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

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

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from __________ to __________

Commission File Number 0-15386

CERNER CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

Yes þ No o

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

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

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

Yes o No þ

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

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

CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

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

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

See notes to condensed consolidated financial statements.

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

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

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

See notes to condensed consolidated financial statements.

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

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

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

See notes to condensed consolidated financial statements.

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CERNER CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Interim Statement Presentation & Accounting Policies

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

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

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

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

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

(2) Earnings Per Share

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

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

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

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

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

(3) Accounting for Share-Based Awards

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

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

(In thousands, except per share data)

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

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

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

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

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

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

	Nine months ended Sept. 30, 2006	Nine months ended Oct. 1, 2005
Total cost of share-based payments for the period	$ 15,235,000	