QUADRAMED CORP
Form 10-Q
May 10, 2006

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, 2006

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 **(State or Other Jurisdiction of Incorporation or Organization)**	**52-1992861** **(IRS Employer 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 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 April 26, 2006, there were 41,787,777 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, 2006

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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, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 36,786	$ 33,042
Accounts receivable, net of allowance for doubtful accounts of $4,404 and $4,177, respectively	27,743	27,089
Unbilled and other receivables	3,720	3,387
Notes and other receivables, net of allowance for doubtful accounts of $715 and $715, respectively	308	50
Prepaid expenses and other current assets	10,661	11,734
Total current assets	79,218	75,302
Restricted cash	2,311	2,391
Property and equipment, net of accumulated depreciation and amortization of $19,564, and $19,052, respectively	3,414	3,737
Capitalized software development costs, net of accumulated amortization of $12,776, and $12,562, respectively	267	481
Goodwill	25,983	25,983
Other intangible assets, net of accumulated amortization of $24,737 and $23,343, respectively	5,749	7,143
Other long-term assets	4,492	4,859
Total assets	$ 121,434	$ 119,896
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$ 3,380	$ 3,551
Accrued payroll and related	5,900	7,422
Other accrued liabilities	8,205	10,114
Dividends payable	7,779	9,054
Deferred revenue	60,415	52,169
Total current liabilities	85,679	82,310
Accrued exit cost of facility closing	3,216	3,613
Other long-term liabilities	2,907	2,781

Total liabilities	91,802	88,704
Stockholders equity		
Preferred stock, $0.01 par, 5,000 shares authorized; 4,000 shares issued and outstanding	89,470	88,231
Common stock, $0.01 par, 150,000 shares authorized; 41,441 and 41,245 shares issued and outstanding, including 457 and 457 shares of treasury stock, respectively	419	417
Shares held in treasury	(5)	(5)
Additional paid-in-capital	302,936	302,324
Accumulated other comprehensive loss	(114)	(89)
Accumulated deficit	(363,074)	(359,686)
Total stockholders equity	29,632	31,192
Total liabilities and stockholders equity	$ 121,434	$ 119,896

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,	
	2006	**2005**
Revenue		
Services	$ 2,915	$ 3,077
Maintenance	13,562	13,410
Installation and other	2,872	2,696
Services and other revenue	19,349	19,183
Licenses	9,182	10,352
Hardware	397	840
Total revenue	28,928	30,375
Cost of revenue		
Cost of services and other revenue	7,462	7,319
Royalties and other	2,764	2,167
Amortization of acquired technology and capitalized software	995	1,035
Cost of license revenue	3,759	3,202
Cost of hardware revenue	363	965
Total cost of revenue	11,584	11,486
Gross margin	17,344	18,889
Operating expense		
General and administration	6,622	6,110
Software development	8,114	7,717
Sales and marketing	3,491	4,072
Amortization of intangible assets and depreciation	1,123	1,591
Total operating expenses	19,350	19,490
Income (loss) from operations	(2,006)	(601)
Other income (expense)		
Interest expense, includes non-cash charges of $119 and $165	(123)	(169)
Interest income	366	101
Other income (expense), net	18	(154)

Other income (expense)	261	(222)
Loss from continuing operations before income taxes	$ (1,745)	$ (823)
Provision for income taxes	(98)	(11)
Loss from continuing operations	(1,843)	(834)
Loss from discontinued operations		(1,686)
Net Loss	$ (1,843)	$ (2,520)
Preferred stock accretion	(1,239)	(1,175)
Net loss attributable to common shareholders	$ (3,082)	$ (3,695)
Loss per share-basic and diluted		
Continuing operations	$ (0.07)	$ (0.05)
Discontinued operations		(0.04)
Net loss	$ (0.07)	$ (0.09)
Weighted average shares outstanding		
Basic and diluted	41,319	40,219

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 LOSS

(in thousands)

(unaudited)

	Preferred Stock		Common Stock		Treasury Stock						
	Shares	Amount	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders Equity	Other Comprehensive Loss
Balance, December 31, 2005	4,000	$ 88,231	41,702	$ 417	(457)	$ (5)	$ 302,324	$ (89)	$ (359,686)	$ 31,192	$ (8,699)
Issuance of common stock			196	2			245			247	
Accretion of preferred stock		1,239							(1,239)		(1,239)
Dividends declared									(250)	(250)	
Stock-based compensation expense							367			367	
Net unrealized loss on available-for-sale securities								(23)		(23)	(23)
Foreign currency translation								(2)		(2)	(2)
Other									(56)	(56)	
Net loss									(1,843)	(1,843)	(1,843)
Balance, March 31, 2006	4,000	$ 89,470	41,898	$ 419	(457)	$ (5)	$ 302,936	$ (114)	$ (363,074)	$ 29,632	$ (3,107)

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,	
	2006	**2005**
Cash flows from operating activities		
Net loss attributable to common shareholders	$ (3,082)	$ (3,695)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,196	2,808
Preferred stock accretion	1,239	1,175
Impairment and other charges for Financial Services Division		914
Provision for bad debts and other	386	200
Stock-based compensation expense	367	734
Changes in assets and liabilities:		
Accounts receivable	(1,040)	(10,442)
Prepaid expenses and other	850	1,878
Accounts payable and accrued liabilities	(3,898)	(4,954)
Deferred revenue	8,246	10,594
Cash provided by (used in) operating activities	5,264	(788)
Cash flows from investing activities		
Proceeds from sale of assets and available-for-sale securities	9	(82)
Decrease in restricted cash	80	
Capital expenditures	(231)	(303)
Cash used in investing activities	(142)	(385)
Cash flows from financing activities		
Proceeds from issuance of common stock and other	247	498
Payment of preferred stock dividends	(1,625)	(1,375)
Cash used in financing activities	(1,378)	(877)
Net increase (decrease) in cash and cash equivalents	3,744	(2,050)
Cash and cash equivalents, beginning of period	33,042	22,429
Cash and cash equivalents, end of period	$ 36,786	$ 20,379
Supplemental disclosure of cash flow information		
Cash paid for interest		
Net cash paid for taxes	25	11

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

March 31, 2006

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 and support services 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 hospital financial success by leveraging quality of care into positive financial outcomes through performance-based IT solutions. We seek to accomplish this by delivering healthcare information technology products and services supporting the healthcare organizations efforts to improve the quality of the care they provide and the efficiency with which it is delivered.

Using QuadraMed s end-to-end solutions which 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 effective 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. In December 2004, we announced the shutdown of the Financial Services Division; operations ceased to exist in February 2005. Accordingly, beginning in 2005, the Company considers itself to be in a single reporting segment, specifically the software segment. The prior year financial results of these operating segments have been reclassified to conform to the current year presentation.

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, 2005, filed on March 16, 2006. 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, 2006 are not necessarily indicative of the results for the entire year ending December 31, 2006.

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, and 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

Certain reclassifications have been made to prior year balances 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 QuadraMed s proprietary software, as well as 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. 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 purchased software. Cost of hardware revenue consists of third-party equipment and installation.

QuadraMed markets 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.

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.

Certain of the licenses are term or time-based licenses. QuadraMed recognizes revenue from these contracts ratably over the term of the arrangement.

Contract accounting is applied where services include significant software modification, installation or customization. In such instances, the services and license fees are 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.

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 recognized as the services are performed.

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, but for which the Company does not have the right to bill the customer per the contract terms.

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Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments that are comprised principally of taxable, short-term certificates of deposit, money market instruments and commercial paper with original maturities of three months or less at the time of purchase, and demand deposits with financial institutions. These instruments carry insignificant interest rate risk because of their short-term maturities. Cash equivalents are stated at amounts that approximate fair value based on quoted market prices.

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.

Intangible Assets

QuadraMed s acquisitions of other companies typically result in the acquisition of certain intangible assets and goodwill.

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, 2005 and 2006, QuadraMed reviewed the 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.

Capitalized Software. Software development costs are capitalized upon the establishment of technological feasibility, in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Upon the general release of the product to customers, development costs for that product are amortized over the greater of the ratio that current revenues bear to total and anticipated future revenues for the applicable product, or the straight-line method, generally five years. These amounts are charged to cost of licenses. No software development costs were capitalized in 2006 or 2005.

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. Amortization of other intangible assets is computed on the basis of a 3-5 year life.

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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 have adopted SFAS No. 123(R) for our fiscal year beginning January 1, 2006. See Note 10 Stock-Based Compensation.

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.

In the first quarter of 2005, we recorded an additional $1.7 million loss from discontinued operations in connection with the closing of FSD in February. This loss included, among other things, severance costs and a $1.0 million charge related to the future lease obligations of the FSD s office in San Marcos, California.

The lease for this facility terminates in May 2008. Our annual cost under the lease is approximately $0.8 million. We have estimated the facility closing costs based upon current market information available related to potential sublease rental income, sublease commission costs and the length of time expected to secure a sublease. We continue to actively seek a qualified subtenant for the property, but to date have not been successful.

The results of operations for the Financial Services Division as discussed above, are presented in the table below (in thousands):

	For the Three Months Ended March 31,	
	2006	2005
Revenues	$	$ 223
Loss from operation		(772)
Exit cost of facility closing		(1,032)
Other		118
Total loss	$	$ (1,686)

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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 $4.9 million for each of the years 2006 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 continue to actively seek a qualified subtenant for the property, but to date have not been successful.

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, 2006 and 2005 (in thousands):

	March 31,	
	2006	**2005**
Exit Costs for the San Rafael Facility:		
Accrued exit cost of facility closing, beginning of period	$ 4,217	$ 4,048
Payments made	(245)	(324)
Accrued exit cost of facility closing, end of period	$ 3,972	$ 3,724
Exit Cost for the San Marcus Facility:		
Accrued exit cost of facility closing, beginning of period	$ 1,275	$
Exit cost of facility closing, February 2005		1,032
Payments made	(170)	(162)
Accrued exit cost of facility closing, end of period	$ 1,105	$ 870
Summary:		
Accrued Exit Cost Liability		
Short-term	$ 1,861	$ 1,638
Long-term	3,216	2,956
Total	$ 5,077	$ 4,594

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. Annualized savings associated with elimination of these positions, and other related cost savings initiatives is estimated to be approximately $3.6 million.

During the first quarter of fiscal year 2005, the Company announced a corporate reorganization and a reduction in our workforce of 95 positions. The Company recorded a severance charge of approximately $531,000 associated with terminated employees in the Company s results of operations for the quarter ended March 31, 2005.

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6. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets for the three-month period ended March 31, 2006 were as follows (in thousands):

	As of December 31, 2005	Q1 2006 Activity	As of March 31, 2006
Cost			
Capitalized software	$ 13,043	$	$ 13,043
Goodwill	37,896		37,896
Other intangible assets	30,486		30,486
	81,425		81,425
Accumulated amortization			
Capitalized software	$ (12,562)	$ (214)	$ (12,776)
Goodwill	(11,913)		(11,913)
Other intangible assets	(23,343)	(1,394)	(24,737)
	(47,818)	(1,608)	(49,426)
Net book value			
Capitalized software	$ 481	$ (214)	$ 267
Goodwill	25,983		25,983
Other intangible assets	7,143	(1,394)	5,749
	$ 33,607	$ (1,608)	$ 31,999

Amortization of acquired technology, a component of other intangible assets, for the three months ended March 31, 2006 and 2005 was $781,000 and $781,000, respectively, and was included in cost of license revenue. No impairment charges were recorded during the three months ended March 31, 2006 or 2005.

7. 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 2008 Notes and 2005 Notes, together with accrued interest and related redemption premiums; the remainder of the net proceeds 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 $8.0 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

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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.

Generally, 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 will apply until the date the stock is registered. The registration statement for the 4.0 million shares of Series A Preferred Stock, and the 32.3 million shares of common stock into which the Series A Preferred Stock may be converted, was filed with the SEC on February 6, 2006 as Pre- Effective Amendment No. 2 to Form S-3, but has not yet been 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 into shares of common stock on or before May 31, 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 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 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 period ended March 31, 2006 and 2005, respectively approximately $101,000 and $165,000, 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. In both of the three month periods ended March 31, 2006 and 2005 approximately $1.2 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.

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

		As of March 31, 2006
Total issued		$ 100,000
Less: Issuance cost		(3,856)
Less: Unaccreted discount		
Original present value of discount	(15,174)	
2006 preferred stock accretion	1,239	
2005 preferred stock accretion	4,796	
2004 preferred stock accretion	2,465	(6,674)
Carrying value of preferred stock at March 31, 2006		$ 89,470

8. RESTRICTED STOCK GRANTS

During the three months ended March 31, 2006 and 2005, 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 and $142,000 during the three months ended March 31, 2006 and 2005 respectively. In addition to these amounts, $592,000 was charged to severance expense in the quarter ended March 31, 2005 relating to the early-vesting of restricted stock issued to a former officer of the Company.

As of March 31, 2006, 650,000 restricted shares remained subject to forfeiture.

9. NET LOSS PER SHARE AND COMPREHENSIVE LOSS

Basic loss per share is determined using the weighted average number of common shares outstanding during the period. Diluted 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 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 net loss per common share (in thousands):

	Three months ended March 31, 2006	Three months ended March 31, 2005
Numerator:		
Net loss attributable to common shareholders	$ (3,082)	$ (3,695)
Denominator:		
Weighted average number of common shares outstanding basic and diluted	41,319	40,219
Basic and diluted net loss per common share	$ (0.07)	$ (0.09)

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As QuadraMed recorded net losses for both of the three month periods ended March 31, 2006 and 2005, no common equivalent shares were included in diluted net loss per share calculation because they were anti-dilutive. If QuadraMed had reported net income, the calculation of diluted earnings per share would have included the following common stock equivalent shares from the indicated equity instruments (in thousands):

	Three months ended March 31,	
	2006	**2005**
Equity instruments:		
Preferred stock	32,258	29,412
Warrants	3,265	3,267
Stock options	621	1,104
Total common stock equivalent shares	36,144	33,783

The components of QuadraMed s comprehensive 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 loss (in thousands):

	Three months ended March 31,	
	2006	**2005**
Net loss attributable to common shareholders	$ (3,082)	$ (3,695)
Unrealized loss	(23)	(26)
Foreign currency translation adjustment	(2)	5
Comprehensive loss	$ (3,107)	$ (3,716)

10. 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.

As permitted by SFAS No. 123, for 2005, the Company accounted for share-based payments to employees using APB Opinion No. 25 s intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. Effective January 1, 2006, we have 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 included herein. Under the modified prospective method, compensation cost recognized in the three months ended March 31, 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

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adoption. Stock-based compensation expense for the three months ended March 31, 2006 and 2005 totaled $0.4 million and $1.4 million, respectively, and is included in selling, general and administrative expenses in the condensed consolidated statement of operations only for the period ended March 31, 2006. There was no income tax benefit or excess tax benefit related to stock-based compensation during the three months ended March 31, 2006 and 2005. There were no capitalized stock-based compensation costs for the three months ended March 31, 2006 and 2005.

QuadraMed has determined pro-forma information regarding net income and earnings per share as if we had accounted for employee stock options under the fair value method as required by SFAS No. 123. The fair value of these stock-based awards to employees was estimated using the Black-Scholes option pricing model. Had compensation cost for the Company s stock option plans been determined consistent with SFAS No. 123(R) the Company s reported net loss and net loss per share would have been changed to the amounts indicated below (in thousands except per share data):

	Three months ended March 31,	
	2006	**2005**
Net loss attributable to common shareholders, as reported	$ (3,082)	$ (3,695)
Add: Stock-based employee compensation expense in reported net loss, net of tax	367	734
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(367)	(1,369)
Pro forma net loss	$ (3,082)	$ (4,330)
Basic and diluted net loss per common share, as reported	$ (0.07)	$ (0.09)
Basic and diluted net loss per common share, pro forma	$ (0.07)	$ (0.11)

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, as of May 6, 2004, 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, 2006 were 1,575,000.

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 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

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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 4,832,256 were outstanding at March 31, 2006. There were no shares available for grant at March 31, 2006.

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 1,271,938 were outstanding at March 31, 2006. There were no shares available for grant at March 31, 2006.

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 un-issued 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 660,138 were outstanding at March 31, 2006. There were 876,231 shares available for grant at March 31, 2006.

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 special 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 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 453,450 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. As of December 31, 2005, 63,570 shares are available for issuance. The Board has approved an increase in the number of shares reserved under the 2002 Purchase Plan to 703,450, which will be submitted to the stockholders for approval at the 2006 Annual Stockholders meeting. Stock-based compensation expense relating to shares purchased on behalf of plan participants for the three months ended March 31, 2006 and 2005 totaled $7,231 and $13,344, respectively.

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Stock Options:

Stock options generally vest ratably over four 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, 2006	8,387	$ 3.64
Granted	232	1.72
Exercised	(148)	1.24
Cancelled	(132)	5.92
Options outstanding, March 31, 2006	8,339	$ 3.59
Options exercisable, March 31, 2006	6,789	$ 4.00

Stock-based compensation expense relating to stock options for the three months ended March 31, 2006 and 2005 totaled $271,000 and $635,000, respectively. Compensation expense for the three months ended March 31, 2005 was recognized on a proforma basis only.

The weighted average remaining contractual term and the aggregate intrinsic value for options outstanding at March 31, 2006 were 6.0 years and $2.0 million, respectively. The weighted average remaining contractual term and the aggregate intrinsic value for options exercisable at March 31, 2006 were 5.2 years and $1.4 million, respectively. As of March 31, 2006, unrecognized compensation expense related to stock options totaled approximately $1.7 million, which will be recognized over a weighted average period of 1.5 years.

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,	
	2006	2005
Expected dividend yield		
Expected stock price volatility	85.97%	148.70%
Risk-free interest rate	4.53%	3.88%
Expected life of options	5.73 years	4.25 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 31.09% 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 months ended March 31, 2006 was $1.36. There were no options granted during the three months ended March 31, 2005. As of March 31, 2006, unrecognized compensation expense related to stock options totaled approximately $1.0 million, which will be recognized over a weighted average period of 2.3 years.

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

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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, 2006 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, 2006	650	$ 1.77
Granted		
Restrictions released		
Forfeited		
Restricted stock awards, as of March 31, 2006	650	$ 1.77

Stock-based compensation expense relating to restricted share grants for the three months ended March 31, 2006 and 2005 totaled $100,000 and $700,000, respectively. During the three months ended March 31, 2005, $600,000 was charged to severance expense relating to the early-vesting of restricted stock to former officers of the Company.

11. MAJOR CUSTOMERS

For the quarter ended March 31, 2006, sales to Veterans Health Administration facilities accounted for approximately 12% of our total revenues.

12. 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 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 million related to the settlement in its three month period ended March 31, 2006.

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 Report contains forward-looking statements as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are subject to risks and uncertainties. The words believe , expect , target , goal , project , anticipate , predict , intend , plan , will , 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 and 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 Report, 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,			
	2006		2005	
Revenue				
Services	$ 2,915	10%	$ 3,077	10%
Maintenance	13,562	47%	13,410	44%
Installation and other	2,872	10%	2,696	9%
Services and other	19,349	67%	19,183	63%
Licenses	9,182	32%	10,352	34%
Hardware	397	1%	840	3%
Total revenue	28,928	100%	30,375	100%
Cost of revenue				
Cost of services and other	7,462	39%	7,319	38%
Royalties and other	2,763	30%	2,167	21%
Amortization of acquired technology and capitalized software	996	11%	1,035	10%
Cost of licenses	3,759	41%	3,202	31%
Cost of hardware	363	91%	965	115%
Total cost of revenue	11,584	40%	11,486	38%

Gross margin	17,344	60%	18,889	62%
Operating expenses				
General and administration	6,622	23%	6,110	20%
Software development	8,114	28%	7,717	25%
Sales and marketing	3,491	12%	4,072	13%
Amortization of intangible assets and depreciation	577	2%	1,228	4%
Loss on lease Obligation	546	2%	363	1%
Total operating expenses	$ 19,350	67%	$ 19,490	64%
Loss from operations	$ (2,006)		$ (601)	

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Revenue

Total revenue. Total revenue for the three months ended March 31, 2006 was $28.9 million compared to $30.4 million for the three months ended March 31, 2005. The net decrease of $1.5 million or 5% was due primarily to a $2.2 million decrease in revenues from our Enterprise products, principally Affinity and MPI products; this was partially offset by a $0.7 million increase in government revenue.

Services and other. 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 HIM Software products and two to three years for Affinity and other Enterprise products. These services are provided subsequent to the signing of a software license arrangement and depend in large part on our software license revenues. Our maintenance revenue depends on 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, 2006 was $2.9 million or 10% of total revenue, compared to $3.1 million or 10% of total revenue for the three months ended March 31, 2005. The net decrease of $0.2 million or 6% was the result of a decrease in services revenue for government products.

Maintenance revenue for the three months ended March 31, 2006 was $13.6 million, compared to $13.4 million for the three months ended March 31, 2005. Maintenance revenue, as a percentage of total revenue, was 47% and 44% for the three months ended March 31, 2006 and 2005, respectively. The net increase in maintenance revenue is principally due to contractually-based increases in support fees for the Enterprise products, offset in part by non-renewals of annual maintenance agreements.

Installation and other services revenue increased to $2.9 million or 10% of total revenue during the three months ended March 31, 2006 from $2.7 million or 9% of total revenue during the three months ended March 31, 2005. The net increase of $0.2 million was the result of an $0.8 million increase for government products, offset by a $0.6 million decrease in installation revenue related to Affinity and other Enterprise products. Installation and other revenue for government and HIM products are typically recognized upon completion of a contract, whereas the installation and other revenue for Enterprise products are recognized on a percentage of completion basis.

Licenses. License revenue consists of fees and licenses of 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, 2006 was $9.2 million, compared to $10.4 million in the corresponding period of 2005. License revenue as a percentage of total revenue was 32% and 34% for the three months ended March 31, 2006 and 2005, respectively. The net decrease of $1.2 million or 12% was the result of a $1.6 million decrease in license revenue from our Enterprise products, principally Affinity, compared to the same quarter in the prior year. This decrease is partially attributable to a decreased number and size of active Affinity projects compared to the same period in the prior year. This decrease is partially offset by an increase in license revenue from our HIM and government products totaling approximately $0.4 million.

Hardware. Hardware revenue consists of the sale of third-party hardware purchased specifically for use by our customers. Hardware revenue was $0.4 million during the three months ended March 31, 2006 compared to $0.8 million during the three months ended March 31, 2005. Hardware revenue, as a percentage of total revenue, was 1% and 3% for the three months ended March 31, 2006 and 2005, respectively.

Revenue recognized for the three months ended March 31, 2006 and 2005 includes:

- Amounts initially recorded as deferred revenue in which the Company has now completed its contractual commitments;
- Service revenue relating to installation and training, during the period; and
- Revenues recognized on a cash-basis after the Company s contractual commitment has been completed.

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

	For the Three Months Ended March 31	
	2006	2005
Deferred revenue, beginning balance	$ 52,169	$ 44,040
Add: revenue deferred	36,993	39,767
Less: deferred revenue recognized	(28,747)	(29,173)
Deferred revenue, ending balance	$ 60,415	$ 54,634

Cost of Revenue

Cost of services and other. Cost of services and other consists of salaries and related expenses associated with services performed for customer support, installation, maintenance and consulting services. Cost of services and other for the quarter ended March 31, 2006 was $7.5 million, compared to $7.3 million in the corresponding period in 2005. As a percentage of services and other revenue, cost of services and other was 39% and 38% for the three months ended March 31, 2006 and 2005, respectively. The net $0.2 million increase was primarily attributable to an increase in personnel related costs partially offset by a decrease in consulting costs.

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, 2006 was $3.8 million, compared to $3.2 million for the three months ended March 31, 2005. As a percentage of license revenue, cost of licenses was 41% and 31% for the three months ended March 31, 2006 and 2005, respectively. The net increase of $0.6 million was primarily attributable to increases in third party license costs, and cost of license as a percentage of revenue increased as a result of the increase in costs and a decrease in higher margin Enterprise product licen