

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

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

For the quarterly period ended December 31, 2003

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

Commission file number 0-13801

QUALITY SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

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

**95-2888568
(I.R.S. Employer
Identification No.)**

**18191 Von Karman Avenue, Irvine, California
(Address of Principal Executive Offices)**

**92612
(Zip Code)**

Registrant's telephone number, including area code: (949) 255-2600

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 twelve 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 ninety days. Yes No

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock as of the latest practicable date: 6,312,164 shares of Common Stock, \$.01 par value, as of February 9, 2004

PART I – CONSOLIDATED FINANCIAL INFORMATION

Item 1. *Financial Statements*

QUALITY SYSTEMS, INC. CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	<i>December 31, 2003 (unaudited)</i>	<i>March 31, 2003</i>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 45,348	\$ 36,443
Accounts receivable, net	21,545	17,561
Inventories, net	837	667
Deferred tax assets	2,029	2,029
Other current assets	1,408	2,086
Total current assets	71,167	58,786
Equipment and improvements, net	1,919	1,777
Capitalized software costs, net	3,323	2,511
Deferred tax assets	1,819	1,819
Goodwill	1,840	1,840
Other assets	1,049	869
Total assets	\$ 81,117	\$ 67,602
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,066	\$ 2,477
Deferred revenue	16,299	11,699
Other current liabilities	6,747	5,893
Total liabilities	25,112	20,069
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$0.01 par value, 20,000 shares authorized, 6,276 and 6,152 shares issued and outstanding, respectively	63	62
Additional paid-in capital	37,946	35,121
Retained Earnings	19,646	12,350
Deferred Compensation	(1,650)	-
Total shareholders' equity	56,005	47,533
Total liabilities and shareholders' equity	\$ 81,117	\$ 67,602

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(in thousands, except per share amounts)

	<i>Three Months Ended December 31,</i>		<i>Nine Months Ended December 31,</i>	
	<i>2003</i>	<i>2002</i>	<i>2003</i>	<i>2002</i>
Net revenues:				
Sales of computer systems, upgrades and supplies	\$ 9,859	\$ 7,666	\$ 29,359	\$ 20,905
Maintenance and other services	8,340	6,734	22,788	18,796
	18,199	14,400	52,147	39,701
Cost of products and services	7,523	6,353	21,625	16,933
Gross profit	10,676	8,047	30,522	22,768
Selling, general and administrative expenses	4,902	3,918	14,410	11,033
Research and development costs	1,628	1,347	4,496	3,695
Income from operations	4,146	2,782	11,616	8,040
Investment income	95	109	284	336
Income before provision for income taxes	4,241	2,891	11,900	8,376
Provision for income taxes	1,630	956	4,604	3,104
Net income	\$ 2,611	\$ 1,935	\$ 7,296	\$ 5,272
Net income per share, basic	\$.42	\$ 0.32	\$ 1.18	\$ 0.86
Net income per share, diluted	\$.40	\$ 0.30	\$ 1.13	\$ 0.83

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(in thousands)	<i>Nine Months Ended December 31,</i>	
	<i>2003</i>	<i>2002</i>
Cash Flows from Operating Activities:		
Net Income	\$ 7,296	\$ 5,272
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,789	1,622
Non-cash compensation from stock option grants	203	-
Changes in:		
Accounts receivable	(3,984)	(2,793)
Inventories	(170)	141
Other current assets	678	(92)
Other assets	(180)	133
Accounts payable	(411)	(782)
Deferred revenue	4,600	3,584
Other current liabilities	854	2,010
Net Cash Provided By Operating Activities	10,675	9,095
Cash Flows From Investing Activities:		
Proceeds from the sale of short term investments	-	255
Net additions to equipment and improvements	(788)	(859)
Additions to capitalized software costs	(1,955)	(1,045)
Net Cash Used In Investing Activities	(2,743)	(1,649)
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options	973	257
Net Cash Provided by Financing Activities	973	257
Net Increase in Cash and Cash Equivalents	8,905	7,703
Cash and Cash Equivalents, beginning of period	36,443	25,443
Cash and Cash Equivalents, end of period	\$ 45,348	\$ 33,146

Supplemental Information – During the Nine months ended December 31, 2003 and 2002, the Company made income tax payments, net of refunds received, of \$4,254,000 and \$2,411,000 respectively.

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited consolidated financial statements as of December 31, 2003 and for the three and nine month periods ended December 31, 2003 and 2002, have been prepared in accordance with the requirements of Form 10-Q and, therefore, do not include all information and footnotes which would be presented were such financial statements prepared in accordance with generally accepted accounting principles. These financial statements should be read in conjunction with the audited financial statements presented in the Company's Annual Report for the fiscal year ended March 31, 2003. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the results of operations and cash flows for the periods presented. The results of operations for such interim periods are not necessarily indicative of results of operations to be expected for the full year.

2. Summary of Significant Accounting Policies

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant inter-company amounts and transactions have been eliminated.

Basis of Presentation. The accompanying consolidated financial statements have been prepared in accordance with accounting principals generally accepted in the United States of America.

Revenue Recognition. The Company recognizes revenue pursuant to Statement of Position ("SOP") 97-2, "Software Revenue Recognition" ("SOP 97-2") as amended by SOP 98-9 "Modification of SOP 97-2, Software Revenue Recognition". The Company generates revenues from licensing rights to use its software products directly to end-users and value-added resellers (VARs). The Company also generates revenues from sales of hardware and third party software, and implementation, training and post-contract support ("maintenance") services performed for customers who license the Company's products. A typical system contract contains multiple elements of two or more of the above items. SOP 97-2, as amended, requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on objective evidence that is specific to the vendor. When evidence of fair value exists for the delivered and undelivered elements of a transaction, then discounts for individual elements are aggregated and the total discount is allocated back to the individual elements in proportion to the elements' fair value to the total contract fair value.

When evidence of fair value exists for the undelivered elements only, the residual method, provided for under SOP 98-9, is required to be used. Under the residual method, the Company defers revenue related to the undelivered elements in a system sale based on vendor specific objective evidence of each element's fair value, which is based on the average sales price of those elements when sold separately, and allocates the remainder of the contract price to revenue recognized from the delivered elements. Typically, the Company will bill for the entire contract amount upon contract execution. Amounts billed in excess of the amounts contractually due are recorded in accounts receivable as advance billings. Amounts are contractually due when services are performed or in accordance with contractually specified payment dates.

Provided the fees are fixed and determinable and collection is considered probable, revenue from licensing rights and sales of hardware and third party software are generally recognized upon shipment and transfer of title. Revenue from implementation, training and software customization services is recognized as the corresponding services are performed. Maintenance revenue is recognized ratably over the contractual maintenance period.

Certain system sales contracts may contain payment terms based on certain performance milestones or may include services to provide significant customization of the software. License and hardware

revenues for such contracts may be recognized using the percentage of completion or completed contract method, as appropriate.

License arrangements with VARs generally do not provide for returns, and in such cases, license revenues from VARs are generally recognized upon shipment.

Cash and Cash Equivalents. Cash and cash equivalents generally consist of cash, money market funds and short term U.S. Treasuries. The Company invests a portion of its cash in a money market fund which invests in only investment grade money market instruments from a variety of industries, and therefore bears minimal risk. The average maturity of the investments owned by the money market fund is approximately two months.

Accounts Receivable. The Company provides credit terms typically ranging from thirty days to less than twelve months for most system and maintenance contract sales and generally does not require collateral. The Company performs ongoing credit evaluations of its customers and maintains reserves for estimated credit losses. Reserves for potential credit losses are determined by establishing both specific and general reserves. Specific reserves are based on management's estimate of the probability of collection for certain overdue accounts. General reserves are established based on the Company's historical collection experience of bad debt expense and the aging of the Company's accounts receivable balances net of deferred revenues and specifically reserved accounts. Accounts are written off as uncollectible only after the Company has expended extensive collection efforts. Included in accounts receivable are amounts related to maintenance and services which were billed, but which had not yet been rendered as of the end of the fiscal year. Undelivered maintenance and services are included on the balance sheet in deferred revenue.

Inventories. Inventories are valued at lower of cost (first-in, first-out) or market. Certain inventories are maintained for customer support pursuant to service agreements and are amortized over a five-year period using the straight-line method.

Equipment and Improvements. Equipment and improvements are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of equipment and improvements are provided over the estimated useful lives of the assets, or the related lease terms if shorter, by the straight-line method. Useful lives range from three to seven years.

Software Development Costs. Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. After technological feasibility is established, any additional development costs are capitalized in accordance with the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Such costs are amortized on a straight line basis over the estimated economic life of the related product, generally three years. The Company performs an annual review of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

Stock-Based Compensation. The Company accounts for stock-based employee compensation using the intrinsic value method as prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees, and, effective March 31, 2003, has adopted SFAS 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" that supercedes Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation". SFAS 148 requires pro forma disclosures of net income and net income per share as if the fair value based method of accounting for stock-based awards had been applied to employee grants. It also requires disclosure of option status on a more prominent and frequent basis. Such disclosure for the three and nine month periods ended December 31, 2003 and 2002 is presented immediately below. The Company accounts for stock options and warrants issued to non-employees based on the fair value method, but has not elected this treatment for grants to employees and board members. Under the fair value based method, compensation cost is recorded based on the value of the award at the grant date and is recognized over the service period.

On October 29, 2003, the Board of Directors granted 3,500 options to Emad Zikry, a director of the Company, at an exercise price of \$7.00 per share, as director fees solely for his service on the Board of Directors. The options vested immediately and expire on October 20, 2008. This option grant resulted in compensation expense of approximately \$130,000 recorded in the December, 2003 quarter using the intrinsic value method.

On October 29, 2003, the Board of Directors granted 60,000 options to employees at an exercise price of \$15.46 per share. The options vest in four equal annual installments beginning October 29, 2004 and expire on October 20, 2008. Based on the closing share price of the Company's stock on October 29, 2003 (\$44.16 per share), this option grant will result in compensation expense of up to \$1,722,000 (assuming all employees granted options continue their employment at the Company throughout the entire four year vesting period) to be amortized evenly over the next four years. During the quarter ended December 31, 2003, the Company recognized prorata compensation expense of \$73,000 related to these options.

The Company's fair value calculations for options granted in fiscal 2004 were made using the Black-Scholes option pricing model with the following assumptions: expected life – approximately 48 months from the date of the grant; stock volatility – 55% , risk free interest rate of 3.0%; and, no dividends during the expected term. The Company used these assumptions to value the 63,500 options granted on October 29, 2003. No options were granted in fiscal 2003.

The Company's calculations are based on a single option valuation approach and forfeitures are recognized as they occur. If the computed fair values of awards had been amortized to expense over the vesting period of the awards, pro forma net income and net income per share would have been as follows:

(in thousands except for per share amounts)

	<i>Quarter Ended</i>		<i>Nine Months Ended</i>	
	<i>December 31,</i>		<i>December 31,</i>	
	<i>2003</i>	<i>2002</i>	<i>2003</i>	<i>2002</i>
Net Income	\$ 2,611	\$ 1,935	\$ 7,296	\$ 5,272
Proforma Option Compensation Cost (Net of Taxes)	64	80	166	240
Proforma Net Income	\$ 2,547	\$ 1,855	\$ 7,130	\$ 5,032
Reported Basic Net Income Per Share	\$ 0.42	\$ 0.32	\$ 1.18	\$ 0.86
Proforma Net Income Per Share	\$ 0.41	\$ 0.30	\$ 1.16	\$ 0.82
Reported Diluted Net Income Per Share	\$ 0.40	\$ 0.30	\$ 1.13	\$ 0.83
Proforma Diluted Net Income Per Share	\$ 0.39	\$ 0.29	\$ 1.10	\$ 0.79

3. Recent Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), an interpretation of Accounting Research Bulletin No. 51. FIN 46 requires that a company consolidate variable interest entities if that company is subject to a majority of the risk of loss from the entities' activities or the company receives a majority of the entities' residual returns. FIN 46 also requires certain disclosure about variable interest entities in which the company has a significant interest, regardless of whether consolidation is required. The Company has no interests in variable interest entities and therefore the adoption of FIN 46 on January 1, 2003, did not have a material impact on the Company's consolidated financial statements.

In May 2003, the FASB issued Statement No. 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This statement establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. In accordance with the standard, financial instruments that embody obligations for the issuer are required to be classified as liabilities. SFAS 150 is effective for all financial instruments created or modified after May 31, 2003, and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 did not have a material effect on the Company's consolidated financial condition or results of operations because the Company does not have such financial instruments.

In May 2003, the Emerging Issues Task Force of the Financial Accounting Standards Board reached a consensus on Issue 00-21, "Revenue Arrangements with Multiple Deliverables." The consensus sets revenue recognition guidance for arrangements that have multiple deliverables. The consensus is effective for arrangements entered into in fiscal periods beginning after June 15, 2003. The Company adopted the consensus, and the adoption had no material impact on its consolidated financial position or results of operations as the Company continues to account for its software arrangements with multiple elements under SOP 97-2, as amended by SOP 98-9.

4. Intangible Assets

In accordance with FASB 142, the Company does not amortize goodwill. The balance of goodwill is related to the Company's wholly owned subsidiary, NextGen Healthcare Information Systems Inc. ("NextGen Division"), which was acquired by virtue of two acquisitions in May of 1996 and 1997, respectively. In accordance with FASB 142, the Company has compared the fair value of the NextGen Division with the carrying amount of assets associated with the Division and determined that none of the goodwill recorded as of June 30, 2003 was impaired. The fair value of the NextGen Division was determined using a reasonable estimate of future cash flows of the Division and a risk adjusted discount rate to compute a net present value of future cash flows.

As of December 31, 2003, the Company had the following amounts related to intangible assets:

(in thousands)	<i>Gross Carrying Amount</i>	<i>Accumulated Amortization</i>	<i>Net Intangible Assets</i>
Capitalized software development (3 yrs)	\$ 9,926	\$ 6,603	\$ 3,323
Aggregate amortization expense for the nine months ended December 31, 2003			\$ 1,091

The unamortized balance of capitalized software development costs as of December 31, 2003 is estimated to be amortized as follows:

<i>For the year ended March 31,</i>	<i>Estimated Amortization Expense (in thousands)</i>
2004	\$ 356
2005	\$ 1,509
2006	\$ 952
2007	\$ 506

5. Stock Repurchase Plan

In October 2001, the Company's Board of Directors authorized the repurchase on the open market of up to 5% of the shares of the Company's outstanding Common stock, subject to compliance with applicable laws and regulations. There was no requirement that the Company repurchase such shares. This stock repurchase authorization expired on September 24, 2003. No shares were repurchased under the plan.

6. Income Taxes

The provision for income taxes for the three and nine month periods ended December 31, 2003 and 2002 differ from the expected combined statutory rates primarily due to the estimated impact of varying state income tax rates, as well as estimated research and development tax credits.

7. Net Income Per Share

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods indicated. Basic net income per share is based upon the weighted average number of common shares outstanding. Diluted net income per share is based on the assumption that the Company's outstanding options are included in the calculation of diluted earnings per share, except when their effect would be anti-dilutive. Dilution is computed by applying the treasury stock method. Under this method, options are assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

(in thousands, except per share amounts)

	<i>Three Months Ended December 31,</i>		<i>Nine Month Ended December 31,</i>	
	<i>2003</i>	<i>2002</i>	<i>2003</i>	<i>2002</i>
Net income	\$ 2,611	\$ 1,935	\$ 7,296	\$ 5,272
Basic net income per common share:				
Weighted average of common shares outstanding	6,237	6,134	6,162	6,121
Basic net income per common share	\$ 0.42	\$ 0.32	\$ 1.18	\$ 0.86
Diluted net income per share:				
Weighted average of common shares outstanding	6,237	6,134	6,162	6,121
Effect of potentially dilutive securities (options)	312	269	314	242
Weighted average common shares outstanding— diluted	6,549	6,403	6,476	6,363
Diluted net income per common share	\$ 0.40	\$ 0.30	\$ 1.13	\$ 0.83

8. Operating Segment Information

The Company has prepared operating segment information in accordance with Statement of Accounting Standards SFAS No. 131 "Disclosures About Segments of an Enterprise and Related Information" to report components that are evaluated regularly by the Company's chief operating decision maker, or decision making group in deciding how to allocate resources and in assessing performance.

The Company's reportable operating segments include its NextGen Healthcare Information Systems Division and the QSI Division.

The disaggregated financial results of the segments reflect allocation of certain functional expense categories consistent with the basis and manner in which Company management internally disaggregates financial information for the purpose of assisting in making internal operating decisions. Certain corporate overhead costs are not allocated to the individual segments by management. The Company evaluates performance based on stand-alone segment revenue and operating income performance. Because the Company does not evaluate performance based on return on assets at the operating segment level, assets are not tracked internally by segment. Therefore, segment asset information is not presented.

Operating segment data for the three and nine month periods ended December 31, 2003 and 2002 is as follows:

(in thousands)	<i>QSI Division</i>	<i>NextGen Healthcare Information Systems Division</i>	<i>Unallocated Corporate Expenses</i>	<i>Consolidated</i>
Nine Months Ended December 31, 2003				
Revenue	\$ 12,452	\$ 39,695	\$ -	\$ 52,147
Operating income (loss)	\$ 3,701	\$ 10,995	\$ (3,080)	\$ 11,616
Nine Months Ended December 31, 2002				
Revenue	\$ 13,036	\$ 26,665	\$ -	\$ 39,701
Operating income (loss)	\$ 3,642	\$ 6,470	\$ (2,072)	\$ 8,040
Three Months Ended December 31, 2003				
Revenue	\$ 4,198	\$ 14,001	\$ -	\$ 18,199
Operating Income (Loss)	\$ 1,351	\$ 3,789	\$ (994)	\$ 4,146
Three Months Ended December 31, 2002				
Revenue	\$ 4,404	\$ 9,996	\$ -	\$ 14,400
Operating Income (Loss)	\$ 1,340	\$ 2,259	\$ (817)	\$ 2,782

9. Composition of Accounts Receivable

Included in accounts receivable are amounts related to maintenance and services which were billed but not yet rendered as of the end of the period. Undelivered maintenance and services are included on the consolidated balance sheet as part of the deferred revenue balance.

(in thousands)

	December 31, 2003	March 31, 2003
ACCOUNTS RECEIVABLE:	(unaudited)	
Accounts receivable, excluding undelivered maintenance and services	\$ 13,460	\$ 12,392
Undelivered maintenance and services billed in advance, included in deferred revenue	9,214	6,159
Gross Accounts receivable	22,674	18,551
Reserve for bad debts	(1,129)	(990)
Net accounts receivable	\$ 21,545	\$ 17,561

10. Concentration of Credit Risk

The Company had cash deposits at U.S. banks and financial institutions which exceeded federally insured limits at December 31, 2003. The Company is exposed to credit loss for amounts in excess of insured limits in the event of non-performance by the institutions; however, the Company does not anticipate non-performance by these institutions.

11. Commitments and Guarantees

The Company's standard sales agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any United States patent, or any copyright or other intellectual property infringement claim by any third party with respect to the Company's software. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes that its estimated exposure on these agreements is currently minimal. Accordingly, the Company has no liabilities recorded for these indemnifications as of December 31, 2003.

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

Except for the historical information contained herein, the matters discussed in this Quarterly Report on Form 10-Q, including discussions of the Company's product development plans, business strategies and market factors influencing the Company's results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by the Company as a result of various factors, both foreseen and unforeseen, including, but not limited to, the Company's ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution, consolidation within the Company's target marketplace and among the Company's competitors, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact the Company's ability to achieve its goals. Interested persons are urged to review the risks described below, as well as in the Company's other public disclosures and filings with the Securities and Exchange Commission.

Company Overview

Quality Systems Inc., comprised of the QSI Division ("QSI Division") and a wholly owned subsidiary, NextGen Healthcare Information Systems, Inc. ("NextGen Division") (collectively, the "Company") develops and markets healthcare information systems that automate medical and dental practices, networks of practices such as physician hospital organizations (PHO's) and management service organizations ("MSO's"), ambulatory care centers, community health centers, and medical and dental schools.

The Company, a California Corporation formed in 1974, was founded with an early focus on providing information systems to dental group practices. In the mid-1980's, the Company capitalized on the increasing focus on medical cost containment and further expanded its information processing systems to serve the medical market. In the mid 1990's the Company made two acquisitions that accelerated its penetration of the medical market. These two acquisitions formed the basis for what is today the NextGen Division. Today, the Company serves both the medical and dental markets through its two divisions.

The two divisions operate largely as stand-alone operations with each division maintaining its own distinct product lines, product platforms, development, implementation and support teams, sales staffing, and branding. The two divisions share the resources of the "corporate office" which includes a variety of accounting and other administrative functions. Additionally, there are a small number of clients who are simultaneously utilizing software from each of the Company's two divisions.

The QSI Division, co-located with the Corporate headquarters in Irvine, California, currently focuses primarily on developing and marketing software to dental and certain niche medical practices. The division supports a number of medical clients using medical practice management software developed by the division.

The NextGen Division, with headquarters in Horsham, Pennsylvania and a second significant location in Atlanta, Georgia, focuses principally on developing and marketing its products and services to medical practices.

Both divisions develop and market practice management software which is designed to automate and streamline a number of the administrative functions required for operating a medical or dental practice. Examples of practice management software functions include scheduling and billing capabilities. It is important to note that in both the medical and dental environments, practice management software systems have been implemented by the vast majority of practices. Therefore, the Company actively competes for the replacement market.

In addition, both divisions develop and market software that automates the patient record and enhances patient-provider interactions. Adoption of this software, commonly referred to as clinical

software, is in its relatively early stages. Therefore, the Company is typically competing to replace paper-based patient record alternatives as opposed to replacing previously purchased systems.

Electronic Data Interchange (“EDI”)/connectivity products are intended to automate a number of manual, often paper-based or telephony intensive communications between patients and/or providers and/or payors. Two of the more common EDI services are forwarding insurance claims electronically from providers to payors and assisting practices with issuing statements to patients. Most practices utilize at least some of these services from the Company or one of its competitors. Additional EDI/connectivity services are used more sporadically by client practices. The Company typically competes to displace incumbent vendors for claims and statements accounts, and attempts to increase usage of other elements in its product line.

The QSI Division’s practice management software suites utilize a UNIX¹ operating system. Its Clinical Product Suite (CPS) utilizes a Windows NT² operating system and can be fully integrated with the practice management software from each division. CPS incorporates a wide range of clinical tools including, but not limited to, periodontal charting and digital imaging of Xray and inter-oral camera images as part of the electronic patient record. The division develops, markets, and manages the Company’s QUIC product suite which focuses on EDI/connectivity applications. The QSInet Application Service Provider (ASP/Internet) offering is also developed and marketed by the division.

The Company’s NextGen Division develops and sells proprietary electronic medical records software and practice management systems under the NextGen^{®3} product name. Major product categories of the NextGen suite include Electronic Medical Records (NextGen^{emr}), Enterprise Practice Management (NextGen^{epm}), Enterprise Appointment Scheduling (NextGen^{cas}), Enterprise Master Patient Index (NextGen^{epi}), NextGen Image Control System (NextGen^{ics}), Managed Care, Electronic Data Interchange, System Interfaces, Internet Operability (NextGen^{web}), a Patient-centric and Provider-centric Web Portal Solution (NextMD.com⁴), and a handheld product (NextGen^{pda}). NextGen products utilize Microsoft Windows technology and can operate in a client-server environment as well as via private intranet, the Internet, or in an ASP environment.

The Company continues to pursue product enhancement initiatives within each division. The majority of such expenditures are currently targeted to the NextGen Division product line and client base. Recent product enhancements by the QSI Division include laser generated forms and an electronic signature capability within the division’s CPS product line. While these enhancements are not projected to materially increase divisional revenues or profits, the enhancements are designed to maintain and/or increase client satisfaction within the division’s established base of customers.

The NextGen Division recently released NextGen Image Control System (NextGen^{ics}). This module works in conjunction with both NextGen^{epm} and NextGen^{emr} to address the high volume scanning needs of clients. Management does not expect that NextGen^{ics} will add materially to the Company’s revenues in the near term, and views this offering as part of the continued build-out of the division’s product line as well as a viable means of addressing an area where the division had been reliant on third party alternatives.

¹.UNIX is a registered trademark of the AT&T Corporation.

² Microsoft Windows, Windows NT, Windows 95, Windows 98, and Windows 2000 are registered trademarks of the Microsoft Corporation.

³ NextGen is a registered trademark of NextGen Healthcare Information Systems, Inc

⁴ NextMD.com is a trademark of NextGen Healthcare Information Systems, Inc

Inclusive of divisional EDI revenues, the NextGen Division accounts for approximately 76% of the Company's revenues. The QSI Division accounts for the balance. The NextGen Division has been growing at annual rates of between 20% and 37% for the past few years, while the QSI Division's overall revenues have been relatively stable.

In addition to the aforementioned software solutions offered by the Company through its two divisions, each division offers comprehensive hardware and software installation services, maintenance and support services, and system training services.

The Company currently has a base of approximately 800 clients, with each client generally including between one and 500 physicians or dentists.

The Company had 301 employees as of December 31, 2003. This total is comprised of: NextGen Division 219, QSI Division 66, and Corporate 16. For comparison, the Company had 254 employees at December 31, 2002. The NextGen Division accounted for 166, the QSI Division employed 72, and corporate staffing was 16. Revenue per employee was \$242,000 at December 31, 2003, up from \$227,000 at the end of the same quarter of the prior year.

Risk Factors

Competition. The markets for healthcare information systems are intensely competitive, and the Company faces significant competition from a number of different sources. Several of the Company's competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than the Company.

The Company competes in all of its markets with other major healthcare related companies, information management companies, systems integrators, and other software developers. Competitive pressures and other factors, such as new product introductions by the Company or its competitors, may result in price or market share erosion that could have a material adverse effect on the Company's business, results of operations and financial condition. Also, there can be no assurance that the Company's applications will achieve broad market acceptance or will successfully compete with other competing software products.

The Company's inability to make initial sales of its systems to either newly formed groups and/or healthcare providers that are replacing or substantially modifying their healthcare information systems could have a material adverse effect on the Company's business, results of operations and financial condition. If new systems sales do not materialize, the Company's near term and longer term revenues will be negatively affected.

Fluctuation in Quarterly Operating Results. The Company's revenues have fluctuated in the past, and may fluctuate in the future from quarter to quarter and period to period, as a result of a number of factors including, without limitation: the size and timing of orders from clients; the length of sales cycles and installation processes; the ability of the Company's clients to obtain financing for the purchase of the Company's products; changes in pricing policies or price reductions by the Company or its competitors; the timing of new product announcements and product introductions by the Company or its competitors; changes in revenue recognition guidelines employed by the Company and/or established by the Financial Accounting Standards Board or other rule-making bodies; the availability and cost of system components; the financial stability of major clients; market acceptance of new products, applications and product enhancements; the Company's ability to develop, introduce and market new products, applications and product enhancements; the Company's success in expanding its sales and marketing programs; deferrals of client orders in anticipation of new products, applications or product enhancements; changes in Company strategy; personnel changes; and general market/economic factors.

The Company's software products are generally shipped as orders are received and accordingly, the Company has historically operated with a minimal backlog of license fees. As a result, revenues in any quarter are dependent on orders booked and shipped in that quarter and are not predictable with any

degree of certainty. Furthermore, the Company's systems can be relatively large and expensive and individual systems sales can represent a significant portion of the Company's revenues and profits for a quarter such that the loss or deferral of even one such sale can have a significant adverse impact on the Company's quarterly revenue and profitability.

Clients often defer systems purchases until the Company's quarter end, so quarterly results generally cannot be predicted and frequently are not known until the quarter has concluded.

The Company's sales are dependent upon clients' initial decision to replace or substantially modify their existing information system, and subsequently a decision as to which products and services to purchase. These are major decisions for healthcare providers, and accordingly, the sales cycle for the Company's systems can vary significantly and typically ranges from three to twelve months from initial contact to contract execution/shipment.

Because a significant percentage of the Company's expenses are relatively fixed, a variation in the timing of systems sales and installations can cause significant variations in operating results from quarter to quarter. As a result, the Company believes that interim period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, the Company's historical operating results are not necessarily indicative of future performance for any particular period.

The Company currently recognizes revenue pursuant to Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP 97-2"), as modified by SOP 98-9 "Modification of SOP 97-2, Software Revenue Recognition, With Respect of Certain Transactions". Additionally, in December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements" ("SAB 101"). SAB 101 summarizes the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements.

There can be no assurance that application and subsequent interpretations of these pronouncements will not further modify the Company's revenue recognition policies, or that such modifications would not have a material adverse effect on the operating results reported in any particular quarter or year.

Due to all of the foregoing factors, it is possible that the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's Common Stock would likely be materially adversely affected.

Stock Price Volatility. The trading price of the Company's common stock may be volatile. The market for the Company's common stock may experience significant price and volume fluctuations in response to a number of factors including actual or anticipated quarterly variations in operating results, rumors about the Company's performance or software solutions, changes in expectations of future financial performance or changes in estimates of securities analysts, governmental regulatory action, health care reform measures, client relationship developments, changes occurring in the markets in general and other factors, many of which are beyond the Company's control.

Furthermore, the stock market in general, and the market for software, health care and high technology companies in particular, have experienced extreme volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of the Company's common stock, regardless of actual operating performance.

Dependence on Principal Product and New Product Development. The Company currently derives substantially all of its net revenues from sales of its healthcare information systems and related services. The Company believes that a primary factor in the market acceptance of its systems has been its ability to meet the needs of users of healthcare information systems. The Company's future financial performance will depend in large part on the Company's ability to continue to meet the increasingly sophisticated needs of its clients through the timely development and successful introduction and implementation of new and enhanced versions of its systems and other complementary products. The Company has historically expended a significant percentage of its net revenues on product development and believes

that significant continuing product development efforts will be required to sustain the Company's growth. Continued investment in the Company's sales staff and its client implementation and support staff will also be required to support future growth.

There can be no assurance that the Company will be successful in its product development efforts, that the market will continue to accept the Company's existing products, or that new products or product enhancements will be developed and implemented in a timely manner, meet the requirements of healthcare providers, or achieve market acceptance. If new products or product enhancements do not achieve market acceptance, the Company's business, results of operations and financial condition could be materially adversely affected. At certain times in the past, the Company has also experienced delays in purchases of its products by clients anticipating the launch of new products by the Company. There can be no assurance that material order deferrals in anticipation of new product introductions will not occur.

Subscription Pricing And/Or Application Service Provider, Or ASP, Delivered Offerings. The Company currently derives substantially all of its revenues from traditional software license, maintenance and service fees, as well as the resale of computer hardware. Today, customers pay an initial license fee for the use of the Company's products, in addition to a periodic maintenance fee. If the marketplace demands subscription pricing and/or ASP-delivered offerings, the Company may be forced to adjust its strategy accordingly, by offering a higher percentage of the Company's products and services through these means. Shifting to subscription pricing and/or ASP-delivered offerings could materially adversely impact the Company's financial condition, cash flows and quarterly and annual revenues and results of operations, as the Company's revenues would initially decrease substantially. There can be no assurance that the marketplace will not embrace subscription pricing and/or ASP-delivered offerings.

Technological Change. The software market generally is characterized by rapid technological change, changing customer needs, frequent new product introductions, and evolving industry standards. The introduction of products incorporating new technologies and the emergence of new industry standards could render the Company's existing products obsolete and unmarketable. There can be no assurance that the Company will be successful in developing and marketing new products that respond to technological changes or evolving industry standards. New product development depends upon significant research and development expenditures which depend ultimately upon sales growth. Any material weakness in revenues or research funding could impair the Company's ability to respond to technological advances in the marketplace and to remain competitive. If the Company is unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, the Company's business, results of operations and financial condition may be materially adversely affected.

In response to increasing market demand, the Company is currently developing new generations of certain of its software products. There can be no assurance that the Company will successfully develop these new software products or that these products will operate successfully, or that any such development, even if successful, will be completed concurrently with or prior to introduction of competing products. Any such failure or delay could adversely affect the Company's competitive position or could make the Company's current products obsolete.

Web Site Claims. The Company could be subject to third party claims based on the nature and content of information supplied on the Company's Web site by the Company or third parties, including content providers or users. The Company could also be subject to liability for content that may be accessible through the Company's Web site or third party Web sites linked from the Company's Web site or through content and information that may be posted by users in chat rooms, bulletin boards or on Web sites created by professionals using the Company's applications. Even if these claims do not result in liability to the Company, investigating and defending against these claims could be expensive and time consuming and could divert management's attention away from the Company's operations.

Claims From Activities of Strategic Partners. The Company relies on third parties to provide services that impact the Company's business. For example, the Company uses national clearinghouses in the processing of insurance claims and the Company outsources some of its hardware maintenance services and the printing and delivery of patient statements for the Company's customers. The Company

also has relationships with certain third parties where these third parties serve as sales channels through which the Company generates a portion of its revenues. Due to these third-party relationships, the Company could be subject to claims as a result of the activities, products, or services of these third-party service providers even though the Company was not directly involved in the circumstances leading to those claims. Even if these claims do not result in liability to the Company, defending and investigating these claims could be expensive and time-consuming, divert personnel and other resources from its business and result in adverse publicity that could harm the Company's business.

Litigation. The Company faces the risks associated with litigation concerning the operation of its business. The uncertainty associated with substantial unresolved litigation may have an adverse impact on the Company's business. In particular, such litigation could impair the Company's relationships with existing customers and its ability to obtain new customers. Defending such litigation may result in a diversion of management's time and attention away from business operations, which could have a material adverse effect on the Company's business, results of operations and financial condition. Such litigation may also have the effect of discouraging potential acquirers from bidding for the Company or reducing the consideration such acquirers would otherwise be willing to pay in connection with an acquisition.

There can be no assurance that such litigation will not result in liability in excess of its insurance coverage, that the Company's insurance will cover such claims or that appropriate insurance will continue to be available to the Company in the future at commercially reasonable rates.

Proprietary Technology. The Company is heavily dependent on the maintenance and protection of its intellectual property and relies largely on license agreements, confidentiality procedures, and employee nondisclosure agreements to protect its intellectual property. The Company's software is not patented and existing copyright laws offer only limited practical protection.

There can be no assurance that the legal protections and precautions taken by the Company will be adequate to prevent misappropriation of the Company's technology or that competitors will not independently develop technologies equivalent or superior to the Company's. Further, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States and are often not enforced as vigorously as those in the United States.

The Company does not believe that its operations or products infringe on the intellectual property rights of others. However, there can be no assurance that others will not assert infringement or trade secret claims against the Company with respect to its current or future products or that any such assertion will not require the Company to enter into a license agreement or royalty arrangement or other financial arrangement with the party asserting the claim. Responding to and defending any such claims may distract the attention of Company management and have a material adverse effect on the Company's business, results of operations and financial condition. In addition, claims may be brought against third parties from which the Company purchases software, and such claims could adversely affect the Company's ability to access third party software for its systems.

Dependence on License Rights. The Company depends upon licenses from third party vendors for some of the technology used in its products. Most of these licenses can be renewed only by mutual consent and may be terminated if the Company breaches the terms of the license and fails to cure the breach within a specified period of time. The Company may not be able to continue using the technology made available to it under these licenses on commercially reasonable terms or at all. As a result, the Company may have to discontinue, delay or reduce product shipments until it can obtain equivalent technology. Most of the Company's third-party licenses are non-exclusive. The Company's competitors may obtain the right to use any of the technology covered by these licenses and use the technology to compete directly with the Company. In addition, if the Company's vendors choose to discontinue support of the licensed technology in the future or are unsuccessful in their continued research and development efforts, the Company may be negatively impacted.

Possible Security Breaches. In the course of its business operations, the Company compiles and transmits confidential information, including patient health information, in the Company's processing

centers and other facilities. A breach of security in any of these facilities could damage the Company's reputation and result in damages being assessed against the Company. In addition, the other systems with which the Company may interface, such as the Internet and related systems, may be vulnerable to security breaches, viruses, programming errors, or similar disruptive problems. The effect of these security breaches and related issues could reduce demand for the Company's services. Accordingly, the Company believes that it is critical that these facilities and infrastructure not only be secure, but also be viewed by the Company's customers as free from potential breach. Maintaining such standards, protecting against breaches and curing security flaws, may require the Company to expend significant capital.

Development and Maintenance of Internet Infrastructure. The Company delivers Internet-based services and, accordingly, is dependent on the maintenance of the Internet by third parties. The Internet infrastructure may be unable to support the demands placed on it and its performance may decrease if the Internet continues to experience its historic trend of expanding usage. As a result of damages to portions of its infrastructure, the Internet has experienced a variety of performance problems which may continue into the foreseeable future. Such Internet related problems may diminish Internet usage and availability of the Internet to the Company for transmittal of Internet-based services by the Company. In addition, difficulties, outages, and delays by Internet service providers, online service providers and other web site operators may obstruct or diminish access to the Company's web site by its customers resulting in a loss of potential or existing users of the Company's services.

Security Breaches and Viruses. The success of the Company's strategy to offer its EDI services and Internet solutions depends on the confidence of the Company's customers in its ability to securely transmit confidential information. The Company's EDI services and Internet solutions rely on encryption, authentication and other security technology licensed from third parties to achieve secure transmission of confidential information. The Company may not be able to stop unauthorized attempts to gain access to or disrupt the transmission of communications by the Company's customers. Anyone who is able to circumvent security measures could misappropriate confidential user information or interrupt the Company's, or the Company's customers', operations. In addition, the Company's EDI and Internet solutions may be vulnerable to viruses, physical or electronic break-ins, and similar disruptions. Any failure to provide secure electronic communication services could result in a lack of trust by the Company's customers causing them to seek out other vendors, and/or, damage the Company's reputation in the market making it difficult to obtain new customers.

Ability to Manage Growth. The Company has in the past experienced periods of growth which have placed, and may continue to place, a significant strain on the Company's non-cash resources. The Company also anticipates expanding its overall software development, marketing, sales, client management and training capacity. In the event the Company is unable to identify, hire, train and retain qualified individuals in such capacities within a reasonable timeframe, such failure could have a material adverse effect on the Company. In addition, the Company's ability to manage future increases, if any, in the scope of its operations or personnel will depend on significant expansion of its research and development, marketing and sales, management, and administrative and financial capabilities. The failure of the Company's management to effectively manage expansion in its business could have a material adverse effect on the Company's business, results of operations and financial condition.

Dependence Upon Key Personnel. The Company's future performance depends in significant part upon the continued service of its key technical, sales, marketing and senior management personnel, many of whom have been with the Company for a significant period of time and may be difficult to replace. Because the Company has a relatively small number of employees when compared to other leading companies in the same industry, its dependence on maintaining its relationship with key employees is particularly significant and the loss of a few key people can have a relatively major negative impact upon the Company. The Company is also dependent on its ability to attract and retain high quality personnel, particularly in the highly competitive areas of sales, management and applications development.

The industry is characterized by a high level of employee mobility, highly variable compensation packages, and aggressive recruiting of skilled personnel. There can be no assurance that the Company's current employees will continue to work for the Company.

Loss of services of one or more key employees could have a material adverse effect on the Company's business, results of operations and financial condition. Generally, within the industry, key personnel are often attracted by packages that include competitive base remuneration, bonuses and equity (usually option) plans. Accordingly, the Company believes that it may need to grant additional stock options to key employees from time to time and provide other forms of incentive compensation to attract and retain such key personnel. Failure to provide such types of incentive compensation could jeopardize the Company's recruitment and retention capabilities and have a material adverse effect on the Company's business, results of operations and financial condition.

The Company does not maintain key man life insurance on any of its employees.

Product Liability. Certain of the Company's products provide applications that relate to patient clinical information. Any failure by the Company's products to provide accurate and timely information could result in claims against the Company. In addition, a court or government agency may take the position that the Company's delivery of health information directly, including through licensed practitioners, or delivery of information by a third party site that a consumer accesses through the Company's web sites, exposes the Company to assertions of malpractice, other personal injury liability, or other liability for wrongful delivery/handling of healthcare services or erroneous health information. The Company maintains insurance to protect against claims associated with the use of its products, but there can be no assurance that its insurance coverage would adequately cover any claim asserted against the Company. A successful claim brought against the Company in excess of or outside of its insurance coverage could have a material adverse effect on the Company's business, results of operations and financial condition. Even unsuccessful claims could result in the Company's expenditure of funds in litigation and management time and resources.

Certain healthcare professionals who use the Company's Internet-based products will directly enter health information about their patients including information that constitutes a record under applicable law that the Company may store on the Company's computer systems. Numerous federal and state laws and regulations, the common law, and contractual obligations, govern collection, dissemination, use and confidentiality of patient-identifiable health information, including:

- state and federal privacy and confidentiality laws;
- the Company's contracts with customers and partners;
- state laws regulating healthcare professionals;
- medicaid laws; and
- the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") and related rules proposed by the Health Care Financing Administration; and Health Care Financing Administration standards for Internet transmission of health data.

The U.S. Congress has finalized the Health Insurance Portability and Accountability Act of 1996 that established, beginning April, 2003, elements including, but not limited to, new federal privacy and security standards for the use and protection of Protected Health Information. Under contractual arrangement with its customers, any failure by the Company or by its personnel or partners to comply with applicable requirements may result in a material liability to the Company.

Although the Company has systems and policies in place for safeguarding Protected Health Information from unauthorized disclosure, these systems and policies may not preclude claims against the Company for alleged violations of applicable requirements. Also, third party sites and/or links that consumers may access through the Company's web sites may not maintain adequate systems to safeguard this information, or may circumvent systems and policies the Company has put in place. In addition, future laws or changes in current laws may necessitate costly adaptations to the Company's policies, procedures, or systems.

There can be no assurance that the Company will not be subject to product liability claims, that such claims will not result in liability in excess of its insurance coverage, that the Company's insurance will cover such claims or that appropriate insurance will continue to be available to the Company in the future

at commercially reasonable rates. Such product liability claims could have a material adverse effect on the Company's business, results of operations and financial condition.

Effect of Payer and Provider Conduct. Electronic data transmission services are offered by certain payers to healthcare providers that establish a direct link between the provider and payer. This process bypasses third party EDI service providers such as the Company. Accordingly, the Company is unable to insure that the Company and other independent companies will continue to be used by healthcare payers and providers to transmit healthcare transactions. A significant increase in the utilization of direct links between healthcare providers and payers could have a material adverse effect on the Company's transaction volume and financial results. In addition, the company cannot provide assurance that the Company will be able to maintain the Company's exiting links to payers or develop new connections on terms that are economically satisfactory to the Company, if at all.

Uncertainty in Healthcare Industry; Government Regulation. The healthcare industry is subject to changing political, economic and regulatory influences that may affect the procurement processes and operation of healthcare facilities. During the past several years, the healthcare industry has been subject to an increase in governmental regulation of, among other things, reimbursement rates and certain capital expenditures.

In the past, various legislators have announced that they intend to examine proposals to reform certain aspects of the U.S. healthcare system including proposals which may change governmental involvement in healthcare and reimbursement rates, and otherwise alter the operating environment for the Company and its clients. Healthcare providers may react to these proposals, and the uncertainty surrounding such proposals, by curtailing or deferring investments, including those for the Company's systems and related services. Cost-containment measures instituted by healthcare providers as a result of regulatory reform or otherwise could result in a reduction in the allocation of capital funds. Such a reduction could have an adverse effect on the Company's ability to sell its systems and related services. On the other hand, changes in the regulatory environment have increased and may continue to increase the needs of healthcare organizations for cost-effective data management and thereby enhance the overall market for healthcare management information systems. The Company cannot predict what impact, if any, such proposals or healthcare reforms might have on the Company's business, financial condition and results of operations.

The HIPAA regulation, as adopted by the Department of Health and Human Services, established, among other things: (i) a national standard for electronic transactions and code sets to be used in those transactions involving certain common health care transactions, (ii) privacy regulations to protect the privacy of plan participants and patients' medical records and (iii) security regulations designed to establish security controls and measures to protect the privacy and confidentiality of personal identifiable health information when it is electronically stored, maintained or transmitted (even if only internally transmitted within a medical practice.) While the privacy and transaction and code set standards are currently in effect, the security regulation is expected to become effective by 2005. As these regulations mature and become better defined, the Company anticipates that these regulations will continue to directly affect certain of the Company's products and services, but the Company cannot fully predict this impact at this time. The Company has taken steps to modify its products, services and internal practices as necessary to facilitate its and its client's compliance with the final regulations, but there can be no assurance that the Company will be able to do so in a timely or complete manner. Achieving compliance with these regulations could be costly and distract management's attention and other resources, and any noncompliance by the Company could result in civil and criminal penalties.

In addition, development of related federal and state regulations and policies regarding the confidentiality of health information or other matters could positively or negatively affect the Company's business.

In addition, the Company's software may potentially be subject to regulation by the U.S. Food and Drug Administration (the "FDA") as a medical device. Such regulation could require the registration of the applicable manufacturing facility and software and hardware products; application of detailed record-

keeping and manufacturing standards; and FDA approval or clearance prior to marketing. An approval or clearance requirement could create delays in marketing, and the FDA could require supplemental filings or object to certain of these applications, the result of which could have a material adverse effect on the Company's business, financial condition and results of operations.

Other E-commerce Regulations. The Company may be subject to additional federal and state statutes and regulations in connection with offering services and products via the Internet. On an increasingly frequent basis, federal and state legislators are proposing laws and regulations that apply to Internet commerce and communications. Areas being affected by these regulations include user privacy, pricing, content, taxation, copyright protection, distribution, and quality of products and services. To the extent that the Company's products and services are subject to these laws and regulations, the sale of the Company's products and services could be harmed.

Financial Accounting Matters. Based on the Company's reading and interpretations of relevant guidance, principles or concepts, issued by, among other authorities, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the United States Securities and Exchange Commission, Management believes its current sales and licensing contract terms and business arrangements have been properly reported. However, there continue to be issued interpretations and guidance for applying the relevant standards to a wide range of sales and licensing contract terms and business arrangements that are prevalent in the software industry. Future interpretations or changes by the regulators of existing accounting standards or changes in the Company's business practices could result in future changes in the Company's revenue recognition accounting policies and practices that could have a material adverse effect on the Company's business, financial condition, cash flows, revenues and results of operations.

Results of Operations

The following table sets forth for the periods indicated, the percentage of net revenues represented by each item in the Company's Consolidated Statements of Income.

(unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Net Revenues:				
Sales of computer systems, upgrades and supplies	54.2%	53.2%	56.3%	52.7%
Maintenance and other services	45.8	46.8	43.7	47.3
	100.0	100.0	100.0	100.0
Cost of Products and Services	41.3	44.1	41.5	42.7
Gross Profit	58.7	55.9	58.5	57.3
Selling, General and Administrative Expenses	26.9	27.2	27.6	27.8
Research and Development Costs	9.0	9.4	8.6	9.3
Income from Operations	22.8	19.3	22.3	20.3
Investment Income	0.5	0.8	0.5	0.8
Income before Provision for Income Taxes	23.3	20.1	22.8	21.1
Provision for Income Taxes	9.0	6.6	8.8	7.8
Net Income	14.3%	13.5%	14.0%	13.3%

For the Three-Month Periods Ended December 31, 2003 and 2002

The Company's net income for the three months ended December 31, 2003 was \$ 2,611,000 or \$0.42 per share on a basic and \$.40 per share on a diluted basis, as compared to a net income of \$1,935,000, or \$0.32 per share on a basic and \$0.30 per share on a diluted basis, for the three months ended December 31, 2002.

Net Revenues. Net revenues for the three months ended December 31, 2003 increased 26% to \$18.2 million from \$14.4 million for the three months ended December 31, 2002. Net revenue totals were the result of a 40% increase in the NextGen Division's net revenue from \$10 million to \$14 million and a 5% decline in QSI Division net revenue from \$4.4 million from \$4.2.

Company wide sales of computer systems, upgrades and supplies increased 29% to \$9.9 million from \$7.7 million in the year ago quarter while net revenues from maintenance and other services grew 24% to \$8.3 million from \$6.7 million during the comparable period last year. Included in computer systems sales are revenues from the sale of software, hardware, third party software and implementation services. Included in maintenance and other revenues are revenues from maintenance, electronic data interchange services, and professional services, excluding installation.

The increase in net revenues from sales of computer systems, upgrades and supplies was principally the result of a 33% increase in such revenues at the NextGen division, which grew from \$7.0 million to \$9.3 million. This increase was driven by higher sales of software license and related service revenue. Category revenues in the QSI Division declined from approximately \$0.7 million to \$0.5 million. Software sales in the QSI division included had a relatively lower amount of hardware resulting in lower revenue compared to the prior year quarter.

The increase in maintenance and other services revenue resulted principally from a 56% increase in such revenues generated from the expanded client base of the NextGen Division. Total maintenance revenue in the NextGen Division grew 58% to \$3.2 million from \$2.0 million in the year ago quarter. Total EDI revenue in the NextGen Division grew to \$0.9 million from \$0.5 million in the year ago quarter. The QSI Division experienced slight declines in maintenance revenue (from \$2.0 to \$1.9 million) and EDI revenue (from \$1.4 to \$1.3 million) from the quarter ended December 31, 2002 to the quarter ended December 31, 2003.

Cost of Products and Services. Cost of products and services for the three months ended December 31, 2003 rose 18% to \$7.5 million from \$6.4 million in the prior year quarter. Cost of products and services as a percentage of net revenues decreased to 41% from 44% for the respective period. The dollar increase in the cost of products and services was principally the result of increased labor and other costs associated with increased installation and customer support activity. The cost of products and services as a percentage of net revenues decreased in the quarter ended December 31, 2003 compared to the same period last year, largely as a result of a revenue growing at a faster rate than labor and overhead costs associated with installation and customer support services as well as a lower level of hardware and third party software content included in system sales. The gross margin percentage in the quarter ended December 31, 2003 was 58.7% versus 55.9% in the prior year. Despite the year over year increase, the gross margin percentage in the December 31, 2003 quarter was still within the Company's historical band.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the three months ended December 31, 2003 increased 25% to approximately \$4.9 million as compared to \$3.9 million for the three months ended December 31, 2002. Selling, general and administrative expenses as a percentage of net revenues decreased slightly to 26.9% as compared to 27.2% in the prior year quarter. The increase in the amount of such expenses resulted primarily from additions to sales personnel, higher trade show expenses, higher commission expenses in the NextGen Division of \$0.4 million, as well as \$0.2 million of higher corporate expenses.

Research and Development Costs. Research and development costs for the three months ended December 31, 2003 increased by 21% to \$1.6 million from \$1.3 million in the prior year's quarter. The increase in research and development costs is attributed primarily to increased investments in the NextGen Division product suites. Research and development costs as a percentage of net revenues declined to 8.9% as compared to 9.4% for the quarter ended December 31, 2002. This percentage decline was driven by the fact that revenues grew faster than the increase in research and development expense.

Investment Income. Investment income for the three months ended December 31, 2003 decreased by 12.8% from approximately \$109,000 to \$95,000. Investment income in the quarter declined due to the

lower interest rates earned on the Company's balances during the quarter versus the year earlier quarter. The decrease in investment returns were partially offset by higher cash balances.

Provision for Income Taxes. The provision for income taxes for the three months ended December 31, 2003 was approximately \$1.6 million as compared to approximately \$1.0 million for the three months ended December 31, 2002. The provision for income taxes for the three months ended December 31, 2003 differs from the combined statutory rates primarily due to the impact of the effect of varying state income tax rates as well as the impact of estimated research and development tax credits. The provision for income taxes for the three months ended December 31, 2002 differs from the combined statutory rates primarily due to the impact of the effect of varying state income tax rates as well as the impact of the estimated year to date research and development tax credits available to the Company.

For the Nine -Month Periods Ended December 31, 2003 and 2002

The Company's net income for the nine months ended December 31, 2003 was \$7.3 million, or \$1.18 per share on a basic and \$1.13 per share on a diluted basis, as compared to \$5.3 million, or \$.86 per share on a basic and \$.83 per share on a diluted basis for the nine months ended December 31, 2002.

Net Revenues Net revenues for the nine months ended December 31, 2003 increased 31% to \$52.1 million from \$39.7 million for the nine months ended December 31, 2002. NextGen Division net revenue increased 49% from approximately \$26.7 million to approximately \$39.7 million in the period, while QSI Division net revenue declined by 4% during the period from approximately \$13 million to \$12.5 million.

Company wide sales of computer systems, upgrades and supplies increased 41% to \$29.4 million from \$20.9 million while revenues from maintenance and other services grew 21% to \$22.8 million from \$18.8 million during the comparable period.

The increase in revenues from sales of computer systems, upgrades and supplies for the Company was principally the result of a 48% increase in such revenue at the Company's NextGen Division which grew from \$18.8 million to \$27.7 million. This increase was driven by higher sales of NextGen^{em} and NextGen^{epm} software as well as related hardware and third party software. Category revenue in the QSI division declined by 23% from \$2.1 million to \$1.6 million.

The increase in maintenance and other services revenue for the Company resulted principally from an increase in maintenance, EDI and other revenues from the NextGen Division's growing client base. Total maintenance revenue for the nine months ended December 31, 2003 in the NextGen Division grew 52% to \$7.9 million from \$5.2 million in the year ago period while QSI Division maintenance declined 5% from \$6.0 million to \$5.7 million in the same comparable period.. Total EDI revenue in the NextGen Division grew 75% to \$2.1 million compared to \$1.2 million in the year ago period while QSI Division EDI revenue was unchanged at approximately \$4.0 million in both periods.

Cost of Products and Services. Cost of products and services for the nine months ended December 31, 2003 increased 28% to \$21.6 million from \$16.9 million for the nine months ended December 31, 2002, while cost of products and services as a percentage of net revenues declined to 41.5% from 42.7% during the comparable periods. The cost of products and services as a percentage of net revenues decreased primarily as a result of a revenue growing at a faster rate than labor and overhead costs associated with installation and customer support services as well as proportionately lower hardware and third party software content included in revenues.

Selling, General and Administrative Expenses Selling, general and administrative expenses for the nine months ended December 31, 2003 increased 31% to \$14.4 million as compared to \$11.0 million for the nine months ended December 31, 2002. The increase in the amount of such expenses resulted primarily from additions to the sales personnel and higher commission expenses in the NextGen Division of \$1.6 million, and \$1.0 million in higher corporate expenses.

Research and Development Costs Research and development costs for the nine months ended December 31, 2003 and 2002 were \$4.5 million and \$3.7 million respectively. The increase in research and development expenses were primarily due to increased investment in the NextGen product line. Research and development costs as a percentage of net revenues decreased to 8.6% from 9.3% due to the fact that revenues increased more quickly than research and development expense.

Investment Income. Investment income for the nine months ended December 31, 2003 decreased 15% to approximately \$284,000 compared with \$336,000 in the nine months ended December 31, 2002. Investment income in the nine months ended December 31, 2003 declined primarily due to the effect of the drop in short term interest rates versus the prior year. The decrease in returns were partially offset by higher cash balances.

Provision for Income Taxes. The provision for income taxes for the nine months ended December 31, 2003 was approximately \$4.6 million as compared to approximately \$3.1 million for the nine months ended December 31, 2002. The provision for income taxes for the nine months ended December 31, 2003 and 2002 differ from the combined statutory rates primarily due to the impact of varying state income tax rates and the impact of research and development tax credits.

Liquidity and Capital Resources

The following table presents selected financial statistics and information for each of the nine months ended December 31, 2003 and 2002:

<i>(in thousands)</i> <i>(unaudited)</i>	<i>Nine Months Ended December 31,</i>	
	<i>2003</i>	<i>2002</i>
Cash and cash equivalents at end of period	\$ 45,348	\$ 33,146
Net increase in cash and cash equivalents during the period	\$ 8,905	\$ 7,703
Net income during the period	\$ 7,296	\$ 5,272
Net cash provided by operations during the period	\$ 10,675	\$ 9,095
Number of days of sales outstanding at start of period	106	104
Number of days of sales outstanding at end of period	108	104

The Company's principal source of cash was provided by operations. The number of days sales outstanding during the period increased by two days primarily due to an increase in the volume of services sold by the NextGen Division which had not yet been rendered resulting in an increase in both accounts receivable and deferred revenue. With the growth of the NextGen Division as a percentage of consolidated revenues, the overall number of days sales outstanding has more closely mirrored that of the NextGen Division, which has historically had a higher days sales outstanding compared to the QSI Division due to a higher amount of services invoiced in advance and included in deferred revenue. Provided turnover of accounts receivable, deferred revenue, and profitability remain consistent with the quarter ended December 31, 2003, the Company anticipates being able to continue to generate cash from operations primarily from the net income of the Company.

Cash and cash equivalents increased \$8,905,000 between April 1, 2003 and December 31, 2003 primarily as a result of cash provided by operating activities. Cash and cash equivalents increased approximately \$7,703,000 during the nine months ended December 31, 2002, also primarily as a result of cash generated by operating activities. Also, during the nine months ended December 31, 2002, the Company liquidated approximately \$255,000 in short-term equity investments, and moved those funds into cash and cash equivalent accounts.

Net cash used in investing activities for the nine months ended December 31, 2003 and 2002 was \$2,743,000 and \$1,649,000 respectively. Net cash used in investing activities for the nine months ended

December 31, 2003 consisted of additions to equipment and improvements and capitalized software. Net cash used in investing activities for the nine months ended December 31, 2002 consisted of additions to equipment and improvements and capitalized software and was partially offset by the proceeds from the sale of short term investments.

Net cash from financing activities is composed entirely of proceeds from stock option exercises which for the nine periods ended December 31, 2003 and 2002 totaled \$973,000 and \$257,000 respectively.

At December 31, 2003, the Company had cash and cash equivalents of \$45.3 million. The Company intends to expend funds for the development of products complementary to its existing product line as well as new versions of certain of its products. The Company has no additional significant current capital commitments.

Management believes that its cash and cash equivalents on hand at December 31, 2003, together with cash flows from operations, if any, will be sufficient to meet its working capital and capital expenditure requirements for the balance of fiscal 2004.

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

The Company has a significant amount of cash and short-term investments with maturities less than three months. This cash portfolio exposes the Company to interest rate risk as short-term investment rates can be volatile. Given the short-term maturity structure of the Company's investment portfolio, the Company believes that it is not subject to principal fluctuations and the effective interest rate of the Company's portfolio tracks closely to various short-term money market interest rate benchmarks.

Item 4. *Disclosure Controls and Procedures*

The Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) conducted an evaluation 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, as amended ("Exchange Act")). Based on that evaluation, which was conducted within 90 days of the date on which this quarterly report was filed with the Securities and Exchange Commission, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by the Company under the Exchange Act is accumulated, recorded, processed, summarized and reported to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding whether or not disclosure is required.

During the quarter ended December 31, 2003, there were no changes in our "internal controls over financial reporting" (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting. As stated in the Company's most recent Form 10-K, the Company received a letter from its independent auditors expressing the auditor's opinion as to certain material weaknesses in the Company's accounting controls and procedures. The Audit Committee has carefully reviewed such issues and discussed them with the Company's independent auditors and management. In addition, the Audit Committee retained a "Big 4" independent auditing firm (the "Review Accountants") to review the issues raised by the Company's independent auditors and to advise the Audit Committee with respect to corrective action, if any, that would be warranted. Following its review, the Review Accountants submitted their report to the Audit Committee. In response to the report, the Audit Committee and management are in the process of expanding the Company's accounting department resources.

PART II – OTHER INFORMATION

Item 1. *Litigation.*

None

Item 2. *Changes in Securities and Use of Proceeds.*

None.

Item 3. *Defaults Upon Senior Securities.*

None.

Item 4. *Submissions of Matters to a Vote of Securities Holders.*

None

Item 5. *Other Information.*

None.

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

Exhibits:

31.1 Certifications Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Reports on Form 8-K:

On October 30, 2003, the Company filed a Report on Form 8-K with the SEC concerning the Company's financial performance for the period ended September 30, 2003. A copy of the Company's press release announcing the results and certain other information was attached to the Report on Form 8-K.

On November 6, 2003, the Company filed a Report on Form 8-K with the SEC concerning a transcript of the conference call with management covering the financial performance for the period ended September 30, 2003. A copy of a transcript of the conference call was attached to the Report on Form 8-K.

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

QUALITY SYSTEMS, INC.

Date: February 13, 2004

By: /s/ LOUIS SILVERMAN _____

Louis Silverman
Chief Executive Officer

Date: February 13, 2004

By: /s/ PAUL HOLT _____

Paul Holt
Chief Financial Officer; Principal Accounting Officer

CERTIFICATIONS

I, Louis Silverman, certify that:

1. I have reviewed this Form 10-Q of Quality Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) [language omitted pursuant to SEC Release 34-47986] for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) [Omitted pursuant to SEC Release 34-47986];
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 13, 2004

/s/ LOUIS SILVERMAN

Louis Silverman

Chief Executive Officer (principal executive officer)

I, Paul Holt, certify that:

1. I have reviewed this Form 10-Q of Quality Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) [language omitted pursuant to SEC Release 34-47986] for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) [Omitted pursuant to SEC Release 34-47986];
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 13, 2004

/s/ PAUL HOLT

Paul Holt

Chief Financial Officer (principal financial officer)

EXHIBIT 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of Quality Systems, Inc. (the "Company") for the quarterly period ended December 31, 2003 (the "Report"), the undersigned hereby certify in their capacities as Chief Executive Officer and Chief Financial Officer of the Company, respectively, pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 13, 2004

By: /s/ LOUIS SILVERMAN

Louis Silverman
Chief Executive Officer (principal executive officer)

Dated: February 13, 2004

By: /s/ PAUL HOLT

Paul Holt
Chief Financial Officer (principal financial officer)

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signatures that appear in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.