

NETSMART TECHNOLOGIES INC  
Form 10-K  
March 31, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

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

For the fiscal year ended December 31, 2005

Commission file number: 0-21177

**NETSMART TECHNOLOGIES, INC.**  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

13-3680154  
(I.R.S. Employer  
Identification Number)

3500 Sunrise Highway, Suite D-122, Great River, NY  
(Address of principal executive offices)

11739  
(Zip Code)

Registrant's telephone number, including area code: (631) 968-2000

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

Title of each class

Name of each exchange on which registered

None

None

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

Common Stock, par value \$.01 per share  
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. oYes xNo

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. oYes xNo

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.

x Yes oNo

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Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S - K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of June 30, 2005, the last day of the Registrant’s second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non affiliates was approximately \$42,386,000.

As of March 20, 2006, the registrant had outstanding 6,497,724 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

None

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## Part I

### Forward-Looking Statements

Statements in this Form 10-K annual report may be “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions. These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those risks discussed from time to time in this Form 10-K annual report for the year ended December 31, 2005, and in other documents which we file with the Securities and Exchange Commission. In addition, such statements could be affected by risks and uncertainties related to product demand, market and customer acceptance, competition, government regulations and requirements, pricing and development difficulties, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-K.

### Item 1. Business.

In this report, the terms "Netsmart," "we," "us" or "our" mean Netsmart Technologies, Inc. and the subsidiaries in our consolidated financial statements.

### Introduction

We develop market, and support application software for health and human services organizations. In many cases, our software serves as the foundation for the financial, clinical and management processes for our customers, which include mental health clinics, substance abuse clinics, psychiatric hospitals, public health agencies, and managed care entities.

Our software facilitates key functions, such as patient management, billing, scheduling, and electronic medical records, for all modalities of care. We sell our software products, either on a licensed or a subscription basis. We also offer software support and upgrades under maintenance agreements with our customers, an arrangement which provides us with a recurring revenue stream. We currently have in place contracts with more than 1,250 customer organizations in all 50 states, U.S. territories and several other countries. These contracts represent more than 100,000 users and include more than 30 state agencies that operate and/or manage multiple facilities.

The ability for government agencies and non-profit organizations to integrate their services is becoming more critical as they face requirements to provide a wider range of services to more clients, but with less money. Our software, services, and industry knowledge are designed to help our customers gain operational efficiencies, while at the same time protecting the privacy of sensitive health data. As a result, we are seeing increased demand for our software from government agencies who are integrating services, and from major systems integrators interested in reselling our software as part of their role in supporting these agencies.

The cost of a new software system for our customers typically ranges from \$10,000 to \$100,000 for a single-facility healthcare organization to \$250,000 to several million dollars for multi-unit care organizations, such as those run by state agencies. Government agencies, such as mental health, mental retardation, child welfare, addiction, correction and public health facilities, accounted for approximately 44% of revenue in 2005, with the remainder coming from

private hospitals, smaller clinics, group and sole practitioners.

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Netsmart also furnishes data center services to providers that do not wish to maintain the staff and infrastructure required to manage a direct-bill relationship with multiple payers for mental health, alcohol and substance abuse services. Data Center services include statistical reporting, data entry, electronic billing and submission. This business line provides a recurring revenue stream that contributes to the recurring revenue base described above.

We also offer an Application Service Provider (“ASP”) option, which makes our Avatar software suite, CareNet, InfoScriber and Netsmart University products available either via a secure connection to the Internet or via a virtual private network (“VPN”). The ASP model reduces the upfront capital investment required for customers to procure our software and enables customers to deploy our products more rapidly and to pay a monthly services-based fee rather than an upfront license fee. The ASP model also eliminates the need for customers to continually upgrade their hardware systems. In addition, it provides an opportunity for us to become more integrated with the customer’s day-to-day operations.

### **Recent Acquisitions**

In 2005, we completed acquisitions of three companies with products and services complementary to our existing offerings. Each of these acquisitions expands our product offerings, and enhances our ability to offer our customers a wide range of products and services that are designed to meet their needs.

We acquired ContinuedLearning, a Florida-based provider of online training services. We have integrated ContinuedLearning’s product offerings with our existing customer training programs, and branded the combined offerings as “Netsmart University”. Netsmart University includes a wide range of Web-based, classroom and onsite training, as well as a learning management system that is designed to enable behavioral healthcare and other organizations to effectively manage their own training and development initiatives. Netsmart University offers access to hundreds of online courses in behavioral healthcare, safety, and compliance.

We acquired Addiction Management Systems, Inc., solidifying our position as one of the nation’s largest suppliers of automated computerized methadone dispensing systems. We now serve more than 400 of the estimated 1,100 methadone clinics in the U.S., providing a range of offerings for customers ranging from small “storefront” clinics to large clinics managed by large institutional health providers.

In September 2005, we completed the acquisition of CMHC Systems, a leading competitor in the behavioral healthcare software market. As a result of the acquisition, we acquired more than 400 additional customer organizations, primarily in the community behavioral healthcare sector.

### **Our Strategy**

As one of the largest providers of technology solutions in the behavioral health market, we believe we have the unique ability to provide our customers with the widest range of solutions that can help them furnish high quality care to their clients at a high level of efficiency. Our comprehensive information technology solutions include functionality for billing, patient tracking and scheduling (for inpatient and outpatient environments), as well as clinical documentation and medical record generation and management. The key elements of our strategy are to:

**Capitalize on market initiatives.** Our strategy is to recognize the changes in the health and human services market that are necessitated by legislation and other initiatives and to design our software and services to meet the needs of our clients resulting from those changes. Consequently, we have

- designed our software to manage a wide variety of processes from check-in to treatment planning, which we believe is well-suited for agencies seeking to implement a technology infrastructure that supports integrated services

combined our products with products offered by other companies with which we have a marketing arrangement, enabling us to offer comprehensive enterprise-wide HIPAA-compliant and HIPAA-related business services for most human service providers

·positioned and developed our software and services to support the goals and implementation of an Electronic Health Record

We intend to maintain and enhance our market position by continuing to invest significant resources in research and development of software and services solutions designed to address the factors affecting market demand. See “Markets” below.

***Expand our product offerings and revenue base.*** We intend to use our recent acquisitions to expand both our product offerings and our sales to existing and newly-acquired customers. Our recent acquisitions have enabled us to create new packages of products, such as Netsmart University, which we are marketing to existing and prospective customers. With many Continuing Education Units available, we believe Netsmart University will be well-received within our core market and that there are opportunities to sell its more generic capabilities into closely-related market segments. Our acquisitions have also provided us with the opportunity to sell our existing products to the customers of the businesses we acquired, thereby increasing our recurring revenue.

***Continue to pursue strategic acquisitions.*** We have in the past grown in part through acquisitions of complimentary businesses. We intend to continue to identify and acquire companies or lines of business which are complimentary to our existing businesses.

### **Organization of the Company**

We are a Delaware corporation formed in September 1992 under the name Medical Services Corp. Our name was changed to Carte Medical Corporation in October 1993 to CSMC Corporation in June 1995 and to Netsmart Technologies, Inc. in February 1996.

Our executive offices are located at 3500 Sunrise Highway, Suite D-122, Great River, New York 11739, telephone (631) 968-2000. Reference to us and to Netsmart includes both our legal subsidiaries Netsmart New York and Netsmart Ohio. Our website is located at [www.ntst.com](http://www.ntst.com).

Neither the information contained in our website nor the information contained in any Internet Web site is a part of this Form 10-K annual report.

### **Available Information:**

The public may read and copy any materials filed by us with the SEC at the SEC’s public reference room at 450 Fifth Street, NW, Washington D.C., 20549. The public may obtain information about the operation of the SEC’s public reference rooms by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website at <http://www.sec.gov> that contains reports, proxy and information statements and other information about issuers such as us that file electronically with the SEC.

In addition, we make available free of charge on our website at [www.ntst.com](http://www.ntst.com) our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) under the Exchange Act as soon as reasonably practical after we electronically file such material with, or furnish it to, the SEC.

Our Board of Directors has adopted a Code of Business Conduct applicable to the Company’s officers and employees, and has also adopted a Code of Ethics for its senior financial officers. These codes of ethics are posted on the Company’s website at [www.ntst.com](http://www.ntst.com) in the Investor Relations section. Any amendment of the codes of ethics or waiver thereof applicable to any director or executive officer of the Company, including the Chief Executive Officer or any senior financial officer, will be disclosed on the Company’s website within four business days of the date of such amendment or waiver. In the case of a waiver, the nature of the waiver, the name of the person to whom the



waiver was granted and the date of the waiver will also be disclosed.

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The Board of Directors has also adopted, and we have posted in the Investor Relations section of our website, written Charters for each of the Board's standing committees. We will provide without charge, upon a stockholder's request to our address set forth in the preceding section, a copy of the codes of ethics or the Charter of any standing committee of the Board.

## **Business Segments**

For a detailed description of the assets and profits of each of our business segments see note 14 to our Consolidated Financial Statements.

### Software and Related Systems and Services - New York

We develop market and support computer software and provide implementation and business services that enable health and human services organizations to access, manage and share information related to their financial, clinical and management processes.

Customer organizations typically purchase our software in the form of a perpetual license to use the system, as well as purchasing professional services, support, and maintenance. In addition, we resell third party hardware and software to our customers pursuant to value-added reseller agreements with these partners. Our products are designed to operate on most hardware platforms and on most operating systems, including UNIX, Microsoft Windows and Linux. Because our products operate on a variety of platforms, we are not dependent on any single hardware vendor or operating system. Since our Avatar suite of software products utilizes the Cache database and development software provided by Intersystems Corporation, we resell Cache software. Since Avatar is designed to operate solely with Cache products, we are dependent on Cache products for our operations.

Our professional services offerings include project management, implementation, training, consulting and software development services, which are provided either on a time-and-material or fixed-price contract basis. Our software development services may require the adaptation of healthcare information technology systems to meet the specific requirements of the customer.

Our typical license for a health information system ranges from \$10,000 to \$100,000 for a single facility healthcare organization to \$250,000 to \$5,000,000 for multi-unit care organizations such as those run by state agencies. Revenue from license fees was approximately \$2,210,000, or 5.8% of consolidated revenue, for 2005, \$2,066,000, or 7.1% of consolidated revenue, for 2004 and \$2,781,000, or 10.2% of consolidated revenue, for 2003. A customer's purchase order may also include third party hardware or software. Revenue from hardware and third party software accounted for approximately \$5,544,000, or 14.6% of consolidated revenue, for 2005, \$4,336,000, or 15.0% of consolidated revenue, for 2004 and \$4,444,000, or 16.4% of consolidated revenue, for 2003. Revenue from turnkey systems labor accounted for approximately \$9,845,000, or 25.9% of consolidated revenue, for 2005, \$9,602,000, or 33.1% of consolidated revenue, for 2004 and \$9,548,000, or 35.1% of consolidated revenue in 2003.

Our small systems revenue was approximately \$1,042,000, or 2.7% of consolidated revenue, for 2005, \$928,000, or 3.2% of consolidated revenue, for 2004 and \$768,000, or 2.8% of consolidated revenue, for 2003.

Maintenance services have generated increasing revenue and have become a more significant portion of our business, since most purchasers of healthcare information system licenses also purchase maintenance service. Maintenance revenue increases as existing customers purchase additional licenses and new customers purchase their initial software licenses. By agreement with our customers, we provide telephone help desk support and maintain and upgrade their software. Maintenance contracts may require us to make modifications to meet any new federal and state reporting requirements that become effective during the term of the maintenance contract. We do not maintain the hardware and third party software sold to our customers, but we provide a telephone help line service for certain third party software which we license to our customers. Our maintenance revenue was approximately \$9,784,000, or 25.8% of consolidated revenue, for 2005, \$8,290,000, or 28.6% of consolidated revenue, for 2004 and \$7,069,000, or 26% of consolidated revenue, for 2003.

#### Software and Related Systems and Services - Ohio

As with Netsmart New York, the Netsmart Ohio operation develops computer software and provides implementation and business services that are designed to enable health and human services organizations to access, manage and share information related to their financial, clinical and management processes.

The Ohio segment consists mainly of the operations of the former CMHC Systems, Inc., now named Netsmart Ohio. The results of operations from this acquisition are included from October 1, 2005 through December 31, 2005. The focus of the Ohio segment consists primarily of contracts for turnkey system installations of behavioral healthcare information management software for mental health, substance abuse, and addiction services agencies, and some developmental disability centers and behavioral health-related managed care organizations. These turnkey installations are usually completed within a six-month period.

The core product of the Ohio segment is the CMHC/MIS, a comprehensive billing and clinical software product designed for the UNIX operating system. As with the Avatar software, customer organizations typically purchase the CMHC/MIS in the form of a perpetual license to use the system, as well as purchasing professional services, support, and maintenance. In addition, Netsmart Ohio resells third party hardware, typically in the form of servers used to run the application. Professional services for installation and implementation of the software are provided either on a time-and-material or fixed-price contract basis.

Our typical license for a health information system ranges from \$10,000 to \$100,000 for a single facility healthcare organization to \$250,000 to \$500,000 for multi-unit care organizations. Revenue from license fees was approximately \$230,000, or .6% of revenue, for 2005. A customer's purchase order may also include third party hardware or software. Revenue from hardware and third party software accounted for approximately \$654,000, or 1.7% of revenue, for 2005. Revenue from turnkey systems labor accounted for approximately \$802,000, or 2.1% of revenue, for 2005.

#### Data Center Services

Our Data Center provides software that performs clinical and billing services for mental health, alcohol and substance abuse outpatient facilities. Services include statistical reporting, data entry, electronic billing and submission.

Revenue from our Data Center was approximately \$1,795,000, or 4.7% of our consolidated revenue, for 2005, \$2,058,000, or 7.1% of our consolidated revenue, for 2004 and \$1,973,000, or 7.3% of our consolidated revenue, for 2003.

In 2005, three customers each accounted for 10% or more of total Data Center revenue. One customer was a New York State agency, which accounted for \$211,000, or 12% of total Data Center revenue. The other two clients were hospitals in New York City, which accounted for \$209,000 and \$192,000, or 11.6% and 10.7% of total Data Center revenue. None of the above mentioned clients accounted for more than 10% of our consolidated revenue.



In 2004, two customers each accounted for 10% or more of the total Data Center revenue. One customer was a New York State agency, which accounted for \$207,000, or 10% of total Data Center revenue. The other client was a hospital in New York City, which accounted for \$216,000, or 10.5% of total Data Center revenue. In 2003, one customer, a hospital in New York City, accounted for \$274,000, or 13% of the total Data Center revenue. None of the above mentioned clients accounted for more than 10% of our consolidated revenue.

Our Data Center backlog at December 31, 2005 was \$1,660,000. We anticipate that all of this backlog will be earned in 2006. The Data Center backlog at December 31, 2004 was \$2,132,000.

#### Application Service Provider

Our ASP services make our Avatar software suite, CareNet, Netsmart University and InfoScriber products available either via a secure connection to the Internet or via a virtual private network (“VPN”). With the ASP option, Netsmart operates and maintains the software on behalf of customers on computers in a secure data center facility in Columbus, Ohio. This enables customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements. Our CareNet product is a subscription-based Internet solution for Managed Care Organizations that want to exchange data with their providers without having to maintain their own information technology infrastructure. CareNet furnishes a private, secure Web-based portal site where providers and their partner agencies can log in via the Internet to access client information and complete paperwork and necessary reporting on-line.

The InfoScriber product is a secure, Web-based e-prescribing system that enables practitioners in public or private practices to write and transmit electronic prescriptions to pharmacies of choice. It is the only e-prescribing system solely focused on the behavioral healthcare market with its unique medications, treatment settings and reporting requirements.

Revenue from ASP services was approximately for \$2,538,000 for 2005 and \$1,725,000 for 2004.

During 2005, one customer accounted for \$661,000, or 26% of total ASP revenue and during 2004, one customer accounted for \$443,000, or 26% of total ASP revenue. This customer did not account for more than 10% of our total consolidated revenue in either 2005 or 2004.

Our ASP backlog at December 31, 2005 was \$3,011,000. We anticipate that all of this backlog will be earned in 2006. Our ASP backlog at December 31, 2004 was \$2,233,000.

#### **Markets**

Our target market for information systems and related services consists of both private and publicly-operated providers offering hospital or community-based outpatient behavioral/public healthcare services, substance abuse, MR/DD and social services. These healthcare providers require comprehensive information systems to administer their programs. We believe that there are at least 15,000 healthcare providers that fall in our target markets in the United States, including public and private hospitals, private and community-based residential facilities, and federal, state and local governmental agencies.

Many long-term behavioral/public healthcare facilities are operated by government entities and include those operated as part of entitlement programs. During the years ended December 31, 2005, 2004 and 2003, approximately 44%, 49% and 57%, respectively, of our consolidated revenue was generated from contracts with state and local government agencies. Contracts with government agencies generally include provisions which permit the contracting agency to cancel the contract for its convenience, although we have not experienced a termination for convenience in the last five years.



We believe that the demand for information technology solutions will continue to increase as the result of additional federal data standards and requirements for information exchange, as well as continuous pressure from managed care providers to reduce healthcare delivery costs while expanding the availability of services.

In order to remain competitive, health and human services delivery networks need comprehensive financial, clinical and management systems that enable providers within the networks to maintain a broad scope of accurate medical and financial information, manage costs and deliver quality care efficiently. In addition, the need to upgrade existing systems to meet the increased demand for data processing needs of managed care and regulatory oversight has also resulted in an increasing demand for behavioral healthcare information technology. These data management needs include analysis of patient assessments, maintenance of patient records, administration of patient treatment plans and the overall coordination of in-office and remote case management.

In addition to our focus on the behavioral healthcare market segment, we also serve a growing number of public healthcare organizations. Our products are designed with functionality to assist this market segment with important considerations like maximizing the ability for clinicians to provide care to individual patients in high volume patient settings; near real-time analysis of data from different systems for disease outbreak investigations and resolution; and interoperability with other internal health department databases, including environmental health. Since many of the consumers of services of our clients are some of the poorest Americans, they receive their primary care from public health clinics. We believe this is driving the trend towards integration and data sharing between these agencies.

We are also actively engaged in a number of key industry associations and organizations to help assure that we pro-actively address trends and future needs of our customers. In addition, there are active Netsmart user group organizations at the state, regional and national levels. These user groups provide us with a customer/user perspective on emerging requirements and ongoing feedback that helps us determine future product direction and requirements.

Additionally, the health and human services market in which we operate is always subject to changes in state and federal regulations, as well as new demands required by consumers. Some factors which we believe are affecting market demand for software such as ours include:

Electronic Health Record (EHR). There is much discussion at the national level about the implementation of a standardized electronic health record. Proponents state that such a record for patients could enable a virtual healthcare team and a coordinated system of care with consistent, streamlined information exchange and transfer of clinical and billing data. Exchanging health information through secure means — including appropriate authorizations from patients/consumers — could link information from health-related entities with consumers' personal health information. This connection would be intended to make important data available at the right times and places to support optimal treatment across a variety of healthcare levels. We believe that, despite varying views on the best path for adoption of an EHR, it will eventually become reality.

Integrated Services. This concept, sometimes referred to as “no wrong door,” is an approach whereby consumers seeking assistance from social services agencies receive complete and comprehensive services, regardless of their point of entry into the system. As a result, many social service agencies are seeking to implement a technology infrastructure that supports integrated services.

HIPAA. As a supplier of practice management, we believe that the Health Insurance Portability and Accountability Act, generally known as HIPAA, essentially mandates that the U.S. Department of Health and Human Services enact standards regarding the standardization, privacy and security of health care information. This legislation requires more providers of services in the under-automated health and human services industry to install automated systems, creating an increased demand for automated software solutions. We believe that our products, in conjunction with products offered by other companies with which we have a marketing arrangement, enables us to offer comprehensive enterprise-wide HIPAA-compliant and HIPAA-related business services for most human service providers.





**General Unrest.** With the creation of the Department of Homeland Security (DHS) and an increased focus on anti-terrorism preparedness and response, the demand for services in the mental health and public health arena has increased. Anxiety and fear have motivated a growing number of people to seek mental health services. This increased demand puts more pressure on providers to improve the efficiency of their care through the use of practice management and clinical systems. We believe that the potential threat of bio-terrorism will also put similar pressure on public health agencies to improve their delivery capabilities in much the same way. We also believe that this focus on preparedness will lead to more cross-department integration requirements, which play well to our strengths.

We are positioning our existing products and developing additional products in order to address these factors.

No single customer accounted for more than 10% of consolidated revenue for the years ended December 31, 2005 and 2004. During the year ended December 31, 2003, one customer accounted for approximately \$2,861,000 or 11.4% of software and related systems and services revenue and 10.5% of consolidated revenue.

### **Sales and Marketing**

We have a sales force of 47 people who market our products. In addition, since the acquisition of CMHC Systems, we have aligned our go-to-market strategy with the key vertical markets we serve: State Systems, Integrated Delivery Networks (such as hospitals with multiple facilities and behavioral healthcare offerings), Community and Public Healthcare, and Methadone Providers. We also expanded our direct sales force and aligned them with the vertical markets above to enable our sales force to develop in-depth knowledge of the unique needs of each segment. In addition, we established an account management team which is designed to maintain and grow relationships with our current customers, and to identify opportunities to sell additional software and services from our present product offerings to that current customer base. We also added a dedicated business development organization to cultivate large strategic opportunities and build relationships with the large systems integrators that service these organizations. This approach is expected to enable us to leverage our resources and to further extend our reach within the markets we serve.

### **Backlog**

We had a backlog of orders, including ongoing maintenance and data center contracts for our behavioral health information systems, of \$44.1 million at December 31, 2005 and \$25.8 million at December 31, 2004. We expect to fill approximately \$41.2 million of the 2005 backlog during 2006.

Our backlog consists of revenue of approximately \$11.6 million from existing turnkey contracts; maintenance revenue of approximately \$26.9 million that is comprised both of amounts expected to be filled under unexpired maintenance contracts and amounts that are subject to automatic renewal; unexpired Data Center contracts of approximately \$1.7 million, calculated using historical experience to determine future usage; unexpired ASP backlog of approximately \$3.0 million; and facility management contracts of approximately \$.9 million, which are also calculated using historical experience to determine twelve months of future usage.

### **Product Development**

We incurred product development costs relating to our health and human services information systems of approximately \$4,547,000 in 2005, \$3,498,000 in 2004 and \$2,770,000 in 2003, all of which was company-sponsored and expensed as research, development and maintenance. In 2005, we acquired software with a fair value of approximately \$3,300,000, \$2,051,000 and \$692,000 associated with our acquisitions of CMHC Systems, Inc., AMS and Continued Learning, respectively. In 2005, we also capitalized software development costs of \$42,000 relating to one of our Avatar products. This Avatar product is being amortized over a three year period and in 2005 we charged \$2,300 to operations. In 2004, we acquired software with a fair value of approximately \$150,000 associated with our acquisition of TxM software which was related to our partnership arrangement with the MSJ Communications

Corporation, a wholly-owned subsidiary of the Betty Ford Center. In 2003, we capitalized software development costs of \$179,500 relating to our Avatar AM, Order Entry and RAD Plus 2004 products. The Avatar AM and Order Entry products are being amortized over a three year period and in 2004, we charged \$43,100 to operations. In 2003, we acquired software with a fair value of approximately \$883,000 associated with our acquisition of software products from CareNet.

To assure that our customers are informed about our latest product plans and deliverables, we have developed Product Roadmaps for our major products. The roadmaps provide details about future product releases (both “version” and “maintenance”) along with estimated dates and timeframes. This enables our customers to effectively plan and budget for future use of our products and related services.

### **Competition and Competitive Position**

The multi-billion dollar healthcare software industry is highly competitive, and is served by numerous vendors. Although we believe that we can provide healthcare facilities and managed care organizations with software to enable them to perform their services more effectively than our competitors, other software companies provide comparable systems and also have the staff and resources to develop competitive systems.

Some dominant health care information technology vendors have achieved annual sales of more than \$1 billion by focusing on solutions for large medical/surgical healthcare providers. As such, their target market has been large hospital systems and health maintenance organizations, and they have not focused on the behavioral/public healthcare industry. We believe that most of the presently available healthcare management software does not meet the specific needs of the behavioral/public healthcare industry, and that the functionality of our information systems is better designed to meet the needs of this market. However, the behavioral health information systems business is serviced by a number of companies, some of which are better capitalized with larger infrastructures than Netsmart, and we may not be able to continue to compete effectively with such companies. As our business expands and includes sales to larger, integrated healthcare delivery networks, we begin to compete with companies such as Siemens, HBOC, IDX, Meditech, Quadramed, and Misys.

Additionally, we face significant competition in the clearinghouse, medical systems, and ASP market. General ASP utilities offer customers the use of computer facilities and operations staff to process either generalized medical software or software selected by the customer from other software vendors. Many organizations start with billing as their primary reason for automation-related spending. Large billing and clearinghouse computer service companies provide a broad spectrum of billing services for a diverse marketplace. In addition, some professional service firms provide staff to operate a customer’s in-house system when the customer believes that such an approach will provide the needed expertise at a cost-effective price.

Our ASP offering is focused on a specific subset of the large health and human services marketplace. Because behavioral healthcare requires the ideal organization of software, systems and staff to enable a customer to maximize service at a reasonable cost, we believe our specialized experience and investment in related software provides us with a competitive advantage. In addition, our ASP service is based on use of our proprietary suite of Avatar products. This enables our customers to use any or all components of a broad array of clinical and financial systems for as long as these functions are needed. In addition, our experience has shown that once a customer has contracted with us for software and services, they generally remain our customer and seldom move away from us to a competitive offering. In fact, some of our customers have been working with us for 30 years.

We compete with the following behavioral healthcare vendors, among others:

Anasazi Software, Inc.  
Askesis Development Group, Inc.  
Civerex Systems, Inc.  
Geneva Software  
InfoMC, Inc.  
IMPEL Strategic Solutions  
Multi-Health Systems, Inc.  
Qualifacts System inc.  
Raintree Systems Inc.  
SecureHEALTH Inc.  
Sequest Technologies Inc.  
The Echo Group  
UNI/CARE Systems, Inc.  
XAKTsoft, Inc.

As a core part of our business model and growth strategy, we bid on numerous competitive procurements during the calendar year, and have a high win ratio, especially in the statewide mental health/mental retardation field, where we provide 33 statewide systems.

We have an established base of more than 1,200 providers nationwide, including substantial private and government providers of healthcare services. These providers represent approximately 50,000 clinicians, and include 33 state agencies and installations in all 50 states and several foreign countries.

### **Government Regulations and Contracts**

The federal government and state governments have adopted numerous regulations affecting the healthcare industry, including those relating to payments to healthcare providers for various services. The adoption of new regulations can have a significant effect upon the revenue stream and operations of healthcare providers and insurance companies. Our solutions are designed to help our customers meet a variety of regulations and payment requirements, mitigating some of the problems resulting from government regulations. With constantly-changing regulations and efforts to reduce the cost of healthcare, we cannot predict the effect of future regulations by governments and payment practices by government agencies or health insurers, including reductions in the funding for or scope of entitlement programs. Any change in the structure of healthcare in the United States can have a material effect on companies that provide services to the healthcare industry, including those such as us that provide software.

Although we believe that the likely direction which may result from the current study of the healthcare industry would be an increased trend toward managed care programs, thereby increasing the importance of automation, our business may not benefit from any changes in the industry structure. Even if the industry does evolve toward more healthcare being provided by managed care organizations, it is possible that there will be substantial concentration in a few very large organizations, which may seek to develop their own software or obtain software from other sources. Our business may be adversely affected to the extent that the healthcare industry evolves with greater government-sponsored programs and fewer privately-run organizations. Furthermore, to the extent that each state changes its own regulations in the healthcare field, it may be necessary for us to modify our behavioral health information systems to meet new record-keeping or other requirements imposed by changes in regulations, and we may not be able to generate revenues sufficient to cover the costs of developing the modifications.

A significant amount of our business has been with government agencies, including specialized care facilities operated by, or under contract with, government agencies. The decision on the part of a government agency to enter into a contract is dependent upon a number of factors, including local economic and budgetary problems, and government procurement regulations, which may include the need for approval by more than one agency before a contract is signed. In addition, government agencies generally include provisions in their contracts which permit the contracting agency to cancel the contract at its convenience. We have not experienced a termination for convenience in the last five years.

The Sarbanes-Oxley Act of 2002 and rules promulgated thereunder by the SEC and the Nasdaq Stock Market have imposed substantial new or enhanced regulations and disclosure requirements in the areas of corporate governance (including director independence, director selection and audit, corporate governance and compensation committee responsibilities), equity compensation plans, auditor independence, pre-approval of auditor fees and services and disclosure and internal control procedures. We are committed to industry best practices in these areas and believe we are in compliance with the relevant rules and regulations.

### **Intellectual Property Rights**

We have no patent rights for our behavioral health information system software, but we rely upon copyright protection for our software, as well as non-disclosure and secrecy agreements with our employees and third parties to whom we disclose information. We may not be able to protect our proprietary rights to our system, and third parties may claim rights to our system. The disclosure of the codes used in any proprietary product, whether or not in violation of a non-disclosure agreement, could have a material adverse affect upon us, even if we are successful in obtaining injunctive relief. We must continue to invest in product development, employee training, and customer support.

### **Employees**

As of December 31, 2005, we had 322 employees, including 3 executives, 47 sales and marketing, 194 technical and 78 clerical and administrative employees.

### **Executive Officers**

Information concerning our executive officers is included in Item 10, Directors and Executive Officers of the Registrant.

### **Item 1A.**

### **Risk Factors.**

Because we are particularly dependent upon government contracts, any decrease in funding for entitlement programs could result in decreased revenue.

We market our health information systems principally to behavioral health facilities, many of which are operated by state and local government entities and include entitlement programs. During 2005, 2004 and 2003, we generated 44%, 49% and 57%, respectively, of our revenue from contracts that are directly or indirectly with government agencies. Government agencies generally have the right to cancel certain contracts at their convenience. Our ability to generate business from government agencies is affected by funding for entitlement programs, and our revenue would decline if state agencies reduce this funding.

Changes in government regulation of the health care industry may adversely affect our revenue, operating expenses and profitability.

Our business is based on providing systems for behavioral and public health organizations in both the public and private sectors. The federal and state governments have adopted numerous regulations relating to the health care

industry, including regulations relating to the payments to health care providers for various services, and our systems are designed to provide information based on these requirements. The adoption of new regulations can have a significant effect upon the operations of health care providers, particularly those operated by state agencies. Furthermore, changes in regulations in the health care field may force us to modify our health information systems to meet any new record-keeping or other requirements and may impose added costs on our business. If that happens, we may not be able to generate revenues sufficient to cover the costs of developing the modifications. In addition, any failure of our systems to comply with new or amended regulations could result in reductions in our revenue and profitability.

If we are not able to take advantage of technological advances, we may not be able to remain competitive and our revenue may decline.

Our customers require software which enables them to store, retrieve and process very large quantities of data and to provide them with instantaneous communications among the various data bases. Our business requires us to take advantage of recent advances in software, computer and communications technology. This technology has been developing at rapid rates in recent years, and our future may be dependent upon our ability to use and develop or obtain rights to products utilizing such technology. New technology may develop in a manner which may make our software obsolete. Our inability to use or develop new technology would have a significant adverse effect upon our business.

We may have difficulty competing with larger companies that offer similar services, which may result in decreased revenue.

Our customers in the human services market include entitlement programs, managed care organizations and specialty care facilities which have a need for access to information over a distributed data network. Each of the software industry, in general, and the health information software business in particular, is highly competitive. Other companies have the staff and resources to develop competitive systems. We may not be able to compete successfully with such competitors. The health information systems business is served by a number of major companies and a larger number of smaller companies. We believe that price competition is a significant factor in our ability to market our health information systems and services, and our inability to offer competitive pricing may impair our ability to market our systems and services.

If we are unable to protect our intellectual property, our competitors may gain access to our technology, which could harm our ability to successfully compete in our market.

We have no patent protection for our proprietary software. We rely on copyright protection for our software and non-disclosure and secrecy agreements with employees and third parties to whom we disclose information. This protection does not prevent our competitors from independently developing products similar or superior to our products and technologies. To further develop our services or products, we may need to acquire licenses for intellectual property. These licenses may not be available on commercially reasonable terms, if at all. Our failure to protect our proprietary technology or to obtain appropriate licenses could have a material adverse effect on our business, operating results or financial condition. Since our business is dependent upon our proprietary products, the unauthorized use or disclosure of this information could harm our business.

We cannot guarantee that in the future, third parties will not claim that we infringed their intellectual property. Asserting our rights or defending against third party claims could involve substantial costs and diversion of resources, which could materially and adversely affect our financial condition.

Government programs may suggest or mandate initiatives that could impact our ability to sell our products, resulting in decreased revenue.

A major initiative being pushed by President Bush and the Department of Health and Human Services is the National Electronic Health Record. The federal government is promoting this platform and technology which is based on supplying “freeware” to any agency who desires; however, support is not supplied. This initiative competes with the private for profit Health Information Systems vendor community and could adversely affect our ability to sell our products, resulting in decreased revenue.

The covenants in our loan agreements restrict our financial and operational flexibility, including our ability to complete additional acquisitions, invest in new business opportunities, pay down certain indebtedness or declare dividends.

Our term loan agreements contain covenants that restrict, among other things, our ability to borrow money, make particular types of investments, including investments in our subsidiaries, make other restricted payments, swap or sell assets, merge or consolidate, or make acquisitions. An event of default under our loan agreement could allow our lender to declare all amounts outstanding to be immediately due and payable. We have pledged substantially all of our consolidated assets to secure the debt under our loan agreement. If the amounts outstanding under the loan agreements were accelerated, the lender could proceed against those consolidated assets. Any event of default, therefore, could have a material adverse effect on our business. The loan agreements also require us to maintain specified financial ratios. Our ability to meet these financial ratios can be affected by events beyond our control, and we cannot assure you that we will continue to meet those ratios. We also may incur future debt obligations that might subject us to restrictive covenants that could affect our financial and operational flexibility or subject us to other events of default.

We have only paid one cash dividend after getting our lender’s consent and we do not anticipate paying any further cash dividends on our common stock in the foreseeable future. We presently intend to retain future earnings, if any, in order to provide funds for use in the operation and expansion of our business. Consequently, investors cannot rely on the payment of dividends to increase the value of their investment in us. In addition, our loan agreements prohibit us from paying cash dividends without the prior consent of the lender.

Our growth may be limited if we cannot make acquisitions.

A part of our business strategy is to acquire other businesses that are related to our current business. These acquisitions may be made with cash or securities or a combination of cash and securities. To the extent that we require cash, we may have to borrow the funds or issue equity, which could dilute our earnings or the book value per share of our common stock. Our stock price may adversely affect our ability to make acquisitions for equity or to raise funds for acquisitions through the issuance of equity securities. If we fail to make any acquisitions, our future growth may be limited. As of the date hereof, we do not have any agreement or understanding, either formal or informal, as to any acquisition.

We may be unable to effectively integrate CMHC Systems, Inc. or any other acquisitions, which may disrupt or have a negative impact on our business.

In September 2005, we consummated a merger with CMHC Systems, Inc., pursuant to which CMHC has become our wholly-owned subsidiary. We may have difficulty integrating CMHC’s personnel and operations with our own and we may have the same difficulty with any other acquisitions we may make. In addition, the key personnel of any acquired business may not be willing to work for us, and its officers may exercise their rights to terminate their employment with us. We cannot predict the effect expansion may have on our core business. Regardless of whether we are successful in making an acquisition, the negotiations could disrupt our ongoing business, distract our management and employees and increase our expenses.





Because we are dependent on our management, the loss of key executive officers could disrupt our business and our financial performance could suffer.

Our business is largely dependent upon our senior executive officers, Messrs. James L. Conway, our chief executive officer and Anthony F. Grisanti, our chief financial officer. Although we have employment agreements with these officers, the employment agreements do not guarantee that those officers will continue as our employees, and each of those officers has the right to terminate his employment on 90 days notice. Our agreements with Messrs. Conway and Grisanti are scheduled to expire on December 31, 2006. Our business may be adversely affected if any key management personnel or other key employees left our employ.

The employment contracts with our executive officers and provisions of Delaware law may deter or prevent a takeover attempt and may reduce the price investors might be willing to pay for our common stock.

The employment contracts between us and each of James Conway and Anthony Grisanti provide that in the event there is a change in control of our company, the employee has the option to terminate his employment agreement. Upon such termination, each of Messrs. Conway and Grisanti has the right to receive a lump sum payment equal to his compensation for a 48 month period.

In addition, Delaware law restricts business combinations with stockholders who acquire 15% or more of a company's common stock without the consent of the company's board of directors.

These provisions could deter or prevent a takeover attempt and may also reduce the price that investors might be willing to pay in the future for shares of our common stock.

Any issuance of preferred stock may adversely effect the voting power and equity interest of our common stock.

Our certificate of incorporation gives our board of directors the right to create new series of preferred stock. As a result, the board of directors may, without stockholder approval, issue preferred stock with voting, dividend, conversion, liquidation or other rights which could adversely affect the voting power and equity interest of the holders of our common stock. The preferred stock, which could be issued with the right to more than one vote per share, could be utilized as a method of discouraging, delaying or preventing a change of control. The possible impact on takeover attempts could adversely affect the price of our common stock. Although we have no present intention to issue any shares of preferred stock or to create any series of preferred stock, we may issue such shares in the future. If we issue preferred stock in a manner which dilutes the voting rights of the holders of our common stock, our listing on The Nasdaq Capital Market may be impaired.

Shares may be issued pursuant to options and warrants which may adversely affect the market price of our common stock.

We may issue stock upon the exercise of options to purchase shares of our common stock pursuant to our long term incentive plans, under which options to purchase 945,467 shares were outstanding at December 31, 2005. The exercise of these options and the sale of the underlying shares of common stock may have an adverse effect upon the price of our common stock.

We may also issue 147,003 shares of or common stock upon the exercise of warrants to purchase shares of our common stock pursuant to a Private Placement Offering that we entered into in 2005. The exercise of these warrants and the sale of the underlying shares of common stock may have an adverse effect upon the price of our stock.

**Item 1B. Unresolved SEC Staff Comments.**

None.

**Item 2. Property.**

We lease office space at the following locations:

Location	Purpose	Space	Annual Rental	Expiration
3500 Sunrise Highway Great River, New York	Executive offices Software and Related Systems and Services - NY Data Center Services	32,600 square feet	\$521,000, plus 3% annual increases	10/22/14
570 Metro Place North Dublin, Ohio	Software & Related Systems and Services - OH	32,000 square feet	\$377,172	09/30/2010
555 Metro Place North Dublin, Ohio	Software & Related Systems and Services - OH	11,775 square feet	\$194,000	07/31/06
1335 Dublin Road Columbus, Ohio	Software and Related Systems and Services - NY ASP Services	3,500 square feet	\$59,000	11/30/06
5120 Shoreham Place San Diego, California	Software and Related Systems and Services - NY	2,800 square feet	\$73,000	08/31/08
69-730 Highway 11 Ranch Mirage, California	Software and Related Systems and Services - NY	1,400 square feet	\$30,000	10/31/06
117 North 1 <sup>st</sup> Street Ann Arbor, Michigan	ASP Services	2,200 square feet	\$49,000	01/31/07
33-40 37 <sup>th</sup> Street Long Island City, NY	Software & Related Systems and Services - NY	2,000 square feet	\$22,000	10/15/08
146 Second Street North St. Petersburg, FL	ASP Services	2,000 square feet	\$28,000	03/31/08

We believe that our space is adequate for our immediate needs and that, if additional space is required, whether due to the scheduled expiration of a lease or otherwise, it would be readily available at commercially reasonable rates.

**Item 3. Legal Proceedings.**

None

**Item 4.**

**Submission of Matters to a Vote of Security Holders.**

None

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**Part II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

(a) Our common stock is traded on The Nasdaq Capital Market under the symbol NTST. Set forth below is the reported high and low sales prices of our common stock for each quarterly period during 2005 and 2004.

<u>Quarter Ended</u>	<u>High</u>	<u>Low</u>
March 31, 2005	\$ 10.27	\$ 8.28
June 30, 2005	9.74	8.50
September 30, 2005	12.50	8.94
December 31, 2005	15.00	12.17
March 31, 2004	\$ 18.70	11.49
June 30, 2004	13.85	7.11
September 30, 2004	10.00	6.07
December 31, 2004	9.25	7.30

As of December 31, 2005, there were approximately 3,000 beneficial owners of our common stock. The closing price of our common stock was \$13.30 per share on March 20, 2006. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

We do not anticipate that we will pay any dividends in the foreseeable future. We currently intend to retain future earnings for use in operation and development of our business and for potential acquisitions. In addition, the terms of our term loan agreement requires our lender's consent with respect to the payment of cash dividends.

The information required by Item 201(d) of Regulation S-K is located under "Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters".

(b) During the year ended December 31, 2005, no purchases were made under the Company's stock buyback plan.

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**Item 6.****Selected Financial Data.**

The selected consolidated financial data set forth below for the five years in the period ended December 31, 2005 has been derived from the company's audited Consolidated Financial Statements. This information should be read in conjunction with the audited Consolidated Financial Statements and notes thereto.

	Year Ended December 31,				
	2005 <sup>(1)</sup>	2004	2003	2002	2001
	(in thousands except per share data)				
<b>Selected Statements of Operations Data:</b>					
Revenue	\$ 37,978	\$ 29,005	\$ 27,175	\$ 22,126	\$ 18,119
Income from Operations before interest and other financing costs	2,556	3,065	2,368	1,095	399
Net Income	1,590	2,753	3,028	1,195	315
Dividends Declared Per Common Share	--	--	.10	--	--
<b>Per Share Data - Diluted:</b>					
Net Income	\$ .27	\$ .50	\$ .64	\$ .29	\$ .08
Weighted average number of shares outstanding	5,935	5,537	4,752	4,153	3,872
<b>Selected Balance Sheet Data:</b>					
Working Capital	\$ 4,043	\$ 18,216	\$ 14,714	\$ 9,215	\$ 7,903
Total Assets	64,622	37,707	34,633	22,416	18,007
Long Term Debt Including Current Portion	2,750	1,000	1,667	1,750	2,250
Capitalized Leases Including Current Portion	71	86	147	12	41
Stock dividend	--	--	441	--	--
Total Liabilities	28,336	13,080	13,633	11,110	8,060
Accumulated Deficit	(2,004)	(3,594)	(6,347)	(9,376)	(10,571)
Stockholders' Equity	\$ 36,286	\$ 24,627	\$ 21,000	\$ 11,306	\$ 9,948

<sup>1</sup> In 2005, the Company completed three acquisitions (see note 5 to the Consolidated Financial Statements).

<sup>2</sup> The Company's tax provision has been reduced as a result of a \$1,014,000 reduction in its deferred tax asset valuation allowance

<sup>3</sup> The Company's tax provision has been reduced as a result of available net operating loss carry forwards. In addition, a \$900,000 tax benefit was recognized, as a result of a further reduction in its deferred tax asset valuation allowance.

<sup>4</sup> The Company's tax provision has been reduced as a result of available net operating loss carry forwards. In addition, a \$400,000 tax benefit was recognized, as a result of a further reduction in its deferred tax asset valuation allowance.

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**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.****Overview**

Our operations are grouped into four segments:

§	Software and Related Systems and Services - NY
§	Software and Related Systems and Services - Ohio
§	Data Center Services (service bureau services)
§	Application Service Provider Services (ASP)

Software and Related Systems and Services is the design, installation, implementation and maintenance of computer information systems that provide comprehensive healthcare information technology solutions, including billing, patient tracking and scheduling for inpatient and outpatient environments, as well as clinical documentation and medical record generation and management. We perform these services in both the New York and Ohio segments. Within these segments, we recognize revenue based on the nature of the products and services sold, for example, a turnkey system or a maintenance contract. Turnkey revenue includes turnkey systems labor revenue, third party hardware and software, license revenue and sales from our small turnkey division. We further classify our revenue into large turnkey and small turnkey components. The large turnkey components consist mostly of our Avatar suite of products. When we are engaged in fixed price arrangements for large turnkey systems, the installations will usually extend over a six-month to a multi-year time period. The duration of the implementation depends on the size and complexity of the customer organization and the specifics of the implementation. Installations of small turnkey components are usually completed within a six-month period. Small turnkey contracts performed in the New York segment are mostly related to our Avatar methadone related products. The small turnkey contracts in the Ohio segment are for system installations for behavioral healthcare information management software for mental health, substance abuse, and addiction services agencies, developmental disability centers and behavioral health-related managed care organizations. The Ohio segment is a new segment established as a result of the acquisition of Netsmart - Ohio, formerly CMHC Systems, Inc. The Netsmart - Ohio operations are included commencing October 1, 2005. Data Center Services involves our personnel performing data entry and data processing services for customers. Application Service Provider Services involves the offering of our Avatar suite of products, our CareNet products, our InfoScribeR products and our ContinuedLearning products on a virtual private network or through an internet delivery approach, thereby allowing our customers to deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements for such services

On April 28, 2005, we acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offered a comprehensive family of web-based training products and services, including its Learning Management System. The total purchase price, including acquisition costs and recognition of a probable additional payment, was \$739,238 which consisted of cash of \$252,917, which was paid out of existing working capital including legal fees of \$18,632, broker fees of \$10,000, 20,000 shares of the Company's common stock valued at \$191,400, assumed liabilities of \$44,921 and an accrual for a probable additional payment of \$250,000. The purchase agreement provides for the probable additional payment of up to \$250,000 if certain revenue targets are met in year one. Based upon the attainment of certain revenue targets as of December 31, 2005 we recognized the full \$250,000 of this additional payment at December 31, 2005. We also entered into a two year employment agreement at an annual salary of \$100,000 per year with the principal of ContinuedLearning LLC, whereby the principal can receive an additional \$300,000 in cash, to be accounted for as compensation expense, if certain revenue targets are met within a two-year period. As of December 31, 2005, these revenue targets have not been met and consequently, no additional compensation expense has been recognized.

On June 20, 2005, we acquired the assets of Addiction Management Systems, Inc ("AMS"). The total purchase price, including acquisition costs, was \$3,610,682, which consisted of cash of \$2,641,945 plus legal fees of \$19,904 and



assumed liabilities for services to be provided of \$948,833.

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On September 28, 2005, we acquired 100% of the equity interest in CMHC Systems, Inc. (“CMHC”) a company that offers a full suite of behavioral healthcare information management software for mental health, substance abuse, and addiction services agencies, developmental disability centers, and behavioral health-related managed care organizations. The purchase price totaled approximately \$19,565,956, as follows: \$12,994,758 in cash, 435,735 shares of our common stock (valued at \$4,915,091), acquisition costs of \$864,083, plus additional cash consideration currently estimated at \$792,024 as required by the “working capital adjustment”. We have accrued \$792,024 as the “working capital adjustment” which was calculated in accordance with the merger agreement. This calculation is subject to adjustment and is currently being disputed by the company on the basis of the possibility of certain unrecorded liabilities at the acquisition date.

In addition, we booked a deferred tax liability in the amount of \$3,843,000 relating to the non-deductible nature of certain acquired intangible assets, which liability will be amortized in future periods.

Our results of operations are subject to various risks and uncertainties, including those described in Item 1A, Risk Factors, above and the market risks described in Item 7A, Quantitative and Qualitative Disclosures about Market Risks, below.

#### **Years Ended December 31, 2005 and 2004**

##### **Results of Operations**

Our total revenue for 2005 was \$37,978,000, an increase of \$8,973,000, or 31%, from our revenue for 2004 which was \$29,005,000. Revenue from the Netsmart - Ohio acquisition accounted for \$5,219,000 of the increase in revenue from 2005 to 2004. This revenue was for the period October 1, 2005 through December 31, 2005.

Revenue from contracts with state and local government agencies represented 44% of revenue in 2005 and 49% of revenue in 2004. This decrease was the result of the inclusion of the Netsmart - Ohio revenue, approximately 20% of which is generated from contracts with state and local government agencies.

Fixed price software development contracts, which include labor, licenses and third party resale components, accounted for 24% and 34% of consolidated revenue for 2005 and 2004, respectively. This decrease is the result of a decrease in Software and Related Systems and Services revenue generated from fixed price contracts and an increase in Software and Related Systems and Services revenue generated on an as incurred basis. Our recurring revenue components, which include our maintenance contract services, our Data Center and ASP services, accounted for 46% of our consolidated revenue for 2005 compared to 42% of consolidated revenue for 2004. This increase was the result of an increase in both maintenance and ASP revenue which was partially offset by a decrease in Data Center revenue. Revenue from large turnkey fixed price software development contracts is determined using the percentage of completion method, which is based upon the time spent by our technical personnel on a project. Since the billing schedules under the contracts differ from the recognition of revenue, at the end of any quarter, these contracts generally result in either costs and estimated profits in excess of billing or billing in excess of costs and estimated profits. Revenue from our small turnkey fixed price contracts is accounted for under the completed contract method.

##### **Software and Related Systems and Services - New York**

Our Software and Related Systems and Services - New York revenue for 2005 was \$28,425,000, an increase of \$3,204,000, or 13%, from our revenue for 2004, which was \$25,221,000. Software and Related Systems and Services - New York revenue is comprised of turnkey systems labor revenue, revenue from sales of third party hardware and software license revenue, maintenance revenue and revenue from small turnkey systems in the markets in which we operated prior to our acquisition of our Ohio operations in September 2005.



Within this segment is large turnkey and small turnkey components. The large turnkey components consist mostly of our Avatar suite of products. When we are engaged in fixed price arrangements for large turnkey systems, the installations will usually extend over a six-month to a multi-year time period; these installations are accounted for under the percentage of completion method. The duration of the implementation depends on the size and complexity of the customer organization and the specifics of the implementation. Installations of small turnkey components are usually completed within a six-month period; these installations are accounted for under the completed contract method. Small turnkey contracts performed in the New York segment are mostly related to our Avatar methadone related products.

The largest component of Software and Related Systems and Services revenue was turnkey systems labor revenue, which increased \$243,000 or 3% to \$9,845,000 in 2005 from \$9,602,000 in 2004. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. The increase in turnkey systems labor revenue was primarily due to a 4% increase in the average daily billing rate, which accounted for total labor revenue increase of \$208,000 in 2005 as compared to 2004. Revenue from third party hardware and software increased 28% to \$5,544,000 in 2005, from \$4,335,000 in 2004. Sales of third party hardware and software, such as pharmacy and database software, are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our software and related systems and services revenue. During 2005, the increase in revenue from third party hardware and software was partially the result of an increase in database software sales and pharmacy sales to various customers. License revenue increased 7% to \$2,210,000 in 2005, from \$2,066,000 in 2004. License revenue is generated as part of a sale of a human services information system pursuant to a contract or purchase order that includes delivery of the system and maintenance. During 2005, approximately one-third of the increase in license revenue was the result of increased user license sales to existing customers. Maintenance revenue increased 18% to \$9,784,000 in 2005 from \$8,290,000 in 2004. Revenue from the AMS acquisition accounted for approximately one-half of this increase. As turnkey systems are completed, they are transitioned to the maintenance division, thereby increasing our installed base. Revenue from the sales of our small turnkey contracts increased 12% to \$1,042,000 in 2005 from \$928,000 in 2004. Small turnkey contract sales relate to turnkey contracts that are less than \$50,000 and are usually completed within one to six months. On June 20, 2005, we acquired AMS. AMS typically has the type of contracts included in the small turnkey revenue; sales of AMS products and services totaled \$216,000 in 2005.

Gross profit increased 17% to \$13,836,000 in 2005 from \$11,849,000 in 2004. Our gross margin percentage increased to 49% in 2005 from 47% in 2004. Our gross margin increased as a result of improved efficiency from our maintenance division as well as an increase in our license revenue.

#### **Software and Related Systems and Services - Ohio**

The Software and Related Systems and Services-Ohio segment is a new segment established as a result of the acquisition of Netsmart - Ohio, formerly CMHC Systems, Inc. The Ohio operations are included commencing October 1, 2005. Netsmart - Ohio offers a full suite of behavioral healthcare information management software for mental health, substance abuse, and addiction services agencies, developmental disability centers, and behavioral health-related managed care organizations. The small turnkey contracts in the Ohio segment are for system installations for behavioral healthcare information management software for mental health, substance abuse, and addiction services agencies, developmental disability centers and behavioral health-related managed care organizations. The small turnkey contracts are usually completed within a six-month period.

Revenue for October 1 through December 31, 2005 was \$5,219,000 and consisted of the following components; Maintenance revenue of \$3,533,000, third party hardware and software revenue of \$654,000, turnkey systems labor revenue of \$802,000 and license revenue of \$230,000.

Gross profit for 2005 was \$2,704,000 and our gross margin percentage was 52%.



### **Data Center Services (Service Bureau)**

Data center clients typically generate approximately the same amount of revenue each year. We bill on a transaction basis or on a fixed fee arrangement. Historically, each year we increase the transaction or fixed fee by an amount that approximates the New York urban consumer price index increase. The data center revenue decreased to \$1,795,000 in 2005 from \$2,058,000 in 2004, representing a decrease of \$263,000, or 13%. This decrease was the result of two customers discontinuing the use of our services.

Gross profit decreased 25% to \$908,000 in 2005 from \$1,209,000 in 2004. Our gross margin percentage decreased to 51% in 2005 from 59% in 2004. This decrease was the result of the decrease in revenue, as well as an increase in costs of approximately \$38,000. The increase in costs was substantially the result of an increase in communications costs of \$29,000, depreciation of \$20,000 and salaries of \$7,000, which was partially offset by a decrease in support overhead of approximately \$18,000.

### **Application Service Provider Services (“ASP”)**

ASP Services involves the offering of our Avatar suite of products, our CareNet products, our ContinuedLearning products and our InfoScribeR products on a virtual private network or through an internet delivery approach, thereby allowing our customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements for such services.

ASP revenue increased to \$2,538,000 in 2005 from \$1,725,000 in 2004, representing an increase of \$813,000 or 47%. This increase is the result of additional users, including one new customer of our Avatar suite of products, the inclusion of our Netsmart University revenue for the period April 28, 2005 through December 31, 2005, as well as increases in our CareNet and InfoScriber revenue.

On April 28, 2005, we acquired substantially all of the assets, including computer software, customer lists and computer equipment, of ContinuedLearning LLC, a company that offers a comprehensive family of web-based training products and services, including its Learning Management System. ContinuedLearning revenue totaled \$235,000 for 2005.

Gross profit for 2005 was \$927,000 and for 2004 was \$799,000. The gross margin percentage was 37% in 2005 and 46% in 2004. Although revenue increased, the gross profit and gross margin percentage did not increase proportionally due to the increased costs associated with the ContinuedLearning operations which amounted to \$494,000 in 2005. These costs represent the required baseline costs to support the ContinuedLearning operation. We expect that as new revenue is added to this operation, gross profit and margins will increase accordingly.

### **Operating Expenses**

Selling, general and administrative expenses were \$11,272,000 in 2005, reflecting an increase of \$3,978,000, or 55%, from \$7,294,000 in 2004. Approximately \$1,571,000 or 39% of this increase was related to the selling, general and administrative costs associated with Netsmart - Ohio. These costs included such categories as salary and fringe benefits of \$720,000, consulting costs of \$199,000 and rent of \$170,000. Approximately \$641,000 or 16% of this increase was related to an increase in bad debts, which included an amount of \$340,000 related to one customer who filed for bankruptcy. The remaining increases were in: sales and marketing salaries and fringe benefits, which increased by \$503,000; sales and marketing consulting costs, which increased by \$282,000; other consulting which increased by \$215,000, of which \$86,000 related to Sarbanes Oxley compliance efforts and \$79,000 related to strategic planning efforts; sales and marketing conference costs which increased by \$151,000; general administrative salaries and fringe benefits, which increased by \$187,000 and \$558,000 which related to increased amortization related to the ContinuedLearning, Netsmart - Ohio and AMS acquisitions. The cost increases were partially offset by

reductions in: depreciation, which decreased by \$133,000; and provision for bonuses, which decreased by \$142,000.

We incurred research, development and maintenance expenses of \$4,547,000 in 2005, an increase of 30% from \$3,498,000 in 2004. Approximately \$853,000 or 81% of this increase was related to the Netsmart - Ohio operations after the acquisition. During the latter part of 2004, we invested in infrastructure that is designed to improve the way we support our customers and products. This increased infrastructure costs relate to product version control, which includes design, programming, testing, documentation and quality control of our products. These efforts accounted for the remaining increase in our research, development and maintenance expenses. We also continue to invest in product enhancement and extensions. These extensions include the development of new software modules which address Federal reporting requirements, as well as continuing investment in core products. These amounts have been appropriately accounted for in accordance with SFAS No. 86, "Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed."

Interest and other expense was \$119,000 in 2005, a decrease of \$10,000, or 8%, from the \$129,000 in 2004. This decrease is the result of the completion of the amortization of the financing costs associated with our then-current loan agreement, which was amortized over a three year period, as well as reduced borrowing under our then-current loan agreement during 2005. On October 7, 2005, we borrowed \$2,500,000 pursuant to a term loan advanced under a new revolving credit and term loan agreement. The decrease in interest expense was partially offset by an increase in interest expense relating to the increased borrowings under the term loan.

Interest income was \$311,000 in 2005, an increase of \$185,000, or 147%, from \$126,000 in 2004. This increase is the result of maintaining higher cash balances during 2005, as well as an increase in interest rates. Interest income is generated from short-term investments made with a substantial portion of the proceeds received from our term loan, as well as cash generated from operations and the proceeds of the exercise of options and warrants.

We have a net operating loss tax carry forward of approximately \$5.3 million at December 31, 2005. In 2005, we recorded a current income tax expense of \$324,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The income tax provision was increased by a deferred tax provision of \$835,000. In 2004, we recorded a current income tax expense of \$187,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The current provision was reduced by \$952,000 as a result of the use of the available net operating loss carry forward. During 2004, the deferred tax valuation allowance of \$1,731,000 was reversed, \$717,000 of which was recorded as an addition to additional paid in capital and \$1,014,000 as a deferred tax benefit. The deferred tax provision was \$1,136,000 based on utilization of net operating loss carry forwards offset by a reduction in the deferred tax asset valuation allowance of \$1,014,000.

As a result of the foregoing factors, in 2005 we had net income of \$1,590,000, or \$.28 per share (basic) and \$.27 per share (diluted). For 2004, we had net income of \$2,753,000, or \$.52 per share (basic) and \$.50 per share (diluted).

### **Years Ended December 31, 2004 and 2003**

#### **Results of Operations**

Fixed price software development contracts, third party hardware and software components and licenses accounted for 34% and 44% of consolidated revenue for the years ended December 31, 2004 and 2003, respectively. This decrease was the result of more labor revenue being generated on an as incurred basis, as well as a change in the overall mix of our revenue components. Our recurring revenue components, which include our maintenance contract services and our Data Center and ASP services, accounted for 42% of our consolidated revenue for the year ended December 31, 2004 compared to 35% of consolidated revenue for the year ended December 31, 2003. Revenue from fixed price software development contracts is determined using the percentage of completion method which is based upon the time spent by our technical personnel on a project. Since the billing schedules under the contracts differ from the recognition of revenue, at the end of any period, these contracts generally result in either costs and estimated profits in excess of billing or billing in excess of costs and estimated profits.





Our total revenue for 2004 was \$29,005,000, an increase of \$1,830,000, or 7%, from our revenue for 2003, which was \$27,175,000.

Revenue from contracts with state and local government agencies represented 49% of revenue in 2004 and 57% of revenue in 2003. This decrease is the result of the substantial completion towards the end of 2003 of one state contract and two county contracts.

### **Software and Related Systems and Services**

Our Software and Related Systems and Services revenue for 2004 was \$25,221,000, an increase of \$611,000, or 2%, from our revenue for 2003, which was \$24,610,000. Software and Related Systems and Services revenue is comprised of turnkey systems labor revenue, revenue from sales of third party hardware and software, license revenue, maintenance revenue and revenue from small turnkey systems.

Within this segments are large turnkey and small turnkey components. The large turnkey components consist mostly of our Avatar suite of products. When we are engaged in a fixed price arrangement, these installations will usually extend over a six-month to a multi-year time period. The duration of the implementation is dependant on the size and complexity of the customer organization and the specifics of the implementation. The small turnkey components are usually completed within a six-month period. Small turnkey contracts were mostly related to our Avatar methadone related products.

The largest component of revenue was turnkey systems labor revenue, which increased to \$9,602,000 in 2004 from \$9,548,000 in 2003, reflecting a 1% increase. Turnkey systems labor revenue refers to labor associated with turnkey installations and includes categories such as training, installation, project management and development. Revenue from third party hardware and software decreased to \$4,335,000 in 2004, from \$4,444,000 in 2003, which represents a decrease of 2%. Sales of third party hardware and software, such as pharmacy and database software, are made in connection with the sales of turnkey systems. These sales are typically made at lower gross margins than our human services revenue. During 2004, we did not sell and perform on as many contracts containing such third party items. License revenue decreased to \$2,066,000 in 2004, from \$2,781,000 in 2003, reflecting a decrease of 26%. License revenue is generated as part of a sale of a human services information system pursuant to a contract or purchase order that includes delivery of the system and maintenance. We did not sell and perform on as many contracts containing license revenue in 2004 as we did in 2003. In addition, in order to encourage our existing customers to upgrade from our old product to our new Avatar product, we discounted the license fees to our existing clients. Maintenance revenue increased to \$8,290,000 in 2004 from \$7,069,000 in 2003, reflecting an increase of 17%. As turnkey systems are completed, they are transitioned to the maintenance division, thereby increasing our installed base. Revenue from the sales of our small turnkey contracts increased to \$928,000 in 2004 from \$768,000 in 2003, reflecting an increase of 21%. This increase is the result of the introduction of our new Avatar Addictions Management product into the market place during the latter part of 2003. Small turnkey sales relate to turnkey contracts that are less than \$50,000 and are usually completed within one to six months.

Gross profit decreased to \$11,849,000 in 2004 from \$11,953,000 in 2003, reflecting a decrease of 1%. Our gross margin percentage was 47% in 2004 compared to 49% in 2003. Our gross margin decreased as a result of the decrease in license revenue. This decrease was partially offset by improved labor efficiency on our fixed price contracts.

### **Data Center Services (Service Bureau)**

Data center clients typically generate approximately the same amount of revenue each year. We bill on a transaction basis or on a fixed fee arrangement. Historically, each year we increase the transaction or fixed fees by an amount that approximates the New York urban consumer price index increase. The data center revenue increased to \$2,058,000 in 2004 from \$1,973,000 in 2003, representing an increase of \$85,000, or 4%. This increase was due to an increase in the client base as well as increases in pricing.

Gross profit increased to \$1,209,000 in 2004 from \$939,000 in 2003, reflecting an increase of 29%. Our gross margin percentage increased to 59% in 2004 from 48% in the 2003. This increase was the result of the increase in revenue as well as a reduction in costs of approximately \$185,000. The major areas of cost reductions were in the area of payroll and fringe benefits in the amount of \$21,000, support overhead in the amount of \$65,000, facility costs in the amount of \$22,000, supplies in the amount of \$22,000, depreciation in the amount of \$15,000, and other costs in the amount of \$23,000.

### **Application Service Provider Services (“ASP”)**

ASP Services involves the offering of our Avatar suite of products, our CareNet products and our InfoScriber products on a virtual private network or internet delivery approach, thereby allowing our customers to rapidly deploy products and pay on a monthly service basis, thus eliminating capital intensive system requirements. This is the first year that we have accounted for ASP Services as a segment. Prior to our acquisition of CareNet on June 25, 2003, our ASP operations were immaterial.

Revenue for 2004 was \$1,725,000 as compared to \$591,000 in 2003.

Gross profit for 2004 was \$799,000 and our gross margin percentage was 46%. The gross profit for 2003 was \$214,000 and our gross margin percentage was 36%. Because the ASP operations were in their infancy during the 2003, any comparisons between the periods would not be meaningful.

### **Operating Expenses**

Selling, general and administrative expenses were \$7,294,000 in 2004, reflecting a decrease of \$675,000, or 8%, from \$7,969,000 in 2003. The decreases were in: bad debt expense, which decreased by \$1,250,000; provision for bonuses which decreased by \$172,000; and general and administrative salaries and related fringe expense, which decreased by \$101,000. These cost decreases were partially offset by increases in: depreciation expense which increased by \$351,000; amortization of the CareNet acquisition costs, which increased by \$139,000; consulting costs which increased by \$124,000; commissions, which increased by \$87,000; sales salaries and related fringe benefits expense, which increased by \$54,000; advertising and promotion, which increased by \$47,000; accounting costs, which increased by \$40,000; and sales and marketing travel and living costs, which increased by \$41,000.

We incurred research, development and maintenance expenses of \$3,498,000 in 2004, an increase of 26% from \$2,770,000 in 2003. During 2004, we invested in infrastructure to improve the way we support our customers and products. These changes related to redirecting personnel that were previously employed performing actual customer program “bug” fixing procedures, which would be included in costs of goods sold, to our research, development and maintenance area. These personnel now perform product version control, which includes design, programming, testing, documentation and quality control of our products. These efforts accounted for a substantial increase in our research, development and maintenance expenses. The increase in research, development and maintenance expense is also the result of continuing investment in product enhancement and extensions. These extensions include the development of new software modules which addresses Federal reporting requirements, as well as continued investment in core products. These amounts have been appropriately accounted for in accordance with SFAS No. 86,

“Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed.”

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Interest and other expense was \$129,000 in 2004, a decrease of \$71,000, or 35%, from \$200,000 in 2003. This decrease is the result of the completion of the amortization of the financing costs associated with our 2001 term loan agreement, which was amortized over a three year period, as well as reduced borrowing during 2004 under that term loan. This decrease was partially offset by an increase in borrowing related to the promissory note issued to Shuttle Data Systems Corp. in connection with our acquisition of CareNet.

Interest income was \$126,000 in 2004, an increase of \$52,000, or 70%, from the \$74,000 in 2003. Interest income is generated from short-term investments made with a substantial portion of the proceeds received from the term loan, as well as cash generated from operations and the proceeds of the exercise of options and warrants.

We had a net operating loss tax carry forward of approximately \$4.0 million at December 31, 2004. In the 2004 period, we recorded a current income tax expense of \$187,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The current provision was reduced by \$952,000 as a result of a use of the available net operating loss carry forward. The income tax provision was increased by a net deferred tax provision of \$122,000. The deferred tax asset valuation allowance of \$1,731,000 was reversed, \$717,000 of which was recorded as an addition to additional paid in capital and \$1,014,000 was recorded as a deferred tax benefit, during 2004. The deferred tax provision was \$1,136,000 based on utilization of net operating loss carry forwards offset by the reduction in the deferred tax asset valuation allowance of \$1,014,000. In 2003, we recorded a current income tax expense of \$113,000, which related to various state and local taxes, as well as a provision for the Federal alternative minimum tax. The current income tax provision was reduced by \$942,000 as a result of the use of available net operating losses. The deferred tax asset and the valuation allowance were reduced by the same amount. We also re-evaluated the deferred tax asset valuation allowance and further reduced the allowance by \$900,000 to zero, which was recorded as a tax benefit.

As a result of the foregoing factors, in the 2004 period we had net income of \$2,753,000, or \$.52 per share (basic) and \$.50 per share (diluted). For 2003, we had net income of \$3,029,000, or \$.69 per share (basic) and \$.64 per share (diluted).

### **Liquidity and Capital Resources**

We had working capital of approximately \$4.0 million at December 31, 2005 as compared to working capital of approximately \$18.2 million at December 31, 2004. This decrease of approximately \$14.2 million in working capital was the result of the following: \$15,890,000 paid for the acquisitions of CMHC, ContinuedLearning and AMS, \$6,032,000 of negative working capital acquired in the acquisition of CMHC, \$1,656,000 of other costs, paid in connection with the CMHC acquisition, \$1,264,000 in current liabilities assumed and accrued with respect to the acquisitions of ContinuedLearning and AMS, \$458,000 paid for the acquisition of equipment, and \$42,000 related to the capitalization of software. These decreases were partially offset by our net income, after adding back depreciation and amortization, which totaled \$4,041,000, an increase in the current portion of the deferred tax asset in the amount of \$484,000, \$854,000 in net proceeds from the exercise of stock options, \$4,110,000 in net proceeds from the completion of a private placement and \$2,000,000 in net proceeds after classifying the current portion of the term loan agreement entered into in October 2005. The remaining decrease in working capital of \$320,000 was due to changes in other current assets and liabilities.

In October 2005, we entered into a revolving credit and term loan agreement with the Bank of America, which was amended as of December 31, 2005 (as so amended, the "Credit Agreement"). This financing provides us with a five-year term loan of \$2.5 million. The term loan bears interest at LIBOR plus 2.25%. We have entered into an interest rate swap agreement with the Bank for the amount outstanding under the term loan whereby we converted our variable rate on the term loan to a fixed rate of 7.1% in order to reduce the interest rate risk associated with these borrowings. On October 7, 2005, we borrowed the full amount of the \$2,500,000 term loan. The revolving credit facility provides for borrowings of up to \$2,500,000. Any amounts borrowed under this arrangement will bear interest at a rate per annum to be elected by us, equal to either (1) the LIBOR Rate plus 2.00% or (2) the Bank's prime rate. We have not borrowed

any amounts under the revolving credit facility. The amount outstanding under the Credit Agreement at December 31, 2005 is \$2,417,000.

The terms of the Credit Agreement require compliance with certain covenants, including maintaining a minimum tangible net worth of \$2,250,000 until March 31, 2006 with provisions for increases in future periods, minimum cash reserves of \$5,000,000, maintenance of certain financial ratios, limitations on capital expenditures and indebtedness and prohibition of the payment of cash dividends. The Company was not in compliance with one of the covenants at December 31, 2005. As a result, the Company and the Bank entered into a First Amendment and Waiver to the term loan, pursuant to which the Bank agreed to amend the terms of the Tangible Net Worth covenant contained in the Loan Agreement and waive any non-compliance by the Company. As a result, as of December 31, 2005, the Company was in compliance with the financial covenants of the Credit Agreement.

In October 2005, we completed a private placement of units consisting of an aggregate 490,000 shares of our common stock and warrants to purchase 122,504 shares of common stock. The warrants have an exercise price of \$11 per share. We received net proceeds of approximately \$4.1 million.

In September 2001, we entered into the 2001 Term Loan Agreement with Bank of America (formerly Fleet Bank). This financing provides us with a five-year term loan of \$2.5 million. The current term loan bears interest at LIBOR plus 2.5%. We have entered into an interest rate swap agreement with the bank for the amount outstanding under the term loan whereby we converted our variable rate on the term loan to a fixed rate of 7.95% in order to reduce the interest rate risk associated with these borrowings. The amount outstanding at December 31, 2005 is \$250,000.

The terms of the 2001 Term Loan Agreement require compliance with certain covenants, including maintaining a minimum net equity of \$9 million, minimum cash reserves of \$500,000, maintenance of certain financial ratios, limitations on capital expenditures and indebtedness and prohibition of the payment of cash dividends. As of December 31, 2005, we were in compliance with the financial covenants of the 2001 Term Loan Agreement.

We issued a note payable to Shuttle Data Systems Corporation, d/b/a Adia Information Management Corp. in connection with our acquisition of CareNet. This three year promissory note is payable in 36 equal monthly installments of principal plus interest at the prime rate plus 1%. We have made the required principal and interest payments on the note and the principal amount outstanding at December 31, 2005 is \$83,000.

In the 2005, we capitalized software development costs of \$42,000 relating to one of our AVATAR products.

In 2004, we capitalized \$185,000 related to our RAD Plus 2004 product.

A part of our growth strategy is to acquire other businesses that are related to our current business. Such acquisitions may be made with cash, our securities, or a combination of cash and securities. If we fail to make any acquisitions our future growth will be limited to only internal growth. We are continually seeking acquisitions that will add complementary products to our offerings and that will provide value for the markets we serve. As of the date of this Form 10-K annual report, we did not have any formal or informal agreements or understandings with respect to any acquisitions.

Based on our outstanding contracts and our continuing business, we believe that our cash flow from operations and our cash on hand will be sufficient to enable us to fund our operations for at least the next twelve months. It is possible that we may need additional funding if we go forward with certain acquisitions or if our business does not develop as we anticipate, or if our expenses, including our software development costs relating to our expansion of our product line and our marketing costs for seeking to expand the market for our products and services to include smaller clinics and facilities and sole group practitioners, exceed our expectations.

**Off-Balance Sheet Arrangements**

We are not a party to any off-balance sheet arrangements.

**Contractual Obligations**

The following table summarizes, as of December 31, 2005, our obligations and commitments to make future payments under debt, capital leases, operating leases and other long-term liabilities:

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1 - 3 years	4 - 5 years	Over 5 years
Long Term Debt <sup>1</sup>	\$ 2,750,036	\$ 833,369	\$ 1,000,000	\$ 916,667	\$ --
Capital Lease Obligations <sup>2</sup>	70,837	61,316	9,521	--	--
Operating Leases <sup>3</sup>	8,422,459	1,480,565	2,277,794	1,932,100	2,732,000
Other Long-Term Liabilities <sup>3</sup>	1,693,738	741,625	930,863	21,250	--
Total Contractual and Other Long-Term Obligations	\$ 12,937,070	\$ 3,116,875	\$ 4,218,178	\$ 2,870,017	\$ 2,732,000

<sup>1</sup> See Note 7 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2005, 2004 and 2003, which describes the Company's financing agreements.

<sup>2</sup> See Note 10 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2005, 2004 and 2003, which describes the Company's Capital Lease Obligation.

<sup>3</sup> See Note 12 to Netsmart's Consolidated Financial Statements for the years ended December 31, 2005, 2004 and 2003 which describes the Company's Operating Lease and other Contractual Obligations.

**Critical Accounting Policies and Estimates**

Our Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. Among other things, estimates are used in accounting for allowances for bad debts, deferred income taxes, expected realizable values of assets (primarily capitalized software development costs and customer lists) and revenue recognition. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. Following is a discussion of the significant accounting policies and the significant estimates that we believe are the most critical to aid in fully understanding and evaluating our reported financial results:



Revenue Recognition  
Capitalized Software Development Costs  
Impairment of Customer Lists  
Bad Debts  
Fair Value of Acquired Deferred Post-Contract Customer Support  
Valuation Allowance for Deferred Income Tax Assets  
Purchase Price Allocation of Netsmart Ohio Acquisition  
Liquidated Damages of Registration Rights Agreement

Revenue Recognition - The Company recognizes large turnkey revenue from long-term (six months or longer), fixed price contracts for financial statement purposes under the percentage of completion method when significant modification of the software package is required to meet the customer specifications. The percentage of completion method takes into account progress towards completion of a contract using time spent by technical personnel on a particular project as the measuring standard. Revisions in cost estimates and recognition of losses on these contracts are reflected in the accounting period in which the facts become known. Contract terms provide for billing schedules that differ from revenue recognition and give rise to costs and estimated profits in excess of billings, and billings in excess of costs and estimated profits.

The Company recognizes small turnkey revenue from short-term (less than six months), fixed price contracts for financial statement purposes under the completed contract method. Payments received in advance by customers are deferred until earned and represented as deferred revenue in the accompanying balance sheet.

Revenue associated with fixed price turnkey sales consists of the following components: licensing of software, labor associated with the installation and implementation of the software; and maintenance services rendered in connection with such licensing activities. The complexity of the estimation process and issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our Consolidated Financial Statements. A number of internal and external factors can affect our estimates, including labor rates, utilization and efficiency variances and specification and testing requirement changes. Maintenance contract revenue is recognized on a straight-line basis over the life of the respective contract. We also derive revenue from the sale of third party hardware and software which is recognized based upon the terms of each contract. Consulting revenue is recognized when the services are rendered. Data Center revenue and Application Service Provider revenue are recognized in the period in which the services are provided. The above sources of revenue are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable and collectibility is probable.

Contract terms often provide for billing schedules that differ from revenue recognition and give rise to costs and estimated profits in excess of billings, and billings in excess of costs and estimated profits.

Deferred revenue represents revenue billed and collected but not yet earned.

The cost of maintenance revenue, which consists solely of staff payroll and applicable overhead, is expensed as incurred.

Capitalized Software Development Costs - Capitalization of computer software development costs begins upon the establishment of technological feasibility and ends upon its availability for general release to customers. Technological feasibility for our computer software products is generally based upon achievement of a detail program design free of high risk development issues. We capitalize only those costs directly attributable to the development of the software. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized computer software development costs require considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technology. Prior to reaching technological feasibility

these costs are expensed as incurred and included in research, development and maintenance. Activities undertaken after the products are available for general release to customers to correct errors or keep the product updated are expensed as incurred and included in research, development and maintenance. Amortization of capitalized computer software development costs commences when the related products become available for general release to customers. Amortization is provided on a product by product basis. The annual amortization is the greater of the amount computed using (a) the ratio that current gross revenue for a product bears to the total of current and anticipated future gross revenue for that product or (b) the straight-line method over the remaining estimated economic life of the product. The estimated life of these products range from 3 to 8 years.

We periodically perform reviews of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

Impairment of Customer Lists - Pursuant to SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we evaluate our long-lived assets for financial impairment, and continue to evaluate them as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable. We evaluate the recoverability of long-lived assets by measuring the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. At the time such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying amount of such assets, the assets are adjusted to their fair values.

Bad Debts - We maintain allowances for doubtful accounts for estimated bad debts. Our practice is to specifically identify clients and invoices where we believe collection may be at risk and provide for these on a current basis. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances might be required. In addition, since we evaluate each account and invoice on a case-by-case basis, the provision could vary from period to period.

Fair value of acquired deferred post-contract customer support ("PCS") - We value PCS in accordance with View B of EITF 04-11. In order to remain competitive and maintain our existing customer base we upgrade and maintain software for purposes of bug fixes, ongoing regulatory changes as well as software corrections and enhancements. These services are not sold separately and are therefore fair valued as a single unit. Although these services are provided on a when-and-if-available basis, we have an obligation to our existing customer base to develop upgrades and enhancements in order to maintain our customer relationships as well as increase future revenue. The fair value of this liability is estimated using the value of the services provided using an estimated fulfillment margin. As of December 31, 2005 the fair value of PCS recorded as deferred revenue is \$5.3 million. If we did not intend to perform research and development for unspecified software upgrades, the estimated value of the PCS would have been \$4.0 million. We intend to fulfill 100% of our obligations under these PCS obligations assumed.

Valuation Allowance for Deferred Income Tax Assets -- We measure deferred income taxes using enacted tax rates and laws that we expect will be in effect when the underlying assets or liabilities settle. We record a valuation allowance against our deferred income tax assets balance when it is more likely than not that the benefits of the net tax asset balance will not be realized, and record a corresponding charge to income tax expense. Our ability to reduce the valuation allowance for deferred income tax assets depends on our ability to generate taxable income in the future. Based on our projection of the Company's future taxable income we have determined that a valuation allowance is no longer required.

Purchase Price Allocation of Netsmart Ohio Acquisition - Purchase price allocations are subject to change. Changes could include a reallocation of intangible assets which would likely have the effect of increasing or decreasing future amortization expense, since the intangible assets are initially assigned varied lives. Additionally, the lives assigned to the identifiable intangible assets represent management's best estimates of the time periods in which it will continue to receive benefits from these assets. The useful lives may need to be adjusted in the future based upon changes to the expected useful lives of such assets.

Liquidated Damages of Registration Rights Agreement - We are required to deliver registered shares in connection with our private placement of shares and warrants in October 2005 or, in the alternative, pay liquidated damages. In accordance with View A of EITF 05-04 the liquidating damages penalties related to our obligation to register the shares and the shares underlying warrants are combined with our right to deliver unregistered shares. Thus these instruments have two settlement alternatives: (a) the delivery of registered shares in exchange for the exercise price or (b) the delivery of unregistered shares, plus the liquidated damages cash penalty required to be paid under the registration rights provisions of the subscription agreement, in exchange for the exercise price.

The Company has determined that the delivery of unregistered shares is considered an economic alternative, and the combined financial instrument should be classified as equity. In this regard we have also determined that SFAS 5 is the appropriate accounting for the registration rights agreements whereby any potential penalties will be recorded in earnings when and if incurred.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to market risk related to changes in interest rates. Most of our debt is at fixed rates of interest after completing interest rate swap agreements, which effectively converted our variable rate debt into fixed rate debt at 7.95% and 7.1% per annum. Therefore, if the LIBOR rate plus 2.5% increases above 7.95% or 7.1% per annum, it may have a positive effect on our comprehensive income.

Most of our invested cash and cash equivalents, which are invested in money market accounts and commercial paper, are at variable rates of interest. If market interest rates decrease by 10 percent from levels at December 31, 2005, the effect on our net income would be a decrease of approximately \$33,000 per year.

**Netsmart Technologies, Inc.**  
**Quarterly Summary**  
 Unaudited

The following table sets forth certain unaudited quarterly results of operations for each of the quarters in the years ended December 31, 2005 and 2004. All quarterly information was obtained from unaudited financial statements not otherwise contained in this report. We believe that all necessary adjustments have been made to present fairly the quarterly information when read in conjunction with the Consolidated Financial Statements and notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results for any future period.

	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter
<b>2005(a)</b>				
Total revenue	\$ 7,429	\$ 7,759	\$ 8,517	\$ 14,273
Gross profit	3,600	3,862	3,896	7,018
Net income	363	449	379	399
Per share amounts:				
Net earnings - Basic:	\$ .07	\$ .08	\$ .07	\$ .06
Net earnings - Diluted:	\$ .07	\$ .08	\$ .07	\$ .05
<b>2004 (b) (c)</b>				
Total revenue	\$ 6,823	\$ 7,189	\$ 7,421	\$ 7,572
Gross profit	3,163	3,435	3,565	3,694
Net income	325	493	633	1,302
Per share amounts:				
Net earnings - Basic:	\$ .06	\$ .09	\$ .12	\$ .24
Net earnings - Diluted:	\$ .06	\$ .09	\$ .11	\$ .24

In thousands, except per share data amounts

(a) During 2005, the Company made three acquisitions. See note 5 to the Consolidated Financial Statements.

(b) The Company utilized an effective income tax rate of approximately 28% through the third quarter of 2004. In the fourth quarter of 2004, the Company determined that the effective income tax rate should approximate 10%. Accordingly, the change in estimate recorded in the fourth quarter was to reduce the income tax provision by approximately \$360,000 related to the first three quarters of 2004.

(c) During the fourth quarter the Company changed its method of calculating overhead for its research, development and maintenance costs, from using a standard overhead rate factor to a specific costs method. As a result, \$1,248 of costs have been reclassified from research, development and maintenance costs into costs of goods sold. The effect of this reclassification on gross profit for each quarter during 2004 has been reflected above.

**Item 8. Financial Statements and Supplementary Data.**

The financial statements and supplementary data begin on page F-1 of this Form 10-K.

**Item 9. Changes and Disagreements with Accountants on Accounting and Financial Disclosure.**

None

**Item 9A. Controls and Procedures.**

**Evaluation and Disclosure Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) and 15d-15(e)). Our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit to the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified by the Commission's rules and forms, and that information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based upon the evaluation that was conducted, the Chief Executive Officer and Chief Financial Officer have concluded that as of the end of the period covered by this Annual Report on Form 10-K our disclosure controls and procedures were effective.

**Changes in Internal Controls**

There were no changes made in our internal controls over financial reporting that occurred during our most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

As a result of the CMHC acquisition, the company is currently evaluating its operations and, commencing in the first quarter of fiscal 2006, integrating the New York and Ohio operations. In doing so, we have chosen to use the most efficient processes and internal controls of the two operations in each location. This includes combining sales, marketing and certain administrative functions for greater efficiency of operation.

**Limitations on the Effectiveness of Controls**

We believe that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. Our disclosure controls and procedures are designed to provide a reasonable assurance of achieving their objectives and our Chief Executive Officer and Chief Financial Officer have concluded that such controls and procedures are effective at the "reasonable assurance" level.

**Item 9B. Other Information.**

None

### Part III

#### Item 10. Directors and Executive Officers of the Registrant.

Our directors and executive officers are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
James L. Conway	58	Chief executive officer and director
Anthony F. Grisanti	56	Chief financial officer, treasurer and secretary
Gerald O. Koop	67	Director
John F. Phillips	67	Director
Joseph G. Sicinski <sup>1 &amp; 2</sup>	73	Director
Francis J. Calcagno <sup>1, 2 &amp; 3</sup>	56	Director
John S.T. Gallagher <sup>1, 2 &amp; 3</sup>	74	Director
Yacov Shamash <sup>3</sup>	56	Director

1 Member of the compensation committee.

2 Member of the audit committee.

3 Member of the nominating and governance committee.

#### Director and Executive Officer Biographies

Mr. James L. Conway has been our Chief Executive Officer since April 1998, a director since January 1996 and was President from January 1996 until January 2001. From 1993 until April 1998, he was president of a Long Island-based manufacturer of specialty vending equipment for postal, telecommunication and other industries. He was previously vice president, treasurer and director of ITT Credit Corporation. Mr. Conway was recently elected to the board of LISTnet, which is an organization with the objective of promoting Long Island as one of the national centers of excellence for software and technology solutions. He also serves and is a member of the CEO Roundtable for Long Island.

Mr. Anthony F. Grisanti has been our Treasurer since June 1994, Secretary since February 1995 and Chief Financial Officer since January 1996.

Mr. Gerald O. Koop has been one of our directors since June 1998 and was President of Netsmart from January 2001 until his resignation on December 31, 2005. Mr. Koop continues to serve as an employee of Netsmart but is no longer an executive officer.

Mr. John F. Phillips has been one of our directors since June 1994. Mr. Phillips served as a Vice President of Netsmart and as President of Creative Socio-Medics from June 1994 until his retirement in April 2004. Mr. Phillips continues to serve as a consultant to Netsmart pursuant to the terms of the Netsmart Executive Retirement, Non Competition and Consulting Plan.

Mr. Joseph