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

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

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 o Accelerated filer o Non-accelerated filer x

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

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

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.

1

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

2

- 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.

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 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 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.

3

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.

5

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.

6

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.

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

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.

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

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 prio