

QUADRAMED CORP  
Form 10-Q  
November 13, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-32283

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**QUADRAMED CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

52-1992861  
(IRS Employer  
Identification No.)

12110 SUNSET HILLS ROAD, SUITE 600, RESTON, VIRGINIA

20190

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(Address of Principal Executive Offices)

(Zip Code)

(703) 709-2300

(Registrant's Telephone Number, Including Area Code)

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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 accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 24, 2006 there were 42,256,563 shares of the registrant's common stock outstanding, par value \$0.01.

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**Table of Contents**

**QUADRAMED CORPORATION**  
**REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**  
**TABLE OF CONTENTS**

<b>PART I. FINANCIAL INFORMATION</b>		<b>Page</b>
Item 1.	Financial Statements	
	<u>Condensed Consolidated Balance Sheets (unaudited) as of September 30, 2006 and December 31, 2005</u>	3
	<u>Condensed Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2006 and 2005</u>	4
	<u>Condensed Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (loss) (unaudited) for the nine months ended September 30, 2006</u>	5
	<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the three and nine months ended September 30, 2006 and 2005</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	34
Item 4.	<u>Controls and Procedures</u>	35
<b>PART II. OTHER INFORMATION</b>		
Item 1.	<u>Legal Proceedings</u>	36
Item 1A.	<u>Risk Factors</u>	36
Item 6.	<u>Exhibits</u>	49
	<u>Signatures</u>	50

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

(unaudited)

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 36,485	\$ 33,042
Short-term investments	4,185	
Accounts receivable, net of allowance for doubtful accounts of \$2,953 and \$4,177, respectively	19,347	27,089
Unbilled and other receivables	4,375	3,387
Notes and other receivables, net of allowance for doubtful accounts of \$822 and \$715, respectively		50
Prepaid expenses and other current assets	9,947	12,092
<b>Total current assets</b>	<b>74,339</b>	<b>75,660</b>
Restricted cash	2,286	2,391
Long-term investments	1,241	1,334
Property and equipment, net of accumulated depreciation and amortization of \$20,666 and \$19,052, respectively	2,800	3,737
Goodwill	25,983	25,983
Other intangible assets, net of accumulated amortization of \$40,230 and \$35,905, respectively	3,279	7,624
Other long-term assets	3,167	3,167
<b>Total assets</b>	<b>\$ 113,095</b>	<b>\$ 119,896</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 3,479	\$ 3,551
Accrued payroll and related	7,904	7,422
Other accrued liabilities	5,395	10,114
Dividends payable	5,181	9,054
Deferred revenue	45,695	52,169
<b>Total current liabilities</b>	<b>67,654</b>	<b>82,310</b>
Accrued exit cost of facility closing	2,437	3,613
Other long-term liabilities	3,132	2,781
<b>Total liabilities</b>	<b>73,223</b>	<b>88,704</b>
<b>Stockholders equity</b>		
Preferred stock, \$0.01 par, 5,000 shares authorized; 4,000 shares issued and outstanding	92,000	88,231
Common stock, \$0.01 par, 150,000 shares authorized; 42,255 and 41,245 shares issued and outstanding, including 457 and 457 shares of treasury stock, respectively	422	412
Additional paid-in-capital	303,897	302,324
Accumulated other comprehensive loss	(154)	(89)
Accumulated deficit	(356,293)	(359,686)

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<b>Total stockholders equity</b>	39,872	31,192
<b>Total liabilities and stockholders equity</b>	<b>\$ 113,095</b>	<b>\$ 119,896</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents**

**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

(unaudited)

	Three months ended, September 30,		Nine months ended, September 30,	
	2006	2005	2006	2005
<b>Revenue</b>				
Services	\$ 3,859	\$ 2,824	\$ 9,480	\$ 9,448
Maintenance	14,802	13,767	42,605	41,152
Installation and other	2,893	3,196	9,048	8,300
Services and other revenue	21,554	19,787	61,133	58,900
Licenses	11,151	10,009	31,713	30,143
Hardware	327	250	1,142	2,061
<b>Total revenue</b>	33,032	30,046	93,988	91,104
<b>Cost of revenue</b>				
Cost of services and other revenue	6,846	7,326	21,497	21,764
Royalties and other	3,034	2,385	8,824	6,811
Amortization of acquired technology and capitalized software	748	1,014	2,699	3,073
Cost of license revenue	3,782	3,399	11,523	9,884
Cost of hardware revenue	347	682	1,131	2,190
<b>Total cost of revenue</b>	10,975	11,407	34,151	33,838
<b>Gross margin</b>	22,057	18,639	59,837	57,266
<b>Operating expense</b>				
General and administration	4,370	8,340	15,299	20,625
Software development	7,298	7,812	23,254	23,253
Sales and marketing	3,730	3,160	10,849	10,727
Amortization of intangible assets and depreciation	1,035	1,087	3,239	3,793
Exit cost of facility closing		1,066		1,066
<b>Total operating expenses</b>	16,433	21,465	52,641	59,464
<b>Income (loss) from operations</b>	5,624	(2,826)	7,196	(2,198)
<b>Other income (expense)</b>				
Interest expense, includes non-cash charges of \$85, \$383 and \$306, \$740, respectively	(85)	(403)	(311)	(763)
Interest income	501	223	1,266	444
Other income (expense), net	40	(21)	94	(37)
<b>Other income (expense)</b>	456	(201)	1,049	(356)
<b>Income from continuing operations before income taxes</b>	\$ 6,080	\$ (3,027)	\$ 8,245	\$ (2,554)
Provision for income taxes	(101)	(114)	(262)	(128)
<b>Income from continuing operations</b>	5,979	(3,141)	7,983	(2,682)

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Loss from discontinued operations		(817)		(2,503)
<b>Net income (loss)</b>	\$ 5,979	\$ (3,958)	\$ 7,983	\$ (5,185)
Preferred stock accretion	(1,273)	(1,207)	(3,769)	(3,573)
<b>Net income (loss) attributable to common shareholders</b>	\$ 4,706	\$ (5,165)	\$ 4,214	\$ (8,758)
<b>Income (loss) per share-basic</b>				
Continuing operations	\$ 0.11	\$ (0.11)	\$ 0.10	\$ (0.15)
Discontinued operations		(0.02)		(0.07)
Net income (loss)	\$ 0.11	\$ (0.13)	\$ 0.10	\$ (0.22)
<b>Income (loss) per share-diluted</b>				
Continuing operations	\$ 0.08	\$ (0.11)	\$ 0.10	\$ (0.15)
Discontinued operations		(0.02)		(0.07)
Net income (loss)	\$ 0.08	\$ (0.13)	\$ 0.10	\$ (0.22)
<b>Weighted average shares outstanding</b>				
Basic	42,156	40,684	41,788	40,407
Diluted	78,093	40,684	77,932	40,407

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF**  
**CHANGES IN STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)**

(in thousands)

(unaudited)

	Preferred Stock		Common Stock		Treasury Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income		Total Stockholder's Equity	Other Comprehensive Income (loss)
	Shares	Amount	Shares	Amount	Shares	Amount		Loss	Deficit		
<b>Balance, December 31, 2005</b>	<b>4,000</b>	<b>\$ 88,231</b>	<b>41,702</b>	<b>\$ 417</b>	<b>(457)</b>	<b>\$ (5)</b>	<b>\$ 302,324</b>	<b>\$ (89)</b>	<b>\$ (359,686)</b>	<b>\$ 31,192</b>	<b>\$ (8,699)</b>
Issuance of common stock			495	5			593			598	
Issuance of common stock upon exercise of warrants			515	5			(5)				
Accretion of preferred stock		3,769							(3,769)		(3,769)
Dividends declared									(750)	(750)	
Stock-based compensation expense							985			985	
Net unrealized loss on available-for-sale securities								(24)		(24)	(24)
Foreign currency translation								(41)		(41)	(41)
Other									(71)	(71)	
Net income									7,983	7,983	7,983
<b>Balance, September 30, 2006</b>	<b>4,000</b>	<b>\$ 92,000</b>	<b>42,712</b>	<b>\$ 427</b>	<b>(457)</b>	<b>\$ (5)</b>	<b>\$ 303,897</b>	<b>\$ (154)</b>	<b>\$ (356,293)</b>	<b>\$ 39,872</b>	<b>\$ 4,149</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****QUADRAMED CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
<b>Cash flows from operating activities</b>				
Net income (loss) attributable to common shareholders	\$ 4,706	\$ (5,165)	\$ 4,214	\$ (8,758)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	1,851	3,465	6,191	9,478
Preferred stock accretion	1,273	1,207	3,769	3,573
Exit cost of facility closing		1,066		1,066
Impairment and other charges for Financial Services Division		817		1,731
Provision for bad debts		879	820	1,704
Stock-based compensation expense	324		985	
Gain on sale of assets		(383)		(383)
Other			(21)	
Changes in assets and liabilities:				
Accounts receivable	3,494	4,447	6,923	(2,170)
Prepaid expenses and other	869	(1,372)	1,229	1,618
Accounts payable and accrued liabilities	(626)	3,410	(5,199)	219
Deferred revenue	(8,858)	(2,331)	(6,473)	6,065
Payment to former executive out of trust		(3,100)		(3,100)
Cash provided by operating activities	3,033	2,940	12,438	11,043
<b>Cash flows from investing activities</b>				
Decrease (increase) in restricted cash	82	(8)	105	1,539
Capital expenditures	(231)	(297)	(731)	(1,101)
Proceeds from the sale of assets and available-for-sale securities	1,951	462	2,609	345
Purchases of available-for-sale securities	(6,030)		(6,707)	
Termination of trust		3,100		3,100
Other	(30)		5	
Cash provided by (used in) investing activities	(4,258)	3,257	(4,719)	3,883
<b>Cash flows from financing activities</b>				
Proceeds from issuance of common stock and other	181	239	599	845
Payment of preferred stock dividends	(1,625)	(1,458)	(4,875)	(4,208)
Cash used in financing activities	(1,444)	(1,219)	(4,276)	(3,363)
Net increase (decrease) in cash and cash equivalents	(2,669)	4,978	3,443	11,563
<b>Cash and cash equivalents, beginning of period</b>	39,154	29,014	33,042	22,429
<b>Cash and cash equivalents, end of period</b>	\$ 36,485	\$ 33,992	\$ 36,485	\$ 33,992

The accompanying notes are an integral part of these condensed consolidated financial statements.



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**Table of Contents**

**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2006**

**1. THE COMPANY**

The business mission of QuadraMed Corporation along with our subsidiaries ( QuadraMed or the Company ) is to advance the success of healthcare organizations through IT solutions that leverage quality care into positive financial outcomes. QuadraMed's driving principles include: maintaining long-term client relationships, building a culture of customer care, focusing on innovation as the key to success, and striving to always deliver value. QuadraMed offers innovative, user-friendly software applications and support services designed and developed by the healthcare professionals and software specialists we employ.

In the healthcare market, clinical information and quality measurements are becoming drivers of revenue management. Access management, financial decision support, health information management ( HIM ) processes and systems combined with patient accounting systems are driving revenue management improvements and the movement to new quality-based reimbursement models. As evolving reimbursement scenarios will challenge hospitals to leverage quality of care into appropriate payment, we believe that clients committing to QuadraMed's Care-Based Revenue Cycle solutions will realize improved financial performance. QuadraMed's goal is to assist our clients in attaining significant improvement in hospital financial success by leveraging quality of care into positive financial outcomes through performance-based IT solutions. We seek to accomplish this by delivering healthcare information technology products and services supporting the healthcare organizations' efforts to improve the quality of the care they provide and the efficiency with which it is delivered.

Using QuadraMed's end-to-end solutions which are designed to optimize the patient experience and leverage quality of care into payment, our clients seek to receive the proper reimbursement, in the shortest time, at the lowest administrative cost. Our products are designed to eliminate paper, improve processes, streamline efficiencies and decrease error through the effective management of patient clinical and financial records, resulting in better patient safety. Healthcare organizations of varying size - from small single-entity hospitals to large multi-facility care delivery organizations, acute care hospitals, specialty hospitals, Veterans Health Administration facilities and associated/affiliated businesses such as outpatient clinics, long-term care facilities and rehabilitation hospitals gain value from our solutions. Our products are sold as standalone, bundled or fully integrated software packages.

We do business directly and through our subsidiaries, all of which are wholly owned and operated under common management. In December 2004, we announced the shutdown of the Financial Services Division; operations ceased to exist in February 2005. Accordingly, beginning in 2005, the Company considers itself to be in a single reporting segment, specifically the software segment. The prior year financial results of these operating segments have been reclassified to conform to the current year presentation.

**2. SIGNIFICANT ACCOUNTING POLICIES**

**Financial Statement Presentation**

These condensed consolidated financial statements are unaudited and have been prepared in conformity with generally accepted accounting principles in the United States ( GAAP ) and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. We suggest that you read these interim financial statements in conjunction with the consolidated financial statements, and the notes thereto, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, filed on March 16, 2006, as amended by Amendment No. 1, filed with the SEC on August 17, 2006. In the opinion of management, the condensed

**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

consolidated financial statements for the periods presented herein include all normal and recurring adjustments that are necessary for a fair presentation of the results for these interim periods. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results for the entire year ending December 31, 2006.

**Principles of Consolidation**

These condensed consolidated financial statements, which include the accounts of QuadraMed and all significant business divisions and wholly owned subsidiaries, have been prepared in conformity with (i) GAAP and (ii) the rules and regulations of the SEC. All significant intercompany accounts and transactions between QuadraMed and its subsidiaries are eliminated in consolidation.

**Use of Estimates in Preparation of Financial Statements**

QuadraMed makes estimates, assumptions and judgments that affect the reported amounts of assets and liabilities, contingent assets and liabilities, and revenues and expenses. Significant estimates and assumptions have been made regarding revenue recognition, the allowance for doubtful accounts, contingencies, litigation, valuation of stock option grants, intangibles resulting from our purchase business combinations and other amounts. QuadraMed bases its estimates and assumptions on historical experience and on various other assumptions which management believes to be reasonable under the circumstances. Uncertainties inherent in these estimates include, among other things, significant estimates within percentage-of-completion accounting. In addition, QuadraMed annually reviews its estimates related to the valuations of intangibles including acquired technology, goodwill, customer lists, trademarks and other intangibles and capitalized software. Actual results may differ materially from these estimates and assumptions.

**Reclassifications**

Certain reclassifications have been made to prior year balances to conform to the current year presentation.

**Revenue Recognition**

QuadraMed's revenue is principally generated from three sources: (i) licensing arrangements, (ii) services and (iii) hardware.

The Company's license revenue consists of fees for licenses of QuadraMed's proprietary software, as well as third-party software. Cost of license revenue primarily includes the costs of third-party software, royalties and amortization of acquired technology and capitalized software. The Company's services revenue consists of maintenance, software installation, customer training and consulting services related to our license revenue. Cost of services consists primarily of salaries, benefits and allocated costs related to providing such services. Hardware revenue includes third-party hardware used by our customers in connection with purchased software. Cost of hardware revenue consists of third-party equipment and installation.

QuadraMed markets its products through its direct sales force. The Company's license agreements for such products do not provide for a right of return, and historically, product returns have not been significant.

QuadraMed recognizes revenue on its software products in accordance with AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended; SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; and SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*.

**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

QuadraMed recognizes revenue when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered; we no longer have significant obligations with regard to implementation; the fee is fixed and determinable; and collectibility is probable. Delivery is considered to have occurred when title and risk of loss have been transferred to the customer, which generally occurs when media containing the licensed programs is provided to a common carrier. The Company considers all arrangements with payment terms extending beyond 180 days to be neither fixed nor determinable. Revenue for arrangements with extended payment terms is recognized when the payments become due, provided all other recognition criteria are satisfied. If collectibility is not considered probable, revenue is recognized when the fee is collected.

QuadraMed allocates revenue to each element in a multiple-element arrangement based on the element's respective fair value, with the fair value determined by the price charged when that element is sold separately. Specifically, QuadraMed determines the fair value of the maintenance portion of the arrangement based on the price if sold separately and measured by the renewal rate offered to the customer. The professional services portion of the arrangement is based on hourly rates which QuadraMed charges for these services when sold separately from software. If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. The proportion of revenue recognized upon delivery varies from quarter-to-quarter depending upon the mix of licensing arrangements, perpetual or term-based, and the determination of vendor-specific objective evidence (VSOE) of fair value for undelivered elements. Many of our licensing arrangements include fixed implementation fees and do not allow us to recognize license revenue until these services have been performed. We recognize revenue only after establishing that we have VSOE for all undelivered elements.

Certain of the licenses are term or time-based licenses. QuadraMed recognizes revenue from these contracts ratably over the term of the arrangement.

Contract accounting is applied where services include significant software modification, installation or customization. In such instances, the services and license fees are accounted for in accordance with SOP 81-1, whereby the revenue is recognized, generally using the percentage-of-completion method measured on labor input hours. If increases in projected costs-to-complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting can affect the amounts of revenue and related expenses reported in its consolidated financial statements.

Service revenues from software maintenance and support are recognized ratably over the maintenance term, which in most cases is one year. Service revenues from training, consulting and other service elements are recognized as the services are performed.

Hardware revenue is generated primarily from transactions in which customers purchased bundled solutions that included the Company's software and third-party hardware. If the bundled solution includes services that provide significant modification, installation or customization, contract accounting is applied in accordance with SOP 81-1, whereby the revenue is recognized, generally using the percentage-of-completion method measured on labor input hours. Otherwise, hardware revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collection is reasonably assured.

**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

Deferred revenue includes amounts billed to or received from customers for which revenue has not been recognized. This generally results from deferred maintenance, software installation, consulting and training services not yet rendered; license revenue is deferred until all revenue requirements have been met or as services are performed. Additionally, there are term-based licenses for which revenues are recognized over the term of the contract, which is generally one year. Unbilled receivables are established when revenue is deemed to be recognized based on QuadraMed's revenue recognition policy, but for which the Company does not have the right to bill the customer per the contract terms.

**Cash and Cash Equivalents**

Cash and cash equivalents consist of highly liquid investments that are comprised principally of taxable, short-term certificates of deposit, money market instruments and commercial paper with original maturities of three months or less at the time of purchase, and demand deposits with financial institutions. These instruments carry insignificant interest rate risk because of their short-term maturities. Cash equivalents are stated at amounts that approximate fair value based on quoted market prices.

**Investments**

QuadraMed considers its holdings of short-term and long-term securities, consisting primarily of fixed income securities, to be available-for-sale securities. The difference between cost or amortized cost (cost adjusted for amortization of premiums and accretion of discounts that are recognized as adjustments to interest income) and fair value, representing unrealized holdings gains or losses, net of the related tax effect, if any, is recorded, until realized, as a separate component of stockholders' equity. Gains and losses on the sale of debt securities are determined on a specific identification basis. Realized gains and losses are included in other income (expense) in the accompanying Condensed Consolidated Statements of Operations.

**Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable consist primarily of amounts due to QuadraMed from its normal business activities. QuadraMed provides an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific identified risks.

**Intangible Assets**

QuadraMed's acquisitions of other companies typically result in the acquisition of certain intangible assets and goodwill.

*Goodwill.* QuadraMed adopted Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001, and ceased amortization of goodwill as of January 1, 2002. Prior to this point, goodwill was amortized using the straight-line method over its estimated useful life.

As of January 1, 2005 and 2006, QuadraMed reviewed the goodwill for impairment and determined that the fair values of the analyzed reporting units exceeded the carrying values of the net assets. Accordingly, no indicators of impairment existed.

*Capitalized Software.* Software development costs are capitalized upon the establishment of technological feasibility, in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Upon the general release of the product to customers, development costs for that product

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

are amortized over the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product, or the straight-line method, generally five years. These amounts are charged to cost of licenses. No software development costs were capitalized in 2006 or 2005.

*Other Intangible Assets.* Other intangible assets primarily relate to customer lists, acquired technology including developed and core technology and trade names, and other intangible assets acquired in QuadraMed's purchase business combinations. On an annual basis, QuadraMed reviews its intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the provisions of SFAS No. 144. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values. Amortization of other intangible assets is computed on the basis of a 3-5 year life.

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed options-pricing models. We have adopted SFAS No. 123(R) for our fiscal year beginning January 1, 2006. See Note 10 - Stock-Based Compensation.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe the adoption of FIN 48 on January 1, 2007 will have a material impact on its financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the Company's fiscal year ending December 31, 2006, with early application encouraged. The Company is in the process of evaluating the requirements and impacts of SAB 108, and will reflect the adoption of the pronouncement in its financial statements to be filed on Form 10-K for its fiscal year ended December 31, 2006.

In February 2006, the Financial Accounting Standards Board, or FASB, issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which nullifies and amends various accounting guidance relating to accounting for derivative instruments and securitization transactions. In general, these changes will reduce the operational complexity associated with bifurcating embedded derivatives, and increase the number of beneficial interests in securitization transactions. This statement is effective for all financial instruments acquired or issued after the beginning of our first fiscal year that begins after September 15, 2006. The Company does not have any derivative instruments or securitization transactions; therefore it believes the adoption of SFAS No. 155 will have an impact on its financial condition, results of operations or cash flows.

**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets an amendment of SFAS No. 140* . This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* , with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Company does not have any servicing assets or liabilities; therefore it believes the adoption of SFAS No. 156 will not have an impact on its financial condition, results of operations or cash flows.

In September 2006, the FASB issued Statement 157, *Fair Value Measurements* . This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company believes the adoption of Statement 157 will not have an impact on its financial condition, results of operations or cash flows.

In September 2006, the FASB issued Statement 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* . Statement 158 will require the Company to show the funded status of its pension and retiree health care plans as a prepaid asset or accrued liability, and to show the net deferred and unrecognized gains and losses related to the retirement plans, net of tax, as part of accumulated other comprehensive income in shareholders' equity. Previously, the net deferred and unrecognized gains and losses were netted in the prepaid asset or accrued liability recorded for the retirement plans. The Company does not have any defined benefit pension or other post retirement plans; therefore it believes the adoption of Statement 158 will not have an impact on its financial condition, results of operations or cash flows.

**4. DISCONTINUED OPERATION FINANCIAL SERVICES DIVISION AND EXIT COST OF FACILITY CLOSING**  
**Financial Services Division**

Due to increasing operating losses in our Financial Services Division ( FSD ), and the lack of a qualified buyer for the business, we announced the shutdown of this division on December 15, 2004. The shutdown of this division was completed on February 14, 2005.

In the first quarter of 2005, we recorded an additional \$1.7 million loss from discontinued operations in connection with the closing of FSD in February. This loss included, among other things, severance costs and a \$1.0 million charge related to the future lease obligations of the FSD's office in San Marcos, California. In September 2005, the Company recorded an additional charge of \$0.8 million related to the San Marcos, California lease, as a result of a change in sublease income assumptions.

The lease for the San Marcos facility terminates in May 2008. The future minimum lease payments related to the San Marcos facility for the years 2006 through 2008 total approximately \$1.1 million. Effective July 1, 2006, QuadraMed entered into a sublease agreement for 100% of the rentable space in its abandoned San Marcos facility. The sublease is coterminous with the Company's remaining lease term, commencing on July 1, 2006 and expiring May 21, 2008. Total sublease income to be derived under the sublease agreement for the remainder of 2006 through 2008 is expected to be approximately \$1.2 million. In connection with its evaluation of its lease liability associated with the closing of this facility, the Company will continue to evaluate the impact of the sublease income on its calculation of accrued exit cost of facility closing.



Table of Contents

## QUADRAMED CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

September 30, 2006

The results of operations for the Financial Services Division, as discussed above, are presented in the table below (in thousands):

	For the nine months ended	
	September 30, 2006	2005
Revenues	\$	\$ 223
Loss from operation		(772)
Exit cost of facility closing		(1,849)
Other		118
Total loss	\$	\$ (2,503)

**Exit Cost of Facility Closing**

During the fourth quarter of 2004, we vacated and closed our San Rafael, California facility as a result of the relocation of our headquarters to Reston, Virginia. The future minimum lease payments for the San Rafael facility total approximately \$3.1 million for the years 2006 through 2009. The Company estimated its liability under its operating lease agreement, such estimate being reduced by the estimated sublease rental income. The present value of the estimated liability was recorded as an accrued exit cost of facility closing. The lease for this facility terminates in December 2009. Effective June 28, 2006, QuadraMed entered into a sublease agreement for approximately 33% of the rentable space in its abandoned San Rafael facility. The sublease is coterminous with the Company's remaining lease term, commencing on July 28, 2006 and expiring December 31, 2009. Total sublease income to be derived under the sublease agreement for the remainder of 2006 through 2009 is expected to be approximately \$0.9 million. In connection with its evaluation of its lease liability associated with the closing of this facility, the Company will evaluate the impact of the sublease income on its calculation of exit cost of facility closing.

The following table sets forth a summary of the exit cost charges and accrued exit costs for both the San Marcos, California and San Rafael, California facilities as of September 30, 2006 and 2005 (in thousands):

	As of	
	September 30, 2006	2005
<i>Exit Costs for the San Rafael Facility:</i>		
Accrued exit cost of facility closing, beginning of period	\$ 4,217	\$ 4,048
Exit cost for facility closing of former headquarters		1,066
Payments made	(727)	(661)
Accrued exit cost of facility closing, end of period	\$ 3,490	\$ 4,453
<i>Exit Costs for the San Marcos Facility:</i>		
Accrued exit cost of facility closing, beginning of period	\$ 1,275	\$
Exit cost of facility closing, February 2005		1,032

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Exit cost of facility closing, September 2005		817
Payments made	(519)	(413)
Accrued exit cost of facility closing, end of period	\$ 756	\$ 1,436
<i>Summary:</i>		
Accrued exit cost liability		
Short-term	\$ 1,809	\$ 1,868
Long-term	2,437	4,021
Total	\$ 4,246	\$ 5,889

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006****5. REDUCTION IN FORCE**

During the first quarter of fiscal year 2006, the Company announced a corporate reorganization and a reduction in our workforce of 37 positions. The Company recorded a charge for severance and related costs of approximately \$315,000, associated with terminated employees, in the Company's results of operations for the quarter ended March 31, 2006. Annualized savings associated with elimination of these positions, and other related cost savings initiatives is estimated to be approximately \$3.6 million.

During the first quarter of fiscal year 2005, the Company announced a corporate reorganization and a reduction in our workforce of 95 positions. The Company recorded a severance charge of approximately \$531,000 associated with terminated employees in the Company's results of operations for the quarter ended March 31, 2005.

**6. GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill and other intangible assets for the nine month period ended September 30, 2006 were as follows (in thousands):

	As of December 31, 2005	Q1 2006 Activity	Q2 2006 Activity	Q3 2006 Activity	As of September 30, 2006
<b>Cost</b>					
Capitalized software	\$ 13,043	\$	\$	\$	\$ 13,043
Goodwill	37,896				37,896
Other intangible assets	30,486	(11)	(9)		30,466
	81,425	(11)	(9)		81,405
<b>Accumulated amortization</b>					
Capitalized software	\$ (12,562)	\$ (214)	\$ (204)	\$ (54)	\$ (13,034)
Goodwill	(11,913)				(11,913)
Other intangible assets	(23,343)	(1,383)	(1,281)	(1,189)	(27,196)
	(47,818)	(1,597)	(1,485)	(1,243)	(52,143)
<b>Net book value</b>					
Capitalized software	\$ 481	\$ (214)	\$ (204)	\$ (54)	\$ 9
Goodwill	25,983				25,983
Other intangible assets	7,143	(1,394)	(1,290)	(1,189)	3,270
	\$ 33,607	\$ (1,608)	\$ (1,494)	\$ (1,243)	\$ 29,262

Amortization of acquired technology, a component of other intangible assets, for the three months ended September 30, 2006 and 2005 was \$694,000 and \$781,000, respectively. For the nine months ended September 30, 2006 and 2005, amortization of acquired technology was \$2.2 million and \$2.3 million, respectively, and is included in cost of license revenue for the respective periods. No impairment charges were recorded during the three or nine months ended September 30, 2006 or 2005.

**7. SERIES A PREFERRED STOCK**

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On June 17, 2004, QuadraMed issued 4.0 million shares of Series A Cumulative Mandatory Convertible Preferred Stock (the Series A Preferred Stock ) in a private, unregistered offering to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933. The Series A Preferred Stock was sold for \$25 per share, and QuadraMed used the \$96.1 million of net proceeds from the offering to repurchase all of our 2008 Notes and 2005 Notes, together with accrued interest and related redemption premiums; the remainder of the net proceeds was used for general corporate purposes.

**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

The Series A Preferred Stock holders do not have any relative, participating, optional or other voting rights and powers, except that (i) if four quarterly dividend payments are in arrears, such holders are entitled to elect two substitute directors to the Board of Directors at any annual or special meeting and (ii) in certain circumstances, such holders are entitled to vote on the authorization or creation of securities ranking on par with or above the Series A Preferred Stock, certain amendments to the Certificate of Incorporation or the Certificate of Designation for the Series A Preferred Stock, and the incurrence of new senior indebtedness in an aggregate principal amount exceeding \$8.0 million. Prior to the authorization or creation of, or increase in the authorized amount of, any shares of any class or series (or any security convertible into shares of any class or series) ranking

senior to or on par with the Series A Preferred Stock in the distribution of assets upon any liquidation, dissolution or winding up of QuadraMed or in the payment of dividends, QuadraMed must have the affirmative vote of a majority of any outstanding shares of the Series A Preferred Stock (along with any shares of every other series or class of common stock ranking on par with the Series A Preferred Stock having like voting rights). In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Company, before any payment or distribution of the Company's assets is made or set apart for the holders of common stock or any other class or series of shares of the Company's capital stock ranking junior to the Series A Preferred Stock as to the payment of dividends or as to the distribution of assets upon liquidation, dissolution or winding up, the holders of the Series A Preferred Stock shall be entitled to receive a liquidation preference of \$25 per share plus an amount equal to all dividends (whether or not earned or declared) accumulated, accrued and unpaid to the date of final distribution. However, for purposes of the foregoing provision, (1) a consolidation or merger of the Company with one or more entities, (2) a statutory share exchange or (3) a sale or transfer of all or substantially all of the Company's assets shall not be deemed to be a liquidation, dissolution or winding up of the Company.

Generally, the Series A Preferred Stock is entitled to quarterly dividends of \$0.34 (5.5% per annum) and is convertible into shares of common stock of the Company at a conversion price of \$3.10, equivalent to a conversion rate of 8.0645 shares of common stock for each share of Series A Preferred Stock. The initial conversion price of \$3.40 (conversion rate of 7.3529 shares of common stock for each share of Series A Preferred Stock) decreased to \$3.10 as of August 1, 2005, pursuant to the terms of the Certificate of Designation relating to the Series A Preferred Stock, as the volume weighted average of the daily market price per share during a period of 30 consecutive trading days equaled \$2.75 or less during the one year period beginning on the first anniversary of the issue date. Additionally, as provided in the Certificate of Designation, because the Company had not as of June 15, 2005 completed the registration of the Series A Preferred Stock with the SEC, the dividend rate for such stock increased to \$0.40625 per quarter (\$1.625 per annum) on June 16, 2005, and such rate will apply until the date the stock is registered. The registration statement for 3.92 million shares of Series A Preferred Stock, and 31.6 million shares of common stock into which the Series A Preferred Stock may be converted, was filed with the SEC on October 31, 2006 as Pre-Effective Amendment No. 4 to Form S-3, but has not yet been declared effective. The Company has the right to demand conversion on or after May 31, 2007, in the event the volume weighted average of the daily market price per share during a period of 20 consecutive trading days equals or exceeds \$5.10.

Upon the conversion of shares of the Series A Preferred Stock into shares of common stock on or before May 31, 2007, the Series A Preferred Stock holders have an option to convert and receive, when declared by the Board of Directors, dividends equal to the total previously unpaid dividends payable from the effective date of conversion through June 1, 2007 at a rate of \$1.375 per annum, or 5.5% per annum, discounted to present value at a rate of 5.5% per annum, payable in cash or common shares or any combination thereof at the option of the Company.

As a result of the aforementioned feature, at the date of issuance of the Series A Preferred Stock, the Company recorded dividends payable of \$15.2 million, which represents the present value of the three-year dividends. The present value adjustment of \$1.3 million is being amortized over three years as interest expense

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

using the effective interest rate method. For the three months ended September 30, 2006 and 2005, interest expense totaled \$67,000 and \$133,000, respectively, and totaled \$252,000 and \$448,000 for the nine months ended September 30, 2006 and 2005, respectively.

The carrying value of the Series A Preferred Stock was also reduced by \$15.2 million, which represents the imputed discount on the Series A Preferred Stock and which is being accreted over three years using the effective interest rate method. Accretion on the preferred stock discount which was charged to accumulated deficit for the three months ended September 30, 2006 and 2005 was \$1.3 million and \$1.2 million, respectively, and \$3.8 million and \$3.6 million for the nine months ended September 30, 2006 and 2005. If any Series A Preferred Stock shares are converted prior to the end of the three-year period, the related accretion will be accelerated. The Company determined that there was no beneficial conversion feature attributable to the Series A Preferred Stock.

The following table summarizes the Series A Preferred Stock activities (in thousands):

	As of	
	September 30, 2006	
Total issued	\$	100,000
Less: Issuance cost		(3,856)
Less: Unaccreted discount		
Original present value of discount	(15,174)	
2006 preferred stock accretion	3,769	
2005 preferred stock accretion	4,796	
2004 preferred stock accretion	2,465	(4,144)
Carrying value of preferred stock at September 30, 2006	\$	92,000

**8. RESTRICTED STOCK GRANTS**

During the three and nine months ended September 30, 2006, there was no common stock issued as a result of restricted stock grants. During the three and nine months ended September 30, 2005, 100,000 shares of common stock were issued as restricted stock grants. These grants are periodically made to certain senior executives for no monetary consideration. The majority of the Company's restricted shares fully vest over three to four years. QuadraMed has recorded the fair value of the restricted shares on the date they were granted as deferred compensation within the Stockholders' Equity section of the Condensed Consolidated Balance Sheets. This amount is amortized over the period in which the restrictions lapse. Compensation expense associated with the grants of restricted stock total \$96,000 and \$137,000 for the three months ended September 30, 2006 and 2005, respectively, and \$289,000 and \$420,000 for the nine months ended September 30, 2006 and 2005, respectively. In addition to these amounts, \$1,442,000 was charged to severance expense in the nine months ended September 30, 2005 relating to the early-vesting of restricted stock issued to former officers of the Company.

As of September 30, 2006, restricted shares subject to forfeiture totaled 615,000.

**9. NET INCOME (LOSS) PER SHARE AND COMPREHENSIVE INCOME (LOSS)**

Basic income (loss) per share is determined using the weighted average number of common shares outstanding during the period. Diluted loss per share is determined using the weighted average number of common shares and common equivalent shares outstanding during the period. Common equivalent shares consist of shares issuable upon the exercise of stock options and warrants (using the treasury stock method) and conversion of the preferred stock (using the as-converted method). For the three and nine month periods ended September 30, 2005, common

equivalent shares were excluded from the diluted computation as their effect was anti-dilutive.

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

The following table sets forth the computation of basic and diluted net income (loss) per common share (in thousands):

	<b>Three months ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Numerator - basic:</b>		
Net income (loss) attributable to common shareholders	\$ 4,706	\$ (5,165)
<b>Numerator - diluted:</b>		
Net income (loss)	\$ 5,979	\$ (5,165)
<b>Denominator:</b>		
<b>Weighted average number of common shares outstanding:</b>		
Basic	42,156	40,684
Diluted	78,093	40,684
<b>Income (loss) per common share:</b>		
Basic	\$ 0.11	\$ (0.13)
Diluted	\$ 0.08	\$ (0.13)
<b>Nine months ended</b>		
<b>September 30,</b>		
<b>2006 2005</b>		
<b>Numerator - basic:</b>		
Net income (loss) attributable to common shareholders	\$ 4,214	\$ (8,758)
<b>Numerator - diluted:</b>		
Net income (loss)	\$ 7,983	\$ (8,758)
<b>Denominator:</b>		
<b>Weighted average number of common shares outstanding:</b>		
Basic	41,788	40,407
Diluted	77,932	40,407
<b>Income (loss) per common share:</b>		
Basic	\$ 0.10	\$ (0.22)
Diluted	\$ 0.10	\$ (0.22)

As QuadraMed recorded net income for the three and nine month periods ended September 30, 2006, common equivalent shares were included in the diluted net income per share calculation, and the preferred stock accretion was added back to net income attributable to common shareholders in the calculation of diluted earnings per share. As QuadraMed recorded a net loss for the three and nine month periods ended September 30, 2005, no common equivalent shares were included in the diluted net loss per share calculation because they were anti-dilutive. If QuadraMed had reported net income for those periods, the calculation of diluted earnings per share would have included the following common stock equivalent shares from the indicated equity instruments (in thousands):

**Three months ended****September 30,  
2006 2005**



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Equity instruments:		
Preferred stock	32,258	32,258
Warrants	2,753	3,265
Stock options	926	915
Total common stock equivalent shares	35,937	36,438

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

	<b>Nine months ended</b>	
	<b>September 30,</b>	<b>2005</b>
	<b>2006</b>	<b>2005</b>
<b>Equity instruments:</b>		
Preferred stock	32,258	32,258
Warrants	2,984	3,265
Stock options	902	658
<b>Total common stock equivalent shares</b>	<b>36,144</b>	<b>36,181</b>

The calculation of net income per fully diluted share for the three months and nine months ended September 30, 2006 was based on net income before preferred stock accretion. In our Quarterly Report on Form 10-Q for the six months ended June 30, 2006, as filed with the SEC on August 9, 2006, net income per fully diluted share was based on net income attributable to common shareholders, which reflects a deduction for the preferred stock accretion. As presented in the following table, we are revising our calculation of net income per fully diluted share for the second quarter of 2006.

The following table sets forth the computation of basic and diluted net income (loss) per common share (in thousands):

	<b>(Revised)</b>		<b>(As originally reported)</b>	
	<b>Three months ended</b>		<b>Three months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Numerator basic:</b>				
Net income attributable to common shareholders	\$ 2,590	\$ 102	\$ 2,590	\$ 102
<b>Numerator diluted:</b>				
Net income	\$ 3,847	\$ 1,293		
<b>Denominator:</b>				
<b>Weighted average number of common shares outstanding:</b>				
Basic	41,864	40,499	41,864	40,499
Diluted	78,072	73,992	78,072	73,992
<b>Income (loss) per common share:</b>				
Basic	\$ 0.06	\$ 0.00	\$ 0.06	\$ 0.00
Diluted	\$ 0.05	\$ 0.02	\$ 0.03	\$ 0.00

	<b>(Revised)</b>		<b>(As originally reported)</b>	
	<b>Six months ended</b>		<b>Six months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Numerator basic:</b>				
Net loss attributable to common shareholders	\$ (492)	\$ (3,593)	\$ (492)	\$ (3,593)
<b>Numerator diluted:</b>				
Net income (loss)	\$ 2,004	\$ (3,593)		
<b>Denominator:</b>				
<b>Weighted average number of common shares outstanding:</b>				
Basic	41,602	40,338	41,602	40,338
Diluted	77,855	40,338		

Income (loss) per common share:

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Basic	\$	(0.01)	\$	(0.09)	\$	(0.01)	\$	(0.09)
Diluted	\$	0.03	\$	(0.09)	\$	(0.01)	\$	(0.09)

Table of Contents

## QUADRAMED CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

September 30, 2006

The components of QuadraMed's comprehensive income (loss) include the unrealized gain (loss) on available-for-sale securities and foreign currency translation adjustment. The following table sets forth the computation of comprehensive income (loss) (in thousands):

	Nine months ended	
	September 30, 2006	2005
Net income (loss) attributable to common shareholders	\$ 4,214	\$ (8,758)
Unrealized loss	(24)	(44)
Foreign currency translation adjustment	(41)	(2)
Comprehensive income (loss)	\$ 4,149	\$ (8,804)

**10. STOCK-BASED COMPENSATION**

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed option-pricing models. The fair value is expensed over the requisite service period of the individual grantees, which generally equals the vesting period. Since the adoption of SFAS No. 123(R) on January 1, 2006, pro forma disclosure is no longer an alternative.

As permitted by SFAS No. 123, for 2005, the Company accounted for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. Effective January 1, 2006, we have adopted SFAS No. 123(R)'s fair value method of accounting for share-based payments using the modified prospective transition method. Accordingly, periods prior to adoption have not been restated and are not directly comparable to periods after adoption. However, had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 illustrated in the disclosure of pro forma net income and net income per share contained in our notes to condensed consolidated financial statements included herein. Under the modified prospective method, compensation cost recognized in the three and nine month periods ended September 30, 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, less estimated forfeitures, and (b) compensation costs for all share-based payments granted and vested subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R).

SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Stock-based compensation expense for the three months ended September 30, 2006 and 2005 totaled \$0.3 million and \$0.6 million, respectively, and \$1.0 million and \$2.5 million for the nine months ended September 30, 2006 and 2005, respectively, and is allocated to cost of services, sales and marketing, general and administrative or software development expense in the condensed consolidated statement of operations for the three and nine months ended September 30, 2006. There was no income tax benefit or excess tax benefit related to stock-based compensation or capitalized stock-based compensation costs during the three and nine months ended September 30, 2006 and 2005.

Table of Contents

## QUADRAMED CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

September 30, 2006

QuadraMed has determined pro-forma information regarding net income and earnings per share as if we had accounted for employee stock options under the fair value method as required by SFAS No. 123, for the three and nine month periods ended September 30, 2005. The fair value of these stock-based awards to employees was estimated using the Black-Scholes option pricing model. Had compensation cost for the Company's stock option plans been determined consistent with SFAS No. 123(R) for the three and nine months ended September 30, 2005, the Company's reported net loss and net loss per share would have been changed to the amounts indicated below (in thousands except per share data):

	Three months ended September 30,	
	2006	2005
Net income (loss) attributable to common shareholders, as reported	\$ 4,706	\$ (5,165)
<i>Add:</i> Stock-based employee compensation expense in reported net income (loss), net of tax	325	139
<i>Deduct:</i> Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(325)	(563)
Pro forma net income (loss)	\$ 4,706	\$ (5,589)
Basic net income (loss) per common share, as reported	\$ 0.11	\$ (0.13)
Basic net income (loss) per common share, pro forma	\$ 0.11	\$ (0.14)
Diluted net income (loss) per common share, as reported	\$ 0.08	\$ (0.13)
Diluted net income (loss) per common share, pro forma	\$ 0.08	\$ (0.14)
	Nine months ended September 30,	
	2006	2005
Net income (loss) attributable to common shareholders, as reported	\$ 4,214	\$ (8,758)
<i>Add:</i> Stock-based employee compensation expense in reported net income (loss), net of tax	985	1,030
<i>Deduct:</i> Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(985)	(2,497)
Pro forma net income (loss)	\$ 4,214	\$ (10,225)
Basic net income (loss) per common share, as reported	\$ 0.10	\$ (0.22)
Basic net income (loss) per common share, pro forma	\$ 0.10	\$ (0.25)
Diluted net income (loss) per common share, as reported	\$ 0.10	\$ (0.22)
Diluted net income (loss) per common share, pro forma	\$ 0.10	\$ (0.25)

**Stock Incentive Plans**

The Company has issued stock options and restricted stock under its 1996 Stock Incentive Plan (the "1996 Plan"), the 1999 Supplemental Stock Option Plan (the "1999 Plan"), and the 2004 Stock Compensation Plan (the "2004 Plan"), all of which were approved by stockholders. The 2004 Plan superseded the 1996 Plan, as amended, and the 1999 Plan, as amended, as of May 6, 2004, although stock options and restricted stock granted under the 1996 Plan and the 1999 Plan outstanding as of that date remain subject to the terms of those plans. Significant grants were made outside these plans pursuant to contracts with executives as an inducement to employment. Total non-plan stock options outstanding at September 30, 2006 were 1,575,000.



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**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

**1996 Stock Incentive Plan**

Under the 1996 Plan, the Board of Directors may grant incentive and nonqualified stock options to employees, directors and consultants. The 1996 Plan is divided into the following five separate equity programs: (i) the discretionary option grant program under which eligible persons may, at the discretion of the plan administrator, be granted options to purchase shares of common stock; (ii) the salary investment option grant program under which eligible employees may elect to have a portion of their base salary invested each year in special option grants; (iii) the stock issuance program under which eligible persons may, at the discretion of the plan administrator, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered to QuadraMed; (iv) the automatic option grant program under which eligible non-employee board members shall automatically receive option grants at periodic intervals to purchase shares of common stock; and (v) the director fee option program under which non-employee board members may elect to have all or any portion of their annual retainer fee otherwise payable in cash applied to a special option grant.

The exercise price per share for an incentive stock option cannot be less than the fair market value on the date of grant. The exercise price per share for a nonqualified stock option cannot be less than 85% of the fair market value on the date of grant. Option grants under the 1996 Plan generally expire 10 years from the date of grant and generally vest over a four-year period. Options granted under the 1996 Plan are exercisable subject to the vesting schedule. QuadraMed's stockholders had authorized a total of 8,651,097 shares of common stock for grant under the 1996 Plan, of which 4,343,576 were outstanding at September 30, 2006. There were no shares available for grant at September 30, 2006.

**1999 Supplemental Stock Option Plan**

In 1999, QuadraMed's Board of Directors approved the 1999 Plan. The 1999 Plan permits non-statutory option grants to be made to employees, independent consultants and advisors who are not QuadraMed officers, directors or Section 16 insiders. The 1999 Plan is administered by the Board of Directors or its Compensation Committee and was scheduled to terminate in March 2009. The exercise price of all options granted under the 1999 Plan may not be less than 100% of fair market value on the date of the grant. Options vest on a schedule determined by the Board of Directors or the Compensation Committee with a maximum option term of 10 years. QuadraMed's stockholders had authorized a total of 3,519,258 shares of common stock for grant under the 1999 Plan, of which 1,129,617 were outstanding at September 30, 2006. There were no shares available for grant at September 30, 2006.

**2004 Stock Compensation Plan**

On April 1, 2004, QuadraMed's Board of Directors approved the 2004 Plan. QuadraMed's stockholders ratified the adoption of the 2004 Plan on May 6, 2004 at QuadraMed's 2004 Annual Meeting of Stockholders. The 2004 Plan replaces the 1996 Plan and 1999 Plan with respect to the unissued shares of common stock that were remaining in the 1996 Plan and the 1999 Plan on the date the 2004 Plan was ratified. Awards previously granted under the 1996 Plan and 1999 Plan remain subject to the terms of those plans. QuadraMed stockholders have authorized 1,536,369 shares of common stock for grant under the 2004 Plan, of which 774,659 were outstanding at September 30, 2006. There were 761,710 shares available for grant at September 30, 2006.

The 2004 Plan permits the grant of non-statutory options, incentive stock options, stock appreciation rights, restricted stock and restricted stock units to employees, prospective employees, directors, and advisors, consultants and other individuals who provide services to QuadraMed. The exercise price of all options and stock appreciation rights granted under the 2004 Plan may not be less than 100% of fair market value on the date of the grant. The 2004 Plan also features (i) a Non-Employee Director Option Grant Program, whereby non-employee

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

members of the Board automatically receive special grants of options with an exercise price equal to the fair market value per share of common stock as of the date the options are granted and (ii) a Director Fee Option Grant Program, whereby non-employee Board members may elect to have all or any portion of their annual cash retainer fee applied to special stock option grants with a below-market exercise price. The 2004 Plan is administered by the Compensation Committee and terminates in May 2014.

**Employee Stock Purchase Plan**

QuadraMed's 2002 Employee Stock Purchase Plan (the "2002 Purchase Plan") was adopted by the Board of Directors in January 2002. A total of 703,450 shares of common stock are reserved for issuance under the 2002 Purchase Plan, pursuant to which eligible employees are able to contribute up to 10% of their compensation for the purchase of QuadraMed common stock at a purchase price of 85% of the lower of the fair market value of the shares on the first or last day of the six-month purchase period. Stock-based compensation expense relating to shares purchased on behalf of plan participants for the nine months ended September 30, 2006 and 2005 totaled \$32,000 and \$22,000, respectively.

**Stock Options:**

Stock options generally vest ratably over 4 years from the date of grant and terminate ten years from the date of grant. The exercise price of the options granted equaled or exceeded the market value of the common stock at the date of the grant. A summary of the stock option activity under all plans is as follows (in thousands except per share data):

	Number of Shares	Weighted Average Price
Options outstanding, January 1, 2006	8,387	\$ 3.64
Granted	232	1.72
Exercised	(148)	1.24
Cancelled	(132)	5.92
Options outstanding, March 31, 2006	8,339	\$ 3.59
Granted	116	2.07
Exercised	(145)	1.19
Cancelled	(159)	4.24
Options outstanding, June 30, 2006	8,151	\$ 3.60
Granted	65	1.88
Exercised	(109)	1.12
Cancelled	(105)	3.08
Options outstanding, September 30, 2006	8,002	\$ 3.63
Options exercisable, September 30, 2006	6,561	\$ 4.02

Stock-based compensation expense relating to stock options for the three months ended September 30, 2006 and 2005 totaled \$0.2 million and \$0.4 million, respectively, and \$0.7 million and \$1.5 million for the nine months ended September 30, 2006 and 2005, respectively.



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Compensation expense for the three and nine months ended September 30, 2005 was recognized on a pro forma basis only.

The weighted average remaining contractual term and the aggregate intrinsic value for options outstanding at September 30, 2006 were 5.49 years and \$1.8 million, respectively. The weighted average remaining

**Table of Contents****QUADRAMED CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****September 30, 2006**

contractual term and the aggregate intrinsic value for options exercisable at September 30, 2006 were 4.73 years and \$1.2 million, respectively. As of September 30, 2006, unrecognized compensation expense related to stock options totaled approximately \$1.3 million, which will be recognized over a weighted average period of 1.27 years.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

	Nine months ended	
	September 30, 2006	September 30, 2005
Expected dividend yield		
Expected stock price volatility	85.97%	151.30%
Risk-free interest rate	4.84%	3.93%
Expected life of options	5.73 years	3.47 years

The dividend yield of zero is based on the fact that the Company has never paid cash dividends on its common stock, and has no present intention of doing so. The risk-free interest rate is based on U.S. treasury yield curve in effect at the time of the grant for a term equivalent to the expected life of the option. The expected life and expected volatility are based on historical experience. The Company uses an estimated forfeiture rate of 31.09% for calculating stock-based compensation expense related to stock options and this rate is based on historical experience.

Based on the above assumptions, the weighted average estimated fair value of options granted during the three months ended September 30, 2006 and 2005 was \$1.88 and \$1.80, respectively, and \$1.84 and \$1.77 for the nine months ended September 30, 2006 and 2005, respectively.

***Restricted Share Awards:***

The Company issues its common stock as restricted share awards at no exercise price as provided for under QuadraMed's stock compensation plans and other contractual commitments. The grants are generally made to certain senior executives for no monetary consideration. The majority of the restrictions lapse over three to four years. The Company records the fair value of the restricted shares on the date they are granted as deferred compensation within the Stockholders' Equity section of the condensed consolidated balance sheets. Deferred compensation has been combined with additional paid-in-capital as a result of the adoption of SFAS No. 123(R). This amount is amortized as compensation expense over the period in which the restrictions lapse.

A summary of our restricted stock awards as of September 30, 2006 is as follows (in thousands except per share data):

	Number of Shares	Weighted Average Grant Date Fair Value
Restricted stock awards, as of January 1, 2006	650	\$ 1.77
Granted		
Restrictions released	(35)	1.74
Forfeited		

Restricted stock awards, as of September 30, 2006	615	\$	1.77
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**Table of Contents**

**QUADRAMED CORPORATION**

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

**September 30, 2006**

Stock-based compensation expense relating to restricted share grants for the three months ended September 30, 2006 and 2005 totaled \$0.1 million and \$1.0 million, respectively, and \$0.3 million and \$1.9 million for the nine months ended September 30, 2006 and 2005, respectively. During the nine months ended September 30, 2005, \$1.4 million was charged to severance expense relating to the early-vesting of restricted stock to former officer of the Company.

**11. MAJOR CUSTOMERS**

For the three and nine months ended September 30, 2006, sales to Veterans Health Administration facilities accounted for approximately 11.6% and 12.5% of total revenues, respectively. For the three and nine months ended September 30, 2005, no single customer accounted for 10% or more of our total revenues.

**12. LITIGATION AND OTHER MATTERS**

As previously disclosed, on November 15, 2004, the Company received a letter from MedCath Incorporated ( MedCath ), which provided notice of MedCath's decision to terminate the Master Software License and Services Agreement, dated November 20, 2002, by and between QuadraMed Affinity and MedCath (the Contract ). On or about November 15, 2004, MedCath filed a complaint against the Company in Mecklenburg County, North Carolina, Superior Court Division (Case No. 04CVS20137). In its complaint, MedCath alleged that we were in breach of the Contract due to uncured deficiencies in the products and sought at least \$5 million in damages, plus litigation costs. On December 9, 2004, we filed a motion to dismiss the MedCath complaint on the grounds that the complaint fails to state a claim upon which relief can be granted. We also filed a counterclaim against MedCath seeking no less than \$1.14 million in unpaid amounts due to us, plus litigation costs, for MedCath's breach of the Contract by failing to pay licensing fees due to the Company.

On April 28, 2006, we settled this litigation with MedCath. Pursuant to the Release and Settlement Agreement (the Settlement Agreement ), the Company paid MedCath a settlement payment of \$2 million and the parties filed a Joint Stipulation of Dismissal, with prejudice, of this lawsuit on May 8, 2006. Further, the Contract and all obligations thereunder terminated, and the Company removed MedCath's name from all Company websites and marketing materials. The parties have entered into mutual general releases regarding the Contract and both bear their own attorneys fees and costs.

QuadraMed funded the settlement amount from available operating cash. In addition to amounts already recorded at December 31, 2005 and amounts covered by insurance, the Company recorded a charge of approximately \$1 million related to the settlement in its three month period ended March 31, 2006.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Cautionary Statement on Risks Associated With Forward-Looking Statements**

You should read the following discussion in conjunction with our Condensed Consolidated Financial Statements and related notes. This report contains forward-looking statements as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are subject to risks and uncertainties. The words believe, expect, target, goal, project, anticipate, predict, intend, plan, will, should, could and similar expressions and their negatives are intended to identify such statements. Forward-looking statements are not guarantees of future performance, anticipated trends and growth in businesses, or other characterizations of future events or circumstances and are to be interpreted only as of the date on which they are made. We undertake no obligation to update or revise any forward-looking statement. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described below and elsewhere in this Report, and in other documents we file with the SEC from time to time.

**Results of Operations (unaudited)**

The following tables sets forth selected data for the indicated periods. Percentages are expressed as a percentage of total revenues, except for cost of revenue, which is expressed as a percentage of the related revenue classification.

	<b>Three months ended September 30,</b>			
	<b>2006</b>		<b>2005</b>	
<b>Revenue</b>				
Services	\$ 3,859	11%	\$ 2,824	9%
Maintenance	14,802	45%	13,767	46%
Installation and other	2,893	9%	3,196	11%
Services and other	21,554	65%	19,787	66%
Licenses	11,151	34%	10,009	33%
Hardware	327	1%	250	1%
<b>Total revenue</b>	<b>33,032</b>	<b>100%</b>	<b>30,046</b>	<b>100%</b>
<b>Cost of revenue</b>				
Cost of services and other	6,846	32%	7,326	37%
Royalties and other	3,034	27%	2,385	24%
Amortization of acquired technology and capitalized software	748	7%	1,014	10%
Cost of licenses	3,782	34%	3,399	34%
Cost of hardware	347	106%	682	273%
<b>Total cost of revenue</b>	<b>10,975</b>	<b>33%</b>	<b>11,407</b>	<b>38%</b>
<b>Gross margin</b>	<b>22,057</b>	<b>67%</b>	<b>18,639</b>	<b>62%</b>
<b>Operating expenses</b>				
General and administration	4,370	13%	8,340	28%
Software development	7,298	22%	7,812	26%
Sales and marketing	3,730	11%	3,160	10%
Amortization of intangible assets and depreciation	1,035	3%	1,087	4%
Loss on lease obligation		0%	1,066	3%
<b>Total operating expenses</b>	<b>\$ 16,433</b>	<b>49%</b>	<b>\$ 21,465</b>	<b>71%</b>
<b>Income from operations</b>	<b>\$ 5,624</b>		<b>\$ (2,826)</b>	



**Table of Contents**

	Nine months ended September 30,			
	2006		2005	
<b>Revenue</b>				
Services	\$ 9,480	10%	\$ 9,448	11%
Maintenance	42,605	45%	41,152	45%
Installation and other	9,048	10%	8,300	9%
Services and other	61,133	65%	58,900	65%
Licenses	31,713	34%	30,143	33%
Hardware	1,142	8%	2,061	2%
<b>Total revenue</b>	<b>93,988</b>	<b>100%</b>	<b>91,104</b>	<b>100%</b>
<b>Cost of revenue</b>				
Cost of services and other	21,497	35%	21,764	37%
Royalties and other	8,824	28%	6,811	23%
Amortization of acquired technology and capitalized software	2,699	9%	3,073	10%
Cost of licenses	11,523	36%	9,884	33%
Cost of hardware	1,131	99%	2,190	106%
<b>Total cost of revenue</b>	<b>34,151</b>	<b>36%</b>	<b>33,838</b>	<b>37%</b>
<b>Gross margin</b>	<b>59,837</b>	<b>64%</b>	<b>57,266</b>	<b>63%</b>
<b>Operating expenses</b>				
General and administration	15,299	16%	20,625	23%
Software development	23,254	25%	23,253	25%
Sales and marketing	10,849	12%	10,727	12%
Amortization of intangible assets and depreciation	3,239	3%	3,793	4%
Loss on lease obligation		0%	1,066	1%
<b>Total operating expenses</b>	<b>\$ 52,641</b>	<b>56%</b>	<b>\$ 59,464</b>	<b>65%</b>
<b>Income from operations</b>	<b>\$ 7,196</b>		<b>\$ (2,198)</b>	

**Revenue**

*Total revenue.* Total revenue for the three months ended September 30, 2006 was \$33.0 million compared to \$30.0 million for the three months ended September 30, 2005. Revenues from Scheduling, Imaging, Affinity, Pharmacy and other ancillary products increased by \$2.0 million in the three months ended September 30, 2006, offset by a decrease of \$0.3 million for EDI product. In the three months ended September 30, 2006, Quantim HIM Suite revenues increased \$0.7 million compared with the same period in 2005 due to a \$0.9 million increase in license revenue, partially offset by a \$0.2 million decrease in services revenue. In the three months ended September 30, 2006, Government product revenues increased by \$0.6 million compared to the three months ended September 30, 2005 due to increases in services revenue and license revenue.

Total revenues for the nine months ended September 30, 2006 were \$94.0 million, an increase of \$2.9 million or 3.2% from \$91.1 million for the nine months ended September 30, 2005. Quantim HIM Suite product revenues increased \$2.0 million due to a \$1.8 million increase in license revenue and a \$0.2 million increase in services revenue. Government product revenues increased \$1.4 million due to a \$0.9 million increase in services revenue and a \$0.5 million increase in license revenue. Although revenues from Scheduling, Affinity, Imaging and Pharmacy product lines increased by a combined \$2.6 million, this increase was offset by declines in revenues for several other product lines, including \$1.6 million for MPI, \$1.0 million for EDI, \$0.3 million for Lab and Radiology and \$0.2 million for Performance Measurement. The EDI business was sold in the third quarter of 2005.





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**Table of Contents**

*Services and other.* Services and other revenue consist of professional services, such as implementation and installation services, training, maintenance (which consists of technical support and product upgrades), reimbursable expenses and other services revenue. Professional services are typically provided over a period of three to nine months for the Quantim HIM Suite and two to three years for Affinity and its related clinical or revenue cycle products. These services are provided subsequent to the signing of a software license arrangement and depend in large part on our software license revenues. Our maintenance revenue depends on both licenses of our software products and renewals of maintenance agreements by our existing customer base.

Services revenue for the three months ended September 30, 2006 was \$3.9 million or 11% of total revenue, compared to \$2.8 million or 9% of total revenue for the three months ended September 30, 2005. The net increase of \$1.1 million was primarily the result of increases of \$1.0 million for our Affinity products and \$0.1 million for our Government products. Services revenue for the nine months ended September 30, 2006 of \$9.5 million remained relatively flat when compared to services revenue for the nine months ended September 30, 2005 of \$9.4 million.

Maintenance revenue for the three months ended September 30, 2006 was \$14.8 million, compared to \$13.8 million for the three months ended September 30, 2005. Maintenance revenue, as a percentage of total revenue, was 45% and 46% for the three months ended September 30, 2006 and 2005, respectively. Maintenance revenue for the nine months ended September 30, 2006 was \$42.6 million or 45% of total revenue. For the nine months ended September 30, 2005, maintenance revenue was \$41.2 million or 45% of total revenue. The increase in maintenance revenue was principally due to revenue that was recognized when cash was collected from certain cash basis customers and reactivation of revenue plans that were previously put on hold.

Installation and other revenue decreased to \$2.9 million or 9% of total revenue during the three months ended September 30, 2006 from \$3.2 million or 11% of total revenue during the three months ended September 30, 2005. The decrease of \$0.3 million was the result of a \$0.5 million decrease related to our Quantim HIM Suite, which was partially offset by a \$0.2 million increase in training revenue generated from our Government customers. Installation and other revenue for the nine months ended September 30, 2006 was \$9.0 million or 10% of total revenue compared to \$8.3 million or 9% of total revenue for the nine months ended September 30, 2005. The net increase of \$0.7 million is mainly attributable to an increase in training revenue for our Government customers. Installation and other revenue for the Quantim HIM Suite are typically recognized upon completion of a contract, whereas the installation and other revenue for many of our other products, including Affinity, are recognized on a percentage of completion basis.

*Licenses.* License revenue consists of fees and licenses of our owned, proprietary software, as well as third-party owned software that we bundle into our suite of products. License revenue for the three months ended September 30, 2006 was \$11.2 million, compared to \$10.0 million in the corresponding period of 2005. License revenue as a percentage of total revenue was 34% and 33% for the three months ended September 30, 2006 and 2005, respectively. The net increase of \$1.2 million was mainly due to a \$0.9 million increase related to Quantim HIM Suite, a \$0.5 million increase for Scheduling, \$0.2 million of Government and \$0.4 million for several other products net, all partially offset by a \$0.8 million decline for Affinity. Hours worked for Affinity projects were 21% less in the 2006 quarter than in the corresponding 2005 quarter. The increase in Quantim HIM Suite was mainly due to revenue recognized on cash-basis customers whose revenue plans were put on hold until collectability of amounts due was realized. License revenue for the nine months ended September 30, 2006 was \$31.7 million or 34% of total revenue compared to \$30.1 million or 33% of total revenue for the nine months ended September 30, 2005. Quantim HIM license revenues increased \$1.8 million and Government license revenue increased \$0.5 million. In addition, decreases of \$1.5 million for Affinity, \$0.3 million for Lab and Radiology and \$0.3 million for EDI product lines were partially offset by an increase of \$1.3 million in the Scheduling product line. The product line decreases are primarily due to decreased number and size of active projects compared to the same period in the prior year, and due to the sale of the EDI division in late 2005. Scheduling product license revenue increased in the 2006 period due to a much stronger completion of contracts compared to activity in the corresponding 2005 period.

**Table of Contents**

*Hardware.* Hardware revenue consists of the sale of third-party hardware purchased specifically for use by our customers. Hardware revenue remained flat at \$0.3 million for the three months ended September 30, 2006 and 2005. Hardware revenue, as a percentage of total revenue, was 1% for both the three months ended September 30, 2006 and 2005. For the nine months ended September 30, 2006 and September 30, 2005, Hardware revenue was \$1.1 million and \$2.1 million, respectively. Hardware revenue, as a percentage of total revenue, was 1% and 2% for nine months ended September 30, 2006 and 2005, respectively. The decrease is primarily due to decreased number and size of active projects compared to the corresponding period in the prior year.

Revenue recognized for the three and nine months ended September 30, 2006 and 2005 includes:

Amounts initially recorded as deferred revenue in which the Company has now completed its contractual commitments;

Service revenue relating to installation and training, during the period; and

Revenues recognized on a cash-basis after the Company's contractual commitment has been completed, and the monies have been collected from the subject customers.

The following table is a summary roll forward schedule of deferred revenue (in thousands):

	<b>For the three months ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Deferred revenue, beginning balance	\$ 54,554	\$ 52,436
Add: revenue deferred	23,452	26,672
Less: deferred revenue recognized	(32,311)	(29,083)
Deferred revenue, ending balance	\$ 45,695	\$ 50,025
	<b>For the nine months ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Deferred revenue, beginning balance	\$ 52,169	\$ 44,040
Add: revenue deferred	85,880	93,699
Less: deferred revenue recognized	(92,354)	(87,714)
Deferred revenue, ending balance	\$ 45,695	\$ 50,025

**Cost of Revenue**

*Cost of services and other.* Cost of services and other consists of salaries and related expenses associated with services performed for customer support, installation, maintenance and consulting services. Cost of services and other for the three months ended September 30, 2006 was \$6.8 million, compared to \$7.3 million in the corresponding period in 2005. As a percentage of services and other revenue, cost of services was 32% and 37% for three months ended September 30, 2006 and 2005, respectively. The net \$0.5 million decrease was primarily attributable to reductions in salary related expenses and overhead expenses allocated to the service departments.

Cost of services and other for the nine months ended September 30, 2006 of \$21.5 million was \$0.3 million lower than the \$21.8 million in the corresponding period of 2005. As a percentage of services and other revenue, cost of services was 35% and 37% for the nine months ended September 30, 2006 and 2005, respectively. The \$0.3 million decrease was primarily due to reductions in salary related expenses and overhead

expenses allocated to the service departments.

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**Table of Contents**

*Cost of licenses.* Cost of licenses consists primarily of the cost of third-party software, royalties and amortization of capitalized software and acquired technology. A significant percentage of our total cost of revenue is attributable to the cost of third-party software royalties and licenses relating to software embedded within our software applications. Generally, third-party royalty fees fluctuate based on revenue, or the number of customers or licensed users, and therefore may fluctuate on a quarter to quarter basis. Cost of licenses for the three months ended September 30, 2006 was \$3.8 million, compared to \$3.4 million for the three months ended September 30, 2005. As a percentage of license revenue, cost of licenses remained constant at 34% for both the three months ended September 30, 2006 and 2005, respectively. The net increase of \$0.4 million was primarily attributable to increases in third party software royalties.

Cost of licenses for the nine months ended September 30, 2006 of \$11.5 million increased from \$9.9 million for the same period of 2005. As a percentage of license revenue, cost of licenses was 36% and 33% for the nine months ended September 30, 2006 and 2005, respectively. Costs of licenses increased \$1.6 million due to increases in third-party software royalties.

*Cost of hardware.* Cost of hardware consists of third-party hardware and installation costs, primarily related to Affinity contracts. Cost of hardware for the three months ended September 30, 2006 was \$0.3 million, compared to \$0.7 million for the three months ended September 30, 2005. As a percentage of hardware revenue, cost of hardware was 106% and 273% for the three month periods ended September 30, 2006 and 2005, respectively.

During the nine months ended September 30, 2006 cost of hardware was \$1.1 million, a decrease of \$1.1 million, compared to \$2.2 million for the same period last year. As a percentage of hardware revenue, cost of hardware was 99% and 106% for the nine months ended September 30, 2006 and 2005, respectively.

**Gross Margin**

Overall, gross margin was 67% and 62% for the three months ended September 30, 2006 and 2005. Gross margin on services and other revenue was 68% and 63% for the three months ended September 30, 2006 and 2005, respectively. Gross margin on license revenue remained constant at 66% for the three months ended September 30, 2006 and 2005. The gross margin on hardware revenue was negative for both of the three months ended September 30, 2006 and 2005.

Overall, gross margin increased from 63% for the nine months ended September 30, 2005 to 64% for the nine month period ended September 30, 2006. Gross margin on services and other revenue increased from 63% for the nine months ended September 30, 2005 to 65% for the nine months ended September 30, 2006. Gross margin on license revenue declined from 67% to 64% for the respective periods, due to increased third party royalties. The margin on hardware revenue was 1% in the nine months ended September 30, 2006 and was negative for the nine months ended September 30, 2005.

**Operating Expenses**

*General and administration.* General and administration expense consists of compensation and benefit costs for executive, finance, legal, information technology, and administrative personnel. General and administration expense decreased to \$4.4 million for the three months ended September 30, 2006, compared to \$8.3 million for the three months ended September 30, 2005. As a percentage of total revenue, general and administration expense was 13% and 28% for the three month periods ended September 30, 2006 and 2005, respectively. The overall \$3.9 million decrease is primarily attributable to cost savings associated with a reduction in personnel and related costs resulting from the first quarter 2006 reduction in force, decreases in consulting and professional fees, lower bad debt expense, lower severance expense, offset in part by increases in overhead costs allocated among departments. Most significantly, approximately \$3.0 million of executive severance expense was included in general and administrative expense for the 2005 quarter.

**Table of Contents**

For the nine months ended September 30, 2006, general and administration expense decreased to \$15.3 million compared to \$20.6 million during the same period in 2005. As a percentage of total revenue, general and administration expense was 16% and 23% for the nine months ended September 30, 2006 and 2005, respectively. The overall \$5.3 million decrease is primarily attributable cost savings associated with a reduction in personnel and related costs resulting from the first quarter 2006 reduction in force, decreases in accounting and professional fees, lower bad debt expense, lower severance expense, and decreases in overhead costs allocated among departments, all offset in part by approximately \$1.0 million of legal settlement expense recorded in the first quarter of 2006. Approximately \$3.0 million of executive severance expense was included in general and administrative expense for the third quarter of 2005.

*Software development.* Software development expense includes costs associated with the development of new products for which technological feasibility has not been achieved, enhancements of existing products, maintenance and quality assurance activities, and is primarily comprised of compensation and benefits costs. Software development costs during the three months ended September 30, 2006 were \$7.3 million compared to \$7.8 million during the three months ended September 30, 2005. As a percentage of total revenue, software development costs were 22% and 26% for the quarters ended September 30, 2006 and 2005, respectively. The net decrease of \$0.5 million was primarily attributable to decreases in consulting fees, severance costs, travel expenses and overhead costs allocated to software development departments. Salary and wage related expenses, net of severance expenses, increased 2% between quarters, primarily due to the inclusion of cost of employee stock options in the 2006 quarter.

Software development costs were \$23.3 million for both the nine months ended September 30, 2006 and 2005, respectively. This represents as a percentage of revenue 25% for both nine month periods ended September 30, 2006 and 2005. Salary and wages related expenses were relatively flat between the two nine month periods.

*Sales and marketing.* Sales and marketing expense includes costs associated with our sales and marketing personnel and consists primarily of compensation and benefits, commissions and bonuses, promotional and advertising expenses. Sales and marketing expense increased \$0.5 million for the three months ended September 30, 2006 to \$3.7 million from \$3.2 million for the three months ended September 30, 2005. As a percentage of total revenue, sales and marketing expenses were 11% and 10% for the period ended September 30, 2006 and 2005, respectively. The net increase was primarily attributable to commissions, the inclusion of the cost of employee stock options in 2006, and increases in marketing expenses related to our strategic planning initiatives.

Sales and marketing expense increased by \$0.1 million for the nine months ended September 30, 2006 to \$10.8 million, from \$10.7 million in the same period last year. As a percentage of total revenue, sales and marketing expenses remained constant at 12% for both the nine months ended September 30, 2006 and 2005. The \$0.1 million increase was primarily due to commissions, the inclusion of the cost of employee stock options in 2006, and increases in marketing expenses related to our strategic planning initiatives. These increases were partially offset by decreases in salaries and wages and severance.

**Other Income (Expense)**

*Other income (expense), net.* Net other income (expense) for the three months ended September 30, 2006 was \$0.5 million compared to \$(0.2) million in the corresponding period in 2005. The \$0.7 million increase was primarily due to increased interest income earned on investments offset by lower interest expense related to the dividend discount. The majority of interest expense for both periods related to non-cash charges. Net other income (expense) for the nine months ended September 30, 2006 and 2005 was \$1.0 million and \$(0.4) million, respectively. The \$1.4 million increase was primarily due to increased interest income earned on investments offset by lower non-cash interest expense related to the dividend discount.

**Table of Contents****Income Taxes**

*Income taxes.* Provision for income taxes for the three months ended September 30, 2006 and 2005 was \$101,000 and \$114,000, respectively, and \$262,000 and \$128,000 for the nine months ended September 30, 2006 and 2005, respectively. The net increase for the nine months ended September 30, 2006 was primarily the result of the accrual of deferred income tax expense related to the amortization of goodwill for tax purposes.

**Discontinued Operations of Financial Services Division**

Due to increasing operating losses in our Financial Services Division ( FSD ) and the lack of a qualified buyer for the business, we announced the shutdown of this division on December 15, 2004. The shutdown of this division was effective February 15, 2005. In the first quarter of 2005, we recorded an additional \$1.7 million loss from discontinued operations in connection with the closing of FSD in February 2005. This loss included, among other things, severance costs and a \$1.0 million charge related to the future lease obligations of the FSD's office in San Marcos, California. In September 2005, the Company recorded an additional charge of \$0.8 million related to the San Marcos, California lease, as a result of a change in sublease income assumptions.

The results of operations for Financial Services Division are presented as a discontinued operation in 2005. The Financial Services Division's operating results were as follows (in thousands):

	For the nine months ended	
	September 30,	
	2006	2005
Revenue	\$	\$ 223
Loss from operations		(772)
Exit cost of facility closing		(1,849)
Other		118
Total loss	\$	\$ (2,503)

**Liquidity and Capital Resources****Balance Sheet**

As of September 30, 2006, the Company had \$36.5 million in cash and cash equivalents compared to \$33.0 million as of December 31, 2005. Including investments, total available cash resources totaled \$41.9 million and \$34.4 million for the respective periods ended September 30, 2006 and December 31, 2005. As of September 30, 2006, our net working capital was \$6.7 million compared to \$(7.0) million as of December 31, 2005. The \$13.7 million change in working capital between measurement dates is primarily a result of a \$4.7 million reduction in other accrued liabilities, a \$3.9 million decrease in accrued dividends payable and a \$6.5 million decrease in deferred revenues; this is slightly offset by a \$1.0 million decrease in current assets. We have the option to pay the accelerated dividends, as discussed in Note 7 Series A Preferred Stock, in cash or common stock. The Company does not have any bank borrowings outstanding at September 30, 2006. Management believes the Company has sufficient liquidity to meet our short-term cash requirements.

Accounts receivable decreased by \$7.8 million to \$19.3 million as of September 30, 2006 from \$27.1 million as of December 31, 2005, on a net basis. Accounts receivable decreased mainly due to the strong collection efforts during 2006. Days sales outstanding were 57 at September 30, 2006 compared to 81 at December 31, 2005. As of September 30, 2006, the allowance for doubtful accounts decreased to \$3.8 million as compared to \$4.9 million at December 31, 2005. For the three and nine months ended September 30, 2006, bad debt expense was zero and \$0.8 million, respectively. The Company maintains an allowance for doubtful

**Table of Contents**

accounts to reflect the estimated non-collectible accounts receivable, based on past collection history and specific risks identified within the portfolio. If the financial condition of The Company's customers were to deteriorate resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowance might be required.

Unbilled and other receivables increased by \$1.0 million from December 31, 2005 to September 30, 2006 due to the timing of maintenance billings.

Short-term investments increased by \$4.2 million from December 31, 2005 to September 30, 2006 due to the implementation of an investment strategy with more emphasis on short-term opportunities.

Prepaid expenses and other current assets decreased by \$2.1 million from December 31, 2005 to September 30, 2006 due to the timing on year end rent payments and a decrease in deferred government royalties.

Accounts payable and accrued expenses decreased slightly by \$0.1 million to \$3.5 million at September 30, 2006 from \$3.6 million at December 31, 2005, principally due to the normal timing of payments to vendors and quarter-end customer related accruals.

Other accrued liabilities decreased by \$4.7 million from \$10.1 million at December 31, 2005 to \$5.4 million at September 30, 2006, primarily due to a reduction in accrued government royalties as a result of the timing and volume of contracts executed in December 2005, the settlement of the Medcath litigation in May 2006, the timing of tax payments and lower accrued commissions at September 30, 2006.

Deferred revenue decreased by \$6.5 million, from \$52.2 million at December 31, 2005, to \$45.7 million at September 30, 2006. The decrease was principally a result of revenue being recognized over the first nine months of 2006 related to term licenses, milestone activity, and collections from cash basis customers.

**Cash Flows**

The Company's consolidated statement of cash flows is summarized below (in thousands):

	<b>For the three months ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cash provided by operating activities	\$ 3,033	\$ 2,940
Cash provided by (used in) investing activities	(4,258)	3,257
Cash used in financing activities	(1,444)	(1,219)
Net increase (decrease) in cash and cash equivalents	(2,669)	4,978
	<b>For the nine months ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cash provided by operating activities	\$ 12,438	\$ 11,043
Cash provided by (used in) investing activities	(4,719)	3,883
Cash used in financing activities	(4,276)	(3,363)
Net increase in cash and cash equivalents	3,443	11,563

During the three months ended September 30, 2006, cash provided by operating activities was \$3.0 million compared to \$2.9 million provided by operating activities during the corresponding period in 2005. During the three month period ended September 30, 2006, the \$3.0 million of positive cash flow from operations was the result of \$8.2 million of net income after adding back non-cash items, a decrease in accounts receivable of \$3.5 million, a decrease of \$0.9 million in other current assets of \$4.4 million, offset by an \$8.9 million decrease in deferred revenues and a \$0.6 million decrease in other current liabilities. During the three months ended September 30, 2005, the \$2.9 million of cash flow provided by operating activities, resulted primarily from





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**Table of Contents**

\$1.9 million of net income after adding back non-cash items, a decrease in accounts receivable of \$4.4 million, an increase in prepaid expenses of \$1.4 million, a \$2.3 million decrease in deferred revenues, an increase in other current liabilities of \$3.4 million, and a payment to a former executive in the amount of \$3.1 million.

During the nine months ended September 30, 2006, \$12.4 million was provided by operating activities, compared to \$11.0 million provided by operating activities during the same period in 2005. During the nine month period ended September 30, 2006, the \$12.4 million of positive cash flow from operations was the result of \$16.0 million of net income after adding back non-cash items, a decrease in accounts receivable of \$6.9 million due to strong cash collections and a decrease in prepaid expenses of \$1.2 million primarily due to the year-end deferral of government royalty costs in 2005. These sources of cash from working capital are offset by a decrease in accounts payable and other accrued liabilities of \$5.2 million primarily related to payment of commissions, the settlement of the MedCath litigation, payment of accrued sales and use taxes, and royalty payments, and a \$6.5 million decrease in deferred revenues. During the nine months ended September 30, 2005, the \$11.0 million of positive cash flow from operations was primarily the result of \$8.4 million of net income after adding back non-cash items, an increase in accounts receivable of \$2.2 million, a decrease in other current assets of \$1.6 million, an increase of \$0.2 million in accounts payable and other liabilities, an increase in deferred revenue of \$6.1 million, and a payment to a former executive in the amount of \$3.1 million.

Cash used in investing activities was \$4.3 million for the three months ended September 30, 2006, principally due to capital expenditures of \$0.2 million and a net increase in short-term investments in the amount of \$4.1 million. For the three months ended September 30, 2005, investing activities provided cash of \$3.3 million, principally due to net proceeds from the sale of investments in the amount of \$0.5 million and the termination of a trust for the benefit of a former executive in the amount of \$3.1 million, offset by capital expenditures of \$0.3 million.

Cash used in investing activities of \$4.7 million during the nine months ended September 30, 2006 was primarily the result of capital expenditures of \$0.7 million, a \$0.1 million decrease in restricted cash and a net increase in short-term investments in the amount of \$4.1 million. For the nine months ended September 30, 2005, investing activities provided \$3.9 million, primarily due to a decrease in restricted cash of \$1.5 million, net proceeds from the sale of investments in the amount of \$0.3 million, termination of a trust for the benefit of a former executive in the amount of \$3.1 million, offset by capital expenditures of \$1.1 million.

Financing activities used cash of \$1.4 million for the three months ended September 30, 2006 principally due to the payment of \$1.6 million of dividends on the Company's Series A Preferred Stock, offset by \$0.2 million in proceeds from the issuance of common stock under the employee stock purchase plan and the exercise of stock options under employee stock option plans. For the three months ended September 30, 2005, financing activities used cash of \$1.2 million, principally due to the payment of \$1.5 million of dividends on the Company's Series A Preferred Stock, offset by \$0.2 million in proceeds from the issuance of common stock under the employee stock purchase plan and the exercise of stock options under employee stock option plans.

Financing activities used cash of \$4.3 million for the nine months ended September 30, 2006 primarily due to the payment of \$4.9 million for dividends on the Series A Preferred Stock, offset by \$0.6 million in proceeds from the issuance of common stock under the employee stock purchase plan and the exercise of stock options under employee stock option plans. For the nine months ended September 30, 2005, financing activities used cash of \$3.4 million primarily due to the payment of \$4.2 million for dividends on the Series A Preferred Stock, offset by \$0.8 million provided from the issuance of common stock under the employee stock purchase plan and issuance of common stock upon the exercise of employee stock options.

**Table of Contents****Commitments**

The following table summarizes financial data for our contractual obligations and other commercial commitments, including interest obligations, as of September 30, 2006 (in thousands):

	Total	Payments Due by Period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
<b>Contractual Obligations</b>					
Dividends payable (1)	\$ 5,181	\$ 5,181	\$	\$	\$
Accrued exit cost of facility closings (2)	4,246	1,809	2,437		
Operating leases (3)	14,609	3,376	8,984	2,249	
<b>Total contractual obligations</b>	<b>\$ 24,036</b>	<b>\$ 10,366</b>	<b>\$ 11,421</b>	<b>\$ 2,249</b>	<b>\$</b>
<b>Other Commercial Commitments</b>					
Standby letters of credit (4)	\$ 2,366	\$ 2,000	\$	\$	\$ 366
<b>Total commercial commitments</b>	<b>\$ 2,366</b>	<b>\$ 2,000</b>	<b>\$</b>	<b>\$</b>	<b>\$ 366</b>

- (1) The Series A Preferred Stockholders have an option to convert and receive, when declared by the Board, dividends equal to the total previously unpaid dividends payable from effective date of conversion through June 1, 2007 at a rate of \$1.375 per annum, discounted to present value at a rate of 5.5% per annum, payable in cash or common shares or any combination thereof at the option of the Company. Please see Note 7 of our notes to consolidated financial statements included herein.
- (2) We vacated and closed our San Rafael, California facility in 2004 as a result of the relocation of our corporate headquarters to Reston, Virginia. The Company estimated our liability for the future lease obligation due under the operating lease, offset by estimated sublease income, and recorded a liability for the exit cost related to facility closing. The Company has entered into a sublease for a portion of the vacant San Rafael, California facility commencing in August 2006. In 2005, the Company shutdown our Financial Services division ( FSD ) and vacated our facility in San Marcos, California. The Company estimated the liability for the future lease obligations due under the operating lease, offset by estimated sublease income, and recorded a liability for the exit costs related to the facility closing. The Company has also entered into a sublease for the San Marcos, California facility commencing in July 2006.
- (3) The San Marcos and San Rafael operating leases have been disclosed separately in this schedule under accrued exit cost of facility closings.
- (4) The less than 1 year amount of \$2.0 million includes a \$1.0 million letter of credit in favor of the State of New Jersey under its contract and a \$1.0 million letter of credit in favor of another customer under its contract. The remainder represents security deposits for leased facilities.

We believe that we will have sufficient liquidity and capital resources to fund our obligations through the next twelve months.

We expect that cash provided by or used in operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, specifically the timing of when we recognize revenue, our accounts receivable collections and the timing of other payments. In addition, cash used in investing activities may fluctuate due to our software development efforts, any acquisition or disposition we may undertake, and costs associated with our investments in fixed assets and information technology. For additional discussion, see *Business Risks* in *Part II, Item 1A. Risk Factors*.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures About Market Risk**

In addition to the market risks discussed herein, refer to our discussion of business risks in *Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations*, above.

**Interest Rate Risk**

Our exposure to market risk for changes in interest rates primarily relates to our investment portfolio. It is our intent to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We invest in high-quality issuers, including money market funds, corporate debt securities and debt securities issued by the U. S. government and U.S. governmental agencies. We have a policy of investing in securities with maturities of two years or less. We do not invest in derivative financial or foreign investments.

The table below presents fair values of principal amounts and weighted average interest rates for our investment portfolio as of September 30, 2006 (in thousands, except average interest rates):

	Aggregate	
	Fair Value	
<b>Total Cash and Cash equivalents (1):</b>		
Cash	\$ 14,393	
Money Market funds	22,092	
Total cash and cash equivalents (1)	\$ 36,485	
<b>Short-term investments:</b>		
Certificates of Deposit	\$ 2,000	
Corporate debt securities	1,494	
Debt issued by US government	691	
Total long-term investments	\$ 4,185	
<b>Long-term investments:</b>		
Corporate debt securities	\$	
Debt issued by US government	1,241	
Total long-term investments	\$ 1,241	
	Aggregate	Weighted Average
	Fair Value	Interest Rate
<b>Summary:</b>		
Cash	\$ 14,393	
Money Market funds	22,092	4.53%
Certificates of Deposit	2,000	4.99%
Corporate debt securities	1,494	5.31%
Debt issued by US government	1,932	5.10%
Total	\$ 41,911	

(1)

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Excluded from the fair value of the principal amounts of cash is \$ 2.3 million, which is restricted cash that is held in escrow for rental properties, and meeting customer performance expectations.

### **Performance of Equity Markets**

The performance of the equity markets can have an effect on our operations as certain of our variable life insurance policies have premiums invested in equity securities.

**Table of Contents**

**Foreign Currency Risk**

Our primary market risk exposure relates to changes in foreign currency exchange rates and potentially adverse effects of differing tax structures. Changes in foreign exchange rates did not materially impact our results of operations. For the three and nine months ended September 30, 2006, less than 2% of total revenue was denominated in currencies other than the U. S. dollar and less than 3% of our total direct and operating costs were incurred in foreign currencies.

***Item 4. Controls and Procedures***

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

We have established disclosure controls and procedures to ensure that material information relating to the Company is made known to the officers who certify the financial statements and to other members of senior management and the Audit Committee of the Board of Directors. As of September 30, 2006, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (the CEO) and the Chief Financial Officer (the CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based on their evaluation, the Company's CEO and CFO have concluded that the Company's disclosure controls and procedures were effective as of the date of such evaluation to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There were no changes in our internal control over financial reporting that occurred during the quarter or nine months ended September 30, 2006, that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**Table of Contents**

**PART II. OTHER INFORMATION**

***Item 1. Legal Proceedings***

As previously disclosed in our Quarterly Report on Form 10-Q for the three months ended June 30, 2006, filed with the SEC on August 9, 2006, the Company settled litigation with MedCath Incorporated ( MedCath ) on April 28, 2006. Pursuant to a Release and Settlement Agreement, the Company paid MedCath a settlement payment of \$2 million and the parties filed a Joint Stipulation of Dismissal, with prejudice, of this lawsuit on May 8, 2006.

***Item 1A. Risk Factors***

The Company believes there have been no material changes to risk factors previously disclosed in our Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission ( SEC ) on March 16, 2006, as amended by Amendment No. 1, filed with the SEC on August 17, 2006. You should carefully consider the following factors and other information set forth in this report, including our financial statements and the related notes. The risks set forth below are in addition to risks that apply to most businesses. Our business and future performance may be affected by the following:

**We Have Incurred Losses from Continuing Operations for the Past Five Years, Except 2001. Our Losses Have Adversely Affected Our Ability to Compete.**

We incurred losses from continuing operations of \$1.5 million, \$34.8 million, \$19.0 million and \$19.9 million for the years ended December 31, 2005, 2004, 2003 and 2002, respectively, and we had income from continuing operations of \$6.3 million in 2001. For the nine months ended September 30, 2006, we had income from continuing operations of \$8.0 million.

Our losses have impaired our ability to market our products and services in competition against companies that are more profitable. If we are unable to achieve or sustain profitability, it may impair our ability to compete effectively.

**Failure to Achieve and Maintain Effective Internal Controls Could Have a Material Adverse Effect on Our Business, Operating Results and Stock Price.**

We have documented and tested our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, which requires annual management assessments of the effectiveness of our internal control over financial reporting and a report by our independent auditors addressing these assessments. These reports were included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the SEC on March 16, 2006, as amended by Amendment No. 1, filed with the SEC on August 17, 2006. As indicated in that Annual Report and as previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the SEC on March 25, 2005, as amended by Amendment No. 1, filed with the SEC on April 29, 2005, and Amendment No. 2, filed with the SEC on January 4, 2006 and in the Company's Quarterly Reports on Form 10-Q, filed with the SEC on May 10, 2005 (as amended and filed on January 4, 2006), August 9, 2005 and November 9, 2005, our management identified control deficiencies and material weaknesses in internal control over financial reporting and in our disclosure controls and procedures as of December 31, 2004 and as of the end of each quarter in 2005 through September 30, 2005.

During 2005, the Company invested significant time and resources to remediate such material weaknesses, and as such, there were significant changes in our internal control over financial reporting during 2005 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting in a positive way. These changes were aimed at eliminating internal control deficiencies in both the Company's revenue and closing cycles. The significant changes that occurred in 2005 for the Company's internal control over financial reporting within its revenue cycle were as follows:

The Company established a revenue assurance group comprised of five professionals whose primary responsibilities include revenue plan verification and activation, contract review, revenue recognition and other revenue accounting activities;

## Table of Contents

The Company completed the process of converting its financial records from a legacy system called CDI to various modules of its principal financial software, PeopleSoft, which began during the fourth quarter of 2004 and was substantially completed during the second quarter of 2005; and

The Company began utilizing the PeopleSoft software as its single system to monitor, track, summarize and record revenue related activities.

The significant changes that occurred in 2005 related to the Company's closing cycle were as follows:

The Company hired a new Chief Financial Officer, Controller, Assistant Controller, and replacements for virtually all positions in its general accounting staff;

The Company increased the internal training and supervision of its accounting and finance personnel;

The Company improved processes, delineation of responsibilities and segregation of duties for its accounting and finance staff;

The Company significantly improved the general ledger account reconciliation and journal entry preparation and review processes; and

The Company established schedules for routine and timely monthly and quarterly close and reporting cycles.

As a result of these remediation efforts, our management believes that our internal control over financial reporting and disclosure controls and procedures are effective as of December 31, 2005 and September 30, 2006.

However, if we fail to achieve and maintain the adequacy of our internal control over financial reporting and disclosure controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002. Moreover, effective internal controls, particularly those related to revenue recognition, are important in helping ensure that we produce reliable financial reports and prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and operating results could be harmed, investors could lose confidence in our reported financial information and the trading price of our stock could drop significantly.

### **Additional Costs for Complying With Recent and Proposed Future Changes in SEC, American Stock Exchange and Accounting Rules Could Adversely Affect Our Profits.**

Recent and proposed future changes in SEC and American Stock Exchange rules, as well as changes in accounting rules, have caused us, and will continue to cause us, to incur additional costs including professional fees and added personnel costs, in order to keep informed of the changes and operate in a compliant manner. We incurred, and expect to continue to incur, additional general and administrative expenses in order to maintain compliance with Section 404 of the Sarbanes-Oxley Act of 2002, which requires management to report on, and our independent auditors to attest to, our internal controls (in future periods). These additional costs may be significant enough to cause our financial position and results of operation to be adversely affected. In addition, compliance with these rules could also result in continued diversion of management's time and attention, which could prove to be disruptive to our normal business operations. Failure to comply with any of the laws and regulations could adversely impact market perception of our Company, which could make it difficult to access the capital markets or otherwise finance our operations in the future.

### **Our Ability to Borrow or Issue Additional Shares of Preferred Stock Is Restricted by the Terms of Our Series A Preferred Stock.**

The Certificate of Designation governing our Series A Preferred Stock provides that so long as at least 600,000 shares of Series A Preferred Stock are outstanding, at least 66<sup>2</sup>/<sub>3</sub>% of the votes entitled to be cast by the





**Table of Contents**

holders of the Series A Preferred Stock shall be required to approve the incurrence by QuadraMed of any long-term senior indebtedness of QuadraMed in an aggregate principal amount exceeding \$8,000,000, excluding certain prior existing indebtedness. Furthermore, the Certificate of Designation requires the affirmative vote of a majority of any outstanding shares of the Series A Preferred Stock prior to the authorization or creation of, or increase in the authorized amount of, any shares of any class or series (or any security convertible into shares of any class or series) ranking senior to or on par with the Series A Preferred Stock in the distribution of assets upon any liquidation, dissolution or winding up of QuadraMed or in the payment of dividends. This may hinder or delay our ability to borrow funds or issue preferred stock.

**Our Quarterly Operating Results Are Subject to Fluctuations, which Could Adversely Affect Our Financial Results and the Market Price of Our Common Stock.**

Our quarterly operating results have varied significantly in the past and may fluctuate in the future as a result of a variety of factors, many of which are outside our control. Accordingly, quarter-to-quarter comparisons of our operating results may not be indicative of our future performance. Some of the factors causing these fluctuations include:

Variability in demand for products and services;

Introduction of product enhancements and new products by us and our competitors;

Timing and significance of announcements concerning present or prospective strategic alliances;

Discontinuation of, or reduction in, the products and services we offer;

Loss of customers due to consolidation in the healthcare industry;

Delays in product delivery requested by our customers;

Customer budget cycle fluctuation;

Investment in marketing, sales, software development and administrative personnel necessary to support anticipated operations;

Costs incurred for marketing and sales promotional activities;

Software defects and other product quality factors;

General economic conditions and their impact on the healthcare industry;

Cooperation from competitors on interfaces and implementation when a customer chooses a QuadraMed software application to use with various vendors;

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Delays in implementation due to product readiness, customer induced delays in training or installation and third-party interface development delays;

Final negotiated sales prices of systems;

Federal regulations (*i.e.*, OIG, HIPAA, ICD-10) that can increase demand for new, updated systems;

Federal regulations that directly affect reimbursements received, and therefore the amount of money available for purchasing information systems; and

The fines and penalties a healthcare provider or system may incur due to fraudulent billing practices.

In addition to the foregoing, a significant percentage of our total cost of revenue is attributable to the cost of third-party software royalties and licenses relating to third-party software embedded within our software applications. The cost of third-party software royalties and licenses, as a percentage of total cost of revenue, was approximately 21%, 20% and 13% for the years ended December 31, 2005, 2004, and 2003, respectively. For the

## **Table of Contents**

nine months ended September 30, 2006 and 2005, third-party software royalties and licenses, as a percentage of total cost of revenue, was 26% and 20%, respectively. Generally, royalty fees for third-party licenses will fluctuate based on revenue or the number of our customers and therefore will fluctuate on a quarter-to-quarter basis.

### **Our Operating Expenses are Fixed, and We May Not Be Able to Reduce Them to Offset a Potential Future Revenue Decrease.**

Our operating expense levels are relatively fixed. Accordingly, if future revenues are below expectations, we would experience a disproportionate adverse affect on our net income and financial results. In the event of a revenue shortfall, we will likely be unable to, or may elect not to, reduce spending quickly enough to offset any such shortfall. As a result, it is possible that our future revenues or operating results may fall below the expectations of securities analysts and investors. In such a case, the price of our publicly traded securities may be adversely affected.

### **We Could Experience a Significant Impact on Our Revenue if Our Customers Do Not Renew Maintenance Contracts.**

We derive a significant percentage of our revenue, including 45% of our total revenue for fiscal year 2005 and 2006 from maintenance services. We provide maintenance services under maintenance contracts to many of our customers in connection with our healthcare information technology products. In general, these maintenance contracts renew on an annual basis. If a significant portion of these maintenance contracts were not renewed, our maintenance revenues would decline which could have a material adverse effect on our total revenue for the period(s) in which the maintenance contracts were discontinued.

### **Future Sales of Our Common Stock in the Public Market, Warrants or Option Exercises and Sales Could Lower Our Stock Price.**

A substantial number of shares of our common stock are issuable upon the exercise of stock options and warrants and upon conversion of our Series A Preferred Stock. We cannot predict the effect, if any, that future sales of such shares of common stock, or the availability of shares of common stock for future sale, will have on the market price of our common stock. Sales of substantial amounts of common stock issued or issuable upon the exercise of stock options or warrants or upon the conversion of our Series A Preferred Stock, or the perception that such sales could occur, may adversely affect prevailing market prices for our common stock.

### **If Our Series A Preferred Stock is Converted into Common Stock, these Converting Stockholders Will Have Significant Voting Power, and They Will Have the Ability to Exert Substantial Influence Over Matters Requiring Stockholder Approval.**

Each share of our Series A Preferred Stock is convertible into 8.0645 shares of our common stock, and the Series A Preferred Stockholders may convert at any time. If all of our Series A Preferred Stock is converted into common stock, the shares issued upon this conversion will total approximately 43.3% of our outstanding common stock. In addition, many of our Series A Preferred Stockholders own common stock. Therefore, although these stockholders may not acquire majority control upon conversion of their Series A Preferred Stock, if these distinct stockholders were to act together, they will have the ability to exert substantial influence over all matters requiring approval of our stockholders, including the election and removal of directors, the approval of mergers or other business combinations, and other significant corporate actions. This ability to influence our affairs might be disadvantageous to our other stockholders.

### **Recently Adopted Financial Accounting Standards, Which Require the Expensing of All Share-Based Payments to Employees, May Materially and Adversely Affect our Results of Operations.**

In December 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment, which requires all share-based payments to

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**Table of Contents**

employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values. In April 2005, the SEC extended the effective date of SFAS No. 123(R) requiring compliance by public companies for annual, rather than interim, periods that begin after June 15, 2005. Under SFAS No. 123(R), pro forma disclosure is no longer an alternative. As permitted by the former FASB statement, SFAS No. 123, the Company had accounted for share-based payments to employees using the intrinsic value method under Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and as such, has generally recognized no compensation cost for employee stock options.

Accordingly, we have adopted SFAS No. 123(R) s fair value method of accounting for share-based payments, effective January 1, 2006. The full impact of this statement will be dependent on future grants as well as existing grants of employee stock options and restricted stock. We believe that the impact on the Company s results of operations may be significant, as we will be required to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. If the Company reduced its share-based payments to existing and new employees in order to avoid the negative impact on operating results, it could impair the Company s ability to attract and retain quality personnel, which could weaken the Company s competitive position in the marketplace.

**The Trading Price of Our Common Stock Has Been, and Is Expected to Continue to Be, Volatile.**

The American Stock Exchange and stock markets in general, have historically experienced extreme price and volume fluctuations that have affected companies unrelated to their individual operating performance. The trading price of our common stock has been and is likely to continue to be volatile due to such factors as:

Variations in quarterly results of operations;

Announcements of new products or acquisitions by our competitors;

Government regulatory action;

Resolution of pending or unasserted litigation;

Developments or disputes with respect to proprietary rights; and

General trends in our industry and overall market conditions.

Movements in prices of equity securities in general may also affect the market price of our common stock.

**Provisions in Our Certificate of Incorporation and Bylaws and Delaware Law Could Delay or Discourage a Takeover and Could Adversely Affect the Price of Our Common Stock.**

Our Board of Directors has the authority to issue an additional one million shares of preferred stock over and above the four million shares already issued, and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by holders of our common stock. If additional preferred stock is issued, the voting and other rights of the holders of our common stock may be subject to, and may be adversely affected by, the rights of the holders of our preferred stock. The issuance of preferred stock may have the effect of delaying or preventing a change of control of the Company that could have been at a premium price to our stockholders. Our Board of Directors has issued four million shares of such preferred stock as Series A Preferred Stock and the holders of the Series A Preferred Stock have certain voting and board appointment rights.

Certain provisions of our Certificate of Incorporation and Bylaws could discourage potential takeover attempts and make stockholders attempts to change management difficult. Our Board of Directors has the authority to impose various procedural and other requirements that could make it more difficult for our stockholders to effect certain corporate actions. In addition, our Certificate of Incorporation provides that directors may

be removed only by the affirmative vote of the holders of two-thirds of the shares of our capital

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## **Table of Contents**

stock entitled to vote. Any vacancy on our Board of Directors may be filled only by a vote of the majority of directors then in office. Further, our Certificate of Incorporation provides that the affirmative vote of two-thirds of the shares entitled to vote, voting together as a single class, subject to certain exceptions, is required for certain business combination transactions. These provisions, and certain other provisions of our Certificate of Incorporation, could have the effect of delaying or preventing (i) a tender offer for our common stock or other changes of control of the Company that could be at a premium price or (ii) changes in our management.

In addition, certain provisions of Delaware law could have the effect of delaying or preventing a change of control of the Company. Section 203 of the Delaware General Corporation Law, for example, prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years from the date the person became an interested stockholder unless certain conditions are met.

### **We Do Not Expect to Pay Cash Dividends on Common Stock in the Foreseeable Future.**

We have not declared or paid cash or other dividends on our common stock and do not expect to pay cash dividends for the foreseeable future. Our ability to pay dividends is also restricted by the terms of our Series A Preferred Stock which require us to pay full cumulative dividends on the Series A Preferred Stock before making any dividend payment on our common stock. Generally, the Series A Preferred Stock is entitled to quarterly dividends of \$0.34375 (5.5% per annum) per share. However, as provided in the Certificate of Designation relating to the Series A Preferred Stock, because a registration statement for the Series A Preferred Stock was not declared effective by the SEC on or before June 15, 2005, the dividend rate for such stock increased to \$0.40625 per quarter (6.5% per annum) commencing on June 16, 2005, and such rate will apply until the date such registration statement is declared effective. Upon conversion of the Series A Preferred Stock into shares of common stock, the Series A Preferred stockholders have the right to receive, when declared by our Board of Directors, dividends equal to the total previously unpaid dividends payable from the effective date of conversion through June 1, 2007 at a rate of \$1.375 per share per annum or 5.5% per annum, discounted to present value at a rate of 5.5% per annum, payable in cash or common shares, or any combination thereof at our option. We currently intend to retain all future earnings for use in the operation of our business and to fund future growth. Any future cash dividends will depend upon our results of operations, financial conditions, cash requirements, the availability of a surplus and other factors.

### **We May Be Liable for Violating the Intellectual Property Rights of Third Parties, which Could Lead Us to Incur Substantial Litigation Expenses, and, If There Were an Adverse Judgment, Liability for Any Infringement.**

We do not believe that the intellectual property important to the operation of our business, whether owned by us or licensed to us by a third party, infringes or violates the intellectual property rights of any other party. However, intellectual property litigation is increasingly common in the software industry. The risk of an infringement claim against us may increase over time as the number of competitors in our industry segment grows and the functionality of products overlaps. Third parties have, in the past, asserted infringement claims and could assert infringement claims against us in the future. Regardless of the merits, we could incur substantial litigation expenses in defending any such asserted claim. In the event of an unfavorable ruling on any such claim, a license or similar agreement may not be available to us on reasonable terms, if at all. Infringement may also result in significant monetary liabilities that could have a material adverse effect on our business, financial condition and results of operations. We may not be successful in the defense of these or similar claims. We have taken steps to contractually limit our liability for the use of intellectual property licensed to us by third parties. However, there can be no guarantee that we have adequate protection.

### **Our Inability to Protect Our Intellectual Property Could Lead to Unauthorized Use of Our Products, which Could Have an Adverse Effect on Our Business.**

We rely on a combination of trade secret, copyright and trademark laws, nondisclosure, non-compete and other contractual provisions to protect our proprietary rights. In 2001, we filed our first patent application

## **Table of Contents**

covering our developed technology, the Affinity CPOE software application. This application lapsed, and we have no patents. Measures taken by us to protect our intellectual property may not be adequate, and our competitors could independently develop products and services that are substantially equivalent or superior to our products and services. Any infringement or misappropriation of our proprietary software and databases could put us at a competitive disadvantage in a highly competitive market and could cause us to lose revenues, incur substantial litigation expense and divert management's attention from other operations.

### **We are Dependent Upon Third-Party Software Licenses in Connection with the Sale of Our Software. If These Licenses Are Not Renewed or Are Terminated, We May Not Be Able to Continue to Use the Related Technology on Commercially Reasonable Terms or at All.**

We depend on licenses from a number of third-party vendors for certain technology, including the computer hardware, operating systems, database management systems, programming language and runtime environment, upon which we develop and operate our products. We are materially reliant upon licenses with the following third-party vendors: InterSystems Corporation, Document Storage Systems, Inc., Megas Corporation, Unicor Medical, Oracle, Microsoft, Quovadx, the American Medical Association and the American Hospital Association. Most of these licenses expire within three to five years. Such licenses can be renewed only by mutual consent and may be terminated if we breach the license terms and fail to cure the breach within a specified time period. If such licenses are terminated, we may not be able to continue using the technology on commercially reasonable terms or at all. As a result, we may have to discontinue, delay or reduce product shipments until equivalent technology is obtained, which could have a material adverse effect on our business, financial condition and results of operations. However, as all application software companies, including QuadraMed and our competitors, are reliant on licensed technology and third-party components, we believe our reliance on such technology and licenses places us at no competitive disadvantage.

At present, there is no equivalent technology for the InterSystems Corporation technology which is an integral component of our Affinity product line. The Company has entered into several agreements with InterSystems Corporation regarding the licensed technology relating to our Affinity product line. However, if InterSystems Corporation ceased to offer this technology and no other vendor provided the technology, we would be required to migrate our Affinity products to a new database platform or redesign our products to work with new software tools. This could be very costly and difficult to achieve and could have a material adverse effect on our business, financial condition and results of operations. There can be no assurance that we would successfully migrate our Affinity products to a new platform.

Most of our third-party licenses are non-exclusive and competitors may obtain the same or similar technology. In addition, if vendors choose to discontinue support of the licensed technology, we may not be able to modify or adapt our products.

### **We Face Product Development Risks Associated with Rapid Technological Changes.**

The healthcare software market is highly fragmented and characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements. Our success depends on our ability to timely and effectively:

Offer a broad range of software products;

Enhance existing products and expand product offerings;

Respond promptly to new customer requirements and industry standards;

Remain compatible with popular operating systems and develop products that are compatible with new or otherwise emerging operating systems; and

Develop new interfaces with competing healthcare information system vendors to fully integrate our Quantim product suite in order to maximize features and functionality of the new products.





## **Table of Contents**

Our performance depends in large part upon our ability to provide the increasing functionality required by our customers through the timely development and successful introduction of new products and enhancements to our existing suite of products. We may not successfully, or in a timely manner, develop, acquire, integrate, introduce or market new products or product enhancements. Product enhancements or new products developed by us also may not meet the requirements of hospitals or other healthcare providers and payers or achieve or sustain market acceptance. Our failure to either estimate accurately the resources and related expenses required for a project, or to complete our contractual obligations in a manner consistent with the project plan upon which a contract was based, could have a material adverse effect on our business, financial condition and results of operations. In addition, our failure to meet a customer's expectations in the performance of our services could damage our reputation and adversely affect our ability to attract new business.

### **A Significant Amount of Our Assets Comprise Goodwill, Customer Lists and Other Intangible Items Subject to Impairment and Adjustment That Could Possibly Negatively Impact Our Results of Operations and Stockholders' Equity.**

A significant amount of our assets comprise intangible assets, such as the value of the installed customer base, core technology, capitalized software, goodwill and other identifiable intangible assets acquired through our acquisitions, such as trademarks.

Pursuant to SFAS No. 142, Goodwill and Other Intangible Assets, we must test goodwill and other intangible assets for impairment at least annually and adjust them when impaired to the appropriate net realizable value. We performed an impairment test on the carrying value of our goodwill and other intangibles as of January 1, 2006 and 2005. We determined that there was no impairment as of these dates. In addition, our internally developed software has been capitalized assuming our earnings from these product developments exceed the costs incurred to develop them. If it is determined that these assets have been impaired and our future operating results will not support the existing carrying value of our intangible assets, we will be required to adjust the carrying value of such assets to net realizable value.

We, however, cannot predict that all of our intangible assets will continue to remain unimpaired. Our future operating results and stockholders' equity could possibly decrease with any future impairment and write-down of goodwill, customer lists or other such intangibles.

### **The Nature of Our Products Makes Us Particularly Vulnerable to Undetected Errors or Bugs that Could Reduce Revenues, Market Share or Demand for Our Products and Services.**

Products such as those we offer may contain errors or failures, especially when initially introduced or when new versions are released. Although we conduct extensive testing on our products, software errors have been discovered in certain enhancements and products after their introduction. Despite such testing by us and by our current and potential customers, products under development, enhancements or shipped products may contain errors or performance failures, resulting in, among other things:

Loss of customers and revenue;

Delay in market acceptance;

Diversion of resources;

Damage to our reputation; or

Increased service and warranty costs.

Any of these consequences could have a material adverse effect on our business, financial condition and results of operations.

## **Table of Contents**

### **If Our Products Fail to Accurately Assess, Process or Collect Healthcare Claims or Administer Managed Care Contracts, We Could Be Subject to Costly Litigation and Be Forced to Make Costly Changes to Our Products.**

Some of our products and services are used in the payment, collection, coding and billing of healthcare claims and the administration of managed care contracts. If our employees or products fail to accurately assess, process or collect these claims, customers could file claims against us. Our insurance coverage may not be adequate to cover such claims. A successful claim that is in excess of, or is not covered by, insurance coverage could adversely affect our business, financial condition and results of operations. Even a claim without merit could result in significant legal defense costs and could consume management time and resources. In addition, claims could increase our premiums such that appropriate insurance could not be found at commercially reasonable rates. Furthermore, if we were found liable, we may have to significantly alter one or more of our products, possibly resulting in additional unanticipated software development expenses.

### **Changes in Procurement Practices of Hospitals Have and May Continue to Have a Negative Impact on Our Revenues.**

A substantial portion of our revenues has been and is expected to continue to be derived from sales of software products and services to hospitals. Hospitals are slow to make changes and generally favor their existing vendor when considering an upgrade in their systems. Consolidation in the healthcare industry, particularly in the hospital and managed care markets, could decrease the number of existing or potential purchasers of products and services and could adversely affect our business. In addition, the decision to purchase our products often involves a committee approval. Consequently, it is difficult for us to predict the timing or outcome of the buying decisions of our customers or potential customers. In addition, many healthcare providers are consolidating to create integrated delivery networks with greater regional market power. These emerging systems could have greater bargaining power, which may lead to decreases in prices for our products, which could adversely affect our business, financial condition and results of operations.

### **The Department of Veterans Affairs Has Awarded a Contract to Us. It is Unknown Whether Our Overall Revenues Will Increase or Not Related to This Award.**

The Department of Veterans Affairs ( VA ) has awarded contract VA Blanket Purchase Agreement No. 101-049AH-005 (the BPA ) to the Company, as disclosed in the Company's press release dated April 27, 2005. The BPA is a five year single source contract covering approximately 128 VA facilities. Under the BPA, these VA facilities are to be contracted to use our products and services. Previously, both we and other vendors provided healthcare information management ( HIM ) software to these VA facilities. For the fiscal year ended December 31, 2005 we recorded \$12.1 million in revenue; for the three and nine month periods ended September 30, 2006 we recorded approximately \$3.8 million and \$11.7 million, respectively, from providing VA facilities with software. As of December 31, 2005 and September 30, 2006 our HIM software constitutes approximately 90% of the products and services we provide to these facilities. The BPA contains additional HIM software discounts, but it increases the number of VA facilities using our products, so the overall financial impact of the BPA cannot be known. Previously, the VA has directed the individual facilities to order their requirements for this HIM software under the BPA, and each VA facility orders the HIM software individually; however, for the period October 1, 2006 through September 30, 2007, the VA has issued a single purchase order for the HIM software covering all of the VA facilities. This single purchase order also ordered the QuadraMed software upgrade product known as VIP , thus increasing overall revenue under the order compared to the orders for the previous government ordering period. There can be no assurances that the VA will order its QuadraMed HIM software under a single order for the period after September 30, 2007, nor is it assured that any future upgrade sales such as the VIP upgrade sale will be made.

## **Table of Contents**

### **Changes in the Healthcare Financing and Reimbursement System Could Adversely Affect the Amount of and Manner in which Our Customers Purchase Our Products And Services.**

Changes in current healthcare financing and reimbursement systems (e.g., Medicaid) could result in unplanned product enhancements, delays or cancellations of product orders or shipments, or reduce the need for certain systems. We could also have the endorsement of products by hospital associations or other customers revoked. Any of these occurrences could have a material adverse effect on our business. Alternatively, the federal government recently mandated that all but small healthcare providers submit claims to Medicare in electronic format, which may positively affect sales of our systems and products.

### **Healthcare Regulations and Reform Proposals Could Adversely Affect Demand for Our Products.**

The healthcare industry in the United States is subject to changing political, economic and regulatory influences that may affect the procurement practices and operations of healthcare organizations. The traditional hospital delivery system is evolving as more hospital services are being provided by niche, free standing practices and outpatient providers. The commercial value and appeal of our products may be adversely affected if the current healthcare financing and reimbursement systems were to change. During the past several years, the healthcare industry has been subject to increasing levels of governmental regulation. Proposals to reform the healthcare system have been and are being considered by the United States Congress. These proposals, if enacted, could adversely affect the commercial value and appeal of our products or change the operating environment of our customers in ways that cannot be predicted. Healthcare organizations may react to these proposals by curtailing or deferring investments, including those for our products and services. In addition, the regulations promulgated under the Health Insurance Portability and Accountability Act of 1996 ( HIPAA ) could lead healthcare organizations to curtail or defer investments in non-HIPAA related features in the next several years.

### **The Variability and Length of Our Sales Cycle for Our Products May Exacerbate the Unpredictability and Volatility of Our Operating Results.**

We cannot accurately forecast the timing of customer purchases due to the complex procurement decision processes of most healthcare providers and payers. How and when to implement, replace, expand or substantially modify an information system are major decisions for hospitals, and such decisions require these entities to make significant capital expenditures. As a result, we typically experience sales cycles that extend over several quarters. In particular, our Affinity software has a higher average selling price and longer sales cycle than many of our other products. As a result, we have only a limited ability to forecast the timing and size of specific sales, making the prediction of quarterly financial performance more difficult.

### **We Operate in a Highly Competitive Market.**

Competition for our products and services is intense and is expected to increase. Increased competition could result in reductions in our prices, gross margins and market share and have a material adverse effect on our business, financial condition and results of operations. We compete with other providers of healthcare information software and services, as well as healthcare consulting firms. Some competitors have formed business alliances with other competitors that may affect our ability to work with some potential customers. In addition, if some of our competitors merge, a stronger competitor may emerge. Some principal competitors include:

In the market for healthcare information systems: McKesson Corporation, Inc., Siemens Health Services, a division of Siemens Medical Solutions of Siemens AG, MediTech Corporation, Eclipsys Corporation and Cerner;

In the market for electronic document management products: McKesson Corporation, SoftMed Corporation Inc., FileNet, Streamlined Health, MedPlus and Eclipsys Corporation;

In the market for MPI products and services: Initiate Systems, Inc., McKesson Corporation, Siemens Health Services, a division of Siemens Medical Solutions of Siemens AG, and Medibase;

## **Table of Contents**

In the market for decision support products: Eclipsys Corporation, Healthcare Microsystems, Inc., a division of Health Management Systems Inc., McKesson Corporation, Siemens Health Services, a division of Siemens Medical Solutions of Siemens AG, and MediQual Systems, Inc., a division of Cardinal Health, Inc.; and

In the market for coding, compliance, data, and record management products in the Health Information Management Software Division: 3M Corporation, SoftMed Corporation, Inc., MetaHealth, Eclipsys Corporation and HSS, Inc., an Ingenix Corporation. Prospective customers may evaluate our products' capabilities against the merits of their existing information systems and expertise and decide to stay with their incumbent vendor due to the cost associated with conversion. In addition, existing and prospective customers may be reluctant to buy from us because of the losses we have incurred in recent years.

Many of our current and potential competitors have significantly greater financial, technical, product development, marketing and other resources, and market recognition than we have. These competitors may be in a position to devote greater resources to the development, promotion and sale of their products than we can. Our competitors also have, or may develop or acquire, substantial installed customer bases in the healthcare industry. As a result of these factors, our competitors may be able to respond more quickly to new or emerging technologies, changes in customer requirements and changes in the political, economic or regulatory environment in the healthcare industry.

As a result of the current emphasis on patient safety, the selection of a new hospital information system is frequently based on the strength of the vendor's clinical application and many of our competitors have invested considerably more in clinical development than we have.

Major software information systems companies, including those specializing in the healthcare industry, that do not presently offer competing products may enter our markets.

We may not be able to compete successfully against current and future competitors, and such competitive pressures could materially adversely affect our business, financial condition and operating results.

### **We Have Encountered Significant Challenges Integrating Acquired Businesses, and Future Transactions May Adversely Affect Our Business, Operations and Financial Condition.**

Throughout our history, we have made many acquisitions and have encountered significant challenges integrating the acquired businesses into our operations. In recent years, we have made significant progress toward that integration. However, we continue to support several different technology platforms. In the future, we plan to make investments in or acquire additional complementary businesses, products, services or technologies. These investments and acquisitions will create new integration challenges. Some of the challenges we have encountered, and may encounter with acquisitions in the future, in integrating acquired businesses include:

Interruption, disruption or delay of our ongoing business;

Distraction of management's attention from other matters;

Additional operational and administrative expenses;

Difficulty managing geographically dispersed operations;

Failure of acquired businesses to achieve expected results, resulting in our failure to realize anticipated benefits;

## Table of Contents

Write-down or reclassification of acquired assets;

Failure to retain key acquired personnel and difficulty and expense of training those retained;

Increases in compensation and stock compensation expenses resulting from newly hired employees;

Assumption of liabilities and potential for disputes with the sellers of acquired businesses;

Customer dissatisfaction or performance problems related to acquired businesses;

Failure to maintain good relations with customers or suppliers;

Exposure to the risks of entering markets in which we have no prior direct experience and to risks associated with market acceptance of acquired products and technologies; and

Platform and technical issues related to integrating systems from various acquired companies.

All of these factors have had an adverse effect on our business, financial condition and results of operations in the past, and could have an adverse effect in the future.

### **No Mirror Processing Site for Our Customer Data Processing Facilities Exists; Our Business, Financial Condition, and Results of Operations Could Be Adversely Affected if These Facilities Were Subject to a Closure from a Catastrophic Event or Otherwise.**

We currently process substantially all of our customer data at several of our facilities across the United States. Although we back up our data nightly and have safeguards for emergencies, such as power interruption or breakdown in temperature controls, we have no mirror processing site to which processing could be transferred in the case of a catastrophic event at any of these facilities. If a major catastrophic event occurs at these facilities possibly leading to an interruption of data processing, or any other interruption or closure, our business, financial condition and results of operations could be adversely affected.

### **We May Be Required to Make Substantial Changes to Our Products if They Become Subject to FDA Regulation, which Could Require a Significant Capital Investment.**

Computer products used or intended for use in the diagnosis, cure, mitigation, treatment or prevention of diseases or other conditions or that affect the structure or function of the body are subject to regulation by the U.S. Food and Drug Administration ( FDA ) under the Federal Food, Drug and Cosmetic Act. At present, none of our software products are so regulated. In the future, the FDA could determine that some of our products, because of their predictive aspects, are clinical decision tools and subject them to regulation. Compliance with FDA regulations could be burdensome, time consuming and expensive. Other new laws and regulations affecting healthcare software development and marketing also could be enacted in the future. If so, it is possible that our costs and the length of time for product development and marketing could increase and that other unforeseeable consequences could arise.

### **Governmental Regulation of the Confidentiality of Patient Health Information Could Result in Our Customers Being Unable to Use Our Products Without Significant Modification, which Could Require Significant Capital Expenditures.**

There is substantial state and federal regulation of the confidentiality of patient health information and the circumstances under which such information may be used by, disclosed to, or processed by us as a consequence of our contacts with various health plans and healthcare providers. Although compliance with these laws and regulations is presently the principal responsibility of the health plan, hospital, physician or other healthcare provider, regulations governing patient confidentiality rights are dynamic and rapidly evolving. As such, laws and regulations could be modified so that they could directly apply to us. Also, changes to the laws and regulations that would require us to change our systems

and our methods may be made in the future, which could

**Table of Contents**

require significant expenditure of capital and decrease future business prospects. Also, additional federal and state legislation governing the dissemination of patient health information may be proposed and adopted, which may also significantly affect our business. Finally, certain existing laws and regulations require healthcare entities to contractually pass on their obligations to other entities with which they do business; as such, we are indirectly impacted by various additional laws and regulations.

HIPAA is a federal law that affects the use, disclosure, transmission and storage of individually identifiable health information referred to as protected health information. As directed by HIPAA, the United States Department of Health and Human Services ( DHHS ) must promulgate standards or rules for certain electronic health transactions, code sets, data security, unique identification numbers and privacy of protected health information. DHHS has issued some of these rules in final form, while others remain in development. In general, under these rules, we function as a business associate to some of our customers (who are considered to be covered entities under HIPAA). The three rules relevant to us and our customers the Transactions Rule, the Privacy Rule and the Security Rule are discussed below. It is important to note that DHHS could, at any time in the future, modify any existing final rule in a manner that could require us to change our systems or operations. First, DHHS has published a final HIPAA rule governing transactions and code set standards ( Transactions Rule ). The Transactions Rule had a compliance date of October 16, 2003. To the extent necessary to help our covered entity customers conduct transactions, we believe that our current products and services meet the requirements of the Transactions Rule. Nevertheless, as noted above, DHHS may make further revisions to the Transactions Rule, which could require us to change our products and systems to enable our covered entity customers to meet such obligations.

Second, DHHS has published a final HIPAA privacy rule ( Privacy Rule ) which had a compliance date of April 14, 2003. The Privacy Rule is complex and far reaching. Similar to the Transactions Rule, as noted above, the Privacy Rule directly applies to covered entities. Also, covered entities are, in most instances, required to execute a contract with any business associate that performs certain services on the covered entity's behalf involving the exchange or creation of protected health information. Our hospital and health plan customers are covered entities, and to the extent that we are required by our customer contracts to ensure that we comply with various aspects of the Privacy Rule, we believe that we meet the requirements of the Privacy Rule. The Privacy Rule and other similar state healthcare privacy regulations could materially restrict the ability of healthcare providers and health plans to disclose protected health information from patient records using our products and services, or it could require us to make additional capital expenditures to be in compliance. Accordingly, the Privacy Rule and state privacy laws may significantly impact our products' use in the healthcare delivery system and, therefore, decrease our revenues, increase working capital requirements and decrease future business prospects.

Third, DHHS has published the final HIPAA security rule ( Security Rule ) with a compliance date of April 20, 2005. The Security Rule applies to the use, disclosure, transmission, storage and destruction of electronic protected health information by covered entities. The Security Rule requires that covered entities must implement administrative, technical and physical security measures to safeguard electronic protected health information. Also, as with the Privacy Rule, under the Security Rule, covered entities are required to contractually bind their business associates to certain aspects of the Security Rule. As such, where we function as a business associate to a customer that is a covered entity, we are required to enter into a business associate contract with that customer. Implementing such measures may require us to expend substantial capital due to required product, service and procedure changes.

We have completed modifications to our business practices and software offerings so that we are able to assist our customers in complying with the Transactions Rule, Privacy Rule and Security Rule. However, DHHS continues to publish change notices to the existing rules and propose new rules. There is no certainty that we will be able to respond to all such rules in a timely manner and our inability to do so could adversely affect our business.

**Table of Contents**

**Government Regulation to Adopt and Implement ICD-10-CM and ICD-10-PCS Medical Code Set Standards Could Require Substantial Modification of our Coding and Compliance Software.**

The American Health Information Management Association and other prominent healthcare industry advocacy groups are calling on DHHS and the healthcare industry to take action to adopt and implement ICD-10-CM and ICD-10-PCS code sets, rules and guidelines as a replacement for current ICD-9-CM guidelines used in our software products. Adoption of these new code sets would require us to change our systems and our methods which could require a significant expenditure of software development capital and decrease future business prospects for our current product line.

***Item 6. Exhibits***

The exhibits listed on the accompanying Exhibit Index are filed as part of this Quarterly Report on Form 10-Q.



**Table of Contents**

**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.

QUADRAMED CORPORATION

Date: November 13, 2006

By: /s/ KEITH B. HAGEN  
**Keith B. Hagen**

**Chief Executive Officer**

Date: November 13, 2006

By: /s/ DAVID L. PIAZZA  
**David L. Piazza**

**Chief Financial Officer**

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
31.1**	Certification of the Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2**	Certification of the Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.

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\*\* Filed herewith