QUADRAMED CORP
Form 10-Q
September 19, 2003

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
[X] Quarterly Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934

FOR THE QUARTERLY PERIOD ENDED March 31, 2003

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: 0-21031

QUADRAMED CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	52-1992861
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
12110 SUNSET HILLS ROAD, SUITE 600, RESTON, VIRGINIA	20190
(Address of Principal Executive Offices)	(Zip Code)

(703) 709-2300
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: NONE

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $0.01 Par Value Per Share

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 X

Indicate by check mark whether the registrant is an accelerated filer as defined in Rule 12b-2 of the Act. Yes X No _

As of August 31, 2003, there were 27,606,069 shares of the Registrant's common stock outstanding, par value $0.01.

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QUADRAMED CORPORATION
REPORT ON FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2003
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

QUADRAMED CORPORATION
INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)
(unaudited)

ASSETS	March 31, 2003	December 31, 2002
Current assets		
Cash and cash equivalents	$ 20,937	$ 23,663
Short-term investments	2,528	2,528
Accounts receivable, net of allowance for doubtful accounts of $4,585 and $4,346, respectively	39,071	31,612
Unbilled receivables	3,581	3,475
Notes and other receivables	110	4,416
Prepaid expenses and other current assets	9,474	8,972
Total current assets	75,701	74,666
Restricted cash	5,849	5,849
Property and equipment, net of accumulated depreciation and amortization of $17,115 and $16,170 respectively	5,553	6,019
Capitalized software development costs, net of accumulated amortization of $8,454 and $7,776, respectively	5,125	5,670
Goodwill	18,445	18,445
Other intangible assets, net of accumulated amortization of $13,901 and $13,316, respectively	8,690	9,275
Other long-term assets	6,887	7,003
Total assets	$ 126,250	$ 126,927
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable and accrued expenses	$ 2,776	$ 3,586
Accrued payroll and related	5,649	6,942
Other accrued liabilities	8,895	6,509
Deferred revenue	48,704	39,492
Total current liabilities	66,024	56,529
Convertible subordinated debentures	73,719	73,719
Other long-term liabilities	4,100	3,914
Total liabilities	143,843	134,162
Stockholders' equity (deficit)		
Preferred stock, $0.01 par, 5,000 shares authorized, zero shares issued and outstanding	--	--
Common stock, $0.01 par, 50,000 shares authorized, 27,044 and 26,965 shares issued and outstanding, respectively	272	205
Additional paid-in-capital	275,668	275,631
Deferred compensation	(422)	(588)
Accumulated other comprehensive loss	(260)	(310)
Accumulated deficit	(292,851)	(282,173)
Total stockholders' equity (deficit)	(17,593)	(7,235)
Total liabilities and stockholders' equity (deficit)	$ 126,250	$ 126,927

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

QUADRAMED CORPORATION
INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three months ended March 31,	
	2003	2002
Revenue		
Services and other	$ 19,679	$ 19,000
Licenses	9,555	8,180
Total revenue	29,234	27,180
Cost of revenue		
Cost of services and other	11,700	7,727
Cost of licenses	1,882	2,133
Total cost of revenue	13,582	9,860
Gross margin	15,652	17,320
Operating expenses		
General and administration	13,531	7,823
Sales and marketing	5,761	5,175
Research and development	5,477	3,653
Amortization and other operating charges	585	512
Total operating expenses	25,354	17,163
Income (loss) from operations	(9,702)	157
Other income (expense)		
Interest expense	(1,063)	(865)
Interest income	157	174
Other income (expense), net	(70)	(90)
Other income (expense)	(976)	(781)
Loss from continuing operations	(10,678)	(624)
Loss from discontinued operations	--	(704)
Net loss	$ (10,678)	$ (1,328)

Loss per share		
Basic and Diluted		
Continuing operations	$ (0.40)	$ (0.02)
Discontinued operations	--	(0.03)
Net	$ (0.40)	$ (0.05)
Weighted average shares outstanding		
Basic and diluted	27,005	26,809

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

QUADRAMED CORPORATION
INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three months ended March 31,	
	2003	2002
Cash flows from operating activities		
Net loss from continuing operations	$ (10,678)	$ (624)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	2,468	2,115
Provision for bad debts	239	(16)
Write-off of assets	--	102
Other	51	52
Changes in assets and liabilities:		
Accounts receivable	(7,698)	(3,382)
Prepaid expenses and other	(485)	(1,221)
Accounts payable and accrued liabilities	486	(2,105)
Deferred revenue	9,212	6,256
Cash (used in) provided by continuing operations	(6,405)	1,177
Cash (used in) provided by discontinued operations	--	(709)
Cash (used in) provided by operating activities	(6,405)	468
Cash flows from investing activities		

Increase in restricted cash	--	(103)
Proceeds from sale of assets	4,190	--
Purchases of available-for-sale securities	(255)	--
Proceeds from sale of available-for-sale securities	270	--
Capitalized software development costs	(133)	(784)
Purchases of property and equipment	(479)	(707)
Cash provided by (used in) investing activities	3,593	(1,594)
Cash flows from financing activities		
Proceeds from issuance of common stock	104	1,810
Repayments of debt	(18)	(20)
Cash provided by financing activities	86	1,790
Net (decrease) increase in cash and cash equivalents	(2,726)	664
Cash and cash equivalents, beginning of period	23,663	29,799
Cash and cash equivalents, end of period	$ 20,937	$ 30,463
Supplemental disclosure of cash flow information		
Cash paid for interest	$ --	$ --
Net cash (refunded) paid for taxes	$ (13)	$ 336

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

QUADRAMED CORPORATION
NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2003

1. NATURE OF OPERATIONS

QuadraMed Corporation along with all significant business divisions and subsidiaries, (the "Company" or "QuadraMed") is dedicated to improving healthcare delivery by providing innovative healthcare information technology and services. From clinical to patient information management and revenue cycle to health information management, QuadraMed delivers real-world solutions that help healthcare professionals deliver outstanding patient care with optimum efficiency. QuadraMed was reincorporated in Delaware in 1996, having been originally incorporated in California in 1993. QuadraMed is managed in three distinct business segments which are as follows: Enterprise Division, Health Information Management Software Division, and Financial Services Division. In December 2002, QuadraMed sold its Health Information Management Systems Division. Results of operations for this division are reflected as discontinued operations in the Statement of Operations.

2. BASIS OF PRESENTATION

Unaudited Interim Results

The condensed consolidated financial statements at March 31, 2003 and December 31, 2002 and for the three months ended March 31, 2003 and 2002 have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The interim financial information is unaudited, but reflects all adjustments that are, in the opinion of management, necessary for a fair presentation of QuadraMed's condensed consolidated financial position, operating results, and cash flows for the interim periods. The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods.

These condensed consolidated financial statements have been prepared in accordance with the instructions for a report on Form 10-Q as required by the SEC, and therefore, do not include all information and notes normally provided in annual financial statements. As a result, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in QuadraMed's annual report on Form 10-K for the fiscal year ended December 31, 2002. The results of operations for the three months ended March 31, 2003 are not necessarily indicative of the results for the fiscal year ending December 31, 2003 or any other further periods.

3. RECENT ACCOUNTING PRONOUNCEMENTS

In April 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 145, Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. This statement updates and clarifies existing pronouncements relating to the classification and reporting of gains and losses from the extinguishment of debt, the treatment of sale-leaseback transactions and also makes technical corrections to existing pronouncements. QuadraMed adopted the provisions of SFAS 145 effective January 1, 2003. The implementation of this new standard did not have a significant impact on QuadraMed's financial condition, results of operations and cash flows.

In November 2002, the FASB reached a consensus on EITF No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal years beginning after June 15, 2003. This issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one earnings process and, if it does, how to divide the arrangement into separate units of accounting consistent with the identified earning processes for revenue recognition purposes. EITF 00-21 also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. QuadraMed is evaluating the effect of this issue on its financial statements.

QUADRAMED CORPORATION
NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
March 31, 2003

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. FIN 46 expands upon and strengthens existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Disclosure requirements apply to any financial statements issued after January 31, 2003. QuadraMed has considered the provisions of FIN 46 and believe it will not be necessary to include in its financial statements any assets, liabilities, or activities of the third-party entities holding its corporate headquarters leases. QuadraMed will continue to evaluate the impact of FIN 46 on other areas of its financial statements and disclosures, as appropriate.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. QuadraMed is currently evaluating the impact of SFAS 149 on its consolidated financial position and results of operations. QuadraMed does not expect the adoption of SFAS 149 to have a material impact on its consolidated financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS 150 is effective for all financial instruments entered into or modified after May 31, 2003, and

otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. QuadraMed does not expect the adoption of SFAS 150 to have a material impact on its consolidated financial position, results of operations or cash flows.

4. GOODWILL AND OTHER INTANGIBLE ASSETS

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under SFAS 142, goodwill and intangible assets deemed to have indefinite lives are to be separately disclosed on the balance sheet, and no longer amortized but subject to annual impairment tests. With the adoption of SFAS 142, QuadraMed 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.

SFAS 142 requires that goodwill be tested for impairment at the reporting unit level (i.e., business segments) upon adoption and at least annually thereafter using a two-step impairment analysis. In accordance with SFAS 142, QuadraMed performed the first of the required two-step impairment tests of goodwill and indefinite-lived assets as of January 1, 2002 utilizing an independent appraiser. The test results showed no indicators of impairment as of January 1, 2002.

As of January 1, 2003, QuadraMed re-engaged the same independent appraiser to review the goodwill as of this date for impairment. Once again, the test showed no indicators of impairment. QuadraMed will continue to perform the tests of impairment for goodwill required by SFAS 142 on an annual basis or more often, as necessary.

Except for capitalized software development costs, other intangible assets are amortized on a straight-line basis over a period of five to ten years. Capitalized software development costs are amortized on a straight-line basis

generally over a period of five years. These assets are reviewed annually for impairment and written down to net realizable value, if necessary, in accordance with SFAS No. 144, Impairment of Long-Lived Assets.

Amortization of intangible assets for the three months ended March 31, 2003 and 2002 was $585,000 and $512,000, respectively. There were no impairment charges recorded during the three months ended March 31, 2003 and 2002.

5. RESTRICTED STOCK GRANTS

During the three months ended March 31, 2003 and 2002, QuadraMed issued an aggregate of no and 39,000 shares, respectively of its common stock as

restricted stock under QuadraMed's 1996 Stock Plan. QuadraMed grants restricted shares to certain senior executives for no consideration. All of the outstanding restricted shares fully vest at the conclusion of a three-year period. QuadraMed has recorded the difference between fair market value of the restricted shares on the date the restricted stock purchase rights were granted, and the exercise price of such shares on that date as deferred compensation within the Stockholders' Equity (Deficit) section of the Consolidated Balance Sheet. In accordance with the provisions of SFAS 123, QuadraMed amortizes this amount, pro rata over the related service period as it expects the shares to fully vest. Any changes in the expected or actual outcome of the grants are considered to be changes in estimate and are accordingly, recognized in the period the change becomes known. In March 2003, a senior executive of QuadraMed was terminated. In accordance with the provisions of his employment agreement, 75,000 unvested shares immediately vested upon his termination. Accordingly, QuadraMed recognized the remaining $75,000 associated with the accelerated vesting as the vesting was a known event. Compensation expense associated with the grants of restricted stock totaling $91,000 and $131,000 was recognized during the three months ended March 31, 2003 and 2002, respectively. As of March 31, 2003, 332,000 restricted shares remained subject to vesting.

6. STOCK-BASED COMPENSATION

SFAS 123, Accounting for Stock Based Compensation, encourages, but does not require, companies to record compensation cost for stock based employee compensation plans at fair value. QuadraMed has chosen to continue to account for stock based employee compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and Related Interpretations. Accordingly, compensation cost for stock options granted to employees is measured as the excess, if any, of the quoted market price of QuadraMed's stock at the date of the grant over the amount an employee must pay to acquire the stock.

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. The fair value of these stock-based awards to employees was estimated using the Black-Scholes option pricing model. Please see below for assumptions used in the Black-Scholes option pricing model. Had compensation cost for the Company's stock option plan and employee stock purchase plan been determined consistent with SFAS No. 123, the Company's reported net income (loss) and net earnings (loss) per share would have been changed to the amounts indicated below (in thousands except per share data):

	Three months ended March 31,

	2003	2002
Net loss as reported	$ (10,678)	$ (1,328)
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	166	139
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,124)	(1,266)
Pro forma net loss	$ (11,636)	$ (2,455)
Earnings per share:		
Basic and diluted- as reported	$ (0.40)	$ (0.05)
Basic and diluted- pro forma	$ (0.43)	$ (0.09)

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:

	2003	2002
Expected dividend yield	--	--
Expected stock price volatility	142.66%	135.20%
Risk-free interest rate	2.74%	4.12%
Expected life of options	5 years	5 years

NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period less restricted shares of common stock. Diluted net loss per share is computed by dividing income by the sum of the weighted average number of common shares, as adjusted for restricted 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 convertible subordinated debentures (using the as-converted method). Common equivalent shares are excluded from the diluted computation only if their effect is anti-dilutive. As QuadraMed recorded net losses for each of the three-month periods ended March 31, 2003 and 2002, no common equivalent shares were included in the net loss per share calculation because they were anti-dilutive.

7. COMPREHENSIVE LOSS

The components of comprehensive loss for the three months ended March 31, 2003 and 2002 are as follows (in thousands):

	Three months ended March 31,	
	2003	2002
Net loss	$ (10,678)	$ (1,328)
Unrealized gain (loss) on available-for-sale securities, net of taxes	(1)	(48)
Amortization of unrecognized pension costs, net of taxes	51	51
Comprehensive loss	$ (10,628)	$ (1,325)

QUADRAMED CORPORATION
NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
March 31, 2003

8. SEGMENT REPORTING

QuadraMed aligns its operations into three business segments for management reporting purposes. These segments are based on product functionality and shared target markets. This alignment allows management to more accurately measure financial performance by product/division and to establish greater management accountability. QuadraMed's business segments are (i) the Enterprise Division, (ii) the Health Information Management Software Division, and (iii) the Financial Services Division. The operations and assets of these segments are primarily located in the United States. QuadraMed reports the Enterprise Division, the Health Information Management Software Division, and the Financial Services Division as reportable segments in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies described in notes to the financial statements in our Annual Report on Form 10-K for the year ended December 31, 2002. The financial results for these operating segments for prior periods have been reclassified to conform to the current period presentation.

Selected results of operations for these business segments are provided to QuadraMed's Chief Operating Decision Maker (CODM), who is the Chairman of the Board and Chief Executive Officer.

Summary financial data by business segment as reported to the CODM in presented below for the three months ended March 31, 2003 and 2002 (in thousands):

	Three months ended March 31, 2003				
Description	Enterprise	HIM Software	Financial Services	Other (1)	Consolidated Total

Total revenues	$ 18,512	$ 7,816	$ 2,906	$ --	$ 29,234
Gross margin	$ 9,966	$ 5,072	$ 614	$ --	$ 15,652
Interest income (expense), net	$ (577)	$ (220)	$ (181)	$ 72	$ (906)
Segment assets	$ 48,440	$ 35,936	$ 6,129	$ 35,745	$ 126,250
Total depreciation and amortization (2)	$ 944	$ 921	$ 217	$ 386	$ 2,468

	Three months ended March 31, 2002				
Description	Enterprise	HIM Software	Financial Services	Other (1)	Consolidated Total
Total revenues	$ 16,627	$ 6,829	$ 3,724	$ --	$ 27,180
Gross margin	$ 10,535	$ 4,748	$ 2,037	$ --	$ 17,320
Interest income (expense), net	$ (421)	$ (169)	$ (134)	$ 33	$ (691)
Segment assets	$ 34,017	$ 45,236	$ 5,715	$ 44,914	$ 129,882
Total depreciation and amortization (2)	$ 442	$ 811	$ 131	$ 731	$ 2,115

9. MAJOR CUSTOMERS

In the three months ended March 31, 2003 and 2002, no single customer accounted for more than 10% of total revenues however, in the three months ended March 31, 2003 and 2002, sales to the U. S. government accounted for 24.4% and 21.1%, respectively, of HIM Software Division revenues.

10. LITIGATION AND OTHER MATTERS

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against QuadraMed and certain of its officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning its business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief. These matters are at an early stage. No responses to the complaints have yet been filed, and no discovery has taken place. QuadraMed intends to defend itself vigorously against these allegations. However, the ultimate outcome of these matters cannot presently be determined.

On February 28, 2003, QuadraMed reported that the SEC issued a formal non-public order of investigation concerning QuadraMed's accounting and financial reporting practices for the period beginning January 1, 1998. QuadraMed intends to continue to cooperate with the SEC and has complied with the SEC's requests for information. QuadraMed cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof.

On March 4, 2003, QuadraMed's common stock was delisted from the Nasdaq National Market. The delisting constituted a "Repurchase Event" under the provisions of QuadraMed's 5.25% Convertible Subordinated Debentures Agreements due 2005 (the "2005 Debt"). Upon such an event, the 2005 Debt grants to each debenture holder the right, at the holder's option, to require QuadraMed to repurchase all or any of the holder's debentures. On April 17, 2003, under the terms of a refinance agreement with certain of the 2005 debt holders and new investors, QuadraMed issued $71.0 million of its Senior Secured Notes due 2008 (the "2008 Debt"). The proceeds from the issuance of the 2008 Debt were used to repurchase $61.8 million (plus $1.5 million in accrued interest) of the 2005 Debt required to be repurchased. Accordingly, the net proceeds as a result of the issuance of the 2008 Debt less the costs (including fees) associated with the repurchase of the 2005 Debt was $8.5 million, with $11.9 million of the 2005 Debt remaining outstanding. Additionally, the repurchase right on the 2005 Debt remaining outstanding expired on April 17, 2003.

The 2008 Debt bears interest at an initial rate of 10% which will be reduced to 9% upon any relisting of QuadraMed's common stock on the Nasdaq, including Nasdaq SmallCap or U.S. National Market and is secured by certain intellectual property. The 2008 Debt contains certain events of default. These events include: failure to timely repay principal or interest owed on the debentures, default under any other borrowing, and bankruptcy. As part of the transaction, QuadraMed also issued 11.6 million warrants to purchase common stock. The warrants have a term of five years, have an exercise price of $.01 per share and are subject to certain anti-dilution provisions including dilution from the issuance of shares in settlement of any existing litigation.

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 Interim Condensed Consolidated Financial Statements and related Notes. This Report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties. The words "believe", "expect", "target", "goal", "project", "anticipate", "predict", "intend", "plan", "estimate", "may", "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.

Significant Accounting Policies and Estimates

Our significant accounting policies have a considerable impact on Management's Discussion and Analysis.

Principles of Consolidation

These consolidated financial statements, which include our accounts and all our significant business divisions and 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 us and our subsidiaries have been eliminated in the consolidated financial statements.

Use of Estimates

Management's discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. In preparing these financial statements, we make estimates, assumptions, and judgments that affect the reported amounts of assets and liabilities, contingent assets and liabilities, revenues, and expenses. Significant estimates and assumptions have been made regarding revenue recognition, the allowance for doubtful account, investments, capitalized software, income taxes, restructuring, pensions and other benefits, and contingencies and litigation and intangibles, primarily goodwill and customer lists, resulting from our purchase business combinations. We base our estimates, assumptions, and judgments on historical experience and on various other assumptions believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Uncertainties inherent in these estimates include projections of future operating results and the discount rates used to determine the net present values of these future results and useful lives of the acquired assets as well as technological advances. In addition, for our

fixed-price contracts, we make significant estimates within percentage-of-completion accounting, including estimating total costs to be incurred as calculated on a labor hour basis. We annually review and test our estimates, specifically those related to the valuations of intangibles including acquired software, goodwill, customer lists, trademarks and other intangibles, and capitalized software. Actual results may differ materially from these estimates.

Revenue Recognition

Our revenue in the ordinary course of business is principally generated from two sources: (i) licensing arrangements and (ii) services.

Our license revenue consists of fees for licenses of our software and hosted services. Cost of license revenue primarily includes product, delivery and royalty costs and facilities costs. Our service revenue consists of maintenance, customer training and consulting services and fees for providing management services such as accounts receivable and payment collection outsourcing, specialized staffing, analytical services and seminars. Cost of services consists primarily of salaries, benefits, and allocated costs related to providing such services, labor costs for engineers performing implementation services and technical support and training personnel.

We license our products through our direct sales force. Our license agreements for such products do not provide for a right of return, and historically product returns have not been significant.

We recognize revenue on our software products in accordance with Statement of Position ("SOP") 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions; SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts; and Staff Accounting Bulletin ("SAB") 101, Revenue Recognition in Financial Statements.

We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; no significant obligations by us with regard to implementation remain; 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. We consider all arrangements with payment terms extending beyond 180 days to be not fixed and determinable, and revenue is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Revenue recognized from multiple-

element arrangements is allocated to undelivered elements of the arrangement, such as maintenance, support and professional services, based on the relative fair values of the elements specific to us. Our determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence ("VSOE"). We limit our assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

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. Revenue from hosted applications is recognized ratably over the term of the arrangement. The proportion of revenue recognized upon delivery may vary from quarter to quarter depending upon the relative mix of licensing arrangements and the availability of VSOE of fair value for undelivered elements.

Certain of our perpetual and time-based licenses include unspecified additional products and/or payment terms that extend beyond 12 months. We recognize revenue from perpetual and time-based licenses that include unspecified additional software products ratably over the term of the arrangement.

Contract accounting is utilized for service revenue from fixed-price contracts and those requiring significant software modification, development or customization. In such instances, the arrangement fee is accounted for in accordance with SOP 81-1, whereby the arrangement fee is recognized, generally using the percentage-of-completion method measured on labor input costs. 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 affect the amounts of revenue and related expenses reported in its consolidated financial statements. A number of internal and external factors can affect its estimates, including labor rates, utilization, changes to specification and testing requirements and collectibility of unbilled receivables.

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.

Service revenues from providing management services such as accounts receivable and payment collection outsourcing are recognized in accordance with SAB 101. When all criteria for revenue recognition, as noted above, have been met, revenue is recognized upon invoicing. If collectibility is not considered probable, revenue is recognized when the fee is collected.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist primarily of amounts due us from our normal

business activities. We maintain an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified within our portfolio. If the financial condition of our customers were to deteriorate resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowances might be required.

Intangible Assets

Goodwill. In June 2001, the FASB issued Accounting SFAS No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under SFAS 142, goodwill and intangible assets deemed to have indefinite lives are to be separately disclosed on the balance sheet, and no longer amortized but subject to annual impairment tests. With the adoption of SFAS 142, we 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.

SFAS 142 requires that goodwill be tested for impairment at the reporting unit level (i.e., business segments) upon adoption and at least annually thereafter using a two-step impairment analysis. In accordance with SFAS 142, we performed the first of the required two-step impairment tests of goodwill and indefinite-lived assets as of January 1, 2002 utilizing an independent appraiser. The test results showed no indicators of impairment as of January 1, 2002.

As of January 1, 2003, we re-engaged the same independent appraiser to review the goodwill as of this date for impairment. Once again, the test showed no indicators of impairment. We will continue to perform the tests of impairment for goodwill required by SFAS 142 on an annual basis or more often, as necessary.

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, we establish technological feasibility upon completion of a detailed program design determined on a project-by-project basis, which substantiates that the computer software product can be produced in accordance with its design specifications. Software development costs are capitalized based upon an assessment of their recoverability. This assessment requires considerable judgment by management with respect to various factors, including, but not limited to, anticipated future gross margins, estimated economic lives, and changes in software and hardware technology. Amortization is based on the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product, or the straight-line method over the remaining estimated economic life of the product, generally five years, and is charged to cost of licenses.

Other Intangible Assets. Other intangible assets primarily relate to acquired software, trademarks and customer lists acquired in our purchase business combinations. On January 1, 2002, we adopted the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which generally requires impairment losses to be recorded on long-lived assets (excluding goodwill) used in operations, such as property, equipment and

improvements, and intangible assets, when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of the assets. The provisions of this statement did not have a significant impact on our financial condition or operating results.

Recent Accounting Pronouncements

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. This statement updates and clarifies existing pronouncements relating to the classification and reporting of gains and losses from the extinguishment of debt, the treatment of sale-leaseback transactions and also makes technical corrections to existing pronouncements. We adopted the provisions of SFAS 145 effective January 1, 2003. The implementation of this new standard did not have a significant impact on our financial condition, results of operations and cash flows.

In November 2002, the FASB reached a consensus on EITF No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal years beginning after June 15, 2003. This issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one earnings process and, if it does, how to divide the arrangement into separate units of accounting consistent with the identified earning processes for revenue recognition purposes. EITF 00-21 also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. We are evaluating the effect of this issue on our financial statements.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. FIN 46 expands upon and strengthens existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Disclosure requirements apply to any financial statements issued after January 31, 2003. We have considered the provisions of FIN 46 and believe it will not be necessary to include in our financial statements any assets, liabilities, or activities of the third-party

entities holding our corporate headquarters leases. We will continue to evaluate the impact of FIN 46 on other areas of our financial statements and disclosures, as appropriate.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. We are currently evaluating the impact of SFAS 149 on our consolidated financial position and results of operations. We do not expect the adoption of SFAS 149 to have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not expect the adoption of SFAS 150 to have a material impact on our consolidated financial position, results of operations or cash flows.

Results of Operations

The following table sets forth selected data for the indicated periods. Percentages are expressed as a percentage of total revenues.

	Three months ended March 31,			
	2003		2002	
Revenue				
Services and other	$ 19,679	67.3%	$ 19,000	69.9%
Licenses	9,555	32.7	8,180	30.1
Total revenue	29,234	100.0	27,180	100.0

Cost of revenue				
Cost of services and other	11,700	40.0	7,727	28.4
Cost of licenses	1,882	6.4	2,133	7.9
Total cost of revenue	13,582	46.4	9,860	36.3
Gross margin	15,652	53.6	17,320	63.7
Operating expenses				
General and administration	13,531	46.3	7,823	28.8
Sales and marketing	5,761	19.7	5,175	19.0
Research and development	5,477	18.7	3,653	13.4
Amortization and other operating charges	585	2.0	512	1.9
Total operating expenses	25,354	86.7	17,163	63.1

Revenue

Services and Other. Services and other revenue consists of professional services, such as implementation services and training, maintenance, which consists of technical support and product upgrades, hardware, reimbursable expenses and other service revenue. Professional services are typically provided over a period of three months to six months for the HIM software division and up to two years for the Enterprise division. These services are provided subsequent to the signing of a software license arrangement and depend in large part on the Company's software license revenues. The Company's maintenance revenues depend on both the Company's software license revenues and renewals of maintenance agreements by the Company's existing customer base. Services and other revenue was $19.7 million in the three months ended March 31, 2003, an increase of $679,000, or 3.6% from $19.0 million for the corresponding period of 2002.

The increase in absolute dollar amount of services and other revenue was primarily due to a hardware sale, required for the use of the Enterprise products, which was purchased for an existing customer. The cost of the hardware is included in cost of services and other. There was also a decrease in professional services and slight increase in maintenance revenue. The Enterprise division represented a majority of the increase in services and other revenue offset by a decrease in the Financial Services division, which continues to decline due to the decrease in the quality of assignments and average lower contracted fees.

Licenses. License revenue consists of software license and third-party software sales. The Company markets its products through its direct sales force. License revenue in the three months ended March 31, 2003 was $9.6 million, an increase of $1.4 million or 16.8% from $8.2 million in the corresponding period of 2002.

The increase in absolute dollar amount of license revenue was due to an increase in both the Enterprise and HIM software divisions. The Enterprise division grew in the first quarter of 2003, due to the purchase of Pharmacy Data Systems, Inc. (PDS) in June 2002. The HIM software division grew due to increased sales in the government sector.

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, consulting services as well as third-party hardware costs. Cost of services and other for the quarter ended March 31, 2003 of $11.7 million was $4.0 million more than the $7.7 million in the corresponding period of 2002. As a percentage of services and other revenue, cost of services and other was 59.4% and 40.7% for the three months ended March 31, 2003 and 2002, respectively. In absolute dollars, the increase was primarily due to an increase in hardware costs and salary and overhead expenses. The hardware costs were directly affected by the increase in hardware purchase for the first quarter of 2003. The increase was primarily attributable to the Enterprise division. There was a slight increase in Financial Services division offset by the same decrease in HIM Software division.

Cost of Licenses. Cost of licenses consists of third party royalties, amortization of capitalized software, production costs and third party software. Cost of licenses in the three months ended March 31, 2003 was $1.9 million, a decrease of $251,000, compared to $2.1 million for the same period of 2002. As a percentage of license revenues, cost of licenses was 19.7% and 26.1% for the three months ended March 31, 2003 and 2002, respectively. The percentages vary due primarily to the variables in royalty expense. The decrease in absolute dollars was due to slight decreases in royalties and software costs offset by an increase in amortization of capitalized software.

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 was $13.5 million in the first quarter of 2003, an increase of $5.7 million compared to $7.8 million in the corresponding period of 2002. As a percentage of revenue, general and administration expense increased 17.5 percentage points to 46.3% in the first quarter of 2003, compared to 28.8% in the first quarter of 2002. The increase in general and administration expense was the result of an increase in accountants', consultants' and attorneys' fees, retention bonuses, and employee benefits as part of the restatement process, for the restated 2001 Annual Report on Form 10-K/A. For the three months ended March 31, 2003, these expenses were approximately $4.3 million. We expect these expenses to decrease in the following quarter.

Sales and Marketing. Sales and marketing expense includes costs associated with our sales and marketing personnel and product marketing personnel and consists primarily of compensation and benefits, commissions and bonuses, promotional and advertising expenses. Sales and marketing expense increased $586,000 in the first quarter of 2003 to $5.8 million, compared to

the same period of 2002. As a percentage of revenue, sales and marketing expenses increased to 19.7% in the first quarter of 2003 from 19.0% in the same period of 2002. The increase was due primarily to an increase in personnel costs, due to increased salaries and employee benefits expense.

Research and Development. Research and development expense includes costs associated with the development of new products, enhancements of existing products for which technological feasibility has not been achieved, and quality assurance activities, and primarily includes compensation and benefits expense. Research and development costs in the three months ended March 31, 2003 were $5.5 million, compared to $3.7 million in the same period in 2002. As a percentage of revenue, research and development costs were 18.7% in the first quarter of 2003 compared to 13.4% in the corresponding period of 2002. Research and development costs increased due to increased investments in Enterprise Division's Affinity products applications and to a lesser extent in HIM software products. During the first three months of 2003, we capitalized approximately $130,000 in software development costs compared to approximately $700,000 in the same period of 2002.

Amortization and other operating charges. Amortization and other operating charges represented amortization of identifiable intangible assets and amortization of acquired software. The increase to $585,000 in the first quarter of 2003 from $512,000 in the same period of 2002 reflects the net increase in amortization of identifiable intangible assets offset by the amortization of acquired software in the prior period.

Other Income (Expense)

Other Income (Expense), Net. Net other expense was $976,000 and $781,000 in the three-month periods ended March 31, 2003 and 2002, respectively. The slight increase was due to interest expense on the debentures.

Income Taxes

Provision for Income Taxes. There was no provision for income taxes for the three-month periods ended March 31, 2003 and 2002. For financial reporting purposes, a 100% valuation allowance has been recorded against our deferred tax assets under SFAS No. 109.

Liquidity and Capital Resources

Balance Sheet and Cash Flows

Cash and cash equivalents were $20.9 million as of March 31, 2003 and $23.7 million as of December 31, 2002, a decrease of $2.8 million or 12% during the period. Cash flows used in operating activities were $6.4 million for the three months ended March 31, 2003. These amounts primarily resulted from a net

loss of $10.7 million for the three months ended March 31, 2003, offset by $2.5 million of depreciation and amortization and an increase of $9.2 million in deferred revenue and a decrease of $7.7 million in accounts receivable. Cash flows from investing activities of $3.6 million resulted from a $2.7 million payment received for the HIM Services sale and $1.5 million earn-out payment associated with the EZ-CAP sale offset by $479,000 in fixed asset purchases.

We expect that cash provided by 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 our accounts receivable collections, and the timing of other payments. In the three months ended March 31, 2003, the Company paid $4.3 million related to the restatement. These expenses will not continue at this rate in future quarters. In the three months ended March 31, 2003, the Company invested $5.5 million in research and development. The Company expects to continue to invest in research and development in the future.

Commitments

The following table summarizes financial data for our contractual obligations and other commercial commitments, including interest obligations, as of March 31, 2003 (in thousands):

		Payments Due by Period			
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	After 5 years
Long-term debt	$ 81,782	$ 3,870	$ 77,912	$ --	$ --
Operating leases	29,266	5,087	7,954	10,410	5,815
Other long-term obligations	1,449	483	966	--	--
Total contractual cash obligations	$112,497	$ 9,440	$ 86,832	$ 10,410	$ 5,815
Other Commercial Commitments					
Standby letters of credit(1)	$ 4,220	$ 1,100	$ --	$ 2,620	$ 500
Total commercial commitments	$ 4,220	$ 1,100	$ --	$ 2,620	$ 500

As of March 31, 2003, we had $73.7 million in outstanding 5.25% Convertible Subordinated Debentures due 2005 (the "2005 Debt"), which bear interest at 5.25% per annum. On April 16, 2003, we announced that we had executed an agreement with certain of our bondholders and additional investors to refinance our 2005 Debt. On April 17, 2003, under the terms of the refinance agreement, we issued $71.0 million of our Senior Secured Notes due 2008 (the "2008 Debt"). The proceeds from the issuance of the 2008 Debt were used to repurchase $61.8 million (plus $1.5 million in accrued interest) of the 2005 Debt which became subject to repurchase by us as a result of our delisting from the Nasdaq National Market on March 4, 2003. Accordingly, the net

proceeds to us as a result of the issuance of the 2008 Debt less the costs (including fees) associated with the repurchase of the 2005 Debt was $8.5 million, with $11.9 million of the 2005 Debt remaining outstanding.

Additionally, the repurchase right on the 2005 Debt remaining outstanding expired on April 17, 2003. The 2008 Debt bears interest at an initial rate of 10% which will be reduced to 9% upon the relisting of QuadraMed's common stock on the Nasdaq Smallcap or National Market and is secured by certain intellectual property of QuadraMed. However, we may be obligated to redeem the 2005 and 2008 debentures earlier than the maturity dates based upon certain events of default occurring as defined within the debenture agreements. These events include, failure to timely repay principal or interest owed on the debentures, default under any other borrowing, and bankruptcy.

In addition, as of March 31, 2003, we had approximately $29.2 million in minimum operating lease commitments that will be repaid through 2011. Finally, we have a Supplemental Executive Retirement Plan ("SERP") that will require total payments from 2008 through 2027 estimated at $7.8 million. We owe annual premiums of $483,000 on the SERP through 2005 to fund our obligations.

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

Risk Factors That May Impact Future Operating Results

Factors that have affected our results of operations in the past and are likely to affect our results of operations in the future, include the following:

Our Vendors, Suppliers and Customers May React Adversely to the Lack of Timely SEC Filings of Our Historical Financial Statements.

Our future success depends in large part on the support of our vendors and suppliers, who may react adversely to the lack of timely SEC filings of our historical financial statements. The restatement of our historical financial statements has resulted in negative publicity about us, which may cause some of our potential customers to defer purchases of our products. Our vendors and suppliers may re-examine their willingness to do business with us, to develop critical interfaces for us or to supply software and services if they lose confidence in our ability to fulfill our commitments.

We Are Currently the Target of Securities Litigation and May Be the Target of Further Actions, Which May Be Costly and Time Consuming to Defend.

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against us and certain of our officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements

concerning our business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief.

The ultimate outcome of these matters cannot presently be determined and may require significant commitment of our financial and management resources and time, which may seriously harm our business, financial condition and results of operations. We cannot assure you that any of the allegations discussed above can be resolved without costly and protracted litigation, and the outcome may have a materially adverse impact upon our financial position, results of operations and cash flows.

In addition, securities class action litigation has often been brought against a company following a decline in the market price of its securities. The uncertainty of the currently pending investigation and litigation could lead to more volatility in our stock price. We may in the future be the target of securities class action claims similar to those described above.

We Are Subject to a Formal SEC Inquiry as a Result of the Restatement of Our Financial Statements.

Following our August 12, 2002 announcement that we intended to restate prior period financial statements, the staff of the San Francisco District Office of the SEC requested certain information concerning the anticipated restatement as part of an informal, preliminary inquiry.

On February 28, 2003, we reported that the SEC had issued a formal non-public order of investigation concerning our accounting and financial reporting practices for the period beginning January 1, 1998. We have cooperated fully with the SEC and have complied fully with all requests for information by the SEC. We intend to continue such cooperation and compliance. We cannot predict when the SEC will conclude its inquiry, or the outcome and impact thereof.

Our Common Stock Has Been Delisted from the Nasdaq Stock Market.

We received a notice from the Nasdaq Stock Market that required us to file Forms 10-Q for the quarters ended June 30, and September 30, 2002 as well as restated financial statements for the years ended December 31, 2001, 2000 and 1999 and the quarter ended March 31, 2002. Our trading symbol as of August 22, 2002 was amended from "QMDC" to "QMDCE", as a result of the delinquent filings. We requested an appeals hearing before a Nasdaq Listing Qualifications Panel (the "Panel"). The Panel notified us on February 6, 2003, that Nasdaq would continue to list our common shares on the Nasdaq National Market until February 28, 2003, by which date we must file our Quarterly Report on Form 10-Q for the interim periods ended June 30, 2002 and September 30, 2002 and our amended SEC filings for the years ended December 31, 2001, 2000 and 1999 and the interim period ended March 31, 2002. Further, we were required to file timely all other annual and periodic reports with the SEC and evidence our continued compliance with all requirements for continued listing on the Nasdaq National Market upon the filing of these documents as well as an ability to sustain compliance with those requirements over the long term. We were unable to meet these requirements in a timely manner, and on March 4, 2003, our common stock was delisted from the Nasdaq National Market. As of the date of this report,

we have filed with the SEC all annual and periodic reports required under the Exchange Act. Although we intend to comply with all other listing requirements and to apply for relisting on the Nasdaq Small Cap or National Market as soon as practicable, we can offer no assurances that we will be relisted on either market.

The delisting constituted a "Repurchase Event" under the provisions of our Convertible Subordinated Debentures. Upon such an event, our Debentures provide the holders with the individual option to redeem the Debentures (see below). In addition, the delisting of our common stock may have an adverse reaction on our operating results and ultimately, our financial condition.

Our Debentures Have Been Partially Refinanced with Notes that Are Subject to New Terms.

We issued Debentures through a public offering on May 1, 1998 that mature on May 1, 2005 in the principal amount of $115 million (the "2005 Notes"). Our net proceeds from the offering were $110.8 million. The 2005 Notes bear interest at 5.25% per annum and are convertible into common stock at any time prior to the redemption or final maturity, initially at the conversion price of $33.25 per share (resulting in an initial conversion ratio of 30.075 shares per $1,000 principal amount).

We are obligated to provide holders of the 2005 Notes with notice of and the holders have the individual option to redeem the 2005 Notes should we, (i) cease to be traded on a U.S. national securities exchange or cease to be approved for trading on a U.S. automated over-the-counter securities market; or (ii) experience defined Changes of Control, including a merger in which we are not the surviving entity or our shareholders do not control 50% of the new entity, the sale of substantially all of our assets, a liquidation, or if there is a substantial change in the board of directors over a two-year period. Additionally, we are obligated to redeem the 2005 Notes upon defined Events of Default, including failure to timely repay principal or interest under the 2005 Notes, default under any other borrowing, and bankruptcy. On March 4, 2003, our common stock was delisted from the Nasdaq Stock Market, and a repurchase event was triggered.

On April 17, 2003, we closed the partial refinancing of our 2005 Notes. In conjunction with our repurchase of $61.8 million of our outstanding 2005 Notes pursuant to our offer to repurchase such Notes previously announced on March 19, 2003, we issued $71 million of our Senior Secured Notes due 2008 (the "2008 Notes"), together with warrants to purchase 11,303,842 shares of our common stock. Investors in the 2008 Notes included certain holders of 2005 Notes as well as new investors. Additional warrants to purchase 2,047,978 shares of our common stock will be issued to holders of the 2008 Notes if we do not file a registration statement within 90 days after receiving a request from the holders on or after the date that is 270 days after April 17, 2003, the date of issuance of the 2008 Notes. We also issued warrants to purchase 282,596 shares of our common stock to Philadelphia Brokerage Corporation as consideration in connection with the transaction. The warrants have a term of five years, have an exercise price of $0.01 per share and are subject to certain anti-dilution provisions including dilution from any issuance of shares in settlement of existing litigation.

The 2008 Notes bear an initial interest rate of 10%, which interest rate is required to be reduced to 9% upon the listing of the Company's common stock for trading on a U.S. national securities exchange or upon the common stock's relisting on the Nasdaq National Market or the Nasdaq SmallCap Market. The terms of the 2008 Notes provide that interest is initially payable 6% in cash and 4% in additional notes for the first year and payable entirely in cash thereafter. The 2008 Notes are also secured by certain intellectual property of the Company.

The terms of the new debt could result in increased dilution to existing shareholders as a result of the warrants issued and potential future issuances. In addition, the higher rate of interest on the new debt will result in increased interest costs.

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

Our board of directors has the authority to issue up to 5 million shares of preferred stock 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 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.

Certain provisions of our certificate of incorporation and bylaws could discourage potential takeover attempts and make attempts to change management by stockholders difficult. Our board of directors, which is classified into three classes of directors serving staggered, three-year terms, 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 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 in 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.

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

The Nasdaq SmallCap Market on which our common stock was listed, the "Pink Sheets" over-the-counter market, where our stock currently trades, 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;
- Governmental regulatory action;
- Resolution of pending or unasserted litigation, including the existing shareholder lawsuits;
- 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.

Future Sales of a Substantial Number of Shares of Our Common Stock Could Cause the Price of the Stock to Decrease or Fluctuate Substantially.

Our existing stockholders hold a significant number of shares of common stock that may be sold in the future under Rule 144 of the Securities Act or through the exercise of registration rights. Sales of a substantial number of the aforementioned shares in the public markets or the prospect of such sales could adversely affect or cause substantial fluctuations in the market price of our common stock and debt securities and impair our ability to raise additional capital through the sale of our securities.

Future Sales of Our Common Stock in the Public Market or Warrant or Option Exercises and Sales Could Lower Our Stock Price.

A substantial number of the unissued shares of our common stock are subject to outstanding stock options and warrants. In addition, our outstanding 2005 Notes may be converted into shares of common stock. We cannot predict the effect, if any, that future sales of 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, including shares issued upon the exercise of stock options or warrants or the conversion of our outstanding 2005 Notes, or the perception that such sales could occur, may adversely affect prevailing market prices for our common stock.

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 the new or otherwise emerging operating systems; and
- Develop new interfaces with competing HIS vendors to fully integrate our Quantim product suite in order to maximize features and functionality of the new products.

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.

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 covering our developed technology, the Affinity CPOE software application. 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 depend on licenses from a number of third-party vendors for certain technology used to develop and operate our products. 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. 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.

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 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.

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.

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 research and development expenses.

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 disease or other conditions or that affect the structure or function of the body are subject to regulation by the 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 Us to Expend Substantial Amounts.

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 care providers. Although compliance with these laws and regulations is presently the principal responsibility of the hospital, physician, or other healthcare provider, regulations governing patient confidentiality rights are dynamic and rapidly evolving. Changes may be made which require us to change our systems and our methods which could

require significant expenditure of capital and decrease future business prospects. Additional federal and state legislation governing the dissemination of individually identifiable information have been proposed and may be adopted, which may also significantly affect our business.

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") is a federal law that affects the use, disclosure, transmission and storage of individually identifiable health information. As directed by HIPAA, the United States Department of Health and Human Services ("HHS") must promulgate standards and implementation guidelines for certain electronic health transactions, code sets, data security, unique identification numbers, and privacy of individually identifiable health information. HHS has made several regulatory proposals, which are in various stages of development.

First, HHS has published a final regulation governing transaction and code-set standards that had a compliance date of October 16, 2002. If a covered entity (health care providers that transmit certain covered transactions in electronic form, health plans and health care clearinghouses) or its agent file an extension by October 16, 2003, the covered entity would receive an additional year to comply with the HIPAA transaction and code sets requirements.

Second, HHS has published a final HIPAA privacy rule which had a compliance date of April 14, 2003. The HIPAA privacy rule is complex and far reaching. Similar to the HIPAA transaction and code sets rule, the HIPAA privacy rule applies to covered entities. Covered entities are required to execute a contract with any business associate that performs certain services on the covered entity's behalf. We may be implicated by the HIPAA privacy rule as a business associate of a covered entity. The HIPAA privacy rule and state healthcare privacy regulations could materially restrict the ability of healthcare providers to disclose individually identifiable health information from patient records using our products and services or could require us to make substantial capital expenditures to be in compliance. Accordingly, the HIPAA Privacy Rule and state privacy laws may significantly impact our product's use in the health care delivery system and therefore decrease our revenue, increase working capital requirements and decrease future business prospects.

Third, HHS published the final HIPAA security rule with a compliance date of April 20, 2005. The HIPAA security rule applies to the use, disclosure, transmission, storage and destruction of electronic protected health information by covered entities. Covered entities must implement stringent security measures to ensure the confidentiality of the electronic protected

health information, and to protect against the unauthorized use of the electronic protected health information. Implementing such measures will require us to expend substantial capital due to required product, service, and procedure changes.

Government Regulation to Adopt and Implement ICD-10-CM and ICD-10-PCS Medical Code Set Standards.

Prominent HIM organizations are calling on the Department of Health and

Human Services (HHS) 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 R & D capital and decrease future business prospects for our current product line.

Government Regulation of the Health Care Delivery System May Affect Health Care Providers' Discretionary Spending.

During the past several years, the healthcare industry has been subject to, among other things, increasing levels of governmental regulation of reimbursement rates and certain capital expenditures. Certain proposals to reform the healthcare system have been and are being considered by Congress. These proposals, if enacted, could change the operating environment for our clients in ways that could have a negative impact on our business, financial condition, and results of operations. We are unable to predict what, if any, changes will occur.

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. 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 IDNs 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.

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 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 the use of electronic transmissions for large Medicare providers which may positively affect our systems and product.

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 system were to revert to a fee-for-service model. In addition, many of our customers provide services under capitated service agreements, and a reduction in the use of capitation arrangements as a result of regulatory or market changes could have a material adverse effect on our business. During the past several years, the healthcare industry has been subject to increasing levels of governmental regulation of, among other things, reimbursement rates and capital expenditures. Proposals to reform the healthcare system have been and are being considered by the United States Congress. These proposals, if enacted, could 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 HIPAA could lead healthcare organizations to curtail or defer investments in non-HIPAA related features in the next several years.

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, research and 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;

- 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;

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

- Increases in third party royalty fees associated with embedded products in QuadraMed software applications.

Our operating expense levels, which increase with the addition of acquired businesses, are relatively fixed. Accordingly, if future revenues were 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.

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 customers, and such decisions require significant capital expenditures by them. As a result, we typically experience sales cycles that extend over several quarters. In addition, certain products we acquired with Compucare have higher average selling prices and longer sales cycles 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.

If We Are Unable to Compete Effectively, We Could Experience Price Reduction, Reduced Gross Margins and Loss of Market Share.

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 enterprise healthcare information systems in the Enterprise Division: McKesson Corporation, Inc., Shared Medical Systems, Inc., a division of Siemens, MediTech Corporation, Eclipsys Corporation, Cerner, and, IDX Corporation;

- In the market for electronic document management products in the Enterprise Division: McKesson Corporation, SoftMed Corporation Inc., FileNet, Lanvision, MedPlus, and, Eclipsys Corporation;

- In the market for MPI products and services in the Enterprise Division: Madison Technologies, Inc., McKesson Corporation, Shared Medical Systems, Inc., a division of Siemens, and, Medibase;

- In the market for decision support products in the Enterprise Division: Eclipsys Corporation, Healthcare Microsystems, Inc., a division of Health Management Systems Inc., McKesson Corporation, Shared Medical Systems, Inc., a division of Siemens, and, MediQual Systems, Inc., a division of Cardinal Health, Inc.;

- 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, PricewaterhouseCoopers LLP and, HSS, Inc.;

- In the Health Information Management Services Division: PricewaterhouseCoopers LLP, Bearing Point and Cap Gemini for compliance products and services and health information management consulting services; and

- In the Financial Services Division: Advanced Receivables Strategy, Inc., a division of Perot Systems Corporation, NCO Group, Inc., Outsourcing Solutions, Inc., Health Management Systems, Inc., and Triage Consulting Group.

Current and prospective customers also evaluate our products' capabilities against the merits of their existing information systems and expertise. Major software information systems companies, including those specializing in the healthcare industry, that do not presently offer competing products may enter our markets. Many of our competitors and potential competitors have significantly greater financial, technical, product development, marketing and other resources, and market recognition than we have. Many of these 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.

These competitors may be in a position to devote greater resources to the development, promotion, and sale of their products than we can. 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.

Our Services Face Review and Scrutiny from the Department of Health and Human Services, the Department of Justice and Other Law Enforcement Agencies.

As a result of rising health care costs, federal and state governments have placed an increased emphasis on detecting and eliminating fraud and abuse in Medicare, Medicaid, and other health care programs. Numerous laws and regulations now exist to prevent fraudulent or abusive billing, to protect patients' privacy rights, and to ensure patients' access to health care. Violation of the laws or regulations governing our operations could result in the imposition of civil or criminal penalties, including temporary or permanent exclusion from participation in government health care programs such as Medicare and Medicaid, the cancellation of our contracts to provide managed care services, and the suspension or revocation of our licenses. We routinely conduct internal audits in our effort to ensure compliance with all applicable laws and regulations. If errors, discrepancies or violations of laws are discovered in the course of these audits or otherwise, we may be required by law to disclose the relevant facts, once known, to the appropriate authorities.

We Face Risks Associated with U.S. Government Contracting.

We have been awarded a U.S. General Services Administration ("GSA") Schedule Contract for Federal Supply Service of commercial information technology. The willingness of government agencies to enter into future contracts depends upon (i) our ability to continue supporting existing products; (ii) maintaining ongoing relationships with third party suppliers of certain elements of our products; and (iii) developing new products with third party suppliers to address new regulatory requirements of government agencies and having these products added to our GSA commercial price list. These contracts are subject to cancellation at the convenience of the contracting government agency.

As a commercial vendor, we must file a quarterly sales report with the GSA and remit a 1% "Industrial Funding Fee" based on the sales value of the contract. Reductions or delays in federal funds available for projects we are performing could also have an adverse impact on our government business. Contracts involving time and material fees are also subject to the risks of disallowance of costs upon audit, changes in government procurement policies, required competitive bidding for products not identified on the GSA commercial product price list, and, with respect to contracts involving prime contractors or government-designated subcontractors, the inability of those parties to perform under their contracts.

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

From 1993 to 1999, we completed 28 acquisitions encountering significant challenges integrating the acquired businesses into our operations and, in years 2000 and 2002 focused in particular on their integration. Some of the challenges we have encountered, and may encounter with acquisitions in the future, in integrating acquired businesses have included:

- 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;
- Write-down or reclassification of acquired assets;

- Failure to retain key acquired personnel and difficulty and expense of training those retained;
- Increases in stock compensation expense and increased compensation expense 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;
- Exposure to the risks of entering markets in which we have no direct prior 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.

New Accounting Standards May Make Acquisitions Necessary for Our Growth Less Accretive and Less Attractive.

In June 2001, the FASB issued SFAS No. 141, Business Combinations. The statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, Business Combinations, and SFAS No. 38, Accounting for Pre-acquisition Contingencies of Purchased Enterprises. From 1993-1999, we completed 28 acquisitions, certain of which were accounted for using the pooling-of-interests methodology, which is no longer acceptable under SFAS 141. Effective June 2001, prospective business combinations are required to be accounted for using purchase accounting. As a result, any amounts paid in excess of fair value of the assets acquired are capitalized and recorded as intangible assets or goodwill whose amortization or impairment which may reduce future earnings. Accordingly, future business combinations may be less attractive as our reported GAAP operating results are likely to be negatively impacted.

We May Suffer Losses Due to the Investment Performance of Variable Life Insurance Policies That Are Tied to the Performance of Equity Markets That May Lead to Delays in Repayments of Premiums Pursuant to Certain Split-Dollar Life Insurance Agreements or Result in Increased Supplemental Executive Retirement Plan (SERP) Expenses in Future Periods.

We have an investment interest in three variable life insurance policies. Each of the variable life insurance policies provides for the investment of the cash value portion of policies into various sub-accounts that are similar in nature to mutual funds. Two policies are issued pursuant to split-dollar agreements with the former executives, and trusts established for their benefit make the investment decisions on these policies. The third policy is a corporate-owned policy that we contributed to a grantor or "rabbi" trust established to make contributions to satisfy our obligations under the SERP and two other subsequently terminated benefit plans. We make the investment decisions only on this policy. The performance of the variable life insurance policies for cash value and premium amounts will vary depending on the performance of the selected underlying sub-accounts. Pursuant to FTB 85-4 and FTB 97-14, we report the amounts that could be realized under these variable life insurance contracts as an asset valued as of the balance sheet date and treat the change in cash surrender value during the reported period as an adjustment of premiums paid in determining the expense or income to be recognized. The reduced value of the variable life insurance policies and future adverse changes in the condition of equity markets or poor operating results of underlying policy sub-accounts could result in (i) the delayed repayment of advanced premiums in the case of the split-dollar policies, and/or (ii) increased SERP expenses in future periods.

A Significant Amount of Our Assets Are Comprised of Goodwill, Capitalized Software, 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 are comprised of capitalized software and 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, we must test goodwill, capitalized software and other intangible assets beyond their economic life for impairment at least annually, and adjust them when impaired to the appropriate net realizable value. We engaged a valuation firm to perform an impairment test on the carrying value of our goodwill and intangibles as of December 31, 2002 and 2001. The valuation firm 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 exceeds 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 the capitalized software, we will be required to adjust the carrying value of the capitalized software 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.

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 our facilities in Neptune, New Jersey; Irving, Texas; Kansas City, Missouri; and San Rafael, California. 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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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 United States government. 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 March 31, 2003, (in thousands, except average interest rates):

	Aggregate Fair Value	Weighted Average Interest Rate
Cash and cash equivalents:		

Cash	$ 4,377	
Money Market funds	16,560	1.07%
Total cash and cash equivalents	$ 20,937	
Short-term investments:		
Corporate debt securities	$ 2,528	1.68%
Total short-term investments	$ 2,528	
Long-term investments:		
Corporate debt securities	$ 494	5.15%
Debt issued by the U.S. government	790	5.21%
Total long-term investments	$ 1,284	

On March 31, 2003 our long-term debt consists solely of our Debentures totaling $73.7 million, at a fixed interest rate of 5.25% maturing in 2005. On April 17, 2003, we refinanced our Debentures due 2005 and issued %71.0 million of Senior Secured Notes due 2008 with an initial interest rate of 10%.

Performance of Equity Markets

The performance of equity markets can have an effect on our operations, and recent declines in equity markets, if sustained, will have an adverse effect on us related to certain variable life insurance policies in which we have an investment interest.

Foreign Currency Risk

Although we sell our products internationally from time to time, all such transactions are denominated in U.S. Dollars and, as such, there is no foreign currency fluctuation risk associated with these sales.

Item 4. Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, with the participation or our management evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13(a)-14(c), and 15(d), which became effective August 29, 2002) as of a date (the "Evaluation Date") within 90 days prior to the filing date of this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the controls and other procedures they designed to ensure that information required to be disclosed in the reports we file or submit under the Act are accumulated and communicated to them as appropriate to allow timely decisions regarding required disclosures, were effective.

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our Internal Controls as of the Evaluation Date and concluded that our current practices and procedures, albeit not as mature or as formal as management intends them to be in the future, are appropriate under the circumstances. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the

control system are met. Because of the inherent limitations in all control systems no evaluation of controls can provide absolute assurance that all control issues within a company have been detected. No significant changes were made to our internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation.

In addition, our Chief Executive Officer and Chief Financial Officer and Audit Committee are aware of conditions that are considered to be reportable conditions in internal controls under standards established by the American Institute of Certified Public Accountants. These reportable conditions allowed errors to go undetected in some of our 2002 internal financial statements and in our previously issued consolidated financial statements reported in our 2001 10-K and March 31, 2002 10-Q. The 2001 10-K/A was filed in June 2003 and the March 31, 2002 10Q/A was filed in August 2003 to correct these errors in our previously issued consolidated financial statements.

The aforementioned weaknesses our internal controls pertain to the following areas:

- Revenue recognition, billings, collections and allowances;
- Formal policies and procedures for significant transactions;
- Timely analysis and reconciliation of general ledger accounts; and
- Depth of technical accounting knowledge and training.

We have implemented certain new procedures and corrective actions that address the cited weaknesses. These corrective actions included:

- We engaged Deloitte & Touche LLP (D&T) to perform forensic analysis of the Company's accounting records and reported results for the years 2000 through 2002. D&T's forensic analysis also covered years 1999 and prior to the extent any items originating in earlier years impact 2000, 2001 or 2002;
- We engaged a team of accounting consultants, most of whom are CPAs with technology industry experience, to lead the restatement effort of the financial statements for 1999, 2000 and 2001 and the first quarter of 2002. D&T transitioned detailed work and reconciliations to this group of professionals. These professionals filled in gaps in the financial organization where temporary vacancy occurred. They reviewed all material business transactions including revenue contracts, acquisitions & dispositions of businesses, impairment of assets, accrued and actual expenses, stockholders' equity transactions and accounting and financial reporting thereof for 1999, 2000 and 2001 and the first quarter of 2002;
- We retained Charles Stahl, formerly an audit partner with Deloitte & Touche, LLP, as a full-time consultant to lead the final phase of the restatement effort. We then hired him as Executive Vice President and Chief Financial Officer to build a complete permanent finance department to replace the one that was based, in part, on consultants to strengthen our internal controls; and
- Our Audit Committee has strengthened its role in corporate governance.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In October 2002, a series of securities law class action complaints were filed in the United States District Court, California Northern District, against us and certain of our officers and directors. The plaintiffs in these actions allege, among other things, violations of the Securities Exchange Act of 1934 due to issuing a series of allegedly false and misleading statements concerning our business and financial condition between May 11, 2000 and August 11, 2002. The complaints seek unspecified monetary damages and other relief. These matters are at an early stage. No responses to the complaints have yet been filed, and no discovery has taken place. We intend to defend ourselves vigorously against these allegations. On December 31, 2002, the Court entered an order consolidating all related securities class actions against the Company.

Following our August 12, 2002 announcement that we intended to restate prior period financial statements, the staff of the San Francisco District Office of the SEC requested certain information and documents relating to this matter as part of an informal, preliminary inquiry. We provided that information, and expect to provide further information now that the restatement is completed. On February 28, 2003, we reported that the SEC had issued a formal non-public order of investigation concerning our accounting and financial reporting practices for the period beginning January 1, 1998. We intend to continue to cooperate with the SEC in the event it requests other information. We cannot predict whether such information will be requested, when the SEC will conclude its inquiry, or the impact or outcome thereof.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1	Certification of the Chairman of the Board and 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 Chairman of the Board and Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K. There were no reports on Form 8-K during the quarter for which this report is filed.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: September 19, 2003

By: /s/ Lawrence P. English

Lawrence P. English
Chairman of the Board
Chief Executive Officer

Date: September 19, 2003

By: /s/ Charles J. Stahl

Charles J. Stahl
Chief Financial Officer