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

**FORM 10-Q**

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

**For the quarterly period ended December 31, 2004**

**OR**

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

**Commission file number 0-13801**

**QUALITY SYSTEMS, INC.**  
(Exact name of Registrant as specified in its charter)

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

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

**18191 Von Karman Avenue, Irvine California 92612**  
(Address of Principal Executive Offices)

**(Zip Code)**

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

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

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

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock as of the latest practicable date: 6,534,105 shares of Common Stock, \$0.01 par value, as of January 24, 2005.

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**PART I**

CONSOLIDATED FINANCIAL INFORMATION

**ITEM 1 - FINANCIAL STATEMENTS**

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(IN THOUSANDS, EXCEPT PER SHARE DATA)

<b>ASSETS</b>	December 31, 2004 <u>(UNAUDITED)</u>	March 31, 2004 <u>                    </u>
Current assets:		
Cash and cash equivalents.....	\$ 66,432	\$ 51,395
Accounts receivable, net.....	27,929	20,336
Inventories, net.....	1,405	725
Deferred tax assets.....	2,979	2,979
Other current assets.....	<u>1,353</u>	<u>1,437</u>
Total current assets.....	100,098	76,872
Equipment and improvements, net.....	2,406	2,012
Capitalized software costs, net.....	3,961	3,608
Deferred tax assets.....	1,104	1,104
Goodwill.....	1,840	1,840
Other.....	<u>1,616</u>	<u>1,242</u>
Total assets.....	<u>\$ 111,025</u>	<u>\$ 86,678</u>
 <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> 		
Current liabilities:		
Accounts payable.....	\$ 2,269	\$ 1,655
Deferred revenue.....	22,599	16,016
Accrued compensation and related benefits.....	2,304	2,985
Income taxes payable.....	1,806	273
Other current liabilities.....	<u>4,478</u>	<u>3,497</u>
Total current liabilities.....	33,456	24,426
Deferred revenue.....	<u>1,103</u>	<u>1,247</u>
Total liabilities.....	<u>34,559</u>	<u>25,673</u>
Commitments and contingencies.....	--	--
Shareholders' equity:		
Common stock, \$0.01 par value; authorized 20,000 shares; issued and outstanding 6,525 and 6,325 shares at December 31, 2004 and March 31, 2004, respectively.....	65	63
Additional paid-in capital.....	43,553	39,735
Retained earnings.....	34,068	22,750
Deferred compensation.....	<u>(1,220)</u>	<u>(1,543)</u>
Total shareholders' equity.....	<u>76,466</u>	<u>61,005</u>
Total liabilities and shareholders' equity.....	<u>\$ 111,025</u>	<u>\$ 86,678</u>

See accompanying condensed notes to consolidated financial statements.

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(IN THOUSANDS, EXCEPT PER SHARE DATA)  
(UNAUDITED)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	DECEMBER 31, 2004	DECEMBER 31, 2003	DECEMBER 31, 2004	DECEMBER 31, 2003
Revenues:				
Software, hardware and supplies.....	\$ 9,781	\$ 8,068	\$ 27,891	\$ 24,130
Implementation and training services.....	1,889	1,791	6,455	5,229
System sales.....	11,670	9,859	34,346	29,359
Maintenance and other services.....	10,418	8,340	29,089	22,788
Total revenue.....	<u>22,088</u>	<u>18,199</u>	<u>63,435</u>	<u>52,147</u>
Cost of revenue:				
Software, hardware and supplies.....	1,384	1,966	5,428	6,541
Implementation and training services.....	1,575	1,427	4,546	3,964
Total cost of system sales.....	<u>2,959</u>	<u>3,393</u>	<u>9,974</u>	<u>10,505</u>
Total cost of maintenance and other services.....	<u>4,556</u>	<u>4,130</u>	<u>13,580</u>	<u>11,120</u>
Total cost of revenue.....	<u>7,515</u>	<u>7,523</u>	<u>23,554</u>	<u>21,625</u>
Gross profit.....	<u>14,573</u>	<u>10,676</u>	<u>39,881</u>	<u>30,522</u>
Operating expenses:				
Selling, general and administrative.....	6,420	4,902	16,786	14,410
Research and development costs.....	1,707	1,628	5,137	4,496
Total operating expenses.....	<u>8,127</u>	<u>6,530</u>	<u>21,923</u>	<u>18,906</u>
Income from operations.....	6,446	4,146	17,958	11,616
Interest income.....	<u>263</u>	<u>95</u>	<u>553</u>	<u>284</u>
Income before provision for income taxes.....	6,709	4,241	18,511	11,900
Provision for income taxes.....	<u>2,488</u>	<u>1,630</u>	<u>7,193</u>	<u>4,604</u>
Net income.....	<u>\$ 4,221</u>	<u>\$ 2,611</u>	<u>\$ 11,318</u>	<u>\$ 7,296</u>
Net income per share:				
Basic.....	<u>\$ 0.65</u>	<u>\$ 0.42</u>	<u>\$ 1.77</u>	<u>\$ 1.18</u>
Diluted.....	<u>\$ 0.64</u>	<u>\$ 0.40</u>	<u>\$ 1.72</u>	<u>\$ 1.13</u>

See accompanying condensed notes to consolidated financial statements.

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(IN THOUSANDS)  
(UNAUDITED)

	NINE MONTHS ENDED	
	DECEMBER 31, 2004	DECEMBER 31, 2003
Cash flows from operating activities:		
Net income.....	\$ 11,318	\$ 7,296
Adjustments to reconcile net income to net cash used in operating activities:.....		
Depreciation.....	724	676
Amortization of capitalized software costs.....	1,424	1,113
Provision for bad debts.....	635	370
Non-cash compensation from issuance of options.....	323	203
Tax benefit from exercise of stock options.....	2,067	--
Changes in assets and liabilities:		
Accounts receivable.....	(8,228)	(4,354)
Inventories.....	(680)	(170)
Other current assets.....	84	678
Other assets.....	(374)	(180)
Accounts payable.....	614	(411)
Deferred revenue.....	6,439	4,600
Accrued compensation and related benefits.....	(681)	467
Income taxes payable.....	1,533	481
Other current liabilities.....	981	(94)
Net cash provided by operating activities.....	16,179	10,675
Cash flows from investing activities:		
Additions to equipment and improvements.....	(1,118)	(788)
Additions to capitalized software costs.....	(1,777)	(1,955)
Net cash used in investing activities.....	(2,895)	(2,743)
Cash flows from financing activities:		
Proceeds from the exercise of stock options.....	1,753	973
Net cash provided by financing activities.....	1,753	973
Net increase in cash and cash equivalents.....	15,037	8,905
Cash and cash equivalents at beginning of period.....	51,395	36,443
Cash and cash equivalents at end of period.....	\$ 66,432	\$ 45,348
Supplemental disclosures of cash flow information:		
Cash paid during the period for income taxes, net of refunds.	\$ 3,741	\$ 4,254

See accompanying condensed notes to consolidated financial statements.

**QUALITY SYSTEMS, INC.**  
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(UNAUDITED)

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements as of December 31, 2004 and for the three and nine months ended December 31, 2004 and 2003, have been prepared in accordance with the requirements of Form 10-Q and Article 10 of Regulation S-X, and therefore do not include all information and footnotes which would be presented were such financial statements prepared in accordance with accounting principles generally accepted in the United States. These financial statements should be read in conjunction with the audited financial statements presented in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2004. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the results of operations and cash flows for the periods presented. The results of operations for such interim periods are not necessarily indicative of results of operations to be expected for the full year.

References to dollar amounts in this financial statement section 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.

**2. Summary of Significant Accounting Policies**

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

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

**Accounts receivable.** The Company provides credit terms typically ranging from thirty days to less than twelve months for most system and maintenance contract sales and generally does not require collateral. The Company performs 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 the Company's historical experience of bad debt expense and the aging of the Company's accounts receivable balances net of deferred revenues and specifically reserved accounts. Accounts are written off as uncollectible only after the Company has expended extensive collection efforts.

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

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

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

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

**Stock-based compensation.** The Company accounts for stock-based employee compensation using the intrinsic value method as prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 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 supercedes 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 to employee grants. It also requires disclosure of option status on a more prominent and frequent basis. Such disclosure for the three and nine months ended December 31, 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 of Director 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 in the three and nine months ended December 31, 2004 and 2003 were made using the Black-Scholes option pricing model with the following assumptions: expected life - four years; stock volatility - 50%, risk free interest rate of 3.0%; and, no dividends during the expected term. 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 (unaudited):

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	DECEMBER 31,		DECEMBER 31,	
	2004	2003	2004	2003
Net income, as reported.....	\$ 4,221	\$ 2,611	\$ 11,318	\$ 7,296
Deduct: Stock-based employee compensation expense determined under the fair value based method, net of related tax effects.....	279	64	514	166
Pro forma net income.....	<u>\$ 3,942</u>	<u>\$ 2,547</u>	<u>\$ 10,804</u>	<u>\$ 7,130</u>
Net income per share:				
Basic, as reported.....	<u>\$ 0.65</u>	<u>\$ 0.42</u>	<u>\$ 1.77</u>	<u>\$ 1.18</u>
Basic, pro forma.....	<u>\$ 0.61</u>	<u>\$ 0.41</u>	<u>\$ 1.69</u>	<u>\$ 1.16</u>
Diluted, as reported.....	<u>\$ 0.64</u>	<u>\$ 0.40</u>	<u>\$ 1.72</u>	<u>\$ 1.13</u>
Diluted, pro forma.....	<u>\$ 0.59</u>	<u>\$ 0.39</u>	<u>\$ 1.65</u>	<u>\$ 1.10</u>

On October 29, 2003, the Board of Directors granted 60,000 options to selected employees at an exercise price of \$15.46 per share. The options vest in four equal annual installments beginning October 29, 2004 and expire on October 29, 2008. Based on the closing share price of the Company's stock on October 29, 2003 (\$44.16 per share), these option grants 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 four year vest period. During the nine month periods ended December 31, 2004 and 2003, the Company recognized compensation expense of \$323 and \$203, respectively, related to these options.

On June 10, 2004, the Board of Directors granted 150,000 options to selected employees at an exercise price equal to the market price of the Company's common stock on the date of

the grant (\$46.67 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 September 3, 2004, the Board of Directors granted 15,000 options to selected employees at an exercise price equal to the market price of the Company's common stock on the date of the grant (\$47.42 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 September 21, 2004, the Board of Directors granted 17,500 options to Directors (2,500 for each Director) at an exercise price equal to the market price of the Company's common stock on the date of the grant (\$51.00 per share). The options fully vest on March 21, 2005 and expire on September 21, 2009. No compensation expense has been recorded for these options.

### 3. Recent 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 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. The revised standard is effective for public entities in the first interim or annual reporting period beginning after June 15, 2005, which for the Company will be the second quarter of fiscal 2006 beginning July 1, 2005. The adoption of SFAS 123R will result in additional pre-tax compensation expense in fiscal 2006 and beyond for remaining unvested stock options and any future stock option grants.

### 4. Composition of Certain Financial Statement Captions

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

	DECEMBER 31, 2004 <u>(Unaudited)</u>	MARCH 31, 2004 <u></u>
Accounts receivable, excluding undelivered maintenance and services.....	\$ 14,455	\$ 13,131
Undelivered maintenance and services billed in advance, included in deferred revenue.....	<u>15,149</u>	<u>8,498</u>
Accounts receivable, gross.....	29,604	21,629
Reserve for bad debts .....	<u>(1,675)</u>	<u>(1,293)</u>
Accounts receivable, net.....	<u>\$ 27,929</u>	<u>\$ 20,336</u>

Inventories are summarized as follows:

	DECEMBER 31, 2004	MARCH 31, 2004
	(Unaudited)	
Computer systems and components, net of reserve for obsolescence of \$284 and \$207, respectively.....	\$ 1,192	\$ 478
Replacement parts for certain client systems, net of accumulated amortization of \$693 and \$684, respectively	157	221
Miscellaneous parts and supplies.....	56	26
	<u>\$ 1,405</u>	<u>\$ 725</u>

Other current liabilities are summarized as follows:

	DECEMBER 31, 2004	MARCH 31, 2004
	(Unaudited)	
Deferred compensation.....	\$ 1,075	\$ 1,013
Sales tax payable.....	534	442
Accrued EDI expenses.....	421	467
Deferred rent.....	218	352
Customer deposits.....	203	397
Other accrued expenses.....	2,027	826
	<u>\$ 4,478</u>	<u>\$ 3,497</u>

Short and long-term deferred revenue are summarized as follows:

	DECEMBER 31, 2004	MARCH 31, 2004
	(Unaudited)	
Maintenance.....	\$ 5,442	\$ 3,794
Implementation services.....	16,298	10,756
Undelivered software and other.....	1,962	2,713
	<u>\$ 23,702</u>	<u>\$ 17,263</u>

#### 5. Intangible Assets - Goodwill

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), the Company does not amortize goodwill as the goodwill has been determined to have indefinite useful life. The balance of goodwill is related to the Company's NextGen Healthcare Information Systems Division (NextGen or Division), which was acquired by virtue of two acquisitions completed in May of 1996 and 1997, respectively. In accordance with SFAS 142, the Company has compared the fair value of the NextGen Division with the carrying amount of assets associated with the Division and determined that none of the goodwill recorded as of June 30, 2004 (the annual assessment date) was impaired. The fair value of NextGen 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.

#### 6. Intangible Assets - Capitalized Software Development Costs

The Company had the following amounts related to capitalized software development:

	DECEMBER 31, 2004	MARCH 31, 2004
	(Unaudited)	
Gross carrying amount.....	\$ 12,387	\$ 10,610
Accumulated amortization.....	(8,426)	(7,002)
Capitalized software costs, net.....	<u>\$ 3,961</u>	<u>\$ 3,608</u>
Aggregate amortization expense during the nine month and twelve month periods ended, respectively.....	<u>\$ 1,424</u>	<u>\$ 1,490</u>

Activity related to net capitalized software costs for the nine month period ended December 31, 2004 is as follows:

Beginning of period.....	\$ 3,608
Capitalized costs.....	1,777
Amortization expense.....	(1,424)
End of the period.....	<u>\$ 3,961</u>

The following table represents the remaining estimated amortization of intangible assets with determinable lives as of December 31, 2004:

For the year ended March 31,	
2005.....	\$ 330
2006.....	1,320
2007.....	1,320
2008.....	991
Total.....	<u>\$ 3,961</u>

## 7. Income Taxes

The provision for income taxes for the nine month periods ended December 31, 2004 and 2003 differ from the expected combined statutory rates primarily due to the estimated impact of varying state income tax rates, as well as research and development tax credits. As of December 31, 2004, the Company has available a balance of approximately \$575 of research and development credits which may be recognized as a whole or in part, once the amount of the credit has been cleared by the tax authorities, or once the statute of limitations related to the corresponding tax return has expired. The unrecognized research and development credits account for approximately 50% of the aggregate tax credits accumulated from April 1, 2001 through December 31, 2004. During the quarter ended December 31, 2004, the provision for income taxes was reduced by \$231 for research and development tax credits from prior periods which had not been recognized previously, including \$49 related to an adjustment of the estimated credit from the prior fiscal year and \$182 from prior year credits which had expired statute of limitations.

## 8. Net Income Per Share

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

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	DECEMBER 31,		DECEMBER 31,	
	2004	2003	2004	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Net income.....	\$ 4,221	\$ 2,611	\$ 11,318	\$ 7,296
Basic net income per common share:				
Weighted average of common				
shares outstanding.....	6,476	6,237	6,400	6,162
Basic net income per common share	<u>\$ 0.65</u>	<u>\$ 0.42</u>	<u>\$ 1.77</u>	<u>\$ 1.18</u>
Net income.....	\$ 4,221	\$ 2,611	\$ 11,318	\$ 7,296
Diluted net income per common				
Share:				
Weighted average of common				
shares outstanding.....	6,476	6,237	6,400	6,162
Effect of potentially				
dilutive securities (options) ..	165	312	167	314
Weighted average of common				
shares outstanding-diluted.....	6,641	6,549	6,567	6,476
Diluted net income per common				
share.....	<u>\$ 0.64</u>	<u>\$ 0.40</u>	<u>\$ 1.72</u>	<u>\$ 1.13</u>

## 9. Operating Segment Information

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

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

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

Operating segment data for the three and nine month periods ended December 31, 2004 and 2003 is as follows (unaudited):

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2004	2003	2004	2003
Revenue:				
QSI Division.....	\$ 3,742	\$ 4,198	\$ 11,678	\$ 12,452
NextGen Division.....	18,346	14,001	51,757	39,695
Consolidated revenue.....	<u>\$ 22,088</u>	<u>\$ 18,199</u>	<u>\$ 63,435</u>	<u>\$ 52,147</u>
Operating income(loss):				
QSI Division.....	\$ 1,037	\$ 1,351	\$ 3,436	\$ 3,701
NextGen Division.....	6,727	3,789	17,986	10,995
Unallocated corporate expenses	(1,318)	(994)	(3,464)	(3,080)
Consolidated operating income...	<u>\$ 6,446</u>	<u>\$ 4,146</u>	<u>\$ 17,958</u>	<u>\$ 11,616</u>

## 10. Concentration of Credit Risk

The Company had cash deposits at U.S. banks and financial institutions which exceeded federally insured limits at December 31, 2004. The Company is exposed to credit loss for amounts in excess of insured limits in the event of non-performance by the institutions; however, the Company does not anticipate non-performance by these institutions.

## 11. Commitments and Guarantees

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.

From time to time, we offer future purchase discounts on our products and services as part of our sales arrangements. 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.

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.

## **12. Subsequent Events**

On January 31, 2005, the Board of Directors declared a one-time cash dividend of \$3.00 per share payable on its outstanding shares of common stock. The cash dividend record date is February 24, 2005 and is expected to be distributed to shareholders on or about March 16, 2005.

On February 2, 2005, the Board of Directors declared a 2-for-1 stock split with respect to its outstanding shares of common stock. The stock split record date is March 4, 2005. The share and per share data presented and disclosed on the December 31, 2004 Consolidated Financial Statements and the Condensed Notes to the Consolidated Financial Statements are not adjusted for the stock split.

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

Except for the historical information contained herein, the matters discussed in this quarterly report 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 "Risk Factors" as set forth herein, 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 its entirety by, the Consolidated Financial Statements and related notes thereto included elsewhere in this report. Historical results of operations, percentage profit 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 and research and development tax credits are among the most critical accounting policies that impact our consolidated financial statements. We believe that our significant accounting policies, as described in Note 2 of our Condensed Notes to 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.** We currently recognize revenue pursuant to SOP 97-2, as amended by SOP 98-9. We generate revenue from the sale of licensing rights to use our software products sold directly to end-users and value-added resellers (VARs). We also generate revenue from sales of hardware and third party software, and implementation, training, software customization, EDI, post-contract support ("maintenance") and other services performed for customers who license our products.

A typical system contract contains multiple elements of the above items. SOP 97-2, as amended, requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on 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 (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.

We bill for the entire contract amount upon contract execution. Amounts billed in excess of the amounts contractually due are recorded in accounts receivable as advance billings. Amounts are contractually due when services are performed or in accordance with contractually specified payment dates.

Provided the fees are fixed and determinable and collection is considered probable, revenue from licensing rights and sales of hardware and third party software is generally recognized upon shipment and transfer of title. 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.

We measure 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 we are unable to make reliable estimates of progress of completion of the contract, the completed contract method is utilized.

From time to time, we offer future purchase discounts on our products and services as part of our sales arrangements. Pursuant to AICPA TPA 5100.51, 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.

**Valuation Allowances.** We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We perform 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 December 31, 2004 and 2003, respectively. We adopted SFAS 142 effective April 1, 2001. The statement applies to the amortization of goodwill and other intangible assets. We ceased amortizing amounts related to goodwill beginning April 1, 2001 as we determined that it had an indefinite life. 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.

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.

**Research and Development Tax Credits.** During the year ended March 31, 2003, we filed amended federal and certain 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, we claimed research and development credits on our tax returns for the years ended March 31, 2004, 2003 and 2002 and have estimated tax credits for fiscal year 2005. Management has recorded a cumulative tax benefit which accounts for approximately 50% of the aggregate tax credits accumulated from April 1, 2001 through December 31, 2004 due to the uncertainty concerning the ultimate amount to be credited. Management's election to not recognize all of the tax credits claimed represents a significant estimate which affects the effective income tax rate for the Company in the nine month periods ending December 31, 2004 and 2003. Research and development credits taken by the Company involve certain assumptions and judgments regarding qualification of expenses under the relevant tax codes. While we have received all of federal refunds claimed on the amended returns for fiscal years ended March 31, 1998 through 2001, none of the credits have been audited by the Internal Revenue Service. Credits claimed for state income tax purposes are in the process of being audited. However, no final conclusions have been received by us as of January 25, 2005.

#### **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 what is today 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 the "corporate office" which includes a variety of accounting and other administrative functions. Additionally, there are a small number of clients who are simultaneously utilizing software from each of 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.

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

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 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>). 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 83% of our revenue for the third quarter of fiscal 2005 compared to 77% in the third quarter of fiscal 2004. The QSI Division accounted for 17% and 23% of revenue in the third quarter of fiscal 2005 and 2004, respectively. The NextGen Division's year over year revenue grew at 31% and 40% in the third quarter of fiscal 2005 and 2004, respectively, while the QSI Division's year over year revenue declined by 11% and 5% in the third quarter of fiscal 2005 and 2004 respectively.

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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.

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.

### **Risk Factors**

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 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 or product enhancements;
- 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 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, SAB 101 and 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.

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, 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 December 31, 2004. As such, 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;
- 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.

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 reduce demand for our services. Accordingly, we believe that it is critical that these facilities and related infrastructures not only be secure, but also be viewed by our customers as free from potential breach. Maintaining such standards, protecting against breaches and curing security flaws, may require us to expend significant capital. 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 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 its 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 do not maintain key man life insurance on any 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.*** 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).

While the privacy and transaction and code set standards are currently in effect, the security regulation will become effective by 2005. 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 could 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. We are in the process of evaluating and documenting our controls pursuant to Section 404 of the Sarbanes-Oxley Act. In the course of our evaluation and documentation of our internal controls, 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. Our evaluation of our internal controls over financial reporting is still in process.

**Our earnings will be affected beginning quarter ended September 30, 2005 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 quarter ended September 30, 2005 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 declared a one-time cash dividend in January 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.

## **Results of Operations**

### **Overview of results**

- We have experienced significant growth in our total revenue as a result of revenue growth in our NextGen Division. Revenue grew 21.7% on a consolidated basis in the nine months ended December 31, 2004 versus 2003 and 31.4% in the nine months ended December 31, 2003 versus 2002.
- Consolidated income from operations grew 54.6% in the nine months ended December 31, 2004 versus 2003 and 44.5% in the nine months ended December 31, 2003 versus 2002. 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 for electronic medical records and other technology.

### **NextGen Division**

- Our NextGen Division has experienced significant growth in revenue and operating income. Divisional revenue grew 30.4% in the nine months ended December 31, 2004 versus 2003 and 49.9% in the nine months ended December 31, 2003 versus 2002 while divisional operating income (excluding unallocated corporate expenses) grew 63.6% in the nine months end December 31, 2004 and 69.9% in the nine months ended December 31, 2003.
- During the nine months ended December 31, 2004, we added staffing resources to departments including sales, support, implementation, and software development and intend to continue to do so during the remainder of fiscal year 2005.
- 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 6.2% in the nine months ended December 31, 2004 versus 2003 and 4.5% in the nine months ended December 31, 2003 versus 2002. The Division experienced a 7.2% decrease in operating income (excluding unallocated corporate expenses) in the nine months ended December 31, 2004 versus 2003.
- 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 revenues represented by each item in our Consolidated Statements of Income.

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	DECEMBER 31,		December 31,	
	2004	2003	2004	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues:				
Software, hardware and supplies....	44.3%	44.3%	44.0%	46.3%
Implementation and training services	8.5	9.9	10.1	10.0
System sales.....	52.8	54.2	54.1	56.3
Maintenance and other services.....	47.2	45.8	45.9	43.7
Total revenue.....	100.0	100.0	100.0	100.0
Cost of revenue:				
Software, hardware and supplies....	6.3	10.8	8.6	12.6
Implementation and training services	7.1	7.8	7.1	7.6
Total cost of system sales.....	13.4	18.6	15.7	20.2
Total cost of maintenance and other services.....	20.6	22.7	21.4	21.3
Total cost of revenue.....	34.0	41.3	37.1	41.5
Gross profit.....	66.0	58.7	62.9	58.5
Selling, general and administrative	29.1	26.9	26.5	27.6
Research and development.....	7.7	9.0	8.1	8.6
Income from operations.....	29.2	22.8	28.3	22.3
Interest income.....	1.2	0.5	0.9	0.5
Income before provision for income taxes.....	30.4	23.3	29.2	22.8
Provision for income taxes.....	11.3	9.0	11.4	8.8
Net income.....	19.1%	14.3%	17.8%	14.0%

**For the Three-Month Periods December 31, 2004 versus 2003**

**Net Income.** The Company's net income for the three months ended December 31, 2004 was \$4.2 million or \$0.65 per share on a basic and \$0.64 per share on a fully diluted basis. In comparison, we earned \$2.6 million or \$0.42 per share on a basic and \$0.40 per share on a fully diluted basis for the three months ended December 31, 2003. The increase in net income for the three months ended December 31, 2004 was achieved primarily through the following:

- a 21.4% increase in consolidated revenue; and
- an increase in the consolidated gross profit margin percentage which increased to 66.0% in the quarter ended December 31, 2004 versus 58.7% in the same period last year.

**Revenue.** Revenue for the three months ended December 31, 2004 increased 21.4% to \$22.1 million from \$18.2 million for the three months ended December 31, 2003. NextGen Division revenue increased 31.0% from approximately \$14.0 million to approximately \$18.3 million in the period, while QSI Division revenue declined by 10.9% during the period from approximately \$4.2 million to approximately \$3.7 million.

We report revenue in two major categories, "Systems sales" and "Maintenance and other services". Revenue in the systems sales category includes software license fees, hardware, third party software, supplies and implementation and training services related to the purchase of the Company's software systems. The majority of the revenue in the system sales category is related to the sale of software. Revenue in the maintenance and other category includes maintenance, EDI, and other revenue. Maintenance and EDI revenue are the principal sources of revenue in this category.

**System Sales.** Company-wide sales of systems for the three months ended December 31, 2004 increased 18.4% to \$11.7 million from \$9.9 million in the prior year quarter.

Our increase in revenue from sales of systems was principally the result of a 21.1% increase in category revenue at our NextGen Division whose sales in this category grew from \$9.3 million during the quarter ended December 31, 2003 to \$11.3 million during the quarter ended December 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 offset by declines in sales of related hardware, third party software, and supplies.

Systems sales revenue in the QSI Division declined 28.3% to approximately \$0.4 million in the quarter ended December 31, 2004 from \$0.5 million in the quarter ended December 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
Three months ended December 31, 2004				
QSI Division.....	\$ 167	\$ 132	\$ 89	\$ 388
NextGen Division.....	8,660	822	1,800	11,282
Consolidated.....	<u>\$ 8,827</u>	<u>\$ 954</u>	<u>\$ 1,889</u>	<u>\$ 11,670</u>
Three months ended December 31, 2003				
QSI Division.....	\$ 246	\$ 215	\$ 80	\$ 541
NextGen Division.....	5,801	1,806	1,711	9,318
Consolidated.....	<u>\$ 6,047</u>	<u>\$ 2,021</u>	<u>\$ 1,791</u>	<u>\$ 9,859</u>

NextGen Division software revenue increased 49.3% between the three months ended December 31, 2003 and the three months ended December 31, 2004. The Division's software revenue accounted for 76.8% of divisional system sales revenue during the three months ended December 31, 2004, an increase from 62.3% 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 three months ended December 31, 2004, 7.3% of NextGen's system sales revenue was represented by hardware and third party software compared to 19.4% 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 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 quarter 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 5.2% in the three months ended December 31, 2004 compared to the three months ended December 31, 2003. Implementation and training revenue at the NextGen Division decreased its share of divisional system sales revenue to 16.0% in the three months ended December 31, 2004 from 18.4% in the three months ended December 31, 2003. The slight 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 quarter 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 three months ended December 31, 2004 versus 2003 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 2004 and 2003, 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 28.3% in the three months ended December 31, 2004 compared to the three months ended December 31, 2003. 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. The slight year over year increase in implementation services was more than offset by decreases in software and hardware/third party software sales.

**Maintenance and Other Services.** For the three months ended December 31, 2004, company-wide revenue from maintenance and other services grew 24.9% to \$10.4 million from \$8.3 million in the same period in the prior year. The increase in this category resulted from an increase in maintenance and EDI revenue from the NextGen Division's client base. Total NextGen Division maintenance revenue for the three months ended December 31, 2004 grew 53.5% to \$4.9 million from \$3.2 million in the same year ago period, while EDI revenue grew 74.4% to \$1.5 million compared to \$0.9 million during the same period. QSI Division maintenance revenue declined 1.0% from \$1.9 million in the same period during the prior year to \$1.8 million while QSI divisional EDI revenue declined by approximately 7.0% from \$1.3 million to \$1.2 million between the same periods.

The following table details revenue included in the maintenance and other category for the three month periods ended December 31, 2004 and 2003:

	Maintenance	EDI	Other	Total
Three months ended December 31, 2004				
QSI Division.....	\$ 1,845	\$ 1,232	\$ 277	\$ 3,354
NextGen Division.....	4,852	1,505	707	7,064
Consolidated.....	\$ 6,697	\$ 2,737	\$ 984	\$ 10,418
Three months ended December 31, 2003				
QSI Division.....	\$ 1,863	\$ 1,325	\$ 469	\$ 3,657
NextGen Division.....	3,160	863	660	4,683
Consolidated.....	\$ 5,023	\$ 2,188	\$ 1,129	\$ 8,340

The growth in maintenance revenue for the NextGen Division has come from new customers that have been added each quarter as well as our relative success in retaining existing maintenance customers. NextGen's EDI revenue growth has come from new customers and from further penetration of the Division's existing customer base. NextGen's growth in maintenance and EDI revenue was at or above our expectations for the period. We intend to continue to promote maintenance and EDI services to both new and existing customers.

The following table provides the number of billing sites which were receiving maintenance services as of the last business day of the quarters ended December 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
December 31, 2003.....	409	267	240	334	649	601
Billing sites added.....	99	148	10	4	109	152
Billing sites removed.....	(4)	(42)	(25)	(37)	(29)	(79)
December 31, 2004.....	<u>504</u>	<u>373</u>	<u>225</u>	<u>301</u>	<u>729</u>	<u>674</u>

**Cost of Revenue.** Cost of revenue for the three months ended December 31, 2004 was unchanged at \$7.5 million in the quarter ended December 31, 2004 and 2003, while the cost of revenue as a percentage of net revenue decreased to 34.0% from 41.3%.

The decrease in our consolidated cost of revenue as a percentage of revenue between the three months ended December 31, 2004 and the three months ended December 31, 2003 is attributable to three main factors:

- a reduction in the level of hardware and third party software expense as a percentage of revenue in the NextGen Division;
- an increase in the NextGen Division's share of consolidated revenue from 76.9% in the quarter ended December 31, 2003 to 83.1% in the quarter ended December 31, 2004. The NextGen Division's gross profit has been and continues to be higher than the QSI Division; and
- a decrease in the cost of revenue as a percentage of revenue at each of our Divisions causing a corresponding increase in gross profit margins of both of our Divisions.

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	Other	Total Cost of Revenue	Gross Profit
Three months ended December 31, 2004					
QSI Division.....	5.0%	17.8%	25.7%	48.5%	51.5%
NextGen Division..	4.5	12.3	14.3	31.1	68.9
Consolidated.....	<u>4.6%</u>	<u>13.2%</u>	<u>16.2%</u>	<u>34.0%</u>	<u>66.0%</u>
Three months ended December 31, 2003					
QSI Division.....	7.0%	16.0%	26.1%	49.1%	50.9%
NextGen Division..	9.9	16.1	13.0	39.0	61.0
Consolidated.....	<u>9.3%</u>	<u>16.0%</u>	<u>16.0%</u>	<u>41.3%</u>	<u>58.7%</u>

During the three months ended December 31, 2004, hardware and third party software constituted a smaller portion of consolidated revenue compared to the same year ago period driven principally by the composition of NextGen Division revenue. We have noted that the last several quarter's results have included a relatively lower amount of hardware and third party software compared with prior periods. However, this reduction 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 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 13.2% of consolidated revenue compared to 16.0% during the three months ended December 31, 2003. The absolute level of consolidated payroll and benefit expenses grew from \$2.4 million in the three months ended December 31, 2003 to \$2.9 million in the three months ended December 31, 2004, an increase of 21% or \$0.5 million. This increase was due primarily to additions to related headcount, payroll and benefits expense associated

with delivering products and services in the NextGen Division where such expenses increased to \$2.2 million in three months ended December 31, 2004 from \$1.7 million in the three months ended December 31, 2003. Payroll and benefits expense associated with delivering products and services in the QSI Division during the three months ended December 31, 2004 and 2003 remained relatively unchanged at approximately \$0.7 million.

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.

Other, which consists of outside service costs, amortization of software development costs and other costs remained fairly consistent on a consolidated basis between periods.

Should the NextGen Division continue to represent an increasing share of our revenue and should the NextGen Division continue to carry higher gross profit 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, gross profit for the Company and our two operating Divisions increased for the three month period ended December 31, 2004 versus the prior year period.

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

	Three months ended December 31,		Three months ended December 31,	
	2004	%	2003	%
<b>QSI Division</b>				
Revenue.....	\$ 3,742	100.0%	\$ 4,198	100.0%
Cost of revenue..	1,815	48.5	2,060	49.1
Gross profit.....	<u>\$ 1,927</u>	<u>51.5</u>	<u>\$ 2,138</u>	<u>50.9</u>
<b>NextGen Division</b>				
Revenue.....	\$ 18,346	100.0	\$ 14,001	100.0
Cost of revenue..	5,700	31.1	5,463	39.0
Gross profit.....	<u>\$ 12,646</u>	<u>68.9</u>	<u>\$ 8,538</u>	<u>61.0</u>
<b>Consolidated</b>				
Revenue.....	\$ 22,088	100.0	\$ 18,199	100.0
Cost of revenue..	7,515	34.0	7,523	41.3
Gross profit.....	<u>\$ 14,573</u>	<u>66.0%</u>	<u>\$ 10,676</u>	<u>58.7%</u>

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the three months ended December 31, 2004 increased 31% to \$6.4 million as compared to \$4.9 million for the three months ended December 31, 2003. The increase in the amount of such expenses resulted primarily from a \$0.6 million increase in selling related compensation expenses in the NextGen Division, a net \$0.6 million increase in other selling, general and administrative expenses in the NextGen Division and a \$0.3 million increase in corporate related expenses. Selling, general and administrative expenses as a percentage of revenue increased from 26.9% in the three months ended December 31, 2003 to 29.1% in the three months ended December 31, 2004 due to the fact that the rate of growth in selling, general and administrative expense was more than the aggregate revenue growth rate for the Company.

We anticipate increased expenditures for trade shows, advertising and the employment of additional sales representatives primarily at the NextGen Division. We also anticipate future increases in corporate expenditures being made in the areas of staffing and professional services in areas including but not limited to the Sarbanes-Oxley Act and related compliance issues. 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 three months ended December 31, 2004 and 2003 were \$1.7 million and \$1.6 million, respectively. The increases in research and development expenses were primarily due to increased investment in the NextGen product line. Research and development costs as a percentage of net revenue decreased to 7.7% from 9.0% during the months ended December 31, 2004. Research and development expenses are expected to continue at or above current levels.

**Interest Income.** Interest income for the three months ended December 31, 2004 increased 176.8% to approximately \$0.02 million compared with \$0.01 million in the three months ended December 31, 2003. Interest income in the three months ended December 31, 2004 increased primarily due to the effect of an increase in short term interest rates versus the prior year quarter as well as comparatively higher amounts of funds available for investment during the three months ended December 31, 2004.

Our investment policy is determined by our Board of Directors. We currently maintain our cash in very liquid short term assets including money market funds and short term U.S. Treasuries with maturities of less than 90 days. Our Board of Directors may consider alternate uses for our cash including, but not limited to payment of a special dividend, initiation of a regular dividend, initiation of a stock buy-back program, an expansion of our investment policy to include investments with maturities of greater than 90 days, or other items. Additionally, it is possible that we will utilize some or all of our cash to fund an acquisition or other similar business activity. Any or all of these programs could significantly impact our investment income in future periods.

**Provision for Income Taxes.** The provision for income taxes for the three months ended December 31, 2004 was approximately \$2.5 million as compared to approximately \$1.6 million for the year ago period. The effective tax rates for the three months ended December 31, 2004 and 2003 were 37.1% and 38.4%, respectively. The provision for income taxes for the three months ended December 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 the recognition of research and development tax credits. The effective rate for the three months ended December 31, 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 federal income tax rates. During the quarter ended December 31, 2004, the provision for income taxes was reduced by \$0.2 million for research and development tax credits from prior periods which had not been recognized previously. These tax credits are principally from credits in which the statute of limitations had expired.

#### **For the Nine-Month Periods December 31, 2004 versus 2003**

**Net Income.** The Company's net income for the nine months ended December 31, 2004 was \$11.3 million or \$1.77 per share on a basic and \$1.72 per share on a fully diluted basis. In comparison, we earned \$7.3 million or \$1.18 per share on a basic and \$1.13 per share on a fully diluted basis in the nine months ended December 31, 2003. The increase in net income for the nine months ended December 31, 2004, was achieved primarily through the following:

- a 21.7% increase in consolidated revenue; and
- an increase in the consolidated gross profit margin percentage which increased to 62.9% in the nine months ended December 31, 2004 versus 58.5% in the same period last year.

**Revenue.** Revenue for the nine months ended December 31, 2004 increased 21.7% to \$63.4 million from \$52.1 million for the nine months ended December 31, 2003. NextGen Division revenue increased 30.4% from approximately \$39.7 million during the nine month ended December 31, 2003 to approximately \$51.8 million during the nine month ended December 31, 2004, while QSI Division revenue declined by 6.2% during the same period from approximately \$12.5 million to approximately \$11.7 million.

We report revenue in two major categories, "Systems sales" and "Maintenance and other services". Revenue in the systems sales category includes software license fees, hardware, third party software, supplies and implementation and training services related to purchase of the Company's software systems. The majority of the revenue in the system sales category is related to the sale of software. Revenue in the maintenance and other category includes maintenance, EDI, and other revenue. Maintenance and EDI revenue are the principal sources of revenue in this category.

**System Sales.** Company-wide sales of systems for the nine months ended December 31, 2004 increased 17.0% to \$34.3 million from \$29.4 million in the same prior year period.

Our increase in revenue from sales of systems was principally the result of a 18.4% increase in category revenue at our NextGen Division whose systems sales grew from \$27.7 million to \$32.8 million. 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 and training services, partially offset by declines in the sale of hardware, third party software, and supplies.

Category revenue in the QSI Division declined by 6.6% from \$1.6 million in the nine months ended December 31, 2003 to approximately \$1.5 million in the quarter ended December 31, 2004.

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

	Software	Hardware, Third Party Software and Supplies	Implementation and Training Services	Total System Sales
Nine months ended December 31, 2004				
QSI Division.....	\$ 686	\$ 576	\$ 246	\$ 1,508
NextGen Division.....	22,821	3,808	6,209	32,838
Consolidated.....	<u>\$ 23,507</u>	<u>\$ 4,384</u>	<u>\$ 6,455</u>	<u>\$ 34,346</u>
Nine months ended December 31, 2003				
QSI Division.....	\$ 553	\$ 788	\$ 274	\$ 1,615
NextGen Division.....	17,423	5,366	4,955	27,744
Consolidated.....	<u>\$ 17,976</u>	<u>\$ 6,154</u>	<u>\$ 5,229</u>	<u>\$ 29,359</u>

NextGen Division software revenue increased 31.0% between the nine months ended December 31, 2004 and the nine months ended December 31, 2003. The Division's software revenue accounted for 69.5% of divisional systems sales revenue during the nine months ending 2004, an increase from 62.8% in the nine months ended December 31, 2003. This increase was not the result of any new trend or change in emphasis on our part relative to software sales. Software license revenue 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 nine months ended December 31, 2004, 11.6% of NextGen's systems sales revenue was represented by hardware and third party software compared to 19.3% 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 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 quarter 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 25.3% from the nine months ended December 31, 2003 to the nine months ended December 31, 2004. Implementation and training revenue at the NextGen Division increased its share of category revenue from 17.9% in the nine months ended December 31, 2003 to 18.9% in the nine months ended December 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 number of implementation and training staff increased during the course of the nine months ended December 31, 2004 versus 2003 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 will depend upon the availability of qualified staff, business 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 2004 and 2003 as well as in prior years, and the apparent increasing acceptance of electronic medical records technology in the healthcare industry.

For the QSI Division, sales of systems, decreased 6.6% from the nine months ended December 31, 2003 to the nine months ended December 31, 2004. Increased software revenue in the division was offset by decreases in hardware, third party software, and implementation and training services. We do not presently foresee any material changes in the business environment for the division from that which we have experienced in recent quarters.

**Maintenance and Other.** For the nine months ended December 31, 2004, Company-wide revenue from maintenance and other services grew 27.7% to \$29.1 million from \$22.8 million during the same period last year. 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 nine months ended December 31, 2004 grew 61.7% to \$12.9 million from \$7.9 million in the period a year ago, while EDI revenue grew 86.0% to \$3.9 million compared to \$2.1 million during the same period. QSI Division maintenance revenue declined 3.2% from \$5.7 million to \$5.5 million in the same period while QSI Divisional EDI revenue declined by approximately 8.0% from \$4.0 million to \$3.7 million during such period.

The following table details revenue included in maintenance and other for the nine month periods ended December 31, 2004 and 2003:

	Maintenance	EDI	Other	Total
Nine months ended December 31, 2004				
QSI Division.....	\$ 5,523	\$ 3,687	\$ 959	\$ 10,169
NextGen Division.....	12,852	3,925	2,143	18,920
Consolidated.....	\$ 18,375	\$ 7,612	\$ 3,102	\$ 29,089
Nine months ended December 31, 2003				
QSI Division.....	\$ 5,704	\$ 4,006	\$ 1,127	\$ 10,837
NextGen Division.....	7,949	2,110	1,892	11,951
Consolidated.....	\$ 13,653	\$ 6,116	\$ 3,019	\$ 22,788

The growth in overall maintenance revenue has come from new customers that have been added each quarter, additional software purchases by existing customers as well as our relative success in retaining existing maintenance customers. NextGen EDI revenue growth has come from new customers and from further penetration of the Division's existing customer base. NextGen's growth in maintenance and EDI revenue was at or above our general expectations for the period. We intend to continue to promote maintenance and EDI services to both new and existing customers.

The following table provides the number of billing sites which were receiving maintenance services as of the last business day of the quarters ended December 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
December 31, 2003.....	409	267	240	334	649	601
Billing sites added.....	99	148	10	4	109	152
Billing sites removed.....	(4)	(42)	(25)	(37)	(29)	(79)
December 31, 2004.....	504	373	225	301	729	674

**Cost of Revenue.** The cost of revenue for the nine months ended December 31, 2004 increased 8.9% to \$23.6 million from \$21.6 million, while the cost of revenue as a percentage of net revenue decreased to 37.1% from 41.5% during the same period a year ago.

The decrease in our consolidated cost of revenue as a percentage of revenue between the nine months ended December 31, 2004 and the nine months ended December 31, 2003 is attributable to three main factors:

- a reduction in the level of third party hardware and software as a percentage of revenue in the NextGen Division;
- an increase in the NextGen Division's share of consolidated revenue from 76.1% in the nine months ended December 31, 2003 to 81.6% in December 31, 2004. The NextGen Division's gross profit percentage has been and continues to be higher than that of the QSI Division; and
- a decrease in the cost of revenue as a percentage of revenue at each of our Divisions causing a corresponding increase in gross profit margins at both of our Divisions.

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	Other	Total Cost of Revenue	Gross Profit
Nine months ended December 31, 2004					
QSI Division.....	6.9%	17.4%	25.0%	49.3%	50.7%
NextGen Division.	6.8	13.1	14.5	34.4	65.6
Consolidated.....	<u>6.8%</u>	<u>15.0%</u>	<u>15.3%</u>	<u>37.1%</u>	<u>62.9%</u>
Nine months ended December 31, 2003					
QSI Division.....	7.5%	16.7%	26.6%	50.8%	49.2%
NextGen Division.	12.2	13.8	12.5	38.5	61.5
Consolidated.....	<u>11.1%</u>	<u>14.5%</u>	<u>15.9%</u>	<u>41.5%</u>	<u>58.5%</u>

During the nine months ended December 31, 2004, the cost of hardware and third party software constituted 6.8% of consolidated revenue compared to 11.1% in the same year ago 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 periods. However this year over year reduction 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 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 15.0% of consolidated revenue compared to 14.5% in the nine months ended December 31, 2003. The absolute level of consolidated payroll and benefit expenses grew from \$7.6 million in the nine months ended December 31, 2003 to \$8.8 million in 2004, an increase of 16% or \$1.2 million. This increase was due primarily to additions to headcount, payroll and benefits expense associated with delivering products and services in the NextGen Division. These expenses increased to \$6.8 million in the nine months ended December 31, 2004 compared to \$5.5 million in the nine months ended December 31, 2003, an increase of 24%. The Division's payroll and benefits expense associated with delivering products and services as a percentage of divisional revenue in the nine months ended December 31, 2004 decreased to 13.1% compared to 13.8% in the prior year period. Headcount expense as a percentage of revenue for the nine month period ended December 31, 2004 at the QSI Division increased slightly compared to the prior year at 17.4% versus 16.7%, in the prior year period.

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.

Other, which consists of outside service costs, amortization of software development costs and other costs remained fairly consistent on a consolidated basis between periods.

Should the NextGen Division continue to represent an increasing share of our revenue and should NextGen continue to show higher gross profit percentages compared to the QSI Division, our 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 nine month period ended December 31, 2004 versus the prior year period.

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

	Nine months ended December 31,		Nine months ended December 31,	
	2004	%	2003	%
<b>QSI Division</b>				
Revenue.....	\$ 11,678	100.0%	\$ 12,452	100.0%
Cost of revenue..	5,756	49.3	6,323	50.8
Gross profit.....	\$ 5,922	50.7	\$ 6,129	49.2
<b>NextGen Division</b>				
Revenue.....	\$ 51,757	100.0	\$ 39,695	100.0
Cost of revenue..	17,798	34.4	15,302	38.5
Gross profit.....	\$ 33,959	65.6	\$ 24,393	61.5
<b>Consolidated</b>				
Revenue.....	\$ 63,435	100.0	\$ 52,147	100.0
Cost of revenue..	23,554	37.1	21,625	41.5
Gross profit.....	\$ 39,881	62.9%	\$ 30,522	58.5%

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the nine months ended December 31, 2004 increased 16.5% to \$16.8 million as compared to \$14.4 million for the nine months ended December 31, 2003. The increase in the amount of such expenses resulted primarily from increases of \$1.3 million in selling related compensation expenses at the NextGen Division, \$0.8 million in other general selling, general and administrative expenses in the NextGen Division and \$0.3 million in increased corporate related expenses. Selling, general and administrative expenses as a percentage of revenue declined from 27.6% in the nine months ended December 31, 2003 to 26.5% in the nine months ended December 31, 2004 due to revenues growing at a faster rate than selling, general, administrative expenses.

We anticipate increased expenditures for trade shows, advertising and the employment of additional sales representatives primarily at the NextGen Division. We also anticipate continued increases in corporate expenditures being made in the areas of staffing and professional services in areas including but not limited to Sarbanes-Oxley Act and related compliance issues. While we expect selling, general and administrative expenses to increase, 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 nine months ended December 31, 2004 and 2003 were \$5.1 million and \$4.5 million, respectively. The increases in research and development expenses were primarily due to increased investment in the NextGen product line. Research and development costs as a percentage of net revenue decreased to 8.1% from 8.6% due in part, to the fact that revenue growth exceeded the increase in research and development spending. Research and development expenses are expected to continue at or above current levels.

**Interest Income.** Interest income for the nine months ended December 31, 2004 increased 94.7% to approximately \$0.6 million compared with \$0.3 million in the nine months ended

December 31, 2003. Interest income in the nine months ended December 31, 2004 increased primarily due to the effect of an increase in short term interest rates versus the prior year period as well as comparatively higher amounts of funds available for investment during the nine months ended December 31, 2004.

Our investment policy is determined by our Board of Directors. We currently maintain our cash in very liquid short term assets including money market funds and short term U.S. Treasuries with maturities of less than 90 days. Our Board of Directors continues to review alternate uses for our cash including, but not limited to payment of a special dividend, initiation of a regular dividend, initiation of a stock buy back program, an expansion of our investment policy to include investments with maturities of greater than 90 days, or other items. Additionally, it is possible that we will utilize some or all of our cash to fund an acquisition or other similar business activity. Any or all of these programs could significantly impact our investment income in future periods.

**Provision for Income Taxes.** The provision for income taxes for the nine months ended December 31, 2004 was approximately \$7.2 million as compared to approximately \$4.6 million for the year ago period. The effective tax rates for the nine months ended December 31, 2004 and 2003 were 38.9% and 38.7%, respectively. The provision for income taxes for the nine months ended December 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. During the nine months ended December 31, 2004, the provision for income taxes was reduced by approximately \$0.3 million for research and development tax credits from prior periods which had not been recognized previously including \$0.2 million from credits in which the statute of limitations had expired.

**Liquidity and Capital Resources**

The following table presents selected financial statistics and information for each of the nine months ended December 31, 2004 and 2003:

	Nine months ended December 31,	
	2004	2003
Cash and cash equivalents.....	\$ 66,432	\$ 45,348
Net increase in cash and cash equivalents during the nine month period.....	\$ 15,037	\$ 8,905
Net income during the period.....	\$ 11,318	\$ 7,296
Net cash provided by operations during the period.....	\$ 16,179	\$ 10,675
Number of days of sales outstanding at start of the period.....	99	106
Number of days of sales outstanding at the end of the period.....	115	108

The Company's principal source of cash was cash provided by operations. The number of days sales outstanding at the end of the period increased by two days during the nine month period ended December 31, 2003. The number of days sales outstanding increased by 16 days during the nine months ended December 31, 2004 primarily due to an increase in the volume of services sold by the NextGen Division which had not yet been rendered resulting in an increase in both deferred revenue and accounts receivable. Provided turnover of accounts receivable, deferred revenue, and profitability remain consistent with the nine months ended December 31, 2004, we anticipate being able to continue to generate cash from operations during fiscal 2005 primarily from the net income of the Company.

Cash and cash equivalents increased by \$15.0 million between March 31, 2004 and December 31, 2004 primarily as a result of cash provided by operating activities. Cash and cash equivalents increased approximately \$8.9 million during the nine months ended December 31, 2003, also primarily as a result of cash generated by operating activities.

Net cash used in investing activities for the nine months ended December 31, 2004 and 2003 was \$2.9 and \$2.7 million respectively. Net cash used in investing activities for the

nine months ended December 31, 2004 and 2003 consisted of additions to equipment and improvements and capitalized software.

During the nine months ended December 31, 2004, we received proceeds of \$1.8 million from the exercise of stock options and recorded a reduction in income tax liability of \$2.1 million related to tax deductions received from employee stock option exercises. The benefit was recorded as additional paid in capital.

At December 31, 2004, we had cash and cash equivalents of \$66.4 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 its cash and cash equivalents on hand at December 31, 2004, together with cash flows from operations, if any, will be sufficient to meet its working capital and capital expenditure requirements for the balance of fiscal 2005.

### **Contractual Obligations**

The following table summarizes our significant contractual obligations at December 31, 2004, and the effect that such obligations are expected to have on our liquidity and cash in future periods:

Contractual Obligations	Total	Less than a year	1-3 years	3-5 years	Beyond 5 years
Non-cancelable lease obligations	\$ 2,459	\$ 334	\$ 2,068	\$ 56	\$ 0

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

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 4. Controls and Procedures**

The Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our "disclosure controls and procedures" (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")). Based on that evaluation, which was conducted within 90 days of the date on which this quarterly report was filed with the Securities and Exchange Commission, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to ensure that information required to be disclosed by use in the reports filed or submitted by us under the Exchange Act is accumulated, recorded, processed, summarized and reported to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding whether or not disclosure is required.

During the quarter ended December 31, 2004, 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. We have continued a process of implementing new software which will automate certain processes surrounding the recognition and the deferral of revenue related to our software sales arrangements with multiple elements. These processes include computing the amount of deferred revenue related to undelivered elements at the time a new sales arrangement is recorded and then subsequently recognizing the applicable portion of revenue as the elements are delivered to customers or are earned. These processes have historically been, and are currently being performed manually. During the quarter ended December 31, 2004 we used both the existing manual process as well as the new software to perform in a parallel manner the processes

described above which related to revenue recognition of our software sales arrangements with multiple elements. As of December 31, 2004 (i) we had not developed sufficient controls over our new software in order to rely on the new automated processes and instead, relied on our existing manual process for the December 31, 2004 quarter financial statements, and (ii) we had also not completed our evaluation over our internal controls related to this new software. We have hired a third party accounting firm to assist in the process of evaluating and documenting our internal controls structure in preparation for our reporting requirements under Section 404 of the Sarbanes-Oxley Act.

In the course of our evaluation and documentation of our internal controls we have identified various deficiencies which we are in the course of remediating. Management does not believe that any identified deficiencies are considered material to our internal controls. Our evaluation of our internal controls over financial reporting is still in process.

**PART II**

**OTHER INFORMATION**

**Item 1. Legal Proceedings.**

None

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**Item 3. Defaults Upon Senior Securities.**

None.

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

None.

**Item 5. Other Information.**

None.

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

Exhibits:

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

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

**SIGNATURES**

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

QUALITY SYSTEMS, INC.

Date: February 7, 2005

By: /s/ Louis Silverman

Louis Silverman

Chief Executive Officer

Date: February 7, 2005

By: /s/ Paul Holt

Paul Holt

Chief Financial Officer; Principal Accounting  
Officer

**EXHIBIT 31.1**

**CERTIFICATIONS**

I, Louis Silverman, certify that:

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

Date: February 7, 2005

/s/ LOUIS SILVERMAN

\_\_\_\_\_  
Louis Silverman

Chief Executive Officer (principal executive officer)

I, Paul Holt, certify that:

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

Date: February 7, 2005

/s/ PAUL HOLT

Paul Holt

Chief Financial Officer (principal accounting officer)

**EXHIBIT 32.1**

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

In connection with the quarterly report on Form 10-Q of Quality Systems, Inc. (the "Company") for the quarterly period ended December 31, 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: February 7, 2005**

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

**Dated: February 7, 2005**

**By: /s/ PAUL HOLT**  
\_\_\_\_\_  
**Paul Holt**  
**Chief Financial Officer (principal accounting 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.