

QUADRAMED CORP  
Form 10-Q  
May 09, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2008**

Or

**Transition Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**Commission File Number: 001-32283**

**QUADRAMED CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

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**DELAWARE**  
(State or Other Jurisdiction of

**52-1992861**  
(IRS Employer

Incorporation or Organization)

Identification No.)

**12110 SUNSET HILLS ROAD, SUITE 600 RESTON, VIRGINIA**

(Address of Principal Executive Offices)

**20190**

(Zip Code)

**(703) 709-2300**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer   
Non-accelerated Filer  (Do not check if a smaller reporting  
company)

Accelerated Filer   
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of May 1, 2008, there were 44,843,177 shares of the Registrant's common stock outstanding, par value \$0.01.

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**FOR THE QUARTER ENDED MARCH 31, 2008**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share amounts)

(unaudited)

	March 31, 2008	December 31, 2007
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 15,796	\$ 7,119
Short-term investments	2,910	9,169
Accounts receivable, net of allowance for doubtful accounts of \$1,495 and \$1,449, respectively	28,887	26,088
Unbilled receivables	9,051	5,183
Deferred contract expenses	6,311	6,060
Prepaid expenses and other current assets, net of allowance on other receivable of \$1,229 and \$1,229, respectively	9,497	5,367
Deferred tax asset, net of valuation allowance	7,376	7,376
<b>Total current assets</b>	<b>79,828</b>	<b>66,362</b>
Restricted cash	1,947	2,389
Long-term investments	3,372	1,197
Property and equipment, net of accumulated depreciation and amortization of \$23,209, and \$22,855, respectively	3,401	3,778
Goodwill	33,878	33,942
Other amortizable intangible assets, net of accumulated amortization of \$31,737 and \$31,119, respectively	11,150	11,768
Other long-term assets	3,177	3,182
Deferred tax asset, net of valuation allowance	49,724	49,758
<b>Total assets</b>	<b>\$ 186,477</b>	<b>\$ 172,376</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued expenses	\$ 4,863	\$ 4,910
Accrued payroll and related benefits	4,870	9,602
Accrued exit cost of facility closing	896	1,178
Other accrued liabilities	4,926	7,537
Dividends payable	1,375	1,375
Deferred revenue	60,874	36,111
<b>Total current liabilities</b>	<b>77,804</b>	<b>60,713</b>
Accrued exit cost of facility closing	671	888
Other long-term liabilities	2,608	2,722
<b>Total liabilities</b>	<b>81,083</b>	<b>64,323</b>
<b>Commitments and Contingencies</b>		

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<b>Stockholders equity</b>		
Preferred stock, \$0.01 par, 5,000 shares authorized, 4,000 shares issued and outstanding, respectively	96,144	96,144
Common stock, \$0.01 par, 150,000 shares authorized; 45,985 and 45,891 shares issued and 44,120 and 45,284 outstanding, respectively	460	459
Shares held in treasury, 1,408 and 607, respectively	(2,802)	(292)
Additional paid-in-capital	311,575	310,557
Accumulated other comprehensive loss	(182)	(80)
Accumulated deficit	(299,801)	(298,735)
<b>Total stockholders equity</b>	<b>105,394</b>	<b>108,053</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 186,477</b>	<b>\$ 172,376</b>

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

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**QUADRAMED CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

(unaudited)

	Three months ended, March 31,	
	2008	2007
<b>Revenue</b>		
Services	\$ 5,567	\$ 3,528
Maintenance	16,856	13,924
Installation and other	3,329	2,558
Services and other revenue	25,752	20,010
Term licenses	7,767	6,397
Perpetual licenses	1,631	2,278
Licenses	9,398	8,675
Hardware	141	521
<b>Total revenue</b>	<b>35,291</b>	<b>29,206</b>
<b>Cost of revenue</b>		
Cost of services and other revenue	11,334	7,027
Royalties and other	3,817	2,979
Amortization of acquired technology and capitalized software	259	471
Cost of license revenue	4,076	3,450
Cost of hardware revenue	136	492
<b>Total cost of revenue</b>	<b>15,546</b>	<b>10,969</b>
<b>Gross margin</b>	<b>19,745</b>	<b>18,237</b>
<b>Operating expense</b>		
General and administration	5,114	3,873
Software development	8,493	7,412
Sales and marketing	4,960	3,896
Amortization of intangible assets and depreciation	827	923
<b>Total operating expenses</b>	<b>19,394</b>	<b>16,104</b>
<b>Income from operations</b>	<b>351</b>	<b>2,133</b>
<b>Other income (expense)</b>		
Interest expense, includes non-cash charges of \$18 and \$50	(31)	(50)
Interest income	166	573
Other income, net	1	77
<b>Other income, net</b>	<b>136</b>	<b>600</b>

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<b>Income from operations before income taxes</b>	\$ 487	\$ 2,733
Provision for income taxes	(178)	(109)
<b>Net income</b>	\$ 309	\$ 2,624
Preferred stock accretion and dividends declared	(1,375)	(1,308)
<b>Net (loss) income attributable to common shareholders</b>	\$ (1,066)	\$ 1,316
<b>(Loss) income per share</b>		
Basic	\$ (0.02)	\$ 0.03
Diluted	\$ (0.02)	\$ 0.03
<b>Weighted average shares outstanding</b>		
Basic	44,680	43,540
Diluted	46,371	47,097

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

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

(in thousands)

(unaudited)

	<b>Three months ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities</b>		
Net income attributable to common shareholders	\$ (1,066)	\$ 1,316
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,086	1,394
Deferred compensation amortization	94	96
Stock-based compensation	799	383
Preferred Stock accretion and dividend premium	1,375	1,308
Dividend discount amortization		33
Provision for bad debts	130	156
Gain on sale of investments		(11)
Interest income on investments	(20)	(25)
Interest expense on note payable	18	18
Deferred income taxes	1	
Changes in operating assets and liabilities:		
Accounts receivable	(6,797)	351
Prepaid expenses and other	(4,376)	(292)
Accounts payable and accrued liabilities	(8,128)	(4,668)
Deferred revenue	24,763	8,824
Cash provided by operating activities	7,879	8,883
<b>Cash flows from investing activities</b>		
Decrease in restricted cash	442	54
Purchases of available-for-sale securities	(821)	(17,359)
Proceeds from the sale of available-for-sale securities	4,964	5,021
Payment of acquisition costs	64	
Purchases of property and equipment	(91)	(227)
Cash provided by (used in) investing activities	4,558	(12,511)
<b>Cash flows from financing activities</b>		
Payment of preferred stock dividends	(1,375)	(1,503)
Proceeds from issuance of common stock and other	125	1,034
Repurchase of common stock	(2,510)	
Cash used in financing activities	(3,760)	(469)
Net increase (decrease) in cash and cash equivalents	8,677	(4,097)
<b>Cash and cash equivalents, beginning of period</b>	<b>7,119</b>	<b>32,596</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 15,796</b>	<b>\$ 28,499</b>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for taxes	245	249
Dividends declared	1,375	

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





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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

**1. THE COMPANY**

The business mission of QuadraMed Corporation, along with our subsidiaries ( QuadraMed or the Company ), is to advance the success of healthcare organizations through IT solutions that leverage quality care into positive financial outcomes. Our driving principles include: maintaining long-term client relationships, building a culture of customer care, focusing on innovation as the key to winning, and striving to always deliver value. We offer innovative, user-friendly software applications designed and developed by the healthcare professionals and software specialists we employ.

In the healthcare market, clinical information and quality measurements are becoming drivers of revenue management. Access management, financial decision support, health information management ( HIM ) processes and systems combined with patient accounting systems are driving revenue management improvements and the movement to new quality based reimbursement models. As evolving reimbursement scenarios will challenge hospitals to leverage quality of care into appropriate payment, we believe that customers committing to our Care-Based Revenue Cycle solutions will realize improved financial performance. Our goal is to assist our customers in attaining significant improvement in hospital financial success by leveraging quality of care into positive financial outcomes through performance-based IT solutions. We seek to accomplish this goal by delivering healthcare information technology products and services that support the healthcare organizations efforts to improve the quality of care they deliver and the efficiency with which it is delivered.

Using our end-to-end solutions to optimize the patient experience and leverage quality of care into payment, our clients seek to receive the proper reimbursement, in the shortest time, at the lowest administrative cost. Our products are designed to eliminate paper, improve processes, improve efficiencies and decrease error through the efficient management of patient clinical and financial records, resulting in better patient safety. Healthcare organizations of varying size from small single entity hospitals to large multi-facility care delivery organizations, acute care hospitals, specialty hospitals, Veterans Health Administration facilities and associated/affiliated businesses such as outpatient clinics, long-term care facilities, and rehabilitation hospitals can gain value from our solutions.

We conduct business directly and through our subsidiaries, all of which are wholly owned and operated under common management. In February 2004, we acquired Détente Systems Pty Limited of Sydney, Australia, a vendor of laboratory and radiology management software. In June 2004, we acquired Tempus Software, Inc. of Jacksonville, Florida, a vendor of enterprise-wide hospital scheduling software. In September 2007, we acquired the Misys Computerized Patient Record business through an asset purchase. The Company considers itself to be a single reporting segment, specifically the software provider segment.

**2. SIGNIFICANT ACCOUNTING POLICIES**

**Financial Statement Presentation**

These condensed consolidated financial statements are unaudited and have been prepared in conformity with generally accepted accounting principles in the United States ( GAAP ) and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. We suggest that you read these interim financial statements in conjunction with the consolidated financial statements, and the notes thereto, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007, filed on March 14, 2008. In the opinion of management, the condensed consolidated financial statements for the periods presented herein include all normal and recurring adjustments that are necessary for a fair presentation of the results for these interim periods. The results of operations for the three months ended March 31, 2008 are not necessarily indicative of the results for the entire year ending December 31, 2008.



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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

**Principles of Consolidation**

These condensed consolidated financial statements, which include the accounts of QuadraMed and all significant business divisions and wholly owned subsidiaries, have been prepared in conformity with (i) GAAP and (ii) the rules and regulations of the SEC. All significant intercompany accounts and transactions between QuadraMed and its subsidiaries are eliminated in consolidation.

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

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

**Reclassifications**

Certain reclassifications have been made to prior year balances and categories of revenue and expense to conform them to the current year presentation.

**Revenue Recognition**

Our revenue is principally generated from licensing arrangements, services and hardware.

The Company's license revenue consists of fees for licenses of its proprietary software as well as the software of third-party providers. Cost of license revenue primarily includes the costs of third-party software, royalties and amortization of acquired technology and capitalized software. The Company's services revenue consists of maintenance, software installation, customer training and consulting services related to our license revenue, fees for providing management services, specialized staffing, and analytical services. Cost of services consists primarily of salaries, benefits and allocated costs related to providing such services. Hardware revenue includes third-party hardware used by our customers in connection with software purchased. Cost of hardware revenue consists of third-party equipment and installation.

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

We recognize revenue on software products in accordance with AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended; SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; and SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*.

We recognize revenue when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered; we no longer have significant obligations with regard to implementation; the fee is fixed and determinable; and collectibility is probable. Delivery is considered to have



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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

occurred when title and risk of loss have been transferred to the customer, which generally occurs when media containing the licensed programs is provided to a common carrier. The Company considers all arrangements with payment terms extending beyond 180 days to be neither fixed nor determinable. Revenue for arrangements with extended payment terms is recognized when the payments become due, provided all other recognition criteria are satisfied. The Company typically defers revenue and recognizes revenue on a cash basis for renewals of term license and support if the Company's initial assessment is modified by facts and circumstances and collection is no longer deemed probable. Revenue may also be deferred and recognized on a cash basis if there is a contractual dispute and payments are delayed. Revenue is recognized when the collection becomes reasonably assured and/or the contract dispute is resolved.

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

Some of the licenses are term or time-based licenses. We recognize revenue from these contracts ratably over the term of the arrangement. Post-contract Customer Support (PCS) for all of the license term is bundled together with the term license and is included in term license revenue in our consolidated financial statements.

Contract accounting is applied where services include significant software modification, installation or customization. In such instances, the services and license fee is accounted for in accordance with SOP 81-1, whereby the revenue is recognized, generally using the percentage-of-completion method measured on labor input hours. We use the completed-contract method of revenue recognition rather than the percentage-of-completion method for contracts with short implementation service periods (typically less than 3-9 months) and in circumstances in which the Company's financial position and results of operations would not vary materially from those resulting from the use of the percentage-of-completion method. If increases in projected costs-to-complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting can affect the amounts of revenue and related expenses reported in the Company's consolidated financial statements. The Company classifies revenues from these arrangements as license, installation, hardware, and services revenue based on the estimated fair value of each element using the residual method, and revenues are reflected in respective revenue categories in our consolidated financial statements.

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

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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

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

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

**Cash and Cash Equivalents**

Cash and cash equivalents are comprised principally of money market instruments and demand deposits with financial institutions and cash surrender values of life insurance policies. These instruments carry insignificant interest rate risk.

**Investments**

We consider our holdings of short-term and long-term securities, consisting primarily of fixed income securities and cash surrender values of life insurance policies, to be available-for-sale securities. The difference between cost or amortized cost (cost adjusted for amortization of premiums and accretion of discounts that are recognized as adjustments to interest income) and fair value, representing unrealized holdings gains or losses, net of the related tax effect, if any, is recorded, until realized, as a separate component of stockholders' equity. Gains and losses on the sale of debt securities are determined on a specific identification basis. Realized gains and losses are included in other income (expense) in the accompanying Consolidated Statements of Operations. The Company's long-term investments include auction rate securities which were previously classified as short-term investments. Auction rate securities are collateralized long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined intervals, typically every 7 to 28 days. Beginning in February 2008, auctions failed for our holdings because sell orders exceeded buy orders.

The funds associated with these failed auctions will not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. The underlying assets of the auction rate securities we hold, including the securities for which auctions have failed, are preferred shares of closed-end mutual funds. Given the Company's holdings of cash, cash equivalents and short-term investments, its expected operating cash flows and its access to funds through its corporate credit facility, the Company has the ability and intent to hold these securities until liquidity returns to this market or the maturity of the securities. The Company does not believe the carrying values of these securities are permanently impaired and believes the positions will be liquidated without any significant loss.

**Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable consist primarily of amounts due to QuadraMed from normal business activities. We provide an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on

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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

past collection history and specific identified risks.

**Concentration of Credit Risk**

Accounts receivable represent our highest potential concentration of credit risk. We reserve for credit losses and do not require collateral on our trade accounts receivable. In addition, we maintain cash and investment balances in accounts at various domestic banks and brokerage firms. Our balances at banks are insured by the Federal Deposit Insurance Corporation for up to \$100,000 at each bank but balances maintained at the brokerage firms are not insured.

**Property and Equipment**

Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives, which are generally three years for computer equipment and purchased software and five years for office furnishings and equipment. Leasehold improvements are amortized over the shorter of the term of the lease or the useful life (generally 10 years). Maintenance and repair costs are expensed as incurred. We review property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For property and equipment sales and disposals, the cost and related accumulated depreciation are removed from the accounts and net amounts, less proceeds from disposals, are included in income.

**Goodwill**

We account for goodwill and other intangible assets in accordance with Statements of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets* ( SFAS No. 142 ). Goodwill acquired in business combinations is not amortized but is tested for impairment annually or more often if an event or circumstances indicate that an impairment loss has been incurred. We have determined that we have one reporting unit under the criteria set forth by SFAS No. 142. We reviewed goodwill for impairment as of December 31, 2007 and 2006, respectively and determined that the fair value of the single reporting unit exceeded the carrying values of the net assets. Accordingly, no indicators of impairment existed.

**Other Intangible Assets**

Other intangible assets primarily relate to customer lists, acquired technology including developed and core technology, trade names, and other intangible assets acquired in our purchase business combinations. On an annual basis, or upon the occurrence of a triggering event, we review our intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values. Intangible assets are amortized over a period of two to ten years, which the Company estimated to reflect their useful lives.

**Software Development Costs**

In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*, we capitalize software development costs from establishment of technological feasibility to the point at which the product is generally available to the market. No costs were capitalized during the three month period ended March 31, 2008.

**Income Taxes**



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We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* ( SFAS No. 109 ). Under SFAS No. 109, deferred tax assets and liabilities are computed based on the difference between the

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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

financial statement and income tax bases of assets and liabilities using the enacted marginal tax rate. SFAS No. 109 requires that the net deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized.

This process requires us to make assessments regarding the timing and probability of the ultimate tax impact. We record valuation allowances on deferred tax assets if we determine it is more likely than not that the asset will not be realized. Additionally, we establish reserves for uncertain tax positions based upon our judgment regarding potential future challenges to those positions. Actual income taxes could vary from these estimates due to future changes in income tax law, significant changes in the jurisdictions in which we operate, our inability to generate sufficient future taxable income or unpredicted results from the final determination of each year's tax liability by taxing authorities. These changes could have a significant impact on our financial position.

The accounting estimate related to the tax valuation allowance requires us to make assumptions regarding the timing of future events, including the probability of expected future taxable income and available tax planning opportunities. These assumptions require significant judgment because actual performance has fluctuated in the past and may do so in the future. The impact that changes in actual performance versus these estimates could have on the realization of tax benefits as reported in our results of operations could be material.

We adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), on January 1, 2007. The accounting estimates related to liabilities for uncertain tax positions require us to make judgments regarding the sustainability of each uncertain tax position based on its technical merits. If we determine it is more likely than not that a tax position will be sustained based on its technical merits, we record the impact of the position in our consolidated financial statements at the largest amount that is greater than fifty percent likely of being realized upon ultimate settlement. These estimates are updated at each reporting date based on the facts, circumstances and information available. We are also required to assess at each reporting date whether it is reasonably possible that any significant increases or decreases to our unrecognized tax benefits will occur during the next twelve months. See Note 15 *Income Taxes*.

**Sales Taxes**

In accordance with FASB's Emerging Issues Task Force (EITF) 06-3, *How Sales Taxes Collected from Clients and Remitted to Governmental Authorities Should Be Presented in the Income Statement (gross versus net presentation)*, we report sales taxes collected from clients and remitted to governmental authorities on a net basis.

**Accounting for and Disclosure of Guarantees and Indemnifications**

Our software license agreements generally include a performance guarantee that our software products will substantially operate as described in the applicable program documentation for a period of 90 days after delivery. We also generally warrant that services performed will be provided in a manner consistent with reasonably applicable industry standards. To date, we have not incurred any material costs associated with these warranties. Our software license agreements typically provide for indemnification of customers for claims for infringement of intellectual property. To date, no such claims have been filed against the Company.

**Stock-Based Compensation**

We adopted SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R) using the modified prospective method as of January 1, 2006. Under this method, compensation cost is recognized based on the requirements of SFAS No. 123R for all share-based awards granted subsequent to January 1, 2006, and for all awards granted, but not vested, prior to January 1, 2006. Prior to January 1, 2006, the Company used the intrinsic method of



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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

**(unaudited)**

measuring and recognizing employee stock-based transactions under Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*. Consequently, no expense was recognized for stock award grants if the exercise price was at least equal to the market value of the common stock at the date of grant and expense was recognized if the exercise price was below the market value at the date of grant.

**Net Income (Loss) Per Share**

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

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, EITF 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*, ( EITF 06-4 ) was issued and is effective for fiscal years beginning after December 15, 2007. EITF 06-4 requires that, for split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with SFAS No. 106. EITF 06-4 requires that recognition of the effects of adoption should be either by (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. We adopted EITF 06-4 for the current year ending December 31, 2008 without any material impact to the financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. In February 2008, the FASB issued a FASB Staff Position to partially delay the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until fiscal years beginning after November 15, 2008. Based on the FASB Staff Position, the partial adoption of SFAS No. 157 has not had a material impact on our financial position and results of operations for the year ending December 31, 2008. We are still assessing the impact that SFAS No. 157 will have on our nonrecurring measurements for non-financial assets and liabilities in 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Asset and Financial Liability: Including an amendment to FASB Statement No. 115* ( SFAS No. 159 ). The standard permits all entities to elect to measure certain financial instruments and other items at fair value with changes in fair value reported in earnings. SFAS No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Although we adopted this standard for the current year ending December 31, 2008, we did not elect to measure our financial instruments at fair value and accordingly, its adoption did not have a material impact to the financial statements.

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In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* ( SFAS No. 141R ). SFAS No. 141R requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which is our fiscal year 2009. An entity may not apply SFAS No. 141R before that date. The provisions of SFAS No. 141R will generally only impact us if we are party to a business combination after the pronouncement has been adopted.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51* ( SFAS No. 160 ). SFAS No. 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. We do not currently expect the adoption of SFAS No. 160 to have a material impact on our consolidated financial position, results of operations or cash flows.

**4. ACQUISITION OF THE MISYS COMPUTERIZED PATIENT RECORD BUSINESS**

On September 23, 2007, the Company, through QuadCopper, LLC, a Delaware limited liability company and indirect, wholly-owned subsidiary of the Company, completed its acquisition of substantially all of the Computerized Patient Record ( CPR ) assets and related business of Misys plc (the CPR Business ) pursuant to the previously announced asset purchase agreement (the Agreement ), dated July 22, 2007, by and among Misys plc, a company organized under the laws of the United Kingdom, Misys Hospital Systems, Inc., a Pennsylvania corporation and indirect wholly-owned subsidiary of Misys plc, QuadCopper LLC, and the Company. Pursuant to the terms of the Agreement, the Company paid \$33.0 million in cash for the CPR Business.

The total purchase price, including related acquisition costs of approximately \$0.8 million, was approximately \$33.8 million. The cash used by the Company to acquire the CPR Business came from the Company's available cash and the conversion of short term investments into cash. No gains or losses on the conversions were recorded as the investments were not sold prior to their maturity dates. The results of the CPR Business operations have been included in the consolidated financial statements since the date of the acquisition.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition (in thousands):

Current assets acquired	\$ 13,485
Property and equipment	755
Identifiable intangible assets	12,400
Goodwill	12,127
Current liabilities	(4,678)
Long term liabilities-capital lease obligation	(252)
<b>Net Assets Acquired</b>	<b>\$ 33,837</b>

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The goodwill recognized results primarily from the value of the clinical product features and functionality acquired, beyond its current features and functionality and that of the legacy Affinity clinical software that will allow us to compete for clinical information systems business in large hospitals and multi-facility engagements where we would otherwise not be able to compete. Goodwill decreased by approximately \$0.1 million during the first quarter of 2008 due primarily due to the evaluation of deferred revenue on customer contracts acquired and a reduction of estimated commissions offset by additional legal and professional fees. The identifiable intangible assets include the following:

Trade Names (2 years straight line amortization)	\$ 300
Technology (10 years sum of years digits amortization)	5,400
Customer Relationships (10 years sum of years digits amortization)	6,700
 Total identifiable intangible assets	 \$ 12,400

**5. DISCONTINUED OPERATIONS****Division Shutdown and Headquarters Relocation**

We completed the shutdown of our Financial Services division in San Marcos, California on February 14, 2005. We estimated the facility closing costs in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, as the master lease associated with this facility does not terminate until May 2008. We subsequently secured a sub-tenant for 100% of the space. In addition, we also vacated and closed our San Rafael, California facility during the fourth quarter of 2004 as a result of the relocation of our headquarters to Reston, Virginia. We estimated our liability under the operating lease agreement and accrued exit costs as the lease does not terminate until December 2009. We subsequently secured a sub-tenant for 33% of the space. The San Rafael lease payments total approximately \$1.2 million for the years 2008 and 2009, including the Company's share of common costs.

The following table sets forth a summary of the exit cost charges and accrued exit costs for both the San Marcos, California and San Rafael, California facilities as of March 31, 2008 and 2007 (in thousands):

	<b>March 31,</b>	
	<b>2008</b>	<b>2007</b>
<i>Exit Costs for the San Rafael Facility:</i>		
Accrued exit cost of facility closing, beginning of period	\$ 1,931	\$ 3,078
Principal reductions	(418)	(281)
 Accrued exit cost of facility closing, end of period	 \$ 1,513	 \$ 2,797
<i>Exit Cost for the San Marcus Facility:</i>		
Accrued exit cost of facility closing, beginning of period	\$ 135	\$ 534
Principal reductions	(81)	(115)
 Accrued exit cost of facility closing, end of period	 \$ 54	 \$ 419

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Total Exit Cost Charges and Accrued Exit Costs	\$ 1,567	\$ 3,216
<i>Summary:</i>		
Accrued Exit Cost Liability		
Short-term	\$ 896	\$ 1,649
Long-term	671	1,567
Total	\$ 1,567	\$ 3,216

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On February 5, 2008, we announced a strategic initiative to increase overall product development capacity and to further accelerate delivery of our Care-based Revenue Cycle product strategy to the healthcare market. Related to this capacity expansion and resource re-allocation initiative, we eliminated 69 positions in various technical, administrative and other non-technical areas. As a result, the Company incurred a one time severance cost for the quarter ended March 31, 2008 of approximately \$0.6 million.

**7. FAIR VALUE MEASUREMENTS**

The Company adopted SFAS 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements for financial instruments effective January 1, 2008. The framework requires the valuation of investments using a three tiered approach. The statement requires fair value measurement to be classified and disclosed in one of the following three categories:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

The following table represents the assets on our financial statements as of March 31, 2008 subject to SFAS 157, and indicates the fair value hierarchy of the valuation techniques we used to determine the fair value (in thousands):

Description	Balance at March 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Commercial paper, certificates of deposit and other money market instruments	\$ 18,326	\$ 18,326	\$	\$
U.S. government and federal agency debt securities	1,552	1,552		
Auction rate securities	2,200			2,200
Total	\$ 22,078	\$ 19,878	\$	\$ 2,200

The valuation of our auction rate securities is based on Level 3 unobservable inputs which consist of recommended fair values provided by our broker. These securities are held available for sale in conformity with SFAS 115, *Accounting for Certain Investments in Debt and Equity*, and any unrealized gain or loss is included in other comprehensive income in the current period. Due to the uncertainty related to the liquidity in the auction rate security market, the Company has classified these auction rate securities as long term assets on the balance sheet.





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For those financial instruments with significant Level 3 inputs, the following table summarizes the activity for the period by investment type (in thousands):

Description	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Three Months Ended March 31, 2008	
	Auction Rate Securities	Total
Beginning Balance	\$	\$
Transfers in to Level 3	5,350	5,350
Purchases, issuances and settlements	(3,150)	(3,150)
Ending Balance	\$ 2,200	\$ 2,200

**8. GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill and other intangible assets as of March 31, 2008 and December 31, 2007 were as follows (in thousands):

Other intangible assets consisted of the following ( in thousands):

	As of March 31, 2008			As of December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizable intangible assets						
Customer relationships	\$ 18,749	\$ (12,699)	\$ 6,050	\$ 18,749	\$ (12,378)	\$ 6,371
Trade names and other	3,985	(3,760)	225	3,985	(3,722)	263
Technology	20,153	(15,278)	4,875	20,153	(15,019)	5,134
Total amortizable intangible assets	\$ 42,887	(31,737)	\$ 11,150	\$ 42,887	(31,119)	\$ 11,768

Intangible assets are amortized over a period of two to ten years, which we believe to be the estimated useful lives of the individual assets.

Amortization of acquired technology, a component of other intangible assets, for the three months ended March 31, 2008 and 2007 was \$259,000 and \$471,000, respectively, and is included in cost of license revenue. No impairment charges were recorded during the three months ended March 31, 2008 or 2007. For each of the three month periods ended March 31, 2008 and 2007, amortization expense other than for acquired technology was \$0.4 million and is included as amortization of intangible assets and depreciation in the condensed consolidated statements of operations.

We estimate that we will have the following amortization expense for the future periods indicated below (in thousands):

For the remaining nine months ended December 31, 2008	\$ (1,763)
For the years ended December 31,	
2009	(2,103)
2010	(1,750)
2011	(1,510)

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2012	(1,270)
Thereafter	(2,755)
	\$ (11,150)

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**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE QUARTER ENDED MARCH 31, 2008**

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**9. LINE OF CREDIT**

On December 5, 2006, we entered into a working capital line of credit agreement with our principal bank, under which we may borrow up to \$2.0 million. This credit facility is secured by 90-Day Certificates of Deposits. Borrowings under the line of credit bear interest at varying rates based on an independent index which is defined as the rate charged by the Lender on the underlying Certificates of Deposit plus a margin of 1.5%. The initial interest rate is established as 6.4% per annum. The line of credit has a stated maturity of December 1, 2008. There have been no borrowings, and there was no balance outstanding associated with this line of credit as of March 31, 2008 or as of December 31, 2007.

**10. SERIES A PREFERRED STOCK**

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

The Series A Preferred Stock holders do not have any relative, participating, optional or other voting rights and powers, except that (i) if four quarterly dividend payments are in arrears, such holders are entitled to elect two substitute directors to the Board of Directors at any annual or special meeting, and (ii) in certain circumstances, such holders are entitled to vote on the authorization or creation of securities ranking on par with or above the Series A Preferred Stock, certain amendments to the Certificate of Incorporation or the Certificate of Designation for the Series A Preferred Stock and the incurrence of new senior indebtedness in an aggregate principal amount exceeding \$8 million. Prior to the authorization or creation of, or increase in the authorized amount of, any shares of any class or series (or any security convertible into shares of any class or series) ranking senior to or on par with the Series A Preferred Stock in the distribution of assets upon any liquidation, dissolution or winding up of QuadraMed or in the payment of dividends, QuadraMed must have the affirmative vote of a majority of any outstanding shares of the Series A Preferred Stock (along with any shares of every other series or class of common stock ranking on par with the Series A Preferred Stock having like voting rights). In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Company, before any payment or distribution of the Company's assets is made or set apart for the holders of common stock or any other class or series of shares of the Company's capital stock ranking junior to the Series A Preferred Stock as to the payment of dividends or as to the distribution of assets upon liquidation, dissolution or winding up, the holders of the Series A Preferred Stock shall be entitled to receive a liquidation preference of \$25 per share plus an amount equal to all dividends (whether or not earned or declared) accumulated, accrued and unpaid to the date of final distribution. However, for purposes of the foregoing provision, (1) a consolidation or merger of the Company with one or more entities, (2) a statutory share exchange or (3) a sale or transfer of all or substantially all of the Company's assets shall not be deemed to be a liquidation, dissolution or winding up of the Company.

The Series A Preferred Stock is entitled to quarterly dividends of \$0.34 (5.5% per annum) and is convertible into shares of common stock of the Company at a conversion price of \$3.10, equivalent to a conversion rate of 8.0645 shares of common stock for each share of Series A Preferred Stock. The initial conversion price of \$3.40 (conversion rate of 7.3529 shares of common stock for each share of Series A Preferred Stock) decreased to \$3.10 as of August 1, 2005, pursuant to the terms of the Certificate of Designation relating to the Series A Preferred Stock, as the volume weighted average of the daily market price per share during a period of 30 consecutive trading days

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equaled \$2.75 or less during the one year period beginning on the first anniversary of the issue date. Additionally, as provided in the Certificate of Designation, because the Company had not as of June 15, 2005 completed the registration of the Series A Preferred Stock with the SEC, the dividend rate for such stock increased to \$0.40625 per quarter (\$1.625 per annum) on June 16, 2005, and such rate applied through December 1, 2006, the date the registration statement for the four million Series A Preferred Stock shares, and the 32.3 million shares of common stock into which the Series A Preferred Stock may be converted, was declared effective. The Company has the right to demand conversion on or after May 31, 2007, in the event the volume weighted average of the daily market price per share during a period of 20 consecutive trading days equals or exceeds \$5.10.

Upon the conversion of shares of the Series A Preferred Stock to shares of common stock on or before June 1, 2007, the Series A Preferred Stock holders had an option to convert and receive, when declared by the Board of Directors, dividends equal to the total previously unpaid dividends payable from the effective date of conversion through June 1, 2007 at a rate of \$1.375 per annum, or 5.5% per annum, discounted to present value at a rate of 5.5% per annum, payable in cash or common shares or any combination thereof at the option of the Company. No shares were converted on or before the option date of June 1, 2007.

As a result of the aforementioned discounted dividend feature, at the date of issuance of the Series A Preferred Stock, the Company recorded dividends payable of \$15.2 million, which represents the present value of the three-year dividends. The present value adjustment of \$1.3 million was amortized over three years as interest expense using the effective interest rate method. The amortization period ended during 2007, and for the three months ended March 31, 2007, approximately \$33,000 was recorded as interest expense.

The carrying value of the Series A Preferred Stock was also reduced by \$15.2 million, which represents the imputed discount on the Series A Preferred Stock and which is being accreted over three years using the effective interest rate method. The accretion period ended during 2007, and for the three months ended March 31, 2007, approximately \$1.3 million was accreted and charged to accumulated deficit. If any Series A Preferred Stock shares are converted prior to the end of the three-year period, the related accretion will be accelerated. The Company determined that there was no beneficial conversion feature attributable to the Series A Preferred Stock.

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

	<b>As of March 31, 2008</b>
Total issued	\$ 100,000
Less: Issuance cost	(3,856)
Less: Unaccreted discount	
Original present value of discount	(15,174)
2007 preferred stock accretion	2,854
2006 preferred stock accretion	5,059
2005 preferred stock accretion	4,796
2004 preferred stock accretion	2,465
Carrying value of preferred stock at March 31, 2008	\$ 96,144

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Our Company has issued from time to time, common stock as restricted share awards, with a zero exercise price, as provided for under the QuadraMed stock compensation plans and other contractual commitments. The grants are generally made to certain senior executives. The majority of the restrictions lapse over three to four years. During the three months ended March 31, 2008 and 2007, there was no common stock issued as a result of restricted stock grants.

We record the fair value of the restricted shares on the date they are granted as deferred compensation within the Stockholders' Equity section of the condensed consolidated balance sheets. Deferred compensation has been combined with additional paid-in capital as a result of the adoption of SFAS No. 123(R). The fair value of the restricted share award is amortized as compensation expense over the period in which the restrictions lapse. Compensation expense associated with the grants of restricted stock totaled \$94,000 and \$96,000 for the three month periods ended March 31, 2008 and 2007, respectively.

As of March 31, 2008, 580,000 restricted shares remained subject to forfeiture.

**12. NET INCOME (LOSS) PER SHARE AND COMPREHENSIVE INCOME (LOSS)**

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

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

	<b>Three months ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<i>Numerator basic:</i>		
Net income (loss) attributable to common shareholders	\$ (1,066)	\$ 1,316
<i>Numerator diluted:</i>		
Net income	309	2,624