

DATATRAK INTERNATIONAL INC

Form 10-Q

November 09, 2006

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**Securities and Exchange Commission**  
**Washington, D.C. 20549**  
**Form 10-Q**  
**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the Quarterly Period Ended September 30, 2006**  
**Commission file number 000-20699**  
**DATATRAK International, Inc.**  
(Exact name of registrant as specified in its charter)

Ohio	34-1685364
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6150 Parkland Boulevard Mayfield Heights, Ohio	44124
(Address of principal executive offices)	(Zip Code)
(440) 443-0082	
(Registrants telephone number, including area code)	

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by 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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

The number of Common Shares, without par value, outstanding as of October 31, 2006 was 11,406,091.

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CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006 (Unaudited)</b>	<b>December 31, 2005 (Note A)</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 2,270,464	\$ 4,407,431
Short-term investments	2,009,386	4,955,491
Accounts receivable, less allowances	3,301,259	2,853,823
Deferred tax asset		287,000
Prepaid expenses and other current assets	694,373	702,075
Total current assets	8,275,482	13,205,820
Property and equipment, at cost net of accumulated depreciation and amortization	5,102,965	1,878,404
Other assets		
Restricted cash	74,962	69,976
Deferred tax asset	1,200,000	913,000
Deposit	39,549	39,549
Intangible assets, net of accumulated amortization	2,140,040	
Goodwill	12,956,842	
Total other assets	16,411,393	1,022,525
Total assets	\$ 29,789,840	\$ 16,106,749
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 425,136	\$ 549,886
Notes payable	146,210	
Current portion of long-term debt	670,038	
Accrued expenses	1,707,144	832,860
Deferred revenue	977,707	1,027,015
Total current liabilities	3,926,235	2,409,761
Long-term liabilities		
Long-term debt	3,825,235	
Deferred tax liability	2,053,600	
Total long-term liabilities	5,878,835	
Total liabilities	9,805,070	2,409,761
Shareholders' equity		
Serial preferred shares, without par value, 1,000,000 shares authorized, none issued		

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Common share warrants	700,176	711,872
Common shares, without par value, authorized 25,000,000 shares; issued 14,706,091 shares as of September 30, 2006 and 13,613,161 shares as of December 31, 2005; outstanding 11,406,091 shares as of September 30, 2006 and 10,313,161 shares as of December 31, 2005	70,304,643	61,810,321
Treasury shares, 3,300,000 shares at cost	(20,188,308)	(20,188,308)
Accumulated deficit	(30,534,093)	(28,425,289)
Foreign currency translation	(297,648)	(211,608)
Total shareholders' equity	19,984,770	13,696,988
Total liabilities and shareholders' equity	\$ 29,789,840	\$ 16,106,749

Note A: The condensed consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

*See notes to condensed consolidated financial statements.*

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**DATATRAK INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Revenue	\$ 4,374,360	\$ 4,055,914	\$ 13,704,673	\$ 11,415,338
Direct costs	1,327,173	899,306	3,877,047	2,740,840
Gross profit	3,047,187	3,156,608	9,827,626	8,674,498
Selling, general and administrative expenses	3,391,522	2,603,859	9,911,092	7,024,825
Severance expense			294,974	
Depreciation and amortization	628,648	198,272	1,663,692	574,953
(Loss) income from operations	(972,983)	354,477	(2,042,132)	1,074,720
Other income (expense):				
Interest income	50,047	62,272	181,416	159,430
Interest (expense)	(106,208)		(248,088)	
(Loss) income before income taxes	(1,029,144)	416,749	(2,108,804)	1,234,150
Income tax expense	297,000	4,095		28,653
Net (loss) income	\$ (1,326,144)	\$ 412,654	\$ (2,108,804)	\$ 1,205,497
Net (loss) income per share:				
Basic:				
Net (loss) income per share	\$ (0.12)	\$ 0.04	\$ (0.19)	\$ 0.12
Weighted-average shares outstanding	11,400,675	10,284,219	11,205,113	10,168,126
Diluted:				
Net (loss) income per share	\$ (0.12)	\$ 0.04	\$ (0.19)	\$ 0.11
Weighted-average shares outstanding	11,400,675	11,457,454	11,205,113	11,383,493

*See notes to condensed consolidated financial statements.*

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**DATATRAK INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating Activities</b>		
Net (loss) income	\$ (2,108,804)	\$ 1,205,497
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	1,663,692	574,953
Stock based compensation	444,373	79,581
Accretion of discount on investments	(84,347)	(120,290)
Loss from disposal of equipment		357
Changes in operating assets and liabilities:		
Accounts receivable	(301,176)	(653,333)
Prepaid expenses and other current assets	296,377	(196,553)
Accounts payable and accrued expenses	470,887	782
Deferred revenue	(252,104)	522,060
Net cash provided by operating activities	128,898	1,413,054
<b>Investing Activities</b>		
Acquisition of ClickFind, less cash acquired	(4,668,926)	
Purchases of property and equipment	(483,276)	(807,842)
Maturities of short-term investments	6,319,116	6,500,000
Purchases of short-term investments	(3,288,664)	(6,405,314)
Net cash used in investing activities	(2,121,750)	(713,156)
<b>Financing Activities</b>		
Proceeds from issuance of common shares and stock option exercises	167,094	1,073,936
Gross tax benefits from share based awards	8,000	
Share issuance costs		(103,125)
Repayment of long-term debt and notes payable	(215,614)	
Net cash (used in) provided by financing activities	(40,520)	970,811
Effect of exchange rate changes on cash	(103,595)	(140,958)
(Decrease) increase in cash and cash equivalents	(2,136,967)	1,529,751
Cash and cash equivalents at beginning of period	4,407,431	2,232,276
<b>Cash And Cash Equivalents At End Of Period</b>	<b>\$ 2,270,464</b>	<b>\$ 3,762,027</b>
<b>Unpaid Acquisition Costs</b>	<b>\$ 52,448</b>	<b>\$</b>

*See notes to condensed consolidated financial statements.*

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**DATATRAK INTERNATIONAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of DATATRAK International, Inc. and subsidiaries ( DATATRAK or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that might affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**2. ClickFind Acquisition**

On February 13, 2006, DATATRAK acquired all of the outstanding stock of ClickFind, Inc. ( ClickFind ), a technology company focused on the clinical trials industry, located in Bryan, Texas. As a result of the acquisition, the Company's management believes DATATRAK now has the most extensive eClinical software suite in the clinical trials industry.

The negotiated terms of the acquisition were for an aggregate purchase price of \$18,000,000, less approximately \$328,000 in certain transaction expenses and certain indebtedness of ClickFind. A component of the purchase price was paid with common shares of the Company, priced at \$9.25 per share, as determined by the terms of the acquisition agreement. The acquisition was recorded as a purchase, and as such, for the purpose of recording the acquisition, the value of the common shares used in the acquisition were valued at \$7.66 per share, based on the average closing price per share of the Company's common shares for the five business day period from February 9 through February 15, 2006.

Based on the common share valuation of \$7.66 per share, the total recorded acquisition cost including acquisition related expenses of \$848,000 was \$16,672,000. The cash portion of the purchase price, less cash acquired of \$87,000 and including unpaid accrued expenses of \$52,000 at September 30, 2006, was approximately \$4,721,000. The remainder of the purchase price consisted of \$4,000,000 in notes payable and the issuance of approximately \$7,864,000 in common shares (1,026,522 common shares), both of which are excluded from the Company's condensed consolidated statement of cash flows. The notes payable bear interest at prime plus 1%, and principal payments are due in installments of \$500,000, \$500,000 and \$3,000,000 on February 1, 2007, 2008 and 2009, respectively.

The acquisition was accounted for as a purchase, and accordingly, fair value adjustments to the assets acquired and liabilities assumed were recorded as of the date of acquisition. The Company has obtained a third party valuation of certain tangible and intangible assets acquired. DATATRAK has estimated its acquisition related deferred tax liability to be \$2,054,000, pending final determination of the deductibility of certain intangible assets. The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed as of the date of the acquisition.

Cash, accounts receivable and other current assets	\$ 254,000
Amortizable intangible assets	6,040,000
Goodwill	12,957,000
Accounts payable and other current liabilities	(408,000)
Long-term debt	(117,000)
Deferred tax liability	(2,054,000)



Total acquisition cost

\$ 16,672,000

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Subsequent to the acquisition, the \$117,000 of assumed long-term debt was paid in full.

Of the \$6,040,000 of acquired amortizable intangible assets, \$3,330,000 was assigned to the software now known as DATATRAK

eClinical(TM) and is being amortized over seven years. Of the remaining \$2,710,000 of acquired amortizable intangible assets, \$1,160,000 was assigned to employee non-compete agreements and \$1,550,000 was assigned to contracts and customer relationships, each is being amortized over three years. The \$12,957,000 of goodwill is not deductible for income tax purposes.

In accordance with Statement of Financial Accounting Standard ( SFAS ) No. 142, Goodwill and Other Intangible Assets , goodwill is deemed to have an indefinite life and is not amortized but is subject to an impairment test at least annually. The Company is currently performing its initial annual goodwill impairment test as of October 31, 2006. For purposes of impairment testing, the Company has determined that it has one reporting unit. The Company will compare the estimated fair value of the reporting unit to its carrying value, including goodwill. If the fair value of its reporting unit exceeds its carrying value, goodwill will not be deemed to be impaired as of the impairment testing date.

The Company will assess the recoverability of its finite-lived intangible assets using a projected, undiscounted, cash flow analysis when impairment indicators arise.

The operating results of ClickFind have been included in the Company s consolidated results of operations for all periods subsequent to February 13, 2006. Unaudited pro forma operating results for the three and nine months ended September 30, 2006 and September 30, 2005, as though the Company had acquired ClickFind at the beginning of 2005, are set forth below. The unaudited pro forma operating results are not necessarily indicative of what would have occurred had the transaction taken place on January 1, 2005.

	<b>Three Months</b>		<b>Nine Months</b>	
	<b>Ended September 30,</b>		<b>Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Pro forma revenue	\$ 4,374,360	\$4,401,000	\$13,913,071	\$12,417,000
Pro forma net (loss) income	\$(1,326,144)	\$ (97,000)	\$ (2,386,468)	\$ (281,000)
Pro forma basic (loss) income per share	\$ (0.12)	\$ (0.01)	\$ (0.21)	\$ (0.03)
Pro forma diluted (loss) income per share	\$ (0.12)	\$ (0.01)	\$ (0.21)	\$ (0.03)

**3. Stock Based Compensation**

The Company has three share option plans with unexpired options that may be exercised by the holders of such options. At September 30, 2006, the Company had reserved 3,046,066 common shares for the exercise of common share options. The Company has granted 2,730,614 options to purchase common shares to employees, directors and others of which 1,204,104 have been previously exercised. There are 315,452 options to purchase common shares available for future grants; however, no future option grants are expected be made under the Company s share option plans. The weighted-average contractual life of all options outstanding was 5 years as of September 30, 2006. The range of exercise prices for all options outstanding at September 30, 2006 was \$1.33 to \$12.93.

The Amended and Restated 1996 Outside Directors Stock Option Plan, as amended ( the 1996 Director Plan ) was established by the Company to provide common share options as compensation to directors of the Company. Certain options, as approved by the Company s shareholders, were granted under the 1996 Director Plan at exercise prices below the market value of a common share on the date of approval. All compensation expense related to these common share options was recognized prior to January 1, 2005. All other options granted under the 1996 Director Plan have been granted at exercise prices that represented the fair market value of a common share on the date of grant. Options fully vest in no more than three years following the grant date. All options granted under the 1996

Director Plan expire ten years after the grant date. At September 30, 2006 there were 61,750 options outstanding under the 1996 Director Plan with exercise prices ranging from \$2.79 to \$5.50, all of which were 100% vested. These options had a weighted-average contractual life of 1.6 years and a weighted-average exercise price of \$3.10.

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The Amended and Restated 1996 Key Employees and Consultants Stock Option Plan (the 1996 Plan ) provides for the granting of options to purchase common shares to key employees and consultants of the Company and its affiliates. During 2000, common share options totaling 116,031 were granted at exercise prices of less than the fair market value of a common share on the date of grant. All compensation expense related to these common share options was recognized prior to January 1, 2005. All other options granted under the 1996 Plan have been granted at exercise prices that represented the fair market value of a common share on the date of grant. Vesting of options awarded under the 1996 Plan ranges from two to four years, as determined by the Board of Directors Compensation Committee, and all options granted under the 1996 Plan expire ten years after the grant date. At September 30, 2006 there were 939,010 options outstanding under the 1996 Plan with exercise prices ranging from \$1.33 to \$12.93, of which 727,446 were 100% vested. These options had a weighted-average contractual life of 5.1 years and a weighted-average exercise price of \$3.72.

The Amended and Restated Outside Director Stock Option Plan (the Director Plan ) provides for the granting of options to purchase common shares to outside directors of the Company. Certain options approved by Company s Board of Directors and its shareholders have been granted at exercise prices below the market value of a common share on the grant date in 2000. All compensation expense related to these common share options was recognized prior to January 1, 2005. All other options granted under the Director Plan have been granted at exercise prices that represented the fair market value of a common share on the date of grant. Options fully vest one year following the grant date. All options granted under the Director Plan expire ten years after the grant date. At September 30, 2006 there were 525,750 options outstanding under the Director Plan with exercise prices ranging from \$1.33 to \$7.56, all of which were 100% vested. These options had a weighted-average contractual life of 5.1 years and a weighted-average exercise price of \$2.93.

On July 22, 2005, the Company s shareholders approved the DATATRAK International, Inc. 2005 Omnibus Equity Plan (the Omnibus Plan ). The Omnibus Plan is intended to be the primary share-based award program for covered employees and directors. The Omnibus Plan gives the Compensation Committee of the Board of Directors flexibility to grant a wide variety of share-based awards by taking into account such factors as the type and level of employee, relevant business and performance goals and the prevailing tax and accounting treatments. The fair-value of share based awards granted under the Omnibus Plan is equal to the fair market value of a common share on the date of grant.

Pursuant to the Omnibus Plan, during May 2006, an executive officer of the Company was granted 1,364 restricted common shares by the Compensation Committee of the Board of Directors in lieu of a cash bonus. The fair value of the award on the date of grant was \$10,000. The expense related to this award was recorded during the second quarter of 2006. In addition, pursuant to the Company s director compensation program, non-employee Directors were awarded 17,386 common shares under the Omnibus Plan, during the nine months ended September 30, 2006. Total expense related to the director awards was \$118,000.

On January 1, 2006, DATATRAK adopted SFAS No. 123(R), Share Based Payment, using the modified prospective method. Under this method compensation cost is recognized beginning January 1, 2006 based on the requirements of SFAS No. 123(R) for all share based payments granted after January 1, 2006, and based on the requirements of SFAS No. 123, Accounting for Stock Based Compensation, for all awards granted to employees prior to January 1, 2006 that remain unvested at January 1, 2006. The Company used the Black-Scholes option valuation model to calculate the fair value of stock options granted prior to January 1, 2006.

Prior to January 1, 2006, the Company accounted for stock based compensation in accordance with Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, for stock options granted to employees and directors, and followed the alternative fair value accounting provided for under SFAS No. 123 and EITF 96-18 for stock options granted to non-employees. SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, requires disclosure of compensation expense under both APB No. 25 and SFAS No. 123.

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The following assumptions were used to estimate the fair value, for the options granted during 2005, using the Black-Scholes option valuation model.

Weighted-average risk free interest rate	4.2%
Weighted-average volatility of the expected market price of the common shares	1.01
Dividend yield	0.0%
Weighted-average expected life of the options	7 years
Weighted-average fair value per share of options granted	\$ 9.90

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For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period.

Because SFAS No. 123(R) was adopted on January 1, 2006, the Company's statement of operations for the three and nine months ended September 30, 2005 does not include stock compensation expense related to the adoption of SFAS 123(R). The following table sets forth stock based compensation and pro forma information for the three and nine months ended September 30, 2005.

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Net income recorded	\$ 413,000	\$ 1,205,000
Plus: stock compensation expense recognized	16,000	49,000
Less: stock compensation expense that would have been recognized under SFAS No. 123	175,000	740,000
Pro forma net income	\$ 254,000	\$ 514,000
Pro forma basic income per share	\$ 0.02	\$ 0.05
Pro forma diluted income per share	\$ 0.02	\$ 0.05

The adoption of SFAS 123(R) increased DATATRAK's selling, general and administrative expenses by approximately \$90,000 or \$0.01 per share on both a basic and diluted basis, for the three months ended September 30, 2006 and approximately \$296,000 or \$0.03 per share on both a basic and diluted basis, for the nine months ended September 30, 2006. Because this expense is all related to incentive stock options, and not deductible for income tax purposes, deferred tax assets have not been recorded. The Company's unamortized compensation cost, related to nonvested stock options, at September 30, 2006 was \$688,000. These costs are expected to be amortized over a weighted-average period of approximately 1.9 years.

The Company's share option activity and related information for the nine months ended September 30, 2006 is summarized below:

	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Aggregate Intrinsic Value</b>	<b>Weighted Average Remaining Contractual Life</b>
Outstanding at January 1, 2006	1,619,891	\$ 3.52		
Granted				
Exercised	(44,400)	3.53		
Cancelled	(48,981)	6.44		
Outstanding at September 30, 2006	1,526,510	\$ 3.43	\$ 3,288,000	5.0 Years

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Vested or expected to vest at September 30, 2006	1,523,324	\$	3.43	\$	3,282,000	5.0 Years
Exercisable at September 30, 2006	1,314,947	\$	2.93	\$	3,479,000	4.5 Years

The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$183,000 and \$3,253,000, respectively. Total cash received by the Company from stock option exercises was \$157,000 and \$1,074,000 during the nine months ended September 30, 2006 and 2005, respectively.

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

**4. Net (Loss) Income Per Share**

The following table sets forth the computation of basic and diluted net (loss) income per share.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net (loss) income used in the calculation of basic and diluted net (loss) income per share	\$ (1,326,144)	\$ 412,654	\$ (2,108,804)	\$ 1,205,497
Denominator for basic net (loss) income per share weighted-average common shares outstanding	11,400,675	10,284,219	11,205,113	10,168,126
Effect of dilutive common share options and warrants		1,173,235		1,215,367
Denominator for diluted net (loss) income per share	11,400,675	11,457,454	11,205,113	11,383,493
Basic net (loss) income per share	\$ (0.12)	\$ 0.04	\$ (0.19)	\$ 0.12
Diluted net (loss) income per share	\$ (0.12)	\$ 0.04	\$ (0.19)	\$ 0.11
Weighted-average common share options and warrants excluded from the computation of diluted net (loss) income per share because they would have an antidilutive effect on net (loss) income per share	1,723,437	9,450	1,751,664	12,128



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**5. Comprehensive (Loss) Income**

The following table sets forth comprehensive (loss) income.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net (loss) income	\$ (1,326,144)	\$ 412,654	\$ (2,108,804)	\$ 1,205,497
Foreign currency translation	(88,282)	(11,359)	(86,040)	(166,183)
Comprehensive (loss) income	\$ (1,414,426)	\$ 401,295	\$ (2,194,844)	\$ 1,039,314

**6. Shareholders Equity**

A portion of the purchase price for ClickFind was paid in common shares of the Company. Per the terms of the acquisition agreement, the former shareholders of ClickFind were issued 1,026,522 DATATRAK common shares on February 13, 2006.

During March 2006 the holder of 3,258 common share warrants, with an exercise price of \$3.20 per share, surrendered the warrants along with the exercise price in exchange for 3,258 common shares. In addition, during the nine months ended September 30, 2006, the holders of 44,400 common share options, at a weighted average exercise price of \$3.53 per share, exercised the options and purchased 44,400 common shares.

**7. Operating Leases**

The Company leases certain office equipment and space. During 2006, the Company entered into new lease agreements for office space in Mayfield Heights, Ohio and Bryan, Texas. Future minimum lease payments for the Company under noncancelable operating leases as of September 30, 2006 are as follows:

<b>Twelve Months ended September 30,</b>	<b>Amount</b>
2007	\$ 883,000
2008	885,000
2009	764,000
2010	584,000
2011	585,000
Subsequent to September 30, 2011	640,000
	\$ 4,341,000

**8. Income Taxes**

Income tax expense consists of the following:

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2006</b>	<b>2005</b>
Current:		
Federal	\$	\$ 29,000
State and local		29,000

Deferred  
Federal  
State and local

\$ \$ 29,000

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**DATATRAK INTERNATIONAL, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(Unaudited)**

A reconciliation of income tax expense at the U.S. federal statutory rate to the effective income tax rate is as follows:

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2006</b>	<b>2005</b>
Income tax (benefit) provision at the United States statutory rate	\$ (715,000)	\$ 420,000
Increase (reversal) of valuation allowance	615,000	(391,000)
Non-deductible permanent differences	100,000	
	\$	\$ 29,000

During the first six months of 2006, the Company recorded a net tax benefit and deferred tax asset of \$297,000. Due to the uncertainty of the realization of this deferred tax asset DATATRAK provided a full valuation allowance against this asset, which resulted in income tax expense of \$297,000 for the three months ended September 30, 2006.

For the nine months ended September 30, 2006 the Company's pretax loss was \$2,109,000, resulting in an income tax benefit of \$615,000. Because recoverability is uncertain, DATATRAK has fully provided for the \$615,000 deferred tax asset through a valuation allowance.

In July 2006, the Financial Accounting Standards Board issued Financial Interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes. FIN No. 48 clarifies the accounting for uncertain tax positions recognized in an entity's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This interpretation is effective for the Company beginning in 2007. Management is currently evaluating the requirements of FIN No. 48 and has not yet determined the impact on its consolidated financial statements.

**9. Notes Payable**

During May 2006, the Company entered into a financing agreement with Westfield Bank, FSB (the Westfield Agreement ) for the payment of the Company's insurance premiums. At September 30, 2006, \$146,210 is due to Westfield Bank, FSB. The note bears interest at 7.74% and is due in equal installments of \$75,233, including accrued interest on October 20, 2006 and January 20, 2007. The Westfield Agreement is excluded from the Company's condensed consolidated statement of cash flows.

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**(Unaudited)**

**10. Long-term Debt**

Long-term debt at September 30, 2006 and December 31, 2005 is summarized below:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
Notes payable held by certain former shareholders of ClickFind (the ClickFind Notes ). The notes payable bear interest at prime plus 1%, and principal payments are due in installments of \$500,000, \$500,000 and \$3,000,000 on February 1, 2007, 2008 and 2009, respectively. Of the \$4,000,000, \$2,618,000 is held by an executive officer of the Company who was the founder of ClickFind. Of the remaining \$1,382,000 of ClickFind Notes, \$1,017,000 is held by other current employees of the Company	\$ 4,000,000	\$
Financing agreement with Oracle Credit Corporation (the Oracle Agreement ) for the purchase of certain computer equipment. The terms of the financing agreement require DATATRAK to make 36 monthly payments of \$9,012, including accrued interest, beginning in July 2006 through June 2009	254,547	
Capital lease agreement with Dell Financial Services (the Dell Agreement ) for the purchase of certain computer equipment. The terms of the lease agreement require DATATRAK to make 36 monthly payments of \$7,340, including accrued interest, beginning in September 2006 through August 2009	240,726	
	4,495,273	
Less current maturities	670,038	
	\$ 3,825,235	\$

The Oracle Agreement and the Dell Agreement transactions are excluded from the Company's condensed consolidated statement of cash flows.

**11. Severance Expense**

During the second quarter of 2006, the Company recorded a charge of \$295,000 for severance benefits due to terminated employees. This charge was related to a June 2006 staff reduction of 10 employees, whose positions became redundant as a result of the ClickFind acquisition. As of September 30, 2006, \$114,000 of these costs remained unpaid to the former employees. The Company anticipates that substantially all of these costs will be paid prior to December 31, 2006.

The Company accounts for termination benefits in accordance with SFAS No. 146, Accounting for the Cost of Exit or Disposal Activities which requires that termination benefit expenses be recorded ratably over the period during which employees must provide future services in order to obtain the benefit. There were no future service requirements in connection with the above noted terminations.

**12. Restricted Cash**

The Company's wholly owned subsidiary, DATATRAK GmbH, is required to provide a bank guarantee to the lessor of its office space equal to three months of rent. The terms of the bank guarantee require DATATRAK GmbH

to maintain a restricted cash balance of 59,000 euros with the bank. The U.S. dollar equivalent of this amount was \$74,962 at September 30, 2006 and \$69,976 at December 31, 2005.

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**13. Software Development Costs**

Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. After technological feasibility is established, any additional costs are capitalized in accordance with SFAS No. 86,

Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Such costs are amortized over the lesser of three years or the economic life of the related product. The Company performs an annual review of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are expensed.

Research and development expenses included in selling, general and administrative expenses were \$1,774,000 and \$1,153,000 for the nine months ended September 30, 2006 and 2005, respectively.

**14. Reclassification**

Certain prior year amounts have been reclassified to conform to the current year presentation.

**15. Contingencies**

In the ordinary course of business, the Company is involved in employment related legal proceedings. The Company is of the opinion that the ultimate resolution of these matters will not have a material adverse effect on the results of operations, cash flows or the financial position of DATATRAK.

On July 17, 2006, Datasci, LLC ( Datasci ) filed a complaint against the Company, ClickFind, and CF Merger Sub, Inc. ( Merger Sub ) alleging a patent infringement. As previously disclosed, on February 13, 2006, the Company acquired ClickFind pursuant to a merger agreement between the Company, ClickFind and Merger Sub, a wholly owned subsidiary of the Company. The Company believes Datasci's claims are without merit and intends to defend this matter vigorously. On August 14, 2006, the Company filed an answer and counterclaim denying infringement of the patent in suit, asserting numerous affirmative defenses and counterclaiming for a declaratory judgment of non-infringement and invalidity of the patent. Because the litigation is in a preliminary stage, the Company cannot assess the likelihood of an adverse outcome or determine whether potential damages, if any, could have a material adverse impact on the Company's results of operations in a future period or the Company's financial position or liquidity.

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

The information set forth and discussed below for the three and nine month periods ended September 30, 2006 is derived from, and should be read in conjunction with, the condensed consolidated financial statements included elsewhere herein. The financial information set forth and discussed below is unaudited, but in the opinion of management, reflects all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of such information. The Company's results of operations for a particular quarter may not be indicative of results expected during the other quarters or for the entire year.

**General**

DATATRAK is a provider of software and other related services, commonly referred to as an application service provider, or ASP. DATATRAK's customers use the software known as DATATRAK ED<sup>®</sup> and DATATRAK eClinical to collect and transmit clinical trial data, commonly referred to as electronic data capture, or EDC. The Company's services assist companies in the clinical pharmaceutical, biotechnology, contract research organization and medical device research industries, in accelerating the completion of clinical trials. Approximately 14% of the Company's assets, or \$4,280,000, is held in cash, cash equivalents and short-term investments, and goodwill accounts for approximately 43% or, \$12,957,000, of the Company's total assets. The Company is continuing to enhance and commercialize its business and software, and anticipates that its operating results may fluctuate significantly from period to period. There can be no assurance of the Company's long-term future prospects.

On January 1, 2006, DATATRAK adopted SFAS No. 123(R) using the modified prospective method. Under this method compensation cost is recognized beginning January 1, 2006 based on the requirements of SFAS No. 123(R) for all share based payments granted after January 1, 2006, and based on the requirements of SFAS No. 123 for all awards granted to employees prior to January 1, 2006 that remain unvested at January 1, 2006. The Company has chosen to use the Black-Scholes option valuation model in valuing stock options granted prior to January 1, 2006, and will continue to use this valuation model for options granted after January 1, 2006. The adoption of SFAS 123(R) increased DATATRAK's selling, general and administrative expenses by approximately \$90,000, or \$0.01 per share on both a basic and diluted basis, for the three months ended September 30, 2006, and approximately \$296,000, or \$0.03 per share on both a basic and diluted basis, for the nine months ended September 30, 2006. Because this expense is all related to incentive stock options, no income tax benefit is recognized for the stock compensation expense related to FAS 123(R). The Company's unamortized compensation cost, related to nonvested stock options, at September 30, 2006 was \$688,000. These costs are expected to be amortized over a weighted average period of approximately 1.9 years.

On February 13, 2006, DATATRAK acquired all of the outstanding stock of ClickFind, a technology company focused on the clinical trials industry, located in Bryan, Texas. As a result of the acquisition, the Company's management believes DATATRAK now has the most extensive eClinical software suite in the clinical trials industry. The total acquisition cost, on a purchase accounting basis, including acquisition related expenses of approximately \$848,000 was \$16,672,000. The cash portion of the purchase price, less cash acquired of approximately \$87,000 and including unpaid accrued expenses of \$52,000 at September 30, 2006, was approximately \$4,721,000. The remainder of the purchase price consisted of \$4,000,000 in notes payable and the issuance of approximately \$7,864,000 in common shares (1,026,522 common shares). The value of the 1,026,522 common shares, for the purchase allocation, was determined based on the average closing price per share of the Company's common shares for the five business day period from February 9 through February 15, 2006. The notes payable bear interest at prime plus 1%, and principal payments are due in installments of \$500,000, \$500,000 and \$3,000,000 on February 1, 2007, 2008 and 2009, respectively. The operating results of ClickFind have been included in the Company's consolidated results of operations for all periods subsequent to February 13, 2006.

DATATRAK's contracts provide a fixed price for each component or service to be delivered and revenue is recognized as these components or services are delivered. DATATRAK recognizes revenue based on the performance or delivery of the following specified services or components of its contracts in the manner described below:

Project management and data management (design, report and export) service revenue is recognized proportionally over the life of a contract as services are performed, based on the contractual billing rate per hour for those services.

Data items revenue is recognized based on a price per data unit as data items are entered into DATATRAK's hosting facility.

Classroom training services revenue is recognized as classroom training is completed, at rates based on the length of the training program.



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Internet-based training services revenue is recognized on a per user basis as self-study courses are completed.

Help desk revenue is recognized based on a monthly price per registered user under the contract.

Services provided by DATATRAK that are in addition to those provided for in its contracts are billed on a fee for service basis as services are completed. Costs associated with contract revenue are recognized as incurred. Costs that are paid directly by the Company's clients, and for which the Company does not bear the risk of economic loss, are excluded from revenue. The termination of a standard contract will not result in a material adjustment to the revenue or costs previously recognized.

In some instances, the Company offers volume discounts to customers over multiple contracts. The Company estimates the volume discounts to be earned over the life of the contracts to which the discount applies. As a contract progresses, revenues are recorded using rates that reflect the anticipated volume discount to be achieved by the customer. The termination of a contract subject to a volume discount could result in a material adjustment to revenue previously recognized, in order to reflect the true economic value of the contract at the time of cancellation. At December 31, 2005, DATATRAK had deferred \$125,000 of revenue as a result of its contracts subject to volume discounts. For the nine months ended September 30, 2006, an additional \$28,000 of revenue was deferred as a result of its contracts subject to volume discounts.

Backlog consists of anticipated revenue from authorization letters to commence services and signed contracts yet to be completed. Potential contracts or authorization letters that have passed the verbal stage, but have not yet been signed, are excluded from backlog. At September 30, 2006, DATATRAK's backlog was \$13,005,000. DATATRAK's contracts can be cancelled or delayed at anytime and, therefore, the Company's backlog, at any point in time, is not an accurate predictor of future levels of revenue. As a result of DATATRAK's transactional and service-based business model combined with the dynamic nature of the clinical trials market where changes in scope are common, backlog has historically not been an accurate predictor of short-term revenue.

**Critical Accounting Policies**

In response to the SEC's Release No. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, the Company has identified the most critical accounting principles upon which its financial status depends. Critical principles were determined by considering accounting policies that involve the most complex or subjective decisions or assessments. The most critical accounting policies were identified to be those related to revenue recognition, software development costs, stock based compensation, income taxes and goodwill.

A summary of the Company's critical accounting policies related to revenue recognition, software development costs, stock based compensation and income taxes can be found in the Company's Annual Report on Form 10-K, filed on March 13, 2006, ( *Annual Report* ) under the heading *Critical Accounting Policies* in Management's Discussion and Analysis of Financial Condition and Results of Operations.

In connection with the Company's acquisition of ClickFind, in February 2006, \$12,957,000 of goodwill has been recorded by the Company. In accordance with SFAS No. 142, goodwill is deemed to have an indefinite life and is not amortized but is subject to an impairment test at least annually. The Company is currently performing its initial annual goodwill impairment test as of October 31, 2006. For purposes of impairment testing, the Company has determined that it has one reporting unit. The Company will compare the estimated fair value of the reporting unit to its carrying value, including goodwill. If the fair value of its reporting unit exceeds its carrying value, goodwill will not be deemed to be impaired as of the impairment testing date.

The Company will assess the recoverability of its finite-lived intangible assets using a projected, undiscounted, cash flow analysis when impairment indicators arise.

**Table of Contents****Results of Operations***Three months ended September 30, 2006 compared with three months ended September 30, 2005*

Revenue for the three months ended September 30, 2006 increased 7.8% to \$4,374,000, as compared to \$4,056,000 for the three months ended September 30, 2005. During the third quarter of 2006, DATATRAK recorded revenue related to 123 contracts compared to 67 contracts during the three months ended September 30, 2005. Included in the 123 contracts are 23 contracts that were acquired from ClickFind on February 13, 2006. For the three months ended September 30, 2006, \$3,128,000 of revenue was the result of contracts that were in backlog at December 31, 2005, \$757,000 was the result of new business signed since January 1, 2006, and \$489,000 was the result of contracts acquired from ClickFind. For the third quarter of 2005, \$3,444,000 of revenue was generated from contracts that were in backlog at December 31, 2004 and \$612,000 of revenue was the result of new business signed since January 1, 2005. Accounting for the acquisition of ClickFind as though it occurred on January 1, 2005, actual revenue for the three month period ended September 30, 2006 would have decreased 0.6% over pro forma revenue of \$4,401,000 for the three month period ended September 30, 2005.

Direct costs of revenue, mainly personnel costs, were \$1,327,000 and \$899,000 during the three months ended September 30, 2006 and 2005, respectively. Additional staff and other payroll cost increases accounted for \$410,000, or 95.8%, of the \$428,000 increase. DATATRAK's gross margin decreased to 69.7% for the three months ended September 30, 2006 compared to 77.8% for the three months ended September 30, 2005. Accounting for the acquisition of ClickFind as though it occurred on January 1, 2005, actual gross margin would have decreased to 69.7% for the three month period ended September 30, 2006 from pro forma gross margin of 76.8% for the three month period ended September 30, 2005.

Selling, general and administrative expenses ( SG&A ) include all administrative personnel costs, business and software development costs, and all other expenses not directly chargeable to a specific contract. SG&A expenses increased by 30.3% to \$3,392,000 from \$2,604,000 for the three months ended September 30, 2006 and 2005, respectively. Additional staff and other payroll cost increases accounted for \$469,000, or 59.5%, of the \$788,000 increase. The increase in personnel costs was caused by additional hiring and the addition of employees from the acquisition of ClickFind offset by 10 terminated employees in late June 2006. In part, the additional personnel was necessary to bring certain development functions in-house and allow for the discontinuation of outsourced research and development. Also contributing to the SG&A increase was higher office rent of \$132,000 resulting primarily from the addition of the Bryan, TX office, \$90,000 of stock compensation expense caused by the adoption of FAS 123(R) and higher travel expense due to additional sales efforts and corporate integration.

Depreciation and amortization expense increased to \$629,000 during the three months ended September 30, 2006 from \$198,000 during the three months ended September 30, 2005. Included in depreciation and amortization expense is \$226,000 of amortization expense related to \$2,710,000 of intangible assets acquired in the ClickFind acquisition. In addition, depreciation and amortization expense includes \$119,000 of depreciation expense related to \$3,330,000 of software acquired in the ClickFind acquisition. The remainder of the increase was the result of an increase in the amount of assets being placed in service during the past year.

Interest expense of \$106,000 was recorded during the three months ended September 30, 2006. This expense is due to the debt issued in conjunction with the ClickFind acquisition and the Company's insurance and capital expenditure financing arrangements.

During the first six months of 2006, the Company recorded a net tax benefit and deferred tax asset of \$297,000. Due to the uncertainty of the realization of this deferred tax asset, DATATRAK provided a full valuation allowance against this asset, which resulted in income tax expense of \$297,000 for the three months ended September 30, 2006.

*Nine months ended September 30, 2006 compared with nine months ended September 30, 2005*

Revenue for the nine months ended September 30, 2006 increased 20.1% to \$13,705,000, as compared to \$11,415,000 for the nine months ended September 30, 2005. During the nine months ended September 30, 2006, DATATRAK recorded revenue related to 134 contracts compared to 73 contracts during the nine months ended September 30, 2005. Included in the 134 contracts are 25 contracts that were acquired from ClickFind on February 13, 2006. For the nine months ended September 30, 2006, \$10,883,000 of revenue was the result of contracts that were in backlog at December 31, 2005, \$1,659,000 was the result of new business signed since January 1, 2006 and

\$1,163,000 was the result of contracts acquired from ClickFind. For the nine months ended September 30, 2005, \$10,184,000 of revenue was generated from contracts that were in backlog at December 31, 2004 and \$1,231,000 of revenue was the result of new business signed since January 1, 2005. Accounting for the acquisition of ClickFind as though it occurred on January 1,

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2005, pro forma revenue for the nine month period ended September 30, 2006, would have been \$13,913,000, an increase of 12.0% over pro forma revenue of \$12,417,000 for the nine month period ended September 30, 2005.

Direct costs of revenue, mainly personnel costs, were \$3,877,000 and \$2,741,000 during the nine months ended September 30, 2006 and 2005, respectively. Additional staff and other payroll cost increases accounted for \$1,063,000, or 93.6%, of the \$1,136,000 increase. DATATRAK's gross margin decreased to 71.7% for the nine months ended September 30, 2006 compared to 76.0% for the nine months ended September 30, 2005. Accounting for the acquisition of ClickFind as though it occurred on January 1, 2005, pro forma gross margin would have decreased to 71.5% for the nine month period ended September 30, 2006 from pro forma gross margin of 75.0% for the nine month period ended September 30, 2005.

SG&A expenses increased by 41.1% to \$9,911,000 from \$7,025,000 for the nine months ended September 30, 2006 and 2005, respectively. Personnel and payroll cost increases, director compensation costs, stock compensation expense and the Company's sales incentive bonus plan accounted for \$1,776,000 of the \$2,886,000 increase. Of this \$1,776,000 increase, \$1,211,000 was due to additional hiring and additional staff costs caused by the addition of employees from the acquisition of ClickFind offset by 10 terminated employees in late June, \$296,000 was caused by the adoption of FAS 123(R) and \$128,000 was due to the Company's director compensation plan. In part, the additional personnel was necessary to bring certain development functions in-house and allow for the discontinuation of outsourced research and development. DATATRAK's travel expenses increased by \$360,000 due to additional sales efforts and corporate integration. Outside consulting fees increased \$240,000, due to the Company's software and business development projects. Increased marketing efforts resulted in \$160,000 of higher expense.

During the nine months ended September 30, 2006, DATATRAK recorded a charge of \$295,000 for severance benefits due to 10 terminated employees.

Depreciation and amortization expense increased to \$1,664,000 during the nine months ended September 30, 2006 from \$575,000 during the nine months ended September 30, 2005. Included in depreciation and amortization expense is \$570,000 of amortization expense related to \$2,710,000 of intangible assets acquired in the ClickFind acquisition. In addition, depreciation and amortization expense includes \$317,000 of depreciation expense related to \$3,330,000 of software acquired in the ClickFind acquisition. The remainder of the increase was the result of an increase in the amount of assets being placed in service during the past year.

Interest expense of \$248,000 was recorded during the nine months ended September 30, 2006. This expense is due to the debt issued in conjunction with the ClickFind acquisition and the Company's insurance and capital expenditure financing arrangements.

For the nine months ended September 30, 2006 the Company's pretax loss was \$2,109,000, resulting in an income tax benefit of \$615,000. Because recoverability is uncertain, DATATRAK has provided a full valuation allowance for the \$615,000 deferred tax asset.

**Liquidity and Capital Resources**

Since its inception, the Company's principal sources of cash have been cash flow from operations and proceeds from the sale of equity securities. The Company's investing activities primarily reflect capital expenditures and sales and purchases of short-term investments. During the first nine months of 2006, the Company used approximately \$4,669,000 in cash for the ClickFind acquisition.

The Company's contracts usually require a portion of the contract amount to be paid at the time the contract is initiated. Additional payments are generally received monthly as work on the contract progresses. All amounts received are recorded as a liability (deferred revenue) until work has been completed and revenue is recognized. Cash receipts do not necessarily correspond to costs incurred or revenue recognized. The Company typically receives a low volume of large-dollar receipts. DATATRAK's accounts receivable fluctuates due to the timing and size of cash receipts. Contracting and collection practices are designed to maintain an average collection period for accounts receivable of one to three months. Any increase in the Company's normal collection period for accounts receivable will negatively impact its cash flow from operations and working capital. At September 30, 2006, the average collection period for accounts receivable was 58 days compared to 56 days at December 31, 2005. Accounts receivable (net of allowance for doubtful accounts) was \$3,301,000 at September 30, 2006 and \$2,854,000 at December 31, 2005. The increase in accounts receivable was caused primarily by the Company's revenue growth and

the increase in the average collection period. Deferred revenue was \$978,000 at September 30, 2006 compared to \$1,027,000 at December 31, 2005.

Cash and cash equivalents decreased \$2,137,000 during the nine months ended September 30, 2006. This was the net result of \$129,000 provided by operating activities, \$2,122,000 used in investing activities and \$40,000 used in financing activities. Foreign

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currency fluctuations caused a \$104,000 decrease in cash and cash equivalents. Cash provided by operating activities was mainly the result of the Company's net loss of \$2,109,000, which was offset mainly by non cash depreciation and amortization of \$1,664,000 and stock based compensation of \$444,000. Investing activities included \$4,669,000 used for the acquisition of ClickFind, as well as \$483,000 to purchase property and equipment, offset by net maturities of investments totaling \$3,030,000. Financing activities primarily consist of \$167,000 of proceeds from the issuance of common shares resulting from exercises of common share options and warrants, which was offset by \$117,000 used to repay long-term debt assumed from ClickFind and other debt obligations of DATATRAK totaling \$99,000.

At September 30, 2006, the Company had working capital of \$4,349,000 and its cash, cash equivalents and short-term investments totaled \$4,280,000. The Company's working capital decreased by \$6,447,000 since December 31, 2005. The decrease was primarily due to cash, cash equivalents and short-term investments decreasing by \$5,083,000, caused mainly by the \$4,669,000 of cash used for the acquisition of ClickFind.

The Company is party to a lease agreement that requires it to maintain a restricted cash balance. DATATRAK's restricted cash balance was \$75,000 at September 30, 2006.

The Company has established two lines of credit with two separate banks. One of the lines allow the Company to borrow up to a certain percentage of its investments, as determined by the type of investment, held at the bank. The line of credit bears interest at rates based on the prime rate, and is payable on demand. The other line of credit allows DATATRAK to borrow up to \$2,000,000 at an interest rate equal to the prime rate minus 100 basis points for U.S. dollar borrowings and the euro dollar rate plus 125 basis points for euro borrowings, payable on demand. The \$2,000,000 in available borrowing would be collateralized by certain assets of the Company. At September 30, 2006, the Company had no amounts outstanding against these lines of credit.

At September 30, 2006, DATATRAK has a note payable of \$146,210 due to Westfield Bank, FSB. The note bears interest at 7.74% and is due in equal installments of \$75,233, including accrued interest on October 20, 2006 and January 20, 2007. As of September 30, 2006, the Company also has a note payable of \$254,547 due to Oracle Credit Corporation, payable in monthly payments of \$9,012, including accrued interest, through June 2009. In addition, the Company had a capital lease payable at September 30, 2006 of \$240,726 due to Dell Financial Services, payable in monthly installments of \$7,340, including accrued interest, through August 2009.

The terms of the Company's recently completed acquisition of ClickFind required it to pay approximately \$4,000,000 of cash to the former shareholders of ClickFind in February 2006. DATATRAK also issued notes payable to certain former shareholders of ClickFind in the amount of \$4,000,000 that bear interest at prime plus 1%, and are payable in installments of \$500,000, \$500,000 and \$3,000,000 on February 1, 2007, 2008 and 2009, respectively. Of the \$4,000,000, \$2,618,000 is held by an executive officer of the Company who was the founder of ClickFind. Of the remaining \$1,382,000 of ClickFind Notes, \$1,017,000 is held by other current employees of the Company. The Company is responsible for the costs of integrating ClickFind's operations with its current operations, and all future operating costs of ClickFind. The Company intends to fund these additional costs with its cash and cash equivalents, maturities of short-term investments, cash flow from operations and borrowings against its lines of credit.

The Company intends to continue to fund the maintenance and testing of the DATATRAK EDC<sup>®</sup> software, as well as invest in the development, enhancement and testing of DATATRAK eClinical. The Company's operations and the EDC market are still in a developmental stage. DATATRAK expects to have modest revenue growth and near breakeven cash flow from operations for 2006 as it continues to build its customer base and convert backlog into revenue. However, the achievement of the Company's previously disclosed goal of reporting net income for 2006 is not achievable as a result of the delayed timing of clinical trial sponsor decisions to conduct new clinical trials along with cancellations and delays in ongoing clinical trials all of which are difficult to predict.

During the nine months ended September 30, 2006, the Company had cash expenditures totaling \$483,000 for purchases of property and equipment. The Company also entered into the Oracle Agreement and Dell Agreement resulting in additional purchases of property and equipment of \$492,000. The Oracle Agreement and Dell Agreement transactions are excluded from the Company's condensed consolidated statement of cash flows.

The Company anticipates additional cash expenditures for capital assets and related items of approximately \$250,000, net of anticipated financing, through the end of 2006 for continued commercialization, product development and maintenance of DATATRAK EDC<sup>®</sup> and DATATRAK eClinical and the anticipated growth of

DATATRAK's business and information technology infrastructure. A portion of these anticipated expenditures are dependent on the Company's growth, and are therefore discretionary in nature.

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The Company records research and development expenditures as part of its SG&A expenses. During the nine months ended September 30, 2006, the Company recorded \$1,774,000 for research and development expenditures. DATATRAK's 2006 research and development expenditures have been and will continue to be for the maintenance and testing of the DATATRAK EDC® software, as well as the development, enhancement and testing of DATATRAK eClinical .

DATATRAK anticipates funding its short-term working capital requirements from existing cash and cash equivalents, maturities of short-term investments, cash flow from operations and its lines of credit. However, DATATRAK may need to raise additional funds for its long-term capital requirements or to offset delays or cancellations of contracts, support expansion, respond to competitive pressures, acquire complementary businesses or technology or take advantage of unanticipated opportunities. Additional funds may be raised by selling debt or equity securities, by entering into strategic relationships or through other arrangements. Additional capital may not be available on acceptable terms, if at all. To the extent that additional equity capital is raised, it could have a dilutive effect on existing shareholders.

**Inflation**

To date, the Company believes the effects of inflation have not had a material adverse effect on its results of operations or financial condition.

**Information About Forward-Looking Statements**

Certain statements made in this Form 10-Q, other SEC filings, written materials or orally by the Company or its representatives may constitute forward-looking statements that are based on management's current beliefs, estimates and assumptions concerning the operations, future results and prospects of the Company and the clinical pharmaceutical research industry in general. All statements that address operating performance, events or developments that management anticipates will occur in the future, including statements related to future revenue, profits, expenses, income and earnings per share or statements expressing general optimism about future results, are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended ( Exchange Act ). In addition, words such as expects, anticipates, intends, plans, believes, estimates, variati words, and similar expressions are intended to identify forward-looking statements. Forward-looking statements are subject to the safe harbors created in the Exchange Act. Factors that may cause actual results to differ materially from those in the forward-looking statements include the limited operating history on which the Company's performance can be evaluated; the ability of the Company to continue to enhance its software products to meet customer and market needs; fluctuations in the Company's quarterly results; the viability of the Company's business strategy and its early stage of development; the timing of clinical trial sponsor decisions to conduct new clinical trials or cancel or delay ongoing trials; the Company's dependence on major customers; government regulation associated with clinical trials and the approval of new drugs; the ability of the Company to compete in the emerging EDC market; losses that potentially could be incurred from breaches of contracts or loss of customer data; the inability to protect intellectual property rights or the infringement upon other's intellectual property rights; the Company's success in integrating ClickFind's operations into its own operations and the costs associated with maintaining and/or developing two product suites; and general economic conditions such as the rate of employment, inflation, interest rates and the condition of capital markets. This list of factors is not all inclusive. In addition, the Company's success depends on the outcome of various strategic initiatives it has undertaken, all of which are based on assumptions made by the Company concerning trends in the clinical research market and the health care industry. Any forward-looking statement speaks only as of the date on which such statement is made and the Company does not undertake any obligation to update any statements whether as a result of new information, future events or otherwise.

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

The Company is exposed to market risk from changes in interest rates and foreign currency exchange rates since it funds its operations through short-term investments, has issued variable rate debt and has business transactions in euros. A summary of the Company's market risk exposures is presented below.

*Interest Rate Risk*

DATATRAK has fixed income investments consisting of cash equivalents and short-term investments, and short and long-term notes payable which may be affected by changes in market interest rates. The Company does not use



derivative financial instruments in its investment portfolio. The Company places its cash equivalents and short-term investments with high-quality financial

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institutions, limits the amount of credit exposure to any one institution and has established investment guidelines relative to diversification and maturities designed to maintain safety and liquidity. Investments are reported at amortized cost, which approximates fair value. A 1.0% change in interest rates during the nine months ended September 30, 2006, would have resulted in a \$52,000 change in DATATRAK's interest income during the period.

The Company's notes payable to certain former shareholders of ClickFind bear interest at prime plus 1%, and interest is paid quarterly. A 1% change in the prime rate during the nine months ended September 30, 2006, would have resulted in a \$25,000 change in DATATRAK's interest expense during the period.

*Foreign Currency Risk*

DATATRAK's foreign results of operations are subject to the impact of foreign currency fluctuations through both foreign currency transaction and foreign currency translation adjustments. The Company manages its risk to foreign currency transaction adjustments by maintaining foreign currency bank accounts in currencies in which we regularly transact business. DATATRAK does not currently hedge against the risk of exchange rate fluctuations.

DATATRAK's financial position and results of operations are impacted by translation adjustments caused by the conversion of foreign currency accounts and operating results into U.S. dollars for financial reporting purposes. A 1.0% fluctuation in the exchange rate between the U.S. dollar and the euro at September 30, 2006, would have resulted in a \$25,000 change in the foreign currency translation amount recorded on the Company's balance sheet, due to foreign currency translations. A 1.0% fluctuation in the average exchange rate between the U.S. dollar and the euro for the nine months ended September 30, 2006 would have resulted in a \$38,000 change in the Company's net loss for the nine months ended September 30, 2006 due to foreign currency translations. During the nine months ended September 30, 2006, the average exchange rate between the euro and the U.S. dollar decreased by approximately 1.5% compared to the nine months ended September 30, 2005. The conversion of the Company's foreign operations into U.S. dollars upon consolidation resulted in a net loss that was approximately \$58,000 less than would have been recorded had the exchange rate between the euro and the U.S. dollar remained consistent with 2005 rates.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the chief executive officer and chief financial officer, of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-14(e)) as of the end of the period covered by this report. Based upon that evaluation the Company's management, including the chief executive officer and chief financial officer, have concluded that, as of September 30, 2006, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports it files and submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

*Changes in Internal Controls*

There were no changes in the Company's internal controls over financial reporting that occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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**Part II. Other Information**

**Item 1. Legal Proceedings**

On July 17, 2006, Datasci, LLC ( Datasci ) filed a complaint against the Company, ClickFind, Inc. ( ClickFind ) and CF Merger Sub, Inc. ( Merger Sub ) (Civil Docket No. 8:06-cv-01820-MJG, United States District Court, District of Maryland) alleging infringement of United States Patent No. 6,496,827. As previously disclosed, on February 13, 2006, the Company acquired ClickFind pursuant to a merger agreement between the Company, ClickFind and Merger Sub, a wholly owned subsidiary of the Company. Datasci seeks injunctive relief and money damages in an unspecified amount. The Company believes Datasci's claims are without merit and intends to defend this matter vigorously. On August 14, 2006, the Company filed an answer and counterclaim denying infringement of the patent in suit, asserting numerous affirmative defenses and counterclaiming for a declaratory judgment of non-infringement and invalidity of the patent. Because the litigation is in a preliminary stage, the Company cannot assess the likelihood of an adverse outcome or determine whether potential damages, if any, could have a material adverse impact on the Company's results of operations in a future period or the Company's financial position or liquidity.

**Item 1A. Risk Factors**

There are no material changes to the Risk Factors described under the title Risk Factors in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer

32.2 Section 1350 Certification of Chief Financial Officer

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**SIGNATURES**

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

DATATRAK International, Inc.

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