

Computer Software Innovations, Inc.

Form 10-Q

November 14, 2011

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

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from            to

Commission file number: 000-51758

**COMPUTER SOFTWARE INNOVATIONS, INC.**

(Exact name of registrant as specified in its charter)

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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**  
(Address of principal executive offices)

**(864) 855-3900**  
(Registrant's telephone number, including area code)

**29640**  
(Zip Code)

**[None]**  
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                                     | Outstanding at November 9, 2011 |
|---|---------------------------------|
| Common Stock, \$0.001 par value per share | 6,584,191 shares                |

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

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.**

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

(Amounts in thousands, except per share data)

|  | Three Months Ended |               | Nine Months Ended |               |
|--|--------------------|---------------|-------------------|---------------|
|  | September 30,      | September 30, | September 30,     | September 30, |
|  | 2011               | 2010          | 2011              | 2010          |
| <b>REVENUES</b>  |                    |               |                   |               |
| Financial Management Applications Segment                              | \$ 3,526           | \$ 3,381      | \$ 10,184         | \$ 10,472     |
| Cloud Services Segment   | 277                | 214           | 866               | 698           |
| Technology Solutions Segment   | 13,471             | 10,871        | 29,787            | 30,121        |
| Net sales and service revenue  | 17,274             | 14,466        | 40,837            | 41,291        |
| <b>COST OF SALES</b>   |                    |               |                   |               |
| <i>Financial Management Applications Segment</i>                       |                    |               |                   |               |
| Cost of sales, excluding depreciation, amortization and capitalization | 2,116              | 1,887         | 6,053             | 5,633         |
| Depreciation   | 31                 | 30            | 86                | 88            |
| Amortization of capitalized software costs                             | 289                | 306           | 787               | 843           |
| Capitalization of software costs                                       | (320)              | (302)         | (914)             | (783)         |
| Total Financial Management Applications Segment cost of sales          | 2,116              | 1,921         | 6,012             | 5,781         |
| <i>Cloud Services Segment</i>  |                    |               |                   |               |
| Cost of sales, excluding depreciation, amortization and capitalization | 672                | 433           | 1,846             | 1,418         |
| Depreciation   | 75                 | 19            | 180               | 38            |
| Amortization of capitalized software costs                             | 116                | 81            | 252               | 242           |
| Capitalization of software costs                                       | (189)              | (113)         | (522)             | (487)         |
| Total Cloud Services Segment cost of sales                             | 674                | 420           | 1,756             | 1,211         |
| <i>Technology Solutions Segment</i>                                    |                    |               |                   |               |
| Cost of sales, excluding depreciation                                  | 11,055             | 9,081         | 24,935            | 25,826        |
| Depreciation   | 24                 | 28            | 71                | 76            |
| Total Technology Solutions Segment cost of sales                       | 11,079             | 9,109         | 25,006            | 25,902        |
| Total cost of sales  | 13,869             | 11,450        | 32,774            | 32,894        |
| Gross profit   | 3,405              | 3,016         | 8,063             | 8,397         |
| <b>OPERATING EXPENSES</b>  |                    |               |                   |               |
| Research and development   | 17                 | 45            | 69                | 122           |
| Selling costs  | 1,324              | 1,154         | 3,763             | 3,363         |
| Marketing costs  | 137                | 118           | 440               | 387           |
| Stock based (non-employee wage) compensation                           | 7                  | 8             | 22                | 49            |
| Professional and legal public company compliance costs                 | 157                | 66            | 386               | 385           |
| Depreciation and amortization  | 100                | 134           | 308               | 434           |
| Other general and administrative expenses                              | 864                | 755           | 2,596             | 2,496         |
| Total operating expenses   | 2,606              | 2,280         | 7,584             | 7,236         |

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|   |                |                |                |                |
|---|----------------|----------------|----------------|----------------|
| Operating income                            | 799            | 736            | 479            | 1,161          |
| <b>OTHER EXPENSE</b>                        |                |                |                |                |
| Interest expense                            | (49)           | (54)           | (137)          | (201)          |
| Loss on disposal of property and equipment  |                |                |                | (2)            |
| Other expense                               | (49)           | (54)           | (137)          | (203)          |
| Income before income taxes                  | 750            | 682            | 342            | 958            |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>         | (44)           | 295            | (82)           | 443            |
| <b>NET INCOME</b>                           | <b>\$ 794</b>  | <b>\$ 387</b>  | <b>\$ 424</b>  | <b>\$ 515</b>  |
| <b>BASIC EARNINGS PER SHARE</b>             | <b>\$ 0.12</b> | <b>\$ 0.06</b> | <b>\$ 0.06</b> | <b>\$ 0.08</b> |
| <b>DILUTED EARNINGS PER SHARE</b>           | <b>\$ 0.06</b> | <b>\$ 0.03</b> | <b>\$ 0.03</b> | <b>\$ 0.04</b> |
| <b>WEIGHTED AVERAGE SHARES OUTSTANDING:</b> |                |                |                |                |
| <b>Basic</b>                                | <b>6,577</b>   | <b>6,522</b>   | <b>6,565</b>   | <b>6,490</b>   |
| <b>Diluted</b>                              | <b>13,641</b>  | <b>13,912</b>  | <b>13,629</b>  | <b>13,889</b>  |

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

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

| <i>(Amounts in thousands)</i>   | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010 |
|---|--------------------------------------|----------------------|
| <b>ASSETS</b>   |                                      |                      |
| <b>CURRENT ASSETS</b>   |                                      |                      |
| Cash and cash equivalents   | \$                                   | \$ 1,578             |
| Accounts receivable, net  | 11,266                               | 8,681                |
| Inventories   | 2,283                                | 558                  |
| Prepaid expenses  | 261                                  | 159                  |
| Income taxes receivable   | 313                                  | 284                  |
| Total current assets  | 14,123                               | 11,260               |
| <b>PROPERTY AND EQUIPMENT, net</b>  | 1,381                                | 1,033                |
| <b>COMPUTER SOFTWARE COSTS, net</b>   | 3,243                                | 2,844                |
| <b>GOODWILL</b>   | 2,431                                | 2,431                |
| <b>OTHER INTANGIBLE ASSETS, net</b>   | 2,206                                | 2,359                |
| <b>DEFERRED TAX ASSET</b>   | 26                                   |                      |
| Total assets  | <b>\$ 23,410</b>                     | <b>\$ 19,927</b>     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                      |                      |
| <b>CURRENT LIABILITIES</b>  |                                      |                      |
| Accounts payable  | \$ 4,155                             | \$ 2,600             |
| Deferred revenue  | 6,674                                | 8,014                |
| Deferred tax liability  | 886                                  | 693                  |
| Bank line of credit   | 3,187                                |                      |
| Current portion of notes payable  | 466                                  | 456                  |
| Current portion of subordinated notes payable to shareholders   | 64                                   | 58                   |
| Total current liabilities   | 15,432                               | 11,821               |
| <b>LONG-TERM DEFERRED TAX LIABILITY, net</b>  |                                      | 226                  |
| <b>NOTES PAYABLE, less current portion</b>  | 268                                  | 618                  |
| <b>SUBORDINATED NOTES PAYABLE TO SHAREHOLDERS, less current portion</b>   | 719                                  | 783                  |
| Total liabilities   | 16,419                               | 13,448               |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                                      |                      |
| <b>SHAREHOLDERS EQUITY</b>  |                                      |                      |
| Preferred stock - \$0.001 par value; 15,000 shares authorized; 6,740 shares issued and outstanding                      | 7                                    | 7                    |
| Common stock - \$0.001 par value; 40,000 shares authorized; 6,584 and 6,541 shares issued and outstanding, respectively | 7                                    | 7                    |
| Additional paid-in capital  | 9,373                                | 9,249                |
| Accumulated deficit   | (2,276)                              | (2,700)              |
| Unearned stock compensation   | (120)                                | (84)                 |
| Total shareholders equity   | 6,991                                | 6,479                |
| Total liabilities and shareholders equity   | <b>\$ 23,410</b>                     | <b>\$ 19,927</b>     |

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

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

| <i>(Amounts in thousands)</i>                           | <b>Common<br/>Stock</b> | <b>Preferred<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Accumulated<br/>Deficit</b> | <b>Unearned<br/>Stock<br/>Compensation</b> | <b>Total</b> |
|---|-------------------------|----------------------------|---|--------------------------------|--|--------------|
| <b>Balances at December 31, 2010</b>                    | \$ 7                    | \$ 7                       | \$ 9,249                                  | \$ (2,700)                     | \$ (84)                                    | \$ 6,479     |
| Common stock based compensation                         |                         |                            | 22  |                                |  | 22           |
| Issuance of stock options                               |                         |                            | 102                                       |                                | (102)                                      |              |
| Stock option based compensation                         |                         |                            |   |                                | 66   | 66           |
| Net income for the nine months ended September 30, 2011 |                         |                            |   | 424                            |  | 424          |
| <b>Balances at September 30, 2011</b>                   | \$ 7                    | \$ 7                       | \$ 9,373                                  | \$ (2,276)                     | \$ (120)                                   | \$ 6,991     |

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



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

*(Amounts in thousands)*

|   | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2011 | September 30,<br>2010 |
| <b>OPERATING ACTIVITIES</b>   |                       |                       |
| Net income  | \$ 424                | \$ 515                |
| Adjustments to reconcile net income to net cash (used for) provided by operating activities |                       |                       |
| Depreciation and amortization   | 1,684                 | 1,721                 |
| Stock compensation expense, net   | 88                    | 93                    |
| Deferred income taxes   | (59)                  | 168                   |
| Loss on disposal of property and equipment  |                       | 2                     |
| Changes in deferred and accrued amounts   |                       |                       |
| Accounts receivable   | (2,585)               | (1,107)               |
| Inventories   | (1,725)               | 1,711                 |
| Prepaid expenses  | (102)                 | (51)                  |
| Accounts payable  | 1,555                 | 1,077                 |
| Deferred revenue  | (1,340)               | (2,230)               |
| Income taxes receivable/payable   | (29)                  | (11)                  |
| Net cash (used for) provided by operating activities  | (2,089)               | 1,888                 |
| <b>INVESTING ACTIVITIES</b>   |                       |                       |
| Purchases of property and equipment   | (842)                 | (604)                 |
| Capitalization of computer software   | (1,436)               | (1,285)               |
| Net cash used for investing activities  | (2,278)               | (1,889)               |
| <b>FINANCING ACTIVITIES</b>   |                       |                       |
| Net borrowings under line of credit   | 3,187                 | 1,241                 |
| Repayments of notes payable   | (398)                 | (1,245)               |
| Proceeds from exercise of stock options and warrants  |                       | 5                     |
| Net cash provided by financing activities   | 2,789                 | 1                     |
| Net change in cash and cash equivalents   | (1,578)               |                       |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                       | 1,578                 |                       |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>   | \$                    | \$                    |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                                   |                       |                       |
| Cash paid during the period for:  |                       |                       |
| Interest  | \$ 134                | \$ 199                |
| Income Taxes  | \$ 7                  | \$ 287                |

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



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**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, the Company concluded a series of recapitalization transactions which began January 31, 2005 with a change in control due to the purchase of a majority of the Company's common stock by Computer Software Innovations, Inc., a South Carolina corporation (CSI South Carolina). These transactions culminated on February 11, 2005 with the merger of CSI South Carolina into the Company (reverse merger), the Company's issuance of preferred stock, common stock, warrants and certain subordinated notes, and the change of the Company's name to Computer Software Innovations, Inc. At the time, VerticalBuyer was a public shell, having disposed of all prior operations, and CSI South Carolina merged into the shell in a reverse merger transaction, which is a transaction whereby the historical records of VerticalBuyer prior to the merger, for future reporting purposes become those of acquirer, in this case CSI South Carolina, as the prior operations of VerticalBuyer are not comparable to its future operations, which are those carried over from CSI South Carolina. The Company's historical references are now to operations reported under CSI South Carolina since its start in late 1989 and formal organization in 1990. Thus CSI's operations have existed for more than 20 years, 10 years beyond its new corporate organization's (VerticalBuyer's) incorporation which occurred in 1999.

**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 began as an internal developer of software in 1989. The Company's internally developed software consists of its original product line, fund accounting based financial management software (the results of which are reported through its Financial Management Applications Segment), which is now accompanied by other internal applications development, including standards-based lesson planning software, solutions that facilitate single sign-on application access management provisioning based on Microsoft's Identity Lifecycle Management, referred to as its identity and access management solutions, cloud-based communications and collaboration solutions, including both hosted email and hosted voice-over-internet, using internet protocol (VoIP) services, and Microsoft SharePoint deployments (the results of which are all reported through its Cloud Services Segment). 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. The Company's solutions for single sign-on application access management provide the ability to eliminate the need for users to sign on to every application separately (thereby allowing single sign-on) and provides for other efficiencies related to setting-up and controlling user access. The Company's hosted email solutions and hosted VoIP solutions focus on making security and administration of email and VoIP telecommunications more efficient and up-front cost of adoption of the technology lower for its primary kindergarten through grade 12 (K-12) market space.

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 (the results of which are reported through its Technology Solutions Segment). The Company added its Technology solutions segment in 1999 to meet the needs of customers to have infrastructure adequate to run its software applications. Its Technology solutions include computers, networking, security, internet protocol (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. The Company also markets to other verticals such as mid- and larger-sized commercial businesses and healthcare businesses. The majority of the Company's business is with K-12 public education and local government entities, although many of its solutions are also applicable to the commercial market space. The majority of the Company's customers are located in the southeastern United States (US) but, primarily with its cloud products, the Company is adding customers in other US regions.



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### **Disclosure regarding segments**

The Company reports its operations under three operating segments: the Financial Management Applications Segment, the Cloud Services Segment and the Technology Solutions Segment.

#### ***Financial Management Applications Segment***

Through the Financial Management Applications Segment, the Company reports the results of the development, sales, and deployment and provision of ongoing support of its fund accounting based financial management software. Through this segment, the Company also reports the results of operations related to complimentary third-party applications and services and supplies the Company resells supporting or complementing the use of its Financial Management Applications.

#### ***Cloud Services Segment***

Through the Cloud Services Segment, the Company reports the results of the development, integration, sales and deployment of its proprietary standards based lesson planning software, solutions that facilitate single sign-on application access management provisioning based on Microsoft's Identity Lifecycle Management, cloud-based communication and collaboration solutions, based on Microsoft's Live@edu hosted exchange and SharePoint environments and Microsoft SharePoint deployments, and for Hosted VoIP (voice calls over Internet protocol via off premises hosting). Through this segment the Company also reports the results of operations related to complimentary third-party applications and services which are an integral part of its Cloud Services solutions.

#### ***Technology Solutions Segment***

Through the Technology Solutions Segment, the Company reports the results of the technology solutions products through the sales and distribution of computers, infrastructure and physical security hardware and accessories and the wide range of technology consulting services, including network and systems integration and computer support and maintenance services, that the Company provides.

### **Basis of presentation**

The consolidated financial statements include CSI Technology Resources, Inc., a wholly-owned subsidiary. CSI Technology Resources, Inc. was acquired by CSI on May 1, 2000 and became the Technology Solutions Segment of CSI. This subsidiary no longer has any significant operations or separate accounting, as all activities are now accounted for within CSI, except that certain vendor contracts are still in the name of CSI Technology Resources, Inc. At a future date, the name on these contracts may be converted and the subsidiary deactivated, subject to a review of any tax or legal implications. As the Company files a consolidated tax return and has been accounting for all activities through the parent, there should be no financial or tax implications related to the formal procedures which would be undertaken to deactivate the subsidiary. Intercompany balances and transactions have been eliminated. The Company uses the accrual basis of accounting.

### **Reclassification**

Certain prior period amounts have been reclassified to the current presentation. Such reclassifications had no impact on previously reported net income, or shareholders' equity.

### **Use of estimates and interim adjustments and seasonal considerations impacting financial results**

The accounting and reporting policies conform to accounting principles generally accepted in the United States of America (generally accepted accounting principles or GAAP). GAAP requires Company management (Management) to make estimates, assumptions and judgments and to rely on projections of future results of operations and cash flows. Those estimates, assumptions, judgments and projections are an integral part of the consolidated financial statements. The Company's management bases its 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 Company management believes 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 its consolidated financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

Management's judgments are based on its assessment as to the effect certain estimates, assumptions of future trends or events may have on the financial condition and results of operations reported in the Company's consolidated financial statements. Actual results could differ materially

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from these estimates, assumptions, projections and judgments.

The interim consolidated balance sheet and the related consolidated statements of operations, and the changes in shareholders' equity and cash flows are unaudited. In Management's opinion, all adjustments (consisting of normal recurring

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adjustments) necessary for fair presentation of the interim financial statements have been made. The results of the three and nine month periods ended September 30, 2011 are not necessarily indicative of the results to be expected for the full year. The Company's operations are seasonal, being driven by its primary client base, K-12 schools being closed or having significantly reduced operations during the summer months. At such time infrastructure and systems changes are less disruptive to their operations and so during such times they prefer to have a larger number of projects completed. As a result, and with the Company's fiscal quarter corresponding to the calendar year, the results for the Company's first and fourth quarters of each fiscal year when schools are in session are typically lower than the results for its second and third quarters, which contain the summer months when schools are closed or have significantly reduced operations. These consolidated 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 the Company's most recent Annual Report on Form 10-K.

**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 September 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-08, which is intended to simplify testing for goodwill impairment. This guidance gives an entity the option to first assess qualitative factors to determine if it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. This guidance will be effective for the Company beginning January 1, 2012. Management is currently evaluating the impact of this update on the Company's financial statements, but they do not expect the adoption of this guidance to have a material impact on the Company's financial position, results of operations, or cash flows.

In May 2011, FASB issued ASU No. 2011-04, which clarifies and changes fair value measurement and disclosure requirements. This guidance expands existing disclosure requirements for fair value measurements and makes other amendments but does not require additional fair value measurements. This guidance will be effective for the Company beginning January 1, 2012. Management does not expect the adoption of this guidance to have a material impact on the Company's financial position, results of operations, or cash flows.

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.

**NOTE 2 EARNINGS PER SHARE**

Basic earnings per share are computed by dividing net income by the weighted average number of common stock shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of common and potential common shares outstanding, including common stock held in escrow, 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, 2011 and 2010, both prior to and after application of the treasury stock method.

|  | For the Three Months Ended<br>September 30, |               | For the Nine Months Ended<br>September 30, |               |
|--|---|---------------|--|---------------|
|  | 2011  | 2010          | 2011                                       | 2010          |
| <b>Weighted Average Shares Outstanding Prior to Application of the Treasury Stock Method</b> |   |               |  |               |
| Common stock (excluding shares held in escrow)   | 6,577                                       | 6,522         | 6,565                                      | 6,490         |
| Common stock held in escrow  | 200   | 500           | 200  | 500           |
| Preferred stock  | 6,740                                       | 6,740         | 6,740                                      | 6,740         |
| Warrants   |   | 300           | 167  | 1,226         |
| Options  | 727   | 642           | 604  | 545           |
| <b>Total Weighted Average Shares Outstanding</b>   | <b>14,244</b>                               | <b>14,704</b> | <b>14,276</b>                              | <b>15,501</b> |

**Weighted Average Shares Outstanding After Application of the Treasury Stock Method**

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Common stock (excluding shares held in escrow)                  | 6,577  | 6,522  | 6,565  | 6,490  |
| Common stock held in escrow                                     | 200    | 500    | 200    | 500    |
| Preferred stock   | 6,740  | 6,740  | 6,740  | 6,740  |
| Warrants  |        |        |        |        |
| Options   | 124    | 150    | 124    | 159    |
| Total Weighted Average Shares Outstanding treasury stock method | 13,641 | 13,912 | 13,629 | 13,889 |



**Table of Contents****NOTE 3 STOCK-BASED COMPENSATION**

The Company has a stock based compensation plan, established in 2005, (the 2005 Incentive Compensation Plan ). The Company accounts for stock based compensation using the fair value method prescribed in the Stock Compensation section of the FASB's Accounting Standards Codification ( ASC ), which the Company adopted in 2006 using the modified prospective method. The Company utilizes the Black-Scholes model to estimate the fair value of options granted. In 2005, the Company assumed the stock based employee compensation plan of CSI South Carolina as a result of the reverse merger.

The Company has granted options to purchase shares of common stock in connection with acquisitions, certain hiring agreements and to incent and encourage the longevity of senior employees through option vesting. The issuance of options is further detailed below. The fair value of stock-based compensation was estimated at the grant date for each issuance using the Black-Scholes option-pricing model. For further information and discussion related to the weighted average assumptions used in the option pricing model please see the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

*Assumptions used in calculation of fair value*

|                          | For the Nine Months Ended September 30, |      |
|--------------------------|---|------|
|                          | 2011                                    | 2010 |
| Expected term (in years) | 7                                       | 7    |
| Expected volatility      | 208%                                    | 169% |
| Expected dividend yield  | 0.0%                                    | 0.0% |
| Risk-free interest rate  | 2.3%                                    | 2.8% |

*Stock options*

| Detail                                       | Number of Options | Weighted Average |                  |
|--|-------------------|------------------|------------------|
|  |                   | Exercise Price   | Expiration       |
| Options assumed in reverse merger            | 158               | \$ 0.12          | November 1, 2012 |
| Options granted to key employees             | 100               | \$ 1.42          | November 9, 2017 |
| Options granted to other employees           | 10                | \$ 1.09          | May 28, 2018     |
| Options granted to key employees             | 50                | \$ 0.70          | April 17, 2019   |
| Options granted to a key and other employees | 196               | \$ 0.70          | June 1, 2020     |
| Options granted to a key and other employees | 213               | \$ 0.70          | June 1, 2021     |

The following table summarizes option activity under the plans for the three months ended September, 30 2011.

| Stock Options                     | Number of Shares | Weighted Average         |                            | Aggregate Intrinsic Value |
|-----------------------------------|------------------|--------------------------|----------------------------|---------------------------|
|                                   |                  | Exercise Price per Share | Remaining Contractual Term |                           |
| Outstanding at June 30, 2011      | 727              | \$ 0.68                  | 7.12                       | \$ 236                    |
| Granted                           |                  |                          |                            |                           |
| Cancelled                         |                  |                          |                            |                           |
| Exercised                         |                  |                          |                            |                           |
| Forfeited/expired                 |                  |                          |                            |                           |
| Outstanding at September 30, 2011 | 727              | \$ 0.68                  | 6.87                       | \$                        |
| Exercisable at September 30, 2011 | 383              | \$ 0.65                  | 4.49                       | \$                        |



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The following table summarizes option activity under the plans for the first nine months of 2011.

| Stock Options                     | Number of Shares | Weighted Average Exercise Price per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|-----------------------------------|------------------|---|---|---------------------------|
| Outstanding at December 31, 2010  | 615              | \$ 0.68                                   | 6.31  | \$                        |
| Granted                           | 213              | 0.70                                      |   |                           |
| Cancelled                         |                  |   |   |                           |
| Exercised                         |                  |   |   |                           |
| Forfeited/expired                 | (101)            | 0.76                                      |   |                           |
| Outstanding at September 30, 2011 | 727              | \$ 0.68                                   | 6.87  | \$                        |
| Exercisable at September 30, 2011 | 383              | \$ 0.65                                   | 4.49  | \$                        |

The aggregate intrinsic value represents the difference between the Company's closing stock price of \$0.50 as of September 30, 2011 and the exercise price multiplied by the number of options outstanding as of that date. Because the weighted average exercise price is higher than the market price of \$0.50 per share as of September 30, 2011, the aggregate intrinsic value is reflected at \$0.

As of September 30, 2011 there remained \$120 of unrecognized compensation cost related to non-vested stock options which is expected to be recognized over a weighted-average period of approximately three years.

The Company issued 32 shares of common stock to outside Board of Directors and 213 employee stock options under the plan in the first nine months of 2011. There were no other issuances of common stock during the period.

Total stock based compensation for the three months ended September 30, 2011 was \$32, of which \$7 related to the stock issued to the Company's outside Directors and \$25 is related to employee stock compensation (wage-related). Total stock based compensation for the three months ended September 30, 2010 was \$32, of which \$7 related to the stock issued to the Company's outside Board of Directors, \$1 related to stock options granted from acquisition, and the remaining \$24 is related to employee stock compensation (wage-related).

Total stock based compensation for the nine months ended September 30, 2011 was \$88, of which \$22 related to the stock issued to the Company's outside Directors and \$66 is related to employee stock compensation (wage-related). Total stock based compensation for the first nine months of 2010 was \$93, of which \$22 related to the stock issued to the Company's investor relations firm, \$22 related to the stock issued to the Company's outside Board of Directors, \$5 related to stock options granted from acquisition, and the remaining \$44 is related to employee stock compensation (wage-related).

Employee stock compensation (wage related) is included in the Statements of Operations categories of cost of sales or departmental operating expense categories as appropriate.

**NOTE 4 LONG-TERM AND SHORT-TERM DEBT, INCLUDING RELATED PARTY TRANSACTIONS, AND OFF-BALANCE SHEET INSTRUMENTS**

*Bank Credit Facilities*

The Company maintains a line of credit facility with its bank. The terms of the facility are as follows:

the principal amount of the facility is \$7.8 million;

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the latest renewal was on September 21, 2011, with a maturity date of July 3, 2013;

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

the definition of the borrowing base includes 50% of eligible inventory (with a maximum borrowing ability against eligible inventory of \$1.0 million), in addition to 80% of eligible accounts receivable.

On September 21, 2011, the Company entered into a modification of the line of credit facility, extending the maturity date from June 30, 2012 to July 3, 2013. Previously, on June 25, 2010, the Company entered into a modification of the line of credit facility temporarily increasing the line of credit from \$7.0 million to \$8.0 million and this increase will be reduced annually by \$200 beginning January 31, 2011 until the balance reaches \$7.0 million on January 31, 2015 (assuming the facility would be customarily renewed with no significant change in borrowing ability and working capital needs). The

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increase in the bank's revolving line of credit from \$7.0 million to \$8.0 million was for the purpose of accommodating a capital need to fund the June 2010 payments of \$875, paid on and as agreed in an extension of, the Subordinated Notes (discussed below), while deferring any immediate impact on working capital line availability.

Other than the amendments noted above, the material obligations and provisions of the facility remain unchanged. Previous 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 acquisitions, including the use of bank credit facility advances to fund such acquisitions, and incurring related mortgage indebtedness for acquired real estate subsequently sold. The bank also waived any cross-default relating to the subordinated notes payable to certain shareholders, which the Company did not repay at their May 2006 maturity. Such waivers and prior modifications have been disclosed in the Company's previous filings on Forms 10-K, 10-Q and 8-K.

Under the Company's bank facility, eligible accounts receivable balances essentially include all of the Company's 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 the Company's management have determined to be of doubtful collectability; and (iii) accounts due from any one of the Company's customers if such accounts constitute more than 20% of the total eligible accounts. The loans bear interest at LIBOR plus 2.50%, subject to a 3% floor, payable monthly. LIBOR plus 2.50% was 2.72% at September 30, 2011 and 2.76% at December 31, 2010.

The Company's domestic asset-based lending agreement was negotiated to exceed one year with the intent that borrowings on the revolving credit facility would be classified as long-term debt. However, pursuant to the Debt-Classification of Revolving Credit Agreements Subject to Lock-Box Arrangement and Subjective Acceleration Clauses subtopic of the FASB's ASC (the Revolving Credit Subtopic), a revolving credit facility which includes both a subjective acceleration clause and a lock-box arrangement should be classified as a current liability. The Company's revolving credit facility provides for a lock-box arrangement, whereby cash received is used to reduce the balance on a daily basis. Also, the Company's revolver includes a subjective acceleration clause, providing for acceleration upon a material change in the Company's business or financial condition. This is a customary provision for revolving credit agreements. In accordance with the Revolving Credit Subtopic, the balance outstanding under the Company's revolving credit facility has been classified as a current liability.

The Company maintains an equipment term loan which has been modified and increased from time to time with a term of three to four years. The term loan is used periodically to refinance the Company's capital expenditures initially financed through its bank credit facility and improve its availability under its bank credit facility for working capital purposes. The latest modification prior to September 30, 2011 was November 5, 2010. Pursuant to the modification, the equipment loan was increased from \$113 to \$1.1 million, and bore interest at 30-day LIBOR plus 250 basis points. Principal and interest are payable in thirty consecutive monthly payments of principal and interest of \$40 continuing until April 30, 2013.

The amount outstanding on the equipment notes payable to the bank was \$734 at September 30, 2011 and \$1,074 at December 31, 2010.

Scheduled principal payments under the Company's bank notes payable for the years ending December 31 are presented below:

|                          |        |
|--------------------------|--------|
| 2011                     | \$ 115 |
| 2012                     | 469    |
| 2013                     | 150    |
| Total Principal Payments | \$ 734 |

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, and 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. This ratio is calculated by adding certain nonrecurring special items to EBITDA ( Adjusted 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 or loss from continuing operations (excluding extraordinary gains or losses), and to the extent deducted in determining net income or loss (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

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measured annually. 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. Management is not aware of any debt covenant violations at September 30, 2011 and December 31, 2010.

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The amended loan agreement also contains certain restrictive covenants. These include general prohibitions on: 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. There was \$3,187 of draws outstanding as of September 30, 2011 and no draws as of December 31, 2010.

### *Subordinated Notes*

The Company has subordinated notes payable to shareholders with amounts outstanding totaling \$783 at September 30, 2011, and \$841 at December 31, 2010. On June 25, 2010, the Company and each of the holders of certain Subordinated Promissory Notes dated February 11, 2005 (the Subordinated Notes) entered into an Extension of Subordinated Notes and Waiver dated June 24, 2010 (the Extension). Pursuant to the Extension:

the Company agreed to make, within five days of the date of approval of the Extension, principal payments on the notes totaling \$875, \$438 in the case of the Subordinated Note held by Barron Partners LP (Barron) and \$88 each in the case of the other five note holders. These payments were made on June 29, 2010.

the maturity date of each Subordinated Note was extended from August 30, 2009 until no later than January 1, 2018, on which date all principal and accrued interest will be due and payable in full, if not earlier paid.

the Company, beginning October 1, 2010, will make quarterly payments on the Subordinated Notes of principal and accrued interest in the amount of \$50 in the aggregate to be applied pro-rata among the note holders, \$25 on the Barron Subordinated Note and \$5 each on the other Subordinated Notes.

the Company expressed its intention to consider subsequent to each fiscal year end during the term of the Subordinated Notes whether it can make principal payments in addition to those expressly set forth in the Extension. Any such determination by the management and board of directors of the Company is in their sole discretion, and shall be based on factors they deem relevant, including but not limited to the financial performance of the Company during such fiscal year.

at the discretion of management and the board of directors of the Company, the remaining balance on the Subordinated Notes can be repaid in full at any time without penalty.

the Subordinated Notes will no longer be in default, and each note holder waived any existing or past default based upon the Company failing to make any payment of interest or principal when due.

despite the Subordinated Notes not being in default, they will continue to bear interest at the Default Rate of 15% until repaid.

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except as modified by the Extension, all other terms and conditions of the Subordinated Notes were confirmed and shall remain in full force and effect.

The Subordinated Notes were issued on February 11, 2005 as a part of our reverse merger and recapitalization. The Subordinated Notes are unsecured and are subordinated to the Company's senior debt, including its revolving credit and term debt with its bank lender. The original principal of all of the Subordinated Notes aggregated \$3,750. At June 25, 2010, immediately prior to the Extension, principal on the Subordinated Notes totaled \$1,750 and accrued interest totaled \$62. The Company has paid interest at the default rate of 15% per annum since the original maturity date of May 9, 2006, when the Company, with the support of its management, board of directors and the Bank elected to defer the payment and pay the default interest rate to use the funds to support working capital needs and investments in acquisitions. The Subordinated Notes were extended several times, the latest being June 25, 2010, as described above, when the maturity date was extended to January 1, 2018. The history of the Subordinated Notes has been previously disclosed in the Company's Form 8-K dated September 3, 2009, as well as in its prior Forms 10-Q and Forms 10-K.

In addition to Barron, which owns all of our preferred stock, the Subordinated Notes are held by the five shareholders of our predecessor, Computer Software Innovations, Inc., a South Carolina corporation. Four of these note holders are currently



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executive officers of the Company, and include: Nancy K. Hedrick, President and Chief Executive Officer; Thomas P. Clinton, Senior Vice President of Strategic Relationships; Beverly N. Hawkins, Senior Vice President of Software Development; and William J. Buchanan, Senior Vice President of Technical Delivery and Support. The fifth holder, Joe G. Black, formerly served as chief financial officer of the Company. The Extension and the related restructuring of the Subordinated Notes were approved by the Company's three outside directors, none of whom have any interest in the Subordinated Notes.

The restructuring of the Subordinated Notes permits the Company to repay the remaining principal over the approximate seven-year period following the restructure. Although the Company may choose to repay the Subordinated Notes earlier, particularly as a result of superior financial performance, the arrangement removes a default and gives the Company flexibility in managing its future liquidity and capital needs. Such future needs might include future acquisitions, and increased working capital relating to significant sales growth as a result of a turnaround in the general economy or increased Federal funding of technology expenditures for education.

The Extension was formulated in cooperation with the Company's primary lender, RBC Bank (USA) (the Bank), which had previously waived any cross default under the Bank's revolving and other credit facilities as a result of the previous default under the Subordinated Notes. In conjunction with the Company entering into the Extension, it also entered into a related modification of its credit facilities with the Bank.

Scheduled principal payments under the Company's subordinated notes payable for the years ending December 31 are presented below:

|                              |            |
|------------------------------|------------|
| 2012                         | \$ 87      |
| 2013                         | 101        |
| 2014                         | 117        |
| 2015                         | 136        |
| Thereafter                   | 342        |
| <br>Total Principal Payments | <br>\$ 783 |

*Off Balance Sheet Instruments*

As of September 30, 2011, and for the periods reported, and through the filing date, CSI had no off-balance sheet instruments except for certain operating leases discussed in Note 7.

*Related Party Transactions*

During the first nine months of 2011 the Company made principal and interest payments to the five former shareholders of CSI - South Carolina, all of whom are significant shareholders of the Company, and four of whom are executive officers, and Barron, who owns all of the Company's preferred shares. These payments were made on the subordinated notes payable which were associated with the reverse merger transaction which occurred in 2005, and represented an annual interest rate of 15% as of September 30, 2011. In 2011, principal and interest payments to the five original shareholders of CSI - South Carolina totaled \$75 and principal and interest payments to Barron also totaled \$75.

**NOTE 5 - PREFERRED STOCK AND RELATED WARRANTS**

**Warrants**

On February 11, 2005, pursuant to the terms of a Preferred Stock Purchase Agreement with Barron, the Company issued to Barron common stock purchase warrants to purchase a total of 7,218 shares of our common stock (Barron warrants). The unexercised portion of these warrants, detailed below, expired on February 11, 2010.

Barron warrant exercises could have been accomplished in one or a series of transactions, subject to a 4.9% beneficial ownership restriction. The terms and conditions of the Barron warrants were identical except with respect to the exercise price.

On May 13, 2009, pursuant to the terms of a Consulting Agreement with DC Consulting, LLC whereby DC Consulting provided investor relations services, the Company issued to DC Consulting common stock purchase warrants to purchase a total of 300 shares of our common stock. Under the agreement, if at any time prior to their stated expiration date (noted below) the market price for the Company's common stock

equals or exceeds the warrant exercise price for a period of 30 days, and the warrants are not exercised, they expire.

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Activity related to the common stock purchase warrants for the three and nine month periods ended September 30, 2011 and 2010 and outstanding balances are as follows:

*Common Stock Purchase Warrants*

|                 | Warrant A1 | Warrant A2 | Warrant B1 | Warrant B2 | DC Consulting Warrant | DC Consulting Warrant | DC Consulting Warrant |
|-----------------|------------|------------|------------|------------|-----------------------|-----------------------|-----------------------|
| Exercise Price  | \$ 1.3972  | \$ 0.70    | \$ 2.0958  | \$ 0.85    | \$ 0.70               | \$ 1.00               | \$ 1.20               |
| Expiration Date | 2/10/2010  | 2/10/2010  | 2/10/2010  | 2/10/2010  | 6/1/2011              | 6/1/2011              | 6/1/2011              |

*Warrant related activity for the three months ended September 30, 2011*

|   | Warrant A1 | Warrant A2 | Warrant B1 | Warrant B2 | DC Consulting Warrant | DC Consulting Warrant | DC Consulting Warrant |
|---|------------|------------|------------|------------|-----------------------|-----------------------|-----------------------|
| Outstanding at June 30, 2011                    |            |            |            |            | 100                   | 100                   | 100                   |
| Issued three months ended September 30, 2011    |            |            |            |            |                       |                       |                       |
| Exercised three months ended September 30, 2011 |            |            |            |            |                       |                       |                       |
| Expired three months ended September 30, 2011   |            |            |            |            | (100)                 | (100)                 | (100)                 |

Outstanding at September 30, 2011

*Warrant related activity for the three months ended September 30, 2010*

|   | Warrant A1 | Warrant A2 | Warrant B1 | Warrant B2 | DC Consulting Warrant | DC Consulting Warrant | DC Consulting Warrant |
|---|------------|------------|------------|------------|-----------------------|-----------------------|-----------------------|
| Outstanding at June 30, 2010                    |            |            |            |            | 100                   | 100                   | 100                   |
| Issued three months ended September 30, 2010    |            |            |            |            |                       |                       |                       |
| Exercised three months ended September 30, 2010 |            |            |            |            |                       |                       |                       |
| Expired three months ended September 30, 2010   |            |            |            |            |                       |                       |                       |

Outstanding at September 30, 2010

*Warrant related activity for the nine months ended September 30, 2011*

|  | Warrant A1 | Warrant A2 | Warrant B1 | Warrant B2 | DC Consulting Warrant | DC Consulting Warrant | DC Consulting Warrant |
|--|------------|------------|------------|------------|-----------------------|-----------------------|-----------------------|
| Outstanding at December 31, 2010               |            |            |            |            | 100                   | 100                   | 100                   |
| Issued nine months ended September 30, 2011    |            |            |            |            |                       |                       |                       |
| Exercised nine months ended September 30, 2011 |            |            |            |            |                       |                       |                       |
| Expired nine months ended September 30, 2011   |            |            |            |            | (100)                 | (100)                 | (100)                 |

Outstanding at September 30, 2011

*Warrant related activity for the nine months ended September 30, 2010*

|                                  | Warrant A1 | Warrant A2 | Warrant B1 | Warrant B2 | DC Consulting Warrant | DC Consulting Warrant | DC Consulting Warrant |
|----------------------------------|------------|------------|------------|------------|-----------------------|-----------------------|-----------------------|
| Outstanding at December 31, 2009 | 2,000      | 555        | 2,000      | 1,609      | 100                   | 100                   | 100                   |

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Issued nine months ended September 30, 2010

Exercised nine months ended September 30, 2010

Expired nine months ended September 30, 2010

(2,000) (555) (2,000) (1,609)

Outstanding at September 30, 2010

100 100 100

**Table of Contents****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 could also demand the registration of all or part of such shares on a one-time basis and, pursuant to piggy-back rights, could require the Company (subject to carve back by a managing underwriter) to include such shares in certain registration statements it may file. The Company was obligated to pay all expenses in connection with the registration of the shares. The Company's registration rights obligation ended with the expiration of the warrants held by Barron on February 10, 2010.

**NOTE 6 INCOME TAXES**

The effective tax rates for the three months ended September 30, 2011 and 2010 were approximately -5.9% and 43.3%, respectively.

The effective tax rates for the nine months ended September 30, 2011 and 2010 were approximately -24.0% and 46.2%, respectively.

Income tax expense decreased by \$0.3 million or 115% compared to the third quarter of 2010, to a tax benefit of under \$0.1 million in the third quarter of 2011. The decrease in tax expense was due to a lower effective rate when compared to the prior year, primarily in connection with increased deferred tax assets recorded for additional South Carolina Jobs Tax Credits in connection with an increase in sustained jobs and potential utilization of future credits in connection with the new solutions introduced in the Cloud Services Segment.

The income tax provision or benefit for the interim periods presented is computed to arrive at the estimate of the effective rate expected to be applicable in each respective full year using the statutory rate. Income tax expense recorded in the consolidated financial statements differs from the federal statutory income tax rate due to a variety of factors, including state income taxes, non-deductible meals and entertainment expenses, and other miscellaneous permanent differences. Due to the dollar size of non-deductible items, primarily related to the volume of meals paid for engineers traveling to customer sites, when net income is closer to zero, either positively or (when there is a loss) negatively the effective tax rate is significantly higher (or when there is a loss closer to zero, the effective benefit rate is significantly lower) than the federal statutory income tax rate. The effective tax rate was also reduced during the quarter when the Company recorded tax credits related to investment and research credits and credits available under the South Carolina Jobs Tax Credit program. The Company recorded these credits in connection with changes in the estimated amounts the Company may record and realize based on management's estimates of future income.

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

The Company leases certain facilities and equipment under various operating leases. At September 30, 2011, future minimum lease payments under non-cancelable leases were:

|              |                 |
|--------------|-----------------|
| 2011         | \$ 286          |
| 2012         | 1,073           |
| 2013         | 928             |
| 2014         | 701             |
| 2015         | 185             |
| 2016         | 46              |
| <b>Total</b> | <b>\$ 3,219</b> |

Rent expense for the three months ended September 30, 2011 and 2010 was \$281 and \$253, respectively. Rent expense for the nine months ended September 30, 2011 and 2010 was \$845 and \$770, respectively.

The Company entered into an operating lease on November 30, 2005 related to the lease of its office facility. The building comprises 32,163 square feet, with approximately 7,600 square feet being warehouse space. On February 8, 2011, the Company extended this lease for five years, now ending on March 31, 2016, with monthly payments of \$15 due on the first of each month. The total commitment of the five-year renewal totals \$925 and is included in the future payments in the table above. If at any time the Company terminates the lease, the lessor may recover

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from the Company all damages approximately 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.

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On April 1, 2008 the Company entered into a one year lease with Edge Developments, LLC for 18,000 square feet of warehouse space located at 903B East Main Street, Easley, SC. The terms of this lease required monthly payments of \$4, which are included in the rent expense disclosed above, and expired on March 31, 2010. On March 23, 2010, the Company entered into a one year lease with Edge Developments, LLC for 30,000 square feet of warehouse space at 903A East Main Street, Easley, SC. The terms of this lease require monthly payments of \$5, which are included in rent expense above, and expired on March 31, 2011, at which point the Company occupied the facility under a month to month arrangement. On July 8, 2011, the Company amended the lease dated March 23, 2010. This amendment now requires monthly payments of \$6 and extends the terms of the lease for one year. The lease is now set to expire on June 30, 2012. The future minimum lease payments under this lease are included in the schedule above.

In December 2008, the Company entered into a lease with the University of South Alabama Research and Technology Corporation for the lease by the Company of 11,110 square feet of office space located at 650 Clinic Drive, Suite 1150, Mobile, AL 36688. The term of the Lease began in March 2009 and runs through June 2012. The lease calls for annual rent of \$142, payable monthly. The future minimum lease payments under this lease are included in the schedule above.

On April 1, 2008, in connection with the acquisition of ICS, the Company entered into a lease with Byers Properties, LLC for the lease by the Company of the former single-story brick facilities of ICS comprising 7,207 square feet, including approximately 300 square feet of warehouse space located at 8518 Triad Drive, Colfax, North Carolina. Byers Properties is controlled by Michael Byers, who is the sole shareholder of ICS. The term of the Lease began April 1, 2008 and ran for a period of three years through March 2011. The lease called for annual rent of \$80, payable monthly. In connection with the expiration of this lease, the Company elected to move its facilities to a smaller, 4,155 square feet space in a multi-story brick and glass commercial building at 5509-B West Friendly Avenue, Suite 304, Greensboro, NC 27410, with rent beginning April 1, 2011 and running through April 2014 at a beginning amount of \$4 per month subject to an annual increase in rent of 3%. This lease has a three year extension option also subject to the 3% increase in rent. The future minimum lease payments under this lease are included in the schedule above.

In August 2008, the Company entered into a corporate fleet lease program with Enterprise Fleet Services, for which individual vehicle open-ended leases are signed that may amount to a total commitment of \$2.0 million over a weighted-average lease term of approximately three years. This program provides for the Company to incur directly the costs of automobile related transportation for engineers and sales persons with a high amount of travel as a cost-savings effort when compared to the alternative of paying a mileage allowance for such transportation needs at the generally accepted, federal tax deductible rate, and the commitment includes insurance, certain maintenance and other committed costs. The future minimum lease payment for leases executed under the program as of September 30, 2011 is included in the schedule above.

**Executive Officer Employment Agreements**

The Company entered into new, separate employment agreements with each of the four most highly compensated executive officers on March 1, 2009, with terms similar to their prior agreements. The term of all the employment agreements is three years, expiring on February 28, 2012. The agreements renew for a one year term automatically upon the expiration of the initial term or any renewal periods unless sooner terminated by any one of the parties. Such agreements provide for minimum salary levels adjusted for performance based on review by the Board of Directors. The aggregate commitment for future salaries at September 30, 2011, excluding bonuses, is approximately \$361.

**NOTE 8 SEGMENT INFORMATION**

CSI is organized into the three reportable segments: the Financial Management Applications Segment, the Cloud Services Segment and the Technology Solutions Segment. Below is a description of the types of products and services from which each reportable segment derives its revenues.

***Financial Management Applications Segment***

Through the Company's Financial Management Applications Segment, the Company reports the results of the development, sales, and deployment and provision of ongoing support of our fund accounting based financial management software. Through this segment, the Company also reports the results of operations related to complimentary third-party applications and services the Company resells.

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### ***Cloud Services Segment***

Through the Company's Cloud Services Segment, the Company reports the results of the development, integration, sales and deployment of our proprietary standards based lesson planning software, solutions that facilitate single sign-on application access management provisioning based on Microsoft's Identity Lifecycle Management, cloud-based communication and collaboration solutions, based on Microsoft's Live@edu hosted exchange and SharePoint environments and Microsoft SharePoint deployments, and for Hosted VoIP. Through this segment the Company also reports the results of operations related to complementary third-party applications and services which are an integral part of the Company's solutions.

### ***Technology Solutions Segment***

Through the Company's Technology Solutions Segment, the Company reports the results of the technology solutions products through the sales and distribution of computers and accessories and the wide range of technology consulting services, including network and systems integration and computer support and maintenance services, that the Company provides.

### **Factors management used to identify the Company's 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 which sales and investment decisions may be made to evaluate existing or potential new products. Through its Financial Management Applications Segment, the Company develops, sells, deploys and provides ongoing support of its financial management software applications, which are generally sold to organizations financial personnel and generate the highest margins for the Company, and are more comparable to those of the software development industry in general. Through its Cloud Services Segment, the Company develops, integrates, sells, deploys and provides a variety of products primarily delivered through the Cloud (internet), which results in a higher level of commitment to Company hosted hardware to run the software, more so than historically required of the Financial Management Applications Segment. As a result, the margins of the Cloud Services Segment are expected to be, once the solutions gain traction in the market space, generally somewhere between those of its other two primarily software-based, or hardware-based segments. Through its Technology Solutions Segment, the Company provides technology solutions through the sale and distribution of primarily hardware-based solutions including computers and accessories and offers a wide range of technology consulting services, including network and systems integration and computer support and maintenance services. Due to the higher percent of hardware which compose its Technology Solutions Segment sales, this segment produces the lowest margins for the Company.

Prior to the year ended 2010, the Company reported its operations in two segments, the Software Applications Segment and the Technology Solutions Segment. In the process of its budgeting cycle in 2011, management elected to give more weight to the separation of the Cloud Services offerings due to consideration of the factors above and the recent introduction of additional offerings in this group and the amount of investment being made to support them. This also resulted in further breakout of the 2010 and 2009 year numbers for purposes of comparing historical information to the new budget format. As a result of this change in focus, the Company elected to report its year end numbers with the additional breakout of its former Software Applications Segment into the separate Financial Applications and Cloud Services Segments, increasing the number of segments reported from two to three. All prior year 2010 amounts have been restated to match the current year's segment reclassifications.

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 Statements of Operations. Operating expenses are allocated to segment income based on estimate 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 are allocated to our segments, since they are reviewed separately by management. Certain non-recurring items (those items occurring for reasons which have not occurred in the prior 2 years and are not likely to reoccur in 2 years) and compliance 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 non-recurring and compliance items, if any, is equal to Operating income as reported in our Consolidated Statements of Operations.

The total of Segment assets for all segments is equal to Total Assets as reported in our Consolidated Balance Sheets. The Company allocates cash and taxes receivable based on the segment's operating income. No cash is allocated when a segment reports ongoing losses. The Company allocates accounts receivable based on each segment's percent of revenues to total consolidated revenues. All other assets are allocated based on each segment's activities giving rise to the assets or need for or use of the assets (e.g., capitalized Computer Software costs, net, and, for Property and Equipment, net).





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The following tables summarize information about segment income (loss) for the three and nine months ended September 30, 2011 and 2010 and assets allocated to segments as of September 30, 2011 and 2010.

|  | Financial<br>Management<br>Applications | Cloud Services | Technology<br>Solutions | Total<br>Company |
|--|---|----------------|-------------------------|------------------|
| <b>Three months ended September 30, 2011</b> |   |                |                         |                  |
| Net sales and service revenue                | \$ 3,526                                | \$ 277         | \$ 13,471               | \$ 17,274        |
| Gross profit (loss)                          | 1,410                                   | (397)          | 2,392                   | 3,405            |
| Segment income (loss)                        | 524                                     | (752)          | 1,191                   | (*)              |
| Segment assets                               | 9,186                                   | 3,100          | 11,124                  | 23,410           |
| <b>Three months ended September 30, 2010</b> |   |                |                         |                  |
| Net sales and service revenue                | \$ 3,381                                | \$ 214         | \$ 10,871               | \$ 14,466        |
| Gross profit (loss)                          | 1,460                                   | (206)          | 1,762                   | 3,016            |
| Segment income (loss)                        | 633                                     | (532)          | 709                     | (*)              |
| Segment assets                               | 8,302                                   | 2,431          | 7,661                   | 18,394           |

\* See reconciliation below

|   | Financial<br>Management<br>Applications | Cloud Services | Technology<br>Solutions | Total<br>Company |
|---|---|----------------|-------------------------|------------------|
| <b>Nine months ended September 30, 2011</b> |   |                |                         |                  |
| Net sales and service revenue               | \$ 10,184                               | \$ 866         | \$ 29,787               | \$ 40,837        |
| Gross profit (loss)                         | 4,172                                   | (890)          | 4,781                   | 8,063            |
| Segment income (loss)                       | 1,521                                   | (1,838)        | 1,204                   | (*)              |
| Segment assets                              | 9,186                                   | 3,100          | 11,124                  | 23,410           |
| <b>Nine months ended September 30, 2010</b> |   |                |                         |                  |
| Net sales and service revenue               | \$ 10,472                               | \$ 698         | \$ 30,121               | \$ 41,291        |
| Gross profit (loss)                         | 4,691                                   | (513)          | 4,219                   | 8,397            |
| Segment income (loss)                       | 2,061                                   | (1,519)        | 1,053                   | (*)              |
| Segment assets                              | 8,302                                   | 2,431          | 7,661                   | 18,394           |

\* See reconciliation below

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

|  | For the Three Months Ended<br>September 30, |            |
|--|---|------------|
|  | 2011  | 2010       |
| <b>Segment income (loss):</b>                    |   |            |
| Financial Management Applications Segment        | \$ 524                                      | \$ 633     |
| Cloud Services Segment                           | (752)                                       | (532)      |
| Technology Solutions Segment                     | 1,191                                       | 709        |
| <b>TOTAL SEGMENT INCOME</b>                      | <b>963</b>                                  | <b>810</b> |
| <b>Less: merger-related and compliance costs</b> |   |            |
| Stock compensation non-cash                      | (7)   | (8)        |

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|   |               |               |
|---|---------------|---------------|
| Professional and legal compliance and litigation related costs    | (157)         | (66)          |
| <b>OPERATING INCOME Per Consolidated Statements of Operations</b> | <b>\$ 799</b> | <b>\$ 736</b> |

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|   | For the Nine Months<br>Ended<br>September 30, |                 |
|---|---|-----------------|
|   | 2011  | 2010            |
| <b>Segment income (loss):</b>                                     |   |                 |
| Financial Management Applications Segment                         | \$ 1,521                                      | \$ 2,061        |
| Cloud Services Segment  | (1,838)                                       | (1,519)         |
| Technology Solutions Segment                                      | 1,204   | 1,053           |
| <b>TOTAL SEGMENT INCOME</b>                                       | <b>887</b>                                    | <b>1,595</b>    |
| <b>Less: merger-related and compliance costs</b>                  |   |                 |
| Stock compensation non-cash                                       | (22)  | (49)            |
| Professional and legal compliance and litigation related costs    | (386)   | (385)           |
| <b>OPERATING INCOME Per Consolidated Statements of Operations</b> | <b>\$ 479</b>                                 | <b>\$ 1,161</b> |

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

*(Dollar amounts are presented in thousands, except where specifically stated.)*

**A. Introduction**

Unless the context requires otherwise, 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, which also operates under the DBA (doing business as) name CSI Technology Outfitters and its subsidiary, CSI Technology Resources, Inc., a South Carolina corporation.

**Products and Services**

We develop software applications and provide hardware-based 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 kindergarten through grade 12 ( K-12 ) public education and local government organizations including counties and municipalities. Our clients also include public libraries, disabilities boards, higher education and other non-governmental clients, including commercial enterprises. While we have a significant number of non-education focused clients which represent our fastest growing sector based on increases in the number of new clients being added, our education focused customers typically generate more than 80% of our revenues in a given year. Of the remaining revenues the majority come from the local government entity market space, such as counties, cities and municipalities. Other customer verticals, such as mid- to large-size commercial businesses and healthcare, are becoming an increasing focus for those technology solutions which have cross-application to other verticals. This is due in part to encouragement from our vendors to represent their products on a broader scale, and as we add talent with experience in those markets. These other customer verticals still represent a fairly small portion of our business (typically less than 5%).

**Organization**

Our business efforts are focused on three key operating segments: (i) internally developed financial management applications and related services and support (our Financial Management Applications Segment ); (ii) applications development and integration primarily related to cloud-based services and solutions (our Cloud Services Segment ); and (iii) other technology solutions and related services and support (our Technology Solutions Segment ).

**Financial Management Applications Segment**

Our initial internally developed software product was developed for financial management of public sector entities, primarily local government and K-12 organizations. The largest portion of our revenues is derived from the K-12 education market space, with local government being one of our fastest growing segments. We may pursue other markets but currently they are not a substantial focus.

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Our internally developed software efforts have grown to consist primarily of four product groups, the first of which is included in our Financial Management Applications Segment:

Fund accounting based financial management software

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Our other internally developed software products groups, discussed further below, are reported as a part of our Cloud Services Segment:

Standards based lesson planning software

Identity and access management software

Cloud-based communication and collaboration solutions

*Fund accounting based financial management software*

Our initial and primary software product, fund accounting based financial management software, was developed for those entities that track expenditures and investments by fund, or by source and purpose of the funding. Our fund accounting software is used by public sector and not-for-profit entities. These organizations are primarily municipalities, school districts and local governments. Specific software modules include:

General (or Fund ) Ledger;

Accounts Payable;

Accounts Receivable;

Purchasing;

Payroll;

Human Resources;

Inventory;

Utility Billing; and

Other specialty modules designed for government markets.

In the initial state of our focus, South Carolina, and that of an acquired operation, Alabama, more than 80% of the K-12 school districts run our fund accounting software products. We also have a significant presence in the local government market space in these two states. In addition we have implementations in school districts or local government entities in six other states in the southeast: North Carolina, Georgia, Louisiana, Mississippi, Tennessee and Florida. We are looking to expand our financial management solutions to a national level, which will include accommodating expanded local and state reporting requirements.

*Staffing*

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Our Financial Management 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.

### *Margins*

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 Financial Management Applications Segment (also referenced as software and related services) than in our other segments. See Technology Solutions Segment Margins below for a detailed margins comparison of our Financial Management Applications Segment and Cloud Services Segment to our Technology Solutions Segment.

### Cloud Services Segment

#### *Standards based lesson planning software*

In September 2005, we acquired standards-based lesson planning software (curriculato<sup>®</sup>). The software is designed to allow teachers to create lesson plans that are tied to a state's curriculum standards. These lesson plans may be reviewed by administrators and a report generated to determine the standards that have been met or need to be met. The product is in several K-12 schools, but is not currently a significant revenue driver.

#### *Identity and access management software*

In August 2008, we acquired our identity and access management solutions through our acquisition of Version3. Our identity and access management solutions provide single sign-on, application access management and provisioning based on Microsoft<sup>®</sup> Identity Lifecycle Management and Microsoft SharePoint deployments. While Version3 solutions are not solely

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designed for the education market segment, many recent projects have been directed to K-12 and higher education. Prior to the acquisition, CSI was a reseller of Version3 solutions. By joining forces with Version3, we have achieved synergies to expand sales efforts, enhance delivery efficiencies, and allow increased focus on new product development and enhancements to existing solutions. Version3's solutions do not require the level of integration with local or state reporting as do our financial management products. As a result, the Version3 installations have already expanded to a national level and include a few international implementations.

### *Cloud-based communication and collaboration solutions*

In August 2009 we began development efforts of our CSI@K12 communication and collaboration solution based on Microsoft's Live@edu hosted email solution. CSI@K12 is an instructional communications management solution providing tools to manage the regulatory compliance and security standards required within a K-12 based email environment. CSI@K12 also provides an integrated portal experience for school administrators, teachers, students and parents providing email, homework and class task, network file access and a rich set of collaboration tools. These include class sites and social media tools, delivered in a browser and native Microsoft Outlook access and views. This solution was made available in the third quarter 2010.

In August 2010, we began the enhancement of our CSI@K12 communications and collaboration solutions with the addition of a hosted virtual Private Branch (or entity level) Exchange (PBX) systems services for Voice calls over Internet Protocol ( VoIP ). This is a solution whereby voice calls are communicated from internet protocol based phones and other end user devices over the internet to telecommunications infrastructure equipment at an off premise hosting location where they are linked to the switched (traditional) telecommunications networks (an internet protocol based solution typically referred to as Hosted VoIP ). The Internet or World Wide Web is also referred to as the Cloud, generally in the context of the medium through which off premise hosted hardware and software are accessed. Hosted (i.e., off customer premise) infrastructure used by customers by connecting to the hosted infrastructure through the Cloud (such as with our Hosted VoIP solution) is also referred to as a Cloud Solution and sometimes also referred to in the abbreviated form as the Cloud. Cloud solutions, including our Hosted VoIP solution, allow customers to purchase telecommunications switching and other hardware and/or software based solutions as a service rather than having to commit to the capital investment required for the purchase of on premise hardware or software. Cloud solutions allow customers to share, at some level, the cost of infrastructure and its management with other customers who also subscribe to the same hosted or Cloud solutions.

### *Staffing*

Our Cloud Services Applications Segment includes a staff of software developers, engineers, implementers, trainers, sales personnel and services support specialists focused primarily on the development, integration, sales, deployment and support of our cloud services products.

### *Margins*

The sales and support of software-based products developed or integrated for resale as services, coupled with the cost of investment in equipment for hosting, should support when mature lower margins in the Cloud Services Segment than in the Financial Management Applications Segment. Conversely, we believe the margins in the Cloud Services Segment will be higher than the margins in the Technology Solutions Segment. See Technology Solutions Segment Margins below for a detailed margins comparison of our Financial Management Applications Segment and Cloud Services Segment to our Technology Solutions Segment.

## Technology Solutions Segment

### *Solutions*

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;



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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);

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

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

Project management (overseeing installation of computers, telephone equipment, cabling and software);

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

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

Education technologies (distance learning and classroom learning tools such as interactive white boards and integrated accessories, such as hand held voting devices and audio systems).

### *Staffing*

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 Dell, HP, Cisco, Microsoft, Novell, Promethean and Tandberg, and supports our other two Segments, as needed.

### *Margins*

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 Financial Management Applications Segment. With Cloud solutions, which include a cost of investment in equipment for hosting not found in Financial Management Applications, but generally having some additional economies of scale compared to solutions in the Technology Solutions Segment, we anticipate that margins for the Cloud Services Segment will, once the new solutions in this segment gain traction, be somewhere mid-way between those for the Financial Management Applications Segment and the Technology Solutions Segment. Gross margins for the Financial Management Applications Segment were 43.4% for the 2010 fiscal year, while margins for the Technology Solutions Segment were 14.3% for the same period. Margins for the Cloud Services Segment, due to the initial development of new solutions without yet producing significant revenue, were (65.2)% for the 2010 fiscal year. Gross margin for the Financial Management Applications Segment was 42.7% for the 2009 fiscal year, while margin for our Technology Solutions Segment was 15.0%, and the margin for the Cloud Services Segment, was 0.5% for the same period.

We believe the combined efforts of our Technology Solutions Segment with that of our Financial Management Applications Segment and Cloud Services Segment provide CSI with a competitive advantage in the education and government markets. For a discussion of the results of the reported segments, see F. Financial Performance below.

### **Strategy**

While we report the business as three 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 financial management applications, Cloud services 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 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

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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 80% 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.

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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 1,000 clients located primarily in the southeastern states of South Carolina, Alabama, North Carolina, Georgia, Florida, Mississippi, Louisiana and Tennessee. In the states of South Carolina, where CSI was founded, and Alabama where one of our acquired operations was founded, we have account penetration in excess of 80% in the K-12 school district market space.

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 acquisitions, we have expanded our reach into the southeastern states significantly and are beginning to look at other areas of the United States. Additionally, with our latest acquisition we have added a small number of customers outside our main southeast footprint, including a few new customers internationally. Not all solutions are marketed to all states. However, we continue to expand the number of solutions offered in each area as resources and expanding vendor relationships permit.

For more information on our strategy, see [Acquisitions](#) below and our latest annual report filed on Form 10-K.

### **Seasonality**

The Company's operations are seasonal, being driven by its primary client base, K-12 schools, being closed or having significantly reduced operations during the summer months. At such time infrastructure and systems changes are less disruptive to their operations and so during the summer months they prefer to have a larger number of projects completed. As a result, and with the Company's fiscal quarter corresponding to the calendar year, the results for the Company's first and fourth quarters of each fiscal year when schools are in session are typically lower than the results for its second and third quarters, which contain the summer months when schools are closed or have significantly reduced operations.

### **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. 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.

Software companies with operations in the public educational and governmental market segments.

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

Our business strategy provides that we will examine the potential acquisition of companies and businesses within our industry. In determining a suitable acquisition candidate, we will carefully analyze a target's potential to add to and complement our product mix, expand our existing revenue base, improve our margins, expand our geographic coverage, strengthen our management team and, above all, improve stockholder returns.

We are unable to predict the nature, size or timing of any acquisition. We can give no assurance that we will reach agreement or procure the financial resources necessary to fund any acquisition, or that we will be able to successfully integrate or improve returns as a result of any such acquisition. We continue to pursue and enter into preliminary discussions with various acquisition candidates. However, the Company has not entered into agreements or understandings for any acquisitions which management deems material.

We manage the Company with the goal of improving long-term value for our shareholders. Generally, we believe the opportunities for creating value have been better driven by reinvesting our capital in new products, acquisitions and organic growth. Accordingly, our current strategy is to remain independent and not to be acquired or merged. Further, we have not made any significant efforts to reduce investment in future revenue

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generating opportunities to provide higher short-term returns for better positioning for a sale or merger. We believe our value to any potential acquirer should include the value we anticipate seeing in future periods from the ongoing investment efforts we are making and should reflect the potential for future returns from those investments. However, we are contacted from time to time by a variety of interests, such as acquiring companies, primarily competitors, and investment firms, who are interested in exploring making an investment, acquiring or merging with our business. We continue to communicate with various parties with respect to future opportunities and from time to time have engaged with investor relations and investment banking resources to assist us in looking at

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strategic options for achieving our growth goals. We are currently working with an investment banking firm who is advising us as to strategic options. However, the Company has not entered into agreements or understandings for any acquisitions or other strategic transactions which management deems material. For further discussion as to strategic options we consider related to funding for growth, see the section on Liquidity and Capital Resources, below.

### **B. Recent Developments**

#### **New Product and Solutions Development**

##### Cloud Services

In August 2009 we began development efforts of our CSI@K12 communication and collaboration solution based on Microsoft's Live@edu hosted email solution. This is an effort driven within our Version3 division, acquired in the fall of 2008. CSI@K12 is an instructional communications management solution providing tools to manage the regulatory compliance and security standards required within a K-12 based email environment. CSI@K12 also provides an integrated portal experience for school administrators, teachers, students and parents providing email, homework and class task, network file access and a rich set of collaboration tools. These include class site and social media tools, delivered in a browser and native Microsoft Outlook access and views. This solution was made available in the second quarter of 2010. It is anticipated this solution will be more widely distributed following the 2010-2011 E-Rate season. E-Rate is a program which provides government matching funds, up to 90%, for schools located in more economically challenged, such as rural, areas. Funding begins in mid-summer following applications for funding in the spring.

We may commit approximately between \$1 million and \$2 million annually to develop this offering, including both research and development and capitalized development costs, as well as capital expenditures to develop and host certain functions related to this solution. In August 2010, we enhanced our CSI@K12 offering with the addition of Hosted VoIP services or virtual Private Branch (or entity level) Exchange (PBX) systems services for VoIP. The addition of voice communications to our CSI@K12 product is a natural extension of our branded communication and collaboration solutions offering, and provides the potential of tighter integration and improved security and management over these services through continued product and systems integration development. Like the email portion of our CSI@K12 offering, the hosted VoIP portion is also E-Rate fundable. We expect our margins on this portion of our solution to more closely resemble those of our other product offerings in our Financial Management Applications Segment than that of our Technology Solutions Segment.

With the addition of Hosted VoIP, our CSI@K12 solution combines our proprietary technology, using our internally developed communications and collaboration tools, with those of third parties to provide a product suite which offers solutions for both voice and data management. The solution set, coupled with our support and services, reduces the management overhead of these services to our customers while providing improved security and compliance for our customer base. The CSI@K12 solutions suite will continue to be enhanced through future additional development and product integration. The integration of voice to the CSI@K12 solution expands the communications functionality of the offering. Due to this offering being supported by third-party software and hardware implemented as a Cloud solution, we anticipate spending more than \$1 million annually and potentially several million dollars in capital investment in software and hardware as sales of this solution grows. We began providing significant services under this solution in the second quarter of 2011. We anticipate we will recover these investments within a three to five year period. More specific information as to the amount we plan to spend across the Company for capitalized development costs and capital expenditures is discussed in more detail in the Liquidity and Capital Resources section below.

The CSI@K12 solution is not currently a significant revenue generator. However, the hosted email and VoIP portions of the solution are eligible for the first priority ( priority one ) level of funding under E-Rate the federal program providing funding for telecommunications, internet access and internal connections for schools. The percentage of a project funded by contributions from E-Rate is based on the percentage of students participating in a subsidized lunch program, due to their being in lower income households. Schools and districts that have a high free and reduced lunch rate count receive a higher percentage of contributions from E-Rate funds to help fund their qualifying projects than do those with a lower count. We believe eligibility for priority one funding coupled with the need for the functionality the product delivers will create revenue growth opportunities in future years. Prior to offering the CSI@K12 solution, CSI's solutions which were E-Rate eligible were only eligible at priority level two. Priority one projects are considered more important and are funded prior to considering priority level two projects. Thereafter, priority two projects are funded until E-Rate funds have run out, leaving many more potential two projects unfunded, than for priority one.

Based on our efforts during the winter of 2010 and spring of 2011 E-Rate season, we won approximately \$1.5 million of contracts to provide services under the CSI@K12 solution set focused primarily for email. We won another \$1.5 million of contracts to provide services under the CSI@K12 solution set focused primarily on our Hosted VoIP portion of the offering. Contract awards are not guaranteed to be funded. We anticipate a higher level of funding due to the priority one status of these offerings; however, we are unsure what the funding level will be or the timing of the funding as the contracts go



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through a review process before approval. In the past our funding experience for priority two contracted services and solutions has been less than 30%. But based on these contract wins, we are looking forward to some potentially significant increases in revenues as a result of our investments in the Cloud space. These increases could push our results for 2011 ahead of our results in 2010, despite a slow recovery for budgets in our primary K-12 market space. However, given continued investment in Cloud solutions with certain products only beginning to generate revenues in the third quarter, the beginning of the latest E-Rate cycle and slower results for the first and second quarters of 2011, our results could easily fall below those achieved in 2010.

Features which have been developed for our CSI@K12 solution set also have application to our higher education and local government clients. Accordingly we are developing these products with these customers in mind, in addition to our K-12 customers and are marketing our CSI@K12 product to higher education customer base as CSI@EDU, and to our local government customer base as CSI@GOV. These opportunities are not eligible or contingent upon E-Rate funding. We anticipate occasional revenue outside of E-Rate for some K-12 customers who, for example, have investment in on-premise products which have not historically qualified for E-Rate funding, like our hosted solutions and who wish to move forward with the solution regardless of whether funding is obtained. Further, we anticipate some additional revenue and activities outside of the E-Rate cycle, particularly for sales to the higher education and local government customer base.

## **Financial Management Applications**

In addition to the changes in our Cloud Services Segment, in our Financial Management Applications Segment, we have completed the process of upgrading all customers for our acquired Mobile, AL product to the latest version of its solutions ( NextGen ). We have also completed the conversion of the majority of our modules for our newest, initially, Easley, SC based product to the more technologically-current .Net and SQL platform ( SmartFusion ), with the few remaining modules substantially wrapping up in 2011. Accordingly, we are now able to focus greater effort on enhancements which will improve both the acquired products and our latest product, and to begin to focus in earnest on the consolidation of our acquired products with our latest SmartFusion release. The completion of these integration efforts will provide our customers with a natural, rather than fork-lift transition to the latest technology while improving our development and support efficiencies in the long-term, as we progress.

## **General Guidance (Forward-Looking Information)**

The impact of the current economic conditions on our customers' budgets and the unknowns related to the timing, issuance of, restrictions on and expiration of the federal government's economic Stimulus have, we believe, extended out the decision making process with regard to the funding of technology solutions and services. This has resulted in an extension of our sales closing cycles. We typically experience a loss in the first and fourth quarters of the year as we experience a lower utilization of staff carried to support the greater influx of opportunities in the summer months when schools are not in full session and technology solutions implementation is less disruptive. The extension of our closing cycles and our continued investment in the Cloud Services Segment has resulted in a first quarter loss greater than 2010 and a profit in the second quarter lower than that achieved in 2010, for year-to-date earnings closer to our 2009 results than 2010. In 2009, we put in place a reduction in force in the second quarter as a result of the low performance in the first quarter of 2009. In 2011 we have no plans for such a reduction in force at this time. Except, primarily for the support for the Cloud investment, our headcount is similar to that following the earlier reduction in force. We anticipated performance for the second quarter of 2011 somewhat similar to 2010, in which we reported a profit for that quarter. Although somewhat lower than expected, we did achieve a profitable quarter. In addition, we have had improved earnings in the third quarter from the first round of E-Rate funding available for our new Cloud Services offerings, but offset by increased costs, and more significantly an increase in our Technology Solutions sales resulted in the increase in profits. However, as a result of continued lower performance potential from increased costs related to the introduction of the new Cloud solutions to the marketplace, we are unsure of whether we will achieve a 2011 performance better than 2010. Due to the uncertainty that remains in our market with regard to economic recovery, we can provide no specific guidance for the coming quarter or year ending 2011.

## **C. Forward-Looking and Cautionary 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 SEC 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, see, predict, project or words of similar import. These forward-looking statements are based upon our current knowledge and 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.





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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.

We have included risk factors and uncertainties that might cause differences between anticipated and actual future results in the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2010. 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;

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

an economic downturn; and

changes in the competitive marketplace and/or customer requirements.

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

### **Basis of Presentation**

Our consolidated financial statements include CSI Technology Resources, Inc., a wholly-owned subsidiary. (The subsidiary has no material operations and we report on a consolidated basis for both book and tax purposes). We use the accrual basis of accounting.

We employ accounting principles generally accepted in the United States of America ( 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 month periods ended September 30, 2011 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.

### **Disclosure Regarding Segments**

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The Company reports its operations under three operating segments: the Financial Management Applications Segment, the Cloud Services Segment and the Technology Solutions Segment. See *-A. Introduction Products and Services and -Organization* for more detailed discussions regarding our segments.

### **Revenue Recognition**

#### *Software License Revenues*

Software revenues consist principally of fees for licenses of our internally developed software products, service and training. We recognize all software revenue using the residual method in accordance with the *Software Revenue Recognition* subtopic of the FASB's ASC. 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.

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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 ASC 985-605 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 ASC 985-605, 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) collectability 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.

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.

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.

Collectability is probable. We determine whether collectability 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 Software Revenue Recognition subtopic of the FASB ASC.

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) collectability 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 the Revenue Recognition topic of the FASB ASC, we record revenues as net when we serve as an agent. In these circumstances, our supplier pays a



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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 uncollectability 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 Revenue Recognition Software subtopic of the FASB ASC.

### ***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 have 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.

### **Warranties**

Our suppliers generally warrant the products distributed by us and allow returns of defective products, including those that have been returned to us by its customers. We do not independently warrant the products we distribute, but we do warrant our services with regard to products that we configure for our customers and products that we build from components purchased from other sources. Warranty expense is not material to our financial statements.

### **Long-lived Assets**

#### ***Capitalization***

Expenditures for major renewals or betterments that extend the useful lives of property and equipment are capitalized. Expenditures for maintenance and repairs are charged to expenses as incurred.

We continually evaluate whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the remaining balance of long-lived assets may not be recoverable in accordance with Property, Plant, and Equipment topic of the FASB ASC. When factors indicate that long-lived assets should be evaluated for possible impairment, we use an estimate of the related undiscounted future cash flows over the remaining life of the long-lived assets in measuring whether they are recoverable. If the estimated undiscounted future cash flows exceed the carrying value of the asset, a loss is recorded as the excess of the asset's carrying value over fair value.

#### ***Depreciation***

Depreciation of property and equipment is provided using the straight-line method over the estimated useful lives of such property and equipment.

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

Computer software costs consist of internal software production costs and purchased software costs capitalized under the provisions of Software subtopic of the FASB ASC, 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 software life or otherwise increase its value are expensed as incurred. Capitalized computer software costs are amortized over the

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economic life of the product, generally three to four years, using the straight-line method. Much of our software development efforts related to our fund accounting and lesson planning products focus on the implementation of known technological capabilities applied to common business processes to enhance our existing products. Historically, through our software solutions segment, prior to 2009, we spent material efforts on technological

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innovation for which the feasibility has been unknown. However, as a result of our acquisition of the more complex Version3 products in the latter part of 2008, and related to efforts to expand those and develop additional product offerings where the technological feasibility is not readily known, we are now increasing our efforts toward research and development and record the costs of such efforts separately, as *research and development*, on the face of our financial statements.

### **Other Intangible Assets**

The Company follows the provisions prescribed by FASB ASC Topic 350, *Intangibles – Goodwill and Other* (ASC 350) in our accounting and reporting for goodwill and other intangible assets.

The *Intangibles – Goodwill and Other* topic of the FASB ASC eliminates the requirement to amortize intangible assets with an indefinite life, addresses the amortization of intangible assets with a defined life, and addresses impairment testing and recognition indefinite-lived intangible assets. In accordance with the *Intangibles – Goodwill and Other* topic of the FASB ASC, we do not amortize indefinite-lived intangible assets (e.g., corporate trademarks for which planned use is indefinite). We evaluate the remaining useful life of intangible assets that are not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, we amortize the intangible asset prospectively over its remaining estimated useful life. Amortizable intangible assets (e.g., product trademarks) are amortized on a straight-line basis over six years or the life of the product, whichever is shorter.

In addition, as required under *Intangibles – Goodwill and Other* subtopic of the FASB ASC, we perform annual tests for impairment of our indefinite-lived intangible assets. Our indefinite-lived intangible assets consist of values assigned to certain trademarks and other intangibles we have developed or acquired.

### **Stock Based Compensation**

The Company has a stock based compensation plan, the 2005 Incentive Compensation Plan. The Company accounts for stock based compensation using the fair value method prescribed in the *Compensation – Stock Compensation* subtopic of the FASB ASC, 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.

### **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.

We follow the provisions of the *Income Taxes* topic of the FASB ASC, which provides specific guidance on the financial statement recognition, measurement, reporting and disclosure of uncertain tax positions taken or expected to be taken in a tax return. We recognize the impact of our tax positions in our financial statements if those positions will more likely than not be sustained on audit, based on the technical merit of the position.

### **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 and payments described in Note 4 to our unaudited financial statements as of and for the nine months ended September 30, 2011 and under *G. 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.

### **E. 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.



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In September 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-08, which is intended to simplify testing for goodwill impairment. This guidance gives an entity the option to first assess qualitative factors to determine if it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. This

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guidance will be effective for the Company beginning January 1, 2012. Management is currently evaluating the impact of this update on the Company's financial statements, but they do not expect the adoption of this guidance to have a material impact on the Company's financial position, results of operations, or cash flows.

In May 2011, FASB issued ASU No. 2011-04, which clarifies and changes fair value measurement and disclosure requirements. This guidance expands existing disclosure requirements for fair value measurements and makes other amendments but does not require additional fair value measurements. This guidance will be effective for the Company beginning January 1, 2012. Management does not expect the adoption of this guidance to have a material impact on the Company's financial position, results of operations, or cash flows.

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.

## **F. Financial Performance**

### **Overview**

Our revenues increased \$2.8 million or 19% to \$17.3 million for the third quarter of 2011 compared to the same period of the prior year. The revenue increase was due to a \$2.6 million increase in Technology Solutions Segment revenues and a \$0.1 million increase in both Financial Management Applications Segment and Cloud Services Segment revenues.

Revenues for the nine months ended September 30, 2011 decreased \$0.5 million or 1% to \$40.8 million compared with the same period of the prior year. The revenue decrease was due to a \$0.4 million decrease in Technology Solutions Segment revenues and a \$0.3 million decrease in Financial Management Applications Segment revenues. These decreases were partially offset by a \$0.2 million increase in Cloud Services revenues.

Gross profit for the third quarter of 2011 increased \$0.4 million, or 13%, to \$3.4 million compared to the same period of the prior year. The increase was due to a \$0.6 million increase from the Technology Solutions Segment, partially offset by a \$0.2 million decrease from the Cloud Services Segment, while gross profit for the Financial Management Applications segment were relatively flat. The overall gross margin decreased from 20.8% to 19.7% due to decreased margins from the Financial Management Applications and Cloud Services segments, partially offset by an increase in the Technology Solutions Segment's gross margin. The Financial Management Applications Segment reported 40.0% margin in the third quarter of 2011 versus 43.2% for the same period in 2010. The Cloud Services Segment reported -143.3% gross margin versus -96.3% in 2010. The Technology Solutions Segment reported 17.8% margin in the third quarter of 2011 versus 16.2% for the same period in 2010.

Gross profit for the nine months ended September 30, 2011 decreased \$0.3 million, or 4%, to \$8.1 million compared to the same period of the prior year. The decrease was due to a \$0.5 million decrease from the Financial Management Applications Segment and a \$0.4 million decrease from the Cloud Services Segment, partially offset by a \$0.6 million increase from the Technology Solutions Segment. The overall gross margin decreased from 20.3% to 19.7% due to decreased margins from the Financial Management Applications and the Cloud Services segments. The Financial Management Applications Segment reported 41.0% margin for the first nine months of 2011 versus 44.8% for the same period in 2010. The Cloud Services Segment reported -102.8% gross margins versus -73.5% in 2010. The Technology Solutions Segment reported 16.1% margin in the first nine months of 2011 versus 14.0% for the same period in 2010.

Operating income increased \$0.1 million, or 9%, to operating income of \$0.8 million for the third quarter of 2011. The increase in operating income came from the increase in gross profit, partially offset by an increase in operating expenses, particularly selling expenses.

For the nine months ended September 30, 2011, operating income decreased \$0.7 million, or 59%, to operating income of \$0.5 million compared to the same period of 2010. The decrease in operating results came from the decrease in gross profit and increase in operating expenses, particularly selling expenses.

Net income for the third quarter of 2011 increased \$0.4 million, or 105%, to net income of \$0.8 million. The increase in net income was due to the increase in operating income and reduced income tax expense.

Net income for the first nine months of 2011 was \$0.4 million, a decrease of \$0.1 million, or 18%, compared to net income of \$0.5 million for the same period of the prior year. The decrease was due to the decrease in operating results, partially offset by reduced interest expense and reduced income tax expense.



**Table of Contents****Consolidated Results of Operations for the Three Months Ended September 30, 2011 and 2010**

|                                      | September 30,<br>2011 | Three Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--------------------------------------|-----------------------|---|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 17,274             | \$ 14,466                                   | \$ 2,808               |
| <b>GROSS PROFIT</b>                  | 3,405                 | 3,016                                       | 389                    |
| <b>OPERATING INCOME</b>              | 799                   | 736   | 63                     |

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

|  |  |  |          |
|--|--|--|----------|
| <b>Gross Profit:</b>   |  |  |          |
| Sales  |  |  | \$ 2,808 |
| Cost of sales excluding depreciation, amortization, and capitalization |  |  | (2,442)  |
| Depreciation and amortization  |  |  | (71)     |
| Capitalization of software costs                                       |  |  | 94       |
|  |  |  | 389      |
| <b>Operating Expenses:</b>   |  |  |          |
| Research and development costs   |  |  | 28       |
| Selling costs  |  |  | (170)    |
| Marketing costs  |  |  | (19)     |
| Stock based compensation   |  |  | 1        |
| Professional and legal compliance costs                                |  |  | (91)     |
| Depreciation and amortization  |  |  | 34       |
| Other general and administrative expenses                              |  |  | (109)    |
|  |  |  | \$ 63    |

**Revenues**

Total revenues in the third quarter of 2011 increased \$2.8 million or 19% in comparison with the third quarter of 2010 to \$17.3 million. Of this increase, Technology Solutions increased \$2.6 million while the Financial Management Applications Segment's and Cloud Services Segment's revenues both increased \$0.1 million. The 24% increase in Technology Solutions revenues was primarily due to increased infrastructure hardware sales. Financial Management Applications revenues increased 4% due to an increase in new software sales and support revenues. The 29% increase in Cloud Services revenues was due to an increase in CSI@K12 hosted email and hosted voice sales.

**Gross Profit**

Gross profit for the third quarter of 2011 increased \$0.4 million or 13% in comparison with the third quarter of 2010, to \$3.4 million. Of this increase, Technology Solutions Segment increased by \$0.6 million, partially offset by a \$0.2 million decrease in Cloud Services gross profit and a slight decrease in Financial Management Applications gross profits. The 3% decrease in Financial Management Applications Segment was driven by an increase in costs of sales from increased product development and support personnel as a percent of revenues added to support additional enhancements to the software. Cloud Services Segment gross profit decreased 93% due to an increase in costs of sales mostly due to the increased costs from the additional workforce for the more recently added hosted voice solution. Technology Solutions Segment gross profit increased 36% due to increased sales, specifically from infrastructure sales. The overall gross margin decreased from 20.8% to 19.7% due to decreased margins in the Financial Management Applications and Cloud Services segments, partially offset by improved margins from the Technology Solutions Segment. The Financial Management Applications Segment reported 40.0% margin in the third quarter of 2011 versus 43.2% for the same period in 2010 due to the same reasons as the decrease in gross profit. The Cloud Services Segment reported -143.3% margin in the third quarter of 2011 versus -96.3% for the same period in 2010 due to the same reasons as the decrease in gross profit. The Technology Solutions Segment reported 17.8% margin for the third quarter of 2011, up from 16.2% for the same period in 2010. The increase was due to better margins on product sales, improved interactive classroom services performance and increased reseller commissions.

**Operating Expenses**

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Operating expenses for the third quarter increased \$0.3 million compared to the third quarter of 2010, to \$2.6 million. The above table analyzes the major items that account for this increase. The increase was primarily a result of increased selling costs related to a focus on increasing contacts in the technology segment, increased professional and legal compliance costs and other general and administrative costs related primarily to bringing on the new Cloud products. The \$0.4 million increase in gross profit, partially offset by the increase in operating expenses, resulted in an increase in operating income of \$0.1 million, or 9% compared to the prior year, to \$0.8 million.

**Table of Contents****Segment Information**

CSI is organized into the three reportable segments: the Financial Management Applications Segment, the Cloud Services Segment and the Technology Solutions Segment. Below is a description of the types of products and services from which each reportable segment derives its revenues.

**Financial Management Applications Segment**

Through our Financial Management Applications Segment, we report the results of the development, sales, and deployment and provision of ongoing support of our fund accounting based financial management software. Through this segment, we also report the results of operations related to complimentary third-party applications and services we resell.

|                                      | September 30,<br>2011 | Three Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--------------------------------------|-----------------------|---|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 3,526              | \$ 3,381                                    | \$ 145                 |
| <b>GROSS PROFIT</b>                  | 1,410                 | 1,460                                       | (50)                   |
| <b>SEGMENT INCOME</b>                | 524                   | 633   | (109)                  |

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

|  |  |  |          |
|--|--|--|----------|
| Gross Profit:  |  |  |          |
| Sales  |  |  | \$ 145   |
| Cost of sales excluding depreciation, amortization, and capitalization |  |  | (229)    |
| Depreciation and amortization  |  |  | 16       |
| Capitalization of software costs                                       |  |  | 18       |
|  |  |  | (50)     |
| Operating Expenses:  |  |  |          |
| Selling costs  |  |  | (21)     |
| Marketing costs  |  |  | (20)     |
| Depreciation and amortization  |  |  | 13       |
| Other general and administrative expenses                              |  |  | (31)     |
|  |  |  | \$ (109) |

Financial management applications revenues increased by \$0.1 million, or 4%, in comparison with the third quarter of 2010. The increase in software revenues was due primarily to increases in fund accounting new software sales and support revenues, partially offset by a decrease in services revenues. The increase in new sales for the latest version of our fund accounting product was sufficient to offset a decline in services due to a decrease in the upgrades of our Mobile, AL acquired applications to their latest platform for which there was a push to complete in 2010. With that complete, the Company has begun shifting its efforts toward the future consolidation of these products, and further enhancements in the interim applicable to both its acquired and newest products.

Financial management applications cost of sales increased by 10% in comparison with the third quarter of 2010. The increase in cost of sales came primarily from increased costs for development and support costs. However, this increase was partially offset by a larger amount of software costs being capitalized than in the prior year. The gross margin for the third quarter of 2011 was 40.0% compared to 43.2% in the third quarter of 2010. The decrease in the margin was due to the increase in costs of sales exceeding the increase in sales.

Financial management applications operating expenses increased by \$0.1 million, or 7%, in comparison with the third quarter of 2010. The increase was primarily due to increased sales, marketing and other general and administrative expenses. The segment experienced a decrease in segment operating income of \$0.1 million, or 17% in comparison to the third quarter of 2010, driven by the decrease in gross profit and the increase in operating expenses.

**Cloud Services Segment**

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Through our Cloud Services Segment, we report the results of the development, integration, sales and deployment of our proprietary standards based lesson planning software, solutions that facilitate single sign-on application access management provisioning based on Microsoft's Identity Lifecycle Management, Cloud-based communication and collaboration solutions, based on Microsoft's Live@edu hosted exchange and SharePoint environments and Microsoft SharePoint deployments, and for Hosted VoIP. Through this segment we also report the results of operations related to complementary third-party applications and services which are an integral part of our solutions.

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|  | September 30,<br>2011 | Three Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--|-----------------------|---|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b>                                   | \$ 277                | \$ 214                                      | \$ 63                  |
| <b>GROSS LOSS</b>  | (397)                 | (206)                                       | (191)                  |
| <b>SEGMENT LOSS</b>  | (752)                 | (532)                                       | (220)                  |
| <b>SIGNIFICANT ITEMS THAT INCREASED<br/>(DECREASED) SEGMENT LOSS</b>   |                       |   |                        |
| Gross Profit:  |                       |   |                        |
| Sales  |                       |   | \$ 63                  |
| Cost of sales excluding depreciation, amortization, and capitalization |                       |   | (239)                  |
| Depreciation and amortization  |                       |   | (91)                   |
| Capitalization of software costs                                       |                       |   | 76                     |
|  |                       |   | (191)                  |
| Operating Expenses:  |                       |   |                        |
| Research and development   |                       |   | 28                     |
| Selling costs  |                       |   | (64)                   |
| Marketing costs  |                       |   | (11)                   |
| Depreciation and amortization  |                       |   | 17                     |
| Other general and administrative expenses                              |                       |   | 1                      |
|  |                       |   | \$ (220)               |

Cloud services revenues increased by \$0.1 million, or 29%, in comparison with the third quarter of 2010. The increase in revenues was due to increased sales of our hosted email and hosted voice solutions, as these solutions were not sold in the same period of 2010.

Cloud services cost of sales increased \$0.3 million, or 60%, in comparison with the third quarter of 2010. The increase in cost of sales came from increased costs for the ramp up of the hosted voice solution just now beginning to be delivered to the marketplace, increased depreciation and amortization due to increased investment in assets for this segment, partially offset by more software costs being capitalized. The gross margin for the third quarter of 2011 was -143.3% compared to -96.3% in the third quarter of 2010. The decline in the margin was due to the increase in costs of sales, primarily the ramp up of the hosted voice solution exceeding the increase in sales.

Cloud services operating expenses for the segment increased by 9% in comparison with the third quarter of 2010. The increase was primarily due to increased selling and marketing costs. The segment experienced an increase in segment operations loss of 41% in comparison to the third quarter of 2010, driven by the decrease in gross profit and the increase in operating expenses.

**Technology Solutions Segment**

Through our Technology Solutions Segment, we report the results of the technology solutions products through the sales and distribution of computers and accessories and the wide range of technology consulting services, including network and systems integration and computer support and maintenance services, that we provide.



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|  | Three Months Ended    |                       |                        |
|--|-----------------------|-----------------------|------------------------|
|  | September 30,<br>2011 | September 30,<br>2010 | Increase<br>(Decrease) |
| <b>NET SALES AND SERVICE REVENUE</b>                                   | \$ 13,471             | \$ 10,871             | \$ 2,600               |
| <b>GROSS PROFIT</b>  | 2,392                 | 1,762                 | 630                    |
| <b>SEGMENT INCOME</b>  | 1,191                 | 709                   | 482                    |
| <b>SIGNIFICANT ITEMS THAT INCREASED<br/>(DECREASED) SEGMENT INCOME</b> |                       |                       |                        |
| Gross Profit:  |                       |                       |                        |
| Sales  |                       |                       | \$ 2,600               |
| Cost of sales excluding depreciation, amortization, and capitalization |                       |                       | (1,974)                |
| Depreciation and amortization  |                       |                       | 4                      |
|  |                       |                       | 630                    |
| Operating Expenses:  |                       |                       |                        |
| Selling costs  |                       |                       | (85)                   |
| Marketing costs  |                       |                       | 12                     |
| Depreciation and amortization  |                       |                       | 4                      |
| Other general and administrative expenses                              |                       |                       | (79)                   |
|  |                       |                       | \$ 482                 |

Technology revenues increased \$2.6 million, or 24%, in comparison to the third quarter of 2010. The increase in technology revenues was due to increased infrastructure and cabling product sales, reseller commissions and internal interactive classroom services.

Technology cost of sales increased \$2.0 million, or 22% in comparison to the third quarter of 2010. The increase in technology cost of sales accompanied the increase in technology revenues for products, and was also the result of an increase in labor costs. Gross profit for the period increased \$0.6 million primarily due to the increase in infrastructure sales, reseller commissions and interactive classroom services. Segment gross margin for the period increased from 16.2% to 17.8% due to improved performance of interactive classroom services, better product margins on infrastructure sales and reseller commissions.

Technology operating expenses increased \$0.1 million, or 14% in comparison to the third quarter of 2010. The increase was primarily due to an increase in selling costs, with a focus on generating more sales activities, accompanied by increased other general and administrative costs for this segment. As a result of the increase in gross profit, partially offset by the increase in operating expenses, the segment experienced an increase in segment operating income of \$0.5 million, or 68% in comparison to the third quarter of 2010.

The following tables summarize information about segment income (loss) for the three months ended September 30, 2011 and 2010, and assets allocated to segments as of September 30, 2011 and 2010. Changes in segment assets came primarily from the following:

Financial Management Applications Segment assets increased due to an increase in accounts receivable, income tax receivable and capitalized computer software costs. This increase was partially offset by a decrease in other assets due to amortization of these assets without any acquisition activity recently.

Cloud Services Segment assets increased due to increased accounts receivable, property and equipment and capitalized computer software costs. This is due to the investment being made in this segment with the hosted email and VoIP solutions.

Technology Solutions Segment assets increased primarily from an increase in accounts receivable, income tax receivable and inventory.

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|                                       | Financial<br>Management<br>Applications | Cloud Services | Technology<br>Solutions | Total<br>Company |
|---------------------------------------|---|----------------|-------------------------|------------------|
| Three months ended September 30, 2011 |   |                |                         |                  |
| Net sales and service revenue         | \$ 3,526                                | \$ 277         | \$ 13,471               | \$ 17,274        |
| Gross profit (loss)                   | 1,410                                   | (397)          | 2,392                   | 3,405            |
| Segment income (loss)                 | 524                                     | (752)          | 1,191                   | (*)              |
| Segment assets                        | 9,186                                   | 3,100          | 11,124                  | 23,410           |
| Three months ended September 30, 2010 |   |                |                         |                  |
| Net sales and service revenue         | \$ 3,381                                | \$ 214         | \$ 10,871               | \$ 14,466        |
| Gross profit (loss)                   | 1,460                                   | (206)          | 1,762                   | 3,016            |
| Segment income (loss)                 | 633                                     | (532)          | 709                     | (*)              |
| Segment assets                        | 8,302                                   | 2,431          | 7,661                   | 18,394           |

\* See reconciliation below

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

|   | Three Months Ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2011 | September 30,<br>2010 |
| <b>Segment income (loss):</b>                                     |                       |                       |
| Financial Management Applications Segment                         | \$ 524                | \$ 633                |
| Cloud Services Segment  | (752)                 | (532)                 |
| Technology Solutions Segment                                      | 1,191                 | 709                   |
| <b>TOTAL SEGMENT INCOME</b>                                       | <b>963</b>            | <b>810</b>            |
| <b>Less: merger-related and compliance costs</b>                  |                       |                       |
| Stock compensation non-cash                                       | (7)                   | (8)                   |
| Professional and legal compliance costs                           | (157)                 | (66)                  |
| <b>OPERATING INCOME Per Consolidated Statements of Operations</b> | <b>\$ 799</b>         | <b>\$ 736</b>         |

**Interest and Other Income and Expenses**

Interest expense decreased in the third quarter of 2011 by 9%, compared to the third quarter of 2010. The decrease was due to reduced borrowings on the subordinated debt during the third quarter of 2011 compared to the same period in 2010.

**Income Taxes**

Income tax expense decreased by \$0.3 million or 115% compared to the third quarter of 2010, to a tax benefit of under \$0.1 million in the third quarter of 2011. The decrease in tax expense was due to a lower effective rate when compared to the prior year. The lower effective tax rate resulted from increased deferred tax assets recorded for additional South Carolina Jobs Tax Credits related to an increase in sustained jobs and potential utilization of future credits in connection with the new solutions introduced in the Cloud Services Segment.

The effective tax rates for the three months ended September 30, 2011 and 2010 were approximately -5.9% and 43.3%, respectively. The decrease in the effective tax rate is also due to the recognition of deferred tax asset related to the South Carolina Jobs Tax Credits.

**Net Income and Earnings per Share**

Net income increased in the third quarter of 2011 by \$0.4 million, or 105%, to net income of \$0.8 million compared to the same period of 2010. The increase was due to the increase in operating income and reduced income tax expense.

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Basic earnings per share increased from \$0.06 in the third quarter of 2010 to \$0.12 in the third quarter of 2011. The increase was due to the increase in net income. Diluted earnings per share increased from \$0.03 in the third quarter of 2010 to earnings of \$0.06 in the third quarter of 2011. The increase was primarily due to the increase in net income.

**Table of Contents****Consolidated Results of Operations for the Nine Months Ended September 30, 2011 and 2010**

|                                      | September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--------------------------------------|-----------------------|--|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 40,837             | \$ 41,291                                  | \$ (454)               |
| <b>GROSS PROFIT</b>                  | 8,063                 | 8,397                                      | (334)                  |
| <b>OPERATING INCOME</b>              | 479                   | 1,161                                      | (682)                  |

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

|  |  |  |          |
|--|--|--|----------|
| <b>Gross Profit:</b>   |  |  |          |
| Sales  |  |  | \$ (454) |
| Cost of sales excluding depreciation, amortization, and capitalization |  |  | 43       |
| Depreciation and amortization  |  |  | (89)     |
| Capitalization of software costs                                       |  |  | 166      |
|  |  |  | (334)    |
| <b>Operating Expenses:</b>   |  |  |          |
| Research and development costs   |  |  | 53       |
| Selling costs  |  |  | (400)    |
| Marketing costs  |  |  | (53)     |
| Stock based compensation   |  |  | 27       |
| Professional and legal compliance costs                                |  |  | (1)      |
| Depreciation and amortization  |  |  | 126      |
| Other general and administrative expenses                              |  |  | (100)    |
|  |  |  | \$ (682) |

**Revenues**

Total revenues for the nine months ended September 30, 2011 decreased \$0.5 million or 1% in comparison with the same period of 2010 to \$40.8 million. Of this decrease, Technology Solutions Segment revenues decreased \$0.4 million while Financial Management Applications Segment revenues decreased \$0.3 million. These decreases were partially offset by a \$0.2 million increase in Cloud Services Segment revenues. The 1% decrease in Technology Solutions Segment revenues was primarily due to a decrease in PC and interactive classroom sales, partially offset by an increase in infrastructure sales. The 3% decrease in Financial Management Applications revenues was due to a decrease in new software sales and services. The 24% increase in Cloud Services revenues was due to an increase in CSI@K12 hosted email and hosted voice revenues.

**Gross Profit**

Gross profit for the first nine months of 2011 decreased \$0.3 million or 4% in comparison with the same period of 2010, to \$8.1 million. Of this decrease, \$0.5 million was due to a decrease in Financial Management Applications Segment and \$0.4 million was due to a decrease in Cloud Services Segment, partially offset by a \$0.6 million increase in Technology Solutions Segment gross profit. The gross profit decrease in Financial Management Applications Segment was driven by a decrease in new software and service revenues and an increase in costs of sales from personnel increases focusing on enhancements and increased support of the new version of the product. The decrease in the Cloud Services Segment was due to additional staffing for the new hosted voice product line which was in start-up mode and limited sales through the first nine months of 2011. The platform is functioning with demonstrable services and we had some revenue from the full implementation of this solution offering beginning with the third quarter of 2011. The increase in Technology Solutions Segment gross profit was due to increased infrastructure sales and reseller commissions. The Financial Management Applications Segment reported 41.0% margin for the first nine months of 2011 versus 44.8% for the same period in 2010 due to decreased new software and services sales with increased costs to operate this segment. The Cloud Services Segment reported -102.8% margin for the first nine months of 2011 versus -73.5% for the same period in 2010 due to increased costs from the additional workforce for the hosted voice solution, while revenues for the segment were improved 24%, but off a much smaller base compared to the other segments. The Technology Solutions Segment reported 16.1% margin for the first nine months of 2011, up from 14.0% for the same period of the prior year. The increase was due to a shift in product mix with less PC sales, which carry lower margins, and

improved performance of interactive classroom and cabling services and reseller commissions.

**Table of Contents****Operating Expenses**

Operating expenses for the nine months ended September 30, 2011 increased \$0.3 million compared to the same period of 2010, to \$7.6 million. The above table analyzes the major items that account for this increase. The increase was primarily a result of increased selling and marketing costs focused on increasing sales activity, as well as increased general and administrative costs focused on increased compliance related to the new start-up products. These factors were partially offset by reduced depreciation and amortization due to reduced amortizable assets from acquisitions. The \$0.3 million decrease in gross profit with the increase in operating expenses resulted in a decrease in operating results of \$0.7 million, or 59% compared to the prior year, to \$0.5 million.

**Segment Information**

CSI is organized into the three reportable segments: the Financial Management Applications Segment, the Cloud Services Segment and the Technology Solutions Segment. Below is a description of the types of products and services from which each reportable segment derives its revenues.

**Financial Management Applications Segment**

Through our Financial Management Applications Segment, we report the results of the development, sales, and deployment and provision of ongoing support of our fund accounting based financial management software. Through this segment, we also report the results of operations related to complimentary third-party applications and services we resell.

|  | September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--|-----------------------|--|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b>                                   | \$ 10,184             | \$ 10,472                                  | \$ (288)               |
| <b>GROSS PROFIT</b>  | 4,172                 | 4,691                                      | (519)                  |
| <b>SEGMENT INCOME</b>  | 1,521                 | 2,061                                      | (540)                  |
| <b>SIGNIFICANT ITEMS THAT INCREASED<br/>(DECREASED) SEGMENT INCOME</b> |                       |  |                        |
| Gross Profit:  |                       |  |                        |
| Sales  |                       |  | \$ (288)               |
| Cost of sales excluding depreciation, amortization, and capitalization |                       |  | (420)                  |
| Depreciation and amortization  |                       |  | 58                     |
| Capitalization of software costs                                       |                       |  | 131                    |
|  |                       |  | (519)                  |
| Operating Expenses:  |                       |  |                        |
| Selling costs  |                       |  | (48)                   |
| Marketing costs  |                       |  | (68)                   |
| Depreciation and amortization  |                       |  | 36                     |
| Other general and administrative expenses                              |                       |  | 59                     |
|  |                       |  | \$ (540)               |

Financial Management Applications revenues decreased by \$0.3 million, or 3%, in comparison with the first nine months of 2010. The decrease in software revenues was due primarily to decreases in fund accounting new software sales and services, partially offset by an increase in support revenues. The decline in new sales and services was due to a decrease in the upgrades of our Mobile applications for which there was a push to complete in 2010, without sufficient new license sales of our newest product to offset this decrease in prior quarters.

Financial Management Applications cost of sales increased by 4% in comparison with the first nine months of 2010. The increase in cost of sales came primarily from increased costs for development and support costs for enhancement work and support of the new version for which installs and conversions are increasing. It is anticipated that the development cost will be offset by economies of scale in future periods. This increase was partially offset by a larger amount of software costs being capitalized than in the prior year. The gross margin for the nine months ended

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September 30, 2011 was 41.0% compared to 44.8% in the same period of 2010. The decrease in the margin was due to decreased sales while cost of sales increased.

Financial management applications operating expenses for the segment increased slightly by 1% in comparison with the first nine months of 2010. The increase was primarily due to increased selling and marketing costs from increased marketing efforts, partially offset by reduced other general and administrative expenses. The segment experienced a decrease in segment operating income of \$0.5 million, or 26% in comparison to the nine months ended September 30, 2010, driven by the decrease in gross profit and the slight increase in operating expenses.

**Table of Contents****Cloud Services Segment**

Through our Cloud Services Segment, we report the results of the development, integration, sales and deployment of our proprietary standards based lesson planning software, solutions that facilitate single sign-on application access management and provisioning based on Microsoft's Identity Lifecycle Management, Cloud-based communication and collaboration solutions, based on Microsoft's Live@edu hosted exchange and SharePoint environments and Microsoft SharePoint deployments, and for Hosted VoIP. Through this segment we also report the results of operations related to complementary third-party applications and services which are an integral part of our solutions.

|                                      | September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--------------------------------------|-----------------------|--|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 866                | \$ 698                                     | \$ 168                 |
| <b>GROSS LOSS</b>                    | (890)                 | (513)                                      | (377)                  |
| <b>SEGMENT LOSS</b>                  | (1,838)               | (1,519)                                    | (319)                  |

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

|  |  |  |          |
|--|--|--|----------|
| Gross Profit:  |  |  |          |
| Sales  |  |  | \$ 168   |
| Cost of sales excluding depreciation, amortization, and capitalization |  |  | (428)    |
| Depreciation and amortization  |  |  | (152)    |
| Capitalization of software costs                                       |  |  | 35       |
|  |  |  | (377)    |
| Operating Expenses:  |  |  |          |
| Research and development   |  |  | 53       |
| Selling costs  |  |  | (43)     |
| Marketing costs  |  |  | 11       |
| Depreciation and amortization  |  |  | 81       |
| Other general and administrative expenses                              |  |  | (44)     |
|  |  |  | \$ (319) |

Cloud Services revenues increased by \$0.2 million, or 24%, in comparison with the first nine months of 2010. The increase in revenues was due to increased sales of our hosted email and hosted voice solutions, while we did not have any sales of these solutions in the prior year.

Cloud Services cost of sales increased \$0.5 million, or 45%, in comparison with the first nine months of 2010. The increase in cost of sales came from increased costs for the hosted voice solution, primarily additional operations personnel, increased depreciation and amortization due to an increased investment in assets for this segment, partially offset by an increase in software costs being capitalized. The gross margin for the nine months ended September 30, 2011 was -102.8% compared to -73.5% in the same period of 2010. The decrease in the margin was due to the increase in costs of sales exceeding the sales increase.

Cloud Services operating expenses decreased \$0.1 million, or 6% in comparison with the nine months ended September 30, 2010. The decrease was primarily due to reduced research and development costs with more costs being capitalized as the CSI@K12 project matures, and decreased depreciation and amortization. The segment experienced a decrease in segment operating income of \$0.3 million, or 21% in comparison to the first nine months of 2010, driven by the decrease in gross profit, partially offset by the decrease in operating expenses.

**Technology Solutions Segment**

Through our Technology Solutions Segment, we report the results of the technology solutions products through the sales and distribution of computers, networks, technology infrastructure, on-premise VoIP systems, interactive classroom solutions, security and surveillance systems, cabling and accessories and the wide range of technology consulting services, including network and systems integration and computer support and maintenance services, that we provide.





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|                                      | September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2010 | Increase<br>(Decrease) |
|--------------------------------------|-----------------------|--|------------------------|
| <b>NET SALES AND SERVICE REVENUE</b> | \$ 29,787             | \$ 30,121                                  | \$ (334)               |
| <b>GROSS PROFIT</b>                  | 4,781                 | 4,219                                      | 562                    |
| <b>SEGMENT INCOME</b>                | 1,204                 | 1,053                                      | 151                    |

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

|  |  |  |          |
|--|--|--|----------|
| <b>Gross Profit:</b>   |  |  |          |
| Sales  |  |  | \$ (334) |
| Cost of sales excluding depreciation, amortization, and capitalization |  |  | 891      |
| Depreciation and amortization  |  |  | 5        |
|  |  |  | 562      |
| <b>Operating Expenses:</b>   |  |  |          |
| Selling costs  |  |  | (309)    |
| Marketing costs  |  |  | 4        |
| Depreciation and amortization  |  |  | 9        |
| Other general and administrative expenses                              |  |  | (115)    |
|  |  |  | \$ 151   |

Technology Solutions revenues decreased by \$0.4 million, or 1%, in comparison to the nine months ended September 30, 2010. The decrease in technology revenues was due to a decrease in PC and interactive classroom sales, partially offset by an increase in infrastructure, reseller commissions and interactive classroom and cabling services.

Technology Solutions cost of sales decreased \$0.9 million, or 3% in comparison to the first nine months of 2010. The decrease in technology cost of sales accompanied the decrease in technology revenues for products, and combined with a favorable shift in product mix. Gross profit for the period increased \$0.6 million due to a favorable product mix with increased infrastructure sales, reseller commissions and internal interactive classroom services. Segment gross margin for the period increased from 14.0% to 16.1% due to the favorable change in product mix, primarily from increased reseller commissions, improved performance of interactive classroom and cabling services and less PC sales which carry lower margins (typically less than 5%).

Technology Solutions operating expenses increased \$0.4 million, or 13% in comparison to the first nine months of 2010. The increase was primarily due to an increase in selling costs to focus on generating more sales activities, accompanied by increased other general and administrative costs for this segment. As a result of the increase in gross profit, partially offset by the increase in operating expenses, the segment experienced an increase in segment operating income of \$0.2 million, or 14% in comparison to the first nine months of 2010.

The following tables summarize information about segment income (loss) for the nine months ended September 30, 2011 and 2010, and assets allocated to segments as of September 30, 2011 and 2010. Changes in segment assets came primarily from the following:

Financial Management Applications Segment assets increased due to increases in accounts receivable, income tax receivable and capitalized computer software costs. The aggregate increase was partially offset by a decrease in other assets due to amortization of these assets without any acquisition activity recently.

Cloud Services Segment assets increased due to increased accounts receivable, property and equipment and capitalized computer software costs. This is due to the investment being made in this segment with the hosted email and VoIP solutions.

Technology Solutions Segment assets increased primarily from an increase in accounts receivable, income tax receivable and inventory.



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|                                      | Financial<br>Management<br>Applications | Cloud Services | Technology<br>Solutions | Total<br>Company |
|--------------------------------------|---|----------------|-------------------------|------------------|
| Nine months ended September 30, 2011 |   |                |                         |                  |
| Net sales and service revenue        | \$ 10,184                               | \$ 866         | \$ 29,787               | \$ 40,837        |
| Gross profit (loss)                  | 4,172                                   | (890)          | 4,781                   | 8,063            |
| Segment income (loss)                | 1,521                                   | (1,838)        | 1,204                   | (*)              |
| Segment assets                       | 9,186                                   | 3,100          | 11,124                  | 23,410           |
| Nine months ended September 30, 2010 |   |                |                         |                  |
| Net sales and service revenue        | \$ 10,472                               | \$ 698         | \$ 30,121               | \$ 41,291        |
| Gross profit (loss)                  | 4,691                                   | (513)          | 4,219                   | 8,397            |
| Segment income (loss)                | 2,061                                   | (1,519)        | 1,053                   | (*)              |
| Segment assets                       | 8,302                                   | 2,431          | 7,661                   | 18,394           |

\* See reconciliation below

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

|   | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2011 | September 30,<br>2010 |
| <b>Segment income (loss):</b>                                     |                       |                       |
| Financial Management Applications Segment                         | \$ 1,521              | \$ 2,061              |
| Cloud Services Segment  | (1,838)               | (1,519)               |
| Technology Solutions Segment                                      | 1,204                 | 1,053                 |
| <b>TOTAL SEGMENT INCOME</b>                                       | <b>887</b>            | <b>1,595</b>          |
| <b>Less: merger-related and compliance costs</b>                  |                       |                       |
| Stock compensation non-cash                                       | (22)                  | (49)                  |
| Professional and legal compliance costs                           | (386)                 | (385)                 |
| <b>OPERATING INCOME Per Consolidated Statements of Operations</b> | <b>\$ 479</b>         | <b>\$ 1,161</b>       |

**Interest and Other Income and Expenses**

Interest expense decreased for the nine months ended September 30, 2011 by 33%, compared to the same period of 2010. The decrease was due to reduced borrowings on the subordinated debt during the first nine months of 2011 compared to the same period in 2010.

**Income Taxes**

Income tax expense decreased by \$0.5 million, or 119% compared to the first nine months of 2010, to an income tax benefit of \$0.1 million in the first nine months of 2011. The decrease was due to the reduced pretax income and a lower effective tax when compared to the prior year.

The effective tax rates for the nine months ended September 30, 2011 and 2010 were approximately -24.0% and 46.2%, respectively. The decrease in the effective tax rate is due to the impact of non-deductible items on a negative pre-tax base for the nine months ended September 30, 2011, coupled with increased deferred tax assets recorded for additional South Carolina Jobs Tax Credits related to an increase in sustained jobs and potential utilization of future credits in connection with the new solutions introduced in the Cloud Services Segment. This shifted income tax expense to a benefit in the current year.

**Net Income and Income per Share**

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Net income decreased in the first nine months of 2011 by \$0.1 million, or 18% compared to the same period of 2010, to net income of \$0.4 million.

Basic earnings per share decreased from earnings per share of \$0.08 for the nine months ended September 30, 2010 to earnings per share of \$0.06 for the nine months ended September 30, 2011. The decrease was primarily due to the decrease in net income. Diluted earnings per share decreased from earnings per share of \$0.04 for the nine months ended September 30, 2010 to earnings per share of \$0.03 for the nine months ended September 30, 2011. The decrease was primarily due to the decrease in net income.

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### **G. Liquidity and Capital Resources**

Our strategic plan includes the expansion of the Company both organically and through acquisitions. Due to the long-term nature of investments in acquisitions, new product development, selling, marketing, administration and product modification investment to support geographic expansion 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 \$7.8 million revolving line of credit.

#### **Cash Flows**

For the nine months ended September 30, 2011, we had a decrease of \$1.6 million in cash and cash equivalents generated from \$2.1 million used for operating activities and \$2.3 million used for investment in property and equipment and capitalized software, partially offset by \$2.8 million of cash provided by financing activities. For the nine months ended September 30, 2010, we had no change in cash and cash equivalents. Since the time of the reverse merger in 2005 the Company has operated in most periods without cash and in reliance on a revolving line of credit facility to fund its day to day working capital needs and acquisition activities. The increase in cash used from the prior year was primarily from an increase in accounts receivable and inventory levels, with movement upward in 2011 from lower levels at the end of 2010 and from increased sales and product delivery later in the third quarter, close to the end of the reporting period than in the prior year, which sustained higher second quarter sales and higher collections in the third quarter. Increased capital expenditures for the addition of Hosted VoIP to our Cloud Services offerings also contributed to the increased use.

#### *Cash from Operating Activities*

For the nine months ended September 30, 2011, cash used for operating activities totaled \$2.1 million compared to cash provided by operating activities of approximately \$1.9 million for the same period of 2010. The decrease, \$4.0 million, was due to reduced operating income in the first nine months of 2011 compared to that of the prior year and changes in accounts receivable and inventory levels for the reasons previously mentioned.

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 decreased collections and increased billings through September 30, 2011 as compared to the amounts billed prior to December 31, 2010. The increase in inventories was due to more purchases of interactive classroom products than sales since the year end. Accounts payable increased primarily due to increased business activity as of third quarter end than compared to December 31, 2010. Deferred revenue decreased due to more billings for support agreements being deferred at December 31, 2010 than as of the current period end.

#### *Cash used for Investing Activities*

Cash used for investing activities totaled \$2.3 million in the first nine months of 2011 compared to \$1.9 million in the first nine months of 2010. The increase of \$0.4 million was due to increased purchases of property and equipment, mostly for the Hosted VoIP solution in the Cloud Services Segment and increased capitalization of software costs.

On the balance sheet, since year end 2010, capitalized software costs and property and equipment have increased due to the Cloud Services Segment investment and CSI@K12 development. Other intangible assets declined from no increase in other intangible assets with no new acquisitions, offset by ongoing depreciation and amortization. Goodwill also remained flat with no acquisition activity.

#### *Cash from Financing Activities*

Cash provided by financing activities totaled \$2.8 million in the first nine months of 2011 compared to a small amount of cash provided by financing activities in the first nine months of 2010. In the current year, net borrowings under the line of credit exceeded the scheduled repayments on notes payable, with the borrowings on the line of credit in the current year driven primarily by the changes in operating and investing activities.

On the balance sheet, interest bearing debt was higher than the balance at the end of the year, due to the increase in line of credit borrowings for operations and investing activities.

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

*Three and Nine Month Periods Ended September 30, 2011 and 2010*

EBITDA increased \$0.1 million, or 7%, to \$1.4 million for the three months ended September 30, 2011 compared to the same period in 2010. The increase in EBITDA was primarily due to the increase in operating income compared to the prior year. Adjusted (financing) EBITDA for the quarter ended September 30, 2011 increased by \$0.1 million, or 7%, to \$1.4 million for the same reason as the change in EBITDA.

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EBITDA decreased \$0.7 million, or 25%, to \$2.2 million for the nine months ended September 30, 2011 compared to the same period in 2010. The decrease in EBITDA was primarily due to the decrease in operating income compared to the prior year. Adjusted (financing) EBITDA for the nine months ended September 30, 2011 decreased by \$0.7 million, or 25%, to \$2.2 million for the same reason as the change in EBITDA.

*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 or loss (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.



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

|  | Three Months Ended |                 | Nine Months Ended |                 |
|--|--------------------|-----------------|-------------------|-----------------|
|  | September 30,      | September 30,   | September 30,     | September 30,   |
|  | 2011               | 2010            | 2011              | 2010            |
| <b>Reconciliation of net income per GAAP to EBITDA and Adjusted (Financing) EBITDA:</b>                        |                    |                 |                   |                 |
| Net income per GAAP  | \$ 794             | \$ 387          | \$ 424            | \$ 515          |
| <b>Adjustments:</b>  |                    |                 |                   |                 |
| Income tax expense (benefit)   | (44)               | 295             | (82)              | 443             |
| Interest expense, net  | 49                 | 54              | 137               | 201             |
| Depreciation and amortization of property and equipment and intangible assets (excluding Software development) | 230                | 211             | 645               | 636             |
| Amortization of software development costs   | 405                | 387             | 1,039             | 1,085           |
| <b>EBITDA</b>  | <b>\$ 1,434</b>    | <b>\$ 1,334</b> | <b>\$ 2,163</b>   | <b>\$ 2,880</b> |
| <b>Adjustments to EBITDA to exclude those items excluded in loan covenant calculations:</b>                    |                    |                 |                   |                 |
| Stock based compensation (non-cash portion)  | 7                  | 8               | 22                | 49              |
| <b>Adjusted (Financing) EBITDA</b>   | <b>\$ 1,441</b>    | <b>\$ 1,342</b> | <b>\$ 2,185</b>   | <b>\$ 2,929</b> |

**Credit Arrangements***Credit Facilities*

Prior to our going public through the reverse merger, we funded operations through cash flow from operations. In our 2005 reverse merger, which took the CSI operations public, substantially all of our cash was distributed to the founders in exchange for ownership. Due to continued acquisition activity and the recapitalization of the Company in connection with going public through a reverse merger, the Company frequently has no excess cash and relies on its \$7.8 million line of credit facility with its bank to fund its working capital and other funding needs. Accordingly, we now use primarily our working capital facility and term loans to fund our operations. See the notes to our unaudited consolidated financial statements included in this report for more details on our borrowing facilities.

Our current credit facilities consist of:

\$7.8 million revolving line of credit (temporarily increased from \$7.0 million), of which \$3.2 million was drawn and \$4.6 million was available at September 30, 2011, which bears interest at LIBOR plus 2.5% (subject to a 3% floor) and matures July 3, 2013 (the temporary \$1.0 million increase will be reduced by \$200 annually each January 31, beginning 2011 through 2015 and was provided in consideration of our paydown of \$0.9 million on our subordinated notes, with a draw on the line, not impacting our prior ability to access \$7.0 million of working capital via the line);

\$1.1 million equipment note, of which approximately \$0.7 million was outstanding at September 30, 2011, which bears interest at LIBOR plus 2.5%, and has a two and one-half year amortization maturing in April 2013; and

\$2.3 million in subordinated notes to Barron Partners and the five founding shareholders, of which \$0.8 million remained outstanding at September 30, 2011, which bear interest at 15% and mature no later than January 1, 2018. The notes are subordinated to our bank lender with whom we have our line of credit.

*Auto Fleet Lease Facility*

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The Company has a \$2 million facility under which it leases multiple automobiles under a managed, out-sourced (or fleet ) program, to support the transportation needs for certain (where cost-effective) sales and delivery efforts. The automobile leases are accounted for as operating leases and lease payments and all other expenses related to these transportation needs are expensed as incurred, just as they would be without the program. Additionally, the program manages the commitment to adding vehicles and exiting of commitments for vehicles when replaced or disposed of, with minimal cost. The Company utilizes the fleet lease program to avoid the administrative costs it would incur if it were to manage such an activity in house. Without the advantage of sharing overhead costs necessary for the management of such a program with others and through economies of scale, such as an outsourced provider can achieve, management would not achieve sufficient savings to administer such a program and would simply choose to incur all related costs as a mileage reimbursement to the employees for use of their personal vehicles. Management believes it would not be cost effective to purchase the vehicles through any type of capital funding, and incur the costs to internally manage and dispose of the vehicles. In addition to the increased costs of internal administration, the disposal costs would likely be greater than incurred under the fleet management program, since the Company is not in the used vehicle market. Accordingly, the Company considers the leasing arrangement an administrative tool, and not a significant source of capital. The program consists of mid-sized, standard vehicles traditionally used for sales activities with a reasonable step up in vehicle model for key managers. Individuals pay a portion of the costs

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for personal use, with an increased payment by managers. Vehicles are only provided for those who travel sufficient miles for the company to experience savings over traditional per mile reimbursement if driving a personal car, sufficient to justify their inclusion in the car program. We do not provide luxury vehicles for any members of management, and neither the CEO nor CFO are provided cars as they do not currently drive sufficient mileage to justify one. The auto fleet leases are discussed under Note 7 to our unaudited consolidated financial statements for the period ended September 30, 2011.

*Factors Affecting Capital Needs and Resources*

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:

our operating cash flow;

\$4.6 million available to our operations at September 30, 2011 under our \$7.8 million line of credit;

the anticipated level of capital expenditures for 2011 of \$1.6 million (\$0.8 million expended through September 30, 2011);

capitalized software development costs of approximately \$1.9 million;

estimated purchase commitments with suppliers;

our scheduled debt service on senior term borrowings;

repayment of our subordinated notes; and

potential future acquisitions.

The above items are described in more detail below.

*Expected Cash Flow from Operations*

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 costs and operating expenses required to sell and provide our solutions and services and to administer our business;

the cost of acquiring and retaining customers; and

our ability to continue to grow our customer base.

Our cash flow from operations has been reasonably strong over the past several years and through the current quarter, as we have increased our business, including recurring revenues and collected cash generally applied to our revolver, and have had sufficient availability under our line of credit to support our working capital needs and fund acquisitions. Two of the three acquisitions have generated cash sufficient to service the borrowings made to purchase them, and the third was purchased primarily with shares of our stock. Our greatest risk to cash flows at this time is the potential continuing impact of the current economic downturn, potentially mitigated by greater opportunities from an expanded geographic reach following our acquisitions.

#### *Bank Credit Facilities*

In light of our growth and acquisition strategy, we believe for the foreseeable future we will rely on our bank credit facilities.

While we have drawn on our line significantly and paid it down from time to time, we cannot guarantee that cash flow from operations will be sufficient to repay our line of credit facility at the time it is due and adequately fund our growing working capital needs. In the alternative, we would attempt to refinance the credit facility with another lender. Our bank line of credit currently is due to expire in July 2013. Although management currently believes that our existing lender will agree to a future 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. We cannot guarantee that operations will generate sufficient results to meet leverage ratios to support necessary borrowings or procure new financing. 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.

On September 21, 2011, the Company entered into a modification of the line of credit facility, extending the maturity date from June 30, 2012 to July 3, 2013. Previously, on June 25, 2010 the Company entered into a modification of the line of credit facility temporarily increasing the line of credit from \$7.0 million to \$8.0 million and this increase will be reduced

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annually by \$200 beginning January 31, 2011 until the balance reaches \$7.0 million on January 31, 2015. The increase in the bank's revolving line of credit from \$7.0 million to \$8.0 million was for the purpose of accommodating a capital need to fund the June 2010 payments of \$875, paid on and as agreed in an extension of, the Subordinated Notes (discussed below), while deferring any immediate impact on working capital line availability.

On November 5, 2010, we refinanced our equipment note increasing it by \$1.0 million to approximately the same amount to which it was previously increased and refinanced. The purpose of the increase was to refinance our recent capital expenditures originally financed by draws on our line of credit, to match the period over which they are generally used and to replenish working capital availability under the line for these purchases. The terms of the equipment note, including payment and interest, remained the same as with the prior refinance.

### *Capital Expenditures and Software Development Costs*

We currently anticipate that our capital needs for 2011 will principally consist of \$1.9 million for software development and \$1.6 million capital expenditures. The increase in capital expenditures is anticipated in connection with a growth in revenues for Hosted VoIP and the infrastructure needed to support such growth. This need could be significantly higher or lower dependent on the actual growth achieved in this new product area and should relate directly to revenues and profitability for this solution area. Unlike our past investments in capital expenditures, which have been primarily small to support internal administrative and customer support needs, this investment will be more directly linked to the number of customers we onboard to use this solution. We generally fund equipment purchases through our line of credit but periodically finance or refinance such purchases over a longer period, typically around three years to coincide with the longer-term nature of the relationships with customers and return on investment timeline under such solutions.

For the nine months ended September 30, 2011, we have capitalized approximately \$1.4 million of software development costs and \$0.8 million in capital expenditures. We plan to fund remaining 2011 needs for these items through cash flow from operations and draws under our bank line of credit or longer term borrowings such as our equipment note. The Company also considers leasing of capital equipment as a financing option, to the extent terms are reasonable in comparison to other financing options, and particularly where there may be a benefit related to the costs of administration of the equipment, particularly with regard to its disposal. The Company currently leases a number of vehicles for the sales people and engineers who are on the road due to the cost-effective nature of the program in comparison to the costs of paying standard mileage rates for a high level of travel, and considering the low cost of outsourced administration through the program. Under our agreements for borrowings with our bank we are required to obtain and have obtained permission to enter into leasing programs, particularly as the terms have been beneficial to our operations. We anticipate, but cannot guarantee our bank will continue to support our entering into additional leasing facilities, particularly when the terms are favorable and purposes effectively support our operations.

### *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. In prior years we have had purchase order commitments to one of our major suppliers for interactive whiteboard inventory purchases in excess of \$12.0 million. We may receive and agree to, but have not yet committed to any amounts for 2011. 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.

### *Subordinated Promissory Notes*

At September 30, 2011, subordinated promissory notes payable to shareholders totaled approximately \$0.8 million. On June 25, 2010, we entered into an extension of Subordinated Notes and Waiver dated June 24, 2010 (the "Extension"). Pursuant to the Extension:

the Company agreed to make, within five days of the date of approval of the Extension, principal payments on the notes totaling \$875, \$438 in the case of the Subordinated Note held by Barron Partners LP ( "Barron") and \$88 each in the case of the other five note holders. These payments were made on June 29, 2010;

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the maturity date of each Subordinated Note was extended from August 30, 2009 until no later than January 1, 2018, on which date all principal and accrued interest will be due and payable in full, if not earlier paid;

the Company, beginning October 1, 2010, will make quarterly payments on the Subordinated Notes of principal and accrued interest in the amount of \$50 in the aggregate to be applied pro-rata among the note holders, \$25 on the Barron Subordinated Note and \$5 each on the other Subordinated Notes;

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the Company expressed its intention to consider subsequent to each fiscal year end during the term of the Subordinated Notes whether it can make principal payments in addition to those expressly set forth in the Extension. Any such determination by the management and board of directors of the Company is in their sole discretion, and shall be based on factors they deem relevant, including but not limited to the financial performance of the Company during such fiscal year;

at the discretion of management and the board of directors of the Company, the remaining balance on the Subordinated Notes can be repaid in full at any time without penalty;

the Subordinated Notes are no longer in default, and each note holder waived any existing or past default based upon the Company failing to make any payment of interest or principal when due;

despite the Subordinated Notes not being in default, they will continue to bear interest at the Default Rate of 15% until repaid; and

except as modified by the Extension, all other terms and conditions of the Subordinated Notes were confirmed and shall remain in full force and effect.

The Subordinated Notes were issued on February 11, 2005 as a part of our reverse merger and recapitalization. The Subordinated Notes are unsecured and are subordinated to the Company's senior debt, including its revolving credit and term debt with its bank lender. The original principal of all of the Subordinated Notes aggregated \$3,750. The Company has paid interest at the default rate of 15% per annum since the original maturity date of May 9, 2006, when the Company, with the support of its management, board of directors and the Bank elected to defer the payment and pay the default interest rate to use the funds to support working capital needs and investments in acquisitions. The Subordinated Notes were extended several times, the latest being pursuant to the September 21, 2011 Extension, described above.

In addition to Barron Partners, LP, which owns all of our preferred stock, the Subordinated Notes are held by the five shareholders of our predecessor, Computer Software Innovations, Inc., a South Carolina corporation. Four of these note holders are currently executive officers of the Company, and include: Nancy K. Hedrick, President and Chief Executive Officer; Thomas P. Clinton, Senior Vice President of Strategic Relationships; Beverly N. Hawkins, Senior Vice President of Software Development; and William J. Buchanan, Senior Vice President of House Accounts. The fifth holder, Joe G. Black, formerly served as chief financial officer of the Company.

The restructuring of the Subordinated Notes permits the Company to repay the remaining \$858 in principal over an approximate seven-year period. Although the Company may choose to repay the Subordinated Notes earlier, particularly as a result of superior financial performance and to reduce interest costs, the arrangement removes a default and gives the Company flexibility in managing its future liquidity and capital needs. Such future needs might include future acquisitions, and increased working capital relating to significant sales growth as a result of a turnaround in the general economy or increased Federal funding of technology expenditures for education.

### *Expiration of Warrants*

On June 1, 2011, warrants issued to DC Consulting expired. The warrants were originally issued in May 2009 pursuant to the terms of a Consulting Agreement with DC Consulting, LLC whereby DC Consulting provided investor relations services.

On February 10, 2010, warrants issued to Barron expired. The warrants were issued in February 2005 as a part of the preferred stock investment by Barron in the Company. At the time, it was anticipated that the exercise of the warrants by Barron would generate a significant amount of capital for the Company. Given the stock price of our common stock following issuance of the warrants, few of the warrants were exercised. On December 29, 2006, we entered into an agreement with Barron to divide, amend and restate the warrants, including a reduction in the exercise price. Subsequent to the price reduction and prior to the expiration of the warrants, Barron effectuated exercises in the latter part of 2007 with proceeds to the Company totaling \$738. The remaining warrants ranging in price from \$.70 per share to \$2.0958 per share would have generated proceeds of approximately \$8.7 million.

Accordingly, the expiration of the warrants took away a potential source of additional capital for the Company. Other financing options are discussed in *-Adequacy of Liquidity and Capital Resources* below.

### *Potential Acquisitions*

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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 capital 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



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otherwise be able to conclude and successfully integrate any acquisition. Also, while our line of credit may be sufficient, its adequacy may be strained by 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 are under consideration and could provide longer-term financing to match the longer-term nature of an acquisition related investment.

### *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, and presuming no impact from the current economic downturn so significant as to cause the Company to not meet its debt covenants, 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. 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 any 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 acquisition activities and increased working capital. Depending on cash flow from current operations, should we find longer-term funding unnecessary, we may not take advantage of such additional funding options, thereby paying down debt and minimizing any potential for dilution from any additional raise of capital. In May 2011, we retained an investment banking firm to advise us with respect to strategic options, including potential capital and financing alternatives.

Any of the aforementioned events or circumstances 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, or obtain other funding at reasonable rates could have a negative impact on our business.

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

### **Evaluation of Disclosure 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, as amended, is recorded, processed, summarized and reported within the time periods required by the SEC, including, without limitation, those controls and procedures designed to ensure that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosures.

Our management, under the direction of our chief executive officer and chief financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such terms are defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2011. Based upon this evaluation our management, including our chief executive officer and chief financial officer, has concluded that our disclosure controls were effective for the reporting period ended September 30, 2011, such that the information relating to us required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of published financial statements in accordance with generally accepted accounting principles.

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However, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or the degree of compliance with policies may deteriorate.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

The Company is involved in various claims and legal actions arising in the normal course of business. Management believes that these proceedings will not result in a material loss to the Company.

**Item 1A. Risk Factors.**

Information regarding risk factors appears in Management's Discussion and Analysis of Financial Condition and Results of Operations Forward-looking and Cautionary Statements, in Part I-Item 2 of this Form 10-Q. More detailed information concerning our risk factors may be found in Part I-Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010 (the Form 10-K).

There have been no material changes in the risk factors previously disclosed in Part I-Item 1A of our Form 10-K.

**Item 5. Other Information.****Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant**

Our revolving credit arrangement with RBC Bank (USA) is a facility under which we may borrow, repay and then re-borrow. Advances and repayments occur daily under the credit facility, reflecting cash receipts and the Company's working capital needs. Set forth below is the outstanding balance as of specific dates through November 7, 2011. The balances presented reflect aggregate advances and pay downs which the Company deems material, or significant. Such information through September 19, 2011, was previously disclosed in our Form 8-K filed with the Commission on September 23, 2011.

| <b>Date</b>        | <b>Loan Balance</b> |
|--------------------|---------------------|
| September 26, 2011 | \$ 2,782,000        |
| October 6, 2011    | 3,749,000           |
| October 13, 2011   | 3,651,000           |
| October 20, 2011   | 4,098,000           |
| October 27, 2011   | 3,742,000           |
| November 1, 2011   | 3,304,000           |
| November 7, 2011   | 4,080,000           |

**Table of Contents****Item 6. Exhibits.**

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 10.1                  | Modification Agreement between the Company and RBC Bank (USA) dated September 21, 2011 (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed September 23, 2011). |
| 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.  |
| 101.INS**             | XBRL Instance Document  |
| 101.SCH**             | XBRL Taxonomy Schema  |
| 101.CAL**             | XBRL Taxonomy Calculation Linkbase Document   |
| 101.DEF**             | XBRL Taxonomy Definition Linkbase Document  |
| 101.LAB**             | XBRL Taxonomy Label Linkbase Document   |
| 101.PRE**             | XBRL Taxonomy Presentation Linkbase Document  |

\* Filed herewith.

\*\* Pursuant to Rule 406T of Regulation S-T, exhibits marked with two asterisks (\*\*) are interactive data files and are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability

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**SIGNATURES**

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

COMPUTER SOFTWARE INNOVATIONS, INC.

Date: November 14, 2011

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

Date: November 14, 2011

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

**Table of Contents****EXHIBIT INDEX**

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| 10.1                  | Modification Agreement between the Company and RBC Bank (USA) dated September 21, 2011 (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed September 23, 2011). |
| 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.  |
| 101.INS**             | XBRL Instance Document  |
| 101.SCH**             | XBRL Taxonomy Schema  |
| 101.CAL**             | XBRL Taxonomy Calculation Linkbase Document   |
| 101.DEF**             | XBRL Taxonomy Definition Linkbase Document  |
| 101.LAB**             | XBRL Taxonomy Label Linkbase Document   |
| 101.PRE**             | XBRL Taxonomy Presentation Linkbase Document  |

\* Filed herewith.

\*\* Pursuant to Rule 406T of Regulation S-T, exhibits marked with two asterisks (\*\*) are interactive data files and are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability