# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended March 31, 2006.**

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

**For the transition period from ______ to ______ .**

**Commission file number: 000-49796**

# COMPUTER PROGRAMS AND SYSTEMS, INC.

**(Exact Name of Registrant as Specified in Its Charter)**

| | |
|---|---|
| **Delaware** | **74-3032373** |
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(I.R.S. Employer Identification No.)** |
| **6600 Wall Street, Mobile, Alabama** | **36695** |
| **(Address of Principal Executive Offices)** | **(Zip Code)** |

**(251) 639-8100**

**(Registrant s Telephone Number, Including Area Code)**

**N/A**

**(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)**

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

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 x Non-accelerated filer ¨

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

As of May 5, 2006, there were 10,752,986 shares of the issuer s common stock outstanding.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**Form 10-Q**

**(For the period ended March 31, 2006)**

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**PART I**

**FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**CONDENSED BALANCE SHEETS**

| | March 31, 2006 (Unaudited) | December 31, 2005 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 10,920,819 | $ 11,669,690 |
| Investments | 10,309,855 | 10,231,446 |
| Accounts receivable, net of allowance for doubtful accounts of $796,000 and $704,000, respectively | 12,873,782 | 12,413,797 |
| Financing receivables, current portion | 1,569,067 | 1,168,472 |
| Inventories | 1,947,295 | 1,988,184 |
| Deferred tax assets | 1,292,590 | 1,200,637 |
| Prepaid income taxes | | 268,321 |
| Prepaid expenses | 125,589 | 265,128 |
| Total current assets | 39,038,997 | 39,205,675 |
| Property and equipment | | |
| Land | 936,026 | 936,026 |
| Maintenance equipment | 3,827,406 | 3,674,200 |
| Computer equipment | 5,607,803 | 5,690,497 |
| Office furniture and equipment | 1,742,373 | 1,626,940 |
| Automobiles | 111,394 | 111,394 |
| | 12,225,002 | 12,039,057 |
| Less accumulated depreciation | (6,169,507) | (5,866,020) |
| Net property and equipment | 6,055,495 | 6,173,037 |
| Financing receivables | 1,405,546 | 1,605,226 |
| Total assets | $ 46,500,038 | $ 46,983,938 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,424,212 | $ 2,051,195 |
| Deferred revenue | 2,902,624 | 3,285,678 |
| Accrued vacation | 2,000,366 | 1,875,365 |
| Other accrued liabilities | 1,731,974 | 2,685,231 |
| Income taxes payable | 705,824 | |
| Total current liabilities | 8,765,000 | 9,897,469 |
| Deferred tax liabilities | 547,720 | 698,320 |
| Stockholders equity: | | |
| Common stock, par value $0.001 per share; 30,000,000 shares authorized; 10,752,316 and 10,624,901 shares issued and outstanding | 10,752 | 10,625 |
| Additional paid-in capital | 21,088,106 | 20,576,268 |

| | | |
|---|---|---|
| Deferred compensation | | (72,305) |
| Accumulated other comprehensive loss | (78,323) | (67,979) |
| Retained earnings | 16,166,783 | 15,941,540 |
| Total stockholders equity | 37,187,318 | 36,388,149 |
| Total liabilities and stockholders equity | $ 46,500,038 | $ 46,983,938 |

See accompanying notes.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**CONDENSED STATEMENTS OF INCOME (Unaudited)**

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|---|---|---|
| **Sales revenues:** | | |
| System sales | $ 14,519,049 | $ 12,642,831 |
| Support and maintenance | 11,170,310 | 10,192,293 |
| Outsourcing | 3,847,953 | 3,561,455 |
| Total sales revenues | 29,537,312 | 26,396,579 |
| **Costs of sales:** | | |
| System sales | 8,755,432 | 7,955,288 |
| Support and maintenance | 4,907,559 | 4,564,421 |
| Outsourcing | 2,223,377 | 1,961,405 |
| Total costs of sales | 15,886,368 | 14,481,114 |
| Gross profit | 13,650,944 | 11,915,465 |
| **Operating expenses:** | | |
| Sales and marketing | 2,208,796 | 1,834,650 |
| General and administrative | 4,982,009 | 4,868,249 |
| Total operating expenses | 7,190,805 | 6,702,899 |
| Operating income | 6,460,139 | 5,212,566 |
| **Other income (expense):** | | |
| Interest income | 256,710 | 109,816 |
| Miscellaneous income | | 64,873 |
| Total other income | 256,710 | 174,689 |
| Income before taxes | 6,716,849 | 5,387,255 |
| Income taxes | 2,623,647 | 2,153,413 |
| Net income | $ 4,093,202 | $ 3,233,842 |
| Net income per share - basic | $ 0.38 | $ 0.31 |
| Net income per share - diluted | $ 0.38 | $ 0.31 |
| Weighted average shares outstanding | | |
| Basic | 10,706,256 | 10,489,849 |
| Diluted | 10,798,099 | 10,574,145 |
| Dividends declared per share | $ 0.36 | $ 0.22 |

See accompanying notes.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**CONDENSED STATEMENT OF STOCKHOLDERS EQUITY (Unaudited)**

| | Common Shares | Common Stock | Additional Paid-in Capital | Deferred Compensation | Accumulated Other Comprehensive Loss | Retained Earnings | Total Stockholder s Equity |
|---|---|---|---|---|---|---|---|
| Balance at December 31, 2005 | 10,624,901 | $ 10,625 | $ 20,576,268 | $ (72,305) | $ (67,979) | $ 15,941,540 | $ 36,388,149 |
| Net Income | | | | | | 4,093,202 | 4,093,202 |
| Issuance of common stock | 127,415 | 127 | 180,004 | | | | 180,131 |
| Unrealized loss on available for sales investments, net of tax of $7,036 | | | | | (10,344) | | (10,344) |
| Share-based compensation | | | 274,966 | | | | 274,966 |
| Dividends | | | | | | (3,867,959) | (3,867,959) |
| Income tax benefit from stock option exercise | | | 129,173 | | | | 129,173 |
| Adoption of SFAS No. 123R | | | (72,305) | 72,305 | | | |
| Balance at March 31, 2006 | 10,752,316 | $ 10,752 | $ 21,088,106 | $ | $ (78,323) | $ 16,166,783 | $ 37,187,318 |

See accompanying notes.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)**

| | Three months ended March 31, 2006 | 2005 |
|---|---|---|
| **Operating Activities** | | |
| Net income | $ 4,093,202 | $ 3,233,842 |
| Adjustments to net income: | | |
| Provision for bad debt | (69,938) | (259,202) |
| Deferred taxes | (235,517) | 13,020 |
| Share-based compensation | 274,966 | 12,760 |
| Excess tax benefit from stock based compensation | (129,173) | |
| Depreciation | 503,958 | 427,477 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (390,047) | 244,216 |
| Financing receivables | (200,915) | (203,545) |
| Inventories | 40,889 | (128,772) |
| Prepaid expenses | 139,539 | 211,071 |
| Accounts payable | (626,983) | 619,383 |
| Deferred revenue | (383,054) | 458,605 |
| Other liabilities | (828,256) | 284,874 |
| Income taxes payable | 1,103,318 | 1,552,093 |
| Net cash provided by operating activities | 3,291,989 | 6,465,822 |
| **Investing Activities** | | |
| Purchases of property and equipment | (386,416) | (697,396) |
| Purchases of investments | (95,789) | (6,148,223) |
| Net cash used in investing activities | (482,205) | (6,845,619) |
| **Financing Activities** | | |
| Proceeds from exercise of stock options | 180,131 | |
| Excess tax benefit from stock based compensation | 129,173 | |
| Dividends paid | (3,867,959) | (2,307,767) |
| Net cash used in financing activities | (3,558,655) | (2,307,767) |
| Decrease in cash and cash equivalents | (748,871) | (2,687,564) |
| Cash and cash equivalents at beginning of period | 11,669,690 | 13,785,377 |
| Cash and cash equivalents at end of period | $ 10,920,819 | $ 11,097,813 |
| Cash paid for income taxes, net of refund | $ 1,755,846 | $ 588,300 |

See accompanying notes.

**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

## 1. BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and include all adjustments that, in the opinion of management, are necessary for a fair presentation of the results of the periods presented. All such adjustments are considered of a normal recurring nature. Quarterly results of operations are not necessarily indicative of annual results.

Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These unaudited condensed financial statements should be read in conjunction with the Company s audited financial statements for the year ended December 31, 2005 and the notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

## 2. REVENUE RECOGNITION

The Company s revenue is generated from three sources:

- the sale of information systems, which includes software, conversion and installation services, hardware, peripherals, forms and supplies
- the provision of system support services, which includes software application support, hardware maintenance, continuing education, application service provider ( ASP ) products, and internet service provider ( ISP ) products.
- the provision of outsourcing services, which includes electronic billing, statement processing, and business office outsourcing.

Depending upon the terms of the contract, revenue is recognized in accordance with SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements,* as amended by SAB No. 104, *Revenue Recognition*, and the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition*, which states that revenue should be recognized when persuasive evidence of an agreement exists, the product or service has been delivered, fees and prices are fixed and determinable, collectibility is probable, and when all other significant obligations have been fulfilled.

License revenue in connection with license agreements for proprietary software is recognized upon delivery of the software, providing collection is considered probable, the fee is fixed or determinable, there is evidence of an arrangement, and vendor specific objective evidence (VSOE) exists with respect to any undelivered elements of the arrangement. For multiple-element arrangements, the Company recognizes revenue under the residual method as permitted by the American Institute of Certified Public Accountants Statement of Position (SOP) 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, whereby (1) the total fair value of the undelivered elements, as indicated by VSOE, is deferred and subsequently recognized in accordance with SOP 97-2 and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Revenue derived from maintenance contracts primarily includes software application support, hardware maintenance, continuing education and related services. Maintenance contracts are typically sold for a separate fee with initial contractual periods ranging from one to three years with renewal for additional periods thereafter. Maintenance revenue is recognized ratably over the term of the maintenance agreement. In situations where all or a portion of the maintenance fee is bundled with the license fee, VSOE for maintenance is determined based on prices when sold separately.

Revenue for hardware is recognized under SAB No. 104. Under SAB No. 104, revenue is recognized provided that persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable, and collectibility is reasonably assured. For hardware, delivery is considered to have occurred upon shipment provided that risk of loss has been transferred to the customer.

Revenue for ISP, ASP, and outsourcing services are recognized in the period in which the services are performed.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

**3. DETAILS ON BALANCE SHEET AMOUNTS**

Other accrued liabilities are comprised of the following:

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Accrued salaries and benefits | $ 786,623 | $ 1,920,861 |
| Accrued commissions | 399,254 | 306,704 |
| Accrued self-insurance reserves | 380,600 | 380,600 |
| Other | 165,497 | 77,066 |
| | $ 1,731,974 | $ 2,685,231 |

**4. INVESTMENTS**

The Company accounts for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, investments are classified as available-for-sale securities and are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholder s equity. The Company s management determines the appropriate classifications of investments in fixed maturity securities at the time of acquisition and re-evaluates the classifications at each balance sheet date. The Company s investments in fixed maturity securities are classified as available-for-sale.

Investments are comprised of the following at March 31, 2006:

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Short term investments | $ 129,071 | $ | $ | $ 129,071 |
| Obligations of U.S. Treasury, U.S. government corporation and agencies | 4,670,155 | 13,308 | 31,552 | 4,651,911 |
| Mortgaged backed securities | 464,166 | | 8,838 | 455,328 |
| Municipal obligations | 400,000 | | | 400,000 |
| Corporate bonds | 4,780,616 | 2,079 | 109,150 | 4,673,545 |
| | $ 10,444,008 | $ 15,387 | $ 149,540 | $ 10,309,855 |

Shown below are the amortized cost and estimated fair value of securities with fixed maturities at March 31, 2006, by contract maturity date. Actual maturities may differ from contractual maturities because issuers of certain securities retain early call or prepayment rights.

| | Amortized Cost | Fair Value |
|---|---|---|

| | | |
|---|---|---|
| Due in 2006 | $ 5,648,027 | $ 5,564,039 |
| Due in 2007 | 2,294,293 | 2,276,562 |
| Due in 2008 | 1,510,007 | 1,486,412 |
| Due thereafter | 862,610 | 853,771 |
| | $ 10,314,937 | $ 10,180,784 |

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

**5. NET INCOME PER SHARE**

The Company presents both basic and diluted earnings per share (EPS) amounts. Basic EPS is calculated by dividing net income by the weighted average number of common shares outstanding during the period presented. Diluted EPS amounts are based upon the weighted average number of common and common equivalent shares outstanding during the period presented. The difference between basic and diluted EPS is solely attributable to stock options. The Company uses the treasury stock method to calculate the impact of outstanding stock options. For the three month periods ended March 31, 2006 and 2005, these dilutive shares were 91,843 and 84,296 respectively.

**6. INCOME TAXES**

The Company accounts for income taxes using the liability method in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Deferred income taxes arise from the temporary differences in the recognition of income and expenses for tax purposes. Deferred tax assets and liabilities are comprised of the following:

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Deferred tax assets: | | |
| Accounts receivable | $ 310,688 | $ 274,520 |
| Accrued vacation | 780,143 | 731,392 |
| Stock compensation | 102,261 | |
| Other accrued liabilities | 201,759 | 194,725 |
| Total gross deferred tax assets | $ 1,394,851 | $ 1,200,637 |
| Deferred tax liabilities: | | |
| Deferred compensation | $ 23,223 | $ 28,199 |
| Depreciation | 626,758 | 670,121 |
| Total gross deferred tax liabilities | $ 649,981 | $ 698,320 |
| Net deferred tax asset | $ 744,870 | $ 502,317 |

Significant components of the Company s income tax provision for the three months ended March 31 are as follows:

| | 2006 | 2005 |
|---|---|---|
| Current provision: | | |
| Federal | $ 2,355,245 | $ 1,773,833 |
| State | 503,919 | 366,560 |
| Deferred provision: | | |
| Federal | (211,362) | 11,685 |
| State | (24,155) | 1,335 |
| Total income tax provision | $ 2,623,647 | $ 2,153,413 |

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

The difference between income taxes at the U. S. federal statutory income tax rate of 35% and those reported in the condensed statements of income for the three months ended March 31 are as follows:

| | 2006 | 2005 |
|---|---|---|
| Income taxes at U. S. Federal statutory rate | $ 2,351,011 | $ 1,885,539 |
| State income tax, net of federal tax effect | 303,392 | 238,264 |
| Other | (30,756) | 29,610 |
| Total income tax provision | $ 2,623,647 | $ 2,153,413 |

**7. STOCK BASED COMPENSATION**

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share Based Payment* (SFAS No. 123R). SFAS No. 123R establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date based on the fair value of the award, and is recognized as an expense over the employee s requisite service period. The Company previously applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations and provided pro forma disclosures of SFAS No. 123, *Accounting for Stock Based Compensation.* The Company elected to adopt the modified prospective application method as provided by SFAS No. 123R, and, accordingly, prior periods are not restated for the effects of SFAS No. 123R. The Company recorded compensation costs as the requisite service rendered for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption and any awards issued, modified, repurchased, or cancelled after the effective date of SFAS No. 123R.

The adoption of SFAS No. 123R reduced basic and diluted net income per share by $0.02 for the three months ended March 31, 2006. The following table shows total stock-based compensation expense for the three months ended March 31, 2006, included in the Condensed Statement of Income:

| | Three Months Ended March 31, 2006 |
|---|---|
| Costs of sales | $ 129,351 |
| Operating expenses | 145,615 |
| Pre-tax stock-based compensation expense | 274,966 |
| Less: income tax effect | 102,261 |
| Net stock-based compensation expense | $ 172,705 |

Prior to adopting SFAS No. 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS No. 123R requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting SFAS No. 123R, $129,173 of excess tax benefits for the three months ended March 31, 2006 have been classified as a financing cash inflow.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

*2002 Stock Option Plan*

Under the 2002 Stock Option Plan, the Company has authorized the issuance of equity-based awards for up to 865,333 shares of common stock to provide additional incentive to employees and officers. Pursuant to the plan, the Company can grant either incentive or non-qualified stock options. Options to purchase common stock under the 2002 Stock Option Plan have been granted to Company employees with an exercise price equal to the fair market value of the underlying shares on the date of grant.

Stock options granted under the 2002 Stock Option Plan to executive officers of the Company become vested as to all of the shares covered by such grant on the fifth anniversary of the grant date and expire on the seventh anniversary of the grant date. Stock options granted under the 2002 Stock Option Plan to employees other than executive officers become vested as to 50% of the shares covered by the option grant on the third anniversary of the grant date and as to 100% of such shares on the fifth anniversary of the grant date. In addition, options become vested upon termination of employment resulting from death, disability or retirement. Such options expire on the seventh anniversary of the grant date.

Under the methodology of SFAS No. 123, the fair value of the Company s stock options was estimated at the date of grant using the Black-Scholes option pricing model. The multiple option approach was used, with assumptions for expected option life of 5 years and 44% expected volatility for the market price of the Company s stock in 2002. An estimated dividend yield of 3% was used. The risk-free rate of return was determined to be 2.79% in 2002. No options were granted in 2005, 2004 or 2003.

As required under SFAS No. 123R, the reported net income and earnings per share for the three months ended March 31, 2005 have been presented to reflect the impact had the Company been required to include the amortization of the Black-Scholes option value as an expense. The pro forma amounts are as follows:

| | Three Months Ended March 31, 2005 | |
|---|---|---|
| Net income as reported | $ | 3,233,842 |
| Add: Stock-based compensation expense, net of tax, included in reported net income | | 7,784 |
| Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of tax | | (64,136) |
| Pro forma net income | $ | 3,177,490 |
| Basic and diluted income per share as reported | $ | 0.31 |
| Pro forma basic and diluted income per share | $ | 0.30 |

A summary of stock option activity under the plan during the three month period ended March 31, 2006 is as follows:

| | Shares | Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Instrincic Value |
|---|---|---|---|---|
| Outstanding at beginning of period | 251,519 | $ 16.50 | | |

| | | | | |
|---|---|---|---|---|
| Granted | | | | |
| Exercised | (10,917) | 16.50 | | |
| Forfeited | (1,961) | 16.50 | | |
| Outstanding at end of period | 238,641 | $ 16.50 | 3.25 | 7,994,474 |
| Exercisable at end of period | 40,749 | $ | 3.25 | 1,365,092 |
| Shares available for future grants under the plan at end of period | | 478,874 | | |

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

The aggregate intrinsic value in the above table represents the total pre-tax intrinsic value (the difference between the Company s closing stock price on the last trading date of the first quarter of 2006 and the exercise price, multiplied by the number of options). The amount of aggregate intrinsic value will change based on the fair market value of the Company s common stock.

The aggregate intrinsic value of options exercised during the quarters ended March 31, 2006 and March 31, 2005 was $314,086 and $0 respectively.

As of March 31, 2006, there was $410,740 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the existing stock option plan. This cost is expected to be recognized over a weighted-average period of 1.2 years.

*2005 Restricted Stock Plan*

On January 27, 2006, the Compensation Committee of the Board of Directors approved the grant of 116,498 shares of restricted stock, effective January 30, 2006, to certain executive officers of the Company. The grant date fair value was $42.91 per share. The restricted stock vests in five equal annual installments commencing on the first anniversary of the date of grant.

| | Shares | Weighted-Average Grant-Date Fair Value |
|---|---|---|
| Nonvested stock outstanding at beginning of period | | $ |
| Granted | 116,498 | 42.91 |
| Vested | | |
| Forfeited | | |
| Nonvested stock outstanding at end of period | 116,498 | $ 42.91 |

As of March 31, 2006, there was $4,826,887 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 2005 Restricted Stock Plan. This cost is expected to be recognized over a weighted-average period of 4.8 years.

*Deferred Compensation*

On May 17, 2002, Kenny Muscat, one of the Company s directors and a principal stockholder, sold 66,667 shares of common stock to J. Boyd Douglas, Jr., one of the Company s directors and its Chief Operating Officer, for a price of $13.20 per share. The share price was determined by an independent valuation of the fair market value of the shares. A promissory note was delivered for the entire purchase price. The promissory note bears interest at the applicable rate for federal income tax purposes, and the entire principal balance is due five years after the date of the stock sale. As a part of the same transaction, Mr. Muscat also transferred to Mr. Douglas 19,333 shares of common stock for $1.00. These shares are subject to a mandatory transfer obligation under which Mr. Douglas will be required to transfer the shares back to Mr. Muscat in the event Mr. Douglas s employment with the Company terminates for certain reasons prior to the fifth anniversary of the transaction date. The mandatory transfer obligation lapses as to 20% of the shares on each anniversary of the transaction date over the five year restriction period.

| | Shares | Weighted-Average Grant-Date Fair Value |
|---|---|---|

| | | | |
|---|---|---|---|
| Nonvested stock outstanding at beginning of period | 5,478 | $ | 13.20 |
| Granted | | | |
| Vested | | | |
| Forfeited | | | |
| Nonvested stock outstanding at end of period | 5,478 | $ | 13.20 |

As of March 31, 2006, there was $59,546 of total unrecognized compensation cost related to the unlapsed portion of the mandatory transfer obligation. This cost is expected to be recognized over a weighted-average period of 1.2 years.

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**COMPUTER PROGRAMS AND SYSTEMS, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)**

**8. COMPREHENSIVE INCOME**

Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income*, requires the disclosure of certain revenue, expenses, gains and losses that are excluded from net income in accordance with accounting principles generally accepted in the United States of America. Total comprehensive income for the three months ended March 31, 2006 and 2005 are as follows:

| | Three months ended March 31 | |
|---|---|---|
| | 2006 | 2005 |
| Net income as reported | $ 4,093,202 | $ 3,233,842 |
| Other comprehensive income: | | |
| Unrealized loss on investments, net of taxes | (10,344) | (27,752) |
| Total comprehensive income | $ 4,082,858 | $ 3,206,090 |

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

You should read the following discussion and analysis of our financial condition and results of operations together with the unaudited condensed financial statements and related notes appearing elsewhere herein.

This discussion and analysis contains forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements can be identified generally by the use of forward-looking terminology and words such as expects, anticipates, estimates, believes, predicts, intends, plans, potential, may, continue, should, will an meaning. Without limiting the generality of the preceding statement, all statements in this report relating to estimated and projected earnings, margins, costs, expenditures, cash flows, growth rates and future financial results are forward-looking statements. We caution investors that any such forward-looking statements are only predictions and are not guarantees of future performance. Certain risks, uncertainties and other factors may cause actual results to differ materially from those projected in the forward-looking statements. Such factors may include:

- overall business and economic conditions affecting the healthcare industry;
- saturation of our target market and hospital consolidations;
- changes in customer purchasing priorities and demand for information technology systems;
- competition with companies that have greater financial, technical and marketing resources than we have;
- failure to develop new technology and products in response to market demands;
- fluctuations in quarterly financial performance due to, among other factors, timing of customer installations;
- failure of our products to function properly resulting in claims for medical losses;
- government regulation of our products and customers, including changes in healthcare policy affecting Medicare reimbursement rates; and
- interruptions in our power supply and/or telecommunications capabilities.

Additional information concerning these and other factors which could cause differences between forward-looking statements and future actual results is discussed under the heading Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

**Overview**

We are a healthcare information technology company that designs, develops, markets, installs and supports computerized information technology systems to meet the unique demands of small and midsize hospitals. Our target market includes acute care community hospitals with 300 or fewer beds and small specialty hospitals. We are a single-source vendor providing comprehensive software and hardware products, complemented by data conversion, complete installation and extensive support. Our fully integrated, enterprise-wide system automates the management of clinical and financial data across the primary functional areas of a hospital. In addition, we provide services that enable our customers to outsource certain data-related business processes which we can perform more efficiently. We believe our products and services enhance hospital performance in the critical areas of clinical care, revenue cycle management, cost control and regulatory compliance. From our initial hospital installation in 1981, we have grown to serve more than 580 hospital customers across 46 states and the District of Columbia. In the three months ended March 31, 2006, we generated revenues of $29.5 million from the sale of our products and services.

**Results of Operations**

***Three Months Ended March 31, 2006 Compared with Three Months Ended March 31, 2005***

*Revenues.* Total revenues increased by 11.9%, or $3.1 million, to $29.5 million for the three months ended March 31, 2006, from $26.4 million for the three months ended March 31, 2005.

System sales revenues increased by 14.8%, or $1.9 million, to $14.5 million for the three months ended March 31, 2006, from $12.6 million for the three months ended March 31, 2005. This increase was primarily due to an increase in sales of add-on business to existing customers along with the conversion of an ASP contract to a system purchase.

Support and maintenance revenues increased by 9.6%, or $1.0 million, to $11.2 million for the three months ended March 31, 2006, from $10.2 million for the three months ended March 31, 2005. This increase was attributable to an increase in recurring revenues as a result of a larger customer base.

Outsourcing revenues increased by 8.0%, or $0.2 million, to $3.8 million for the three months ended March 31, 2006, from $3.6 million for the three months ended March 31, 2005. We experienced an increase in outsourcing revenues as a result of continued growth in existing customer demand for electronic billing and business office outsourcing services. We were providing business office outsourcing services to fifteen customers at March 31, 2006 and March 31, 2005.

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*Costs of Sales*. Total costs of sales increased by 9.7%, or $1.4 million, to $15.9 million for the three months ended March 31, 2006, from $14.5 million for the three months ended March 31, 2005. As a percentage of total revenues, costs of sales decreased to 53.8% for the three months ended March 31, 2006, from 54.9% for the three months ended March 31, 2005.

Cost of system sales increased by 10.1%, or $0.8 million, to $8.8 million for the three months ended March 31, 2006, from $8.0 million for the three months ended March 31, 2005. Cost of equipment increased $0.5 million as a result of an increase in equipment sales. Payroll related expenses increased $0.3 million as a result of annual salary increases and an increase in the number of employees. The gross margin on system sales increased to 39.7% for the three months ended March 31, 2006, from 37.1% for the three months ended March 31, 2005. The increase in the sale of add-on business to existing customers resulted in an improved gross margin percentage.

Cost of support and maintenance increased by 7.5%, or $0.3 million, to $4.9 million for the three months ended March 31, 2006, from $4.6 million for the three months ended March 31, 2005. This increase was caused primarily by an increase of $0.4 million in payroll related expenses as a result of annual salary increases and an increase in the number of employees. General departmental expenses decreased $0.1 million. The gross margin on support and maintenance revenues increased to 56.1% for the three months ended March 31, 2006, compared to 55.2% for the three months ended March 31, 2005. The increase in gross margin was primarily due to the addition of new customers with a proportionately smaller increase in support personnel.

Our costs associated with outsourcing services increased by 13.4%, or $0.2 million, to $2.2 million for the three months ended March 31, 2006, from $2.0 million for the three months ended March 31, 2005. This increase was caused primarily by an increase of $0.2 million in payroll related expenses as a result of an increase in the number of employees needed to support our growing business office outsourcing operations and electronic billing operations.

*Sales and Marketing Expenses.* Sales and marketing expenses increased by 20.4%, or $0.4 million, to $2.2 million for the three months ended March 31, 2006, from $1.8 million for the three months ended March 31, 2005. The increase was attributable to an increase in salary expense of $0.2 million as a result of an increase in the number of personnel in sales and marketing and an increase in travel related expenses of $0.2 million.

*General and Administrative Expenses.* General and administrative expenses increased 2.3%, or $0.1 million, to $5.0 million for the three months ended March 31, 2006, from $4.9 million for the three months ended March 31, 2005. Our 2005 National Users Conference was postponed from September 2005 to January 2006 as a result of the impact of Hurricane Katrina on the Gulf Coast region. Expenses related to this meeting are normally incurred during the third quarter each year.

As a percentage of total revenues, sales and marketing expenses, and general and administrative expenses decreased to 24.3% for the three months ended March 31, 2006, from 25.4% for three months ended March 31, 2005.

*Net Income*. Net income for the three months ended March 31, 2006 increased by 26.6%, or $0.9 million, to $4.1 million, or $0.38 per diluted share, as compared with net income of $3.2 million, or $0.31 per diluted share, for the three months ended March 31, 2005. Net income represents 13.9% of revenue for the three months ended March 31, 2006, as compared to 12.3% of revenue for the three months ended March 31, 2005.

**Liquidity and Capital Resources**

At March 31, 2006, we had cash and cash equivalents of $10.9 million, compared with $11.1 million at March 31, 2005. Net cash provided by operating activities for the three months ended March 31, 2006 was $3.3 million, compared to $6.5 million for the three months ended March 31, 2005. The decrease was primarily due to an increase in net income offset by decreases in accounts payable, other liabilities and deferred revenue.

Net cash used in investing activities totaled $0.5 million for the three months ended March 31, 2006, compared to $6.8 million for the three months ended March 31, 2005. We used cash primarily for the purchase of property and equipment. In 2005, we used cash primarily for the purchase of $6.1 million in investments which are classified as available for sale.

Net cash used in financing activities totaled $3.6 million for the three months ended March 31, 2006, compared to $2.3 million for the three months ended March 31, 2005, as a result of $3.9 million in dividends that we declared and paid during the first quarter of 2006.

We currently do not have a bank line of credit or other credit facility in place. Our future capital requirements will depend upon a number of factors, including the rate of growth of our sales, cash collections from our customers and our future investments in fixed assets. We believe that our available cash and cash equivalents and anticipated cash generated from operations will be sufficient to meet our operating requirements for the next 12 months.

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**Off Balance Sheet Arrangements**

We are not currently a party to any material off-balance sheet arrangement as defined in Item 303 of Regulation S-K.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

We currently do not use derivative financial instruments. Cash and cash equivalents consist of highly liquid financial instruments, primarily cash, money market funds and short term U.S. Government obligations, purchased with an original maturity of three months or less. Interest income on our income statement is included in Other Income.

As of March 31, 2006, the Company had no borrowings and is, therefore, not subject to interest rate risks related to debt instruments.

**Item 4. Controls and Procedures**

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company that is required to be included in our periodic SEC filings. There have not been any changes in the Company s internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

## PART II

## OTHER INFORMATION

**Item 1. Legal Proceedings.**

From time to time, we are involved in routine litigation that arises in the ordinary course of business. We were involved in a litigated dispute relating to the installation of a hospital information system. On March 13, 2006, we reached a compromise on this dispute. The terms of the compromise are embodied in a settlement agreement which has been approved by the Supreme Court of the State of New York, County of New York. The settlement will not have an adverse effect on our business or financial condition, nor will it affect our quarterly earnings. We are not currently involved in any other litigation that we believe could reasonably be expected to have a material adverse effect on our business, financial condition, or results of operations.

**Item 1A. Risk Factors.**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

(a) None.

(b) None.

(c) None.

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Item 5. Other Information.**

None.

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**Item 6. Exhibits**

| No. | Exhibit |
|---|---|
| 3.1 | Certificate of Incorporation (filed as Exhibit 3.4 to CPSI s Registration Statement on Form S-1 (Registration No. 333-84726) and incorporated herein by reference) |
| 3.2 | Bylaws (filed as Exhibit 3.6 to CPSI s Registration Statement on Form S-1 (Registration No. 333-84726) and incorporated herein by reference) |
| 10.1 | Form of Restricted Stock Award Agreement (filed as Exhibit 10.1 to CPSI s Current Report on Form 8-K dated January 30, 2006, and incorporated herein by reference) |
| 31.1 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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## SIGNATURES

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

**COMPUTER PROGRAMS AND SYSTEMS, INC.**

Date: May 8, 2006

By: /s/ David A. Dye

David A. Dye

President and Chief Executive Officer

Date: May 8, 2006 By: /s/ M. Stephen Walker

M. Stephen Walker

Vice President - Finance and

Chief Financial Officer

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