

QUADRAMED CORP  
Form 10-Q  
August 09, 2005  
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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

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(Mark One)

**Quarterly Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934**

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005**

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**

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## QUADRAMED CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

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**DELAWARE**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**52-1992861**  
(IRS Employer  
Identification No.)

**12110 SUNSET HILLS ROAD, SUITE 600, RESTON, VIRGINIA**  
(Address of Principal Executive Offices)

**20190**  
(Zip Code)

**(703) 709-2300**

(Registrant's Telephone Number, Including Area Code)

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

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

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

As of June 24, 2005, there were 40,543,674 shares of the Registrant's common stock outstanding, par value \$0.01.

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**FOR THE QUARTER ENDED JUNE 30, 2005**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****QUADRAMED CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

(unaudited)

	<u>June 30, 2005</u>	<u>December 31, 2004</u>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 29,014	\$ 22,429
Accounts receivable, net of allowance for doubtful accounts of \$3,639 and \$3,303, respectively	31,342	25,550
Unbilled and other receivables	3,665	6,603
Notes and other receivables	1,122	832
Prepaid expenses and other current assets	7,164	8,001
	<u>72,307</u>	<u>63,415</u>
<b>Total current assets</b>	<b>72,307</b>	<b>63,415</b>
Restricted cash	2,342	3,889
Property and equipment, net	4,365	5,129
Capitalized software development costs, net	930	1,427
Goodwill	25,983	25,983
Other intangible assets, net	9,740	12,451
Other long-term assets	7,721	7,116
	<u>123,388</u>	<u>119,410</u>
<b>Total assets</b>	<b>\$ 123,388</b>	<b>\$ 119,410</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 4,165	\$ 4,501
Accrued payroll and related	7,209	7,637
Other accrued liabilities	6,807	8,549
Dividends payable	11,386	13,780
Deferred revenue	52,436	44,040
	<u>82,003</u>	<u>78,507</u>
<b>Total current liabilities</b>	<b>82,003</b>	<b>78,507</b>
Accrued exit cost of facility closing	2,814	2,898
Other long-term liabilities	5,695	5,366
	<u>90,512</u>	<u>86,771</u>
<b>Total liabilities</b>	<b>90,512</b>	<b>86,771</b>

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<b>Stockholders equity</b>		
Preferred stock, \$0.01 par, 5,000 shares authorized, 4,000 shares issued and outstanding	85,801	83,412
Common stock, \$0.01 par, 150,000 shares authorized; 40,484 and 40,043 shares issued and outstanding, respectively	405	400
Additional paid-in-capital	301,807	301,231
Deferred compensation	(987)	(1,870)
Accumulated other comprehensive loss	(147)	(124)
Accumulated deficit	(354,003)	(350,410)
	<u>          </u>	<u>          </u>
<b>Total stockholders equity</b>	<b>32,876</b>	<b>32,639</b>
	<u>          </u>	<u>          </u>
<b>Total liabilities and stockholders equity</b>	<b>\$ 123,388</b>	<b>\$ 119,410</b>
	<u>          </u>	<u>          </u>

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

**Table of Contents****QUADRAMED CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
<b>Revenue</b>				
Services	\$ 3,547	\$ 3,421	\$ 6,624	\$ 6,024
Maintenance	13,975	11,693	27,385	23,309
Installation and other	2,408	3,140	5,104	6,561
<b>Services and other revenue</b>	<b>19,930</b>	<b>18,254</b>	<b>39,113</b>	<b>35,894</b>
Licenses	9,782	11,182	20,134	23,674
Hardware	971	1,034	1,811	5,548
<b>Total revenue</b>	<b>30,683</b>	<b>30,470</b>	<b>61,058</b>	<b>65,116</b>
<b>Cost of revenue</b>				
Cost of services and other revenue	7,119	7,620	14,438	15,306
Royalties and other	2,259	2,959	4,426	5,465
Amortization of acquired technology and capitalized software	1,024	691	2,059	1,351
<b>Cost of license revenue</b>	<b>3,283</b>	<b>3,650</b>	<b>6,485</b>	<b>6,816</b>
Cost of hardware revenue	543	775	1,508	3,606
<b>Total cost of revenue</b>	<b>10,945</b>	<b>12,045</b>	<b>22,431</b>	<b>25,728</b>
<b>Gross margin</b>	<b>19,738</b>	<b>18,425</b>	<b>38,627</b>	<b>39,388</b>
<b>Operating expense</b>				
General and administration	6,175	7,759	12,285	16,563
Software development	7,724	6,835	15,441	13,945
Sales and marketing	3,495	6,006	7,567	11,825
Amortization of intangible assets and depreciation	1,115	976	2,706	2,026
<b>Total operating expenses</b>	<b>18,509</b>	<b>21,576</b>	<b>37,999</b>	<b>44,359</b>
<b>Income (loss) from operations</b>	<b>1,229</b>	<b>(3,151)</b>	<b>628</b>	<b>(4,971)</b>
<b>Other income (expense)</b>				
Interest expense, includes non-cash charges of \$191, \$961 and \$356, \$1,482	(191)	(2,081)	(360)	(4,379)
Interest income	120	127	221	244
Other income (expense), net	138	(85)	(16)	118
Loss on retirement of debt		(3,145)		(3,145)

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Benefit (provision) for income taxes	(3)		(14)	163
<b>Other income (expense)</b>	<b>64</b>	<b>(5,184)</b>	<b>(169)</b>	<b>(6,999)</b>
<b>Net income (loss) from continuing operations</b>	<b>\$ 1,293</b>	<b>\$ (8,335)</b>	<b>\$ 459</b>	<b>\$ (11,970)</b>
Loss from discontinued operations		(1,334)	(1,686)	(2,240)
<b>Net income (loss)</b>	<b>\$ 1,293</b>	<b>\$ (9,669)</b>	<b>\$ (1,227)</b>	<b>\$ (14,210)</b>
Preferred stock accretion	(1,191)		(2,366)	
<b>Net income (loss) attributable to common shareholders</b>	<b>\$ 102</b>	<b>\$ (9,669)</b>	<b>\$ (3,593)</b>	<b>\$ (14,210)</b>
<b>Income (loss) per share-basic and diluted</b>				
Continuing operations	0.00	(0.24)	(0.05)	(0.37)
Discontinued operations	0.00	(0.04)	(0.04)	(0.07)
<b>Net income (loss)</b>	<b>\$ 0.00</b>	<b>\$ (0.28)</b>	<b>\$ (0.09)</b>	<b>\$ (0.44)</b>
<b>Weighted average shares outstanding</b>				
Basic and diluted	40,499	34,872	40,338	32,014

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

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**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF**  
**CHANGES IN STOCKHOLDERS EQUITY AND COMPREHENSIVE LOSS**

(in thousands)

(unaudited)

	(Share #)	(Share #)	(Share #)				Accumulated Other Comprehensive Income (loss) and Accumulated Deficit	Total Stockholder's Equity
	Preferred Stock	Preferred Stock	Common and Treasury Stock	Common and Treasury Stock	Additional Paid-in Capital	Deferred Compensation		
Balance, December 31, 2004	4,000	\$ 83,412	40,043	\$ 400	\$ 301,231	\$ (1,870)	\$ (350,534)	\$ 32,639
Issuance of common stock			441	5	576			581
Accretion of preferred stock		2,366					(2,366)	
Amortization of deferred compensation						875		875
Other		23				8	(23)	8
Net loss							(1,227)	(1,227)
Balance, June 30, 2005	4,000	\$ 85,801	40,484	\$ 405	\$ 301,807	\$ (987)	\$ (354,150)	\$ 32,876

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



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

(in thousands)

(unaudited)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
<b>Cash flows from operating activities</b>				
Net income (loss) attributable to common shareholders	\$ 102	\$ (9,669)	\$ (3,593)	\$ (14,210)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization	2,471	2,911	6,013	5,646
Preferred stock accretion	1,191		2,366	
Loss on retirement of debt		2,302		2,302
Exit cost of facility closing and other costs for Financial Services Division			914	
Provision for bad debts and other	625	414	825	1,092
Changes in assets and liabilities:				
Accounts receivable	3,825	6,738	(6,617)	4,108
Prepaid expenses and other	1,112	52	2,990	398
Accounts payable and accrued liabilities	1,763	(7,858)	(3,191)	(6,083)
Deferred revenue	(2,198)	(4,350)	8,396	(944)
Cash provided by (used in) operating activities	8,891	(9,460)	8,103	(7,691)
<b>Cash flows from investing activities</b>				
Purchases of property and equipment	(501)	(1,131)	(804)	(2,293)
Decrease in restricted Cash	1,562	1,557	1,547	1,557
Acquisition of Détente				(4,074)
Acquisition of Tempus		(5,052)		(5,052)
Other	(50)	(30)	(117)	76
Cash provided by (used in) investing activities	1,011	(4,656)	626	(9,786)
<b>Cash flows from financing activities</b>				
Proceeds from issuance of common stock and other	108	390	606	1,570
Proceeds from issuance of preferred stock, net of issuance cost		96,131		96,131
Payment of preferred stock dividends	(1,375)		(2,750)	
Repayments under notes and subordinated debentures		(25,768)		(25,768)
Cash provided by (used in) financing activities	(1,267)	70,753	(2,144)	71,933
Net increase in cash and cash equivalents	8,635	56,637	6,585	54,456
<b>Cash and cash equivalents, beginning of period</b>	<b>20,379</b>	<b>34,763</b>	<b>22,429</b>	<b>36,944</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 29,014</b>	<b>\$ 91,400</b>	<b>\$ 29,014</b>	<b>\$ 91,400</b>
<b>Supplemental disclosure of cash flow information</b>				
Cash paid for interest		518		2,482
Net cash (refunded) paid for taxes		12		(163)

**Supplemental disclosure of non cash flow information**

Issuance of common stock upon acquisition of Tempus

7,651

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

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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2005**

**NOTE 1. THE COMPANY**

QuadraMed Corporation along with its subsidiaries, (the Company or QuadraMed ) is dedicated to improving healthcare delivery by providing innovative healthcare information technology and services. QuadraMed provides healthcare information technology products and services that help healthcare providers to improve the quality of the care they deliver and the efficiency with which it is delivered. QuadraMed does this by developing and implementing sophisticated, user-friendly software applications designed and developed by the healthcare professionals and software specialists we employ.

Our products are designed to eliminate paper, improve processes, and decrease errors through the efficient management of patient clinical and financial records. They are suitable for acute care hospitals, specialty hospitals, Veterans Health Administration facilities and associated/affiliated businesses such as outpatient clinics, long-term care facilities, and rehabilitation hospitals and are used by healthcare organizations of varying size from small single entity hospitals to large multi-facility care delivery organizations. Our products are sold as standalone, bundled, or fully integrated software packages. We have, in the past, provided services to support the hospital's collection of receivables and its administration of contractual reimbursements from managed care companies; however, this segment of our business was discontinued in the first quarter of 2005.

Since 2004 we have been managed in two distinct segments, the Software Division and the Financial Services Division. In February 2004, we acquired Détente Systems Pty Limited of Sydney, Australia, a vendor of laboratory management software ( Détente ) and in June 2004 we acquired Tempus Software, Inc. of Jacksonville, Florida, a vendor of enterprise-wide hospital scheduling software ( Tempus ). The operations of both Tempus and Détente have been rolled into our Software Division. On December 15, 2004, QuadraMed announced the closing of the Financial Services Division; its operations ceased to exist in February of 2005. In 2005, the Company considers itself to be in a single reporting segment, specifically the software segment, as a result of the discontinued operations of the Financial Services Division in the first quarter of 2005. The financial results for these operating segments for prior periods have been reclassified to conform to the current period presentation.

**NOTE 2. SIGNIFICANT ACCOUNTING POLICIES**

**Financial Statement Presentation**

These condensed consolidated financial statements are unaudited and have been prepared in conformity with generally accepted accounting principles and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. It is suggested that these interim financial statements be read in conjunction with the consolidated financial statements, and the notes thereto, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004, as amended by Form 10-K/A, filed on April 29, 2005. In the opinion of management, the condensed consolidated financial statements for the periods presented herein include all normal and recurring adjustments that are necessary for a fair presentation of the results for these interim periods. The results of operations for the three and six months ended June 30, 2005 are not necessarily indicative of the results for the entire year ending

December 31, 2005.

**Principles of Consolidation**

These condensed consolidated financial statements include our accounts and all our significant business divisions and subsidiaries. Since February 2004, results of operations of Détente have been included in the

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Company's condensed consolidated statements of operations and the results of operations of Tempus have been included in the Company's consolidated statements of operations since July 2004. All significant intercompany accounts and transactions between the Company and our subsidiaries have been eliminated in the consolidated financial statements.

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

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

## **Reclassifications**

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

## **Revenue Recognition**

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

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

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

QuadraMed recognizes revenue on its software products in accordance with AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended 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 SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*.

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QuadraMed recognizes revenue when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered; we no longer have significant obligations with regard to implementation; the fee is fixed and determinable; and collectability is probable. Delivery is considered to have occurred when title and risk of loss have been transferred to the customer, which generally occurs when media containing the licensed programs is provided to a common carrier. The Company considers all arrangements with payment terms extending beyond 180 days not to be fixed and determinable. Revenue for arrangements with extended payment terms is recognized when the payments become due, provided all other recognition criteria are satisfied. If collectability is not considered probable, revenue is recognized when the fee is collected.

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

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

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

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

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

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

## **Cash and Cash Equivalents**

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





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### **Accounts Receivable and Allowance for Doubtful Accounts**

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

### **Intangible Assets**

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

*Goodwill.* QuadraMed adopted Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001, and ceased amortization of goodwill as of January 1, 2002. Prior to this point, goodwill was amortized using the straight-line method over its estimated useful life. Goodwill is subject to annual impairment tests or whenever changes in circumstances indicate that the fair value of the Company is less than the carrying value.

*Capitalized Software.* Software development costs are capitalized upon the establishment of technological feasibility, in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Upon the general release of the product to customers, development costs for that product are amortized over the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product or the straight-line method, generally five years. These amounts are charged to cost of licenses. No amounts were capitalized in 2005 and 2004.

*Other Intangible Assets.* Other intangible assets primarily relate to acquired technology including developed and core technology, trade names and customer lists acquired in QuadraMed's purchase business combinations. Amortization of other intangible assets is computed on the basis of a 3-5 year life.

On an annual basis, QuadraMed reviews its intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the provisions of SFAS No. 144. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values.

### **NOTE 3. RECENT ACCOUNTING PRONOUNCEMENTS**

In March 2004, the Financial Accounting Standards Board ( FASB ) issued a proposed statement, *Share-Based Payment*, which addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the grant-date fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The proposed statement would eliminate the ability to account for share-based compensation transactions using Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123.

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However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values. Pro forma disclosure is no longer an alternative.

As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123(R)'s fair value method may have a significant impact on the Company's result of operations as we will be required to recognize the cost of

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employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. SFAS No. 123(R) permits public companies to adopt its requirements using either the modified prospective method or the modified retrospective method. The Company expects to adopt SFAS No. 123(R) using the modified-prospective method. In April 2005, the Securities and Exchange Commission delayed the effective date of SFAS No. 123(R), which is now effective for public companies for annual, rather than interim, periods that begin after June 15, 2005. The Company is currently evaluating the impact on its financial statements upon the adoption of SFAS No. 123(R).

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*, which amends APB Opinion No. 29, *Accounting for Nonmonetary Transactions (SFAS No. 153)*, which requires a nonmonetary exchange of assets be accounted for at fair value, recognizing any gain or loss, if the exchange meets a commercial substance criterion and fair value is determinable. The commercial substance criterion is assessed by comparing the entity's expected cash flows immediately before and after the exchange. This eliminates the similar productive assets exception, which accounts for the exchange of assets at book value with no recognition of gain or loss. SFAS No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. We do not believe the adoption of SFAS No. 153 will have a material impact on our financial statements.

In March 2005, the FASB issued FIN 47, *Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143 (FIN 47)*, which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. We do not anticipate that the adoption of FIN 47 will have a material impact on our financial statements.

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 replaces APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not anticipate that the adoption of SFAS No. 154 will have a material impact on our financial statements.

**NOTE 4. CLOSING AND DISCONTINUED OPERATION OF FINANCIAL SERVICES DIVISION**

Due to increasing operating losses in our Financial Services Division, and the lack of a qualified buyer for the business, we announced the shutdown of this division on December 15, 2004. The shutdown of this division was completed on February 14, 2005. In connection with the shutdown, we recorded an impairment charge of \$3.3 million in the fourth quarter of 2004, which was comprised of severance expense of \$414,000, write-off of intangible assets of \$820,000, write-off of purchased software of \$1.85 million and write-off of leasehold improvement of \$246,000.

In the first six months of 2005, the Company recorded a charge of approximately \$1.0 million in connection with our future obligations under the division's San Marcos lease, net of estimated sublease income. The lease for this facility terminates in May 2008; our annual expense under the lease is approximately \$778,000, and we are actively seeking a qualified subtenant for the property. We have estimated the facility closing costs based upon current market information available related to potential sublease rental income, sublease commission costs, and the length of time expected to secure a sublease.



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

	For the Six Months Ended June 30,	
	2005	2004
Revenues	\$ 223	\$ 3,252
Loss from operation	(772)	(2,240)
Exit cost of facility closing	(1,032)	
Other	118	
<b>Total loss</b>	<b>\$ (1,686)</b>	<b>\$ (2,240)</b>

The following table sets forth a summary of the exit cost of facility closing, and the accrued facility cost as of June 30, 2005:

	For the Six Months Ended June 30, 2005		
	Short term	Long term	Total
Exit cost of facility closing accrued as of December 31, 2004	\$ 1,150	\$ 2,898	\$ 4,048
Add: Exit cost for facility closing related to Financial Services	674	358	1,032
Less: Payments made in the first six months of 2005	(320)	(442)	(762)
<b>Exit cost of facility closing accrued as of June 30, 2005</b>	<b>\$ 1,504</b>	<b>\$ 2,814</b>	<b>\$ 4,318</b>

The exit cost of facility closing accrued as of December 31, 2004 relates to the shut-down of our former headquarters in San Rafael, California. The Company estimated approximately \$4.0 million in connection with our future obligations on the lease, net of estimated sublease income, and recorded this expense in the fourth quarter of 2004. The short term portion of accrued exit cost of facility closing is included in the other accrued liabilities on the Consolidated Balance Sheets.

**NOTE 5. REDUCTION IN FORCE**

During the first quarter of fiscal year 2005, the Company announced a corporate reorganization and a reduction in our workforce of some 95 positions. The Company recorded a severance charge of \$531,000 related to terminated employees. As of June 30, 2005, approximately \$42,000 of this amount remains unpaid.



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Goodwill and other intangible assets for the six-month period ended June 30, 2005 were as follows (in thousands):

	As of December 31, 2004	Q1 2005 Activity	Q2 2005 Activity	As of June 30, 2005
<b>Cost</b>				
Capitalized software	\$ 13,445	\$	\$	\$ 13,445
Goodwill	37,896			37,896
Other intangible assets	30,486			30,486
	<u>81,827</u>			<u>81,827</u>
<b>Accumulated amortization</b>				
Capitalized software	\$ (12,018)	\$ (254)	\$ (243)	\$ (12,515)
Goodwill	(11,913)			(11,913)
Other intangible assets	(18,035)	(1,362)	(1,349)	(20,746)
	<u>(41,966)</u>	<u>(1,616)</u>	<u>(1,592)</u>	<u>(45,174)</u>
<b>Net book value</b>				
Capitalized software	\$ 1,427	\$ (254)	\$ (243)	\$ 930
Goodwill	25,983			25,983
Other intangible assets	12,451	(1,362)	(1,349)	9,740
	<u>\$ 39,861</u>	<u>\$ (1,616)</u>	<u>\$ (1,592)</u>	<u>\$ 36,653</u>

Amortization of acquired technology, a component of other intangible assets, for the three and six months ended June 30, 2005 and 2004 was \$781,000, \$195,000 and \$1,562,000, \$193,000, respectively, and was included in cost of license revenue. There were no impairment charges recorded during the six months ended June 30, 2005 or 2004.

**NOTE 7. SERIES A PREFERRED STOCK**

On June 17, 2004, QuadraMed issued 4.0 million shares of Series A Cumulative Mandatory Convertible Preferred Stock (the Series A Preferred Stock) in a private, unregistered offering to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933. The Series A Preferred Stock was sold for \$25 per share, and QuadraMed used the \$96.1 million of net proceeds of the offering to repurchase all of our Senior Secured Notes due 2008 (the 2008 Notes) and our 5.25% Convertible Subordinated 2005 Notes (the 2005 Notes), together with accrued interest and related redemption premiums; the remainder is to be used for general corporate purposes.

The Series A Preferred Stock holders do not have any relative, participating, optional or other voting rights and powers, except that (i) if four quarterly dividend payments are in arrears, such holders are entitled to elect two substitute directors to the Board of Directors at any annual or special meeting, and (ii) in certain circumstances, such holders are entitled to vote on the authorization or creation of securities ranking on par

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with or above the Series A Preferred Stock, certain amendments to the certificate of incorporation or the certificate of designation for the Series A Preferred Stock, and the incurrence of new senior indebtedness in an aggregate principal amount exceeding \$8 million. Prior to the authorization or creation of, or increase in the authorized amount of, any shares of any class or series (or any security convertible into shares of any class or series) ranking senior to or on par with the Series A Preferred Stock in the distribution of assets upon any liquidation, dissolution or winding up of QuadraMed or in the payment of dividends, QuadraMed must have the affirmative vote of a majority of any outstanding shares of the Series A Preferred Stock (along with any shares of every other series or class of common stock ranking on par with the Series A Preferred Stock having like voting rights).



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The Series A Preferred Stock is entitled to quarterly dividends of \$0.34 (5.5% per annum) and is convertible into shares of common stock of the Company at a conversion price of \$3.10, equivalent to a conversion rate of 8.0645 shares of common stock for each share of Series A Preferred Stock. The initial conversion price of \$3.40 (conversion rate of 7.3529 shares of common stock for each share of Series A Preferred Stock) decreased to \$3.10 as of August 1, 2005, pursuant to the terms of the Certificate of Designation relating to the Series A Preferred Stock, as the volume weighted average of the daily market price per share during a period of 30 consecutive trading days equaled \$2.75 or less during the one year period beginning on the first anniversary of the issue date. Additionally, as provided in the Certificate of Designation, because the Company has not as of June 15, 2005, registered this Preferred Stock with the SEC, the dividend rate for such stock increased to \$0.40625 per quarter (\$1.625 per annum) on June 16, 2005, and such rate will apply until the date the stock is registered. The Company has the right to demand conversion on or after May 31, 2007, in the event the volume weighted average of the daily market price per share during a period of 20 consecutive trading days equals or exceeds \$5.10.

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

As a result of the aforementioned feature, at the date of issuance of the Series A Preferred Stock, the Company recorded dividends payable of \$15.2 million, which represents the present value of the three-year dividends. The present value adjustment of \$1.3 million is being amortized over three years as interest expense using the effective interest rate method. For the period ended June 30, 2005, approximately \$356,000 was recorded as interest expense.

The carrying value of the Series A Preferred Stock was also reduced by \$15.2 million, which represents the imputed discount on the Series A Preferred Stock and which is being accreted over three years using the effective interest rate method. For the six months ended June 30, 2005, approximately \$2.4 million was accreted and charged to accumulated deficit. If any Series A Preferred Stock shares are converted prior to the end of the three-year period, the related accretion will be accelerated. The Company determined that there was no beneficial conversion feature attributable to the Series A Preferred Stock.

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

		<b>As of June 30, 2005</b>
Total issued		\$ 100,000
Less: Issuance cost		(3,856)
Less: Unaccreted discount		
Original present value of discount	(15,174)	
2005 preferred stock accretion	2,366	
Prior preferred stock accretion	2,465	(10,343)
		<hr/>
Carrying value of Preferred Stock at June 30, 2005		\$ 85,801

**NOTE 8. LONG-TERM DEBT**

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In June 2004, the Company commenced, with net proceeds from the Series A Preferred Stock offering, a cash tender offer to purchase all of its outstanding 2008 Notes and 2005 Notes. In the quarter ended June 30,

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2004, a principal balance of \$15.1 million of the 2008 Notes was retired with a premium of \$754,000 (5%) and a principal balance of \$11.9 million of the 2005 Notes was retired with a premium of \$89,000 (0.75%). As a result, the Company wrote off prorated portions of debt offering costs and the discount on the 2008 Notes and recorded a \$3.1 million loss on the retirement of Notes. In the quarter ended September 30, 2004, the Company retired the remaining \$58.8 million of the 2008 Notes and \$56,000 of the 2005 Notes. The total cash payment in July 2004 was \$63.2 million, which includes additional interest expense of \$54,000. Total loss recorded on the retirement of debt during the third quarter of 2004 was approximately \$11.7 million, which includes redemption premiums of \$2.9 million and write-offs of remaining balances of debt offering costs of \$577,000, the discount relative to the 2008 Notes of \$7.9 million, and the effective interest rate adjustment of \$339,000.

**NOTE 9. RESTRICTED STOCK GRANTS**

During the three and six months ended June 30, 2005, zero shares of common stock were issued as restricted stock grants. During the three and six months ended June 30, 2004, zero and 50,000 shares of common stock were issued as restricted stock at no exercise price as provided for under QuadraMed's 1996 Stock Plan. The grants were made to certain senior executives for no monetary consideration. The majority of the Company's restricted shares fully vest over three to four years. QuadraMed has recorded the fair value of the restricted shares on the date they were granted as deferred compensation within the Stockholders' Equity section of the Consolidated Balance Sheets. This amount is amortized over the vesting period. Compensation expense associated with the grants of restricted stock total \$142,000 and \$265,000 during the three months ended June 30, 2005 and 2004 respectively, and \$284,000 and \$573,000 during the six months ended June 30, 2005 and 2004, respectively. In addition to these amounts, \$592,000 was charged to severance expense in the six months ended June 30, 2005 relating to the early-vesting of restricted stock issued to a former officer of the Company.

As of June 30, 2005, 775,000 issued restricted shares remained unvested.

**NOTE 10. NET LOSS PER SHARE AND COMPREHENSIVE LOSS**

Basic loss per share is determined using the weighted average number of common shares outstanding during the period. Diluted loss per share is determined using the weighted average number of common shares and common equivalent shares outstanding during the period. Common equivalent shares consist of shares issuable upon the exercise of stock options and warrants (using the treasury stock method) and conversion of the preferred stock and subordinated debentures (using the as-converted method). Common equivalent shares are excluded from the diluted computation if their effect is anti-dilutive.

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

	<b>Three months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Numerator:</b>		
Net income (loss) attributable to common shareholders	\$ 102	\$ (9,669)
<b>Denominator:</b>		

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Weighted average number of common shares outstanding	basic and diluted	40,499	34,872
Basic and diluted net income (loss) per common share		\$ 0.00	\$ (0.28)

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	Six months ended June 30,	
	2005	2004
<b>Numerator:</b>		
Net loss attributable to common shareholders	\$ (3,593)	\$ (14,210)
<b>Denominator:</b>		
Weighted average number of common shares outstanding basic and diluted	40,338	32,014
Basic and diluted net loss per common share	\$ (0.09)	\$ (0.44)

As QuadraMed recorded net losses for both of the six month periods ended June 30, 2005 and 2004, no common equivalent shares were included in diluted net loss per share calculation because they were anti-dilutive. If QuadraMed had reported net income, the calculation of diluted earnings per share would have included the following common stock equivalent shares from the indicated equity instruments (in thousands):

	Six months ended June 30,	
	2005	2004
<b>Equity instruments:</b>		
Preferred stock (as of August 1, 2005 the common equivalent shares becomes 32,258)	29,412	29,412
Warrants	3,265	3,472
Stock options	692	1,776
5.25% Convertible debentures (2005 Notes)		2
<b>Total common stock equivalent shares</b>	<b>33,369</b>	<b>34,662</b>

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

	Six months ended June 30,	
	2005	2004
Net loss attributable to common shareholders	\$ (3,593)	\$ (14,210)
Unrealized loss	(6)	(58)
Foreign currency translation adjustment	(11)	
<b>Comprehensive loss</b>	<b>\$ (3,610)</b>	<b>\$ (14,268)</b>

**NOTE 11. STOCK-BASED COMPENSATION**

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SFAS No. 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 account for stock based employee compensation using the intrinsic value method prescribed in 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.

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed option-pricing models. Upon the adoption of SFAS No. 123(R) on January 1, 2006, pro forma disclosure is no longer an alternative. Accordingly, the adoption of SFAS No. 123(R)'s fair value method may have a significant impact on the Company's result of operations. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time.

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because it will depend on levels of share-based payments granted in the future. The stock-based compensation disclosure within this Note sets out the impact of using fair value accounting for share-based payments for the six months ended June 30, 2005 and 2004. However, the amounts disclosed within our footnote are not necessarily indicative of the amounts that will be expensed in future periods upon the adoption of SFAS No. 123(R). SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

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. 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 loss and net loss per share would have been changed to the amounts indicated below (in thousands except per share data):

	<b>Three months</b>	
	<b>ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Net income (loss) attributable to common shareholders, as reported	\$ 102	\$ (9,669)
Add: Stock-based employee compensation expense in reported net income (loss)	144	326
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards,	(475)	(1,443)
<b>Pro forma net loss</b>	<b>\$ (229)</b>	<b>\$ (10,786)</b>
Basic and diluted net loss per common share, as reported	\$ 0.00	\$ (0.28)
Basic and diluted net loss per common share, pro forma	\$ (0.01)	\$ (0.31)
	<b>Six months</b>	
	<b>ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Net income (loss) attributable to common shareholders, as reported	\$ (3,593)	\$ (14,210)
Add: Stock-based employee compensation expense in reported net income (loss)	898	789
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards,	(1,901)	(4,413)
<b>Pro forma net loss</b>	<b>\$ (4,616)</b>	<b>\$ (17,834)</b>
Basic and diluted net loss per common share, as reported	\$ (0.09)	\$ (0.44)
Basic and diluted net loss per common share, pro forma	\$ (0.11)	\$ (0.56)

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:

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	<u>2005</u>	<u>2004</u>
Expected dividend yield		
Expected stock price volatility	148.94%	120.48%
Risk-free interest rate	3.87%	3.35%
Expected life of options	4.18 years	4.30 years



**Table of Contents****NOTE 12. ADDITIONAL INFORMATION AS TO CERTAIN REVENUE AND EXPENSES**

Included as a component of operating expenses for the three and six months ended June 30, 2005 and 2004 are the following revenue and expense items (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Settlement of litigation	\$ (700)	\$	\$ (700)	\$
Legal fees related to shareholder litigation		(180)		(680)
Life insurance proceeds	532		532	
Insurance reimbursement	407		407	
Mergers and acquisition costs	(572)		(572)	
Executive stock expense for former officer			(592)	
Severance costs and retention bonuses	(200)	(138)	(531)	(842)
Office relocation costs				(365)
<b>Total</b>	<b>\$ (533)</b>	<b>\$ (318)</b>	<b>\$ (1,656)</b>	<b>\$ (1,887)</b>

**NOTE 13. MAJOR CUSTOMERS**

No single customer accounted for more than 10% of total revenues in the three and six months ended June 30, 2005. In the three months ended June 30, 2004, one single customer accounted for 10% of total revenues. Another customer accounted for 14% of total revenues for the six months ended June 30, 2004.

**NOTE 14. LITIGATION AND OTHER MATTERS**

On July 6, 2005, the Company settled its litigation with Mr. James Durham, its former Chief Executive Officer. Under the terms of the Settlement Agreement and General Release ( Settlement Agreement ) between the parties, the Company made an immediate cash payment of approximately \$3.6 million to Mr. Durham and issued a Negotiable Promissory Note (the Note ) to Mr. Durham in the principal amount of \$1.4 million and with an interest rate of 5.12% per annum. The timing of payments under the Note is linked to the Company's realization of amounts invested in a split-dollar insurance arrangement (the Split-Dollar Policy ) with Mr. Durham. As of June 30, 2005, the Company has fully accrued for the payment. The immediate payment of \$3.6 million was funded principally by the liquidation of certain assets earmarked for such purpose in the amount of \$3.1 million, and payment of \$0.5 million out of operating cash. The Company's obligations under the Note are secured by a collateral assignment of the Company's rights under the Split-Dollar Policy and certain related agreements. The Settlement Agreement includes various releases from both parties.

On November 15, 2004, the Company received a letter from MedCath Incorporated ( MedCath ), which provided notice of MedCath's decision to terminate the Master Software License and Services Agreement, dated November 20, 2002, by and between QuadraMed Affinity and MedCath

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(the Contract ). On or about November 15, 2004, MedCath filed a complaint against us in the North Carolina Superior Court, County of Mecklenburg. In its complaint, MedCath alleges that we are in breach of the Contract due to uncured deficiencies in the products, and seeks at least \$5 million in damages, plus litigation costs. We believe that these allegations are without merit and that the termination of the Contract is unwarranted. On December 9, 2004, we filed a motion to dismiss the MedCath complaint on the grounds that the complaint fails to state a claim upon which relief can be granted. We also filed a counterclaim against MedCath seeking no less than \$1.14 million in unpaid amounts due to us, plus litigation costs, for MedCath's breach of the Contract by failing to pay licensing fees due to the Company. A case management conference was held July 29, 2005 in the Superior Court before a judge to whom the case has been assigned. Although the Court has not issued a final case management order at this time, we anticipate that such an order will be issued shortly which, among other things, will schedule a hearing on our motion to dismiss for a date in late September, 2005, will provide for all fact discovery to be completed by April 15, 2006, will provide for all expert discovery to be completed by July 15, 2006, and will provide for the parties to submit the dispute to mediation by approximately April 30, 2006. We will continue to defend ourselves vigorously against any claim that we have breached the Contract and will seek redress through all applicable remedies for any injuries suffered by the Company in connection with this matter.

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

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

**Results of Operations (unaudited)**

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

	Three months ended June 30,			
	2005		2004	
<b>Revenue</b>				
Services	\$ 3,547	12%	\$ 3,421	11%
Maintenance	13,975	46	11,693	38
Installation and other	2,408	8	3,140	10
	<u>19,930</u>	<u>65</u>	<u>18,254</u>	<u>60</u>
Services and other	19,930	65	18,254	60
Licenses	9,782	32	11,182	37
Hardware	971	3	1,034	3
	<u>30,683</u>	<u>100</u>	<u>30,470</u>	<u>100</u>
<b>Cost of revenue</b>				
Cost of services and other	7,119	36	7,620	42
Royalties and other	2,259	23	2,959	26
Amortization of acquired technology and capitalized software	1,024	10	691	6
	<u>3,283</u>	<u>34</u>	<u>3,650</u>	<u>33</u>
Cost of licenses	3,283	34	3,650	33
Cost of hardware	543	56	775	75
	<u>10,945</u>	<u>36</u>	<u>12,045</u>	<u>40</u>
<b>Total cost of revenue</b>	10,945	36	12,045	40

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<b>Gross margin</b>	19,738	64	18,425	60
<b>Operating expenses</b>				
General and administration	6,175	20	7,759	25
Software development	7,724	25	6,835	22
Sales and marketing	3,495	11	6,006	20
Amortization of intangible assets and depreciation	1,115	4	976	3
<b>Total operating expenses</b>	<b>\$ 18,509</b>	<b>60%</b>	<b>\$ 21,576</b>	<b>71%</b>
<b>Income (loss) from operations</b>	<b>\$ 1,229</b>		<b>\$ (3,151)</b>	

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	Six months ended June 30,			
	2005		2004	
<b>Revenue</b>				
Services	\$ 6,624	11%	\$ 6,024	9%
Maintenance	27,385	45	23,309	36
Installation and other	5,104	8	6,561	10
	<u>39,113</u>	<u>64</u>	<u>35,894</u>	<u>55</u>
Services and other				
Licenses	20,134	33	23,674	36
Hardware	1,811	3	5,548	9
	<u>61,058</u>	<u>100</u>	<u>65,116</u>	<u>100</u>
<b>Total revenue</b>				
<b>Cost of revenue</b>				
Cost of services and other	14,438	37	15,306	43
Royalties and other	4,426	22	5,465	23
Amortization of acquired technology and capitalized software	2,059	10	1,351	6
	<u>6,485</u>	<u>32</u>	<u>6,816</u>	<u>29</u>
Cost of licenses				
Cost of hardware	1,508	83	3,606	65
	<u>22,431</u>	<u>37</u>	<u>25,728</u>	<u>40</u>
<b>Total cost of revenue</b>				
<b>Gross margin</b>				
	<u>38,627</u>	<u>63</u>	<u>39,388</u>	<u>60</u>
<b>Operating expenses</b>				
General and administration	12,285	20	16,563	25
Software development	15,441	25	13,945	21
Sales and marketing	7,567	12	11,825	18
Amortization of intangible assets and depreciation	2,706	4	2,026	3
	<u>\$ 37,999</u>	<u>62%</u>	<u>\$ 44,359</u>	<u>68%</u>
<b>Total operating expenses</b>				
<b>Income (loss) from operations</b>				
	<u>\$ 628</u>		<u>\$ (4,971)</u>	

**Revenue**

*Total revenue.* Total revenues for the three months ended June 30, 2005 were \$30.7 million, an increase of \$0.2 million or 1% from \$30.5 million for the three months ended June 30, 2004. Government revenues increased \$0.5 million in the three months ended June 30, 2005 compared with the same period in 2004. The 2004 acquisitions of Tempus and Détente contributed \$2.0 million to revenue in the three months ended June 30, 2005 compared to \$0.5 million in the three months ended June 30, 2004. The additional \$1.5 million in revenue was offset by a \$2.0 million decrease in revenue from other Enterprise products.

Total revenues for the six months ended June 30, 2005 were \$61.1 million, a decrease of \$4.0 million or 6.1% from \$65.1 million for the six months ended June 30, 2004. There was a \$3.7 million decrease in Affinity hardware revenue in 2005. Total revenue for the same period in the

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prior year included approximately \$3.8 million in hardware revenue related to one customer. The 2004 acquisitions of Tempus and Détente contributed \$3.6 million to revenue in 2005 compared to \$0.9 million in 2004.

*Services and other.* Services and other revenue consists of professional services, such as implementation and installation services, training, maintenance, which consists of technical support and product upgrades, reimbursable expenses and other services revenue. Professional services are typically provided over a period of three to nine months for the HIM product solutions and two to three years for Affinity and other related Enterprise products. These services are provided subsequent to the signing of a software license agreement and depend almost exclusively on our software license revenue. Our maintenance revenue depends on both licenses

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of our software products and renewals of maintenance agreements by our existing customer base and are recognized ratably over the term of the agreement.

Services revenue of \$3.5 million, or 12% of total revenue in the three months ended June 30, 2005 increased \$0.1 million, or 4% from \$3.4 million in the same period last year. The increase in revenue of \$0.1 million was mainly related to the growth in the MPI Services business.

Services revenue of \$6.6 million, or 11% of total revenue in the six months ended June 30, 2005 increased \$0.6 million, or 10%, from \$6.0 million in the same period last year. The increase in revenue of \$0.6 million, mainly related to the growth in supplemental services provided to our existing Affinity customers, and an increase in service revenue in the government business and MPI Services business. These increases were offset by a \$0.2 million decline in service related work in PFS.

Maintenance revenue was \$14.0 million in the three months ended June 30, 2005 compared to \$11.7 million in the three months ended June 30, 2004, representing an increase of \$2.3 million or 19%. Maintenance revenue, as a percentage of total revenue, was 46% and 38% in the three months ended June 30, 2005 and 2004, respectively. The increase in maintenance revenue is mainly due to increased contracts in the Enterprise division and the addition of maintenance revenue from the Tempus acquisition.

Maintenance revenue was \$27.4 million in the six months ended June 30, 2005 compared to \$23.3 million in the six months ended June 30, 2004, representing an increase of \$4.1 million or 17%. Maintenance revenue, as a percentage of total revenue, was 45% and 36% in the six months ended June 30, 2005 and 2004, respectively. The increase in maintenance revenue is mainly due to increased contracts in Enterprise division and the addition of maintenance revenue from the Tempus acquisition.

Installation and other services revenue decreased to \$2.4 million in the three months ended June 30, 2005 from \$3.1 million in the in the three months ended June 30, 2004. The installation revenue decrease is primarily due to a decrease in revenue from Affinity and other Enterprise products partially offset by an increase in government installation revenues in the period.

Installation and other services revenue decreased to \$5.1 million in the six months ended June 30, 2005 from \$6.6 million in the six months ended June 30, 2004. The installation revenue decrease is primarily due to a decrease in revenue from Affinity and other Enterprise products partially offset by an increase in government installation revenues in the period.

*Licenses.* License revenue consists of fees and licenses of proprietary and third-party software, all of which is marketed through our direct sales force. License revenue in the three months ended June 30, 2005 was \$9.8 million, a decrease of \$1.4 million or 13% from \$11.2 million in the corresponding period of 2004. License revenue, as a percentage of total revenue, was 32% and 37% in the three months ended June 30, 2005 and 2004, respectively. License revenue for Enterprise products decreased by approximately \$2.5 million to \$3.7 million in the three months ended June 30, 2005 from \$6.2 million in the same quarter prior year. PFS license revenue declined by \$1.3 million from the second quarter of 2004 due to the completion of many contracts in 2004. License revenue for HIM products increased by \$1.0 million in the three months ended June 30, 2005 to \$3.4 million or 45% in the three months ended June 30, 2005 due to the completion of many contracts during the quarter.

License revenue in the six months ended June 30, 2005 was \$20.1 million, a decrease of \$3.5 million or 15% from \$23.6 million in the corresponding period of 2004. License revenue, as a percentage of total revenue, was 33% and 36% in the six months ended June 30, 2005 and 2004, respectively. License revenue for Enterprise products decreased by approximately \$4.6 million to \$8.3 million in the six months ended

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June 30, 2005 from \$12.9 million in the same quarter prior year. The decrease in Enterprise license revenue was the result of a decrease in new Affinity contracts and a reduction in revenue from PFS contracts. However, HIM license



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revenues increased \$1.1M to \$6.4M in the six months ended June 30, 2005 from \$5.3M in the same period prior year. Government license revenue was \$5.4M in the six months ended June 30, 2005 and 2004.

*Hardware.* Hardware revenue consists of the sale of third-party hardware purchased specifically for use by our customers. Hardware revenue was \$1.0M in the three months ended June 30, 2005 and 2004 respectively. Hardware revenue, as a percentage of total revenue, was 3% in both the three months ended June 30, 2005 and 2004, respectively. Hardware revenue in the six months ended June 30, 2005 was \$1.8 million, a 67% decrease from \$5.5 million in the six months ended June 30, 2004. In the first quarter of 2004 the Company completed a significant Affinity contract which was signed at the end of fiscal year 2003 and resulted in a one-time increase in hardware revenue.

Revenue recognized for the three and six months ended June 30, 2005 and 2004 includes:

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

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

revenues recognized on a cash-basis after the Company's contractual commitment has been completed.

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

	<b>For the Three Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Deferred revenue, beginning balance	\$ 54,634	\$ 51,908
Add: revenue deferred	27,260	24,088
Less: deferred revenue recognized	(29,458)	(28,052)
Add: revenue acquired in acquisition		2,381
<b>Deferred revenue, ending balance</b>	<b>52,436</b>	<b>50,325</b>

  

	<b>For the Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Deferred revenue, beginning balance	\$ 44,040	\$ 48,502
Add: revenue deferred	67,027	57,039
Less: deferred revenue recognized	(58,631)	(57,982)
Add: revenue acquired in acquisition		2,766

Deferred revenue, ending balance	52,436	50,325
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### Cost of Revenue

*Cost of services and other.* Cost of services and other consists of salaries and related expenses associated with services performed for customer support, installation, maintenance and consulting services. Cost of services and other for the quarter ended June 30, 2005 of \$7.1 million was \$0.5 million less than the \$7.6 million in the corresponding period of 2004. As a percentage of services and other revenue, cost of services and other was 36% and 42% for the three months ended June 30, 2005 and 2004, respectively. The decrease was primarily due to a decrease in personnel and consulting costs.

Cost of services and other for the six months ended June 30, 2005 of \$14.4 million was \$0.9 million less than the \$15.3 million in the corresponding period of 2004. As a percentage of services and other revenue, cost of services and other was 37% and 43% for the six months ended June 30, 2005 and 2004, respectively. The decrease was primarily due to a decrease in personnel and consulting costs.

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*Cost of licenses.* Cost of licenses consists primarily of the cost of third-party software, royalties and amortization of capitalized software and acquired technology. A significant percentage of our total cost of revenue is attributable to the cost of third-party software royalties and licenses relating to software embedded within our software applications. Generally, third-party royalty fees fluctuate based on revenue or the number of the Company's customers and therefore will fluctuate on a quarter to quarter basis. Cost of licenses in the three months ended June 30, 2005 of \$3.3 million, decreased compared to \$3.7 million for the same period of 2004. Costs of license decreased \$0.4 million due to decreases in third party license costs. As a percentage of license revenue, cost of licenses was 34% and 33% for the three months ended June 30, 2005 and 2004, respectively. Cost of license increased as a percentage of revenue due to a decline in higher margin Enterprise license revenue.

Cost of licenses in the six months ended June 30, 2005 of \$6.5 million, decreased compared to \$6.8 million for the same period of 2004. Costs of license decreased \$0.3 million due to decrease in third party license costs. As a percentage of license revenue, cost of licenses was 32% and 29% for the six months ended June 30, 2005 and 2004, respectively. Cost of license increased as a percentage of revenue due to a decline in higher margin Enterprise license revenue.

*Cost of hardware.* Cost of hardware consists of third-party hardware and installation costs. Cost of hardware in the three months ended June 30, 2005 was \$0.6 million, a decrease of \$0.2 million compared to \$0.8 million for the same period last year. As a percentage of hardware revenue, cost of hardware was 56% and 75% for the three months ended June 30, 2005 and 2004, respectively.

During the six months ended June 30, 2005 cost of hardware was \$1.5 million, a decrease of \$2.1 million, compared to \$3.6 million for the same period last year. As a percentage of hardware revenue, cost of hardware was 83% and 65% for the three months ended June 30, 2005 and 2004, respectively. Cost of hardware in the first quarter of 2004 was unusually high due to a large hardware sale to a single Affinity customer, the revenue for which was also recorded in that period.

## **Gross Margin**

Overall, gross margin improved to 64% for the three months ended June 30, 2005 from 60% for the same period in 2004. Gross margin on license revenue declined to 66% in the three months ended June 30, 2005 from 67% in the three months ended June 30, 2004. Gross margin on services and other revenue improved from 58% to 64% due to increased maintenance revenue and the 2005 reorganization, resulting in decreased costs. The margin on hardware revenue improved from 25% to 44% in the three month period ending June 30, 2005.

Overall, gross margin improved from 60% for the six months ended June 30, 2004 to 63% for the six month period ended June 30, 2005. Gross margin on license revenue declined from 71% to 68% for the respective periods due primarily to increased amortization of acquired technology in 2005 that resulted from the 2004 acquisitions of Détente and Tempus. Gross margin on services and other revenue improved from 57% to 63% due to increased maintenance revenue and the 2005 reorganization, resulting in decreased costs. The margin on hardware revenue declined to 17% in the six months ended June 30, 2005 due to a relatively high 35% margin experienced for the six months ended June 30, 2004. This high margin was due to a significant level of hardware revenue in the first quarter of 2004, which was almost all from a single contract, and which was unusually profitable.

## **Operating Expenses**

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*General and administration.* General and administration expense consists of compensation and benefit costs for executive, finance, legal, information technology, and administrative personnel. General and administration expense, decreased to \$6.2 million in the second quarter of 2005 compared to \$7.8 million in the same quarter in the prior year. As a percentage of total revenue, general and administration expense was 20% and 25% for the three month periods ended June 30, 2005 and 2004, respectively. The overall \$1.6 million decrease is mainly

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attributable to decreased wages and related costs of \$1.0 million, a decrease in bad debt expense of \$0.5 million, and a \$0.6 million decrease in rent and other related common expenses assigned to administrative departments, all offset by a \$0.2 million net increase in legal and professional fees and other categories.

For the six months ending June 30, 2005, general and administration expense decreased to \$12.3 million compared to \$16.6 million in the same period in the prior year. As a percentage of total revenue, general and administration expense was 20% and 25%, respectively for the periods. The overall \$4.3 million decrease is mainly attributable to decreased wages and related costs of \$2.6 million, a decrease in bad debt expense of \$1.0 million, and a \$1.0 million decrease in rent and other related common expenses assigned to administrative departments, all offset by a \$0.4 million net increase in legal and professional fees and other categories.

*Software development.* Software development expense includes costs associated with the development of new products for which technological feasibility has not been achieved, enhancements of existing products, maintenance and quality assurance activities and primarily relates to compensation and benefits costs. Software development costs, in the three months ended June 30, 2005 were \$7.7 million compared to \$6.8 million in the same period in 2004, representing an increase of \$0.9 million. As a percentage of total revenue, software development costs were 25% and 22% for the quarters ended June 30, 2005 and 2004, respectively. The increase was primarily attributed to an increase in personnel costs and overall expenses for software development departments, attributable in part to such expenses at Détente and Tempus, which were acquired during 2004.

Software development costs, in the six months ended June 30, 2005 were \$15.4 million compared to \$13.9 million in the same period in 2004, representing an increase of \$1.5 million. As a percentage of total revenue, software development costs were 25% and 21% for the six months ended June 30, 2005 and 2004, respectively. The increase was primarily attributed to an increase in personnel costs and overall expenses for software development departments, attributable in part to such expenses at Détente and Tempus, which were acquired during 2004.

*Sales and marketing.* Sales and marketing expense includes costs associated with our sales and marketing personnel and consists primarily of compensation and benefits, commissions and bonuses, promotional and advertising expenses. Sales and marketing expense decreased \$2.5 million in the three months ended June 30, 2005 to \$3.5 million from \$6.0 million in the same period last year. As a percentage of total revenue, sales and marketing expenses decreased to 11% in the three months ended June 30, 2005 from 20% in the same period of 2004. This was primarily due to a decrease in commissions of \$1.2 million, a decrease in other wage related expenses of \$1.2 million, and a decrease in advertising expense of \$0.3 million. Salaries and wages decreased primarily as a result of the January 2005 reorganization and realignment of personnel, offset in part by additional personnel acquired through Détente and Tempus.

Sales and marketing expense decreased \$4.2 million in the six months ended June 30, 2005 to \$7.6 million from \$11.8 million in the same period last year. As a percentage of total revenue, sales and marketing expenses decreased to 12% in the six months ended June 30, 2005 from 18% in the same period of 2004. This was primarily due to a decrease in commissions of \$2.1 million, a decrease in other wage related expenses of \$1.6 million, and a decrease in travel expense of \$0.4 million. Salaries and wages decreased primarily as a result of the January 2005 reorganization and realignment of personnel, offset in part by additional personnel acquired through Détente and Tempus.

*Amortization of intangible assets and depreciation.* Amortization of intangible assets and depreciation expense increased to \$1.1 million for the three months ended June 30, 2005 from \$1.0 million in the corresponding period in 2004, principally as a result of non-cash write-off of certain fixed assets at closed office locations. For the six months ended June 30, 2005, amortization of intangible assets and depreciation expense increased to \$2.7 million from \$2.0 million in the corresponding period in 2004.



**Table of Contents****Other Income (Expense)**

*Other income (expense), net.* Net other income was \$0.1 million in the three months ended June 30, 2005 compared to expense of \$5.2 million in the corresponding quarter in 2004 and \$0.2 million and \$7.0 million expense for the six months ended June 30, 2005 and 2004 respectively. The decrease was primarily due to the interest expense and loss from the retirement of debt in the second quarter of 2004, related to the \$73 million of debt that was retired in mid-2004. Interest expense for the quarters ended June 30, 2005 and 2004 was \$0.2 million and \$2.1 million, respectively. Of these amounts, approximately \$0.2 million and \$0.5 million were non-cash charges.

**Discontinued Operations of Financial Services Division**

Due to increasing operating losses in our Financial Services Division, and the lack of a qualified buyer for the business, we announced the shutdown of this division on December 15, 2004. The shutdown of this division was effective February 15, 2005. In connection with the shutdown, we recorded an impairment charge of \$3.3 million in the fourth quarter of 2004, which was comprised of severance expense of \$0.4 million, write-off of intangible assets of \$0.8 million, write-off of purchased software of \$1.9 million and write-off of leasehold improvement of \$0.2 million.

In the six months ended June 30, 2005, the Company recorded a charge of approximately \$1.0 million in connection with our future obligations on the Division's San Marco lease, net of estimated sublease income. The lease for this facility terminates in May 2008; our annual expense under the lease is approximately \$0.8 million, and we are actively seeking a qualified subtenant for the property. We have estimated facility closing costs based upon current market information available related to potential sublease rental income, sublease commission costs, and the length of time expected to sublease to secure a sublease.

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

	<b>For the Three Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Revenue	\$	\$ 1,428
Loss from operations		(1,334)
Exit cost of facility closing		
Other		
<b>Total loss</b>	<b>\$</b>	<b>\$ (1,334)</b>
	<b>For the Six Months Ended June 30,</b>	

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	<u>2005</u>	<u>2004</u>
Revenue	\$ 223	\$ 3,252
Loss from operations	(772)	(2,240)
Exit cost of facility closing	(1,032)	
Other	118	
Total loss	<u>\$ (1,686)</u>	<u>\$ (2,240)</u>



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### **Liquidity and Capital Resources**

#### **Balance Sheet**

As of June 30, 2005, we had \$29 million in cash, cash equivalents and short-term investments, compared to \$22.4 million as of December 31, 2004. As of June 30, 2005, our working capital was \$(9.7) million compared to \$(15.1) million as of December 31, 2004. Our working capital deficiency of \$9.7 million is primarily a result of \$52.4 million of deferred revenue (liability) and \$11.4 million of dividends payable. We have the option to pay the accelerated dividends, as discussed in Note 7, in cash or common stock. We do not have any bank borrowing outstanding at June 30, 2005. We believe that we have adequate liquidity to meet our short-term cash requirements.

Accounts receivable increased by \$5.8 million to \$31.3 million as of June 30, 2005 from \$25.5 million as of December 31, 2004 on a net basis. Accounts receivable increased mainly due to maintenance billings during the first and second quarters. For the six months ended June 30, 2005, bad debt expense was \$0.8 million and the write-offs of uncollectible receivables totaled approximately \$0.5 million. As of June 30, 2005, the allowance for doubtful accounts increased slightly to \$3.6 million from \$3.3 million as of December 31, 2004. QuadraMed maintains an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified within the portfolio. If the financial condition of QuadraMed's customers were to deteriorate resulting in an impairment of their ability to make payments, or if payments from customers are significantly delayed, additional allowance might be required.

Prepaid expenses and other current assets decreased by approximately \$0.8 million from December 31, 2004 to June 30, 2005 primarily due to a decrease in prepaid government royalties and prepaid third party costs. Government royalties are typically one year arrangements with the highest volumes experienced in the September/October timeframe due to the timing of the Government's fiscal year end. In anticipation of the Blanket Purchase Agreement related to the VA Hospitals which was not executed until May, shorter term or monthly agreements were executed in the interim resulting in a lower prepaid asset.

Accounts payable and accrued expenses decreased by \$0.3 million to \$4.2 million at June 30, 2005 from \$4.5 million at December 31, 2004 principally due to timing of payments made after year-end. Certain third-party royalty and legal invoices were accrued as of December 31, 2004 but paid subsequent to year-end.

Accrued payroll and related expenses decreased by \$0.4 million to \$7.2 million at June 30, 2005 from \$7.6 million at December 31, 2004 principally due to decreases in accrued severance. Accrued vacation and accrued medical insurance also decreased from December 31, 2004.

Deferred revenue increased by \$8.4 million from \$44.0 million at December 31, 2004 to \$52.4 million at June 30, 2005. The increase was primarily related to annual maintenance billings that occurred in the first two quarters of the current fiscal year for our Enterprise products.

**Table of Contents****Cash Flows**

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

	<b>For the Three Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Cash provided by (used in) operating activities	\$ 8,891	\$ (9,460)
Cash provided by (used in) investing activities	1,011	(4,656)
Cash provided by (used in) financing activities	(1,267)	70,753
Net increase in cash and cash equivalents	8,635	56,637

  

	<b>For the Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Cash provided by (used in) operating activities	\$ 8,103	\$ (7,691)
Cash provided by (used in) investing activities	626	(9,786)
Cash provided by (used in) financing activities	(2,144)	71,933
Net increase in cash and cash equivalents	6,585	54,456

During the three months ended June 30, 2005, \$8.9 million was provided in operating activities, as compared to the same period last year where \$9.4 million was used in operating activities. The net income of \$0.1 million was increased by non-cash charges totaling \$4.3 million, including depreciation and amortization of \$2.5 million, bad debt expense of \$0.6 million, and preferred stock accretion of \$1.2 million. A decrease in accounts receivable increased cash from operating activities by \$3.8 million. This was principally a result of annual maintenance collections during the period. Increases in accounts payable and accrued liabilities during the quarter of \$1.8 million further increased cash from operations. These increases were offset in part by a \$2.2 million decrease in deferred revenues. During the three months ended June 30, 2004, the \$9.5 million of cash flow used in operating activities, resulted primarily from a net loss of \$9.7 million, reduced by \$2.9 million of depreciation and amortization, \$2.3 million of loss on retirement of debt, \$0.4 million of bad debt expense, a \$4.3 million decrease in deferred revenue, a \$7.9 million decrease in accounts payable and accrued liabilities, and a net \$6.8 million decrease in accounts receivable and prepaid expenses.

During the six months ended June 30, 2005, \$8.1 million was provided in operating activities, as compared to the same period last year where \$7.7 million was used in operating activities. The net loss of \$3.6 million was offset by non-cash charges totaling \$10.1 million, including depreciation and amortization of \$6.0 million, bad debt expense of \$0.8 million, preferred stock accretion of \$2.4 million, and 0.9 million related to exit costs for the Financial Services Division. An increase in accounts receivable decreased cash from operating activities by \$6.6 million. This was principally a result of the timing of annual maintenance billings during the period. Decreases in accounts payable and accrued liabilities during the six months of \$3.2 million further decreased cash from operations. These decreases were offset in part by a \$8.4 million increase in deferred revenues. During the six months ended June 30, 2004, the \$7.7 million of cash flow used in operating activities, resulted primarily from a net loss of \$14.2 million, reduced by \$5.6 million of depreciation and amortization, \$2.3 million of loss on retirement of debt, \$1.1 million of bad debt expense, a \$0.9 million decrease in deferred revenue, a \$6.1 million decrease in accounts payable and accrued liabilities, and a net \$4.5 million decrease in accounts receivable and prepaid expenses.

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Cash flows from investing activities provided \$1.0 million during the three months ended June 30, 2005. This resulted primarily from the net redemption of restricted cash under standby letter of credit arrangements in the amount of \$1.6 million. For the three months ended June 30, 2004, the acquisition of Tempus used cash of \$5 million and purchases of equipment and leasehold improvements used cash of \$1.1 million.

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Cash flows from investing activities provided \$0.6 million during the six months ended June 30, 2005. This resulted primarily from the net redemption of restricted cash under standby letter of credit arrangements in the amount of \$1.6 million offset by the purchase of property and equipment. For the six months ended June 30, 2004, cash of \$9.8 million used in investing activities resulted from the acquisition of D tente in the amount of \$4.1 million, the acquisition of Tempus in the amount of \$5 million and purchases of equipment and leasehold improvements.

Financing activities used cash of \$1.3 million for the three months ended June 30, 2005 primarily due to the payment of \$1.4 million for dividends on the Series A Preferred Stock. For the three months ended June 30, 2004, Series A Preferred Stock was issued, which provided cash of \$96 million offset by \$26 million for the repurchase of all of our senior secured notes and our subordinated debentures, together with accrued interest and related redemption premiums.

Financing activities used cash of \$2.1 million for the six months ended June 30, 2005 primarily due to the payment of \$2.8 million for dividends on the Series A Preferred Stock, offset by proceeds from the issuance of common stock as a result of stock option exercises. For the six months ended June 30, 2004, Series A Preferred Stock was issued, which provided cash of \$96 million offset by \$26 million for the repurchase of all of our senior secured notes and our subordinated debentures, together with accrued interest and related redemption premiums.

At June 30, 2005, the Company's balance of cash and cash equivalents was \$29 million. The Company believes that its current balance of cash and cash equivalents and funds generated from operations, if any, will be sufficient to fund the Company's current projected cash needs for the foreseeable future. The Company may pursue external sources of financing to support additional operational and capital requirements. There can be no assurance that external sources of financing will be available if required, or that such financing will be available on terms acceptable to the Company.

**Commitments**

The following table summarizes financial data for our contractual obligations and other commercial commitments, including interest obligations, as of June 30, 2005 (in thousands):

	Total	Payments Due by Period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
<b>Contractual Obligations</b>					
Accrued dividends	\$ 11,386	\$ 2,792	\$ 8,594	\$	\$
Operating leases(1)	24,400	2,492	13,757	6,550	1,601
<b>Total contractual obligations</b>	<b>\$ 35,786</b>	<b>\$ 5,284</b>	<b>\$ 22,351</b>	<b>\$ 6,550</b>	<b>\$ 1,601</b>
<b>Other Commercial Commitments</b>					
Standby letters of credit(2)	\$ 2,401	\$ 1,018	\$ 1,034	\$	\$ 349
<b>Total commercial commitments</b>	<b>\$ 2,401</b>	<b>\$ 1,018</b>	<b>\$ 1,034</b>	<b>\$</b>	<b>\$ 349</b>

- (1) During the fourth quarter of 2004, the Company vacated and closed its San Rafael, California facility as a result of the relocation of our headquarters to Reston, Virginia. The San Rafael lease payments total approximately \$6.2 million for years 2005 through 2009, including the Company's share of common costs. Of this amount, the minimum rent payment of \$4.5 million is included in the schedule above. QuadraMed hopes to sublease the vacant San Rafael, California facility in 2005.
- (2) The 1-3 years amount of \$1.0 million is for an existing surety bond requirement. Actual requirements may be less as work is completed towards the underlying contract.

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

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

## **Business Risks**

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

We incurred losses from continuing operations of \$41.8 million, \$23.9 million and \$20.9 million for the years ended December 31, 2004, 2003 and 2002, respectively. Although we had income from continuing operations of \$12.0 million in 2001, we incurred losses from continuing operations of \$39.4 million in 2000. We had income from continuing operations of \$0.5 million for the six months ended June 30, 2005.

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

### **We Have Found Material Weaknesses in Our System of Internal Controls over Financial Reporting and Disclosure Controls as of December 31, 2004 and June 30, 2005 that Have Not Been Fully Remediated and that Could Adversely Affect Our Ability to Record, Process, Summarize and Report Certain Financial Data. As a Result, Our Internal Controls over Financial Reporting and Disclosure Controls and Procedures are Ineffective as of December 31, 2004 and June 30, 2005.**

In connection with its evaluation of the effectiveness of the Company's internal controls over financial reporting as of December 31, 2004, our management discovered the following control deficiencies in the Company's revenue cycle related to the Company's conversion of its financial records to PeopleSoft:

The review and supervision of the data entry and contract activation process in connection with the conversion of data for the PeopleSoft modules was inadequate to detect errors in these areas prior to contract activation.

Not all of our legacy contracts were converted completely into the new PeopleSoft module, requiring the continued need for manual review, impairing management's ability to effectively review, monitor, and investigate movements in customer account balances, and limiting the Company's ability to create meaningful deferred revenue roll-forward analysis on a timely basis.

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As of June 30, 2005, these control deficiencies have not been remediated. The Company believes that, both individually and in the aggregate, these control deficiencies continued to constitute material weaknesses in our internal controls over financial reporting as of June 30, 2005, because they resulted in more than a remote likelihood that a material misstatement could occur in our annual or interim financial statements and not be prevented or detected. In fact, these material weaknesses resulted in errors, which were not detected on a timely basis at December 31, 2004 and June 30, 2005. None of these errors, however, resulted in any material adjustments to our financial statements.

Additionally, in February 2004 in connection with its audit of our financial results for 2003, BDO Seidman, LLP ( BDO ) informed our management and Audit Committee of its concern regarding a material weakness in

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our system of internal controls, policies and procedures to track movements in deferred revenue on a roll forward basis. As a result, it was difficult for management to continually monitor movements in the account. Analytical review was done at the end of each period but not on an overall roll forward basis. While the Company has implemented procedures to report movements in deferred revenue on an overall roll forward basis, the completion of this system was not in place as of December 31, 2004 and June 30, 2005, and therefore, management believes this control deficiency remained a material weakness as of these dates.

The aforementioned weaknesses in our revenue cycle also affected our closing cycle for the fiscal year ended December 31, 2004 and for the fiscal quarters ended March 31, 2005 and June 30, 2005. Demands on the time of our staff and their overall workload resulted in inadequate staffing and supervision in our accounting and finance departments, which the Company believes constitutes a significant deficiency in our internal controls as of December 31, 2004 and June 30, 2005, and, in concert with the material weaknesses relating to the revenue cycle discussed above, management has concluded that this deficiency constitutes an additional material weakness in our internal controls over financial reporting as of December 31, 2004 and June 30, 2005.

As a result of these material weaknesses in the Company's internal controls over financial reporting, management has concluded that as of December 31, 2004 and June 30, 2005, the Company's internal controls over financial reporting were not effective. Such material weaknesses in internal controls over financial reporting also led our management to conclude that the Company's disclosure controls and procedures were not effective as of December 31, 2004 and June 30, 2005, to ensure that certain financial information related to these matters required to be disclosed in the Company's filings and submissions to the SEC under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the required time periods.

While management believes that it has taken the appropriate steps to remediate the above material weaknesses by the end of 2005, there can be no assurance that this will occur.

In connection with management's annual report on internal controls over financial reporting included in the Company's Form 10-K/A, filed with the SEC on April 29, 2005, the Company's independent registered public accounting firm, BDO Seidman, LLP, in their report dated April 28, 2005, disclaimed an opinion on management's assessment and on the effectiveness of our Company's internal control over financial reporting. It is unclear what legal effect the disclaimer of an opinion will have on our compliance with the rules and regulations of the SEC and the continued listing standards of the American Stock Exchange and may adversely affect the trading price of our stock.

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

We have documented and tested our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent auditors addressing these assessments. We included these reports in our Amended Annual Report on Form 10-K/A, filed with the SEC on April 29, 2005. As indicated in the previous risk factor, our management has identified control deficiencies and material weaknesses in internal control over financial reporting and in our disclosure controls and procedures. In addition, if we fail to achieve and maintain the adequacy of our internal controls and disclosure controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls, particularly those related to revenue recognition, are important to helping ensure that we produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and operating results could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.





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

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

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

The Certificate of Designation governing our Series A Preferred Stock provides that so long as at least 600,000 shares of Series A Preferred Stock are outstanding, at least 66-2/3% of the votes entitled to be cast by the holders of the Series A Preferred Stock shall be required to approve the incurrence by QuadraMed of any long term, senior indebtedness of QuadraMed in an aggregate principal amount exceeding \$8,000,000, excluding certain prior existing indebtedness. Furthermore, the Certificate of Designation requires the affirmative vote of a majority of any outstanding shares of the Series A Preferred Stock prior to the authorization or creation of, or increase in the authorized amount of, any shares of any class or series (or any security convertible into shares of any class or series) ranking senior to or on par with the Series A Preferred Stock in the distribution of assets upon any liquidation, dissolution or winding up of QuadraMed or in the payment of dividends. This may hinder or delay our ability to borrow funds or issue preferred stock.

**We Were Subject to a Formal SEC Inquiry as a Result of the Restatement of Our Financial Statements, and the SEC Has Issued a Cease and Desist Order to which We Have Consented.**

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. On October 10, 2003, we announced that the Staff of the San Francisco District Office of the SEC informed us that the Staff intended to recommend to the SEC that it institute an enforcement action against us for violations of the antifraud, periodic filing and books and records provisions of the federal securities laws. The proposed recommendation concerned our accounting for transactions that we entered into with Health+Cast LLP in 1998 and 1999. The 1999 transactions were restated as part of the restatement of our 1999 financial statements. The individuals who were involved with the Health+Cast transactions are no longer associated with the Company. On April 30, 2004, that matter was settled with the issuance by the SEC of a Cease and Desist Order, to which QuadraMed consented without admitting or denying the findings in the Order. No fine was assessed against QuadraMed in the Order, which requires the Company to cease and desist from violations of the antifraud, periodic reporting and books and records provisions of the Securities Exchange Act of 1934.

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

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

Variations in quarterly results of operations;

Announcements of new products or acquisitions by our competitors;

Government regulatory action;

Resolution of pending or unasserted litigation;

Developments or disputes with respect to proprietary rights; and

General trends in our industry and overall market conditions.

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

**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;

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Loss of customers due to consolidation in the healthcare industry;

Delays in product delivery requested by our customers;

Customer budget cycle fluctuation;

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

Costs incurred for marketing and sales promotional activities;

Software defects and other product quality factors;

General economic conditions and their impact on the healthcare industry;

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

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

Final negotiated sales prices of systems;

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

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

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

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In addition to the foregoing, a significant percentage of our total cost of revenue is attributable to the cost of third party software royalties and licenses relating to third party software embedded within our software applications. The cost of third-party software royalties and licenses, as a percentage of total cost of revenue, was approximately 17.6%, 11.0% and 12.7% for the years ended December 31, 2004, 2003, and 2002, respectively. The cost of third-party software royalties and licenses, as a percentage of total cost of revenue, was approximately 17.2% and 14.4% for the six months ended June 30, 2005 and 2004, respectively. Generally, royalty fees for third party licenses will fluctuate based on revenue or the number of our customers and therefore will fluctuate on a quarter to quarter basis.

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

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

We derive a significant percentage of our revenue, including 33% of our total revenue for fiscal year 2004, from maintenance services. We provide maintenance services under maintenance contracts to many of our customers in connection with our healthcare information technology products. In general, these maintenance contracts renew on an annual basis. If a significant portion of these maintenance contracts were not renewed, our maintenance revenues would decline which could have a material adverse effect on our total revenue for the period(s) in which the maintenance contracts were discontinued.

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

A substantial number of shares of our common stock are subject to stock options and warrants, and are issuable upon conversion of our Series A Preferred Stock. We cannot predict the effect, if any, that future sales of warrants or 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 registered under this registration statement, or issued upon the exercise of stock options or the conversion of our Series A Preferred Stock, or the perception that such sales could occur, may adversely affect prevailing market prices for our common stock.

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

Each share of our Series A Preferred Stock is convertible into 8.0645 shares of our common stock, and the Series A Preferred Stockholders may convert at any time. If all of our Series A Preferred Stock is converted into common stock, the shares issued upon this conversion will total approximately 44.3% of our outstanding common stock. In addition, many of our Series A Preferred Stockholders own common stock. Therefore, although these stockholders may not acquire majority control upon conversion of their Series A Preferred Stock, if these distinct stockholders were to act together, they will have the ability to exert substantial influence over all matters requiring approval of our stockholders, including the election and removal of directors, the approval of mergers or other business combinations, and other significant corporate actions. This ability to influence our affairs might be disadvantageous to our other stockholders.



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

Certain provisions of our Certificate of Incorporation and Bylaws could discourage potential takeover attempts and make attempts to change management by stockholders difficult. Our Board of Directors has the authority to impose various procedural and other requirements that could make it more difficult for our stockholders to effect certain corporate actions. In addition, our Certificate of Incorporation provides that directors may be removed only by the affirmative vote of the holders of two-thirds of the shares of our capital stock entitled to vote. Any vacancy on our Board of Directors may be filled only by a vote of the majority of directors then in office. Further, our Certificate of Incorporation provides that the affirmative vote of two-thirds of the shares entitled to vote, voting together as a single class, subject to certain exceptions, is required for certain business combination transactions. These provisions, and certain other provisions of our Certificate of Incorporation, could have the effect of delaying or preventing (i) a tender offer for our common stock or other changes of control of the Company that could be at a premium price or (ii) changes in our management.

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

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

We have not declared or paid cash or other dividends on our common stock and do not expect to pay cash dividends for the foreseeable future. Our ability to pay dividends is also restricted by the terms of our Series A Preferred Stock which require us to pay full cumulative dividends on the Series A Preferred Stock before making any dividend payment on our common stock. Under normal circumstances, the Series A Preferred Stock is entitled to quarterly dividends of \$0.34 (5.5% per annum) per share. However, as provided in the Certificate of Designation relating to the Series A Preferred Stock, because a registration statement covering resales of the Series A Preferred Stock and the common stock into which the Series A Preferred Stock is convertible, was not declared effective by the SEC on or before June 15, 2005, the dividend rate for such stock has increased to \$0.40625 per quarter (\$1.625 per annum) commencing on June 16, 2005, and such rate will apply until the date the registration statement is declared effective. Upon conversion of the Series A Preferred Stock into shares of common stock, the Series A Preferred stockholders have the right to receive, when declared by our Board of Directors, dividends equal to the total previously unpaid dividends payable from the effective date of conversion through June 1, 2007 at a rate of \$1.375 per share per annum or 5.5% per annum, discounted to present value at a rate of 5.5% per annum, payable in cash or common shares, or any combination thereof at our option. We currently intend to retain all future earnings for use in the operation of our business and to fund future growth. Any future cash dividends will depend upon our results of operations, financial conditions, cash requirements, the availability of a surplus and other factors.

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

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

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

We rely on a combination of trade secret, copyright and trademark laws, nondisclosure, non-compete, and other contractual provisions to protect our proprietary rights. In 2001, we filed our first patent application covering our developed technology, the Affinity CPOE software application. This application lapsed, and we have no patents. Measures taken by us to protect our intellectual property may not be adequate, and our competitors could independently develop products and services that are substantially equivalent or superior to our products and services. Any infringement or misappropriation of our proprietary software and databases could put us at a competitive disadvantage in a highly competitive market and could cause us to lose revenues, incur substantial litigation expense, and divert management's attention from other operations.

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

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

At present, there is no equivalent technology for the InterSystems Corporation technology which is an integral component of our Affinity product line. The Company has entered into several agreements with InterSystems Corporation regarding the licensed technology relating to our Affinity product line. However, if InterSystems Corporation ceased to offer this technology and no other vendor provided the technology, we would be required to migrate our Affinity products to a new database platform or redesign our products to work with





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new software tools. This could be very costly and difficult to achieve and could have a material adverse effect on our business, financial condition and results of operations. There can be no assurance that we would successfully migrate our Affinity products to a new platform. Most of our third-party licenses are non-exclusive and competitors may obtain the same or similar technology. In addition, if vendors choose to discontinue support of the licensed technology, we may not be able to modify or adapt our products.

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

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

Offer a broad range of software products;

Enhance existing products and expand product offerings;

Respond promptly to new customer requirements and industry standards;

Remain compatible with popular operating systems and develop products that are compatible with 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.

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

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

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Pursuant to SFAS No. 142, we must test goodwill and other intangible assets for impairment at least annually and adjust them when impaired to the appropriate net realizable value. We performed an impairment test on the carrying value of our goodwill and intangibles as of January 1, 2005 and 2004. We determined that there was no impairment as of these dates. In addition, our internally developed software has been capitalized assuming our earnings from these product developments 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 our intangible assets, we will be required to adjust the carrying value of such assets to net realizable value.

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

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### **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 software development expenses.

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

A substantial portion of our revenues has been and is expected to continue to be derived from sales of software products and services to hospitals. Hospitals are slow to make changes and generally favor their existing vendor when considering an upgrade in their systems. Consolidation in the healthcare industry, particularly in the hospital and managed care markets, could decrease the number of existing or potential purchasers of products and services and could adversely affect our business. In addition, the decision to purchase our products often involves a committee approval. Consequently, it is difficult for us to predict the timing or outcome of the buying decisions of our customers or

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potential customers. In addition, many healthcare providers are consolidating to create integrated delivery networks with greater regional market power. These emerging systems could have greater bargaining power, which may lead to decreases in prices for our products, which could adversely affect our business, financial condition, and results of operations.

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

The Department of Veterans Affairs ( VA ) has awarded contract VA Blanket Purchase Agreement No. 101-049AH-005 (the BPA ) to the Company, as disclosed in the Company s press release dated April 27, 2005.

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The BPA is a five-year single source contract covering approximately 128 VA facilities. Under the BPA, these VA facilities are to be contracted to use our products and services. Previously, both we and other vendors have provided HIM software to these VA facilities. As of December 31, 2004, we had approximately \$12.9 million in annual revenue from providing VA facilities with software. The BPA contains additional HIM software discounts, but it increases the number of VA facilities using our products, so the overall financial impact of the BPA cannot be known. Additionally, the VA is directing the individual facilities to order their requirements for this HIM software under the BPA, but each VA facility orders the HIM software individually, and there can be no guarantee that a VA facility will order its HIM software and/or services from us. For these reasons there can be no assurances what, if any, material financial impact the BPA will have.

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

Changes in current healthcare financing and reimbursement systems (e.g. Medicaid) could result in unplanned product enhancements, delays, or cancellations of product orders or shipments, or reduce the need for certain systems. We could also have the endorsement of products by hospital associations or other customers revoked. Any of these occurrences could have a material adverse effect on our business. Alternatively, the federal government recently mandated that all but small healthcare providers submit claims to Medicare in electronic format, which may positively affect 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 systems were to change. During the past several years, the healthcare industry has been subject to increasing levels of governmental regulation. Proposals to reform the healthcare system have been and are being considered by the United States Congress. These proposals, if enacted, could adversely affect the commercial value and appeal of our products or change the operating environment of our customers in ways that cannot be predicted. Healthcare organizations may react to these proposals by curtailing or deferring investments, including those for our products and services. In addition, the regulations promulgated under the Health Insurance Portability and Accountability Act of 1996 ( HIPAA ) could lead healthcare organizations to curtail or defer investments in non-HIPAA related features in the next several years.

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

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

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

Competition for our products and services is intense and is expected to increase. Increased competition could result in reductions in our prices, gross margins, and market share and have a material adverse effect on our business, financial condition, and results of operations. We compete

with other providers of healthcare information software and services, as well as healthcare consulting firms. Some competitors have formed

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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: 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: McKesson Corporation, SoftMed Corporation Inc., FileNet, Streamline Health, MedPlus, and Eclipsys Corporation;

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

In the market for decision support products: 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 and HSS, Inc.;

Prospective customers may evaluate our products' capabilities against the merits of their existing information systems and expertise and may decide to stay with their incumbent vendor because of the cost associated with conversion. In addition, existing and prospective customers may be reluctant to buy from us because of the losses we have incurred in recent years.

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

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

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

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



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

Throughout our history, we have made many acquisitions, and we encountered significant challenges integrating the acquired businesses into our operations. In recent years, we have made significant progress toward that integration. However, we continue to support several different technology platforms. In February 2004, we acquired Détente Systems Pty Limited, an Australian proprietary limited company, and Détente Systems Trust, an Australian business trust, and in June 2004, we acquired Tempus Software, Inc., a Florida corporation. In the future, we plan to make investments in or acquire additional complementary businesses,

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products, services or technologies. These investments and acquisitions will create new integration challenges. Some of the challenges we have encountered, and may encounter with acquisitions in the future, in integrating acquired businesses 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;

Failure to maintain good relations with customers or suppliers;

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.

**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.**

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

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

Computer products used or intended for use in the diagnosis, cure, mitigation, treatment, or prevention of diseases or other conditions or that affect the structure or function of the body are subject to regulation by the 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.

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**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 plans and healthcare providers. Although compliance with these laws and regulations is presently the principal responsibility of the health plan, hospital, physician, or other healthcare provider, regulations governing patient confidentiality rights are dynamic and rapidly evolving. As such, laws and regulations could be modified so that they could directly apply to us. Also, changes to the laws and regulations that would require us to change our systems and our methods may be made in the future, which could require significant expenditure of capital and decrease future business prospects. Also, additional federal and state legislation governing the dissemination of patient health information may be proposed and may be adopted, which may also significantly affect our business. Finally, certain existing laws and regulations require healthcare entities to pass-on their obligations to other entities with which they do business, through a contract; as such, we are indirectly impacted by various additional laws and regulations.

The Health Insurance Portability and Accountability Act of 1996 is a federal law that affects the use, disclosure, transmission and storage of individually identifiable health information referred to as protected health information. As directed by HIPAA, the United States Department of Health and Human Services ( HHS ) must promulgate standards or rules for certain electronic health transactions, code sets, data security, unique identification numbers, and privacy of protected health information. HHS has issued some of these rules in final form, while others remain in development. In general, under these rules, we function as a business associate to some of our customers (who are considered to be covered entities under HIPAA). In some instances, we also may function as a healthcare clearinghouse (which is a covered entity under HIPAA). The three rules relevant to us the Transaction Rule, the Privacy Rule, and the Security Rule are discussed below. It is important to note that HHS could, at any time in the future, modify any existing final rule in a manner that could require us to change our systems or operations.

First, HHS has published a final rule governing transactions and code set standards ( Transactions Rule ). The Transactions Rule had a compliance date of October 16, 2003. To the extent necessary to help our covered entity customers conduct transactions, our current products and services meet the requirements of the Transactions Rule. Nevertheless, as noted above, HHS may make further revisions to the Transactions Rule, which could require us to change our products and systems to enable our covered entity customers to meet such obligations.

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

Third, HHS has published the final HIPAA security rule ( Security Rule ) with a compliance date of April 20, 2005. The Security Rule applies to the use, disclosure, transmission, storage and destruction of electronic

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protected health information by covered entities. Per the Security Rule, covered entities must implement administrative, technical and physical security measures to safeguard electronic protected health information. Also, as with the Privacy Rule, under the Security Rule, covered entities are required to contractually bind their business associates to certain aspects of the Security Rule. As such, where we function as a business associate to a customer that is a covered entity, we will be required to enter into a business associate contract with that customer. Implementing such measures may require us to expend substantial capital due to required product, service, and procedure changes.

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

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

The American Health Information Management Association and other prominent healthcare industry advocacy groups are calling on 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 software development capital and decrease future business prospects for our current product line.

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

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

#### **Interest Rate Risk**

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

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The table below presents fair values of principal amounts and weighted average interest rates for our investment portfolio as of June 30, 2005 (in thousands, except average interest rates):

	<u>Aggregate Fair Value</u>	<u>Weighted Average Interest Rate</u>
<b>Cash and Cash equivalents:</b>		
Cash	\$ 16,784	
Money Market funds	12,230	2.51%
	<u>          </u>	
<b>Total cash and Cash equivalents(1)</b>	<b>\$ 29,014</b>	
	<u>          </u>	
<b>Short-term investments:</b>		
Debt issued by US government	\$	
	<u>          </u>	
<b>Total short-term investments</b>	<b>\$</b>	
	<u>          </u>	
<b>Long-term investments:</b>		
Corporate debt securities	\$ 550	4.98%
Debt issued by US government	838	5.09%
	<u>          </u>	
<b>Total long-term investments</b>	<b>\$ 1,388</b>	
	<u>          </u>	

- (1) Excluded from the fair value of the principal amounts of cash is \$3.9 million, which is restricted cash that is held in escrow for rental properties, and meeting customer performance expectations.

**Performance of Equity Markets**

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

**Foreign Currency Risk**

Our primary market risk exposure relates to changes in foreign currency exchange rates and potentially adverse effects of differing tax structures. Changes in foreign exchange rates did not materially impact our results of operations. For the six months ended June 30, 2005, less than 3% of total revenue was denominated in currencies other than the U. S. dollar and less than 3% of our total direct and operating costs were incurred in currencies other than the U. S. dollar.

**Item 4. Controls and Procedures**

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

In connection with the preparation of our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, our management, in consultation with the Audit Committee of the Board of Directors, identified material weaknesses, as described below.

*Revenue Cycle*

In the fourth quarter of 2004, the Company began the process of converting a significant portion of its financial records (principally revenue cycle related items) from a legacy system called CDI, to various modules of our principal financial software, PeopleSoft. As of June 30, 2005, this conversion to PeopleSoft is substantially complete.

PeopleSoft is a widely used and very powerful software system. While we have encountered no significant difficulties in expanding the use of the various PeopleSoft modules, planning for the conversion was flawed in

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that our estimate of the time and resources required to successfully complete the process was underestimated. In addition, the training of personnel in the contract data entry process was inadequate to ensure the accurate entry of data into the system.

As a result, management has concluded that the following control deficiencies in our revenue cycle existed as of December 31, 2004 and continued to exist as of June 30, 2005:

The training of contract accounting staff and the review and supervision of the data entry and contract activation process in connection with the data conversion, including access controls to the PeopleSoft contracts module, was inadequate to detect errors before contract activation.

Not all of the legacy contracts were converted completely into the new PeopleSoft module, resulting in the need to continue the use of manual processes, which significantly impairs management's ability to effectively review, monitor and investigate movements in customer account balances. It also limits our ability to create meaningful deferred revenue roll forward analysis on a timely basis.

As of June 30, 2005, these control deficiencies have not been remediated. The Company believes that, both individually and in the aggregate, these control deficiencies continued to constitute material weaknesses in our internal controls over financial reporting as of June 30, 2005, because they resulted in more than a remote likelihood that a material misstatement could occur in our annual or interim financial statements and not be prevented or detected. In fact, these material weaknesses resulted in errors, which were not detected on a timely basis. None of these errors, however, resulted in any material adjustments to our financial statements.

In addition to the material weaknesses described above, in connection with performing its audit of our financial results for 2003, BDO Seidman, LLP ( BDO ) informed us that they noted a matter involving internal control that they considered to be a material weakness. The material weakness noted by BDO concerned the fact that the Company had not implemented procedures to track movements in deferred revenue on an overall roll forward basis. As a result, it was difficult for management to continually monitor movements in the account. Analytical review was done at the end of each period but not on an overall roll forward basis. While the Company has implemented procedures in the legacy systems to report movements in deferred revenue on an overall roll forward basis, the completion of this in PeopleSoft was not in place as of June 30, 2005. Accordingly, as of June 30, 2005, management believes that this control deficiency remained a material weakness.

The Company continues to invest significant effort and resources to eliminate these deficiencies in internal controls, and will continue to do so throughout 2005. We will not, however, be in a position to change our current assessment of internal controls until we perform a comprehensive assessment of such controls as part of our 2005 Sarbanes-Oxley Section 404 procedures later this year and into early 2006.

### ***Closing Cycle***

The aforementioned weaknesses in our revenue cycle also affected our closing cycle for the fiscal year ended December 31, 2004 and for the fiscal quarters ended March 31 and June 30, 2005. The manual processes referred to above were performed substantially by our accounting and finance staff, with some reliance on outside consultants, who are the same individuals who are involved in the normal closing cycle. As a result, our quarterly close processes were affected in that less time was available from our staff for normal closing and review procedures, and these procedures are an important component of our controls surrounding the closing process. This situation was exacerbated by the fact that we replaced our corporate controller on January 11, 2005. We believe that these demands on the time of our staff and their overall workload resulted in inadequate staffing and supervision in our accounting and finance departments, which the Company believes continued to constitute a significant deficiency in our internal controls as of June 30, 2005 and, taken together with the material weaknesses relating to the revenue cycle



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discussed above, remained an additional material weakness in our internal controls over financial reporting as of June 30, 2005.

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Through the second fiscal quarter of 2005, we have taken steps to bolster the personnel involved in the closing cycle and have initiated what we believe to be improved processes and a better delineation of duties. While there can be no assurance in this regard, we expect that these steps will eliminate this material weakness in 2005. Until that time, we will continue to rely on manual processes and require additional commitment of resources to the closing process to produce our financial records and reports.

As a result of the material weaknesses relating to our revenue cycle and our closing cycle noted above, management has concluded that as of June 30, 2005, the Company did not maintain effective internal control over financial reporting.

Other than the actions mentioned above, there has been no change to the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

While management believes that it has taken the appropriate steps to remediate the above material weaknesses by the end of 2005, there can be no assurance that this will occur.

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

We have established disclosure controls and procedures to ensure that material information relating to the Company is made known to the officers who certify the financial statements and to other members of senior management and the Audit Committee of the Board of Directors. As of June 30, 2005, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (the CEO) and the Chief Financial Officer (the CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e), and 15d-15(e) under the Securities Exchange Act of 1934). Based on the material weaknesses in internal controls over financial reporting discussed above, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were not effective as of the end of the period covered by this report.

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**Table of Contents****PART II. OTHER INFORMATION*****Item 1. Legal Proceedings***

In January 2004, Mr. James Durham, the Company's former Chief Executive Officer, filed an amended complaint against us in the Superior Court of the State of California, Marin County, alleging a breach of his SERP contract and a breach of good faith and fair dealing under this contract. This amended complaint seeks payment of his lump sum SERP benefits, interest, attorneys' fees, and other relief. On January 30, 2004, this matter was moved to the United States District Court, Northern District of California. On May 6, 2005, the Court, over our objection, entered judgment in favor of Mr. Durham against us, in the total amount of \$5,067,130, plus interest thereon, at the rate prescribed by 28 U.S.C. §1961 accruing after that date. On July 6, 2005, the Company settled its litigation with Mr. James Durham. Under the terms of the Settlement Agreement and General Release (the "Settlement Agreement") between the parties, the Company made an immediate cash payment of approximately \$3.6 million to Mr. Durham and issued a Negotiable Promissory Note (the "Note") to Mr. Durham in the principal amount of \$1.4 million and with an interest rate of 5.12% per annum. As of June 30, 2005, the Company has fully accrued for the payment. The timing of payments under the Note is linked to the Company's realization of amounts invested in a split-dollar insurance arrangement (the "Split-Dollar Policy") with Mr. Durham. The immediate payment of \$3.6 million was funded principally by the liquidation of certain assets earmarked for such purpose in the amount of \$3.1 million, and payment of \$0.5 million out of operating cash. The Company's obligations under the Note are secured by a collateral assignment of the Company's rights under the Split-Dollar Policy and certain related agreements. The Settlement Agreement includes various releases from both parties.

On November 15, 2004, the company received a letter from MedCath Incorporated ( "MedCath" ), which provided notice of MedCath's decision to terminate the Master Software License and Services Agreement, dated November 20, 2002, by and between QuadraMed Affinity and MedCath (the "Contract" ). On or about November 15, 2004, MedCath filed a complaint against us in the North Carolina Superior Court, County of Mecklenburg. In its complaint, MedCath alleges that we are in breach of the Contract due to uncured deficiencies in the products, and seeks at least \$5 million in damages, plus litigation costs. We believe that these allegations are without merit and that the termination of the Contract is unwarranted. On December 9, 2004, we filed a motion to dismiss the MedCath complaint on the grounds that the complaint fails to state a claim upon which relief can be granted. We also filed a counterclaim against MedCath seeking no less than \$1.14 million in unpaid amounts due to us, plus litigation costs, for MedCath's breach of the Contract by failing to pay licensing fees due to the Company. A case management conference was held July 29, 2005 in the Superior Court before a judge to whom the case has been assigned. Although the Court has not issued a final case management order at this time, we anticipate that such an order will be issued shortly which, among other things, will schedule a hearing on our motion to dismiss for a date in late September, 2005, will provide for all fact discovery to be completed by April 15, 2006, will provide for all expert discovery to be completed by July 15, 2006, and will provide for the parties to submit the dispute to mediation by approximately April 30, 2006. We will continue to defend ourselves vigorously against any claim that we have breached the Contract and will seek redress through all applicable remedies for any injuries suffered by the Company in connection with this matter.

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***Item 6. Exhibits and Reports on Form 8-K***

- (a) Reports on Form 8-K.

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

- (b) Reports on Form 8-K.

On May 5, 2005, the Company filed a Form 8-K press release of May 4, 2005, announcing the release of the Company's 2005 first quarter earnings on May 10, 2005.

On May 12, 2005, the Company filed a Form 8-K press release of May 10, 2005, announcing the Company's 2005 first quarter earnings, and a follow-up press release regarding the reclassification of an item.

On July 7, 2005, the Company filed a Form 8-K press release of July 5, 2005, announcing Frank J. Pecaitis's resignation as Senior Vice President, Client Development effective July 15, 2005.

On July 8, 2005, the Company filed a Form 8-K press release of July 7, 2005, announcing the settlement of the litigation with Mr. James D. Durham, former Chief Executive Officer.

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**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: August 9, 2005

By: /s/ LAWRENCE P. ENGLISH  
**Lawrence P. English**  
**Chairman of the Board**  
**Chief Executive Officer**

Date: August 9, 2005

By: /s/ JOHN C. WRIGHT  
**John C. Wright**  
**Chief Financial Officer**

**Table of Contents****EXHIBIT INDEX**

Certain of the following exhibits have been previously filed with the SEC and are incorporated herein by reference from the document described in parentheses. Certain others are filed herewith.

<b>Exhibit Number</b>	<b>Exhibit Description</b>
2.1	Agreement and Plan of Merger, dated as of June 30, 2004, by and among QuadraMed Corporation, Sawgrass, LLC, Tempus Software, Inc. and each of the shareholders of Tempus Software, Inc. (Exhibit 2.1 to our Current Report on Form 8-K as filed with the SEC on July 15, 2004.)
3.1	Amended and Restated Bylaws of QuadraMed. (Exhibit 3.1 to our current report on 8-K filed with SEC on November 1, 2004.)
3.2	Third Amended and Restated Certificate of Incorporation of QuadraMed. (Exhibit 3.5 to our Annual Report Amended on Form 10-Q/A, as filed with the SEC on August 24, 1998.)
3.3	Amendment to the Third Amended and Restated Certificate of Incorporation of QuadraMed. (Exhibit 3.3 to our Registration Statement on Form S-1, No. 333-112040 as filed January 21, 2004.)
3.4	Certificate of Designation, Powers, Preferences and Rights of the Series A Cumulative Mandatory Convertible Preferred Shares. (Exhibit 3.1 to our Current Report on Form 8-K as filed with the SEC on June 17, 2004)
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3.
4.2	Form of Common Stock certificate. (Exhibit 4.2 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
4.3	Purchase Agreement, dated as of April 27, 1998, by and among QuadraMed Corporation and the Initial Purchasers named therein. (Exhibit 1.1 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.4	Securities Purchase Agreement, dated as of April 17, 2003, among QuadraMed Corporation and certain investors listed on the signature pages attached thereto. (Exhibit 4.1 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.5	Form of Note. (Exhibit 4.2 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.6	Warrant Agreement dated as of April 17, 2003, by and between QuadraMed Corporation and The Bank of New York, as warrant agent. (Exhibit 4.3 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.7	Indenture, dated as of April 17, 2003, between QuadraMed Corporation and the Bank of New York, as trustee. (Exhibit 4.4 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.8	Registration Rights Agreement, dated as of April 17, 2003, among QuadraMed, the investors listed on the signature pages thereto, and Philadelphia Brokerage Corporation. (Exhibit 4.5 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.9	Security Agreement, dated as of April 17, 2003, made by QuadraMed Corporation in favor of The Bank of New York, as collateral agent. (Exhibit 4.6 to our Current Report on Form 8-K filed with the SEC on April 30, 2003.)
4.10	Form of Warrant to Purchase Common Stock. (Exhibit 4.11 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)

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<b>Exhibit Number</b>	<b>Exhibit Description</b>
4.11	Subordinated Indenture, dated as of May 1, 1998, between QuadraMed and The Bank of New York. (Exhibit 4.6 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.12	Officers Certificate delivered pursuant to Sections 2.3 and 11.5 of the Subordinated Indenture. (Exhibit 4.7 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.13	Registration Rights Agreement dated April 27, 1998, by and among QuadraMed and the Initial Purchasers named therein. (Exhibit 4.8 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.14	Form of Global Debenture. (Exhibit 4.9 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.15	Form of Certificated Debenture. (Exhibit 4.10 to our Registration Statement on Form S-3, No. 333-55775, as filed with the SEC on June 2, 1998, as amended by Amendment No. 1 thereto, as filed with the SEC on June 17, 1998.)
4.16	Registration Rights Agreement dated as of June 30, 2004, by and between QuadraMed and the shareholders identified on the signature pages thereto. (Exhibit 4.1 to our Current Report on Form 8-K as filed with the SEC on July 15, 2004.)
4.17	Form of Preferred Stock certificate for the Series A Cumulative Mandatory Convertible Preferred Shares. (Exhibit 4.17 to our Pre-Effective Amendment No. 3 to our Registration Statement on Form S-1, No. 333-112040, as filed with the SEC on August 25, 2004.)
10.1	1996 Stock Incentive Plan of QuadraMed. (Exhibit 10.1 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
10.2	1996 Employee Stock Purchase Plan of QuadraMed. (Exhibit 10.2 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
10.3	Summary Plan Description, QuadraMed Corporation 401(k) Plan. (Exhibit 10.3 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
10.4	Form of Indemnification Agreement between QuadraMed and its directors and executive officers. (Exhibit 10.4 to our Registration Statement on Form SB-2, No. 333-5180-LA, as filed with the SEC on June 28, 1996, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3 thereto, as filed with the SEC on July 26, 1996, September 9, 1996, and October 2, 1996, respectively.)
10.5	1999 Supplemental Stock Option Plan for QuadraMed. (Exhibit 10.5 to our annual report on Form 10-K, as filed with the SEC on March 30, 2000, as amended by May 1, 2000.)
10.6	2004 Stock Compensation Plan of QuadraMed. (Exhibit 4.36 to our Registration Statement on Form S-8, No. 333-118581, as filed with the SEC on August 26, 2004.)
10.7	Separation Agreement dated June 12, 2000, between James D. Durham and QuadraMed. (Exhibit 10.64 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2000, as filed with the SEC on August 14, 2000.)

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<b>Exhibit Number</b>	<b>Exhibit Description</b>
10.8	Employment Agreement dated June 12, 2000, between Lawrence P. English and QuadraMed. (Exhibit 10.66 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2000, as filed with the SEC on August 14, 2000.)
10.9	Amendment of Employment Agreement dated September 20, 2001, between Lawrence P. English and QuadraMed. (Exhibit 10.5 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2001, as filed with the SEC on November 14, 2001.)
10.10	Employment Agreement dated April 1, 1999, between Michael S. Wilstead and QuadraMed. (Exhibit 10.53 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, as filed with the SEC on August 16, 1999.)
10.11	Amendment of Employment Agreement dated September 20, 2001, between Michael S. Wilstead and QuadraMed. (Exhibit 10.9 to our Quarterly Report on form 10-Q for the quarter ended September 30, 2001, as filed with the SEC on November 14, 2001.)
10.12	Employment Agreement dated August 16, 2000, between Dean Souleles and QuadraMed. (Exhibit 10.67 to our annual report on Form 10-K for the year ended December 31, 2000, as filed with the SEC on April 2, 2001.)
10.13	Amendment of Employment Agreement dated September 19, 2001, between Dean Souleles and QuadraMed. (Exhibit 10.7 to our Quarterly Report on form 10-Q for the quarter ended September 30, 2001, as filed with the SEC on November 14, 2001.)
10.14	Second Amendment of Employment Agreement dated November 8, 2002, between Dean Souleles and QuadraMed. (Exhibit 10.14 to our Registration Statement on Form S-1, No. 333-112040 as filed January 21, 2004.)
10.15	Employment Agreement dated June 1, 2001, between Frank Pecaitis and QuadraMed. (Exhibit 10.16 to our Registration Statement on Form S-1, No. 333-112040 as filed January 21, 2004.)
10.16	Lease dated November 19, 1998 for facilities located at 22 Pelican Way, San Rafael, California. (Exhibit 1.7 to our Annual Report on Form 10-K for the year ended December 31, 1999, as filed with the SEC on March 30, 2000.)
10.17	Lease dated November 26, 2001 for facilities located at 1050 Los Vallecitos Boulevard, San Marcos, California. (Exhibit 10.18 to our Registration Statement on Form S-1, No. 333-112040 as filed January 21, 2004.)
10.18	Lease dated June 15, 2001 for facilities located at 12110 Sunset Hills Road, Reston, Virginia. (Exhibit 10.19 to our Registration Statement on Form S-1, No. 333-112040 as filed January 21, 2004.)
10.19	Employment Agreement dated July 9, 2003, between John C. Wright and QuadraMed Corporation. (Exhibit 10.20 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)
10.20	Inducement Stock Agreement dated July 9, 2003, by and between John C. Wright and QuadraMed Corporation. (Exhibit 10.21 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)



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<b>Exhibit Number</b>	<b>Exhibit Description</b>
10.21	Restricted Stock Agreement dated July 9, 2003, by and between John C. Wright and QuadraMed Corporation. (Exhibit 10.22 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)
10.22	Amendment of Employment Agreement dated October 5, 2003, by and between Charles J. Stahl and QuadraMed Corporation. (Exhibit 10.23 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)
10.23	Stock Issuance Agreement dated December 30, 2003, by and between Lawrence P. English and QuadraMed Corporation. (Exhibit 10.24 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)
10.24	Stock Issuance Agreement dated December 30, 2003, by and between Michael S. Wilstead and QuadraMed Corporation. (Exhibit 10.25 to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 22, 2004.)
10.25	Value Added Remarketing Agreement dated June 26, 1989, by and between InterSystems Corporation and the Compucare Company. (Exhibit 10.28 to our Registration Statement on Form S-1, No. 333-112040, as filed with the SEC on August 25, 2004.)
10.26	Amendment to VAR Agreement between QuadraMed Affinity Corporation and InterSystems Corporation. (Exhibit 10.29 to our Registration Statement on Form S-1, No. 333-112040, as filed with the SEC on August 25, 2004.)
31.1**	Section 302 Certification CEO
31.2**	Section 302 Certification CFO
32.1**	Section 906 Certification CEO
32.2**	Section 906 Certification CFO

\*\* Filed herewith