

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**FORM 10-K**

(Mark One)

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

**For the fiscal year ended March 31, 2005**

or

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

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

**Commission file number: 0-13801**

**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 92603**

(Address of principal executive offices, including zip code)

**(949) 255-2600**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

**None**

(Title of each class)

**None**

(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, par value \$.01 per Share**

(Title of class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of September 30, 2004: \$210,543,000 (based on the closing sales price of the Registrant's Common Stock as reported in the NASDAQ National Market System on that date, \$50.51 per share).\*

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of June 3, 2005: \$415,011,000 (based on the closing sales price of the Registrant's Common Stock as reported in the NASDAQ National Market System on that date, \$51.30 per share).\*

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock, as of the latest practicable date.

**Common Stock, \$.01 par value**

(Class)

**13,115,360**

(Outstanding at June 8, 2005)

## **DOCUMENTS INCORPORATED BY REFERENCE**

The information required by Part III, Items 10, 11, 12, 13 and 14, of the Form 10-K is incorporated by reference from Registrant's Definitive Proxy Statement for its 2005 annual meeting which is to be filed with the Commission within 120 days of its fiscal year ended on March 31, 2005.

\* For purposes of this report, in addition to those shareholders which fall within the definition of "affiliates" under Rule 405 of the Securities Act of 1933, as amended, holders of ten percent or more of the Registrant's Common Stock are deemed to be affiliates for purposes of this Report.

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## CAUTIONARY STATEMENT

Statements made in this report, the Annual Report to Shareholders in which this report is made a part, other reports and proxy statements filed with the Securities and Exchange Commission, communications to shareholders, press releases and oral statements made by our representatives that are not historical in nature, or that state our or management's intentions, hopes, beliefs, expectations or predictions of the future, may constitute "forward-looking statements" within the meaning of Section 21E of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements can often be identified by the use of forward-looking terminology, such as "could," "should," "will," "will be," "will lead," "will assist," "intended," "continue," "believe," "may," "expect," "hope," "anticipate," "goal," "forecast," "plan," or "estimate" or variations thereof or similar expressions. Forward-looking statements are not guarantees of future performance or results. They involve risks, uncertainties and assumptions. It is important to note that any such performance and actual results, financial condition or business, could differ materially from those expressed in such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below as well as those discussed elsewhere in reports filed with the Securities and Exchange Commission. Other unforeseen factors not identified herein could also have such an effect. We undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results, financial condition or business over time.

## PART I

### ITEM 1. BUSINESS

#### General

Except for the historical information contained herein, the matters discussed in this Annual Report on Form 10-K, including discussions of the Registrant's product development plans, business strategies and market factors influencing the Registrant's results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by the Registrant as a result of various factors, both foreseen and unforeseen, including, but not limited to, the Registrant's ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution, consolidation within the Registrant's target marketplace and among the Registrant's competitors, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact the Registrant's ability to achieve our goals. Interested persons are urged to review the risks described under "Item 1. Business. Risk Factors" and in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" as well as in the Registrant'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, we, our, or us) develops and markets healthcare information systems that automate certain aspects of 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, we capitalized on the increasing focus on medical cost containment and further expanded our information processing systems to serve the medical market. In the mid 1990's we made two acquisitions that accelerated our penetration of the medical market. These two acquisitions formed the basis for the NextGen Division. Today, we serve the medical and dental markets through our 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 our "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 our two Divisions.

The QSI Division, co-located with our Corporate Headquarters in Irvine, California, currently focuses on developing, marketing and supporting software suites sold to dental and certain niche medical practices. In addition, the Division supports a number of medical clients that utilize the Division's UNIX<sup>1</sup> based medical practice management software product.

The NextGen Division, with headquarters in Horsham, Pennsylvania, and a second significant location in Atlanta, Georgia, focuses principally on developing and marketing products and services for 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 already been implemented by the vast majority of practices. Therefore, we actively compete 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, we are 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 us or one of our competitors. Other EDI/connectivity services are used

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<sup>1</sup> UNIX is a registered trademark of the AT&T Corporation.

more sporadically by client practices. We typically compete to displace incumbent vendors for claims and statements accounts, and attempt to increase usage of other elements in our EDI/connectivity product line. In general, EDI services are only sold to those accounts utilizing software from one of our Divisions.

The QSI Division's practice management software suite utilizes a UNIX operating system. Its Clinical Product Suite (CPS) utilizes a Windows NT<sup>2</sup> 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 X-ray and inter-oral camera images as part of the electronic patient record. The Division develops, markets, and manages our EDI/connectivity applications. The QSI Inet Application Service Provider (ASP/Internet) offering is also developed and marketed by the Division.

Our NextGen Division develops and sells proprietary electronic medical records software and practice management systems under the NextGen<sup>®3</sup> product name. Major product categories of the NextGen suite include Electronic Medical Records (NextGen<sup>emr</sup>), Enterprise Practice Management (NextGen<sup>epm</sup>), Enterprise Appointment Scheduling (NextGen <sup>eas</sup>), Enterprise Master Patient Index (NextGen<sup>epi</sup>), NextGen Image Control System (NextGen<sup>ics</sup>), Managed Care Server (NextGen<sup>mcs</sup>), Electronic Data Interchange, System Interfaces, Internet Operability (NextGen<sup>web</sup>), a Patient-centric and Provider-centric Web Portal solution (NextMD<sup>4</sup>.com), and a handheld product (NextGen<sup>pda</sup>). During the year ended March 31, 2005, the NextGen Division introduced NextGen Express, a version of NextGen<sup>emr</sup> designed for small practices. 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.

We continue 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.

Inclusive of divisional EDI revenue, the NextGen Division accounted for approximately 82.7% of our revenue for fiscal 2005 compared to 76.8% in fiscal 2004. Inclusive of divisional EDI revenue, the QSI Division accounted for 17.3% and 23.2% of revenue in fiscal 2005 and 2004, respectively. The NextGen Division's year over year revenue grew at 35.2% and 45.8% in fiscal 2005 and 2004, respectively, while the QSI Division's year over year revenue declined by 6.8% and 5.3% in fiscal 2005 and 2004, respectively.

In addition to the aforementioned software solutions which we offer through our two divisions, each division offers comprehensive hardware and software installation services, maintenance and support services, and system training services.

## **Industry Background**

To compete in the continually changing healthcare environment, providers are increasingly using technology to help maximize the efficiency of their business practices, to assist in enhancing patient care, and to maintain the privacy of patient information.

As the reimbursement environment continues to evolve, more healthcare providers enter into contracts, often with multiple entities, which define the terms under which care is administered and paid for. The diversity of payor organizations, as well as additional government regulation and changes in

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<sup>2</sup> Microsoft Windows, Windows NT, Windows 95, Windows 98, Windows XP, and Windows 2000 are registered trademarks of the Microsoft Corporation.

<sup>3</sup> NextGen is a registered trademark of NextGen Healthcare Information Systems, Inc.

<sup>4</sup> NextMD is a registered trademark of NextGen Healthcare Information Systems, Inc.

reimbursement models, have greatly increased the complexity of pricing, billing, reimbursement, and records management for medical and dental practices. To operate effectively, healthcare provider organizations must efficiently manage patient care and other information and workflow processes which increasingly extend across multiple locations and business entities.

In response, healthcare provider organizations have placed increasing demands on their information systems. Initially, these information systems automated financial and administrative functions. As it became necessary to manage patient flow processes, the need arose to integrate “back-office” data with such clinical information as patient test results and office visits. The Company believes information systems must facilitate management of patient information incorporating administrative, financial and clinical information from multiple entities. In addition, large healthcare organizations increasingly require information systems that can deliver high performance in environments with multiple concurrent computer users.

Many existing healthcare information systems were designed for limited administrative tasks such as billing and scheduling and can neither accommodate multiple computing environments nor operate effectively across multiple locations and entities. We believe that practices that leverage technology to more efficiently handle patient clinical data as well as administrative, financial and other practice management data, will be best able to enhance patient flow, pursue cost efficiencies, and improve quality of care. As healthcare organizations transition to new computer platforms and newer technologies, we believe such organizations will be migrating toward the implementation of enterprise-wide, patient-centric computing systems embedded with automated clinical patient records.

## **Company Strategy**

The Company’s strategy is, at present, to focus on its core software business. Among the key elements central to this strategy are:

- Continued development and enhancement of select software solutions in target markets;
- Continued investments in our infrastructure including but not limited to product development, sales, marketing, implementation, and support;
- Continued efforts to make infrastructure investments within an overall context of maintaining reasonable expense discipline; and
- Addition of new customers through maintaining and expanding sales, marketing and product development activities.

While these are the key elements of our current strategy, there can be no guarantees that our strategy will not change, or that we will succeed in achieving these goals individually or collectively.

## **Products**

In response to the growing need for more comprehensive, cost-effective healthcare information solutions for physician and dental practices, our systems provide our clients with the ability to redesign patient care and other workflow processes while improving productivity through facilitation of managed access to patient information. Utilizing our proprietary software in combination with third party hardware and software solutions, our products enable the integration of a variety of administrative and clinical information operations. Leveraging more than 30 years of experience in the healthcare information services industry, we believe that we continue to add value by providing our clients with sophisticated, full-featured software systems along with comprehensive systems implementation, maintenance and support services. Any single transaction may or may not include software, hardware or services.

***Practice Management Systems.*** Our products consist primarily of proprietary healthcare software applications together with third party hardware and other non-industry specific software. The systems range in capacity from one to thousands of users, allowing us to address the needs of both small and large

organizations. The systems are modular in design and may be expanded to accommodate changing client requirements.

The QSI Division's character-based practice management system is available in both dental and medical versions and primarily uses the IBM RS6000<sup>5</sup> central processing unit and IBM'S AIX<sup>6</sup> version of the UNIX operating system as a platform for our application software enabling a wide range of flexible and functional systems. The hardware components, as well as the requisite operating system licenses, are purchased from manufacturers or distributors of those components. We configure and test the hardware components and incorporate our software and other third party packages into completed systems tailored to accommodate particular client requirements. We continually evaluate third party hardware components with a view toward utilizing hardware that is functional, reliable and cost-effective.

NextGen<sup>epm</sup> is the NextGen division's practice management offering. NextGen<sup>epm</sup> has been developed using a graphical user interface (GUI) client-server platform for compatibility with Windows 2000, Windows NT and Windows XP operating systems and relational databases that are ANSI SQL-compliant. NextGen<sup>epm</sup> is scalable and includes a master patient index, enterprise-wide appointment scheduling with referral tracking, clinical support, and centralized or decentralized patient financial management based on either a managed care or fee-for-service model. The system's three-tiered architecture allows work to be performed on the database server, the application server and the client workstation.

We also offer practice management solutions for both dental and medical practices through the Internet. These products are marketed under the QSINet and NextGen<sup>web</sup> trade names, respectively.

**Clinical Systems.** Our dental charting software system, the Clinical Product Suite (CPS), is a comprehensive solution designed specifically for the dental group practice environment. CPS integrates the dental practice management product with a computer-based clinical information system that incorporates a wide range of clinical tools, including:

- Electronic charting of dental procedures, treatment plans and existing conditions;
- Periodontal charting via light-pen, voice-activation, or keyboard entry for full periodontal examinations and PSR scoring;
- Digital imaging of X-ray and intra-oral camera images;
- Computer-based patient education modules, viewable chair-side to enhance case presentation;
- Full access to patient information, treatment plans, and insurance plans via a fully integrated interface with our dental practice management product; and
- Document and image scanning for digital storage and linkage to the electronic patient record.

The result is a comprehensive clinical information management system that helps practices save time, reduce costs, improve case presentation, and enhance the delivery of dental services and quality of care. Clinical information is managed and maintained electronically thus forming an electronic patient record that allows for the implementation of the "chartless" office.

CPS incorporates Windows-based client-server technology consisting of one or more file servers together with any combination of one or more desktop, laptop, or pen-based PC workstations. The file server(s) used in connection with CPS utilize(s) a Windows NT or Windows 2000 or Windows XP operating system and the hardware is typically a Pentium<sup>7</sup>-based single or multi-processor platform. Based on the

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<sup>5</sup> RS6000 is a registered trademark of International Business Machines Corporation.

<sup>6</sup> AIX is a registered trademark of International Business Machines Corporation.

<sup>7</sup> Pentium is a registered trademark of Intel Corporation.

server configuration chosen, CPS is scalable from one to hundreds of workstations. A typical configuration may also include redundant disk storage, magnetic tape units, intra- and extra-oral cameras, digital X-ray components, digital scanners, conventional and flat screen displays, and printers. The hardware components, including the requisite operating system licenses, are purchased from third party manufacturers or distributors either directly by the customer or by us for resale to the customer.

NextGen provides clinical software applications that are complementary to, and are integrated with, our medical practice management offerings and interface with many of the other leading practice management software systems on the market. The applications incorporated into our practice management solutions and others such as scheduling, eligibility, billing and claims processing are augmented by clinical information captured by NextGen<sup>emr</sup>, including services rendered and diagnoses used for billing purposes. We believe that we currently provide a comprehensive information management solution for the medical marketplace.

NextGen<sup>emr</sup> was developed with client-server architecture and a GUI and utilizes Microsoft Windows 2000, Windows NT or Windows XP on each workstation and either Windows 2000, Windows NT, Windows XP or UNIX on the database server. NextGen<sup>emr</sup> maintains data using industry standard relational database engines such as Microsoft SQL Server<sup>8</sup> or Oracle<sup>9</sup>. The system is scalable from one to hundreds of workstations.

NextGen<sup>emr</sup> stores and maintains clinical data including:

- Data captured using user-customized input “templates”;
- Scanned or electronically acquired images, including X-rays and photographs;
- Data electronically acquired through interfaces with clinical instruments or external systems;
- Other records, documents or notes, including electronically captured handwriting and annotations; and
- Digital voice recordings.

NextGen<sup>emr</sup> also offers a workflow module, prescription management, automatic document and letter generation, patient education, referral tracking, interfaces to billing and lab systems, physician alerts and reminders, and powerful reporting and data analysis tools.

NextGen<sup>pda</sup>, the Pocket-PC-based suite of solutions, allows mobile health professionals to utilize many of NextGen’s functions using a palm-sized device.

**Connectivity Services.** The Company makes available electronic data interchange (“EDI”) capabilities and connectivity services to our customers. The EDI/connectivity capabilities encompass direct interfaces between our products and external third party systems, as well as transaction-based services. Services include:

- Electronic claims submission through our relationships with a number of payors and national claims clearinghouses;
- Electronic patient statement processing, appointment reminder cards and calls, recall cards, patient letters, and other correspondence;
- Electronic insurance eligibility verification; and
- Electronic posting of remittances from insurance carriers into the accounts receivable application.

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<sup>8</sup> Microsoft and SQL Server is a registered trademark of Microsoft Corporation.

<sup>9</sup> Oracle is a registered trademark of Oracle Corporation.

***Internet Applications.*** Our NextGen Division maintains an Internet-based consumer health portal, NextMD.com. NextMD.com is a vertical portal for the healthcare industry, linking patients with their physicians, insurers, laboratories, and online pharmacies, while providing a centralized source of health-oriented information for both consumers and medical professionals. Patients whose physicians are linked to the portal are able to request appointments, send appointment changes or cancellations, receive test results on-line, request prescription refills, view and/or pay their statements, and communicate with their physicians, all in a secure, on-line environment. Our NextGen suite of information systems are or can be linked to NextMD.com, integrating a number of these features with physicians' existing systems.

Our QSI Division also provides a web-based application called QSINet which allows clients to access information from their practice management system via the Internet. This application also enables providers to offer their patients convenient services such as on-line appointment scheduling and electronic bill payment through the client's website, and posts this data directly to the client's existing practice management system.

## **Sales and Marketing**

We sell and market our products nationwide primarily through a direct sales force. The efforts of the direct sales force are augmented by a small number of reseller relationships established by us. Software license sales to resellers represented less than 10% of total revenue for the years ended March 31, 2005 and 2004.

Our direct sales force typically makes presentations to potential clients by demonstrating the system and our capabilities on the prospective client's premises. Sales efforts aimed at smaller practices are primarily performed remotely via telephone or internet based presentations. Our sales and marketing employees identify prospective clients through a variety of means, including referrals from existing clients, industry consultants, contacts at professional society meetings, trade shows and seminars, trade journal advertising, direct mail advertising, and telemarketing.

Our sales cycle can vary significantly and typically ranges from three to twelve months from initial contact to contract execution. Software licenses are normally delivered to a customer almost immediately upon receipt of an order. Implementation and training services are normally rendered based on a mutually agreed upon timetable. As part of the fees paid by our clients, we receive up-front licensing fees. Clients have the option to purchase maintenance services which, if purchased, are invoiced on a monthly or quarterly basis.

Several clients have purchased our practice management software and, in turn, are providing either time-share or billing services to single and group practice practitioners. Under the time-share or billing service agreements, the client provides the use of our software for a fee to one or more practitioners. Although we typically do not receive a fee directly from the distributor's customers, implementation of such arrangements has, from time to time, resulted in the purchase of additional software capacity by the distributor, as well as new software purchases made by the distributor's customers should such customers decide to perform the practice management functions in-house.

We continue to concentrate our direct sales and marketing efforts on medical and dental practices, networks of such practices including MSO's and PHO's, professional schools, community health centers and other ambulatory care settings.

MSO's, PHO's and similar networks to which we have sold systems provide use of our software to those group and single physician practices associated with the organization or hospital on either a service basis or by directing us to contract with those practices for the sale of stand-alone systems.

We have also entered into marketing assistance agreements with certain of our clients pursuant to which the clients allow us to demonstrate to potential clients the use of systems on the existing clients' premises.

From time to time we assist prospective clients in identifying third party sources for financing the purchase of our systems. The financing is typically obtained by the client directly from institutional lenders and typically takes the form of a loan from the institution secured by the system to be purchased or a leasing arrangement. We do not guarantee the financing nor retain any continuing interest in the transaction.

We have numerous clients and do not believe that the loss of any single client would have a material adverse effect on us. No client accounted for ten percent or more of net revenue during the fiscal years ended March 31, 2005, 2004, or 2003.

### **Customer Service and Support**

We believe our success is attributable in part to our customer service and support departments. We offer support to our clients seven days a week, 24 hours a day.

Our client support staff is comprised of specialists who are knowledgeable in the areas of software and hardware as well as in the day-to-day operations of a practice. System support activities range from correcting minor procedural problems in the client's system to performing complex database reconstructions or software updates.

We utilize automated online support systems which assist clients in resolving minor problems and facilitate automated electronic retrieval of problems and symptoms following a client's call to the automated support system. Additionally, our online support systems maintain call records, available at both the client's facility and our offices.

We offer our clients support services for most system components, including hardware and software, for a fixed monthly or quarterly fee. Customers also receive access to future unspecified versions of the software, on a when-and-if available basis, as part of support services. We also subcontract, in certain instances, with third party vendors to perform specific hardware maintenance tasks.

### **Implementation and Training**

We offer full service implementation and training services. When a client signs a contract for the purchase of a system that includes implementation and training services, a client manager/implementation specialist trained in medical and/or dental group practice procedures is assigned to assist the client in the installation of the system and the training of appropriate practice staff. Implementation services include loading the software, training customer personnel, data conversion, running test data, and assisting in the development and documentation of procedures. Implementation and training services are provided by our employees as well as certified third parties and certain resellers.

Training may include a combination of computer assisted instruction (CAI) for certain of our products, remote training techniques and training classes conducted at the client's or our office(s). CAI consists of workbooks, computer interaction and self-paced instruction. CAI is also offered to clients, for an additional charge, after the initial training program is completed for the purpose of training new and additional employees. Remote training allows a trainer at our offices to train one or more people at a client site via telephone and computer connection, thus allowing an interactive and client-specific mode of training without the expense and time required for travel. In addition, our on-line "help" and other documentation features facilitate client training as well as ongoing support.

## **Competition**

The markets for healthcare information systems are intensely competitive. The industry is highly fragmented and includes numerous competitors, none of which we believe dominates these markets. The electronic patient records and connectivity markets, in particular, are subject to rapid changes in technology, and we expect that competition in these market segments will increase as new competitors enter the market. We believe our principal competitive advantages are the features and capabilities of our products and services, our high level of customer support, and our extensive experience in the industry.

## **Production Enhancement and Development**

The healthcare information management and computer software and hardware industries are characterized by rapid technological change requiring us to engage in continuing investments to update, enhance, and improve our systems. During fiscal years 2005, 2004, and 2003, we expended approximately \$9.6 million, \$8.7 million, and \$6.7 million, respectively, on research and development activities, including capitalized software amounts of \$2.7 million, \$2.6 million, and \$1.7 million, respectively. In addition, a portion of our product enhancements have resulted from software development work performed under contracts with our clients.

## **Employees**

As of May 27, 2005, we employed 418 persons, of which 409 were full-time employees. We believe that our future success depends in part upon recruiting and retaining qualified sales, marketing and technical personnel as well as other employees.

## **Risks Relating to our Business**

The more prominent risks and uncertainties inherent in our business are described below. However, additional risks and uncertainties may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations will likely suffer. Any of these or other factors could harm our business and future results of operations and may cause you to lose all or part of your investment.

***We face significant competition.*** The markets for healthcare information systems are intensely competitive and we face significant competition from a number of different sources. Several of our competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than we do.

We compete in all of our 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 ourselves or our competitors, may result in price or market share erosion that could have a material adverse effect on our business, results of operations and financial condition. Also, there can be no assurance that our applications will achieve broad market acceptance or will successfully compete with other available software products.

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

***Our quarterly operating results have historically fluctuated and may do so in the future.*** Our revenue has 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 specific mix of software, hardware, and services in client orders;
- the length of sales cycles and installation processes;
- the ability of our clients to obtain financing for the purchase of our products;
- changes in pricing policies or price reductions by us or our competitors;
- the timing of new product announcements and product introductions by us or our competitors;
- changes in revenue recognition or other accounting guidelines employed by us 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 clients;
- market acceptance of new products, applications and product enhancements;
- our ability to develop, introduce and market new products, applications and product enhancements;
- our success in expanding our sales and marketing programs;
- deferrals of client orders in anticipation of new products, applications, product enhancements, or public/private sector initiatives;
- execution of or changes to our strategy;
- personnel changes; and
- general market/economic factors.

Our software products are generally shipped as orders are received and accordingly, we have historically operated with a minimal backlog of license fees. As a result, revenue in any quarter is dependent on orders booked and shipped in that quarter and is not predictable with any degree of certainty. Furthermore, our systems can be relatively large and expensive and individual systems sales can represent a significant portion of our revenue and profits for a quarter such that the loss or deferral of even one such sale can have a significant adverse impact on our quarterly revenue and profitability.

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

Our sales are dependent upon clients' initial decisions to replace or substantially modify their existing information systems, 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 our systems can vary significantly and typically ranges from three to twelve months from initial contact to contract execution/shipment.

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

We currently recognize revenue pursuant to SOP 97-2, as modified by SOP 98-9 and SAB 104. SAB 104 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 our 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 our operating results may be below the expectations of public market analysts and investors. In such event, the price of our common stock would likely be materially adversely affected.

**The price of our shares and the trading volume of our shares have been volatile historically and may continue to be volatile.** Volatility may be caused by a number of factors including but not limited to:

- actual or anticipated quarterly variations in operating results;
- rumors about our performance, software solutions, or merger and acquisition activity;
- changes in expectations of future financial performance or changes in estimates of securities analysts;
- governmental regulatory action;
- health care reform measures;
- client relationship developments;
- purchases or sales of company stock;
- changes occurring in the markets in general; and
- other factors, many of which are beyond our control.

Furthermore, the stock market in general, and the market for software, healthcare and high technology companies in particular, has 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 our common stock, regardless of actual operating performance.

**Two of our directors are significant shareholders, which makes it possible for them to have significant influence over the outcome of all matters submitted to our shareholders for approval and which influence may be alleged to conflict with our interests and the interests of our other shareholders.** Two of our directors and principal shareholders beneficially owned an aggregate of approximately 38% of the outstanding shares of our common stock at March 31, 2005. The Company's Bylaws permit its shareholders to cumulate their votes, the effect of which is to provide shareholders with sufficiently large concentrations of Company shares the opportunity to assure themselves one or more seats on the Company's Board. The amounts required to assure a Board position can vary based upon the number of shares outstanding, the number of shares voting, the number of directors to be elected and the number of shares held by the shareholder exercising cumulative voting rights. In the event that cumulative voting is invoked, it is likely that the two of our directors holding an aggregate of approximately 38% of the outstanding shares of our common stock at March 31, 2005 will each have sufficient votes to assure themselves of one or more seats on our Board. With or without cumulative voting, these shareholders will have significant influence over the outcome of all matters submitted to our shareholders for approval, including the election of our directors and other corporate actions. In addition, such influence by one or both of these affiliates could have the effect of discouraging others from attempting to purchase us, take us over, and/or reducing the market price offered for our common stock in such an event.

**We are dependent on our principal products and our new product development.** We currently derive substantially all of our net revenue from sales of our healthcare information systems and related services. We believe that a primary factor in the market acceptance of our systems has been our ability to meet the needs of users of healthcare information systems. Our future financial performance will depend in large part on our ability to continue to meet the increasingly sophisticated needs of our clients through the timely development and successful introduction and implementation of new and enhanced versions of our systems and other complementary products. We have historically expended a significant percentage of our net revenue on product development and believe that significant continuing product development efforts will be required to sustain our growth. Continued investment in our sales staff and our client implementation and support staffs will also be required to support future growth.

There can be no assurance that we will be successful in our product development efforts, that the market will continue to accept our 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, our business, results of operations and financial condition could be materially adversely affected. At certain times in the past, we have also experienced delays in purchases of our products by clients anticipating our launch of new products. There can be no assurance that material order deferrals in anticipation of new product introductions from ourselves or other entities will not occur.

***If the emerging technologies and platforms of Microsoft and others upon which we build our products do not gain broad market acceptance, or if we fail to develop and introduce in a timely manner new products and services compatible with such emerging technologies, we may not be able to compete effectively and our ability to generate revenue will suffer.*** Our software products are built and depend upon several underlying and evolving relational database management system platforms such as those developed by Microsoft. To date, the standards and technologies upon which we have chosen to develop our products have proven to have gained industry acceptance. However, the market for our software products is subject to ongoing rapid technological developments, quickly evolving industry standards and rapid changes in customer requirements, and there may be existing or future technologies and platforms that achieve industry standard status, which are not compatible with our products.

***We face the possibility of subscription pricing.*** We currently derive substantially all of our revenue 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 our products, in addition to a periodic maintenance fee. If the marketplace demands subscription pricing, we may be forced to adjust our sales, marketing and pricing strategies accordingly, by offering a higher percentage of our products and services through these means. Shifting to a significantly greater degree of subscription pricing could materially adversely impact our financial condition, cash flows and quarterly and annual revenue and results of operations, as our revenue would initially decrease substantially. There can be no assurance that the marketplace will not increasingly embrace subscription pricing.

***The industry in which we operate is subject to significant 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 our existing products obsolete and unmarketable. There can be no assurance that we 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 revenue or research funding could impair our ability to respond to technological advances or opportunities in the marketplace and to remain competitive. If we are 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, our business, results of operations and financial condition may be materially adversely affected.

In response to increasing market demand, we are currently developing new generations of certain of our software products. There can be no assurance that we 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 our competitive position or could make our current products obsolete.

***We face the possibility of claims based upon our web site.*** We could be subject to third party claims based on the nature and content of information supplied on our Web site by us or third parties, including content providers or users. We could also be

subject to liability for content that may be accessible through our Web site or third party Web sites linked from our 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 our applications. Even if these claims do not result in liability to us, investigating and defending against these claims could be expensive and time consuming and could divert management's attention away from our operations.

**We face the possibility of claims from activities of strategic partners.** We rely on third parties to provide services that impact our business. For example, we use national clearinghouses in the processing of some insurance claims and we outsource some of our hardware maintenance services and the printing and delivery of patient statements for our customers. We also have relationships with certain third parties where these third parties serve as sales channels through which we generate a portion of our revenue. Due to these third-party relationships, we could be subject to claims as a result of the activities, products, or services of these third-party service providers even though we were not directly involved in the circumstances leading to those claims. Even if these claims do not result in liability to us, defending and investigating these claims could be expensive and time-consuming, divert personnel and other resources from our business and result in adverse publicity that could harm our business.

**We may engage in future acquisitions, which may be expensive and time consuming and from which we may not realize anticipated benefits.** We may acquire additional businesses, technologies and products if we determine that these additional businesses, technologies and products are likely to serve our strategic goals. We currently have no commitments or agreements with respect to any acquisitions. The specific risks we may encounter in these types of transactions include but are not limited to the following:

- potentially dilutive issuances of our securities, the incurrence of debt and contingent liabilities and amortization expenses related to intangible assets, which could adversely affect our results of operations and financial conditions;
- use of cash as acquisition currency may adversely impact interest or investment income, thereby potentially negatively affecting our earnings and /or earnings per share
- difficulty in effectively integrating any acquired technologies or software products into our current products and technologies;
- difficulty in predicting and responding to issues related to product transition such as development, distribution and customer support;
- the possible adverse impact of such acquisitions on existing relationships with third party partners and suppliers of technologies and services;
- the possibility that staff or customers of the acquired company might not accept new ownership and may transition to different technologies or attempt to renegotiate contract terms or relationships, including maintenance or support agreements;
- the possibility that the due diligence process in any such acquisition may not completely identify material issues associated with product quality, product architecture, product development, intellectual property issues, key personnel issues or legal and financial contingencies; and
- difficulty in integrating acquired operations due to geographical distance, and language and cultural differences;
- The possibility that acquired assets become impaired, requiring the Company to take a charge to earnings which could be significant.

A failure to successfully integrate acquired businesses or technology for any of these reasons could have a material adverse effect on the Company's results of operations.

**We face the risks and uncertainties that are associated with litigation against us.** We face the risks associated with litigation concerning the operation of our business. The uncertainty associated with substantial unresolved litigation may have an adverse impact on our business. In particular, such litigation could impair our relationships with existing customers and our 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 our business, results of operations and financial condition. Such litigation may also have the effect of discouraging potential acquirers from bidding for us 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 our insurance coverage, that our insurance will cover such claims or that appropriate insurance will continue to be available to us in the future at commercially reasonable rates.

***We rely heavily on our proprietary technology.*** We are heavily dependent on the maintenance and protection of our intellectual property and we rely largely on license agreements, confidentiality procedures, and employee nondisclosure agreements to protect our intellectual property. Our software is not patented and existing copyright laws offer only limited practical protection.

There can be no assurance that the legal protections and precautions we take will be adequate to prevent misappropriation of our technology or that competitors will not independently develop technologies equivalent or superior to ours. Further, the laws of some foreign countries do not protect our 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.

We do not believe that our 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 us with respect to our current or future products or that any such assertion will not require us 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 our business, results of operations and financial condition. In addition, claims may be brought against third parties from which we purchase software, and such claims could adversely affect our ability to access third party software for our systems.

***We are dependent on our license rights from third parties.*** We depend upon licenses for some of the technology used in our products from third-party vendors. Most of these licenses can be renewed only by mutual consent and may be terminated if we breach the terms of the license and fail to cure the breach within a specified period of time. We may not be able to continue using the technology made available to us under these licenses on commercially reasonable terms or at all. As a result, we may have to discontinue, delay or reduce product shipments until we can obtain equivalent technology. Most of our third-party licenses are non-exclusive. Our competitors may obtain the right to use any of the technology covered by these licenses and use the technology to compete directly with us. In addition, if our vendors choose to discontinue support of the licensed technology in the future or are unsuccessful in their continued research and development efforts, we may not be able to modify or adapt our own products.

***We face the possibility of damages resulting from internal and external security breaches, and viruses.*** In the course of our business operations, we compile and transmit confidential information, including patient health information, in our processing centers and other facilities. A breach of security in any of these facilities could damage our reputation and result in damages being assessed against us. In addition, the other systems with which we 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 disrupt our ability to perform certain key business functions and could potentially reduce demand for our services. Accordingly, we have expended significant resources toward establishing and enhancing the security of our related infrastructures, although no assurance can be given that they will be entirely free from potential breach. Maintaining and enhancing our infrastructure security may require us to expend significant capital in the future.

The success of our strategy to offer our EDI services and Internet solutions depends on the confidence of our customers in our ability to securely transmit confidential information. Our EDI services and Internet solutions rely on encryption, authentication and other security technology licensed from third parties to achieve secure transmission of confidential information. We may not be able to stop unauthorized attempts to gain access to or disrupt the transmission of communications by our customers. Anyone who is able to circumvent our security measures could misappropriate confidential user information or interrupt us, or our customers', operations. In addition, our EDI and Internet solutions may be vulnerable to viruses, physical or electronic break-ins, and similar disruptions.

Any failure to provide secure infrastructure and/or electronic communication services could result in a lack of trust by our customers causing them to seek out other vendors, and/or, damage our reputation in the market making it difficult to obtain new customers.

***We are subject to the development and maintenance of the Internet infrastructure which is not within our control.*** We deliver Internet-based services and, accordingly, we are dependent on the maintenance of the Internet by third parties. The Internet infrastructure may be unable to support the demands placed on it and our performance may decrease if the Internet continues to experience it's historic trend of expanding usage. As a result of damage 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 us for transmittal of our Internet-based services. In addition, difficulties, outages, and delays by Internet service providers, online service providers and other web site operators may obstruct or diminish access to our Web site by our customers resulting in a loss of potential or existing users of our services.

***Our failure to manage growth could harm us.*** We have in the past experienced periods of growth which have placed, and may continue to place, a significant strain on our non-cash resources. We also anticipate expanding our overall software development, marketing, sales, client management and training capacity. In the event we are 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 us. In addition, our ability to manage future increases, if any, in the scope of our operations or personnel will depend on significant expansion of our research and development, marketing and sales, management, and administrative and financial capabilities. The failure of our management to effectively manage expansion in our business could have a material adverse effect on our business, results of operations and financial condition.

***Our operations are dependent upon our key personnel. If such personnel were to leave unexpectedly, we may not be able to execute our business plan.*** Our future performance depends in significant part upon the continued service of our key technical and senior management personnel, many of whom have been with us for a significant period of time. These personnel have acquired specialized knowledge and skills with respect to our business. We maintain key man life insurance on only one of our employees. Because we have a relatively small number of employees when compared to other leading companies in our industry, our dependence on maintaining our relationships with key employees is particularly significant. We are also dependent on our ability to attract high quality personnel, particularly in the areas of sales and applications development.

The industry in which we operate is characterized by a high level of employee mobility and aggressive recruiting of skilled personnel. There can be no assurance that our current employees will continue to work for us. Loss of services of key employees could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may need to grant additional equity incentives to key employees and provide other forms of incentive compensation to attract and retain such key personnel. Failure to provide such types of incentive compensation could jeopardize our recruitment and retention capabilities.

***Our products may be subject to product liability legal claims.*** Certain of our products provide applications that relate to patient clinical information. Any failure by our products to provide accurate and timely information could result in claims against us. In addition, a court or government agency may take the position that our delivery of health information directly, including through licensed practitioners, or delivery of information by a third party site that a consumer accesses through our web sites, exposes us to assertions of malpractice, other personal injury liability, or other liability for wrongful delivery/handling of healthcare services or erroneous health information. We maintain insurance to protect against claims associated with the use of our products as well as liability limitation language in our end-user license agreements, but there can be no assurance that our insurance coverage or contractual language would adequately cover any claim asserted against us. A successful claim brought against us in excess of or outside of our insurance coverage could have a material adverse effect on our business, results of operations and financial condition. Even unsuccessful claims could result in our expenditure of funds for litigation and management time and resources.

Certain healthcare professionals who use our Internet-based products will directly enter health information about their patients including information that constitutes a record under applicable law that we may store on our 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;
- our contracts with customers and partners;
- state laws regulating healthcare professionals;
- Medicaid laws;
- 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 elements including, but not limited to, new federal privacy and security standards for the use and protection of Protected Health Information. Any failure by us or by our personnel or partners to comply with applicable requirements may result in a material liability to us.

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

There can be no assurance that we will not be subject to product liability claims, that such claims will not result in liability in excess of our insurance coverage, that our insurance will cover such claims or that appropriate insurance will continue to be available to us in the future at commercially reasonable rates. Such product liability claims could have a material adverse affect on our business, results of operations and financial condition.

***We are subject to the effect of payor and provider conduct which we cannot control.*** We offer certain electronic claims submission products and services as part of our product line. While we have implemented certain product features designed to maximize the accuracy and completeness of claims submissions, these features may not be sufficient to prevent inaccurate claims data from being submitted to payors. Should inaccurate claims data be submitted to payors, we may be subject to liability claims.

Electronic data transmission services are offered by certain payors to healthcare providers that establish a direct link between the provider and payor. This process

reduces revenue to third party EDI service providers such as us. Accordingly, we are unable to insure that we will continue to generate revenue at or in excess of prior levels for such services. A significant increase in the utilization of direct links between healthcare providers and payers could have a material adverse effect on our transaction volume and financial results. In addition, we cannot provide assurance that we will be able to maintain our existing links to payors or develop new connections on terms that are economically satisfactory to us, if at all.

***There is significant uncertainty in the healthcare industry in which we operate and we are subject to the possibility of changing 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 us and our clients. Healthcare providers may react to these proposals, and the uncertainty surrounding such proposals, by curtailing or deferring investments, including those for our 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 our ability to sell our 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. We cannot predict what impact, if any, such proposals or healthcare reforms might have on our business, financial condition and results of operations.

The HIPAA regulations, as adopted by the Department of Health and Human Services, established, among other things:

- a national standard for electronic transactions and code sets to be used in those transactions involving certain common health care transactions;
- privacy regulations to protect the privacy of plan participants and patients' medical records; and
- 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).

As these regulations mature and become better defined, we anticipate that these regulations will continue to directly affect certain of our products and services, but we cannot fully predict the impact at this time. We have taken steps to modify our products, services and internal practices as necessary to facilitate our and our client's compliance with the final regulations, but there can be no assurance that we 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 us 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 may or may not supercede HIPAA and have the potential to positively or negatively affect our business.

In addition, our 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 our business, financial condition and results of operations.

***We may be subject to other e-commerce regulations.*** We 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 our products and services are subject to these laws and regulations, the sale of our products and services could be harmed.

***We are subject to changes in and interpretations of financial accounting matters that govern the measurement of our performance.*** Based on our 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 our 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 our business practices could result in future changes in our revenue recognition and/or other accounting policies and practices that could have a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

***Our per share price may be adversely effected if weaknesses in our internal controls are identified by ourselves or our independent auditors.*** Any weaknesses identified in our internal controls as part of the evaluation being undertaken by us and our independent public accountants pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 could have an adverse effect on the price at which our stock trades. In the process of evaluating and documenting our controls pursuant to Section 404 of the Sarbanes-Oxley Act, we have identified various deficiencies which we are in the course of remediating. Management does not believe that any of these identified deficiencies constitute a material weakness in our internal controls.

No evaluation process can provide complete assurance that our internal controls will detect and correct all failures within the Company to disclose material information otherwise required to be reported. The effectiveness of our controls and procedures could also be limited by simple errors or faulty judgments. In addition, if we continue to expand, the challenges involved in implementing appropriate controls will increase and may require that we evolve some or all of our internal control processes.

It is also possible that the overall scope of Section 404 of the Sarbanes Oxley Act of 2002 may be revised in the future, thereby causing our auditors and ourselves to review, revise or reevaluate our internal control processes which may result in the expenditure of additional human and financial resources.

***Our earnings will be affected beginning fiscal year 2007 when we begin recognizing employee stock option expense, pursuant to recently issued accounting standards.*** Stock options have from time to time been an important component of the compensation packages for many of our mid- and senior-level employees. We currently do not deduct the expense of employee stock option grants from our income. However, beginning with the quarter ended June 30, 2006 and beyond, we will begin recognizing employee stock option expense for remaining unvested stock options and any future stock option grants, resulting in additional pre-tax compensation expense. Option expensing could have a negative impact upon the price of our stock.

***Continuing worldwide political and economic uncertainties may adversely impact our revenue and profitability.*** In the last three years, worldwide economic conditions have experienced a downturn due to numerous factors including but not limited to concerns about inflation and deflation, decreased consumer confidence, the lingering

effects of international conflicts, and terrorist and military activities. These conditions make it extremely difficult for our customers, our vendors and ourselves to accurately forecast and plan future business activities, and they could cause constrained spending on our products and services, and/or delay and lengthen sales cycles.

***Our future policy concerning the payment of dividends is uncertain.*** While we paid a one-time cash dividend in March 2005, we have not historically paid dividends, cash or otherwise, and there can be no assurance that we will pay another dividend in the future. Unfulfilled expectation to the contrary could have a material negative impact upon the price of our stock.

**ITEM 2. PROPERTIES**

Our principal administrative, accounting and QSI Division operations are located in Irvine, California, under a lease that commenced May 15, 2002, and expired in April 30, 2005. In April 2005, we renewed our lease through May 31, 2008. We lease approximately 12,000 square feet of space at this location. In August 2002, we executed a new lease for the principal office of our NextGen Division. This lease includes approximately 32,000 square feet of space in Horsham, Pennsylvania, and expires on January 31, 2010. In the year ended March 31, 2005, we added approximately 14,000 of additional space in Horsham, Pennsylvania under new lease which expires on January 31, 2010. In addition, we lease approximately 6,000 square feet of space in Santa Ana, California, to house our assembly and warehouse operations. We have approximately 12,000 square feet of space in Atlanta, Georgia under a lease which expires in February, 2006. We also have an aggregate of approximately 4,000 square feet of space in Massachusetts, Minnesota, New Jersey, Texas, Utah, Wisconsin, and Washington to house additional sales, training, development and service operations. These leases, excluding options, have expiration dates ranging from month-to-month to March 2010. The Company’s growth will require it to lease additional space. We believe that suitable additional or substitute space is available, if needed, at commercially reasonable rates.

**ITEM 3. LEGAL PROCEEDINGS**

In the normal course of business, we are involved in various claims and legal proceedings. While the ultimate resolution of these matters, has yet to be determined, we do not believe that their outcome will have a material adverse effect on our financial position, results of operations or liquidity.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matter was submitted to a vote of security holders during the fourth quarter of fiscal year 2005.

**Executive Officers of the Company**

Our executive officers as of May 31, 2005 were as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Louis E. Silverman.....	46	President, Chief Executive Officer
Patrick B. Cline .....	44	President, NextGen Healthcare Information Systems Division
Greg Flynn .....	47	Executive Vice President and General Manger of QSI Division
Paul A. Holt.....	39	Secretary, Chief Financial Officer

Our executive officers are elected by, and serve at the discretion of, the Board of Directors. Additional information regarding our executive officers is set forth below.

Louis E. Silverman was appointed President and Chief Executive Officer of the company on July 31, 2000. Mr. Silverman was previously Chief Operations Officer of CorVel Corp., a publicly traded national managed care services and technology firm with headquarters in Irvine, California. Mr. Silverman holds a Master of Business Administration degree from Harvard Graduate School of Business Administration and a Bachelor of Arts degree from Amherst College.

Patrick B. Cline currently serves as President of our NextGen Healthcare Information Systems Division. He served as our interim Chief Executive Officer for the April - July 2000 period. Mr. Cline was a co-founder of Clinitec and has served as its President since its inception in January 1994 and throughout its transition to NextGen Healthcare Information Systems. Prior to co-founding Clinitec, Mr. Cline served, from July 1987 to January 1994, as Vice President of Sales and Marketing with Script Systems, a subsidiary of InfoMed, a healthcare information systems company. From January 1994 to May 1994, after the founding of Clinitec, Mr. Cline continued to serve, on a part time basis, as Script Systems' Vice President of Sales and Marketing. Mr. Cline has held senior positions in the healthcare information systems industry since 1981.

Greg Flynn has served as the QSI Division's General Manager since April 2000 and as Executive Vice President since August 1998 after serving as Vice President of Sales and Marketing from January 1996 to August 1998. Between June 1992 and January 1996, Mr. Flynn served as Vice President Administration. In these capacities, Mr. Flynn has been responsible for numerous functions related to our ongoing management and sales. Previously, Mr. Flynn served as our Vice President, Corporate Communications. Mr. Flynn joined us in January 1982. He holds a B.A. degree in English from the University of California, Santa Barbara.

Paul A. Holt was appointed Chief Financial Officer in November 2000. Mr. Holt has served as our Controller from January 2000 to May 2000 and was appointed interim Chief Financial Officer in May 2000. Prior to joining us, Mr. Holt was the Controller of Sierra Alloys Co., Inc., a titanium metal manufacturing company from August 1999 to December 1999. From May 1997 to July 1999, he was Controller of Refrigeration Supplies Distributor, a wholesale distributor and manufacturer of refrigeration supplies and heating controls. From March 1995 to April 1997 he was Assistant Controller of Refrigeration Supplies Distributor. Mr. Holt is a Certified Public Accountant and holds an M.B.A. from the University of Southern California and a B.A. in Economics from the University of California, Irvine.

## PART II

### **ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our Common Stock is traded on the NASDAQ National Market under the symbol "QSII". The following table sets forth for the quarters indicated the high and low sales prices as reported by NASDAQ. The quotations reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions.

<u>Quarter Ended</u>	<u>High</u>	<u>Low</u>
June 30, 2003 .....	\$18.23	\$11.25
September 30, 2003.....	23.43	12.58
December 31, 2003 .....	24.88	19.91

March 31, 2004 .....	30.80	19.50
June 30, 2004 .....	25.75	19.75
September 30, 2004.....	27.75	20.77
December 31, 2004 .....	32.49	24.05
March 31, 2005 .....	\$48.90	\$27.90

At May 31, 2005, there were approximately 130 holders of record of our Common Stock. We estimate the number of beneficial holders of our Common Stock to be in excess of 6,000.

On February 2, 2005, the Company announced that its Board of Directors had declared a 2-for-1 stock split with respect to our outstanding shares of common stock for shareholders of record on March 4, 2005. The stock began trading post split on March 28, 2005. All share prices in the foregoing table have been retroactively adjusted to reflect such stock split.

On March 16, 2005, we paid a one time dividend on shares of our Common Stock equal to \$1.50 per share. (\$3.00 pre-split) The record date for the dividend was February 24, 2005. Payment of future dividends, if any, will be at the discretion of our Board of Directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs and plans for expansion.

We did not make any unregistered sales of our common stock during the fourth quarter of 2005.

## ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data with respect to our Consolidated Statements of Income data for each of the five years in the period ended March 31 and the Consolidated Balance Sheet data as of the end of each such fiscal year are derived from our audited financial statements. The following information should be read in conjunction with our Consolidated Financial Statements and the related notes thereto and “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” included elsewhere herein.

### Consolidated Financial Data

(In Thousands, Except Per Share Data)	Year Ended March 31,				
	2005	2004	2003	2002	2001
<b>Statement of Income Data:</b>					
Revenue.....	\$ 88,961	\$ 70,934	\$ 54,769	\$ 44,422	\$ 39,936
Cost of revenue .....	32,669	28,673	23,755	19,253	17,283
Gross profit.....	56,292	42,261	31,014	25,169	22,653
Selling, general and administrative expenses.....	24,776	19,482	15,293	13,068	13,585
Research and development costs.....	6,903	6,139	5,062	4,243	4,081
Income from operations .....	24,613	16,640	10,659	7,858	4,987
Investment income .....	876	386	434	643	1,032
Income before provision for income taxes ....	25,489	17,026	11,093	8,501	6,019
Provision for income taxes.....	9,380	6,626	4,058	3,233	2,510
Net income .....	<u>\$ 16,109</u>	<u>\$ 10,400</u>	<u>\$ 7,035</u>	<u>\$ 5,268</u>	<u>\$ 3,509</u>
Basic net income per share.....	\$ 1.25	\$ 0.84	\$ 0.57	\$ 0.44	\$ 0.29
Diluted net income per share.....	\$ 1.22	\$ 0.80	\$ 0.55	\$ 0.42	\$ 0.28
Basic weighted average shares outstanding ..	12,872	12,436	12,254	12,050	12,260
Diluted weighted average shares outstanding.....	13,203	12,966	12,778	12,480	12,406
<b>Balance Sheet Data (at end of period):</b>					
Cash and cash equivalents and short-term investments.....	\$ 51,157	\$ 51,395	\$ 36,443	\$ 25,698	\$ 18,729
Working capital.....	55,111	53,415	38,717	30,799	24,196
Total assets.....	99,442	86,678	67,602	52,143	44,883
Total liabilities .....	36,711	25,673	20,069	12,093	10,996
Total shareholders' equity.....	\$ 62,731	\$ 61,005	\$ 47,533	\$ 40,050	\$ 33,887

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

Except for the historical information contained herein, the matters discussed in this Annual Report on Form 10-K, including discussions of our product development plans, business strategies and market factors influencing our results, may include forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by us as a result of various factors, both foreseen and unforeseen, including, but not limited to, our ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution, consolidation, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact our ability to achieve our goals, and interested persons are urged to review the risks described in "Item 1. Business. Risk Factors" as set forth above, as well as in our other public disclosures and filings with the Securities and Exchange Commission.

The following discussion should be read in conjunction with, and is qualified in our entirety by, the Consolidated Financial Statements and related notes thereto included elsewhere in this Report. Historical results of operations, percentage margin fluctuations and any trends that may be inferred from the discussion below are not necessarily indicative of the operating results for any future period.

### **Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate estimates, including those related to revenue recognition, uncollectible accounts receivable, and intangible assets, for reasonableness. We base our estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe revenue recognition, the allowance for doubtful accounts, goodwill impairment, capitalized software costs and research and development tax credits are among the most critical accounting policies that impact our consolidated financial statements. We believe that significant accounting policies, as described in Note 2 of our Consolidated Financial Statements, "Summary of Significant Accounting Policies", should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Revenue Recognition.** Our revenue is primarily generated from the sale of software licenses, services, hardware, maintenance fees, and EDI services. We currently recognize revenue pursuant to Statement of Position No. 97-2, "Software Revenue Recognition" (SOP 97-2), as modified by Statement of Position No. 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect of Certain Transactions" (SOP 98-9), Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101) and Staff Accounting Bulletin No. 104, "Revenue Recognition" (SAB 104). SAB 101 summarizes the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. SAB 104 modifies certain guidance provided in SAB 101.

Inherent in the revenue recognition process are significant management estimates and judgments, which influence the timing and amount of revenue recognition.

In accordance with the governing revenue recognition guidelines, if the arrangement between vendor and purchaser does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the vendor's fee is fixed or determinable; and
- collectibility is probable.

In accordance with generally accepted accounting principles in the United States of America, the recognition of software license revenue is based on our assessment that the above criteria have been met. In general, the first two criteria are met with a signed contract and evidence that we have shipped our software to the customer. We determine that our fee is fixed and determinable based on the contract terms, which specify payment terms tied to specific dates and not to any future deliverables. Probability of collection is based on a credit review of customers. The timing or amount of revenue recognition may differ if different assessments of the above listed criteria had been made at the time transactions were recorded in revenue.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Our determination of the fair value of each element in multi-element arrangements is based on vendor-specific objective evidence (VSOE). We limit our assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management having the relevant authority to do so, for an element not yet sold separately. Management determines the price of individual elements sold separately using a rolling average of stand alone transactions. VSOE calculations are reviewed on a quarterly basis.

If evidence of fair value of all undelivered elements exists but evidence of fair value does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred at VSOE and the remaining portion of the arrangement fee is recognized as revenue, net of all discounts.

Contract accounting is applied where services include significant software modification, development or customization. In such instances, the arrangement fee is accounted for in accordance with Statement of Position No. 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" (SOP 81-1), whereby the revenue is recognized, generally using the percentage-of-completion method measured on labor input hours. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting affect the amounts of revenue reported in its consolidated financial statements.

**Valuation Allowances.** We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We perform ongoing credit evaluations of our customers and maintain 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 troubled accounts. General reserves are established based on our historical experience of bad debt expense and the aging of our accounts receivable balances net of deferred revenue and specifically reserved accounts. If the financial condition of our customers were to deteriorate resulting in an impairment of their ability to make payments, additional allowances would be required.

**Goodwill Impairment.** Our long-lived assets include goodwill of \$1.8 million as of March 31, 2005 and 2004, respectively. We follow Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" (SFAS 142). The statement applies to the amortization of goodwill and other

intangible assets. We no longer amortize amounts related to goodwill. The balance of goodwill is related to our NextGen Division. Under SFAS 142, we are required to perform an annual assessment of the implied fair value of goodwill and intangible assets with indefinite lives for impairment. We have 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, 2004 (the date of our last annual impairment test) 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. There have been no changes that would lead us to believe there is any impairment of the goodwill since the date of the last annual impairment test through March 31, 2005.

The process of evaluating goodwill for impairment involves the determination of the fair value of our business segments. Inherent in such fair value determinations are certain judgments and estimates, including the interpretation of current economic indicators and market valuations, and assumptions about our strategic plans with regard to operations. To the extent additional information arises or our strategies change, it is possible that our conclusion regarding goodwill impairment could change and result in a material effect on our financial position or results of operations.

**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 Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" (SFAS 86). Such capitalized costs are amortized on a straight line basis over the estimated economic life of the related product, of three years. We perform 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.

**Research and Development Tax Credits.** During the year ended March 31, 2003, the Company filed amended federal and state tax returns for the fiscal years ended March 31, 1998 through 2001, to take advantage of tax credits related to our research and development activities. In addition, the Company claimed research and development credit on its tax returns for the years ended March 31, 2004, 2003 and 2002. The provision for income taxes for the year ended March 31, 2004 and 2003 accounted for a portion of the aggregate tax credits accumulated through the end of each period due to the uncertainty concerning the ultimate amount of tax to be credited. As of March 31, 2004, the Company had a balance of \$0.5 million in credits which had not been recognized. In the quarter ended March 31, 2005, the state of California completed an audit of the Company's tax returns and did not materially change credits related to research and development. Based on the results of that audit as well the expiration of the statute of limitations on certain amended returns, the provision for income taxes for the year ended March 31, 2005 was reduced by the \$0.5 million in tax credits which had not been recognized as of March 31 2004.

Management's treatment of research and development tax credits represented a significant estimate which affected the effective income tax rates for the Company in the years ending March 31, 2005 and 2004. Research and development credits taken by the Company involve certain assumptions and judgments regarding qualification of expenses under the relevant tax codes. While the Company has received all of federal refunds claimed, none of the credits have been audited by the Internal Revenue Service.

## **Overview of Company results**

- We have experienced significant growth in our total revenue as a result of revenue growth in our NextGen Healthcare Information Services Division. Our total Company revenue grew 25.4% on a consolidated basis during the twelve months ended March 31, 2005 versus 2004 and 29.5% in the twelve months ended March 31, 2004 versus 2003.
- Consolidated income from operations grew 47.9% in the twelve months ended March 31, 2005 versus 2004 and 56.1% in the twelve months ended March 31, 2004 versus 2003. This performance was driven in large part by the results in our NextGen Division.
- We have benefited and hope to continue to benefit from the increased demands on healthcare providers for greater efficiency and lower costs, as well as increased adoption rates of technology in the healthcare arena.

## **NextGen Division**

- Our NextGen Division has experienced significant growth in revenue and operating income. Divisional revenue grew 35.2% in the twelve months ended March 31, 2005 versus 2004 and 45.8% in the twelve months ended March 31, 2004 versus 2003 while divisional operating income (excluding unallocated corporate expenses) grew 64.1% in the twelve months end March 31, 2005 and 77.4% in the twelve months ended March 31, 2004.
- During the twelve months ended March 31, 2005, we added staffing resources to departments including sales, marketing, support, implementation, software development, and administration and intend to continue to do so in fiscal year 2006.
- Our goals include continuing to further enhance our existing products, developing new products for targeted markets, continuing to add new customers, selling additional software and services to existing customers and expanding penetration of connectivity services to new and existing customers.

## **QSI Division**

- Our QSI Division experienced a revenue decline of 6.8% in the twelve months ended March 31, 2005 versus 2004 and 5.3% in the twelve months ended March 31, 2004 versus 2003. The Division experienced a 14.7% decrease in operating income (excluding unallocated corporate expenses) in the twelve months ended March 31, 2005 versus 2004.
- Our goals for the QSI Division include maximizing revenue and profit performance given the constraints present in this Division's target market.

The following table sets forth for the periods indicated the percentage of net revenue represented by each item in our Consolidated Statements of Operations.

	Year Ended March 31,		
	2005	2004	2003
Revenue:			
System sales .....	54.5%	55.7%	53.3%
Maintenance, EDI, and other services .....	45.5	44.3	46.7
Total revenue .....	100.0	100.0	100.0
Cost of revenue .....	36.7	40.4	43.4
Gross profit .....	63.3	59.6	56.6
Selling, general and administrative expenses .....	27.9	27.4	27.9
Research and development costs .....	7.8	8.7	9.2
Income from operations .....	27.7	23.5	19.5
Investment income .....	1.0	0.5	0.8
Income before provision for income taxes .....	28.7	24.0	20.3
Provision for income taxes .....	10.5	9.3	7.5
Net income .....	18.1%	14.7%	12.8%

#### Comparison of the Years Ended March 31, 2005 and March 31, 2004

For the year ended March 31, 2005, our net income was \$16.1 million or \$1.25 per share on a basic and \$1.22 per share on a fully diluted basis. In comparison, we earned \$10.4 million or \$0.84 per share on a basic and \$0.80 on a fully diluted basis in the year ended March 31, 2004. The increase in net income for the year ended March 31, 2005, was achieved primarily through the following:

- a 25.4% increase in revenue;
- an increase in our gross profit margin from 59.6% to 63.3%.

**Revenue.** Revenue for the year ended March 31, 2005 increased 25.4% to \$89.0 million from \$70.9 million for the year ended March 31, 2004. NextGen Division revenue increased 35.2% from \$54.4 million to approximately \$73.6 million in the period, while QSI Division revenue declined by 6.8% during the period from approximately \$16.5 million to \$15.4 million.

We divide revenue into two categories, “System sales” and “Maintenance, EDI, and other services”. Revenue in the system sales category includes software license fees, third party hardware and software, and implementation and training services related to purchase of the Company’s software systems. Revenue in the maintenance and other services category includes maintenance, EDI, and other revenue. Maintenance and EDI revenue are the principle sources of revenue in this category.

**System Sales.** Company-wide sales of systems for the twelve months ended March 31, 2005 increased 22.8% to \$48.5 million from \$39.5 million in the prior year.

Our increase in revenue from sales of systems was principally the result of a 24.8% increase in category revenue at our NextGen Division whose sales in this category grew from \$37.3 million during the year ended March 31, 2004 to \$46.6 million during the year ended March 31, 2005. This increase was driven primarily by higher sales of NextGen<sup>cmf</sup> and NextGen<sup>cpm</sup> software to both new and existing clients, as well as an increase in the delivery of related implementation services offset by a decline in the sale of related hardware, third party software and supplies.

Systems sales revenue in the QSI Division declined 11.1% to approximately \$1.9 million in the year ended March 31, 2005 from \$2.2 million in the year ended March 31, 2004.

The following table breaks down our reported system sales into software, hardware, third party software, supplies, and implementation and training services components by Division:

	Software	Hardware, Third Party Software and Supplies	Implementation and Training Services	Total System Sales
Twelve months ended				
March 31, 2005				
QSI Division.....	\$ 889	\$ 744	\$ 306	\$ 1,939
NextGen Division.....	33,230	4,811	8,548	46,589
Consolidated.....	<u>\$ 34,119</u>	<u>\$ 5,555</u>	<u>\$ 8,854</u>	<u>\$ 48,528</u>
Twelve months ended				
March 31, 2004				
QSI Division.....	\$ 807	\$ 1,029	\$ 345	\$ 2,181
NextGen Division.....	24,657	6,139	6,548	37,344
Consolidated.....	<u>\$ 25,464</u>	<u>\$ 7,168</u>	<u>\$ 6,893</u>	<u>\$ 39,525</u>

NextGen Division software revenue increased 34.8% between the twelve months ended March 31, 2004 and the twelve months ended March 31, 2005. The Division's software revenue accounted for 71.3% of divisional system sales revenue during the twelve months ended March 31, 2005, an increase from 66.0% in the prior year period. The increase in software's share of systems sales was not the result of any new trend or change in emphasis on our part relative to software sales. Software license revenue growth continues to be an area of primary emphasis for the NextGen Division and management was pleased with the Division's performance in this area.

During the twelve months ended March 31, 2005, 10.3% of NextGen's system sales revenue was represented by hardware and third party software compared to 16.4% in the same prior year period. We have noted that the last several quarter's results have included a relatively lower amount of hardware and third party software compared to prior year periods. However, this decrease was not the result of any change in emphasis on our part. The number of customers who purchase hardware and third party software and the dollar amount of hardware and third party software revenue fluctuates each year depending on the needs of customers. The inclusion of hardware and third party software in the division's sales arrangements is typically at the request of the customer and is not a priority focus for us.

Implementation and training revenue at the NextGen Division increased 30.5% in the twelve months ended March 31, 2005 compared to the twelve months ended March 31, 2004. Implementation and training revenue at the NextGen Division increased its share of divisional system sales revenue to 18.3% in the twelve months ended March 31, 2005 from 17.5% in the twelve months ended March 31, 2004. The growth in implementation and training revenue is the result of increases in the amount of implementation and training services rendered to our customers. The amount of implementation and training services revenue and the corresponding rate of growth compared to a prior period in any given year is dependant on several factors including timing of customer implementations, the availability of qualified staff, and the mix of services being rendered. The number of implementation and training staff increased during the twelve months ended March 31, 2005 versus March 31, 2004 in order to accommodate the increased amount of implementation services sold in conjunction with increased software sales. In order to achieve continued increased revenue in this area, additional staffing increases are anticipated, though actual future increases in revenue and staff will depend upon the availability of qualified staff, business mix and conditions, and our ability to retain current staff members.

The NextGen Division's growth has come in part from investments in sales and marketing activities, including hiring additional sales representatives, trade show attendance, and advertising expenditures. We have also benefited from winning numerous industry awards for the NextGen Division's flagship NextGen<sup>emr</sup> and NextGen<sup>epm</sup> software products in fiscal years 2005 and 2004, as well as in prior years, and the apparent increasing acceptance of electronic medical records technology in the healthcare industry.

For the QSI Division, total system sales decreased 11.1% in the twelve months ended March 31, 2005 compared to the twelve months ended March 31, 2004. We do not presently foresee any material changes in the business environment for the Division with respect to the constrained environment that has been in place for the past several years. QSI systems sales during the fiscal year ended March 31, 2005 were impacted by year over year declines in hardware and implementation and training services.

**Maintenance, EDI and Other.** Company-wide revenue from maintenance, EDI, and other services grew 28.7% to \$40.4 million from \$31.4 million. The increase in this category resulted principally from an increase in maintenance and EDI revenue generated from the NextGen Division's client base. Total NextGen Division maintenance revenue for the year ended March 31, 2005 grew 55.7% to \$17.9 million from \$11.5 million in the year ago period, while EDI revenue grew 86.0% to \$5.6 million compared to \$3.0 million in the year ago period. QSI Division maintenance revenue declined 3.8% from \$7.6 million to \$7.3 million in the same period while divisional EDI revenue declined by approximately 7.6% from \$5.3 million to \$4.9 million.

The following table details revenue by category for the twelve month periods ended March 31, 2005 and 2004:

	Maintenance	EDI	Other	Total
Twelve months ended				
March 31, 2005				
QSI Division.....	\$ 7,279	\$ 4,877	\$ 1,273	\$ 13,429
NextGen Division.....	17,881	5,611	3,512	27,004
Consolidated.....	<u>\$ 25,160</u>	<u>\$ 10,488</u>	<u>\$ 4,785</u>	<u>\$ 40,433</u>
Twelve months ended				
March 31, 2004				
QSI Division.....	\$ 7,570	\$ 5,276	\$ 1,464	\$ 14,310
NextGen Division.....	11,481	3,016	2,602	17,099
Consolidated.....	<u>\$ 19,051</u>	<u>\$ 8,292</u>	<u>\$ 4,066</u>	<u>\$ 31,409</u>

The following table provides the number of billing sites which were receiving maintenance services as of the last business day of the period ended March 31, 2005 and 2004 respectively, as well as the number of billing sites receiving EDI services during the last month of each respective period at each Division of the Company. The table presents summary information only and includes billing entities added and removed for any reason. Note also that a single client may include one or multiple billing sites.

	NextGen		QSI		Consolidated	
	Maintenance	EDI	Maintenance	EDI	Maintenance	EDI
March 31, 2004.	421	293	321	234	742	527
Billing sites added	138	144	4	7	142	151
Billing sites removed	(1)	(43)	(29)	(23)	(30)	(66)
March 31, 2005	<u>558</u>	<u>394</u>	<u>296</u>	<u>218</u>	<u>854</u>	<u>612</u>

**Cost of revenue.** Cost of revenue for the year ended March 31, 2005 increased 13.9% to \$32.7 million from \$28.7 million for the year ended March 31, 2004, while the cost of revenue as a percentage of net revenue declined to 36.7% from 40.4% during the same period. Our consolidated gross profit is impacted by the level of hardware content included in system sales, the percentage of EDI revenue in our overall sales mix, and certain headcount expenses directly related to the cost of delivering our products and services. Consolidated gross profit is also impacted by the higher margin revenues of the NextGen Division which increased its share of total company revenue to 82.7% from 76.8% in the prior year.

The following table details revenue and cost of revenue on a consolidated and divisional basis for the twelve month periods ended March 31, 2005 and 2004:

	Year Ended March 31,			
	2005	%	2004	%
<b>Consolidated</b>				
Revenue .....	\$ 88,961	100.0%	\$ 70,934	100.0%
Cost of revenue.....	32,669	36.7	28,673	40.4
Gross profit.....	56,292	63.3	42,261	59.6
<b>NextGen Division</b>				
Revenue .....	73,594	100.0	54,443	100.0
Cost of revenue.....	25,004	34.0	20,398	37.5
Gross profit.....	48,590	66.0	34,045	62.5
<b>QSI Division</b>				
Revenue .....	15,367	100.0	16,491	100.0
Cost of revenue.....	7,665	49.9	8,275	50.2
Gross profit.....	\$ 7,702	50.1%	\$ 8,216	49.8%

Gross profit margins at the NextGen Division for the year ended March 31, 2005 increased to 66.0% from 62.5% primarily due to a decrease in the proportionate level of hardware and third party software content included in revenue as well as a slight decrease in the relative level of applicable headcount expense associated with delivering our products and services. The QSI Division's gross profit margin improved slightly to 50.1% in the year ended March 31, 2005 from 49.8% in the same period last year due to proportionately lower hardware and third party software content included in revenue.

The following table details the individual components of cost of revenue and gross profit as a percentage of total revenue for our Company and our two divisions:

	Hardware, Third Party Software	Payroll and related Benefits	Outside Services, Amortization of Software Development Costs and Other	Total Cost of Revenue	Gross Profit
Twelve months ended March 31, 2005					
QSI Division.....	6.1%	17.8%	26.0%	49.9%	50.1%
NextGen Division.....	6.8	12.6	14.6	34.0	66.0
Consolidated.....	6.7	13.5	16.5	36.7	63.3
Twelve months ended March 31, 2004					
QSI Division.....	7.6	16.8	25.8	50.2	49.8
NextGen Division.....	10.8	14.2	12.5	37.5	62.5
Consolidated.....	10.0%	14.8%	15.6%	40.4%	59.6%

During the twelve months ended March 31, 2005, hardware and third party software constituted a smaller portion of consolidated revenue compared to the same prior year period, driven principally by the composition of NextGen Division revenue. This year over year reduction was not the result of any identifiable trend or change in emphasis on our part. The number of customers who purchase hardware and third party software and the dollar amount of hardware and third party software purchased fluctuates each quarter depending on the needs of the customers and is not a priority focus for us.

Our payroll and benefits expense associated with delivering our products and services decreased to 13.5% of consolidated revenue compared to 14.8% during the prior twelve months ended March 31, 2004. The absolute level of consolidated payroll and benefit expenses grew primarily due to additions to related headcount, payroll and benefits expense associated with delivering products and services in the NextGen Division. Payroll and benefits expense associated with delivering products and services in the QSI Division declined slightly on an absolute basis, but increased slightly on a percentage of revenue basis. We anticipate continued additions to headcount in the NextGen Division in areas related to delivering products and services in future periods, but due to the uncertainties in the timing of our sales arrangements, our sales mix, the acquisition and training of qualified personnel, and other issues, we cannot accurately predict if related headcount expense as a percentage of revenue will increase or decrease in the future.

We do not currently intend to make any significant additions to related headcount at the QSI Division.

Should the NextGen Division continue to represent an increasing share of our revenue and should the NextGen Division continue to carry higher gross margins than the QSI Division, our consolidated gross margin percentages should increase to more closely match those of the NextGen Division.

As a result of the foregoing events and activities, our gross profit for the Company and our two operating divisions increased for the twelve month period ending March 31, 2005 versus the prior year period.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the year ended March 31, 2005 increased 27.2% to \$24.8 million as compared to \$19.5 million for the year ended

March 31, 2004. The increase resulted primarily from increases of \$2.0 million in selling and administrative salaries and related benefits expenses in the NextGen Division, \$0.9 million for corporate related professional services principally in the area of Sarbanes-Oxley compliance, \$0.6 million in commission expense principally in the NextGen division, \$0.4 million in corporate related salaries and related benefit expenses, \$0.4 million in NextGen travel expenses and \$1.0 million in other general and administrative expenses primarily in the NextGen Division. Selling, general and administrative expenses as a percentage of revenue slightly increased to 27.9% in the fiscal year ended March 31, 2005 from 27.4% in the fiscal period ended March 31, 2004 due to selling, general and administrative expenses growing at a slightly faster rate than revenue.

We anticipate increased expenditures for trade shows, advertising and the employment of additional sales representatives primarily at the NextGen Division. We are hopeful that we will be able to achieve at least a moderate reduction in expenses related to Sarbanes Oxley Act compliance. While we expect selling, general and administrative expenses to increase on an absolute basis, we cannot accurately predict the impact these additional expenditures will have on selling, general, and administrative expenses as a percentage of revenue.

**Research and Development Costs.** Research and development costs for the year ended March 31, 2005 and 2004 were \$6.9 million and \$6.1 million, respectively. The increase in research and development costs was primarily due to increased investment in the NextGen product line. Research and development costs as a percentage of net revenue decreased to 7.8% from 8.7% primarily due to revenue growing at a faster rate than the increase in research and development spending. Research and development costs are expected to continue at or above current levels.

**Investment Income.** Investment income for the year ended March 31, 2005 increased 127% to approximately \$0.9 million compared with \$0.4 million in the year ended March 31, 2004. The increase was primarily due to the effect of an increase in short term interest rates versus the prior year period as well as comparatively higher amounts available for investment during the fiscal period ended March 31, 2005. During the fourth quarter of fiscal year 2005, the Company paid a one time dividend of approximately \$19.6 million, which reduced the amount of funds available for investment during this period.

**Provision for Income Taxes.** The provision for income taxes for the year ended March 31, 2005 was approximately \$9.4 million as compared to approximately \$6.6 million for the year ago period. The effective tax rates for fiscal 2005 and 2004 were 36.8% and 38.9%, respectively. The provision for income taxes for the years ended March 31, 2005 and 2004 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. During fiscal 2005, the Company recognized approximately \$0.5 million of research and development credits which had not been recognized previously due to the uncertainty concerning the ultimate amount of tax to be credited. In the quarter ended March 31, 2005, the State of California completed an audit of the Company's tax returns and did not materially change credits related to research and development. Based on the results of that audit as well the expiration of the statute of limitations on certain amended returns, the provision for income taxes for the year ended March 31, 2005 was reduced by the \$0.5 million in tax credits which had not been recognized as of March 31 2004.

### **Comparison of the Years Ended March 31, 2004 and March 31, 2003**

For the year ended March 31, 2004, our net income was \$10.4 million or \$0.84 per share on a basic and \$0.80 per share on a fully diluted basis. In comparison, the Company earned \$7.0 million or \$0.57 per share on a basic and \$0.55 per shares on a diluted basis in the year ended March 31, 2003. The increase in net income for the year ended March 31, 2004, was achieved through the following:

- a 29.5% increase in revenue;
- an increase in our gross profit margin from 56.6% to 59.6%; and
- Selling, general and administrative and research and development expenses which grew at 27.4% and 21.3% respectively; slower than the overall revenue growth rate.

**Revenue.** Net revenue for the year ended March 31, 2004 increased 29.5% to \$70.9 million from \$54.8 million for the year ended March 31, 2003. Sales of computer systems, upgrades and supplies increased 35.5% to \$39.5 million from \$29.2 million while net revenue from maintenance, EDI, and other service grew 22.7% to \$31.4 from \$25.6 million during the comparable prior period. The increase in net revenue from sales of computer systems, upgrades and supplies was principally due to increased sales of the Company's NextGen<sup>epm</sup> and NextGen<sup>emr</sup> software licenses to new customers.

We divide revenue into two categories, "System sales" and "Maintenance, EDI, and other services". Revenue in the systems sales category includes software license fees, third party hardware and software, and implementation and training services related to purchase of the Company's software systems. Revenue in the maintenance and other services category includes maintenance, EDI, and other revenue. Maintenance and EDI revenue are the principle sources of revenue in this category.

**System Sales.** Company-wide sales of systems for the twelve months ended March 31, 2004 increased 35.5% to \$39.5 million from \$29.2 million in the prior year.

Our increase in revenue from sales of systems was principally the result of a 42.5% increase in category revenue at our NextGen Division whose sales in this category grew from \$26.2 million during the year ended March 31, 2003 to \$37.3 million during the year ended March 31, 2004. This increase was driven primarily by higher sales of NextGen<sup>emr</sup> and NextGen<sup>epm</sup> software to both new and existing clients, as well as delivery of related implementation services and sales of related hardware, third party software, and supplies.

Systems sales revenue in the QSI Division declined 26.2% to approximately \$2.2 million in the year ended March 31, 2004 from \$3.0 million in the year ended March 31, 2003.

The following table breaks down our reported system sales into software, hardware, third party software, supplies, and implementation and training services components by Division:

	Software	Hardware, Third Party Software and Supplies	Implementation and Training Services	Total System Sales
Twelve months ended March 31, 2004				
QSI Division.....	\$ 807	\$ 1,029	\$ 345	\$ 2,181
NextGen Division.....	24,657	6,139	6,548	37,344
Consolidated.....	<u>\$ 25,464</u>	<u>\$ 7,168</u>	<u>\$ 6,893</u>	<u>\$ 39,525</u>
Twelve months ended March 31, 2003				
QSI Division.....	\$ 1,591	\$ 1,160	\$ 205	\$ 2,956
NextGen Division.....	17,982	4,658	3,573	26,213
Consolidated.....	<u>\$ 19,573</u>	<u>\$ 5,818</u>	<u>\$ 3,778</u>	<u>\$ 29,169</u>

**Maintenance, EDI, and Other.** Company-wide revenue from maintenance, EDI, and other services grew 22.7% to \$31.4 million from \$25.6 million. The increase in this category resulted principally from an increase in maintenance and EDI revenue from the NextGen Division's client base. Total NextGen Division maintenance revenue for the year ended March 31, 2004 grew 58.0% to \$11.5 million from \$7.3 million in the year ago period, while EDI revenue grew 74.0% to \$3.0 million compared to \$1.7 million in the same period. QSI Division maintenance revenue declined 4.7% from \$7.9 million to \$7.6 million in the same period while divisional EDI revenue declined by approximately 2.8% from \$5.4 million to \$5.3 million.

The following table details revenue by category for the twelve month periods ended March 31, 2004 and 2003:

	Maintenance	EDI	Other	Total
Twelve months ended March 31, 2004				
QSI Division.....	\$ 7,570	\$ 5,276	\$ 1,464	\$ 14,310
NextGen Division.....	11,481	3,016	2,602	17,099
Consolidated.....	<u>\$ 19,051</u>	<u>\$ 8,292</u>	<u>\$ 4,066</u>	<u>\$ 31,409</u>
Twelve months ended March 31, 2003				
QSI Division.....	\$ 7,941	\$ 5,426	\$ 1,100	\$ 14,467
NextGen Division.....	7,267	1,733	2,133	11,133
Consolidated.....	<u>\$ 15,208</u>	<u>\$ 7,159</u>	<u>\$ 3,233</u>	<u>\$ 25,600</u>

The following table provides the number of billing sites which were receiving maintenance services as of the last business day of the period ended March 31, 2004 and 2003 respectively, as well as the number of billing sites receiving EDI services during the last month of each respective period at each Division of the Company. The table presents summary information only and includes billing entities added and removed for any reason. Note also that a single client may include one or multiple billing sites.

	NextGen		QSI		Consolidated	
	Maintenance	EDI	Maintenance	EDI	Maintenance	EDI
March 31, 2003	315	219	348	254	663	473
Billing sites added	117	99	4	4	121	103
Billing sites removed	(11)	(25)	(31)	(24)	(42)	(49)
March 31, 2004	<u>421</u>	<u>293</u>	<u>321</u>	<u>234</u>	<u>742</u>	<u>527</u>

**Cost of Revenue.** Cost of revenue for the year ended March 31, 2004 increased 20.7% to \$28.7 million from \$23.8 million for the year ended March 31, 2003, while the cost of revenue as a percentage of revenue at 40.4% for 2004 declined compared to the prior year's 43.4% of revenue.

The following table details revenue and cost of revenue on a consolidated and divisional basis for the twelve month periods ended March 31, 2004 and 2003:

	Year Ended March 31,			
	2004	%	2003	%
<b>Consolidated</b>				
Revenue .....	\$ 70,934	100.0%	\$ 54,769	100.0%
Cost of revenue .....	<u>28,673</u>	<u>40.4</u>	<u>23,755</u>	<u>43.4</u>
Gross profit .....	42,261	59.6	31,014	56.6
<b>NextGen Division</b>				
Revenue .....	54,443	100.0	37,346	100.0
Cost of revenue .....	<u>20,398</u>	<u>37.5</u>	<u>14,511</u>	<u>38.9</u>
Gross profit .....	34,045	62.5	22,835	61.1
<b>QSI Division</b>				
Revenue .....	16,491	100.0	17,423	100.0
Cost of revenue .....	<u>8,275</u>	<u>50.2</u>	<u>9,244</u>	<u>53.1</u>
Gross profit .....	\$ 8,216	49.8%	\$ 8,179	46.9%

Gross profit is impacted by the level of hardware content included in system sales, the percentage of EDI revenue in our overall sales mix, and certain headcount expenses. Gross profit at the NextGen Division for the year ended March 31, 2004 improved to 62.5% from 61.1% primarily due to a decrease in the relative level of applicable outside service, amortization of software development costs and other expenses associated with delivering the Company's products and services. The QSI Division's gross profit for the year ended March 31, 2004 improved to 49.8% from 46.9% in the same period during the prior year primarily due to a proportionately lower hardware and third party software content included in revenue. In addition, our gross profit percentage increased as the higher margined NextGen Division increased its share of total Company revenue to 76.8% from 68.2% in the prior year.

The following table details the individual components of cost of revenue and gross profit as a percentage of total revenue for our Company and our two divisions:

	Hardware, Third Party Software	Payroll and related Benefits	Outside Services, Amortization of Software Development Costs and Other	Total Cost of Revenue	Gross Profit
Twelve months ended March 31, 2004					
QSI division.....	7.6%	16.8%	25.8%	50.2%	49.8%
NextGen division..	10.8	14.2	12.5	37.5	62.5
Consolidated.....	10.0	14.8	15.6	40.4	59.6
Twelve months ended March 31, 2003					
QSI division.....	11.1	15.5	26.5	53.1	46.9
NextGen division..	11.9	11.8	15.2	38.9	61.1
Consolidated.....	11.6%	13.0%	18.8%	43.4%	56.6%

During the twelve months ended March 31, 2004, hardware and third party software constituted a slightly smaller portion of consolidated revenue compared to the same year ago period driven principally by the composition of NextGen Division revenue. This year over year reduction was not the result of any identifiable trend or change in emphasis on our part. The number of customers who purchase hardware and third party software and the dollar amount of hardware and third party software purchased fluctuates each quarter depending on the needs of the customers and is not a priority focus for us.

Our payroll and benefits expense associated with delivering our products and services increased to 14.8% of consolidated revenue compared to 13.0% during the prior twelve months ended March 31, 2003. The level of consolidated payroll and benefit expenses grew due to additions to related headcount, payroll and benefits expense associated with delivering products and services in the NextGen Division. Payroll and benefits expense associated with delivering products and services in the QSI Division increased slightly on both an absolute and a percentage of revenue basis. We anticipate continued additions to headcount in the NextGen Division in areas related to delivering products and services in future periods but due to the uncertainties in the timing of our sales arrangements, our sales mix, the acquisition and training of qualified personnel, and other issues, we cannot accurately predict if related headcount expense as a percentage of revenue will increase or decrease in the future. We do not currently intend to make any significant additions to related headcount at the QSI Division.

Our outside services, amortization of software development costs and other expenses included in cost of revenue declined to 15.6% compared to 18.8% during the twelve months ended March 31, 2003. This decline was due to a number of factors including a slight decline in the proportion of EDI revenue included in consolidated revenue during fiscal 2004, a slight improvement in gross profit related to EDI revenue, and certain overhead and amortization of capitalized software costs increasing at a slower rate compared to the rate of revenue growth.

Should the NextGen Division continue to represent an increasing share of our revenue and should the NextGen Division continue to carry higher gross margins than the QSI Division, our consolidated gross profit percentages should increase to more closely match those of the NextGen Division.

As a result of the foregoing events and activities, our gross profit for the Company and our two operating divisions increased for the twelve month period ending March 31, 2004 versus the prior year period.

**Selling, General and Administrative.** Selling, general and administrative expenses for the year ended March 31, 2004 increased 27.4% to \$19.5 million from \$15.3 million for the year ended March 31, 2003, and declined on a percentage of revenue basis to 27.4% from 27.9% for the respective fiscal years. The increase in the amount of such expenses resulted primarily from increases of \$1.1 million in corporate expenses, principally in the area of professional service fees, as well as \$1.0 million in selling and administrative payroll and benefits expenses, \$0.9 million in commissions expenses, and \$0.6 million in travel and trade show expenses primarily in the NextGen Division. Further increases in selling, general and administrative expenses are expected.

**Research and Development Costs.** Research and development costs for the year ended March 31, 2004 and 2003 were \$6.1 million and \$5.1 million, respectively. The increase in research and development costs was primarily due to increased investment in the NextGen product line. Research and development costs as a percentage of net revenue decreased to 8.7% from 9.2% due in part, to the fact that revenue growth exceeded the increase in research and development spending, and in part due to the fact that our investments in capitalized software increased to \$2.6 million from \$1.7 million in the prior year, reflecting increased expenditures directed at enhancements of the NextGen products. Research and development costs are expected to continue at or above current levels.

**Investment Income.** Investment income for the year ended March 31, 2004 decreased 11.1% to approximately \$0.4 million compared with \$0.4 million in the year ended March 31, 2003. Investment income in the year ended March 31, 2004 declined primarily due to the effect of the drop in short term interest rates versus the prior year. The decline in interest rates was partially offset by an increase in average funds available for investment during the year ended March 31, 2004.

**Provision for Income Taxes.** The provision for income taxes for the year ended March 31, 2004 was approximately \$6.6 million as compared to approximately \$4.1 million for the year ago period. The effective tax rates for fiscal 2004 and 2003 were 38.9% and 36.6%, respectively. The provision for income taxes for the years ended March 31, 2004 and 2003 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. The effective rate for the fiscal year 2004 increased from the prior year primarily due to a relatively smaller impact of research and development tax credits as well as slightly higher effective state income tax rates. The provision for income taxes for the year ended March 31, 2004 and 2003 accounted for a portion of the aggregate tax credits accumulated through the end of each period due to the uncertainty concerning the ultimate amount of tax to be credited.

**Liquidity and Capital Resources.** The following table presents selected financial statistics and information for each of the past three fiscal years:

	Year Ended March 31,		
	2005	2004	2003
Cash and cash equivalents at year end.....	\$ 51,157	\$ 51,395	\$ 36,443
Net (decrease) increase in cash and cash equivalents....	(238)	14,952	11,000
Net income .....	16,109	10,400	7,035
Net cash provided by operating activities.....	\$ 21,631	\$ 17,303	\$ 13,183
Days of sales outstanding .....	119	98	104

Cash provided by operations is our principal source of cash. Cash from operations for the year ended March 31, 2005 consisted principally of net income before non-cash related expenses of depreciation,

amortization, and provision for bad debts and inventory obsolescence, and increases in deferred revenue and other current liabilities, offset by an increase in gross accounts receivable. We were able to generate operating cash flows significantly in excess of net income in the year ended March 31, 2005 primarily as a result of increases in deferred revenue of \$8.2 million. We were able to generate operating cash flows significantly in excess of net income in the year ended March 31, 2004 primarily as a result of increases in deferred revenue of \$5.6 million and improved turnover of accounts receivable. Provided turnover of accounts receivable, increased revenue, and profitability remain consistent with results experienced for the year ended March 31, 2005, we anticipate continuing to generate cash from operations primarily from net income.

Net cash used in investing activities for the year ended March 31, 2005 was \$4.4 million and was primarily composed of investments in capitalized software and equipment and improvements. We have no significant capital commitments, and currently anticipate that additions to equipment and improvements for fiscal 2006 will be equal to or greater than historical levels.

Net cash used in financing activities for the year ended March 31, 2005 was \$17.5 million was primarily composed of a one-time dividend paid to shareholders of \$19.6 million partially offset by proceeds from the exercise of stock options. Cash received from employee stock option exercises can fluctuate from year to year.

At March 31, 2005, we had cash and cash equivalents of \$51.2 million. We intend to expend some of these funds for the development of products complementary to our existing product line as well as new versions of certain of our products. These developments are intended to take advantage of more powerful technologies and to increase the integration of our products. We have no additional significant current capital commitments. Management believes that our cash and cash equivalents on hand at March 31, 2005, together with the cash flows from operations, if any, will be sufficient to meet our working capital and capital expenditure requirements for fiscal 2006.

The following table summarizes our significant contractual obligations at March 31, 2005, and the effect of such obligations is expected to have on our liquidity and cash in future periods:

Contractual Obligations	Total	2006	2007-2008	2009-2010	Beyond 2010
Non-cancelable operating leases	\$4,001	\$1,257	\$1,867	\$877	--

#### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS**

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

#### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our Financial Statements identified in the Index to Financial Statements appearing under “Item 15. Exhibits and Financial Statement Schedules” of this report are incorporated herein by reference to Item 15.

#### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### *Evaluation of Disclosure Controls and Procedures*

Based on their evaluation of our disclosure controls and procedures as of a date within 90 days of the filing date of this report, our officers including our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures result in the effective recordation, processing, summarization and reporting of information that is required to be disclosed in the reports that we file under the Securities Exchange Act of 1934 and the rules there under.

### *Changes in Internal Control Over Financial Reporting*

During the year ended March 31, 2005, the following changes have occurred 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, our financial reporting function.

During the year ended March 31, 2005, the Company implemented revenue application software “Softrax” to automate certain processes surrounding the recognition and the deferral of revenue related to our software sales arrangements with multiple elements. The Company added numerous additional policies and procedures in order to strengthen the Company’s internal control structure in conjunction with the Company’s evaluation of internal controls. The Company also added a controller with public accounting and SEC reporting experience.

There were no other significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

### *Management’s Report on Internal Control Over Financial Reporting*

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of the Company’s management, including our principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework set forth in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, the Company’s management concluded that its internal control over financial reporting was effective as of March 31, 2005.

The Company’s internal control over financial reporting is supported by written policies and procedures, that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company’s assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of the Company’s management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's independent registered public accounting firm has audited management's assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2005 as stated in their report which is included herein.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF REGISTRANT**

Except for information concerning our executive officers which is included under the caption "Executive Officers of the Company" following Part I, Item 4 of this Report, the information required by Item 10 is incorporated herein by reference from our definitive proxy statement for our 2005 annual shareholders' meeting to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended March 31, 2005.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 is incorporated herein by reference from our definitive proxy statement for our 2005 annual shareholders' meeting to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended March 31, 2005.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 12 is incorporated herein by reference from our definitive proxy statement for our 2005 annual shareholders' meeting to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended March 31, 2005.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by Item 13 is incorporated herein by reference from our definitive proxy statement for our 2005 annual shareholders' meeting to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended March 31, 2005.

**ITEM 14. PRINCIPAL ACCOUNTING AND FEES AND SERVICES**

The information required by Item 14 is incorporated herein by reference from our definitive proxy statement for our 2005 annual shareholders' meeting to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended March 31, 2005.

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT, SCHEDULES AND REPORTS ON FORM 10-K**

(a) (1) Index to Financial Statements:

	<u>Page</u>
▪ Report of Independent Registered Public Accounting Firm.....	49
▪ Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting.....	50
▪ Consolidated Balance Sheets — Years Ended March 31, 2005 and March 31, 2004.....	52
▪ Consolidated Statements of Income — Years Ended March 31, 2005, March 31, 2004 and 2003.....	53
▪ Consolidated Statements of Shareholders' Equity — Years Ended March 31, 2005, March 31, 2004 and 2003.....	54
▪ Consolidated Statements of Cash Flows — Years Ended March 31, 2005, March 31, 2004 and 2003.....	55
▪ Notes to Consolidated Financial Statements.....	56
(2) The following financial statement schedule for the years ended March 31, 2005, March 31, 2004 and 2003, read in conjunction with the financial statements of Quality Systems, Inc., is filed as part of this Annual Report on Form 10-K.	
▪ Schedule II — Valuation and Qualifying Accounts .....	71

Schedules other than that listed above have been omitted since they are either not required, not applicable, or because the information required is included in the financial statements or the notes thereto.

(3) The exhibits listed in the Index to Exhibits hereof are attached hereto or incorporated herein by reference and filed as apart of this Report.

## INDEX TO EXHIBITS

### EXHIBIT NUMBER

### EXHIBIT

- 3.1 Articles of Incorporation of the Company, as amended, are hereby incorporated by reference to Exhibit 3.1 to our Annual Report on Form 10-K for the year ended March 31, 1984, File No. 2-80056.
- 3.1.1 Amendment to Articles of Incorporation, effective March 4, 2005. \*\*
- 3.2 Bylaws of the Company, as amended and restated. \*\*
- 3.3 Certificate of Amendment of Bylaws of the Company is hereby incorporated by reference to Exhibit 3.2.1 to our Registration Statement on Form S-1, File No. 333-00161.
- 3.4 Text of Sections 2 and 3 of Article II of the Bylaws of the Company is hereby incorporated By reference to Exhibit 3.2.2 to our Quarterly report on Form 10-QSB for the period Ended December 31, 1996, File No. 0-13801.
- 3.5 Certificate of Amendment of Bylaws of the Company, is hereby incorporated by reference to Exhibit 3.2.3 to our Annual Report on Form 10-K for the year ended March 31, 2000, File No. 0-13801.
- 10.2\* 1989 Incentive Stock Option Plan is hereby incorporated by reference to Exhibit 4.1 to our Registration Statement on Form S-8, File No. 33-31949.
- 10.2.1\* Form of Incentive Stock Option Agreement is hereby incorporated by reference to Exhibit 10.2 to our Registration Statement on Form S-1, File No. 333-00161.
- 10.2.2\* Form of Non-Qualified Stock Option Agreement is hereby incorporated by reference to Exhibit 10.3 to our Registration Statement on Form S-1, File No. 333-00161.
- 10.3\* Form of Incentive Stock Option Agreement is hereby incorporated by reference to Exhibit 10.2 to our Registration Statement on Form S-1, File No. 2-80056.
- 10.4\* 1993 Deferred Compensation Plan is hereby incorporated by reference to Exhibit 10.5 to our Annual Report on Form 10-KSB for the year ended March 31, 1994, File No. 0-13801.
- 10.4.2\* Profit Sharing and Retirement Plan, as amended, is hereby incorporated by reference to Exhibit 10.4.2 to our Annual Report on Form 10-KSB for the year ended March 31, 1994, File No. 0-13801.
- 10.4.3\* Profit Sharing and Retirement Plan, as amended, amendments No. 2 and 3, are hereby incorporated by reference to Exhibit 10.4.3 to our Annual Report on Form 10-KSB for the year ended March 31, 1996, File No. 0-13801.
- 10.5 Series "A" Convertible Preferred Stock Purchase Agreement, as amended, dated April 21, 1995 between the Company and Clintec International, Inc., is hereby incorporated by reference to Exhibit 10.11 to our Annual Report on Form 10-KSB for the year ended March 31, 1995, File No. 0-13801.

- 10.6 Form of Indemnification Agreement is hereby incorporated by reference to Exhibit 10.10 to our Registration Statement on Form S-1, File No. 333-00161.
- 10.6.1\* Form of Indemnification Agreement for directors and executive officers authorized January 27, 2005. \*\*
- 10.7 Agreement and Plan of Merger, dated May 16, 1996, by and among Quality Systems, Inc., CII Acquisition Corporation, Clinitec International, Inc. and certain shareholders of Clinitec International, Inc. and certain exhibits are hereby incorporated by reference to Exhibit 2 to our Current Report on Form 8-K, dated May 17, 1996 and filed May 30, 1996.
- 10.8 Asset Purchase Agreement, dated May 15, 1997, by and among NextGen Healthcare Information Systems, Inc., MHIS Acquisition Corp., Quality Systems, Inc., and certain shareholders of NextGen Healthcare Information Systems, Inc. is hereby incorporated by reference to Exhibit 2 of Company's Current Report on Form 8-K, dated May 15, 1997 and filed May 29, 1997, File No. 0-13801.
- 10.9\* 1998 Employee Stock Contribution Plan is hereby incorporated by reference to Exhibit 4.1 to our Registration Statement on Form S-8, File No. 333-63131.
- 10.10\* 1998 Stock Option Plan is hereby incorporated by reference to Exhibit 4.1 to our Registration Statement on Form S-8, File No. 333-67115.
- 10.10.1\* Amended and Restated 1998 Stock Option Plan. \*\*
- 10.11\* Memorandum of Understanding regarding the April 3, 2000 resignation of Sheldon Razin between Sheldon Razin and Quality Systems, Inc., is hereby incorporated by reference to Exhibit 10.16 to our Annual Report on Form 10-K for the year ended March 31, 2000, File No. 0-13801.
- 10.12\* Memorandum of Understanding Relating to Director Nominees is hereby incorporated by reference to Company's Definitive Proxy Statement for our 1999 Shareholder's Meeting, File No. 001-12537.
- 10.13\* Employment Agreement dated July 20, 2000 between Quality Systems, Inc. and Lou Silverman is hereby incorporated by reference to Exhibit 10.18 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2000, File No. 0-13801.
- 10.14 Lease Agreement between Company and Tower Place, L.P. dated November 15, 2000, commencing February 5, 2001 is hereby incorporated by reference to Exhibit 10.14 to our Annual Report on Form 10-K for the year ended March 31, 2001, File No. 0-13801.
- 10.15 Lease Agreement between Company and Orangewood Business Center Inc. dated April 3, 2000, amended February 22, 2001, is hereby incorporated by reference to Exhibit 10.15 to our Annual Report on Form 10-K for the year ended March 31, 2001, File No. 0-13801.
- 10.16 Lease Agreement between Company and Craig Development Corporation dated February 20, 2001 is hereby incorporated by reference to Exhibit 10.16 to our Annual Report on Form 10-K for the year ended March 31, 2001, File No. 0-13801.
- 10.17 Sublease Agreement between Company and Infinium Software dated February 22, 2002 is hereby incorporated by reference to Exhibit 10.17 to our Annual Report on Form 10-K for the year ended March 31, 2003, File No. 0-13801.

- 10.18 Lease Agreement between Company and HUB Properties LLC dated May 8, 2002 is hereby incorporated by reference to Exhibit 10.18 to our Annual Report on Form 10-K for the year ended March 31, 2003, File No. 0-13801.
- 10.19 Lease Agreement between the Company and LakeShore Towers Limited Partnership Phase IV, a California limited partnership, dated September 15, 2004. \*\*
- 10.20\* Board Service Agreement between the Company and Lou Silverman is incorporated by reference to Exhibit 10.2.1 to our Current Report of Form 8-K, dated May 31, 2005, File No. 001-12537.
- 10.21\* Board Service Agreement between the Company and Patrick Cline is incorporated by reference to Exhibit 10.2.1 to our Current Report of Form 8-K, dated May 31, 2005, File No. 001-12537.
- 21 List of Subsidiaries.
- 23.1 Consent of Independent Certified Public Accountants – Grant Thornton LLP.
- 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. \*\*

\* *This exhibit is a management contract or a compensatory plan or arrangement.*

\*\* *Filed herewith.*

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, we have duly caused this Report to be signed on our behalf by the undersigned, thereunto duly authorized.

By: /s/ LOUIS E. SILVERMAN  
Louis E. Silverman,  
President and Chief Executive Officer

Date: June 3, 2005

KNOW ALL PERSONS BY THESE PRESENTS, that each of the persons whose signature appears below hereby constitutes and appoints Louis E. Silverman and Paul Holt, each of them acting individually, as his attorney-in-fact, each with the full power of substitution, for him in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming our signatures as they may be signed by our said attorney-in-fact and any and all amendments to this Annual Report on Form 10-K.

Pursuant to the requirement of the Securities Exchange Act of 1934, this Report has been signed by the following persons on our behalf in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ SHELDON RAZIN</u> Sheldon Razin	Chairman of the Board	June 9, 2005
<u>/s/ LOUIS E. SILVERMAN.</u> Louis E. Silverman	Director, President and Chief Executive Officer (Principal Executive Officer)/Director	June 9, 2005
<u>/s/ PATRICK CLINE</u> Patrick Cline	Director, President, NextGen Healthcare Information Systems Division	June 9, 2005
<u>/s/ PAUL HOLT</u> Paul Holt	Secretary and Chief Financial Officer (Principal Financial Officer)	June 9, 2005
<u>/s/ WILLIAM BOTTS</u> William Botts	Director	June 9, 2005
<u>/s/ MAURICE DEWALD</u> Maurice DeWald	Director	June 9, 2005

<b>Signature</b>	<b>Title</b>	<b>Date</b>
<u>/s/ AHMED HUSSEIN</u> Ahmed Hussein	Director	June 9, 2005
<u>/s/ JONATHAN JAVITT</u> Jonathan Javitt	Director	June 9, 2005
<u>/s/ VINCENT LOVE</u> Vincent Love	Director	June 6, 2005
<u>/s/ STEVEN PLOCHOCKI</u> Steven Plochocki	Director	June 9, 2005

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders  
Quality Systems, Inc.

We have audited the accompanying consolidated balance sheets of Quality Systems, Inc. as of March 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flow for each of the three years in the period ended March 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Quality Systems, Inc. as of March 31, 2005 and 2004 and the consolidated results of operations and its consolidated cash flows for each of the three years in the period ended March 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

We have also audited Schedule II of Quality Systems, Inc. for each of the three years in the period ended March 31, 2005. In our opinion, this schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Quality Systems, Inc.'s internal control over financial reporting as of March 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 3, 2005, expressed an unqualified opinion thereon.

/s/ GRANT THORNTON LLP

Irvine, California  
June 3, 2005

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Board of Directors and Shareholders  
Quality Systems, Inc.

We have audited management's assessment, included in the accompanying Quality Systems, Inc. Management's Report on Internal Control Over Financial Reporting, that Quality Systems, Inc. maintained effective internal control over financial reporting as of March 31, 2005, based on criteria established in Internal Control – Integrated Framework issues by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Quality Systems, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Quality Systems, Inc. maintained effective internal control over financial reporting as of March 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, Quality Systems, Inc. maintained, in all material respects, effective internal control over financial reporting as of March 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Quality Systems, Inc. as of March 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for each of

the three years in the period ended March 31, 2005, and our report dated June 3, 2005 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

Irvine, California  
June 3, 2005

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(In Thousands, Except Share Data)

	<b>March 31, 2005</b>	<b>March 31, 2004</b>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents.....	\$ 51,157	\$ 51,395
Accounts receivable, net .....	33,362	20,280
Inventories, net.....	960	725
Income tax receivable .....	15	—
Net current deferred tax assets .....	1,796	2,979
Other current assets.....	1,677	1,493
Total current assets.....	88,967	76,872
Other assets		
Equipment and improvements, net .....	2,697	2,012
Capitalized software costs, net.....	4,334	3,608
Net long-term deferred tax assets.....	—	1,104
Goodwill, net.....	1,840	1,840
Other assets, net .....	1,604	1,242
Total assets.....	\$ 99,442	\$ 86,678
<b>LIABILITIES and STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable .....	\$ 2,284	\$ 1,655
Deferred revenue.....	24,115	16,060
Accrued employee compensation and benefits .....	3,436	2,610
Income tax payable .....	—	273
Other current liabilities .....	4,021	2,859
Total current liabilities .....	33,856	23,457
Deferred revenue, net of current.....	1,362	1,203
Net deferred tax liabilities .....	291	—
Deferred compensation.....	1,202	1,013
Total liabilities .....	36,711	25,673
Commitments and contingencies .....	—	—
Shareholders' equity		
Common Stock, \$0.01 par value; 40,000 shares authorized, 13,111 and 12,650 shares issued and outstanding at March 31, 2005 and 2004, respectively.....	131	127
Additional paid-in capital.....	44,499	39,671
Retained earnings.....	19,213	22,750
Deferred compensation .....	(1,112)	(1,543)
Total shareholders' equity.....	62,731	61,005
Total liabilities and shareholders' equity .....	\$ 99,442	\$ 86,678

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

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**

(In Thousands, except per share amounts)

	Year Ended March 31,		
	2005	2004	2003
Revenue:			
Software, hardware and supplies .....	\$ 39,672	\$ 32,632	\$ 25,391
Implementation and training services .....	8,856	6,893	3,778
System sales .....	48,528	39,525	29,169
Maintenance and other services .....	29,945	23,117	18,441
Electronic data interchange services.....	10,488	8,292	7,159
Maintenance, EDI, and other services.....	40,433	31,409	25,600
Total revenue .....	88,961	70,934	54,769
Cost of revenue:			
Software, hardware and supplies .....	7,525	8,141	7,299
Implementation and training services .....	6,300	5,197	2,929
Total cost of system sales .....	13,825	13,338	10,228
Maintenance and other.....	12,120	10,313	9,072
Electronic data interchange services.....	6,724	5,022	4,455
Total cost of maintenance, EDI, and other services	18,844	15,335	13,527
Total cost of revenue .....	32,669	28,673	23,755
Gross profit.....	56,292	42,261	31,014
Operating expenses:			
Selling, general and administrative expenses .....	24,776	19,482	15,293
Research and development costs .....	6,903	6,139	5,062
Total operating expenses .....	31,679	25,621	20,355
Income from operations .....	24,613	16,640	10,659
Investment income.....	876	386	434
Income before provision for income taxes.....	25,489	17,026	11,093
Provision for income taxes .....	9,380	6,626	4,058
Net income.....	\$ 16,109	\$ 10,400	\$ 7,035
Net income per share, basic .....	\$ 1.25	\$ 0.84	\$ 0.57
Net income per share, diluted .....	\$ 1.22	\$ 0.80	\$ 0.55
Weighted average shares outstanding, basic.....	12,872	12,436	12,254
Weighted average shares outstanding, diluted.....	13,203	12,966	12,778

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

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS'**  
**EQUITY**  
**For the Three Years Ended March 31, 2005, 2004 and 2003**  
(In Thousands)

	Common Stock			Retained Earnings	Deferred Compensation	Total Shareholders' Equity
	Shares	Amount	APIC			
<b>Balance, March 31, 2002</b>	12,210	\$ 122	\$ 34,613	\$ 5,315	\$ –	\$ 40,050
Exercise of stock options .....	94	1	351	–	–	352
Tax benefit resulting from stock options.....	–	–	96	–	–	96
Net income.....	–	–	–	7,035	–	7,035
<b>Balance, March 31, 2003</b>	12,304	123	35,060	12,350	–	47,533
Exercise of stock options .....	346	4	1,304	–	–	1,308
Tax benefit resulting from stock options.....	–	–	1,454	–	–	1,454
Stock based compensation .....	–	–	1,853	–	(1,543)	310
Net income.....	–	–	–	10,400	–	10,400
<b>Balance, March 31, 2004</b>	12,650	127	39,671	22,750	(1,543)	61,005
Exercise of stock options .....	461	4	2,148	–	–	2,152
Tax benefit resulting from stock options.....	–	–	2,680	–	–	2,680
Stock based compensation .....	–	–	–	–	431	431
Dividends paid .....	–	–	–	(19,646)	–	(19,646)
Net income.....	–	–	–	16,109	–	16,109
<b>Balance, March 31, 2005</b>	<u>13,111</u>	<u>\$ 131</u>	<u>\$ 44,499</u>	<u>\$ 19,213</u>	<u>\$ (1,112)</u>	<u>\$ 62,731</u>

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

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands)

	Year Ended March 31,		
	2005	2004	2003
Cash flows from operating activities:			
Net income	\$ 16,109	\$ 10,400	\$7,035
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation .....	1,012	836	910
Amortization of capitalized software costs .....	1,952	1,490	1,267
Provision for bad debts .....	797	647	623
Provision for inventory obsolescence .....	160	54	40
Non-cash compensation from stock option grants .....	431	310	-
Loss on short-term investments and other .....	-	-	21
Tax benefit from exercise of stock options .....	2,680	1,454	96
Deferred income taxes, net .....	2,578	(235)	298
Change in assets and liabilities:			
Accounts receivable .....	(13,879)	(3,400)	(4,455)
Inventories .....	(395)	(112)	411
Income tax receivable .....	(15)	-	-
Other current assets .....	(184)	627	(943)
Other assets .....	(362)	(373)	-
Accounts payable .....	629	(822)	(180)
Deferred revenue .....	8,214	5,564	5,544
Accrued compensation and related benefits .....	826	248	687
Income tax payable .....	(273)	273	-
Other current liabilities .....	1,162	8	1,871
Deferred compensation .....	189	334	(42)
Net cash provided by operating activities .....	21,631	17,303	13,183
Cash flows from investing activities:			
Additions to capitalized software costs .....	(2,678)	(2,587)	(1,660)
Additions to equipment and improvements .....	(1,697)	(1,072)	(1,109)
Proceeds from the sale of short-term investments .....	-	-	234
Net cash used in investing activities .....	(4,375)	(3,659)	(2,535)
Cash flows from financing activities:			
Dividends paid	(19,646)	-	-
Proceeds from the exercise of stock options .....	2,152	1,308	352
Net cash (used in) provided by financing activities .....	(17,494)	1,308	352
Net (decrease) increase in cash and cash equivalents .....	(238)	14,952	11,000
Cash and cash equivalents, beginning of year .....	51,395	36,443	25,443
Cash and cash equivalents, end of year .....	\$ 51,157	\$51,395	\$36,443

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

**Supplemental Information.** During fiscal 2005, 2004 and 2003 the Company made income tax payments of \$4,541, \$4,716, and \$4,280, respectively.

**QUALITY SYSTEMS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005 and 2004**

(dollars in thousands, except per share amounts)

**1. Description of Business**

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 proprietary healthcare information systems that automate medical and dental group practices, community health centers, physician hospital organizations, management service organizations, and dental schools. The Company's software systems include general patient information, appointment scheduling, billing, insurance claims submission and processing, managed care plan implementation and referral management, treatment outcome studies, treatment planning, drug formularies, electronic patient records, dental charting and letter generation. In addition to providing fully integrated solutions, the Company offers its clients comprehensive hardware and software maintenance and support services, system training services and electronic claims submission services. The Company's principal administrative, accounting and QSI Division operations are located in Irvine, California. The principal office of the NextGen Division is located in Horsham, Pennsylvania.

On February 2, 2005, the Board of Directors declared a 2-for-1 stock split with respect to the Company's outstanding shares of common stock. The stock split record date was March 4, 2005 and the stock began trading post split on March 28, 2005. References to share and per share data contained in the consolidated financial statements and notes to the consolidated financial statements has been retroactively adjusted to reflect the stock split.

**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 intercompany accounts 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.

References to dollar amounts in this financial statement sections are in thousands, except share and per share data, unless otherwise specified. Certain prior year amounts have been reclassified to conform with fiscal year 2005 presentation.

**Revenue recognition.** The Company currently recognizes revenue pursuant to Statement of Position No. 97-2, "Software Revenue Recognition" (SOP 97-2), as amended by Statement of Position No. 98-9 "Modification of SOP 97-2, Software Revenue Recognition" (SOP 98-9). The Company generates revenue from the sale of licensing rights to its software products directly to end-users and value-added resellers (VARs). The Company also generates revenue from sales of hardware and third party software, implementation, training, software customization, Electronic Data Interchange (EDI), post-contract support (maintenance) and other services performed for customers who license its products.

A typical system contract contains multiple elements of the above items. SOP 98-9, 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 vendor specific objective evidence (VSOE). The Company limits its assessment of VSOE for each element to either the price charged when the same element is sold separately (using a rolling average of stand alone transactions) or the price established by management having the relevant authority to do so, for an element not yet sold separately. VSOE calculations are updated and reviewed at the end of each quarter.

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 to the individual elements in proportion to the elements' fair value relative 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 used. Under the residual method, the Company defers revenue related to the undelivered elements in a system sale based on VSOE of fair value of each of the undelivered elements, and allocates the remainder of the contract price net of all discounts to revenue recognized from the delivered elements. Undelivered elements of a system sale may include implementation and training services, hardware and third party software, maintenance, future purchase discounts, or other services. If VSOE of fair value of any undelivered element does not exist, all revenue is deferred until VSOE of fair value of the undelivered element is established or the element has been delivered.

The Company bills 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 is generally recognized upon shipment and transfer of title. In certain transactions where collection risk is high, the cash basis method is used to recognize revenue. Revenue from implementation and training services is recognized as the corresponding services are performed. Maintenance revenue is recognized ratably over the contractual maintenance period.

Contract accounting is applied where services include significant software modification, development or customization. In such instances, the arrangement fee is accounted for in accordance with Statement of Position No. 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" (SOP 81-1). Pursuant to SOP 81-1, the Company uses the percentage of completion method provided all of the following conditions exist:

- contract includes provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement;
- the customer can be expected to satisfy its obligations under the contract;
- the Company can be expected to perform its contractual obligations; and
- reliable estimates of progress towards completion can be made.

The Company measures completion using labor input hours. Costs of providing services, including services accounted for in accordance with SOP 81-1, are expensed as incurred.

If a situation occurs in which a contract is so short term that the financial statements would not vary materially from using the percentage-of-completion method or in which the Company is unable to make reliable estimates of progress of completion of the contract, the completed contract method is utilized.

From time to time, the Company offers future purchase discounts on its products and services as part of its sales arrangements. Pursuant to AICPA TPA 5100.51, such discounts which are incremental to the range of discounts reflected in the pricing of the other elements of the arrangement, which are incremental to the range of discounts typically given in comparable transactions, and which are significant, are treated as an additional element of the contract to be deferred. Amounts deferred related to future purchase options are not recognized until either the customer exercises the discount offer or the offer expires.

**Cash and Cash Equivalents.** Cash and cash equivalents consist of cash, money market funds and short term U.S. Treasuries with maturities of less than 90 days. The money market fund in which the Company holds a portion of its cash invests in only investment grade money market instruments from a variety of industries, and therefore bears minimal risk. The average maturity of the investments held by the money market fund is approximately two months.

**Short-Term Investments.** The Company classifies any short-term investments into one of the following categories:

- Trading – Debt securities that do not meet the “intent-to-hold” criteria and equity securities, both of which are bought and held principally for the purpose of being sold in the near term.
- Available-for-sale – Debt securities that do not meet the “intent-to-hold” criteria and which are not classified as trading securities, as well as all equity securities not otherwise classified as trading securities.
- Held to maturity – Debt securities for which the Company has the intent and the ability to hold to maturity.

Trading securities are carried on the balance sheet at fair market value and unrealized gains and losses are recorded in the statement of operations. Available-for-sale securities are carried in the balance sheet at fair market value; realized gains and losses are recorded in the statement of operations when they are earned or incurred, and unrealized gains and losses, net of tax effect, are recognized as a component of shareholders' equity. Held to maturity securities are carried in the balance sheet at cost (unless there are declines in the values of individual securities that are not due to temporary declines), and realized gains and losses are recorded in the statement of operations in the period that they are earned or incurred. Realized gains and losses from investment transactions are determined on a specific identification basis. The Company had no short term investments at March 31, 2005 or 2004.

**Accounts Receivable.** The Company provides credit terms 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 troubled accounts. General reserves are established based on our historical experience of bad debt expense and the aging of our accounts receivable balances, net of deferred revenue 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 consist of hardware for specific customer orders and spare parts, and are valued at lower of cost (first-in, first-out) or market. Management provides a reserve to reduce inventory to its net realizable value.

**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, generally by the straight-line method. Useful lives range as follows:

Computers and electronic test equipment	3-5 years
Furniture and fixtures	5-7 years
Vehicles	7 years
Leasehold improvements	lesser of lease term or estimated useful life of asset

**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 Statement of Financial Accounting Standards No. 86, “Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed” (SFAS 86). Such capitalized costs are amortized on a straight line basis over the estimated economic life of the related product, of 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.

**Goodwill and Intangible Assets.** The Company follows Statement of Financial Accounting Standards No. 142, “Goodwill and Other Intangible Assets” (SFAS 142). This statement applies to the

amortization of goodwill and other intangible assets. The Company ceased amortizing amounts related to goodwill effective April 1, 2001. The balance of goodwill is related to the NextGen Division. Under SFAS 142, management is required to perform an annual assessment of the implied fair value of goodwill and intangible assets with indefinite lives for impairment. The Company compared the fair value of the NextGen Division with the carrying amount of its assets and determined that none of the goodwill recorded was impaired as of June 30, 2004 (the date of the Company's last annual impairment test). The fair value of the NextGen Division was determined using an estimate of future cash flows for the NextGen Division over ten years and risk adjusted discount rates of between 15 and 25 percent to compute a net present value of future cash flows.

**Long Lived Assets.** The Company follows Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144). SFAS 144 establishes a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. SFAS 144 superseded Statement of Financial Accounting Standard No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" (SFAS 121), and Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" (APB 30). Management periodically reviews the carrying value of long-lived assets to determine whether or not impairment to such value has occurred and has determined that there was no impairment at March 31, 2005.

**Income Taxes.** Income taxes are provided for the tax effects of transactions reported in the financial statements and consists of taxes currently due plus deferred taxes related to differences between the basis of assets and liabilities for financial and tax reporting. The deferred income tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred income taxes also are recognized for operating losses that are available to offset future taxable income and tax credits that are available to offset future income taxes. Valuation allowances are established as a reduction of net deferred income tax assets when management determines that it is more likely than not that the deferred assets will not be realized.

**Advertising Costs.** Advertising costs are charged to operations as incurred. The Company does not have any direct-response advertising. Advertising costs, which includes trade shows and conventions, were approximately \$1,251, \$1,262 and \$874 for the years ended March 31, 2005, 2004 and 2003, respectively, and were included primarily in selling, general and administrative expenses in the consolidated statements of income

**Marketing Assistance Agreements.** The Company has entered into marketing assistance agreements with existing users of the Company's products which provide the opportunity for those users to earn commissions if and only if they host specific site visits upon our request for prospective customers which directly result in a purchase of our software by the visiting prospects. Amounts earned by existing users under this program are treated as a selling expense in the period in which commissionable software has been recognized as revenue.

**Earnings per Share.** Pursuant to Statement of Financial Accounting Standards No. 128, "Earnings Per Share" (SFAS 128), the Company provides dual presentation of "basic" and "diluted" earnings per share (EPS).

Basic EPS excludes dilution from common stock equivalents and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from common stock equivalents.

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods presented.

(In thousands except per share amounts)	Year Ended March 31,		
	2005	2004	2003
Basic net income per share:			
Net income.....	\$ 16,109	\$ 10,400	\$ 7,035
Weighted average of common shares outstanding.....	12,872	12,436	12,254
Net income share .....	<u>\$ 1.25</u>	<u>\$ 0.84</u>	<u>\$ 0.57</u>
Diluted net income per share:			
Weighted average of common shares outstanding	12,872	12,436	12,254
Weighted average of common shares equivalents:			
Weighted average options outstanding .....	331	530	524
Weighted average number of common and common equivalent shares.....	<u>13,203</u>	<u>12,966</u>	<u>12,778</u>
Net income per share .....	<u>\$ 1.22</u>	<u>\$ 0.80</u>	<u>\$ 0.55</u>

**Stock-Based Compensation.** The Company accounts for stock-based employee compensation as prescribed by Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (APB No. 25), and has adopted the disclosure provisions from the Statement of Financial Accounting Standards No. 148, “Accounting for Stock-Based Compensation-Transition and Disclosure” (SFAS 148) that supersedes Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (SFAS 123). 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 for both employee and non-employee grants. It also requires disclosure of option status on a more prominent and frequent basis. Such disclosure for the years ended March 31, 2005, 2004 and 2003 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.

The Company’s fair value calculations for options granted on February 11, 2005 were made using the Black-Scholes option pricing model with the following assumptions: expected life – approximately 57 months from the date of the grant; stock volatility – 47.7% , risk free interest rate of 3.7% and, no dividends during the expected term. Although the Company announced a one-time \$1.50 per share dividend on January 31, 2005, no commitment to any future dividends was made at the time the dividend was announced and no commitment to any future dividends exists as of the filing of the Company’s annual report. The Company had not paid a dividend to its shareholders prior to the one-time dividend announced on January 31, 2005. Therefore, management believes that using a zero dividend rate in the valuation of the stock options granted on February 11, 2005 is appropriate.

The Company’s fair value calculations for options granted in fiscal years ended 2005 and 2004 with the exception of the above grant on February 11, 2005, 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 to 57% , risk free interest rate of 3.0% ; and, no dividends during the expected term. 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)

	Year Ended March 31,		
	2005	2004	2003
Net income .....	\$ 16,109	\$ 10,400	\$ 7,035
Option compensation expense (net of taxes)	272	189	–
Proforma option compensation cost (net of taxes)	(1,483)	(414)	(322)
Proforma net income .....	<u>14,898</u>	<u>10,175</u>	<u>6,713</u>
Reported basic net income per share .....	\$ 1.25	\$ 0.84	\$ 0.57
Proforma basic net income per share .....	1.16	0.82	0.55
Reported diluted net income per share.....	1.22	0.80	0.55
Proforma diluted net income per share.....	1.13	0.78	0.53
Fair value of option awards granted.....	\$ 12,707	\$ 2,078	\$ --

Had the Company used a different methodology such as the binomial model to value options, a different valuation may have been determined which may have changed the proforma expense.

**Segment Disclosures.** The Company presents reporting information regarding operating segments in accordance with Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" (SFAS 131). Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision making group, in making decisions on how to allocate resources and assess performance.

**Use of Estimates.** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to uncollectible receivables, vendor specific objective evidence, and the percentage of completion related to certain service revenue. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

**New Accounting Pronouncements.** In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151 "Inventory Costs – an amendment of ARB No. 43, Chapter 4" (SFAS 151) to clarify the accounting for abnormal amount of idle facility expense, freight, handling costs and wasted material. This statement requires that those items be recognized as current period charges. In addition, this statement requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect the adoption of SFAS 151 to have material effect on its financial statements.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, "Share-Based Payment" (SFAS 123R) which is a revision of SFAS 123. Statement 123R supersedes APB 25 and amends Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows" (SFAS 95). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values and the pro forma disclosure alternative is no longer allowable under Statement 123R. Subsequently, in April 2005, the Securities and Exchange Commission (SEC) changed the effective date from the first interim or annual reporting period beginning after June 15, 2005 to the first annual reporting period beginning after June 15, 2005, which for the Company will be fiscal year 2007. The Company has not completed the process of evaluating the impact that will result from adopting SFAS 123R and is

therefore unable to disclose the impact that adoption will have on the Company's financial position and results of operations.

### 3. Intangible Assets – Capitalized Software Costs

As of March 31, 2005 and 2004, the Company had the following amounts related to intangible assets with definite lives:

(in thousands)	As of March 31,	
	2005	2004
Capitalized software development (3 yrs):		
Gross carry amount.....	\$ 13,287	\$ 10,610
Accumulated amortization.....	(8,953)	(7,002)
Net capitalization software development.....	\$ 4,334	\$ 3,608
Aggregate amortization expense during year ended March 31.....	\$ 1,952	\$ 1,490

Information related to net capitalized software costs is as follows:

(in thousands)	As of March 31,	
	2005	2004
Beginning of year.....	\$ 3,608	\$ 2,511
Capitalization.....	2,678	2,587
Amortization.....	(1,952)	(1,490)
End of year.....	\$ 4,334	\$ 3,608

The following table represents the remaining estimated amortization of intangible assets with determinable lives as of March 31, 2005 (in thousands):

<u>For the year ended March 31,</u>	
2006 .....	\$ 2,055
2007 .....	1,574
2008 .....	705
Total	<u>\$ 4,334</u>

### 4. Cash and Cash Equivalents

At March 31, 2005 and 2004, the Company had cash and cash equivalents of \$51,157 and \$51,395, respectively, invested in both a major national brokerage firm's institutional fund that specializes in U.S. government securities and commercial paper with high credit ratings, and short term U.S. treasury securities.

Investment income for each of the three years ended March 31 consists of the following:

(in thousands)	Year Ended		
	March 31, 2005	March 31, 2004	March 31, 2003
Investment income.....	\$876	\$386	\$434

## 5. Composition of Certain Financial Statement Captions

(in thousands)	March 31,	
	2005	2004
<b>Accounts Receivable</b>		
Accounts receivable, excluding undelivered maintenance and services .....	\$ 22,162	\$ 13,075
Undelivered maintenance and services billed in advance, included in deferred revenue.....	13,037	8,498
Reserve for bad debt.....	(1,837)	(1,293)
Accounts receivable, net.....	<u>\$ 33,362</u>	<u>\$ 20,280</u>
<b>Inventories</b> .....		
Computer systems and components, net of reserve for obsolescence of \$146 and \$207, respectively.....	\$ 891	\$ 478
Replacement parts for certain client systems, net of accumulated amortization of \$849 and \$684, respectively .....	--	221
Miscellaneous parts and supplies .....	69	26
Inventories, net.....	<u>\$ 960</u>	<u>\$ 725</u>
<b>Equipment and Improvements</b>		
Computer and electronic test equipment .....	\$ 5,788	\$ 4,568
Furniture and fixtures .....	1,950	1,509
Vehicles.....	--	8
Leasehold improvements.....	187	151
	7,925	6,236
Accumulated depreciation and amortization .....	(5,228)	(4,224)
Equipment and improvements, net .....	<u>\$ 2,697</u>	<u>\$ 2,012</u>
<b>Deferred Revenue</b>		
Maintenance .....	\$ 4,639	\$ 3,794
Implementation services.....	17,471	10,756
Undelivered software and other .....	3,367	2,713
Deferred revenue .....	<u>\$ 25,477</u>	<u>\$ 17,263</u>
<b>Accrued Compensation and Related Benefits</b>		
Bonus .....	\$ 1,998	\$ 1,435
Vacation .....	1,438	1,175
	<u>\$ 3,436</u>	<u>\$ 2,610</u>
<b>Other current liabilities</b>		
Sales tax payable .....	\$ 726	\$ 442
Commissions payable.....	625	356
Customer deposits .....	527	397
Accrued EDI expenses .....	419	467
Professional services .....	417	96
Deferred rent .....	198	352
Other accrued expenses.....	1,109	749
	<u>\$ 4,021</u>	<u>\$ 2,859</u>

## 6. Income Taxes

During the year ended March 31, 2003, the Company filed amended federal returns for the fiscal years ended March 31, 1999 through 2001 and certain state tax returns for the fiscal years ended March 31, 1998 through 2001, to take advantage of available tax credits related to its research and development activities. The tax credits reported on the aforementioned returns resulted in refund claims of \$418 for federal and \$158 for state income tax purposes. Additionally, the Company claimed research and

development credits of \$781 for the years ended March 31, 2002, 2003, and 2004 and has estimated \$400 in tax credits for the year ended March 31, 2005.

The provision for income taxes for the year ended March 31, 2004 and 2003 accounted for a portion of the aggregate tax credits accumulated through the end of each period due to the uncertainty concerning the ultimate amount of tax to be credited. As of March 31, 2004, the Company had a balance of \$505 in credits which had not been recognized. In the quarter ended March 31, 2005, the state of California completed an audit of the Company's tax returns and did not materially change credits related to research and development. Based on the results of that audit, the provision for income taxes for the year ended March 31, 2005 was offset by the recognition of the \$505 in tax credits which had not been recognized as of March 31 2004.

The provision for income taxes consists of the following components:

(in thousands)	Year Ended		
	March 31, 2005	March 31, 2004	March 31, 2003
<b>Current:</b>			
Federal taxes .....	\$ 5,365	\$ 5,551	\$ 3,211
State taxes .....	1,438	1,310	549
Total .....	<u>6,803</u>	<u>6,861</u>	<u>3,760</u>
<b>Deferred:</b>			
Federal taxes	2,040	(179)	268
State taxes .....	537	(56)	30
	<u>2,577</u>	<u>(235)</u>	<u>298</u>
Total .....	<u>\$ 9,380</u>	<u>\$ 6,626</u>	<u>\$ 4,058</u>

The provision for income taxes differs from the amount computed at the federal statutory rate as follows:

(in thousands)	Year Ended		
	March 31, 2005	March 31, 2004	March 31, 2003
Federal income tax statutory .....	35.0%	35.0%	34.0%
<b>Increase (decreases) resulting from:</b>			
State income taxes .....	4.6	4.9	5.1
Research & development tax credits .....	(4.3)	(1.0)	(1.9)
Other .....	1.5	--	(0.6)
	<u>36.8%</u>	<u>38.9%</u>	<u>36.6%</u>
Effective income tax rate .....	<u>36.8%</u>	<u>38.9%</u>	<u>36.6%</u>

The net deferred tax assets in the accompanying consolidated balance sheets consist of the following at March 31, 2005 and 2004:

(in thousands)	As of March 31,	
	2005	2004
Deferred tax assets:		
Deferred revenue and bad debt allowance.....	\$ 1,081	\$ 2,477
Inventory valuation.....	195	164
Purchased in-process research and development.....	2,038	2,348
Intangible assets.....	118	118
Accrued compensation.....	903	716
Deferred compensation.....	517	442
Other.....	102	147
Total deferred tax assets.....	<u>4,954</u>	<u>6,412</u>
Deferred tax liabilities:		
Accelerated depreciation.....	(1,791)	(927)
Capitalized software.....	(1,469)	(1,133)
State income taxes/Other.....	(189)	(269)
Total deferred tax liabilities.....	<u>(3,449)</u>	<u>(2,329)</u>
Total deferred tax assets, net.....	<u>\$ 1,505</u>	<u>\$ 4,083</u>

The deferred tax assets and liabilities have been shown net in the accompanying consolidated balance sheets based on the long-term or short-term nature of the items which give rise to the deferred amount. No valuation allowance has been made against the deferred tax assets as the Company expects to receive the full benefit of the assets recorded.

## 7. Employee Benefit Plans and Employment Agreements

The Company has a 401 (k) for the benefit of substantially all of its employees. Participating employees may defer up to the IRS limit based on the IRS Code per year. The annual contribution is determined by a formula set by the Company's Board of Directors and may include matching and/or discretionary contributions. The Retirement Plans may be amended or discontinued at the discretion of the Board of Directors. Contributions of \$162, \$161 and \$143 were made by the Company to the retirement plan for the fiscal years ended March 31, 2005, 2004 and 2003, respectively.

The Company has a deferred compensation plan (the Deferral Plan) for the benefit of officers and key employees. Participating employees may defer between five and 50% of their compensation for a Deferral Plan year. In addition, the Company may, but is not required to, make contributions into the Deferral Plan on behalf of participating employees. Each employee's deferrals together with earnings thereon are accrued as part of the long-term liabilities of the Company. Investment decisions are made by each participating employee from a family of mutual funds. To offset this liability, the Company has purchased life insurance policies on most of the participants. The Company is the owner and beneficiary of the policies and the cash values are intended to produce cash needed to help make the benefit payments to employees when they retire or otherwise leave the Company. The values of the life insurance policies and the cumulative liability for deferrals are included on the balance sheet of the Company. The net cash surrender value of the life insurance policies and an equal amount of related Company obligation for deferred compensation was \$1,202 and \$1,013 at March 31, 2005 and 2004, respectively. The values of the life insurance policies and the related Company obligation are included on the balance sheet in other assets and other liabilities, respectively. The Company made contributions of \$13, \$12 and \$12 to the Deferral Plan for each of the fiscal years ended March 31, 2005, 2004 and 2003, respectively.

The Company has a voluntary employee stock contribution plan for the benefit of all full time employees. The plan is designed to allow employees to acquire shares of the Company's common stock through automatic payroll deduction. Each eligible employee may authorize the withholding of up to

10% of his/her gross payroll each pay period to be used to purchase shares on the open market by a broker designated by the Company. In addition, the Company will match 5% of each employee's contribution and will pay all brokerage commissions and fees in connection with each purchase. The amount of the Company match is discretionary and subject to change. The plan is not intended to be an employee benefit plan under the Employee Retirement Income Security Act of 1974, and is therefore not required to comply with that act. Contributions of approximately \$6, \$3 and \$1 were made by the Company for fiscal years ended March 31, 2005, 2004 and 2003, respectively.

The Company has an Employment Agreement ("Agreement") with Mr. Louis E. Silverman dated July 20, 2000 which details the terms of his employment as its Chief Executive Officer. Mr. Silverman is eligible for a cash bonus of up to 50% of his annual base compensation based on performance goals established jointly between himself and the Board of Directors.

Mr. Silverman's employment may be terminated for any reason by himself or the Company upon 60 days written notice. Should Mr. Silverman terminate his employment due to the Company's breach of the Agreement he will be entitled to (i) a lump sum payment equal to six months base compensation; and (ii) 12 months worth of accelerated vesting of stock options granted pursuant to the agreement. Should Mr. Silverman's employment be terminated without cause or by himself for good reason, he will be entitled to (i) unpaid base compensation and vacation earned and accrued through his date of termination plus a lump sum equal to six months base compensation, (ii) any other performance bonus earned and not paid, and (iii) 12 months worth of accelerated vesting of stock options granted pursuant to the agreement. Should Mr. Silverman's employment be terminated due to a "change of control" he will be entitled to (i) unpaid base compensation and vacation earned plus a lump sum payment equal to six months base compensation; (ii) any performance bonus earned but not paid; and (iii) immediate vesting of all unvested options. A "change of control" is defined as the earliest occurrence of any of the following events: the direct or indirect sale, lease, exchange or other transfer of 35% or more of the total assets of the Company, the merger or consolidation of the Company with another company with the effect that the shareholders of the Company immediately prior to the merger hold less than 51% of the combined voting power of the then outstanding securities of the surviving company; the replacement of a majority of the Company's Directors without the approval of the Board of Directors; the purchase of 25% or more of the combined voting power of the outstanding securities of the Company with the exception of the purchase of securities by Sheldon Razin or Ahmed Hussein of shares owned by either Sheldon Razin or Ahmed Hussein. The Agreement also grants immediate vesting of all unvested options should a change of control occur whether or not Mr. Silverman's employment is terminated.

## **8. Employee Stock Option Plans**

During fiscal 1990, the Company's shareholders approved a stock option plan (the "1989 Plan") under which 2,000,000 shares of Common Stock were reserved for the issuance of options. The 1989 Plan provides that salaried officers, key employees and non-employee Directors of the Company may, at the discretion of the Board of Directors, be granted options to purchase shares of Common Stock at an exercise price not less than 85% of their fair market value on the option grant date. Upon an acquisition of the Company by merger or asset sale, each outstanding option may be subject to accelerated vesting under certain circumstances. The 1989 Plan terminated on June 30, 1999, and there are no outstanding options under this plan at March 31, 2005.

In September 1998, the Company's shareholders approved a stock option plan (the "1998 Plan") under which 2,000,000 shares of Common Stock have been reserved for the issuance of options. The 1998 Plan provides that employees, directors and consultants of the Company, at the discretion of the Board of Directors or a duly designated compensation committee, be granted options to purchase shares of Common Stock. The exercise price of each option granted shall be determined by the Board of Directors at the date of grant. Upon an acquisition of the Company by merger or asset sale, each outstanding option may be subject to accelerated vesting under certain circumstances. The 1998 Plan terminates on December 31, 2007, unless sooner terminated by the Board. At March 31, 2005, 138,150 shares were available for future grant under the 1998 Plan. As of March 31, 2005, there were 1,084,722 outstanding options related to this plan.

On February 11, 2005, the Board of Directors granted 522,450 options under the 1998 plan to selected employees and to Directors (7,000 for each Director) at an exercise price equal to the market price of the Company's Common Stock on the date of grant (\$38.68 per share). The options granted to employees vest in four annual installments beginning February 11, 2006 and expire on February 11, 2012. The options granted to Directors fully vested on May 11, 2005 and expire on February 11, 2012. No compensation expense has been recorded for these options.

On September 21, 2004, the Board of Directors granted 35,000 options under the 1998 plan to Directors (5,000 for each Director) at an exercise price equal to the market price of the Company's Common Stock on the date of the grant (\$25.50 per share). The options fully vested on March 21, 2005 and expire on September 21, 2009. No compensation expense has been recorded for these options.

On September 3, 2004, the Board of Directors granted 30,000 options under the 1998 plan to selected employees at an exercise price equal to the market price of the Company's Common Stock on the date of the grant (\$23.71 per share). The options vest in four equal annual installments beginning September 3, 2005 and expire on September 3, 2009. No compensation expense has been recorded for these options.

On June 10, 2004, the Board of Directors granted 300,000 options under the 1998 plan to selected employees at an exercise price equal to the market price of the Company's Common Stock on the date of the grant (\$23.34 per share). The options vest in four equal annual installments beginning June 10, 2005 and expire on June 10, 2009. No compensation expense has been recorded for these options.

On October 29, 2003, the Board of Directors granted 7,000 options under the 1998 plan to Emad Zikry, a then Director of the Company, at an exercise price of \$3.50 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 recorded in the quarter ended December 31, 2003 using the intrinsic value method.

On October 29, 2003, the Board of Directors granted 120,000 options under the 1998 plan to employees at an exercise price of \$7.73 per share. The options vest in four equal annual installments beginning October 29, 2004 and expire on October 29, 2008. Based on the closing share price of the Company's stock on October 29, 2003 (\$22.08 per share), this option grant will result in compensation expense of up to \$1,722 (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 ending October, 2007. During the years ended March 31, 2005 and 2004, the Company recognized compensation expense of \$431 and \$180 related to these options. During the years ended March 31, 2005, 2004 and 2003, the Company received tax benefit from the exercise of stock options of \$2,680, \$1,454 and \$96, respectively.

A summary of option transactions under the 1989 & 1998 Plans for the three years ended March 31, 2005 is as follows:

	2005		2004		2003	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding, beginning of year	661,174	\$ 5.26	896,154	4.37	990,966	\$ 4.31
Granted	887,450	32.46	127,000	7.50	--	--
Exercised	(460,278)	4.58	(346,480)	3.78	(94,812)	3.72
Canceled	(3,624)	4.05	(15,500)	4.49	--	--
Outstanding, end of year	<u>1,084,722</u>	<u>\$ 27.77</u>	<u>661,174</u>	<u>\$ 5.26</u>	<u>896,154</u>	<u>\$ 4.37</u>
Available for future grants	<u>138,150</u>		<u>1,025,600</u>		<u>1,152,600</u>	

The majority of the outstanding stock options vest ratably over a four-year period commencing from the respective option grant dates. Stock options outstanding at March 31, 2005 are summarized as follows:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 3.50 to \$ 7.73	197,272	2.44	\$ 6.68	46,550	\$ 5.46
23.34 to 25.50	365,000	4.17	23.57	35,000	25.50
\$38.68 to \$ 38.68	522,450	6.22	\$ 38.68	--	\$ --

## 9. Commitments and Contingencies

**Litigation.** The Company is a party to various legal proceedings incidental to its business, none of which are considered by management to be material.

**Rental Commitments.** The Company leases facilities and offices under irrevocable operating lease agreements expiring at various dates through March 2010. Rent expense for the years ended March 31, 2005, 2004, and 2003 was \$1,285, \$1,226 and \$1,068, respectively. Rental commitments under these agreements are as follows:

### Year Ending March 31,

2006	.....	\$1,257
2007	.....	925
2008	.....	942
2009	.....	671
2010	.....	206
		\$4,001

**Commitments & Guarantees.** Software license agreements in both our QSI and NextGen Divisions include a performance guarantee that our software products will substantially operate as described in the applicable program documentation for a period of 365 days after delivery. To date, we have not incurred any significant costs associated with these warranties and do not expect to incur significant warranty costs in the future. Therefore, no accrual has been made for potential costs associated with these warranties.

We have historically offered short-term rights of return of less than 20 days in certain of our sales arrangements. Based on our historical experience with similar types of sales transactions bearing these short-term rights of return, we have not recorded any accrual for returns in our financial statements.

Our standard sales agreements in the NextGen Division contain an indemnification provision pursuant to which we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any United States patent, any copyright or other intellectual property infringement claim by any third party with respect to our software. The QSI division arrangements occasionally utilize this type of language as well. As we have not incurred any significant costs to defend lawsuits or settle claims related to these indemnification agreements, we believe that our estimated exposure on these agreements is currently minimal. Accordingly, we have no liabilities recorded for these indemnification obligations.

## 10. Fair Value of Financial Instruments

The Company's financial instruments include cash, accounts receivable, accounts payable, deferred revenue and accrued liabilities. Management believes that the fair value of cash, accounts receivable, accounts payable, deferred revenue, and accrued liabilities approximate their carrying values due to the short-term nature of these instruments.

## 11. Operating Segment Information

The Company has prepared operating segment information in accordance with SFAS 131 "Disclosures About Segments of an Enterprise and Related Information" to report components that are evaluated regularly by its chief operating decision maker, or decision making group in deciding how to allocate resources and in assessing performance. Reportable operating segments include the NextGen Division and the QSI Division.

The accounting policies of the Company's operating segments are the same as those described in Note 2 - Summary of Significant Accounting Policies, except that 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, such as executive and accounting department personnel related expenses, are not allocated to the individual segments by management. Management evaluates performance based on stand-alone segment operating income. 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 years ended March 31, was as follows:

(in thousands)

Year Ended March 31,	QSI Division	NextGen Division	Unallocated Corp. Expenses	Consolidated
2005				
Revenue .....	\$ 15,367	\$ 73,594	\$ --	\$ 88,961
Operating income (loss).....	4,162	25,904	(5,453)	24,613
2004				
Revenue .....	16,491	54,443	--	70,934
Operating income (loss).....	4,877	15,789	(4,026)	16,640
2003				
Revenue .....	17,423	37,346	--	54,769
Operating income (loss).....	\$ 4,675	\$ 8,902	\$ (2,918)	\$ 10,659

## 12. Selected Quarterly Operating Results (unaudited)

The following table presents quarterly unaudited consolidated financial information for the eight quarters in the period ended March 31, 2005. Such information is presented on the same basis as the annual information presented in other sections of this report. In management's opinion, this information reflects all adjustments that are necessary for a fair presentation of the results for these periods.

### COMPARISON BY QUARTER \*

(in thousands)

	Quarter Ended (Unaudited)							
	6/30/03	9/30/03	12/31/03	3/31/04	6/30/04	9/30/04	12/31/04	3/31/05
Software, hardware and supplies	\$ 7,819	\$ 8,244	\$ 8,068	\$ 8,501	\$8,819	\$9,307	\$ 9,781	\$ 11,765
Implementation and training	1,655	1,782	1,791	1,665	2,265	2,300	1,889	2,402
Total system sales	9,474	10,026	9,859	10,166	11,084	11,607	11,670	14,167
Maintenance, EDI and other	6,832	7,616	8,340	8,621	9,046	9,610	10,418	11,359
Total revenue	16,306	17,642	18,199	18,787	20,130	21,217	22,088	25,526
Cost of revenue:								
Software, hardware and supplies	1,972	2,603	1,966	1,600	2,352	1,692	1,384	2,097
Implementation and training	1,253	1,129	1,427	1,388	1,392	1,579	1,575	1,754
Total cost of system sales	3,225	3,732	3,393	2,988	3,744	3,271	2,959	3,851
Cost of maintenance, EDI and other	3,385	3,760	4,130	4,060	4,357	4,666	4,556	5,265
Total cost of revenue	6,610	7,492	7,523	7,048	8,101	7,937	7,515	9,116
Gross profit	9,696	10,150	10,676	11,739	12,029	13,280	14,573	16,410
Selling, general, & administrative	4,740	4,768	4,902	5,072	4,953	5,414	6,420	7,989
Research and development	1,366	1,502	1,628	1,643	1,612	1,818	1,707	1,766
Income from operations	3,590	3,880	4,146	5,024	5,464	6,048	6,446	6,655
Investment income	100	89	95	102	120	170	263	323
Income before provision for income taxes	3,690	3,969	4,241	5,126	5,584	6,218	6,709	6,978
Provision for income taxes	1,413	1,561	1,630	2,022	2,202	2,503	2,488	2,187
Net income	\$ 2,277	\$ 2,408	\$ 2,611	\$ 3,104	\$3,382	\$3,715	\$ 4,221	\$ 4,791
Net income per share – basic *	\$ 0.18	\$ 0.20	\$ 0.21	\$ 0.25	\$ 0.27	\$ 0.29	\$ 0.33	\$ 0.37
Net income per share – diluted *	\$ 0.18	\$ 0.19	\$ 0.20	\$ 0.24	\$ 0.26	\$ 0.28	\$ 0.32	\$ 0.36
Weighted average shares outstanding – basic	12,314	12,334	12,478	12,624	12,666	12,780	12,952	13,089
Weighted average shares outstanding – diluted	12,932	12,982	13,098	13,164	13,154	13,196	13,282	13,370

\* Will not add to annual EPS due to rounding

**Schedule II**  
**ALLOWANCE FOR DOUBTFUL ACCOUNTS**  
(in thousands)

For the Year Ended	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductions	Balance at End of Period
March 31, 2005 .....	\$ 1,293	\$ 797	\$ (253)	\$ 1,837
March 31, 2004 .....	\$ 990	\$ 647	\$ (344)	\$ 1,293
March 31, 2003 .....	\$ 813	\$ 623	\$ (446)	\$ 990

**ALLOWANCE FOR INVENTORY OBSOLESCENCE**  
(in thousands)

For the Year Ended	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductions	Balance at End of Period
March 31, 2005 .....	\$ 207	\$ 160	\$ (221)	\$ 146
March 31, 2004 .....	\$ 160	\$ 54	\$ (7)	\$ 207
March 31, 2003 .....	\$ 127	\$ 40	\$ (7)	\$ 160

## **INDEX TO EXHIBITS**

- 3.1.1 Amendment to Articles of Incorporation, effective March 4, 2005.
- 3.6 Bylaws of the Company, as amended and restated.
- 10.6.1 Form of Indemnification Agreement for directors and executive officers authorized January 27, 2005.
- 10.10.1 Amended and Restated 1998 Stock Option Plan.
- 10.19 Lease Agreement between the Company and Lakeshore Towers Limited Partnership Phase IV, a California limited partnership.
- 23.1 Consent of Independent Registered Public Accounting Firm – Grant Thornton LLP.
- 31.1 Certification of Chief Executive Officer 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.
- 31.2 Certification of Chief Financial Officer 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.

**QUALITY SYSTEMS, INC.  
LIST OF SUBSIDIARIES**

1. NextGen Healthcare Information Systems, Inc, Inc., a California corporation, is a wholly-owned subsidiary of Quality Systems, Inc.

**EXHIBIT 23.1**

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We have issued reports dated June 3, 2005, accompanying the consolidated financial statements and schedule and management's assessment of the effectiveness of internal control over financial reporting included in the Annual Report of Quality Systems, Inc. on Form 10-K for the year ended March 31, 2005. We hereby consent to the incorporation by reference of said report in the Registration Statements of Quality Systems, Inc. on Forms S-8 (File No. 33-31949, effective November 6, 1989, File No. 333-63131, effective September 10, 1998 and File No. 333-67115, effective November 12, 1998).

/s/ Grant Thornton LLP

Irvine, California  
June 3, 2005

**CERTIFICATION OF CEO PURSUANT TO SECURITIES EXCHANGE ACT RULES  
13A-14 AND 15D-14 AS ADOPTED PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Louis Silverman, certify that:

1. I have reviewed this Form 10-K 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (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: June 3, 2005

By: /s/ LOUIS E. SILVERMAN  
Louis E. Silverman,  
President and Chief Executive Officer

**CERTIFICATION OF CEO PURSUANT TO SECURITIES EXCHANGE ACT RULES  
13A-14 AND 15D-14 AS ADOPTED PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Paul A. Holt, certify that:

1. I have reviewed this Form 10-K 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (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: June 3, 2005

By: /s/ PAUL HOLT  
Paul A. Holt,  
Secretary and Chief 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 annual report on Form 10-K of Quality Systems, Inc. (the “Company”) for the quarterly period ended March 31, 2004 (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: June 3, 2005**

**By: /s/ LOUIS SILVERMAN**  
\_\_\_\_\_  
**Louis Silverman**  
**Chief Executive Officer (principal executive officer)**

**Dated: June 3, 2005**

**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.