160	325,134
Retained earnings	501,007	430,262
Accumulated other comprehensive income:		
Foreign currency translation adjustment	542	4,367
Total shareholders equity	870,490	760,533
Total liabilities and shareholders equity	$ 1,432,966	$ 1,303,629

See notes to condensed consolidated financial statements.

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CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(UNAUDITED)

	Three Months Ended		Nine Months Ended	
(In thousands, except per share data)	Sept 30, 2006	October 1, 2005	Sept 30, 2006	October 1, 2005
Revenues:				
System sales	125,180	110,173	356,394	315,315
Support, maintenance and services	210,265	175,208	612,068	495,460
Reimbursed travel	10,007	9,241	28,787	24,196
Total revenues	345,452	294,622	997,249	834,971
Costs and expenses:				
Cost of system sales	47,213	41,676	134,300	118,772
Cost of support, maintenance and services	12,583	14,388	38,927	37,346
Cost of reimbursed travel	10,007	9,241	28,787	24,196
Sales and client service	144,198	117,010	425,599	342,141
Software development	62,160	53,968	182,064	151,999
General and administrative	25,414	21,142	71,788	60,077
Write off of in-process research and development				6,382
Total expenses	301,575	257,425	881,465	740,913
Operating earnings	43,877	37,197	115,784	94,058
Other income (expense):				
Interest expense, net	(13)	(1,358)	(1,184)	(4,466)
Other income	(33)	310	2,026	387
Total other income (expense), net	(46)	(1,048)	842	(4,079)
Earnings before income taxes	43,831	36,149	116,626	89,979
Income taxes	(17,103)	(9,593)	(45,881)	(31,100)
Net earnings	26,728	26,556	70,745	58,879
Basic earnings per share	$ .34	$ .35	$ .91	$ .79
Basic weighted average shares outstanding	77,844	75,778	77,508	74,108
Diluted earnings per share	$ .33	$ .33	$ .87	$ .76

Diluted weighted average shares outstanding	81,796	79,794	81,536	77,880

See notes to condensed consolidated financial statements.

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CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	Nine Months Ended Sept 30, 2006	Nine Months Ended October 1, 2005
Cash flows from operating activities:		
Net earnings	$ 70,745	$ 58,879
Adjustments to reconcile net earnings to		
Net cash provided by operating activities:		
Depreciation and amortization	89,087	83,065
Share-based compensation expense	14,487	
Write-off of acquired in process research and development		6,382
Provision for deferred income taxes	714	2,311
Tax benefit from disqualifying dispositions of stock options	8,905	
Excess tax benefits from share based compensation	(4,276)	
Changes in assets and liabilities, net of businesses acquired and sold:		
Receivables, net	(32,008)	(22,785)
Inventory	(8,479)	(1,059)
Prepaid expenses and other	(16,877)	(25,291)
Accounts payable	(935)	6,453
Accrued income taxes	18,151	16,419
Deferred revenue	10,056	(511)
Other accrued liabilities	14,207	11,725
Total adjustments	93,032	76,709
Net cash provided by operating activities	163,777	135,588
Cash flows from investing activities:		
Purchase of capital equipment	(50,556)	(49,021)
Purchase of land, buildings and improvements	(41,888)	(15,518)
Acquisition of businesses, net of cash acquired	(13,736)	(118,854)
Net purchases in short-term investments	22,722	
Repayment of notes receivable		54
Capitalized software development costs	(46,962)	(47,343)
Net cash used in investing activities	(130,420)	(230,682)
Cash flows from financing activities:		
Proceeds from revolving line of credit		70,000
Repayment of revolving line of credit and long-term debt	(23,172)	(71,209)
Proceeds from third party warrants	1,010	
Excess tax benefits from share based compensation	4,276	
Proceeds from exercise of options	16,942	43,575

Associate stock purchase plan discounts		(802)
Net cash provided by (used in) financing activities	(944)	41,564
Effect of exchange rate changes on cash	(6,107)	(2,065)
Net increase (decrease) in cash and cash equivalents	26,306	(55,595)
Cash and cash equivalents at beginning of period	113,057	189,784
Cash and cash equivalents at end of period	$ 139,363	$ 134,186
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Income taxes, net of refund	$ 14,833	$ 18,367
Interest	6,497	3,970
Non-cash changes resulting from acquisitions:		
Increase in accounts receivable	$ 618	$ 11,621
Increase in property and equipment, net	205	2,355
Increase in goodwill and intangibles	13,627	124,715
Increase in deferred revenue	(150)	(10,979)
Increase in long term debt	(27)	(3,111)
Decrease in other working capital components	(537)	(5,747)
Total	$ 13,736	$ 118,854

See notes to condensed consolidated financial statements.

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CERNER CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Interim Statement Presentation & Accounting Policies

The condensed consolidated financial statements included herein have been prepared by the Company without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s latest annual report on Form 10-K.

In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position, and the results of operations and cash flows for the periods presented. The results for the three-month and nine-month periods are not necessarily indicative of the operating results for the entire year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Statement of Financial Accounting Standards (SFAS) No. 130, Reporting Comprehensive Income, establishes requirements for reporting and display of comprehensive income and its components. Total Comprehensive Income, which includes net earnings, foreign currency translation adjustments, and gains and losses from a hedge of the Company s net investment in the United Kingdom, amounted to $27,369,000 and $25,966,000 for the three months ended September 30, 2006 and October 1, 2005 and $66,920,000 and $55,499,000 for the nine months ended September 30, 2006 and October 1, 2005, respectively. Every quarter the Company designates substantially all of its GBP-denominated long-term debt (GBP 61,000,000) as a net investment hedge of its U.K. operations. The objective of the hedge is to reduce the Company s foreign currency exposure in the U.K. Changes in the exchange rate between the USD and GBP related to the notional amount of the hedge are being recognized as a component of accumulated other comprehensive income and the net gain and the net loss totaled approximately $1,470,000 and $8,755,000 for the three and nine months ended September 30, 2006, respectively.

The terms of the Company s software license agreements with its clients generally provide for a limited indemnification of such intellectual property against losses, expenses and liabilities arising from third-party claims based on alleged infringement by the Company s solutions of an intellectual property right of such third party. The terms of such indemnification often limit the scope of and remedies for such indemnification obligations and generally include a right to replace or modify an infringing solution. To date, the Company has not had to reimburse any of its clients for any losses related to these indemnification provisions pertaining to third-party intellectual property infringement claims. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases under the terms of the corresponding agreements with its clients, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnification provisions.

(2) Earnings Per Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. A reconciliation of the numerators and denominators of the basic and diluted per-share computations is as follows:

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(In thousands, except per share data)	Three months ended September 30, 2006 Earnings (Numerator)	Shares (Denominator)	Per-Share Amount	Three months ended October 1, 2005 Earnings (Numerator)	Shares (Denominator)	Per-Share Amount
Basic earnings per share:						
Income available to common shareholders	$26,728	77,844	$.34	$26,556	75,778	$.35
Effect of dilutive securities:						
Stock options		3,952			4,016	
Diluted earnings per share:						
Income available to common shareholders including assumed conversions	$26,728	81,796	$.33	$26,556	79,794	$.33

Options to purchase 1,338,000 and 138,000 shares of common stock at per share prices ranging from $34.00 to $136.86 and $38.99 to $136.86 were outstanding at the three-months ended September 30, 2006 and October 1, 2005, respectively, but were not included in the computation of diluted earnings per share because the options were anti-dilutive.

(In thousands, except per share data)	Nine months ended September 30, 2006 Earnings (Numerator)	Shares (Denominator)	Per-Share Amount	Nine months ended October 1, 2005 Earnings (Numerator)	Shares (Denominator)	Per-Share Amount
Basic earnings per share:						
Income available to common shareholders	$70,745	77,508	$.91	$58,879	74,108	$.79
Effect of dilutive securities:						
Stock options		4,028			3,772	
Diluted earnings per share:						
Income available to common shareholders including assumed conversions	$70,745	81,536	$.87	$58,879	77,880	$.76

Options to purchase 1,025,000 and 72,000 shares of common stock at per share prices ranging from $31.41 to $136.86 and $31.75 to $136.86 were outstanding at the nine-months ended September 30, 2006 and October 1, 2005, respectively, but were not included in the computation of diluted earnings per share because the options were anti-dilutive.

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(3) Accounting for Share-Based Awards

On January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payments, using the modified prospective method of adoption. SFAS 123R replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123R addresses the accounting for share-based payment transactions with employees and other third parties and requires that the compensation costs relating to such transactions be recognized in the consolidated statement of earnings.

The impact of adopting SFAS 123R had the following cumulative effects:

(In thousands, except per share data)

	Three months ended Sept 30, 2006	Nine months ended Sept 30, 2006
Decrease in income before income taxes	$4,688	$14,487
Decrease in net earnings	2,895	8,946
Decrease in cash flows from operations	814	4,276
Increase in cash flows from financing activities	814	4,276
Decrease in basic earnings per share	.04	.12
Decrease in diluted earnings per share	.03	.11

Prior to the adoption of SFAS 123R, the Company applied the intrinsic-value-based method of accounting prescribed by APB Opinion No. 25 to account for its fixed-plan stock options. Under this method, compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. As previously allowed under SFAS 123, the Company only adopted the disclosure requirements of SFAS 123, which established a fair-value-based method of accounting for stock-based employee compensation plans. The following is a reconciliation of reported net earnings to adjusted net earnings had the Company recorded compensation expense based on the fair value at the grant date for its stock options under SFAS 123 for the three and nine months ended October 1, 2005.

(In thousands, except per share data)	Three months ended Oct. 1, 2005	Nine months ended Oct. 1, 2005
Reported net earnings	$26,556	$58,879
Less: stock-based compensation expense determined under fair-value-based method for all awards, net of tax	(2,936)	(7,836)
Pro-forma net earnings	23,620	51,043
Basic earnings per share:		
Reported net earnings	$ .35	$ .79
Less: stock-based compensation expense determined under fair-value-based method for all awards, net of tax	(.04)	(.11)
Pro-forma net earnings	.31	.68

Diluted earnings per share:

Reported net earnings	$ .33	$ .76
Less: stock-based compensation expense determined under fair-value-based method for all awards, net of tax	(.04)	(.10)
Pro-forma net earnings	.29	.66

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As of September 30, 2006, the Company had four fixed stock option and equity plans in effect for associates. Amounts recognized in the consolidated financial statements with respect to these plans are as follows:

	Three months ended Sept. 30, 2006	Three months ended Oct. 1, 2005
Total cost of share-based payments for the period	$ 4,915,000	$ 243,000
Amounts capitalized in software development costs	(227,000)	
Amounts charged against earnings, before income tax benefit	4,688,000	243,000
Amount of related income tax benefit recognized in earnings	$ 1,793,000	$ 97,000

	Nine months ended Sept. 30, 2006	Nine months ended Oct. 1, 2005
Total cost of share-based payments for the period	$ 15,235,000	$ 484,000
Amounts capitalized in software development costs	(748,000)	
Amounts charged against earnings, before income tax benefit	14,487,000	484,000
Amount of related income tax benefit recognized in earnings	$ 5,541,000	$ 193,000

During 2006, the Company has had two long-term incentive plans from which it could issue grants.

Under the 2001 Long-Term Incentive Plan F, the Company is authorized to grant to associates, directors and consultants 4,000,000 shares of common stock awards taking into account the stock-split effective January 10, 2006. Awards under this plan may consist of stock options, restricted stock and performance shares, as well as other awards such as stock appreciation rights, phantom stock and performance unit awards which may be payable in the form of common stock or cash. However, not more than 1,000,000 of such shares will be available for granting any types of grants other than options or stock appreciation rights. Options under Plan F are exercisable at a price not less than fair market value on the date of grant as determined by the Stock Option Committee. Options under this plan typically vest over a period of five years as determined by the Stock Option Committee and are exercisable for periods of up to 25 years.

Long-Term Incentive Plan G was approved by the Company s shareholders on May 28, 2004. Under the 2004 Long-Term Incentive Plan G, the Company is authorized to grant to associates and directors 4,000,000 shares of common stock awards taking into account the stock-split effective January 10, 2006. Awards under this plan may consist of stock options, restricted stock and performance shares, as well as other awards such as stock appreciation rights, phantom stock and performance unit awards which may be payable in the form of common stock or cash. Options under Plan G are exercisable at a price not less than fair market value on the date of grant as determined by the Stock Option Committee. Options under this plan typically vest over a period of five years as determined by the Stock Option Committee and are exercisable for periods of up to 12 years.

The Company has also granted 1,708,170 other non-qualified stock options over time through September 30, 2006, under separate agreements to employees and certain third parties. These options are exercisable at a price equal to or greater than the fair market value on the date of grant. These options vest over periods of up to six years and are exercisable for periods of up to 10 years.

The fair value of each stock option award is estimated on the date of grant using a lattice option-pricing model for the nine months ended September 30, 2006 and using the Black-Scholes option-pricing model for the nine months ended October 1, 2005 based on the assumptions noted in the following table. Expected volatilities under the lattice model are based on an equal weighting of implied volatilities from traded options on the Company s shares and historical volatility. Expected volatilities under the Black-Scholes model were based entirely on historical volatility. The Company uses historical data to estimate stock option exercise and associate departure behavior used in the lattice model; groups of associates (executives and non-executives) that have similar historical behavior are considered separately for valuation purposes. The expected term of stock options granted is derived from the output of the lattice option-pricing model and represents the period of time that stock options granted are expected to be outstanding; the range given below results from certain groups of associates exhibiting different post-vesting behaviors. The expected term under the Black-Scholes model was determined using the

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simplified method of estimating the term as described in Staff Accounting Bulletin 107. The risk-free rate used in 2006 and 2005 is based on the zero-coupon U.S. Treasury bond with a term equal to the expected term of the awards.

	Nine months ended September 30, 2006	Nine months ended October 1, 2005
Expected volatility	47.1%	48.1%
Expected term (in years)	8.2 8.7	6.6
Risk-free rate	4.9%	4.0%

A combined summary of the stock option activity of the Company s four fixed stock option and equity plans (Non-Qualified Stock option Plans D and E were in effect during 2003 and 2004; no grants were permitted to be issued from Plans D and E after January 1, 2005 pursuant to the terms of the Plans) and other stock options as of September 30, 2006 and changes during the nine months ended September 30, 2006 are presented below:

	Nine months ended September 30, 2006		
Fixed options	Number of Shares	Weighted-average exercise price	Aggregate Intrinsic Value
Outstanding at beginning of year	11,039,522	$ 18.51	
Granted	1,019,100	42.52	
Exercised	(1,041,525)	15.92	
Forfeited or expired	(264,616)	24.19	
Outstanding at September 30, 2006	10,752,481	$ 20.90	$263,789,000
Options exercisable at September 30, 2006	5,416,129	$ 15.87	$160,101,000

The following table summarizes information about fixed and other stock options outstanding at September 30, 2006.

	Options outstanding			Options exercisable		
Range of Exercise Prices	Number outstanding at 9/30/06	Weighted-average remaining contractual life	Weighted-average exercise price	Number exercisable at 9/30/06	Weighted-average remaining contractual life	Weighted-average exercise price
$6.25 12.00	2,899,771	8.15 Years	$ 9.51	1,866,609		$ 9.40
12.16 20.99	3,058,170	7.87	16.82	2,033,968		16.17
21.01 31.41	3,335,908	6.68	25.39	1,509,730		23.26
31.75 136.86	1,458,632	9.37	41.79	5,822		68.33
	10,752,481	7.78	20.90	5,416,129		15.87

	7.78 years

The weighted-average grant date fair value of stock options granted during the three months ended September 30, 2006 and October 2, 2005 was $22.44 and $20.55, respectively. The weighted-average grant date fair value of stock options granted during the first nine months ended September 30, 2006 and October 2, 2005 was $21.87 and $17.73, respectively. The total intrinsic value of stock options exercised during the three months ended September 30, 2006 and October 2, 2005 was $13,143,000 and $40,601,000 respectively. The total intrinsic value of stock options exercised during the first nine months ended September 30, 2006 and October 2, 2005 was $29,042,000 and $64,904,000 respectively. The Company issues new shares to satisfy option exercises.

The Company also has an Associate Stock Purchase Plan (ASPP), which qualifies under Section 423 of the Internal Revenue Code. All full-time USD paid associates are eligible to participate. Participants may elect to make contributions from 1% to 20% of compensation to the ASPP, subject to annual limitations determined by the Internal Revenue Service. Participants may purchase Company Common Stock at a 15% discount on the last day of the purchase period. Previously under APB No. 25, the ASPP qualified

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as a non-compensatory plan and no compensation expense was recognized. Under FAS 123R, the Company expenses the entire 15% discount. The purchase of the Company s common stock is made through the ASPP on the open market and subsequently reissued to the associates.

The Company granted 15,000 shares of restricted stock from Plan F to members of the Board of Directors on July 6, 2004 valued at $21.16 and vesting on May 26, 2005. The Company made additional grants of restricted stock from Plan F to members of the Board of Directors during 2005. 5,000 shares of restricted stock were granted on April 4, 2005 valued at $26.19, vesting as follows: 1,666 on February 2, 2006; 1,666 on February 2, 2007; and 1,668 on February 2, 2008. 25,000 shares of restricted stock were granted on June 3, 2005 valued at $31.41, vesting on May 25, 2006. The Company granted 5,000 shares of restricted stock from Plan G to a member of the Board of Directors on June 3, 2005 valued at $31.41, vesting as follows: 1,666 on May 25, 2006; 1,666 on May 24, 2007; and 1,668 on May 22, 2008. The Company granted 5,000 shares of restricted stock from Plan F to an employee on June 13, 2005 valued at $31.79. To date in 2006, the Company has granted: 15,000 shares of restricted stock from Plan F to members of the Board of Directors on May 26, 2006 valued at $36.61 and vesting on May 24, 2007, and 6,000 shares of restricted stock from Plan F to members of the Board of Directors on July 25, 2006 valued at $38.75 and vesting on May 24, 2007. All grants were valued at the fair market value on the date of grant and vest provided the recipient has continuously served on the Board of Directors through such vesting date or in the case of an employee provided that performance measures are attained. The expense associated with these grants is being recognized over the period from the date of grant to the vesting date. The Company recognized expenses related to the restricted stock of $197,000 and $243,000 in the third quarter of 2006 and 2005, respectively. The Company recognized expenses related to the restricted stock of $637,000 and $484,000 in the first nine months of 2006 and 2005, respectively.

A summary of the Company s nonvested shares as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

Nonvested stock	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at January 1, 2006	40,000	$ 30.80
Granted	21,000	$ 37.22
Vested	(28,332)	$ 31.10
Forfeited		
Outstanding at September 30, 2006	32,668	$ 34.67

As of September 30, 2006 there was $36,406,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements (including stock option and nonvested share awards) granted under all plans. That cost is expected to be recognized over a weighted-average period of 1.74 years. The total fair value of shares vested during the nine-months ended September 30, 2006 was $1,031,000. The total fair value of shares vested during the nine-months ended October 1, 2005 was $494,400.

(4) Business Acquisition and Divestiture

On July 5, 2006, the Company completed the purchase of Galt Associates, Inc. (Galt) for $13,736,000, net of cash acquired. Galt is a provider of safety and risk management solutions for pharmaceutical, medical device and biotechnology companies. The acquisition of Galt will enhance the Company s LifeSciences portfolio by adding solutions and services that use medical event data to monitor and manage the safety and effectiveness of various therapies. The preliminary allocation of the purchase price to the estimated fair values of the identified tangible and intangible assets acquired and liabilities assumed, resulted in goodwill of $8,723,000 and $4,942,000 in intangible assets. The intangible assets are being amortized over periods between two and five years. The allocation of the purchase price is preliminary until management completes its evaluation of the fair value of the net assets acquired.

On January 3, 2005, the Company completed the purchase of assets of the medical business division of VitalWorks, Inc. for approximately $100,000,000, which was funded with existing cash of approximately $65,000,000 and borrowings on the revolving line of credit of approximately $35,000,000. The medical business consisted of delivering and supporting physician practice management, electronic medical

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record, electronic data interchange and emergency department information solutions and related products and services to physician practices, hospital emergency departments, management service organizations and other related entities. The acquisition of VitalWorks medical business division expanded the Company s presence in the physician practice market. $6,382,000 of the purchase price was allocated to in-process research and development that had not reached technological feasibility and is reflected as a charge to earnings in 2005. The allocation of the purchase price to the estimated fair values of the identified tangible and intangible assets acquired and liabilities assumed, resulted in goodwill of $55,166,000 and $43,450,000 in intangible assets. The intangible assets are being amortized over five years.

(5) Receivables

Receivables consist of accounts receivable and contracts receivable. Accounts receivable represent recorded revenues that have been billed. Contracts receivable represent recorded revenues that are billable by the Company at future dates under the terms of a contract with a client. Billings and other consideration received on contracts in excess of related revenues recognized under the percentage-of completion method are recorded as deferred revenue. A summary of receivables is as follows:

(In thousands)	September 30, 2006	December 31, 2005
Accounts receivable	$225,337	216,248
Contracts receivable	126,279	100,717
Total receivables	$351,616	316,965

The Company performs ongoing credit evaluations of its clients and generally does not require collateral from its clients. The Company provides an allowance for estimated uncollectible accounts based on specific identification, historical experience and management s judgment. At September 30, 2006 and December 31, 2005 the allowance for estimated uncollectible accounts was $15,311,000 and $18,855,000, respectively.

During the first nine months of 2006 and 2005, the Company received total client cash collections of $1,048,200,000 and $855,300,000, respectively, of which $73,671,000 and $53,405,000 were received from third party arrangements with non-recourse payment assignments.

(6) Goodwill and Other Intangible Assets

Goodwill and intangible assets with indefinite lives are evaluated for impairment annually or whenever there is an impairment indicator. All goodwill is assigned to a reporting unit, where it is subject to an impairment test based on fair value. The Company s 2006 review of goodwill was completed in the second quarter of 2006 and indicated that goodwill was not impaired.

The Company s intangible assets, other than goodwill or intangible assets with indefinite lives, are all subject to amortization and are summarized as follows:

(In thousands)

	Weighted Average Amortization Period (Yrs)	September 30, 2006 Gross Carrying Amount	September 30, 2006 Accumulated Amortization	December 31, 2005 Gross Carrying Amount	December 31, 2005 Accumulated Amortization
Purchased software	5.0	$ 59,031	36,396	53,307	29,690
Client lists	5.0	48,239	17,357	45,642	10,514
Patents	17.0	2,361	150	1,556	133
Non-compete agreements	3.0	1,096	250	382	102

Total	5.24	$ 110,727	54,153	100,887	40,439

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Aggregate amortization expense was $4,635,000 and $4,722,000 for the three months ended September 30, 2006 and October 1, 2005 and $13,714,000 and $12,840,000 for the nine months ended September 30, 2006 and October 1, 2005, respectively. Estimated aggregate amortization expense for each of the next five years is as follows:

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(In thousands)

For the remaining three months:	2006	$ 4,616
For year ended:	2007	16,773
	2008	14,530
	2009	12,635
	2010	1,954

The changes in the carrying amount of goodwill for the nine months ended September 30, 2006 are as follows:
(In thousands)

Balance as of December 31, 2005	$ 116,142
Deferred tax liabilities adjustment	1,362
Foreign currency translation adjustment and other	1,349
Goodwill acquired	8,723
Balance as of September 30, 2006	$ 127,576

The Company recorded $1,362,000 of additional goodwill in the first quarter of 2006 to adjust for the impact of accounting for deferred tax liabilities associated with intangible assets in connection with previous stock acquisitions of businesses. At the date of acquisitions prior to 2006, the Company had not recognized deferred tax liabilities related to the difference between the book and tax basis of certain intangible assets. The impact on net earnings related to this oversight was insignificant.

(7) Segment Reporting

In the fourth quarter of 2005, the Company changed its reportable segments to reflect how the chief operating decision maker currently reviews the Company s results in terms of allocating resources and assessing performance. This change effectively presents the Company s operating results by its two geographical operating segments, Domestic and Global. As a result, prior periods have been retroactively adjusted to reflect the change in reportable segments. Revenues are derived primarily from the sale of clinical, financial and administrative information systems and solutions. The cost of revenues includes the cost of third party consulting services, computer hardware and sublicensed software purchased from computer and software manufacturers for delivery to clients. It also includes the cost of hardware maintenance and sublicensed software support subcontracted to the manufacturers. Operating expenses incurred by the geographic business segments consist of sales and client service expenses including salaries of sales and client service personnel, communications expenses and unreimbursed travel expenses. Performance of the segments is assessed at the operating earnings level and, therefore, the segment operations have been presented as such. Other includes revenues not generated by the operating segments and expenses such as software development, marketing, general and administrative and depreciation that have not been allocated to the operating segments. The Company does not track assets by geographical business segment.

Accounting policies for each of the reportable segments are the same as those used on a consolidated basis. The following table presents a summary of the operating information for the three and nine months ended September 30, 2006 and October 1, 2005.

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(In thousands)	Operating Segments Domestic	Global	Other	Total
Three months ended Sept 30, 2006				
Revenues	$ 288,725	$ 55,610	$ 1,117	$ 345,452
Cost of revenues	59,648	10,144	11	69,803
Operating expenses	76,288	28,409	127,075	231,772
Total costs and expenses	135,936	38,553	127,086	301,575
Operating earnings (loss)	$ 152,789	$ 17,057	$ (125,969)	$ 43,877

	Operating Segments Domestic	Global	Other	Total
Three months ended Oct 1, 2005				
Revenues	$ 269,519	$ 24,068	$ 1,035	$ 294,622
Cost of revenues	59,863	4,946	496	65,305
Operating expenses	70,633	11,103	110,384	192,120
Total costs and expenses	130,496	16,049	110,880	257,425
Operating earnings (loss)	$ 139,023	$ 8,019	$ (109,845)	$ 37,197

	Operating Segments Domestic	Global	Other	Total
Nine months ended Sept. 30, 2006				
Revenues	$ 846,520	$ 146,990	$ 3,739	$ 997,249
Cost of revenues	174,544	27,402	68	202,014
Operating expenses	229,564	74,226	375,661	679,451
Total costs and expenses	404,108	101,628	375,729	881,465
Operating earnings (loss)	$ 442,412	$ 45,362	$ (371,990)	$ 115,784

	Operating Segments Domestic	Global	Other	Total
Nine months ended Oct. 1, 2005				

Revenues	$ 754,016	$ 77,952	$ 3,003	$ 834,971
Cost of revenues	168,514	11,754	46	180,314
Operating expenses	208,482	29,033	323,084	560,599
Total costs and expenses	376,996	40,787	323,130	740,913
Operating earnings (loss)	$ 377,020	$ 37,165	$ (320,127)	$ 94,058

(8) Stock Split

On December 14, 2005, the Company s Board of Directors announced a two-for-one stock split, payable on January 9, 2006 in the form of a one hundred percent (100%) stock dividend to shareholders of record on December 30, 2005. In connection with the stock split, a portion of the distribution of the stock dividend came from 1,502,999 treasury shares previously reflected in the consolidated balance sheets. All share and per share data have been retroactively adjusted for all periods presented to reflect the stock split including the use of treasury shares, as if the stock split had occurred at the beginning of the earliest period presented. The number of common shares issued and outstanding at December 31, 2005 previously presented in the Company s 2005 Annual Report on Form 10-K was overstated by 1,502,999 shares. This has been corrected in the accompanying condensed consolidated balance sheet noting the correct number of common shares issued and outstanding at December 31, 2005 was 77,011,464.

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

Introduction

Cerner Corporation (Cerner or the Company) is headquartered in North Kansas City, Missouri. The Company derives revenue by selling, implementing and supporting software solutions and hardware that gives healthcare providers secure access to clinical, administrative and financial data in real time, allowing them to improve the quality, safety and efficiency in the delivery of healthcare. Cerner implements these solutions as stand-alone, combined or enterprise-wide systems. *Cerner Millennium*® software solutions can be managed by the Company s clients or in the Company s data center via a managed services model.

Results Overview

The Company delivered strong levels of new business bookings, revenue, earnings and cash flow in the third quarter of 2006. New business bookings, which reflects the value of executed contracts for software, hardware, services and managed services (hosting of software in the Company s data center), in the third quarter were $352.1 million compared to $450.5 million in the third quarter of 2005. Included in new business bookings in the third quarter of 2005 is a unique large $149.4 million booking related to the National Health Service initiative to automate clinical processes and digitize medical records in the Southern Cluster of England.

Third quarter 2006 revenues increased 17 percent to $345.5 million compared to $294.6 million in the year-ago quarter. Third quarter 2006 net earnings were $26.7 million, and diluted earnings per share were $0.33. Third quarter 2005 net earnings were $26.6 million and diluted earnings per share were $0.33. Third quarter 2006 net earnings and diluted earnings per share reflect the impact of adopting Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, which requires the expensing of stock options. Adoption of SFAS 123R reduced third quarter 2006 net earnings and diluted earnings per share by $2.9 million and $0.03, respectively.

The Company had strong cash collections of receivables of $351.9 million in the third quarter of 2006 compared to $298.9 million in the third quarter of 2005 and lowered days sales outstanding to 93 days compared to 98 days in the third quarter of 2005. Operating cash flows for the third quarter of 2006 were $52.9 million compared to $46.9 million in the third quarter of 2005.

Healthcare Information Technology Market

The Healthcare Information Technology (HIT) marketplace remains healthy. Domestically, the overall financial condition of hospitals remains solid, and there continues to be incentive for them to purchase healthcare information technology to address safety, quality, and efficiency needs. With annual healthcare spending in the United States of $1.9 trillion, or 16 percent of the gross domestic product, there is still broad bipartisan support of HIT, with several pieces of pending legislation containing provisions that encourage both hospitals and physician practices to adopt HIT. Globally, there continues to be a high level of interest in healthcare IT at the country-wide and regional levels that is driven by similar safety, quality, and efficiency needs as those driving demand in the United States.

Results of Operations

Three Months Ended September 30, 2006 Compared to Three Months Ended October 1, 2005

The Company s net earnings increased 1% to $26,728,000 for the three-month period ended September 30, 2006 from $26,556,000 for the three-month period ended October 1, 2005. Third quarter 2006 net earnings included the impact of adopting SFAS No. 123R, which requires the expensing of stock options. The adoption of SFAS 123R reduced net earnings in the third quarter of 2006 by $2,895,000, net of $1,793,000 tax benefit. Third quarter 2005 net earnings for the three month period ended October 1, 2005 included an adjustment related to a prior period tax benefit from the carry back of a capital loss generated by the sale of Zynx Health Incorporated of $4,794,000.

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Revenues increased 17% to $345,452,000 for the three-month period ended September 30, 2006 from $294,622,000 for the three-month period ended October 1, 2005. The revenue composition for the third quarter of 2006 was $125,180,000 in system sales, $87,035,000 in support and maintenance, $123,230,000 in services and $10,007,000 in reimbursed travel.

System sales revenues increased 14% to $125,180,000 for the three-month period ended September 30, 2006 from $110,173,000 for the corresponding period in 2005. Included in system sales are revenues from the sale of software, hardware and sublicensed software, installation fees, transaction processing and subscriptions. The increase in system sales revenue was driven by strong licensed software growth offsetting a year-over-year decline in sublicensed software and flat year-over-year levels of hardware.

Support, maintenance and service revenues increased 20% to $210,265,000 during the third quarter of 2006 from $175,208,000 during the same period in 2005. Included in support, maintenance and service revenues are support and maintenance of software and hardware, professional services excluding installation, and managed services. Support and maintenance revenues were $87,035,000 and $75,117,000 for the third quarter of 2006 and 2005, respectively. Service revenues were $123,230,000 and $100,091,000 for the third quarter of 2006 and 2005, respectively. These increases were driven by an increase in the number of professional services associates and strong performance in delivering *Cerner Millennium* solutions to clients and strong growth in managed services.

Contract backlog, which reflects new business bookings that have not yet been recognized as revenue, increased 22% in the third quarter of 2006 compared to the third quarter of 2005. This increase is due to strong levels of new business bookings during the past four quarters. On September 30, 2006, the Company had $1,932,726,000 in contract backlog and $452,276,000 in support and maintenance backlog, compared to $1,579,746,000 in contract backlog and $389,584,000 in support and maintenance backlog on October 1, 2005.

The cost of revenue was 20% and 22% of total revenues in the third quarter of 2006 and 2005, respectively. The cost of revenues includes the cost of reimbursed travel expense, third party consulting services and subscription content, computer hardware and sublicensed software purchased from hardware and software manufacturers for delivery to clients. It also includes the cost of hardware maintenance and sublicensed software support subcontracted to the manufacturers. Such costs, as a percent of revenues, typically have varied as the mix of revenue (software, hardware, maintenance, support, services and reimbursed travel) carrying different margin rates changes from period to period. The year-over-year decrease in cost of revenue was driven by strong levels of software and a lower mix of sublicensed software and hardware

Sales and client service expenses as a percent of total revenues were 42% and 40% in the third quarter of 2006 and 2005, respectively. Sales and client service expenses include salaries of sales and client service personnel, communications expenses, unreimbursed travel expenses and expense for share-based payment. Also included are sales and marketing salaries, trade show costs and advertising costs. The increase in total sales and client service expenses to $144,198,000 in the third quarter of 2006 from $117,010,000 in the same period of 2005 was primarily attributable to an increase in personnel expense and marketing related expenses as well as $2,817,000 of expense related to share-based payment in the third quarter of 2006.

Software development expenses include salaries, documentation, expense for share-based payment and other direct expenses incurred in product development and amortization of software development costs. Total expenditures for software development, including both capitalized and noncapitalized portions, for the third quarter of 2006 and 2005 were $65,892,000 and $57,043,000, respectively. These amounts exclude amortization. Capitalized software costs were $14,530,000 and $15,184,000 for the third quarter of 2006 and 2005, respectively. Capitalized software costs for the third quarter of 2006 include $227,000 of capitalized expense related to share-based payments. Amortization of capitalized software costs was $10,798,000 and $12,109,000 for the third quarter of 2006 and 2005, respectively. The increase in aggregate expenditures for software development in 2006 is due to continued development of *Cerner Millennium* software solutions. The decrease in amortization of capitalized software costs is due to the Company moving from multiple releases of software each year to an annual release of software. Amortization will increase at the annual release date of software, which is expected in the fourth quarter of 2006. Included in software development expenses in the third quarter of 2006 was $1,038,000 of expense related to share-based payments.

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General and administrative expenses as a percent of total revenues were 7% in the third quarter of 2006 and 2005. General and administrative expenses include salaries for corporate, financial and administrative staffs, utilities, communications expenses, professional fees, the transaction gains or losses on foreign currency and expense for share based payment. Total general and administrative expenses for the third quarter of 2006 and 2005 were $25,414,000 and $21,142,000, respectively. Included in general and administrative expenses in the third quarter of 2006 was $833,000 of expense related to share-based payment. The increase in total general and administrative expense is due primarily to the growth of the Company s core business, a result of acquisitions and increased presence in the global market. The Company had net transaction gains on foreign currency of $764,000 in the third quarter of 2006 compared to net transaction gains on foreign currency of $93,000 in the third quarter of 2005.

Net interest expense was $13,000 in the third quarter of 2006 compared to $1,358,000 in the third quarter of 2005. This decrease in net interest expense is due to an increase in the interest rate of invested funds.

The Company s effective tax rate was 39% and 26.5%, in the third quarter of 2006 and 2005, respectively. The tax expense for the three month period ended October 1, 2005 includes an adjustment related to a prior period for a tax benefit from the carry back of a capital loss generated by the sale of Zynx Health Incorporated for $4,794,000. Excluding this adjustment, the Company s effective tax rate was 40% for the third quarter of 2005.

Operations by Segment

In the fourth quarter of 2005, the Company changed its reportable segments to reflect how the chief operating decision maker currently reviews the Company s results in terms of allocating resources and assessing performance. This change effectively presents the Company s operating results by its two geographical operating segments, Domestic and Global. As a result, the prior periods have been retroactively adjusted to reflect the change in reportable segments. The following table presents a summary of the operating information for the three months ended September 30, 2006 and October 1, 2005:

(In thousands)	Operating Segments			
	Domestic	Global	Other	Total
Three months ended Sept 30, 2006				
Revenues	$ 288,725	$ 55,610	$ 1,117	$ 345,452
Cost of revenues	59,648	10,144	11	69,803
Operating expenses	76,288	28,409	127,075	231,772
Total costs and expenses	135,936	38,553	127,086	301,575
Operating earnings (loss)	$ 152,789	$ 17,057	$ (125,969)	$ 43,877

	Operating Segments			
	Domestic	Global	Other	Total
Three months ended Oct 1, 2005				
Revenues	$ 269,519	$ 24,068	$ 1,035	$ 294,622
Cost of revenues	59,863	4,946	496	65,305
Operating expenses	70,633	11,103	110,384	192,120
Total costs and expenses	130,496	16,049	110,880	257,425

Operating earnings (loss)	$ 139,023	$ 8,019	$ (109,845)	$ 37,197

Operating earnings in the Domestic segment increased 10% for the quarter ended September 30, 2006 compared to the quarter ended October 1, 2005. Total Domestic segment revenues increased 7% in the third quarter of 2006 compared to the third quarter of 2005 driven by strong bookings growth**.** Cost of revenues was 21% and 22% of total Domestic segment revenues for the third quarter of 2006 and 2005,

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respectively. The decrease in cost of revenues was driven primarily by a lower level of hardware and sublicensed software revenue in the 2006 quarter compared to the 2005 quarter. Domestic segment operating expenses in the three months ended September 30, 2006 increased 8% compared to the 2005 period.

Operating earnings in the Global segment increased 113% for the quarter ended September 30, 2006 compared to the quarter ended October 1, 2005. Total Global segment revenues increased 131% in the third quarter of 2006 compared to the third quarter of 2005. Third quarter revenues included approximately $18 million from the Company s major contract in the Southern region of England. The revenues from this contract did not change operating earnings as the Company is accounting for this contract using a zero-margin approach of applying percentage-of-completion accounting until the software customization and development services are completed. Once software customization and development services are completed, which is expected in 2008, the remaining unrecognized portion of the fee will be recognized ratably over the remaining term of the arrangement, which expires in 2014. Cost of revenues was 18% and 21% of total Global segment revenues for the third quarters of 2006 and 2005, respectively. The increase in cost of revenues was driven primarily by a higher level of hardware revenue in the 2006 period compared to the 2005 period. Operating expenses in the 2006 period increased 156% compared to the 2005 period due to hiring personnel and increased presence for the higher level of activity outside the United States.

Operating losses in Other increased 15% for the quarter ended September 30, 2006 compared to the quarter ended October 1, 2005. Included in Other are revenues and expenses not tracked by geographic segment. Operating expenses increased 15% in the 2006 period compared to the 2005 period. This increase in operating expenses is due to an increase in expenses such as software development, marketing, general and administrative, share-based compensation expense and depreciation for the three months ended September 30, 2006 compared to the three months ended October 1, 2005.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended October 1, 2005

The Company s net earnings increased 20% to $70,745,000 for the nine-month period ended September 30, 2006 from $58,879,000 for the nine-month period ended October 1, 2005. The first nine months of 2006 net earnings included the impact of adopting SFAS No. 123R, which requires the expensing of stock options. The adoption of SFAS 123R reduced net earnings in the 2006 period by $8,946,000 net of $5,541,000 tax benefit. Net earnings for the nine-month period ended October 1, 2005 included an adjustment related to a prior period for a tax benefit from the carry back of a capitol loss generated by the sale of Zynx Health Incorporated of $4,794,000 and the write off of acquired in-process research and development of $3,941,000 net of a $2,441,000 tax benefit.

Revenues increased 19% to $997,249,000 for the nine-month period ended September 30, 2006 from $834,971,000 for the nine-month period ended October 1, 2005. The revenue composition for the nine-months ended September 30, 2006 was $356,394,000 in system sales, $251,352,000 in support and maintenance, $360,716,000 in services and $28,787,000 in reimbursed travel.

System sales revenues increased 13% to $356,394,000 for the nine-month period ended
September 30, 2006 from $315,315,000 for the corresponding period in 2005. Included in system sales are revenues from the sale of software, hardware and sublicensed software, installation fees, transaction processing and subscriptions. The increase in system sales revenue was driven by growth in software and subscriptions.

Support, maintenance and service revenues increased 24% to $612,068,000 during the first nine months of 2006 from $495,460,000 during the same period in 2005. Included in support, maintenance and service revenues are support and maintenance of software and hardware, professional services excluding installation, and managed services. Support and maintenance revenues were $251,352,000 and $219,473,000 for the first nine months of 2006 and 2005, respectively. Service revenues were $360,716,000 and $275,987,000 for the first nine months of 2006 and 2005, respectively. These increases were driven by an increase in the number of professional services associates and strong performance in delivering *Cerner Millennium* solutions to clients and strong growth in managed services.

Contract backlog, which reflects new business bookings that have not yet been recognized as revenue, increased 22% in the third quarter of 2006 compared to the third quarter of 2005. This increase is due to strong levels of new business bookings during the past four quarters. On September 30, 2006, the

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Company had $1,932,726,000 in contract backlog and $452,276,000 in support and maintenance backlog, compared to $1,579,746,000 in contract backlog and $389,584,000 in support and maintenance backlog on October 1, 2005.

The cost of revenue was 20% and 22% of total revenues in the first nine months of 2006 and 2005, respectively. The cost of revenues includes the cost of reimbursed travel expense, third party consulting services and subscription content, computer hardware and sublicensed software purchased from hardware and software manufacturers for delivery to clients. It also includes the cost of hardware maintenance and sublicensed software support subcontracted to the manufacturers. Such costs, as a percent of revenues, typically have varied as the mix of revenue (software, hardware, maintenance, support, services and reimbursed travel) carrying different margin rates changes from period to period.

Sales and client service expenses as a percent of total revenues were 43% and 41% in the first nine months of 2006 and 2005, respectively. Sales and client service expenses include salaries of sales and client service personnel, communications expenses, unreimbursed travel expenses and expense for share-based payment. Also included are sales and marketing salaries, trade show costs and advertising costs. The increase in total sales and client service expenses to $425,599,000 in the 2006 period from $342,141,000 in the 2005 period was primarily attributable to an increase in personnel expense and marketing related expenses as well as $8,701,000 of expense related to share-based payment in the 2006 period.

Software development expenses include salaries, documentation, expense for share-based payment and other direct expenses incurred in product development and amortization of software development costs. Total expenditures for software development, including both capitalized and noncapitalized portions, for the nine months of 2006 and 2005 were $196,614,000 and $163,045,000, respectively. These amounts exclude amortization. Capitalized software costs were $46,969,000 and $47,343,000 for the first nine months of 2006 and 2005, respectively. Capitalized software costs for the nine months ended September 30, 2006 include $747,000 of capitalized expense related to share-based payments. Amortization of capitalized software costs was $32,419,000 and $36,297,000 for the first nine months of 2006 and 2005, respectively. The increase in aggregate expenditures for software development in 2006 is due to continued development of *Cerner Millennium* software solutions. The decrease in amortization of capitalized software costs is due to the Company moving from multiple releases of software each year to an annual release of software. Amortization will increase at the annual release date of software, which is expected in the fourth quarter of 2006. Included in software development expenses in the third quarter of 2006 was $3,267,000 of expense related to share-based payments.

General and administrative expenses as a percent of total revenues were 7% for the first nine months of 2006 and 2005. General and administrative expenses include salaries for corporate, financial and administrative staffs, utilities, communications expenses, professional fees, the transaction gains or losses on foreign currency and expense for share based payment. Total general and administrative expenses for the first nine months of 2006 and 2005 were $71,788,000 and $60,077,000, respectively. Included in general and administrative expenses for the nine months ended September 30, 2006 was $2,519,000 of expense related to share-based payment. This increase in total general and administrative expense is due primarily to the growth of the Company s core business, a result of acquisitions and increased presence in the global market. The Company had net transaction gains on foreign currency of $1,738,000 for the first nine months of 2006 compared to net transaction losses on foreign currency of $1,062,000 for 2005.

The write-off of in-process research and development in the third quarter of 2005 was an expense resulting from the acquisition of the medical business division of VitalWorks, Inc.

Net interest expense was $1,184,000 in the first nine months of 2006 compared to $4,466,000 in the first nine months of 2005. This decrease in net interest expense is due to an increase in the interest rate of invested funds.

Other income was $2,026,000 in the first nine months of 2006 compared to $387,000 in the first nine months of 2005. This increase is due primarily to a gain recorded in the first quarter of 2006 related to the renegotiation of a supplier contract that eliminated a liability related to unfavorable future commitments due to that supplier. The Company was able to renegotiate the contract to eliminate certain minimum volume requirements and reduce pricing to market rates leading to the elimination of the previously recorded liability.

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The Company s effective tax rate was 39.3% and 34.6%, respectively in the nine-month period of 2006 and 2005. The tax expense for the nine-month period ended October 1, 2005 includes an adjustment related to a prior period for a tax benefit from the carry back of a capital loss generated by the sale of Zynx Health Incorporated of $4,794,000. Excluding this adjustment, the Company s effective tax rate was 40% for the nine-month period ended October 1, 2005.

Operations by Segment

(In thousands)

	Operating Segments			
	Domestic	Global	Other	Total
Nine months ended Sept. 30, 2006				
Revenues	$ 846,520	$ 146,990	$ 3,739	$ 997,249
Cost of revenues	174,544	27,402	68	202,014
Operating expenses	229,564	74,226	375,661	679,451
Total costs and expenses	404,108	101,628	375,729	881,465
Operating earnings (loss)	$ 442,412	$ 45,362	$ (371,990)	$ 115,784

	Operating Segments			
	Domestic	Global	Other	Total
Nine months ended Oct. 1, 2005				
Revenues	$ 754,016	$ 77,952	$ 3,003	$ 834,971
Cost of revenues	168,514	11,754	46	180,314
Operating expenses	208,482	29,033	323,084	560,599
Total costs and expenses	376,996	40,787	323,130	740,913
Operating earnings (loss)	$ 377,020	$ 37,165	$ (320,127)	$ 94,058

Operating earnings in the Domestic segment increased 17% for the nine months ended September 30, 2006 compared to the nine months ended October 1, 2005, driven by strong bookings growth. Total Domestic segment revenues increased 12% in the 2006 period compared to the 2005 period driven by strong bookings growth**.** Cost of revenues was 21% and 22% of total Domestic segment revenues for the first nine months of 2006 and 2005, respectively. Domestic segment operating expenses in the nine months ended September 30, 2006 increased 10% compared to the 2005 period.

Operating earnings in the Global segment increased 22% for the nine months ended September 30, 2006 compared to the nine months ended October 1, 2005. Total Global segment revenues increased 89% in the first nine months of 2006 compared to the first nine months of 2005. Revenues for the nine-month period of 2006 included approximately $44 million from the Company s major contract in the Southern region of England. The revenues from this contract did not change operating earnings as the Company is accounting for this contract using a zero-margin approach of applying percentage-of-completion accounting until the software customization and development services are

completed. Once software customization and development services are completed which is expected in 2008, the remaining unrecognized portion of the fee will be recognized ratably over the remaining term of the arrangement, which expires in 2014. Cost of revenues was 19% and 15% of total Global segment revenues for the first nine months of 2006 and 2005, respectively. The increase in cost of revenues was driven primarily by a higher level of hardware revenue in the 2006 period compared to the 2005 period. Operating expenses in the 2006 period increased 156% compared to the 2005 period due to hiring personnel for the higher level of activity outside the United States. Operating losses in Other increased 16% for the nine months ended September 30, 2006 compared to the nine months ended October 1, 2005. Included in Other are revenues and expenses not tracked by geographic segment. Operating expenses increased 16% in the 2006 period compared to the 2005 period. This increase in operating expenses is due to an increase in expenses such as software development, marketing, general and administrative, share-based compensation expense and

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depreciation for the nine months ended September 30, 2006 compared to the nine months ended October 1, 2005. Operating expenses in the 2005 period includes the write-off of acquired in-process research and development of $6,382,000.

Capital Resources and Liquidity

The Company s liquidity is influenced by many factors, including the amount and timing of the Company s revenues, its cash collections from its clients and the amounts the Company invests in software development, acquisitions and capital expenditures.

The Company s principal source of liquidity is its cash, cash equivalents and short-term investments. The majority of the Company s cash and cash equivalents and short-term investments consist of U.S. Government Federal Agency Securities, short-term marketable securities and overnight repurchase agreements. At September 30, 2006 the Company had cash and cash equivalents of $139,363,000, short-term investments of $148,080,000 and working capital of $435,040,000.

The Company generated cash of $163,777,000 and $135,588,000 from operations in the first nine months of 2006 and 2005, respectively. The Company has periodically provided long-term financing options to creditworthy clients through third party financing institutions and has directly provided extended payment terms to clients from contract date. Some of these payment streams have been assigned on a non-recourse basis to third party financing institutions. The Company has provided its usual and customary performance guarantees to the third party financing institutions in connection with its on-going obligations under the client contract. During the first nine months of 2006 and 2005, the Company received total client cash collections of $1,048,200,000 and $855,431,000, respectively, of which 7% and 6% were received from third party financing arrangements with non-recourse payment assignments. Days sales outstanding were 93 days at September 30, 2006, decreasing from 98 days at October 1, 2005. Revenues provided under support and maintenance agreements represent recurring cash flows. Support and maintenance revenues increased 16% and 15% in the three-month and nine-month periods of 2006 compared to the three-month and nine-month periods of 2005, and the Company expects these revenues to continue to grow as the base of installed systems grows.

Cash used in investing activities in the first nine months of 2006 consisted primarily of capital purchases of $92,444,000, which includes $50,556,000 of capital equipment and $41,888,000 of land, buildings and improvements. Capitalized software development costs were $46,962,000, and the acquisition of businesses of $13,736,000 in the 2006 period. Cash used in investing activities in the first nine months of 2005 consisted primarily of the acquisition of businesses of $118,854,000, capitalized software development costs were $47,343,000, and capital purchases of $64,539,000 which includes $49,021,000 of capital equipment and $15,518,000 of land, buildings and improvements.

The Company s financing activities for the 2006 period consisted primarily of proceeds from the exercise of stock options of $16,942,000 and the excess tax benefits from share based compensation of $4,276,000 and repayment of debt of $23,172,000. For the 2005 period the Company s financing activities consisted primarily of proceeds of debt of $70,000,000, repayment of debt of $71,209,000 and of the proceeds from the exercise of stock options of $43,575,000.

The Company is currently constructing a new data center on its campus in North Kansas City, Missouri at an approximate cost of $60,000,000 of which approximately $17,000,000 has been spent as of September 30, 2006. The construction is expected to be completed in 2007.

The Company believes that its present cash position, together with cash generated from operations and, if necessary, its line of credit, will be sufficient to meet anticipated cash requirements during 2006.

The effects of inflation on the Company s business during the period discussed herein were minimal.

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Recent Accounting Pronouncements

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 allows registrants to record a one time cumulative effect adjustment to beginning retained earnings in the year of adoption to correct errors existing in prior years deemed to be material in the current year that previously had been considered immaterial. SAB 108 is effective for the fiscal year ending December 30, 2006. The Company is currently assessing the impact of adoption of SAB 108 on its consolidated financial statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, which defines the threshold for recognizing the benefits of tax-return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. FIN 48 also prescribes a method for computing the tax benefit of such tax positions to recognize in the financial statements. In addition, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently assessing the impact of adoption of FIN 48 on its results of operations and its financial position and will be required to adopt FIN 48 as of the first day of the 2007 fiscal year.

Forward Looking and Cautionary Statements

Except for the historical information and discussions contained herein, statements contained in this Form 10-Q may constitute forward looking statements within the meaning of Section 21E of the Securities and Exchange Act of 1934, as amended (the Act). Forward-looking statements can often be identified by the use of forward-looking terminology, such as could, should, will, intended, continue, believe, may, expect, hope, anticipate, goal, f estimate or the negative of these words, variations thereof or similar expressions. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, including: the possibility of product-related liabilities; potential claims for system errors and warranties; the possibility of interruption at our data centers or client support facilities; our proprietary technology may be subjected to infringement claims or may be infringed upon; risks associated with our global operations; recruitment and retention of key personnel; risks related to third party suppliers; risks inherent with business acquisitions; changing political, economic and regulatory influences; government regulation; significant competition and market changes; variations in our quarterly operating results; potential inconsistencies in our sales forecasts compared to actual sales; trading price of our common stock may be volatile; our Board of Directors have authority to issue preferred stock and our corporate governance documents contain anti-takeover provisions; and, other risks, uncertainties and factors discussed elsewhere in this Form 10-Q, in the Company s other filings with the Securities and Exchange Commission or in materials incorporated therein by reference. Forward looking statements are not guarantees of future performance or results. The Company undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results, financial condition or business over time.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

No material changes.

Item 4. Controls and Procedures

a) Evaluation of disclosure controls and procedures. The Company s Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in the Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by the Quarterly Report (the Evaluation Date). They have concluded that, as of the Evaluation Date, these disclosure controls and procedures were effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities and would be disclosed on a timely basis. The CEO and CFO have concluded that the Company s disclosure controls and procedures are designed, and are effective, to give reasonable assurance that the

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information required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the rules and forms of the SEC. They have also concluded that the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that are filed or submitted under the Exchange Act are accumulated and communicated to the Company s management, including the CEO and CFO, to allow timely decisions regarding required disclosure.

b) There were no changes in the Company s internal controls over financial reporting during the three months ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

c) The Company s management, including its Chief Executive Officer and Chief Financial Officer, have concluded that our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at that reasonable assurance level. However, the Company s management can provide no assurance that our disclosure controls and procedures or our internal control over financial reporting can prevent all errors and all fraud under all circumstances. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Part II. Other Information

Item 6. Exhibits

(a) Exhibits

31.1 Certification of Chief Executive Officer pursuant to Section 302.

31.2 Certification of Chief Financial Officer pursuant to Section 302.

32.1 Certification of Chief Executive Officer pursuant to Section 906.

32.2 Certification of Chief Financial Officer pursuant to Section 906.

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SIGNATURES

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

CERNER CORPORATION
Registrant

November 9, 2006 — By: /s/ Marc G. Naughton

Date — Marc G. Naughton
Chief Financial Officer

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