QUADRAMED CORP
Form 10-Q
May 09, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

x **Quarterly Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934**
**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007**

**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)**

| DELAWARE | 52-1992861 |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (IRS Employer Identification No.) |
| 12110 SUNSET HILLS ROAD, SUITE 600, RESTON, VIRGINIA | 20190 |
| (Address of Principal Executive Offices) | (Zip Code) |

**(703) 709-2300**

**(Registrant s Telephone Number, Including Area Code)**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

| Large accelerated filer ¨ | Accelerated filer ¨ | Non-accelerated filer x |
|---|---|---|

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

As of May 1, 2007, there were 43,871,680 shares of the Registrant s common stock outstanding, par value $0.01.

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**QUADRAMED CORPORATION**

**REPORT ON FORM 10-Q**

**FOR THE QUARTER ENDED MARCH 31, 2007**

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## PART I. FINANCIAL INFORMATION

*Item 1. Financial Statements*

### QUADRAMED CORPORATION

### CONDENSED CONSOLIDATED BALANCE SHEETS

**(in thousands, except per share amounts)**

**(unaudited)**

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash and cash equivalents | $ 28,499 | $ 32,596 |
| Short-term investments | 23,181 | 10,703 |
| Accounts receivable, net of allowance for doubtful accounts of $1,876 and $2,612, respectively | 21,373 | 20,358 |
| Unbilled receivables | 2,807 | 4,253 |
| Prepaid expenses and other current assets, net of allowance on other receivable of $909 and $833, respectively | 11,109 | 10,848 |
| **Total current assets** | 86,969 | 78,758 |
| Restricted cash | 2,287 | 2,341 |
| Long-term investments | 1,109 | 1,244 |
| Property and equipment, net of accumulated depreciation and amortization of $21,604, and $21,131, respectively | 2,302 | 2,557 |
| Goodwill | 25,983 | 25,983 |
| Other amortizable intangible assets, net of accumulated amortization of $29,266 and $28,354, respectively | 1,220 | 2,132 |
| Other long-term assets | 3,180 | 3,183 |
| **Total assets** | $ 123,050 | $ 116,198 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **Current liabilities** | | |
| Accounts payable and accrued expenses | $ 2,375 | $ 3,493 |
| Accrued payroll and related expenses | 5,479 | 8,720 |
| Other accrued liabilities | 5,829 | 5,666 |
| Dividends payable | 2,305 | 3,775 |
| Deferred revenue | 55,171 | 46,347 |
| **Total current liabilities** | 71,159 | 68,001 |
| Accrued exit cost of facility closing | 1,567 | 2,066 |
| Deferred income taxes | 1,117 | 1,042 |
| Other long-term liabilities | 2,599 | 2,618 |
| **Total liabilities** | 76,442 | 73,727 |
| **Commitments and Contingencies** | | |

| | | |
|---|---|---|
| **Stockholders equity** | | |
| Preferred stock, $0.01 par, 5,000 shares authorized, 4,000 shares issued and outstanding, respectively | 94,598 | 93,290 |
| Common stock, $0.01 par, 150,000 shares authorized; 44,300 and 43,678 shares issued and 43,843 and 43,221 outstanding, respectively | 443 | 437 |
| Shares held in treasury | (5) | (5) |
| Additional paid-in-capital | 306,012 | 304,504 |
| Accumulated other comprehensive loss | (50) | (49) |
| Accumulated deficit | (354,390) | (355,706) |
| **Total stockholders equity** | 46,608 | 42,471 |
| **Total liabilities and stockholders equity** | $ 123,050 | $ 116,198 |

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, 2007 | 2006 |
|---|---|---|
| **Revenue** | | |
| Services | $ 3,313 | $ 2,915 |
| Maintenance | 13,924 | 13,562 |
| Installation and other | 2,414 | 2,872 |
| Services and other revenue | 19,651 | 19,349 |
| Licenses | 9,057 | 9,182 |
| Hardware | 498 | 397 |
| **Total revenue** | 29,206 | 28,928 |
| **Cost of revenue** | | |
| Cost of services and other revenue | 7,027 | 6,867 |
| Royalties and other | 2,979 | 2,764 |
| Amortization of acquired technology and capitalized software | 471 | 995 |
| Cost of license revenue | 3,450 | 3,759 |
| Cost of hardware revenue | 492 | 363 |
| **Total cost of revenue** | 10,969 | 10,989 |
| **Gross margin** | 18,237 | 17,939 |
| **Operating expense** | | |
| General and administration | 3,873 | 6,557 |
| Software development | 7,412 | 8,569 |
| Sales and marketing | 3,896 | 3,696 |
| Amortization of intangible assets and depreciation | 923 | 1,123 |
| **Total operating expenses** | 16,104 | 19,945 |
| **Income (loss) from operations** | 2,133 | (2,006) |
| **Other income (expense)** | | |
| Interest expense, includes non-cash charges of $51 and $119 | (50) | (123) |
| Interest income | 573 | 366 |
| Other income (expense), net | 77 | 18 |
| **Other income (expense), net** | 600 | 261 |

| | | |
|---|---|---|
| **Income (loss) from continuing operations before income taxes** | $ 2,733 | $ (1,745) |
| Provision for income taxes | (109) | (98) |
| **Income (loss) from continuing operations** | 2,624 | (1,843) |
| **Net income (loss)** | $ 2,624 | $ (1,843) |
| Preferred stock accretion and dividend premium | (1,308) | (1,489) |
| **Net income (loss) attributable to common shareholders** | $ 1,316 | $ (3,332) |
| **Income (loss) per share** | | |
| Basic | $ 0.03 | $ (0.08) |
| Diluted | $ 0.03 | $ (0.08) |
| **Weighted average shares outstanding** | | |
| Basic | 43,540 | 41,319 |
| Diluted | 79,355 | 41,319 |

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

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**QUADRAMED CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF**

**CHANGES IN STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)**

**(in thousands)**

**(unaudited)**

| | Preferred Stock | | Common Shares | | Treasury Shares | | Additional Paid-in | Accumulated Other Comprehensive | Accumulated | Total Stockholders | Other Comprehensive Income (Loss) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | Capital | Loss | Deficit | Equity | |
| **Balance, December 31, 2006** | 4,000 | $ 93,290 | 43,678 | $ 437 | (457) | $ (5) | $ 304,504 | $ (49) | $ (355,706) | $ 42,471 | $ (6,007) |
| Issuance of common stock | | | 581 | 6 | | | 975 | | | 981 | |
| Issuance of common stock under ESPP program | | | 41 | | | | 54 | | | 54 | |
| Accretion of preferred stock | | 1,308 | | | | | | | (1,308) | | (1,308) |
| Amortization of deferred compensation | | | | | | | 96 | | | 96 | |
| Stock-based compensation | | | | | | | 383 | | | 383 | |
| Net unrealized gain (loss) on available-for- sale securities | | | | | | | | 15 | | 15 | 15 |
| Foreign currency translation | | | | | | | | (16) | | (16) | (16) |
| Net income | | | | | | | | | 2,624 | 2,624 | 2,624 |
| **Balance, March 31, 2007** | 4,000 | $ 94,598 | 44,300 | $ 443 | (457) | $ (5) | $ 306,012 | $ (50) | $ (354,390) | $ 46,608 | $ 1,315 |

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

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**QUADRAMED CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

**(unaudited)**

| | Three months ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| **Cash flows from operating activities** | | |
| Net income (loss) attributable to common shareholders | $ 1,316 | $ (3,332) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,394 | 2,118 |
| Deferred compensation amortization | 96 | 96 |
| Dividend discount amortization | 33 | 101 |
| Provision for bad debts | 156 | 386 |
| Stock-based compensation | 383 | 271 |
| Gain on sale of investments | (11) | |
| Interest expense on note payable | 18 | 18 |
| Preferred stock accretion and dividend premium | 1,308 | 1,489 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 290 | (1,373) |
| Prepaid expenses and other | (230) | 1,172 |
| Accounts payable and accrued liabilities | (4,671) | (3,903) |
| Deferred revenue | 8,824 | 8,246 |
| Cash provided by operating activities | 8,906 | 5,289 |
| **Cash flows from investing activities** | | |
| Decrease in restricted cash | 54 | 80 |
| Purchases of available-for-sale securities | (17,412) | (115) |
| Proceeds from sale of assets and available-for-sale securities | 5,046 | 100 |
| Purchases of property and equipment | (227) | (255) |
| Other | 5 | 24 |
| Cash used in investing activities | (12,534) | (166) |
| **Cash flows from financing activities** | | |
| Payment of preferred stock dividends | (1,503) | (1,625) |
| Proceeds from issuance of common stock and other | 1,034 | 246 |
| Cash used in financing activities | (469) | (1,379) |
| Net increase (decrease) in cash and cash equivalents | (4,097) | 3,744 |
| **Cash and cash equivalents**, beginning of period | 32,596 | 33,042 |
| **Cash and cash equivalents**, end of period | $ 28,499 | $ 36,786 |
| **Supplemental disclosure of cash flow information** | | |
| Cash paid for taxes | $ 249 | $ 25 |
| Non-cash transfer of liabilities for implementation of SAB 108 to accumulated deficit | $ | $ 1,915 |

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

**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2007**

## 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. QuadraMed s driving principles include: maintaining long-term client relationships, building a culture of customer care, focusing on innovation as the key to success, and striving to always deliver value. QuadraMed offers 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 clients committing to QuadraMed s Care-Based Revenue Cycle solutions will realize improved financial performance. QuadraMed s goal is to assist our clients in attaining significant improvement in 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 the care they provide and the efficiency with which it is delivered.

Using QuadraMed s solutions that are designed 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, streamline 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 gain value from our solutions. Our products are sold as standalone, bundled or fully integrated software packages.

We do business directly and through our subsidiaries, all of which are wholly owned and operated under common management.

## 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, 2006, filed on March 16, 2007. 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, 2007 are not necessarily indicative of the results for the entire year ending December 31, 2007.

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

**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**

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

**Reclassifications**

QuadraMed has grown through multiple acquisitions based on a product-centric organizational structure. Acquired entities such as Tempus Software, Inc. and Détente Systems Pty Limited had been operated as standalone business units, rather than centralized business functions. Historically, our organizational structure contained several departments and remote locations which performed multiple levels of tasks in a cross-functional environment in order to manage and support specific product lines within the Company. In connection with our corporate vision, mission statement and executive management philosophy, in 2007 we implemented a new organizational structure designed to capitalize on our internal resources and strengths. The new structure supports centralized operations, standardized processes and optimizes functional-based expertise. As a result, certain reclassifications have been made to prior year balances and classification of expenses to conform to the current year presentation.

**Revenue Recognition**

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

The Company s license revenue consists of fees for licenses of the proprietary and third-party software. 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.

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

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

QuadraMed recognizes revenue on its 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*.

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

QuadraMed allocates 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, QuadraMed determines 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 QuadraMed charges for these services when sold separately from software. If evidence of fair value of all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. The proportion of revenue recognized upon delivery varies from quarter-to-quarter depending upon the mix of licensing arrangements, perpetual or term-based, and the determination of vendor-specific objective evidence ( VSOE ) of fair value for undelivered elements. Many of our licensing arrangements include fixed implementation fees and do not allow us to recognize license revenue until these services have been performed. We recognize revenue only after establishing that we have VSOE for all undelivered elements.

Some of the licenses are term or time-based licenses. QuadraMed recognizes 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 license revenue on 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. If increases in projected costs-to-complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting can affect the amounts of revenue and related expenses reported in its consolidated financial statements. 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.

**QUADRAMED CORPORATION**

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

**March 31, 2007**

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 QuadraMed s revenue recognition policy, however the Company does not have the right to bill the customer per the contract terms.

**Cash and Cash Equivalents**

Cash and cash equivalents is comprised principally of money market instruments and demand deposits with financial institutions. These instruments carry insignificant interest rate risk.

**Investments**

QuadraMed considers its holdings of short-term and long-term securities, consisting primarily of fixed income securities, 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.

**Accounts Receivable and Allowance for Doubtful Accounts**

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

**Concentration of Credit Risk**

Accounts receivable subject QuadraMed to its highest potential concentration of credit risk. QuadraMed reserves for credit losses and does not require collateral on its trade accounts receivable. In addition, QuadraMed maintains cash and investment balances in accounts at various domestic banks and brokerage firms. QuadraMed is insured by the Federal Deposit Insurance Corporation for up to $100,000 at each bank. 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

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

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. QuadraMed reviews property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

**Goodwill**

QuadraMed adopted Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*, effective for fiscal years beginning after December 15, 2001, and ceased amortization of goodwill as of January 1, 2002. Prior to this point, goodwill was amortized using the straight-line method over its estimated useful life.

As of January 1, 2006 and 2007, QuadraMed reviewed goodwill for impairment and determined that the fair values of the analyzed reporting units 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 and trade names, and other intangible assets acquired in QuadraMed s purchase business combinations. On an annual basis, QuadraMed reviews its intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the provisions of SFAS No. 144. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values. In accordance with SFAS 142, amortization of other intangible assets is computed on a straight-line basis over lives ranging from 3-5 years, as the pattern of economic benefit is not otherwise determinable.

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

QuadraMed s software license agreements generally include a performance guarantee that QuadraMed s software products will substantially operate as described in the applicable program documentation for a period of 90 days after delivery. QuadraMed also generally warrants that services performed will be provided in a manner consistent with reasonably applicable industry standards. To date, QuadraMed has not incurred any material costs associated with these warranties. QuadraMed s 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**

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment,* which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed options-pricing models. We have adopted SFAS No. 123(R) for our fiscal year beginning January 1, 2006. See Note 11 Stock-based Compensation.

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

**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 December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed options-pricing models. We adopted SFAS No. 123(R) beginning January 1, 2006. See Note 11 Stock-Based Compensation.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* ( FIN 48 ), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes,* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We adopted FIN 48 effective January 1, 2007, see Note 13 Income Taxes.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the Company s fiscal year ending December 31, 2006. We have adopted SAB 108 as of December 31, 2006 and have initially applied its provisions using the cumulative effect transition method in connection with the preparation of our annual financial statements for the year ended December 31, 2006.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Asset and Financial Liability: Including an amendment to FASB Statement No. 115* ( SFAS 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 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. The adoption of SFAS No. 159 is not expected to have a material impact on our results of operations or our financial position.

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

**4. DISCONTINUED OPERATION FINANCIAL SERVICES DIVISION AND EXIT COST OF FACILITY CLOSING**

**Financial Services Division**

Due to increasing operating losses in our Financial Services Division ( FSD ), and the lack of a qualified buyer for the business, we announced the shutdown of this division on December 15, 2004. The shutdown of this division was completed on February 14, 2005. The lease associated with this facility does not terminate until May 2008. Our annual cost under the lease is approximately $0.5 million for the remainder of 2007 and $0.3 million in 2008. At the time of the facility closing, we estimated the facility closing costs based upon then current and available market information related to potential sublease rental income, sublease commission costs and the length of time expected to secure a sublease. We have continued to evaluate those assumptions on an annual basis and have adjusted our accrued liability in accordance with SFAS 146. During 2006, the Company secured a sub-tenant for 100% of the space.

**Exit Cost of Facility Closing**

During the fourth quarter of 2004, we vacated and closed our San Rafael, California facility as a result of the relocation of our headquarters to Reston, Virginia. The San Rafael lease payments total approximately $2.6 million for the years 2007 through 2009, including the Company s share of common costs. The Company estimated its liability under its operating lease agreement, such estimate being reduced by the estimated sublease rental income. The present value of the estimated liability was recorded as an accrued exit cost of facility closing. The lease for this facility terminates in December 2009. We actively marketed and subleased 33% of the vacant San Rafael, California facility in 2006. We continue to actively market for sublease the remaining space.

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, 2007 and 2006 (in thousands):

| | March 31, | |
|---|---|---|
| | **2007** | **2006** |
| *Exit Costs for the San Rafael Facility:* | | |
| Accrued exit cost of facility closing, beginning of period | $ 3,078 | $ 4,217 |
| Principal reductions | (281) | (245) |
| Accrued exit cost of facility closing, end of period | $ 2,797 | $ 3,972 |
| *Exit Cost for the San Marcus Facility:* | | |
| Accrued exit cost of facility closing, beginning of period | $ 534 | $ 1,275 |
| Principal reductions | (115) | (170) |
| Accrued exit cost of facility closing, end of period | $ 419 | $ 1,105 |
| Total Exit Cost Charges and Accrued Exit Costs | $ 3,216 | $ 5,077 |
| *Summary:* | | |
| Accrued Exit Cost Liability | | |
| Short-term | $ 1,649 | $ 1,861 |
| Long-term | 1,567 | 3,216 |

| | | |
|---|---|---|
| Total | $ 3,216 | $ 5,077 |

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

**5. REDUCTION IN FORCE**

During the first quarter of fiscal year 2006, the Company announced a corporate reorganization and a reduction in our workforce of 37 positions. The Company recorded a charge for severance and related costs of approximately $315,000, associated with terminated employees, in the Company s results of operations for the quarter ended March 31, 2006.

**6. GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill and other intangible assets for the three-month period ended March 31, 2007 were as follows (in thousands):

| | As of December 31, 2006 | Q1 2007 Activity | As of March 31, 2007 |
|---|---|---|---|
| Cost | | | |
| Goodwill | 37,896 | | 37,896 |
| Other intangible assets | 43,529 | | 43,529 |
| | 81,425 | | 81,425 |
| Accumulated amortization | | | |
| Goodwill | (11,913) | | (11,913) |
| Other intangible assets | (41,397) | (912) | (42,309) |
| | (53,310) | (912) | (54,222) |
| Net book value | | | |
| Goodwill | 25,983 | | 25,983 |
| Other intangible assets | 2,132 | (912) | 1,220 |
| | $ 28,115 | $ (912) | $ 27,203 |

Amortization of acquired technology, a component of other intangible assets, for the three months ended March 31, 2007 and 2006 was $471,000 and $781,000, respectively, and was included in cost of license revenue. No impairment charges were recorded during the three months ended March 31, 2007 or 2006.

**7. LINE OF CREDIT**

On December 5, 2006, QuadraMed entered into a working capital line of credit agreement with our principal bank, under which we may borrow up to $2,000,000. 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 1.5 basis points. The initial interest rate is established as 6.4% per annum. The line of credit has a stated maturity of December 1, 2007. There have been no borrowings, and there is no balance outstanding associated with this line of credit as of December 31, 2006 and March 31, 2007.

**8. 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

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

$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 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 have an option to convert and receive, when declared by the Board of Directors, dividends equal to the total previously unpaid dividends payable from the effective date of conversion through June 1, 2007 at a rate of $1.375 per annum, or 5.5% per annum, discounted to present value

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**QUADRAMED CORPORATION**

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

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at a rate of 5.5% per annum, payable in cash or common shares or any combination thereof at the option of the Company.

As a result of the aforementioned 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 is being amortized over three years as interest expense using the effective interest rate method. For the three months ended March 31, 2007 and 2006, approximately $33,000 and $0.1 million was recorded as interest expense, respectively.

The carrying value of the Series A Preferred Stock was also reduced by $15.2 million, which represents the imputed discount on the Series A Preferred Stock and which is being accreted over three years using the effective interest rate method. For the three months ended March 31, 2007 and 2006, approximately $1.3 million and $1.2 million, respectively were 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):

| | | As of March 31, 2007 |
|---|---|---|
| Total issued | | $ 100,000 |
| Less: Issuance cost | | (3,856) |
| Less: Unaccreted discount | | |
| Original present value of discount | (15,174) | |
| 2007 preferred stock accretion | 1,308 | |
| 2006 preferred stock accretion | 5,059 | |
| 2005 preferred stock accretion | 4,796 | |
| 2004 preferred stock accretion | 2,465 | (1,546) |
| Carrying value of preferred stock at March 31, 2007 | | $ 94,598 |

**9. RESTRICTED STOCK GRANTS**

During the three months ended March 31, 2007 and 2006, there was no common stock issued as a result of restricted stock grants. These grants are periodically made to certain senior executives for no monetary consideration. The majority of the Company s restricted shares fully vest over three to four years. QuadraMed has recorded the fair value of the restricted shares on the date they were granted as deferred compensation within the Stockholders Equity section of the Condensed Consolidated Balance Sheets. This amount is amortized over the period in which the restrictions lapse. Compensation expense associated with the grants of restricted stock total $96,000 for both the three month period ended March 31, 2007 and 2006.

As of March 31, 2007, 615,000 restricted shares remained subject to forfeiture.

**10. 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

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conversion of the preferred stock and subordinated debentures (using the as-converted method). Common equivalent shares are excluded from the diluted computation if their effect is anti-dilutive.

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

| | Three months ended March 31, | |
|---|---|---|
| | 2007 | 2006 |
| *Numerator basic:* | | |
| Net income (loss) attributable to common shareholders | $ 1,316 | $ (3,332) |
| *Numerator diluted:* | | |
| Net income (loss) | $ 2,624 | $ (1,843) |
| *Denominator:* | | |
| Weighted average number of common shares outstanding: | | |
| Basic | 43,540 | 41,319 |
| Diluted | 79,355 | 41,319 |
| Income (loss) per common share: | | |
| Basic | $ 0.03 | $ (0.08) |
| Diluted | $ 0.03 | $ (0.08) |

QuadraMed recorded net income for the three months ended March 31, 2007, and as such included the following common stock equivalent shares from the indicated equity instruments in the calculation of diluted earnings per share. As QuadraMed recorded a net loss for the three month period ended March 31, 2006 no common equivalent shares were included in diluted net loss per share calculation because they were anti-dilutive. If QuadraMed had reported net income for the three months ended March 31, 2006, the calculation of diluted earnings per share would have also included the following common stock equivalent shares from the indicated equity instruments (in thousands):

| | Three months ended March 31, | |
|---|---|---|
| | 2007 | 2006 |
| *Equity instruments:* | | |
| Preferred stock | 32,258 | 32,258 |
| Warrants | 2,063 | 3,265 |
| Stock options | 1,494 | 621 |
| Total common stock equivalent shares | 35,815 | 36,144 |

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

| | Three months ended March 31, | |
|---|---|---|
| | 2007 | 2006 |

| | | |
|---|---|---|
| Net income (loss) attributable to common shareholders | $ 1,316 | $ (3,332) |
| Unrealized gain (loss) | 15 | (23) |
| Foreign currency translation adjustment | (16) | (2) |
| Comprehensive income (loss) | $ 1,315 | $ (3,357) |

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

**March 31, 2007**

**11. STOCK-BASED COMPENSATION**

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which is a revision of SFAS No. 123. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values, using prescribed option-pricing models. The fair value is expensed over the requisite service period of the individual grantees, which generally equals the vesting period. Since the adoption of SFAS No. 123(R) on January 1, 2006, pro forma disclosure is no longer an alternative.

Effective January 1, 2006, the Company adopted SFAS No. 123(R) s fair value method of accounting for share-based payments, using the modified prospective transition method. Accordingly, periods prior to adoption have not been restated and are not directly comparable to periods after adoption. However, had we adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 illustrated in the disclosure of pro forma net income and net income per share contained in our notes to condensed consolidated financial statements for those periods. Under the modified prospective method, compensation cost recognized in the three months ended March 31, 2007 and 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, less estimated forfeitures, and (b) compensation costs for all share-based payments granted and vested subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).

SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Stock-based compensation expense for the three months ended March 31, 2007 and 2006 totaled $0.4 million and $0.3 million, respectively, and is included in cost of services, general and administration, software development and sales and marketing expenses in the condensed consolidated statement of operations. There was no income tax benefit or excess tax benefit related to stock-based compensation or capitalized stock-based compensation costs during the three months ended March 31, 2007 and 2006.

**Stock Incentive Plans**

The Company has issued stock options and restricted stock under its 1996 Stock Incentive Plan (the 1996 Plan ), the 1999 Supplemental Stock Option Plan (the 1999 Plan ), and the 2004 Stock Compensation Plan (the 2004 Plan ), all of which were approved by stockholders. The 2004 Plan superseded the 1996 Plan, as amended, and the 1999 Plan, as amended, although stock options and restricted stock under the 1996 and 1999 Plans outstanding as of that date remain subject to the terms of those plans. Significant grants were made outside these plans pursuant to contracts with executives as an inducement to employment. Total non-plan stock options outstanding at March 31, 2007 were 1,375,000.

**1996 Stock Incentive Plan**

Under the 1996 Plan, the Board of Directors may grant incentive and nonqualified stock options to employees, directors, and consultants. The 1996 Plan is divided into the following five separate equity programs: (i) the discretionary option grant program under which eligible persons may, at the discretion of the plan administrator, be granted options to purchase shares of common stock; (ii) the salary investment option grant program under which eligible employees may elect to have a portion of their base salary invested each year in special option grants; (iii) the stock issuance program under which eligible persons may, at the discretion of the

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**March 31, 2007**

plan administrator, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered to QuadraMed; (iv) the automatic option grant program under which eligible non-employee board members shall automatically receive option grants at periodic intervals to purchase shares of common stock; and (v) the director fee option program under which non-employee board members may elect to have all or any portion of their annual retainer fee otherwise payable in cash applied to a special option grant.

The exercise price per share for an incentive stock option cannot be less than the fair market value on the date of grant. The exercise price per share for a nonqualified stock option cannot be less than 85% of the fair market value on the date of grant. Option grants under the 1996 Plan generally expire 10 years from the date of grant and generally vest over a four-year period. Options granted under the 1996 Plan are exercisable subject to the vesting schedule. QuadraMed s stockholders had authorized a total of 8,651,097 shares of common stock for grant under the 1996 Plan, of which 3,305,977 were outstanding at March 31, 2007. There were no shares available for grant under this plan at March 31, 2007.

**1999 Supplemental Stock Option Plan**

In 1999, QuadraMed s Board of Directors approved the 1999 Plan. The 1999 Plan permits non-statutory option grants to be made to employees, independent consultants, and advisors who are not QuadraMed officers, directors, or Section 16 insiders. The 1999 Plan is administered by the Board of Directors or its Compensation Committee and was scheduled to terminate in March 2009. The exercise price of all options granted under the 1999 Plan may not be less than 100% of fair market value on the date of the grant. Options vest on a schedule determined by the Board of Directors or the Compensation Committee with a maximum option term of 10 years. QuadraMed s stockholders had authorized a total of 3,519,258 shares of common stock, for grant under the 1999 Plan, of which 1,034,887 were outstanding at March 31, 2007. There were no shares available for grant under this plan at March 31, 2007.

**2004 Stock Compensation Plan**

On April 1, 2004, QuadraMed s Board of Directors approved the 2004 Plan. QuadraMed s stockholders ratified the adoption of the 2004 Plan on May 6, 2004 at QuadraMed s 2004 Annual Meeting of Stockholders. The 2004 Plan replaces the 1996 Plan and 1999 Plan with respect to the unissued shares of common stock that were remaining in the 1996 Plan and the 1999 Plan on the date the 2004 Plan was ratified. Awards previously granted under the 1996 Plan and 1999 Plan remain subject to the terms of those plans. QuadraMed stockholders have authorized 1,536,369 shares of common stock for grant under the 2004 Plan, of which 1,432,992 were outstanding at March 31, 2007. There were 65,252 shares available for grant under this plan at March 31, 2007. QuadraMed has proposed to increase the number of shares available to the 2004 Plan by 3,000,000 shares; this proposal is included in the Company s Proxy Statement on Schedule 14A, filed with the SEC on April 25, 2007 for consideration and approval at the 2007 Annual Meeting of Stockholders to be held on June 7, 2007.

The 2004 Plan permits the grant of non-statutory options, incentive stock options, stock appreciation rights, restricted stock and restricted stock units to employees, prospective employees, directors, and advisors, consultants, and other individuals who provide services to QuadraMed. The exercise price of all options and stock appreciation rights granted under the 2004 Plan may not be less than 100% of fair market value on the date of the grant. The 2004 Plan also features (i) a Non-Employee Director Option Grant Program, whereby non-employee members of the Board automatically receive grants of options with an exercise price of the fair market value per share of common stock as of the date the options are granted as of the date of our annual

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

meetings of stockholders or upon their initial election or appointment to the Board and (ii) a Director Fee Option Grant Program, whereby non-employee Board members may elect to have all or any portion of their annual cash retainer fee applied to special stock option grants with a below-market exercise price. The 2004 Plan is administered by the Compensation Committee and terminates in May 2014.

**Employee Stock Purchase Plan**

QuadraMed s 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan ) was adopted by the Board of Directors in January 2002. A total of 703,450 shares of common stock are reserved for issuance under the 2002 Purchase Plan, pursuant to which eligible employees are able to contribute up to 10% of their compensation for the purchase of QuadraMed common stock at a purchase price of 85% of the lower of the fair market value of the shares on the first or last day of the six-month purchase period. Stock-based compensation expense relating to shares purchased on behalf of plan participants for the three months ended March 31, 2007 and 2006 totaled $61,000 and $7,200, respectively.

***Stock Options:***

Stock options generally vest over four years, 25% after the first year and monthly increments over the next three years, from date of grant and terminate ten years from date of grant. The exercise price of the options granted equaled or exceeded the market value of the common stock at the date of the grant. A summary of the stock option activity under all plans is as follows (in thousands except per share data):

| | Number of Shares | Weighted Average Exercised Price |
|---|---|---|
| Options outstanding, January 1, 2007 | 7,833 | $ 3.61 |
| Granted | 500 | 2.83 |
| Exercised | (581) | 1.69 |
| Cancelled | (429) | 10.16 |
| Options outstanding, March 31, 2007 | 7,323 | $ 3.33 |
| Options exercisable, March 31, 2007 | 5,582 | $ 3.68 |

Stock-based compensation expense relating to stock options for the three months ended March 31, 2007 and 2006 totaled $322,000 and $271,000, respectively.

The weighted average remaining contractual term and the aggregate intrinsic value for options outstanding at March 31, 2007 were 5.7 years and $5.0 million, respectively. The weighted average remaining contractual term and the aggregate intrinsic value for options exercisable at March 31, 2007 were 4.6 years and $3.6 million, respectively. As of March 31, 2007, unrecognized compensation expense related to stock options totaled approximately $2.3 million, which will be recognized over a weighted average period of 1.5 years.

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March 31, 2007

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2007 | 2006 |
| Expected dividend yield | | |
| Expected stock price volatility | 85.97% | 85.97% |
| Risk-free interest rate | 4.48% | 4.53% |
| Expected life of options | 5.29 years | 5.73 years |

The dividend yield of zero is based on the fact that the Company has never paid cash dividends on its common stock, and has no present intention of doing so. The risk-free interest rate is based on U.S. treasury yield curve in effect at the time of the grant for a term equivalent to the expected life of the option. The expected life and expected volatility are based on historical experience. The Company uses an estimated forfeiture rate of 25.63% for calculating stock-based compensation expense related to stock options and this rate is based on historical experience.

Based on the above assumptions, the weighted average estimated fair value of options granted during the three month periods ended March 31, 2007 and 2006 was $2.25 and $1.39, respectively.

***Restricted Share Awards:***

The Company issues its common stock as restricted share awards at no exercise price as provided for under QuadraMed s stock compensation plans and other contractual commitments. The grants are generally made to certain senior executives for no monetary consideration. The majority of the restrictions lapse over three to four years. The Company records 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). This amount is amortized as compensation expense over the period in which the restrictions lapse.

A summary of our restricted stock awards as of March 31, 2007 is as follows (in thousands except per share data):

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Restricted stock awards, as of January 1, 2007 | 615 | $ 1.77 |
| Granted Granted | | |
| Exercised Restrictions released | | |
| Cancelled Forfeited | | |
| Restricted stock awards, as of March 31, 2007 | 615 | $ 1.77 |

Stock-based compensation expense relating to restricted share grants for the three months ended March 31, 2007 and 2006 totaled $96,000 and $101,000, respectively.

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**QUADRAMED CORPORATION**

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

**March 31, 2007**

**12. MAJOR CUSTOMERS**

For the three months ended March 31, 2007, two customers accounted for more than 10% of total revenue. The Veterans Health Administration facilities accounted for 16% of our total revenues and the County of Los Angeles ( LACO ) accounted for 14% of our total revenues. For the three months ended March 31, 2006, sales to Veterans Health Administration facilities accounted for 12% of total revenues.

**13. INCOME TAXES**

The Company has adopted *FIN 48, Accounting for Uncertainty in Income Taxes*, as of January, 1, 2007. This standard modifies the previous guidance provided by *FAS 5, Accounting for Contingencies* and *FAS 109, Accounting for Income Taxes* for uncertainties related to the Company s global income tax liabilities. The company has analyzed its income tax posture using the criteria required by FIN 48 and concluded that there is no cumulative effect allocable to equity as a result of adopting this standard. The Company has derecognized approximately $8.1 million in deferred tax assets related to its general business credits and net operating loss carry forwards that were previously offset by a full valuation allowance as a result of adopting FIN 48, which has no net balance sheet impact and has not been charged to equity in the transition.

A condensed roll forward of the Company s unrecognized tax benefits is presented as follows (in thousands):

| | Balance 12/31/06 | Non-Equity Transition Adjustment | Adjusted Balance 1/1/07 | Changes Through 3/31/07 | Balance 3/31/07 |
|---|---|---|---|---|---|
| Unrecognized tax benefits affecting tax rate upon recognition | $ | $ | $ | $ | $ |
| Unrecognized tax benefits not affecting tax rate or are offset by valuation allowances | | (8,100) | (8,100) | | (8,100) |
| Interest | | | | | |
| Penalties | | | | | |
| Total unrecognized tax benefits | $ | $ (8,100) | $ (8,100) | $ | $ (8,100) |

There is no material change to the amount of unrecognized tax benefits reported at March 31, 2007. The Company is maintaining its historical method of accruing interest (net of related tax benefits) and penalties associated with unrecognized income tax benefits as a component of its income tax expense.

As of January 1, 2007 open tax years in major jurisdictions date back to 1993 due to the taxing authorities ability to adjust operating loss carry forwards. No changes in settled tax years have occurred through March 31, 2007. The Company does not anticipate a material change to its total amount of unrecognized tax benefits within the next 12 months.

**14. LITIGATION AND OTHER MATTERS**

As previously disclosed, on November 15, 2004, QuadraMed Corporation (the Company ) received a letter from MedCath Incorporated ( MedCath ), which provided notice of MedCath s decision to terminate the Master Software License and Services Agreement, dated November 20, 2002, by and between QuadraMed Affinity and MedCath (the Contract ). On or about November 15, 2004, MedCath filed a complaint against the Company in Mecklenburg County, North Carolina, Superior Court Division (Case No. 04CVS20137). In its complaint, MedCath alleged that we were in breach of the Contract due to uncured deficiencies in the products and sought at

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

**March 31, 2007**

least $5 million in damages, plus litigation costs. On December 9, 2004, we filed a motion to dismiss the MedCath complaint on the grounds that the complaint fails to state a claim upon which relief can be granted. We also filed a counterclaim against MedCath seeking no less than $1.14 million in unpaid amounts due to us, plus litigation costs, for MedCath s breach of the Contract by failing to pay licensing fees due to the Company.

On April 28, 2006, we settled this litigation with MedCath. Pursuant to the Release and Settlement Agreement (the Settlement Agreement ), the Company paid MedCath a settlement payment of $2 million and the parties filed a Joint Stipulation of Dismissal, with prejudice, of this lawsuit on May 8, 2006. Further, the Contract and all obligations thereunder terminated, and the Company removed MedCath s name from all Company websites and marketing materials. The parties have entered into mutual general releases regarding the Contract and both will bear their own attorneys fees and costs.

QuadraMed funded the settlement amount from available operating cash. In addition to amounts already recorded at December 31, 2005 and amounts covered by insurance, the Company has recorded a charge of approximately $1.0 million related to the settlement in its three month period ended March 31, 2006.

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

**Cautionary Statement on Risks Associated With Forward-Looking Statements**

You should read the following discussion in conjunction with our Condensed Consolidated Financial Statements and related notes. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties. The words believe , expect , target , goal , project , anticipate , predict , intend , plan , estin should , could , and similar expressions and their negatives are intended to identify such statements. Forward-looking statements are not guarantees of future performance, anticipated trends or growth in businesses, or other characterizations of future events or circumstances and are to be interpreted only as of the date on which they are made. We undertake no obligation to update or revise any forward-looking statement. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described below and elsewhere in this Quarterly Report on Form 10-Q, and in other documents we file with the SEC from time to time.

**Results of Operations (unaudited)**

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

| | Three months ended March 31, 2007 | | 2006 | |
|---|---|---|---|---|
| **Revenue** | | | | |
| Services | $ 3,313 | 11% | $ 2,915 | 10% |
| Maintenance | 13,924 | 48% | 13,562 | 47% |
| Installation and other | 2,414 | 8% | 2,872 | 10% |
| Services and other | 19,651 | 67% | 19,349 | 67% |
| Licenses | 9,057 | 31% | 9,182 | 32% |
| Hardware | 498 | 2% | 397 | 1% |
| **Total revenue** | 29,206 | 100% | 28,928 | 100% |
| **Cost of revenue** | | | | |
| Cost of services and other | 7,027 | 36% | 6,867 | 35% |
| Royalties and other | 2,979 | 33% | 2,764 | 30% |
| Amortization of acquired technology and capitalized software | 471 | 5% | 995 | 11% |
| Cost of licenses | 3,450 | 38% | 3,759 | 41% |
| Cost of hardware | 492 | 99% | 363 | 91% |
| **Total cost of revenue** | 10,969 | 38% | 10,989 | 38% |
| **Gross margin** | 18,237 | 62% | 17,939 | 62% |
| **Operating expenses** | | | | |
| General and administration | 3,873 | 13% | 6,557 | 23% |
| Software development | 7,412 | 25% | 8,569 | 30% |
| Sales and marketing | 3,896 | 13% | 3,696 | 13% |
| Amortization of intangible assets and depreciation | 923 | 3% | 1,123 | 4% |
| **Total operating expenses** | $ 16,104 | 54% | $ 19,945 | 70% |
| **Income (loss) from operations** | $ 2,133 | | $ (2,006) | |

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**Revenue**

Revenue is recognized during the respective periods from various sources, including but not limited to amounts initially recorded as deferred revenue and for which the Company has now completed its contractual commitments; service revenue relating to installation, consulting and training; maintenance contracts that renew periodically, typically on an annual basis; and revenues recognized on a cash-basis.

*Total revenue.* Total revenue for the three months ended March 31, 2007 was $29.2 million compared to $28.9 million for the three months ended March 31, 2006. The net increase of $0.3 million consisted of a $0.4 million increase in services revenue, a $0.4 million increase in maintenance revenue, and a $0.1 million increase in hardware revenue, all partially offset by a $0.5 million decrease in installation and other revenue and a $0.1 million decrease in license revenue.

*Services and other revenue.* Services and other revenue consist of professional services, such as implementation and installation services, training, maintenance (which consists of technical support and product upgrades), reimbursable expenses and other services revenue. Professional services are typically provided over a period of three to nine months for the Health Information Management Suite and two to three years for Patient Care and Revenue Management products. These services are provided subsequent to the signing of a software license arrangement and are related in large part on our software license revenues. Our maintenance revenue is a function of both licenses of our software products and renewals of maintenance agreements by our existing customer base.

Services revenue for the three months ended March 31, 2007 was $3.3 million or 11% of total revenue, compared to $2.9 million or 10% of total revenue for the three months ended March 31, 2006. An increase of approximately $0.4 million was attributable to the Smart Identity Management products, primarily clean up services provided to two significant customers during the three months ended March 31, 2007. An additional $0.3 million was attributable to the government solutions workflow analysis project completions. These increases were offset by decreases of approximately $0.2 million in the Acuity Plus products and approximately $0.1 million in the Patient Care and Revenue Management products due to customer delays.

Maintenance revenue for the three months ended March 31, 2007 was $13.9 million, compared to $13.6 million for the three months ended March 31, 2006. Maintenance revenue as a percentage of total revenue was 48% and 47% for the three month periods ended March 31, 2007 and 2006, respectively. Approximately $0.2 million of the increase was attributable to the Health Information Management Suite and another $0.2 million of the increase was attributable to Pharmacy products. These increases were principally due to revenue that was recognized from certain cash basis customers resulting in reactivation of revenue plans that were previously on hold as well as contractually-based increases. Maintenance revenue for Electronic Document Management, Lab & Radiology, Scheduling, Smart Identity Management and Acuity Plus products also increased approximately $0.2 million combined, mainly due to contractually-based increases in fees. These increases were partially offset by a $0.2 million decrease in the Patient Care and Revenue Management products as a result of cancellation of certain annual maintenance agreements in 2006.

Installation and other services revenue decreased to $2.4 million or 8% of total revenue during the three months ended March 31, 2007, from $2.9 million or 10% of total revenue during the three months ended March 31, 2006. The net decrease of $0.5 million was the result of a $0.3 million decrease for Patient Care and Revenue Management products, a $0.2 million decrease in the Health Information Management Suite and a $0.1 million decrease for Electronic Document Management products, partially offset by a $0.1 million increase in the government solutions products. Installation and other revenue for Patient Care and Revenue Management products decreased due to decreased hours worked on contracts that were being recognized on the percentage of completion ( POC ) method in the three months ended March 31, 2007. Hours worked for Patient Care and Revenue Management projects were 38% less in the three months ended March 31, 2007 compared to the

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corresponding period in 2006, resulting in decreased revenue for these POC contracts. The decrease in installation and other services revenue for Health Information Management Suite was principally due to a decreased number of significant contracts completed in the three months ended March 31, 2007, compared to the corresponding prior period. The $0.1 million increase in the installation and other services revenue for government solution products was attributable to revenue recognized on installation and training services in conjunction with a new government solution product. Installation revenue related to the Health Information Management Suite term licenses is recognized ratably over the license term. Installation and other revenue for Health Information Management Suite perpetual licenses, Patient Access and government solution products are typically recognized upon completion of a contract, whereas the installation and other revenue for many of our other products, including Patient Care and Revenue Management, are recognized on a POC basis of accounting.

*Licenses.* License revenue consists of fees and licenses for our owned, proprietary software, as well as third-party owned software that we bundle into our suite of products. License revenue for the three months ended March 31, 2007 was $9.1 million, compared to $9.2 million in the corresponding period in 2006. License revenue, as a percentage of total revenue, was 31% and 32% for the three month period ended March 31, 2007 and 2006, respectively. The net decrease of $0.1 million was principally due to a $0.4 million decrease in license revenue for the Health Information Management Suite which was attributable to the decreased number of significant contracts being completed during the three months ended March 31, 2007 and a $0.3 million decrease in license revenue of Electronic Document Management products, offset by a $0.4 million increase in government solution product revenue, a $0.1 million increase in Acuity Plus product revenue and a $0.1 million increase in Decision Support product revenue. The $0.4 million increase in license revenue for government solution products was attributable to license revenue recognized on a new product sold as a term license. License revenue for the Acuity Plus products increased principally due to completion of projects during the three months ended March 31, 2007. License revenue for the Decision Support product increased as a result of an increased number of term licenses during the three months ended March 31, 2007, compared to the corresponding period in 2006.

*Hardware*. Hardware revenue consists of the sale of third-party hardware purchased specifically for use by our customers. Hardware revenue was $0.5 million during the three months ended March 31, 2007 compared to $0.4 million during the three months ended March 31, 2006. Hardware revenue, as a percentage of total revenue, was 2% and 1% for the three months ended March 31, 2007 and 2006, respectively.

***Deferred Revenue***

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

| | For the Three Months Ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| Deferred revenue, beginning balance | $ 46,347 | $ 52,169 |
| Add: revenue deferred | 38,013 | 36,993 |
| Add: SAB 108 implementation | | 1,314 |
| Less: deferred revenue recognized | (29,189) | (28,747) |
| Deferred revenue, ending balance | $ 55,171 | $ 61,729 |

Deferred revenue includes amounts billed to or received from customers for which revenue has not been recognized. Fluctuation within the deferred revenue balance is dependent upon the timing associated with reaching billing milestones and revenue recognition criteria. Deferred revenue is typically increased when the Company invoices a customer based on the terms of the contracts and is decreased when revenue is recognized based on percentage of completion or the attainment of a milestone in the customer contract, or the passage of time in the case of an apportionment contract.

The majority of the Company s revenue flows through the deferred revenue accounts and is attributable to favorable payment terms such as execution payments and achievement of billing milestones prior to meeting all revenue recognition requirements.

The deferred revenue balance decreased approximately $6.5 million to $55.2 million at March 31, 2007 when compared to $61.7 million at March 31, 2006. Approximately $4.0 million of the decrease in the deferred revenue balance was attributable to revenue recognized as a result of settlements of disputed contracts, resolution of stalled projects and amounts received from cash-basis customers whose revenue plans were put on hold until collectability of amounts due became certain. Approximately $1.4 million of the decrease was attributable to revenue recognized upon completion of four large perpetual license contracts. Approximately $1.1 million of the decrease was attributable to the cancellation of four large annual maintenance agreements in 2006.

The deferred revenue balance of $55.2 million as of March 31, 2007 consisted of approximately $15.5 million in deferred license revenue, approximately $28.0 million in deferred maintenance revenue, and approximately $11.7 million in deferred services and other revenue. Included in the deferred revenue balance as of March 31, 2007 was $0.8 million in deferred license revenue, $2.7 million in hardware revenue and $0.3 million in deferred services revenue related to a hardware deal with a single customer, totaling $3.8 million, which will be recognized during the second quarter of 2007. The $55.4 million in deferred revenue balance as of March 31, 2007 also included approximately $6.3 million for Veterans Health Administration contracts compared to $6.1 million included in the deferred revenue balance as of March 31, 2006.

The deferred revenue balance of $61.7 million as of March 31, 2006 consisted of approximately $22.0 million in deferred license revenue, approximately $26.3 million in deferred maintenance revenue, and approximately $13.4 million in deferred services and other revenue. The $3.8 million related to the aforementioned hardware deal to a single customer was also included in deferred revenue as of March 31, 2006.

**Cost of Revenue**

*Cost of services and other.* Cost of services and other consist of salaries and related expenses associated with services performed for customer support, installation, maintenance and consulting services. Cost of services and other for the three months ended March 31, 2007 was $7.0 million, compared to $6.9 million in the corresponding period in 2006. As a percentage of services and other revenue, cost of services and other was 36% and 35% for the three months ended March 31, 2007 and 2006, respectively. The net $0.1 million increase was primarily attributable to an increase in maintenance costs associated with third-party applications as a result of higher maintenance revenue being recognized in 2007.

*Cost of licenses*. Cost of licenses consists primarily of the cost of third-party software, royalties and amortization of capitalized software and acquired technology. A significant percentage of our total cost of revenue is attributable to the cost of third-party software royalties and licenses relating to software embedded within our software applications. Generally, third-party royalty fees fluctuate based on revenue, or the number of customers or licensed users, and therefore may fluctuate on a quarter-to-quarter basis. Cost of licenses for the three months ended March 31, 2007 was $3.5 million, compared to $3.8 million for the three months ended March 31, 2006. As a percentage of license revenue, cost of licenses was 38% and 41% for the three months ended March 31, 2007 and 2006, respectively. The net decrease of $0.3 million was primarily attributable to decreases in amortization of acquired technologies of $0.1 million related to the PDS acquisition, $0.2 million lower amortization associated with developed technologies from the Détente acquisition, and $0.2 million lower amortization of capitalized software, all partially offset by a $0.3 million increase in third party costs.

*Cost of hardware*. Cost of hardware consists of third-party hardware and installation costs, primarily related to Patient Care and Revenue Management contracts. Cost of hardware for the three months ended March 31, 2007 was $0.5 million, compared to $0.4 million for the three months ended March 31, 2006. Cost of hardware increased in 2007 due to the completion of a milestone contract with one of our major customers. As a percentage of hardware revenue, cost of hardware was 99% and 91% for the three months ended March 31, 2007 and 2006, respectively.

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**Gross Margin**

Overall, gross margin remained constant at 62% for both of the three month periods ended March 31, 2007 and 2006. Gross margin on license revenue increased by 3% from 59% in the three months ended March 31, 2006 to 62% during the three months ended March 31, 2007 due to lower acquired technology and capitalized software amortization. Gross margin on services and other revenue decreased by 1% for the three months ended March 31, 2007 to 64% as compared to 65% for the three months ended March 31, 2006. The gross margin on hardware revenue declined from 9% for the first three months of 2006 to 1% for the three month period ending March 31, 2007.

**Operating Expenses**

*General and administration*. General and administration expense consists of compensation and benefit costs for executive, finance, legal, information technology, and administrative personnel. General and administration expense decreased to $3.9 million for the three months ended March 31, 2007, compared to $6.6 million for the three months ended March 31, 2006. As a percentage of total revenue, general and administration expense was 13% and 23% for the three month period ended March 31, 2007 and 2006, respectively. The overall $2.7 million decrease is primarily attributable to the absence of any legal settlement charges in 2007 compared to a $1.0 million settlement charge recorded in 2006 resulting from the MedCath litigation, lower legal fees due to the $0.4 million associated with the MedCath litigation and other legal matters during the 2006 period, and the absence of costs in the 2007 period for our S-3 filings which were declared effective in December 2006; also, as compared to the 2006 period the three months ended March 31, 2007 reflected $0.2 million less professional and consulting fees related to compliance with the Sarbanes Oxley Act of 2002 and strategic activities, $0.2 million lower bad debt expense, and $0.4 million lower personnel-related costs associated with the 2006 reduction in force. The remaining decrease is principally due to the implementation of cost savings initiatives at the end of the 2006 period.

*Software development.* Software development expense includes costs associated with the development of new products for which technological feasibility has not been achieved, enhancements of existing products, maintenance and quality assurance activities, and is primarily comprised of compensation and benefits costs. Software development costs during the three months ended March 31, 2007 were $7.4 million compared to $8.6 million during the three months ended March 31, 2006. As a percentage of total revenue, software development costs were 25% and 30% for the three month period ended March 31, 2007 and 2006, respectively. The net decrease of $1.2 million was primarily attributable to a $1.0 million decrease in personnel costs associated with the 2006 reduction in force and the implementation of cost savings initiatives.

*Sales and marketing.* Sales and marketing expense includes costs associated with our sales and marketing personnel and consists primarily of compensation and benefits, commissions, bonuses, promotional and advertising expenses. Sales and marketing expense increased $0.2 million for the three months ended March 31, 2007 to $3.9 million, from $3.7 million for the three months ended March 31, 2006. As a percentage of total revenue, sales and marketing expenses remained consistent at 13% for both quarterly periods. The net increase was primarily attributable to a $0.1 million increase in personnel related costs, a $0.1 million increase in expenses related to our corporate re-branding and marketing initiatives, a $0.1 million increase in training, conferences, professional fees and shareholder relations costs, offset by $0.1 million of lower travel expenses.

*Amortization of intangible assets and depreciation.* Amortization of intangible assets and depreciation expense decreased to $0.9 million for the three months ended March 31, 2007 from $1.1 million during the three months ended March 31, 2006. The net decrease was principally the result of the expiration of the amortization periods associated with intangibles from the PDS, Détente and Tempus acquisitions during the twelve months ended March 31, 2007.

**Other Income (Expense)**

*Other income (expense), net.* Net other income was $0.6 million during the three months ended March 31, 2007 compared to net other income of $0.3 million in the corresponding quarter in 2006. The increase was

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primarily due to the interest income earned on our investment portfolios. Interest expense for both of the quarters ended March 31, 2007 and 2006 was approximately $0.1 million. The majority of interest expense for both periods was the result of non-cash charges.

**Income Taxes**

*Income taxes*. The provision for income taxes for both of the three month periods ended March 31, 2007 and 2006 was $0.1 million as a result of recording of deferred income tax expense related to the amortization of goodwill for tax purposes.

**Liquidity and Capital Resources**