TYLER TECHNOLOGIES INC
Form 10-Q
October 26, 2006

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

þ **QUARTERLY REPORT UNDER 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.**

Commission File Number 1-10485
TYLER TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	75-2303920
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

5949 SHERRY LANE, SUITE 1400
DALLAS, TEXAS
75225
(Address of principal executive offices)
(Zip code)
(972) 713-3700
(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), 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 o Accelerated filer þ Non-accelerated filer o

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

Number of shares of common stock of registrant outstanding at October 24, 2006: 38,817,719

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

TYLER TECHNOLOGIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Revenues:				
Software licenses	$ 10,422	$ 7,153	$ 27,817	$ 21,362
Software services	14,497	13,103	42,678	38,824
Maintenance	18,847	16,655	54,220	47,882
Appraisal services	4,920	4,147	14,727	13,931
Hardware and other	1,453	1,248	4,706	4,151
Total revenues	50,139	42,306	144,148	126,150
Cost of revenues:				
Software licenses	2,500	2,159	7,592	6,683
Acquired software	353	198	1,007	595
Software services and maintenance	22,647	20,171	67,341	60,047
Appraisal services	3,386	3,027	10,246	11,045
Hardware and other	1,096	929	3,397	2,993
Total cost of revenues	29,982	26,484	89,583	81,363
Gross profit	20,157	15,822	54,565	44,787
Selling, general and administrative expenses	13,201	11,445	38,072	34,652
Restructuring charge				1,260
Amortization of customer and trade name intangibles	326	317	973	950
Operating income	6,630	4,060	15,520	7,925
Other income, net	306	224	603	603
Income before income taxes	6,936	4,284	16,123	8,528
Income tax provision	2,523	1,703	5,938	3,456
Net income	$ 4,413	$ 2,581	$ 10,185	$ 5,072
Earnings per common share:				
Basic	$ 0.11	$ 0.07	$ 0.26	$ 0.13

Diluted	$ 0.11	$ 0.06	$ 0.24	$ 0.12
Basic weighted average common shares outstanding	38,705	39,104	38,947	39,659
Diluted weighted average common shares outstanding	41,898	41,771	41,911	42,160

See accompanying notes.

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TYLER TECHNOLOGIES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value and share amounts)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,052	$ 20,733
Short-term investments available-for-sale	12,025	11,750
Restricted certificate of deposit	5,000	4,750
Accounts receivable (less allowance for losses of $2,303 in 2006 and $1,991 in 2005)	44,632	49,644
Prepaid expenses	5,937	5,158
Other current assets	2,783	2,201
Deferred income taxes	2,128	2,128
Total current assets	93,557	96,364
Accounts receivable, long-term portion	1,500	1,547
Property and equipment, net	7,233	5,759
Other assets:		
Restricted certificate of deposit		250
Goodwill	65,889	53,709
Customer related intangibles, net	17,816	17,696
Software, net	16,062	17,645
Trade name, net	1,217	1,262
Sundry	178	205
	$ 203,452	$ 194,437
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,655	$ 3,330
Accrued liabilities	16,516	16,027
Deferred revenue	52,845	51,304
Income taxes payable		289
Total current liabilities	73,016	70,950
Deferred income taxes	9,659	11,290
Commitments and contingencies		

Shareholders equity:		
Preferred stock, $10.00 par value; 1,000,000 shares authorized, none issued		
Common stock, $0.01 par value; 100,000,000 shares authorized; 48,147,969 shares issued in 2006 and 2005	481	481
Additional paid-in capital	151,463	151,515
Accumulated earnings	13,954	3,769
Treasury stock, at cost; 9,329,395 and 9,273,342 shares in 2006 and 2005, respectively	(45,121)	(43,568)
Total shareholders equity	120,777	112,197
	$ 203,452	$ 194,437

See accompanying notes.

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TYLER TECHNOLOGIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine months ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income	$ 10,185	$ 5,072
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	7,592	7,857
Share-based compensation	1,529	
Purchased in-process research and development charge	140	
Non cash item	307	
Deferred income taxes	(141)	
Gain on disposal of assets		(85)
Changes in operating assets and liabilities, exclusive of effects of acquired companies:		
Accounts receivable	5,496	5,523
Income tax payable	(2,201)	(2,328)
Prepaid expenses and other current assets	(591)	(604)
Accounts payable	177	(360)
Accrued liabilities	(103)	(531)
Deferred revenue	297	2,156
Net cash provided by operating activities	22,687	16,700
Cash flows from investing activities:		
Proceeds from sale of short-term investments	14,691	13,176
Purchases of short-term investments	(14,966)	(10,032)
Cost of acquisitions	(12,237)	
Investment in software development costs	(203)	(951)
Additions to property and equipment	(3,288)	(1,196)
Other	(6)	15
Net cash (used by) provided by investing activities	(16,009)	1,012
Cash flows from financing activities:		
Purchase of treasury shares	(9,923)	(15,429)
Proceeds from employee stock purchase plan	719	896
Proceeds from exercise of stock options	2,420	349
Other	425	(31)
Net cash used by financing activities	(6,359)	(14,215)

Net increase in cash and cash equivalents	319	3,497
Cash and cash equivalents at beginning of period	20,733	12,573
Cash and cash equivalents at end of period	$ 21,052	$ 16,070

See accompanying notes.

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Tyler Technologies, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)
(Tables in thousands, except per share data)

(1) Basis of Presentation

We prepared the accompanying condensed consolidated financial statements following the requirements of the Securities and Exchange Commission (SEC) and accounting principles generally accepted in the United States, or GAAP, for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by GAAP can be condensed or omitted for interim periods. Balance sheet amounts are as of September 30, 2006 and December 31, 2005 and operating result amounts are for the three and nine months ended September 30, 2006 and 2005, and include all normal and recurring adjustments that we considered necessary for the fair summarized presentation of our financial position and operating results. As these are condensed financial statements, one should also read the financial statements and notes included in our latest Form 10-K for the year ended December 31, 2005. Revenues, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those for the full year.

Although we have a number of divisions, separate segment data has not been presented as they meet the criteria set forth in Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures About Segments of an Enterprise and Related Information to be presented as one segment.

In addition, certain other amounts for the previous year have been reclassified to conform to the current year presentation.

(2) Revenue Recognition

We recognize revenue related to our software arrangements pursuant to the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-4 and SOP 98-9, and related interpretations, as well as the SEC Staff Accounting Bulletin No. 104, Revenue Recognition. We recognize revenue on our appraisal services contracts using the proportionate performance method of accounting, with considerations for the provisions of Emerging Issues Task Force (EITF) No. 00-21, Revenue Arrangements with Multiple Deliverables.

Software Arrangements:

We earn revenue from software licenses, post-contract customer support (PCS or maintenance), software related services and hardware. PCS includes telephone support, bug fixes, and rights to upgrades on a when-and-if available basis. We provide services that range from installation, training, and basic consulting to software modification and customization to meet specific customer needs. In software arrangements that include rights to multiple software products, specified upgrades, PCS, and/or other services, we allocate the total arrangement fee among each deliverable based on the relative fair value of each.

We typically enter into multiple element arrangements, which include software licenses, software services, PCS and occasionally hardware. The majority of our software arrangements are multiple element arrangements, but for those arrangements that include customization or significant modification of the software, or where software services are otherwise considered essential to the functionality of the software in the customer s environment, we use contract accounting and apply the provisions of SOP 81-1 Accounting for Performance of Construction Type and Certain Production Type Contracts.

If the arrangement does not require significant modification or customization, revenue is recognized when all of the following conditions are met:

i. persuasive evidence of an arrangement exists;

ii. delivery has occurred;

iii. our fee is fixed or determinable; and

iv. collectibility is probable.

For multiple element arrangements, each element of the arrangement is analyzed and we allocate a portion of the total arrangement fee to the elements based on the fair value of the element using vendor-specific objective evidence of fair value (VSOE), regardless of any separate prices stated within the contract for each element. Fair value is considered the price a customer would

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be required to pay if the element was sold separately based on our historical experience of stand-alone sales of these elements to third parties. For PCS, we use renewal rates for continued support arrangements to determine fair value. For software services, we use the fair value we charge our customers when those services are sold separately. In software arrangements in which we have the fair value of all undelivered elements but not of a delivered element, we apply the residual method as allowed under SOP 98-9 in accounting for any element of a multiple element arrangement involving software that remains undelivered such that any discount inherent in a contract is allocated to the delivered element. Under the residual method, if the fair value of all undelivered elements is determinable, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered element(s) and is recognized as revenue assuming the other revenue recognition criteria are met. In software arrangements in which we do not have VSOE for all undelivered elements, revenue is deferred until fair value is determined or all elements for which we do not have VSOE have been delivered. Alternatively, if sufficient VSOE does not exist and the only undelivered element is services that do not involve significant modification or customization of the software, the entire fee is recognized over the period during which the services are expected to be performed.

Software Licenses

A majority of our software arrangements involve off-the-shelf software. We consider software to be off-the-shelf software if it can be added to an arrangement with minor changes in the underlying code and it can be used by the customer for the customer s purpose upon installation. For off-the-shelf software arrangements, we recognize the software license fee as revenue after delivery has occurred, customer acceptance is reasonably assured, that portion of the fee represents a non-refundable enforceable claim and is probable of collection, and the remaining services such as training are not considered essential to the product s functionality. If the fee is not fixed or determinable, including new customers whose payment terms are three months or more from shipment, revenue is generally recognized as payments become due from the customer.

For arrangements that include significant customization or modification of the software, or where software services are otherwise considered essential, we recognize revenue using contract accounting. We generally use the percentage-of-completion method to recognize revenue from these arrangements. We measure progress-to-completion primarily using labor hours incurred, or value added. The percentage-of-completion methodology generally results in the recognition of reasonably consistent profit margins over the life of a contract since we have the ability to produce reasonably dependable estimates of contract billings and contract costs. We use the level of profit margin that is most likely to occur on a contract. If the most likely profit margin cannot be precisely determined, the lowest probable level of profit in the range of estimates is used until the results can be estimated more precisely. These arrangements are often implemented over an extended time period and occasionally require us to revise total cost estimates. Amounts recognized in revenue are calculated using the progress-to-completion measurement after giving effect to any changes in our cost estimates. Changes to total estimated contract costs, if any, are recorded in the period they are determined. Estimated losses on uncompleted contracts are recorded in the period in which we first determine that a loss is apparent. Certain contracts that include significant customization or modification of the software may contain a general right of return that lapses upon customer acceptance. For these contracts we generally recognize revenue upon customer acceptance. This may result in revenue being recognized in irregular increments.

For arrangements that include new product releases for which it is difficult to estimate final profitability except to assume that no loss will ultimately be incurred, we recognize revenue under the completed contract method. Under the completed contract method, revenue is recognized only when a contract is completed or substantially complete. Historically these amounts have been immaterial.

Software Services

Some of our software arrangements include services considered essential for the customer to use the software for the customer s purposes. For these software arrangements, both the software license revenue and the services revenue are recognized as the services are performed using the percentage-of-completion contract accounting method. When software services are not considered essential, the fee allocable to the service element is recognized as revenue as we perform the services.

Computer Hardware Equipment

Revenue allocable to computer hardware equipment, which is based on VSOE, is recognized when we deliver the equipment and collection is probable.

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Postcontract Customer Support

Our customers generally enter into PCS agreements when they purchase our software licenses. Our PCS agreements are typically renewable annually. Revenue allocated to PCS is recognized on a straight-line basis over the period the PCS is provided. All significant costs and expenses associated with PCS are expensed as incurred. Fair value for the maintenance and support obligations for software licenses is based upon the specific sale renewals to customers or upon renewal rates quoted in the contracts.

Appraisal Services:

For our property appraisal projects, we recognize revenue using the proportionate performance method of revenue recognition since many of these projects are implemented over one to three year periods and consist of various unique activities. Under this method of revenue recognition, we identify each activity for the appraisal project, with a typical project generally calling for bonding, office set up, training, routing of map information, data entry, data collection, data verification, informal hearings, appeals and project management. Each activity or act is specifically identified and assigned an estimated cost. Costs which are considered to be associated with indirect activities, such as bonding costs and office set up, are expensed as incurred. These costs are typically billed as incurred and are recognized as revenue equal to cost. Direct contract fulfillment activities and related supervisory costs such as data collection, data entry and verification are expensed as incurred. The direct costs for these activities are determined and the total contract value is then allocated to each activity based on a consistent profit margin. Each activity is assigned a consistent unit of measure to determine progress towards completion and revenue is recognized for each activity based upon the percentage complete as applied to the estimated revenue for that activity. Progress for the fulfillment activities is typically based on labor hours or an output measure such as the number of parcel counts completed for that activity. Estimated losses on uncompleted contracts are recorded in the period in which we first determine that a loss is apparent.

Other:

Deferred revenue consists primarily of unearned support and maintenance revenue that has been billed based on contractual terms in the underlying arrangement with the remaining balance consisting of payments received in advance of revenue being earned under software licensing, software services and hardware installation. Unbilled revenue is not billable at the balance sheet date but is recoverable over the remaining life of the contract through billings made in accordance with contractual agreements. The termination clauses in most of our contracts provide for the payment for the fair value of products delivered and services performed in the event of an early termination.

Prepaid expenses and other current assets include direct and incremental costs, consisting primarily of third party subcontractor payments and commissions associated with arrangements for which revenue recognition has been deferred. Such costs are expensed at the time the related revenue is recognized.

(3) Acquisitions

In late January 2006, we completed the acquisitions of all of the capital stock of MazikUSA, Inc. (Mazik) and TACS, Inc. (TACS). The total value of these transactions, including transaction costs, was approximately $14.6 million, which was comprised of $11.7 million in cash and 325,000 shares of Tyler common stock valued at $2.9 million.

Mazik provides an integrated software solution for schools that combines the functionalities of student performance monitoring, student tracking, financial accounting, human resources and reporting.

TACS provides pension and retirement software solutions that assist public and private pension institutions in increasing operational efficiency and accuracy.

We acquired assets of approximately $400,000 and assumed liabilities of approximately $1.5 million. We recorded goodwill of $12.2 million, all of which is expected to be deductible for tax purposes, and other intangible assets of $3.4 million. The $3.4 million of intangible assets is attributable to acquired software and customer relationships that will be amortized over a weighted average period of approximately five years, and purchased in-process research and development of $140,000 which we expensed during the first quarter of 2006. Our consolidated balance sheet as of September 30, 2006 reflects the allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The operating results of the acquired business are included in our results of operations since their respective dates of acquisition in late January 2006.

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In September 2006, we also purchased certain maintenance and support agreements associated with one of our financial products for approximately $580,000. These costs have been capitalized and will be amortized over 13 years.

(4) Restructuring Charge

Because of unsatisfactory financial performance early in 2005, we made significant organizational changes in the second quarter of 2005 to those areas of our business that were not performing to our expectations. Our goal was to bring costs in line with expected levels of revenue while improving the efficiency of our organizational structure to ensure that clients continue to receive superior service.

We reorganized our appraisal services business to eliminate levels of management and reduce overhead expense. We also took actions to reduce headcount and costs in our appraisal and tax software division, and we consolidated certain senior management positions at the corporate office. These cost reductions were made in the second quarter of 2005. As a result, we eliminated approximately 120 positions, including management, staff and project-related personnel.

In connection with the reorganization, we incurred certain charges which were primarily comprised of employee severance costs and related fringe benefits, and totaled approximately $1.3 million before income taxes. The related payments were paid in 2005.

(5) Shareholders Equity

The following table details activity in our common stock:

	Nine months ended September 30,			
	2006		2005	
	Shares	Amount	Shares	Amount
Repurchases of common stock	(987)	$(9,923)	(2,181)	$(15,429)
Stock option exercises	526	2,420	169	349
Employee stock plan purchases	80	700	134	896
Shares issued for acquisitions	325	2,891		

As of September 30, 2006 we have authorization from our board of directors to repurchase up to 1.1 million additional shares of Tyler common stock.

(6) Income Tax Provision

The following table sets forth a comparison of our income tax provision for the following periods:

	Three months ended September 30		Nine months ended September 30	
	2006	2005	2006	2005
Income tax provision	$2,523	$1,703	$5,938	$3,456
Effective income tax rate	36.4%	39.8%	36.8%	40.5%

The effective income tax rates were different from the statutory United States federal income tax rate of 35% primarily due to the state income taxes, the qualified manufacturing activities deduction, non-deductible meals and entertainment costs and in 2006 the rate is also impacted by non-deductible share-based compensation expense.

The effective rate for the three months ended September 30, 2006 was lower than the prior year mainly due to a benefit from previously unclaimed tax credits resulting from the completion of state income tax audits. The effective rate for the nine months ended September 30, 2006 was lower than the prior year mainly due to changes in the Texas franchise tax law and rates enacted in the second quarter of 2006, favorable state income tax audit results and lower state income taxes as a result of a change in our corporate structure implemented in early 2005.

We made federal and state income tax payments, net of refunds, of $7.9 million in the nine months ended September 30, 2006, compared to $5.9 million in net payments for the same period of the prior year.

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(7) Earnings Per Share

The following table details the reconciliation of basic earnings per share to diluted earnings per share:

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Numerator for basic and diluted earnings per share:				
Net income	$ 4,413	$ 2,581	$ 10,185	$ 5,072
Denominator:				
Weighted-average basic common shares outstanding	38,705	39,104	38,947	39,659
Assumed conversion of dilutive securities:				
Stock options	1,921	1,567	1,734	1,446
Warrants	1,272	1,100	1,230	1,055
Potentially dilutive common shares	3,193	2,667	2,964	2,501
Weighted-average common shares outstanding, assuming full dilution	41,898	41,771	41,911	42,160
Earnings per common share:				
Basic	$ 0.11	$ 0.07	$ 0.26	$ 0.13