QUADRAMED CORP
Form 10-Q
November 05, 2009
**Table of Contents**

# 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 September 30, 2009**

**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** | **(IRS Employer** |
| **Incorporation or Organization)** | **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)**

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

As of November 2, 2009, there were 8,307,277 shares of the Registrant s common stock outstanding, par value $0.01.

Table of Contents

**QUADRAMED CORPORATION**

**REPORT ON FORM 10-Q**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**TABLE OF CONTENTS**

Table of Contents

## PART I. FINANCIAL INFORMATION

*Item 1. Consolidated Financial Statements*

## QUADRAMED CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

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

**(unaudited)**

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash and cash equivalents | $ 7,879 | $ 20,649 |
| Short-term investments | 7,650 | 4,213 |
| Accounts receivable, net of allowance for doubtful accounts of $1,402 and $1,052, respectively | 27,384 | 20,843 |
| Unbilled receivables | 6,817 | 6,177 |
| Deferred contract expenses | 5,678 | 5,005 |
| Prepaid royalty expenses | 1,094 | 7,831 |
| Prepaid expenses and other current assets, net of allowance on other receivable of $919, respectively | 4,330 | 4,485 |
| Deferred tax asset, net of valuation allowance | 6,241 | 6,240 |
| **Total current assets** | 67,073 | 75,443 |
| Restricted cash | 1,522 | 1,444 |
| Long-term investments | 3,506 | 3,043 |
| Property and equipment, net of accumulated depreciation and amortization of $19,169 and $17,732, respectively | 3,556 | 3,895 |
| Goodwill | 35,632 | 35,632 |
| Other amortizable intangible assets, net of accumulated amortization of $30,932 and $29,305, respectively | 7,760 | 9,387 |
| Other long-term assets | 2,831 | 2,829 |
| Deferred tax asset, net of valuation allowance | 48,009 | 47,921 |
| **Total assets** | $ 169,889 | $ 179,594 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **Current liabilities** | | |
| Accounts payable and accrued expenses | $ 5,794 | $ 4,705 |
| Accrued payroll and related benefits | 5,221 | 7,228 |
| Accrued exit cost of facility closing | 346 | 888 |
| Income tax payable | 2,079 | 688 |
| Other accrued liabilities | 3,491 | 4,721 |
| Dividends payable | 1,375 | 1,375 |
| Deferred revenue | 43,004 | 53,190 |
| **Total current liabilities** | 61,310 | 72,795 |
| Other long-term liabilities | 1,458 | 1,834 |
| **Total liabilities** | 62,768 | 74,629 |
| **Commitments and Contingencies** | | |
| **Stockholders equity** | | |
| Preferred stock, $0.01 par, 5,000 shares authorized, 4,000 shares issued and outstanding, respectively | 96,144 | 96,144 |
| | 95 | 95 |

| | | |
|---|---|---|
| Common stock, $0.01 par, 30,000 shares authorized; 9,471 and 9,451 shares issued and 8,307 and 8,287 outstanding, respectively | | |
| Shares held in treasury, 1,164, respectively | (9,031) | (9,031) |
| Additional paid-in-capital | 317,868 | 316,027 |
| Accumulated other comprehensive loss | (987) | (1,675) |
| Accumulated deficit | (296,968) | (296,595) |
| **Total stockholders equity** | 107,121 | 104,965 |
| **Total liabilities and stockholders equity** | $ 169,889 | $ 179,594 |

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

3

Table of Contents

**QUADRAMED CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

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

**(unaudited)**

| | Three months ended, September 30, | | Nine months ended, September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| **Revenue** | | | | |
| Services | $ 5,803 | $ 5,930 | $ 16,441 | $ 17,102 |
| Maintenance | 16,849 | 18,205 | 49,349 | 51,734 |
| Installation and other | 3,064 | 3,153 | 9,133 | 9,614 |
| Services and other revenue | 25,716 | 27,288 | 74,923 | 78,450 |
| Term licenses | 8,500 | 8,099 | 25,925 | 23,651 |
| Perpetual licenses | 1,446 | 3,127 | 5,454 | 9,260 |
| License revenue | 9,946 | 11,226 | 31,379 | 32,911 |
| Hardware | 140 | 75 | 387 | 505 |
| **Total revenue** | 35,802 | 38,589 | 106,689 | 111,866 |
| **Cost of revenue** | | | | |
| Cost of services and other revenue | 10,502 | 11,487 | 31,615 | 34,324 |
| Royalties and other | 3,592 | 3,671 | 10,944 | 11,365 |
| Amortization of acquired technology and capitalized software | 219 | 245 | 676 | 756 |
| Cost of license revenue | 3,811 | 3,916 | 11,620 | 12,121 |
| Cost of hardware revenue | 217 | 64 | 361 | 328 |
| **Total cost of revenue** | 14,530 | 15,467 | 43,596 | 46,773 |
| **Gross margin** | 21,272 | 23,122 | 63,093 | 65,093 |
| **Operating expense** | | | | |
| General and administration | 4,876 | 5,027 | 16,619 | 14,907 |
| Software development | 9,316 | 8,328 | 25,937 | 25,362 |
| Sales and marketing | 4,247 | 4,968 | 13,117 | 14,105 |
| Loss on sale of assets | | 46 | | 1,161 |
| Amortization of intangible assets and depreciation | 856 | 761 | 2,387 | 2,400 |
| **Total operating expenses** | 19,295 | 19,130 | 58,060 | 57,935 |
| **Income from operations** | 1,977 | 3,992 | 5,033 | 7,158 |
| **Other income (expense)** | | | | |
| Interest expense, includes non-cash charges of $14, $18 and $47, $54 | (16) | (26) | (51) | (99) |
| Interest income | 58 | 136 | 179 | 460 |
| Other income, net | 160 | 1 | 268 | 9 |

| | | | | |
|---|---|---|---|---|
| **Other income, net** | 202 | 111 | 396 | 370 |
| **Income from operations before income taxes** | $ 2,179 | $ 4,103 | $ 5,429 | $ 7,528 |
| Provision for income taxes | (669) | (1,634) | (1,677) | (2,963) |
| **Net Income** | 1,510 | 2,469 | 3,752 | 4,565 |
| Preferred stock dividends declared | (1,375) | (1,375) | (4,125) | (4,125) |
| **Net income (loss) attributable to common shareholders** | $ 135 | $ 1,094 | $ (373) | $ 440 |
| **Income (loss) per share** | | | | |
| Basic | $ 0.02 | $ 0.12 | $ (0.05) | $ 0.05 |
| Diluted | $ 0.02 | $ 0.12 | $ (0.05) | $ 0.05 |
| **Weighted average shares outstanding** | | | | |
| Basic | 8,300 | 8,931 | 8,296 | 8,930 |
| Diluted | 8,324 | 8,962 | 8,296 | 8,963 |

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

Table of Contents

**QUADRAMED CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

**(unaudited)**

| | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Net income | $ 1,510 | $ 2,469 | $ 3,752 | $ 4,565 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | | | |
| Depreciation and amortization | 1,075 | 1,006 | 3,063 | 3,156 |
| Deferred compensation amortization | | 85 | | 273 |
| Stock-based compensation | 295 | 805 | 1,740 | 2,445 |
| Provision for bad debts | 322 | 34 | 894 | 164 |
| Provision for income taxes | 669 | 1,634 | 1,677 | 2,963 |
| Loss on sale of assets | | 46 | | 1,161 |
| Changes in operating assets and liabilities: | | | | |
| Accounts receivable | (4,776) | (1,835) | (8,075) | (3,861) |
| Prepaid expenses and other | 2,515 | 3,271 | 5,889 | 866 |
| Accounts payable and accrued liabilities | (704) | 960 | (2,425) | (8,355) |
| Deferred revenue | (2,951) | (6,081) | (10,186) | 11,155 |
| Cash (used in) provided by operating activities | (2,045) | 2,394 | (3,671) | 14,532 |
| **Cash flows from investing activities** | | | | |
| Decrease (increase) in restricted cash | 6 | 173 | (78) | 833 |
| Purchases of available-for-sale securities | (8,161) | (190) | (15,837) | (4,220) |
| Proceeds from sale of available-for-sale securities | 9,210 | 190 | 11,734 | 6,049 |
| Payment of acquisition costs | | (10) | | (56) |
| Purchases of property and equipment | (588) | (577) | (1,097) | (1,420) |
| Proceeds from sale of assets | | | | 106 |
| Cash provided by (used in) investing activities | 467 | (414) | (5,278) | 1,292 |
| **Cash flows from financing activities** | | | | |
| Payment of preferred stock dividends | (1,375) | (1,375) | (4,125) | (4,125) |
| Proceeds from issuance of common stock and other | 53 | 395 | 101 | 544 |
| Repurchase of common stock | | | | (3,728) |
| Cash used in financing activities | (1,322) | (980) | (4,024) | (7,309) |
| **Effect of exchange rate changes on cash** | 26 | (193) | 203 | (224) |
| Net (decrease) increase in cash and cash equivalents | (2,874) | 807 | (12,770) | 8,291 |
| **Cash and cash equivalents**, beginning of period | 10,753 | 14,603 | 20,649 | 7,119 |
| **Cash and cash equivalents**, end of period | $ 7,879 | $ 15,410 | $ 7,879 | $ 15,410 |
| **Supplemental disclosure of cash flow information** | | | | |
| Cash paid for taxes | 49 | 96 | 150 | 410 |
| Dividends declared | 1,375 | 1,375 | 4,125 | 4,125 |

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

Table of Contents

**QUADRAMED CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

## 1. THE COMPANY

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

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

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

We conduct business directly and through our subsidiaries, all of which are wholly owned and operated under common management. The Company considers itself to be a single reporting segment, specifically a software provider segment.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Financial Statement Presentation

These Condensed Consolidated Financial Statements are unaudited and have been prepared in conformity with generally accepted accounting principles in the United States ( GAAP ) and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and disclosures required by GAAP for complete financial statements. We suggest that you read these interim condensed consolidated 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, 2008, filed with the SEC on March 11, 2009. 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 and nine months ended September 30, 2009 are not necessarily indicative of the results for the entire year ending December 31, 2009.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

**Principles of Consolidation and Basis of Presentation**

These Condensed Consolidated Financial Statements, which include the accounts of QuadraMed and all wholly owned subsidiaries, have been prepared in conformity with GAAP and the rules and regulations of the SEC. The Accounting Standards Codification ( ASC ) has become the source of authoritative GAAP. The ASC only changes the referencing of financial accounting standards and does not change or alter existing GAAP. All significant intercompany accounts and transactions between QuadraMed and its subsidiaries are eliminated in consolidation. In preparing the financial statements, we have evaluated subsequent events, as defined by ASC 855 for subsequent event accounting through November 5, 2009, which is the date that the financial statements were issued.

Share and per share data (except par value) presented for all periods reflect the effect of a one-for-five reverse stock split effective on June 13, 2008, as discussed in Note 12 *Reverse Stock Split*. In addition, the number of shares of common stock issuable upon conversion of the Series A Preferred Stock, the exercise of outstanding stock options and the vesting of other stock awards, as well as the number of shares of common stock reserved for issuance under our various employee benefit plans, were proportionately adjusted in accordance with the terms of those respective agreements and plans.

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

The preparation of financial statements in conformity with GAAP requires management to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities, revenues and expenses. Significant estimates and assumptions have been made regarding revenue recognition, the allowance for doubtful accounts, stock-based compensation input assumptions, the purchase price allocation related to the CPR business acquisition, the provision for income taxes, contingencies, litigation, intangibles, charges associated with exit activities and other amounts. We base our estimates and assumptions on historical experience and on various other assumptions which management believes to be reasonable under the circumstances. Uncertainties are inherent in all of these estimates including the estimates underlying percentage-of-completion accounting method of revenue recognition. In addition, we annually review and test our estimates related to the valuations of intangibles including acquired technology, goodwill, customer lists, trademarks and other intangibles and capitalized software. Actual results may differ materially from these estimates.

**Reclassifications**

Certain reclassifications to the consolidated balance sheets and condensed consolidated statement of cash flows have been made to prior year information to conform with the current year presentation.

**Revenue Recognition**

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

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

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

includes third-party hardware used by our customers in connection with software purchased. Cost of hardware revenue consists of third-party equipment and installation.

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

We recognize revenue on software products in accordance with the Software Revenue Recognition guidance of ASC 605 and ASC 985.

We recognize revenue when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered; we no longer have significant obligations with regard to implementation; the fee is fixed and determinable; and collectability 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. The Company typically defers revenue and recognizes revenue on a cash basis for renewals of term license and support if the Company s initial assessment is modified by facts and circumstances and collection is no longer deemed probable. Revenue may also be deferred and recognized on a cash basis if there is a contractual dispute and payments are delayed. Revenue is recognized when the collection becomes reasonably assured and/or the contract dispute is resolved.

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

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

Contract accounting is applied where services include significant software modification, installation or customization. In such instances, the services and license fee is accounted for in accordance with ASC 605, whereby the revenue is recognized, generally using the percentage-of-completion method measured on labor input hours. We use the completed-contract method of revenue recognition rather than the percentage-of-completion method for contracts with short implementation service periods (typically less than 3-9 months) and in circumstances in which the Company s financial position and results of operations would not

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

vary materially from those resulting from the use of the percentage-of-completion method. If increases in projected costs-to-complete are sufficient to create a loss contract, the entire estimated loss is charged to operations in the period the loss first becomes known. The complexity of the estimation process and judgment related to the assumptions, risks and uncertainties inherent with the application of the percentage-of-completion method of accounting can affect the amounts of revenue and related expenses reported in the Company s consolidated financial statements. The Company classifies revenues from these arrangements as license, installation, hardware, and services revenue based on the estimated fair value of each element using the residual method, and revenues are reflected in respective revenue categories in our consolidated financial statements.

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

Hardware revenue is generated primarily from transactions in which customers purchase bundled solutions that include 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 ASC 605, whereby the revenue is recognized generally using the percentage-of-completion method measured on labor input hours. Otherwise, hardware revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collection is reasonably assured.

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

**Cash and Cash Equivalents**

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

**Investments**

We consider our holdings of short-term and long-term securities, consisting primarily of fixed income securities 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.

As of September 30, 2008, the Company s long-term investments included $1.9 million of auction rate securities. Auction rate securities are collateralized long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined intervals, typically every 7 to 28

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

days. Beginning in February 2008, auctions failed for our holdings because sell orders had exceeded buy orders. The funds associated with these failed auctions were not accessible until the issuer called the security, a successful auction occurred, or a buyer was found outside of the auction process. The underlying assets of the auction rate securities we held, including the securities for which auctions had failed, were preferred shares of closed-end mutual funds. Given the Company s holdings of cash, cash equivalents and short-term investments, our expected operating cash flows and our access to funds through our corporate credit facility, the Company had the ability and intent to hold these securities until liquidity returned to this market or the securities were redeemed. The Company has subsequently successfully liquidated these positions during the third and fourth quarters of 2008 without any significant loss and no permanent impairment occurred. As of September 30, 2009, our investment portfolio does not contain any auction rate securities.

**Accounts Receivable and Allowance for Doubtful Accounts**

Accounts receivable consist primarily of amounts due to us from our customers for the delivery of products and services. We provide an allowance for doubtful accounts, which reflects our estimate of non-collection of accounts receivable based on past collection history and other specifically identified risks.

**Concentration of Credit Risk**

Accounts receivable represent our highest potential concentration of credit risk. We reserve for credit losses and do not require collateral on our trade accounts receivable. In addition, we maintain cash and investment balances in accounts at various domestic banks and brokerage firms. Our balances at banks are insured by the Federal Deposit Insurance Corporation for up to $250,000 at each bank.

**Property and Equipment**

Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives, which are generally three years for computer equipment and purchased software and five years for office furnishings and equipment. Leasehold improvements are amortized over the shorter of the term of the lease or the useful life (generally 10 years). Maintenance and repair costs are expensed as incurred. We review property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For property and equipment sales and disposals, the cost and related accumulated depreciation are removed from the accounts and net amounts, less proceeds from disposals, are included in income. Accordingly, no indications of impairment exist.

**Goodwill**

We record as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired in accordance with ASC 805 guidance related to business combinations. The determination of fair value of the identifiable net assets acquired is determined based upon a valuation analysis, performance of fair value calculations, financial projections and evaluation of other information.

ASC 350 prescribes a two-step process for impairment testing of goodwill and intangibles with indefinite lives, which is performed annually, and when an event triggering impairment may have occurred. The first step tests determine impairment, while the second step, if necessary, measures the impairment. We elected to perform our annual analysis at year end and no indicators of impairment have been identified.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

Intangible assets subject to amortization include trademarks, customer marketing and technology related assets. Such intangible assets are amortized based on the estimated economic benefit over their estimated useful lives, which are generally two to ten years.

**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 our purchase business combinations. On an annual basis, or upon the occurrence of a triggering event, we review our intangible assets for impairment based on estimated future undiscounted cash flows attributable to the assets in accordance with the provisions of ASC 350 at year-end and no indicators of impairment have been identified. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their net realizable values. Intangible assets are amortized over a period of two to ten years, which the Company estimated to reflect their useful lives.

**Software Development Costs**

In accordance with ASC 985, we capitalize software development costs from establishment of technological feasibility to the point at which the product is generally available to the market. No costs were capitalized during the nine month period ended September 30, 2009.

**Income Taxes**

We account for income taxes in accordance with ASC 740. Under ASC 740, deferred tax assets and liabilities are computed based on the difference between the financial statement and income tax basis of assets and liabilities using the enacted marginal tax rate. ASC 740 requires that the net deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized.

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

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

On January 1, 2007, we adopted the provision of ASC 740 related to accounting for uncertainty in income taxes. The accounting estimates related to liabilities for uncertain tax positions require us to make judgments

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

regarding the sustainability of each uncertain tax position based on its technical merits. If we determine it is more likely than not that a tax position will be sustained based on its technical merits, we record the impact of the position in our consolidated financial statements at the largest amount that is greater than fifty percent likely of being realized upon ultimate settlement. These estimates are updated at each reporting date based on the facts, circumstances and information available. We are also required to assess at each reporting date whether it is reasonably possible that any significant increases or decreases to our unrecognized tax benefits will occur during the next twelve months. See Note 18 *Income Taxes*.

**Sales Taxes**

In accordance with ASC 605, we report sales taxes collected from clients and remitted to governmental authorities on a net basis.

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

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

**Stock-Based Compensation**

We adopted ASC 718 for stock-based compensation using the modified prospective method as of January 1, 2006. Under this method, compensation cost is recognized based on the requirements of ASC 718 for all share-based awards granted subsequent to January 1, 2006, and for all awards granted, but not vested, prior to January 1, 2006.

**Net (Loss) Income Per Share**

Basic (loss) income per share is determined using the weighted average number of common shares outstanding during the period. Diluted (loss) income 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 October 2009, the FASB issued ASU No. 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements a consensus of the FASB Emerging Issue Task Force* ( ASU No. 2009-14 ). The objective of this Update is to address the accounting for revenue arrangements that contain tangible products and software for which vendor-specific objective evidence of selling price does not exist. We are assessing the impact ASU No. 2009-14 will have on our consolidated financial position, results of operations or cash flows when it becomes effective for our fiscal year beginning January 1, 2011.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issue Task Force* ( ASU No. 2009-13 ). The objective of this Update is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. We are assessing the impact ASU No. 2009-13 will have on our consolidated financial position, results of operations or cash flows when it becomes effective for our fiscal year beginning January 1, 2011.

In June 2009, the FASB issued guidance now codified as FASB ASC Topic 105 ( ASC 105 ) with regard to GAAP. The Accounting Standards Codification ( ASC ) has become the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. This only changes the referencing of financial accounting standards and does not change or alter existing GAAP. For financial statements issued for interim and annual periods ending after September 15, 2009, the ASC supersedes all then-existing non-SEC accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the ASC will become nonauthoritative. The adoption of ASC 105 did not have a material impact on our consolidated financial position, results of operations or cash flows.

On May 28, 2009, the FASB issued guidance now codified as FASB ASC Topic 855 related to subsequent events ( ASC 855 ). ASC 855 introduces the concept of financial statements being *available to be issued.* This statement requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material impact on our consolidated financial statements. The Company has evaluated subsequent events through November 5, 2009, which is the date these financial statements were issued.

On April 9, 2009, the FASB issued three related Staff Positions: (i) FSP 157-4 now codified within FASB Topic 820 ( ASC 820 ) which is related to fair value measurements and disclosures (ii) SFAS 115-2 and SFAS 124-2 now codified within FASB ASC Topic 320 ( ASC 320 ) with regard to investments in debt or equity securities, and (iii) SFAS 107-1 and APB 28-1 now codified within FASB ASC Topic 825 ( ASC 825 ) related to financial instruments, which are effective for interim and annual periods ending after June 15, 2009. ASC 820 provides guidance on how to determine the fair value of assets and liabilities under ASC 820 in the current economic environment and reemphasizes that the objective of a fair value measurement remains an exit price. If we were to conclude that there has been a significant decrease in the volume and level of activity of the asset or liability in relation to *normal* market activities, quoted market values may not be representative of fair value and we may conclude that a change in valuation technique or the use of multiple valuation techniques may be appropriate. ASC 320 modifies the requirements for recognizing other-than-temporarily impaired debt securities and revises the existing impairment model for such securities, by modifying the current *intent and ability* indicator in determining whether a debt security is other-than-temporarily impaired. ASC 825 enhances the disclosure of instruments under the scope of ASC 820 for both interim and annual periods. Our adoption of these staff positions did not have a material impact on our consolidated financial position, results of operations, or cash flows.

**4. RESTRUCTURING AND DISCONTINUED OPERATIONS**

In April 2009, we closed and vacated our Oakland, California office. We estimated the facility closing costs in accordance with ASC 420 with regard to exit or disposal cost obligations, and accrued $0.2 million of exit costs as the master lease associated with this facility does not terminate until July 2011. Previously, in February

Table of Contents

QUADRAMED CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FOR THE QUARTER ENDED SEPTEMBER 30, 2009

(unaudited)

2005, we completed the shutdown of our Financial Services division in San Marcos, California. At that time, we estimated our liability under the operating lease and accrued $1.8 million of exit costs as the lease did not terminate until May 2008. In addition, we also vacated and closed our San Rafael, California facility during the fourth quarter of 2004 as a result of the relocation of our headquarters to Reston, Virginia. We estimated our liability under the operating lease agreement and accrued $5.1 million of exit costs as the lease does not terminate until December 2009. The aggregate lease payments for the remainder of 2009 through 2011 for the Oakland and San Rafael facilities will be approximately $0.5 million.

The following table sets forth a summary of the exit cost charges and accrued exit costs for the San Marcos, California, the San Rafael, California and the Oakland, California facilities as of September 30, 2009 and December 31, 2008 (in thousands):

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| *Exit Costs for the San Rafael Facility:* | | |
| Accrued exit cost of facility closing, beginning of period | $ 888 | $ 1,931 |
| Principal reductions | (661) | (1,043) |
| Accrued exit cost of facility closing, end of period | $ 227 | $ 888 |
| *Exit Cost for the Oakland Facility:* | | |
| Accrued exit cost of facility closing, beginning of period | $ | $ |
| Exit cost of facility closing, April 2009 | 216 | |
| Principal reductions | (54) | |
| Accrued exit cost of facility closing, end of period | $ 162 | $ |
| *Exit Cost for the San Marcos Facility:* | | |
| Accrued exit cost of facility closing, beginning of period | $ | $ 135 |
| Principal reductions | | (135) |
| Accrued exit cost of facility closing, end of period | $ | $ |
| Total Exit Cost Charges and Accrued Exit Costs | $ 389 | $ 888 |
| Accrued Exit Costs Liability: | | |
| Short-term | 346 | 888 |
| Long-term | 43 | |
| Total | $ 389 | $ 888 |

**5. SALE OF ASSETS**

On April 30, 2008, we completed the sale of substantially all of the assets of our wholly owned subsidiaries, QuadraMed International Pty Limited in Australia and QuadraMed International Limited in the United Kingdom for initial cash proceeds of $0.1 million and future earn-out payments over a three-year period based on a schedule of targeted revenue between $100,000 AUD and $200,000 AUD per year. We recorded an estimated loss on sale of assets of $1.1 million in the second quarter of 2008. The loss on sale of assets was subsequently reduced by $0.3

million during December of 2008 in conjunction with the final accounting for the sale transaction resulting in an overall loss on sale of assets of $0.8 million. The products contained within these subsidiaries focused on stand-alone lab and radiology products installed in the United Kingdom, Australia and New Zealand. However, with the addition of the QuadraMed CPR ( QCPR ) product in 2007, which includes

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

integrated lab and radiology, and our focus on the Care-Based Revenue Cycle and core products, these foreign- based products were considered redundant to our portfolio. As a result, the 2009 information presented for the nine months ended September 30, 2009 is not comparable to the nine months ended September 30, 2008 information with regard to this event.

In accordance with the asset purchase agreement, we received a $0.2 million earn-out payment from the buyer based on their reported 2008 results of operations. We recorded this payment during the second quarter of 2009 as other income.

**6. EMPLOYMENT MATTERS**

On February 5, 2008, we announced a strategic initiative to increase overall product development capacity and to further accelerate delivery of our Care-Based Revenue Cycle product strategy to the healthcare market. Related to this capacity expansion and resource realignment initiative, we eliminated 69 positions in various technical, administrative and other non-technical areas. As a result, the Company incurred a one time severance cost for the three month period ended March 31, 2008 of approximately $0.6 million. The reduction in force within the Software Development teams was tied to the strategic initiative to increase overall product development capacity and to further accelerate delivery of our Care-Based Revenue Cycle product strategy to the healthcare market through a partnering arrangement with Tata Consultancy Services ( TCS ).

On March 25, 2009 and June 9, 2009, the Company announced changes in its executive management team. As a result, the Company incurred severance and accelerated stock compensation costs of $1.7 million for the nine month period ended September 30, 2009.

**7. FAIR VALUE MEASUREMENTS**

Effective January 1, 2008, the Company adopted ASC 820, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements for financial instruments. The framework requires the valuation of investments using a three-tiered approach. The statement requires fair value measurement to be classified and disclosed in one of the following three categories:

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

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

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

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

The following table represents the assets on our financial statements as of September 30, 2009 subject to ASC 820, and indicates the fair value hierarchy of the valuation techniques we used to determine the fair value (in thousands):

| | | Fair Value Measurements at Reporting Date Using | | |
|---|---|---|---|---|
| **Description** | **Balance at September 30, 2009** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Commercial paper, certificates of deposit and other money market instruments | $ 10,231 | $ 10,231 | $ | $ |
| U.S. government and federal agency debt securities | 3,704 | 3,704 | | |
| Total | $ 13,935 | $ 13,935 | $ | $ |

| | | Fair Value Measurements at Reporting Date Using | | |
|---|---|---|---|---|
| **Description** | **Balance at December 31, 2008** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Commercial paper, certificates of deposit and other money market instruments | $ 5,974 | $ 5,974 | $ | $ |
| U.S. government and federal agency debt securities | 3,763 | 3,763 | | |
| Total | $ 9,737 | $ 9,737 | $ | $ |

As of and for the nine month period ended September 30, 2009, we did not have any financial instruments with significant Level 3 inputs and we did not have any transfers in and out, or purchases and sales of level 3 financial instruments during 2009. As of September 30, 2008, we had $1.8 million of auction rate securities which were classified as Level 3 financial instruments and during the nine month period ended September 30, 2008, we transferred out $3.5 million of auction rate securities upon settlement.

**8. OTHER INTANGIBLE ASSETS**

Other intangible assets as of September 30, 2009 and December 31, 2008 were as follows (in thousands):

| | As of September 30, 2009 | | | As of December 31, 2008 | | | |
|---|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Disposals | Accumulated Amortization | Net Carrying Amount |
| Amortizable intangible assets | | | | | | | |
| Customer relationships | $ 18,696 | $ (14,399) | $ 4,297 | $ 18,749 | $ (53) | $ (13,561) | $ 5,135 |
| Trade names and other | 3,843 | (3,843) | | 3,985 | (142) | (3,730) | 113 |
| Technology | 16,153 | (12,690) | 3,463 | 20,153 | (4,000) | (12,014) | 4,139 |
| Total amortizable intangible assets | $ 38,692 | (30,932) | $ 7,760 | $ 42,887 | (4,195) | (29,305) | $ 9,387 |

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

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

Amortization of acquired technology, a component of other intangible assets, for both of the three month periods ended September 30, 2009 and 2008 was $0.2 million, and is included in cost of license revenue. Amortization expense for other than acquired technology for both of the three month periods ended September 30, 2009 and 2008 was $0.3 million, respectively. Amortization of acquired technology, a component of other intangible assets, for the nine months ended September 30, 2009 and 2008 was $0.7 million and $0.8 million, respectively, and is included in cost of license revenue. Amortization expense for other than acquired technology for the nine months ended September 30, 2009 and 2008 was $1.0 million and $1.1 million, respectively. No impairment charges were recorded during the three or nine month periods ended September 30, 2009 or 2008.

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

| | |
|---|---|
| For the remaining three months ending December 31, 2009 | $ 475 |
| For the years ended December 31, | |
| 2010 | 1,750 |
| 2011 | 1,510 |
| 2012 | 1,270 |
| 2013 | 1,030 |
| Thereafter | 1,725 |
| | $ 7,760 |

**9. LINE OF CREDIT**

We have a line-of-credit agreement with our principal bank under which we can borrow up to $2.0 million. This credit facility is secured by Certificates of Deposit with our principal bank and borrowings under the line-of-credit bear interest at varying rates based on an independent index defined as the rate charged by the lender plus 2%. The initial interest rate was established as 4% per annum. The line-of-credit has a maturity date of February 17, 2010. There have been no borrowings and as such there was no balance outstanding associated with this line-of-credit as of September 30, 2009.

**10. SERIES A PREFERRED STOCK**

On June 17, 2004, QuadraMed issued 4.0 million shares of Series A Cumulative Mandatory Convertible Preferred Stock (the Series A Preferred Stock ) in a private, unregistered offering to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933. The Series A Preferred Stock was sold for $25 per share, and we 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

17

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

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 Fourth Amended and Restated Certificate of Incorporation 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 $15.50, equivalent to a conversion rate of 1.6129 shares of common stock for each share of Series A Preferred Stock. 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 $25.50.

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 represented the present value of the three-year dividends. The present value adjustment of $1.3 million was being amortized over three years as interest expense using the effective interest rate method. The $1.3 million present value adjustment was fully amortized as of July 31, 2007.

The following table summarizes the carrying value of preferred stock (in thousands):

| | | As of September 30, 2009 |
|---|---|---|
| Total issued | | $ 100,000 |
| Less: Issuance cost | | (3,856) |
| Less: Unaccreted discount | | |
| Original present value of discount | (15,174) | |
| 2007 preferred stock accretion | 2,854 | |
| 2006 preferred stock accretion | 5,059 | |
| 2005 preferred stock accretion | 4,796 | |
| 2004 preferred stock accretion | 2,465 | |
| Carrying value of preferred stock at September 30, 2009 | | $ 96,144 |

18

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

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

The following common stock equivalent shares from the indicated equity instruments were considered in the calculation of diluted earnings per share (in thousands):

| | Three months ended September 30, | |
|---|---|---|
| | **2009** | **2008** |
| *Equity instruments:* | | |
| Preferred stock | 6,452 | 6,452 |
| Stock options | 24 | 31 |
| Total common stock equivalent shares | 6,476 | 6,483 |

| | Nine months ended September 30, | |
|---|---|---|
| | **2009** | **2008** |
| *Equity instruments:* | | |
| Preferred stock | 6,452 | 6,452 |
| Stock options | 23 | 33 |
| Total common stock equivalent shares | 6,475 | 6,485 |

For the three month periods ended September 30, 2009 and 2008, preferred stock equivalent shares were excluded from the computation of diluted earnings per share as their effect would be antidilutive. For the nine months ended September 30, 2009, the options and preferred stock equivalent shares were excluded from the computation of diluted earnings per share as their effect would be antidilutive. For the nine months ended September 30, 2008, the preferred stock equivalent shares were excluded from the computation of diluted earnings per share as their effect would be antidilutive.

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

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

| | Three months ended September 30, 2009 | Three months ended September 30, 2008 |
|---|---|---|
| *Numerator:* | | |
| Net income attributable to common shareholders | $ 135 | $ 1,094 |
| *Denominator:* | | |
| Weighted average number of common shares outstanding: | | |
| Basic | 8,300 | 8,931 |
| Diluted | 8,324 | 8,962 |
| Income per common share: | | |
| Basic | $ 0.02 | $ 0.12 |
| Diluted | $ 0.02 | $ 0.12 |

| | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|
| *Numerator:* | | |
| Net income attributable to common shareholders | $ (373) | $ 440 |
| *Denominator:* | | |
| Weighted average number of common shares outstanding: | | |
| Basic | 8,296 | 8,930 |
| Diluted | 8,296 | 8,963 |
| (Loss) income per common share: | | |
| Basic | $ (0.05) | $ 0.05 |
| Diluted | $ (0.05) | $ 0.05 |

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

| | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|---|---|---|
| Net (loss) income attributable to common shareholders | $ (373) | $ 440 |
| Unrealized loss | (144) | (4) |
| Foreign currency translation adjustment | 832 | (420) |
| Comprehensive income | $ 315 | $ 16 |

**12. REVERSE STOCK SPLIT**

On June 13, 2008, QuadraMed Corporation announced the effectiveness of the reverse split of its common stock in the ratio of one-for-five (the Reverse Split ). No fractional shares of common stock were issued as a result of the Reverse Split and stockholders received an insignificant cash payment in lieu of fractional shares. In connection with the Reverse Split, the Company transferred $0.4 million from common stock to additional paid-in capital representing the par value of the original common shares outstanding prior to the Reverse Split.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

**13. TREASURY STOCK**

On December 17, 2007, the Company announced that our Board of Directors authorized a program to repurchase, with available cash, up to $5.0 million of the Company s common stock. The repurchase program was structured to comply with Rule 10b5-1 and Rule 10b-18 under the Securities Exchange Act of 1934, as amended. We repurchased the common stock through registered broker-dealers in open market purchase transactions and plan to hold the shares repurchased as treasury shares. The Board of Directors authorized the termination of the program to repurchase effective as of the close of trading on June 5, 2008. As of the termination date, the Company repurchased under the program a total of 405,520 shares at a cost of $4.0 million.

On October 16, 2008, the Company repurchased 620,614 shares of its common stock from a group of commonly managed investment funds in a privately negotiated transaction for an aggregate purchase price of $3.4 million. The aggregate purchase price was based upon a price per common share of $5.50, which at such time constituted a 37% discount to the average daily closing price of our common stock since it began trading on the NASDAQ Global Market, on July 9, 2008. The Company repurchased the shares with existing cash on hand, and the repurchased shares were deposited into our treasury account.

The Company s Board of Directors approved a policy on July 17, 2008 under which the Company would offer to repurchase shares of restricted stock granted to the Company s employees on the date such shares vest, with the repurchase limited to the number of shares sufficient to permit the employee to meet the tax obligations resulting from the vesting of such shares (the Policy ). Pursuant to the Policy, on October 17, 2008, the Company entered into a definitive stock repurchase agreement with Keith B. Hagen, the Company s President, Chief Executive Officer and a Director at the time, for the repurchase of 46,420 shares of the Company s common stock, for an aggregate purchase price of $0.3 million. The aggregate purchase price was based upon a price per common share of $6.75, the closing price of the Company s common stock as reported by The NASDAQ Stock Market, LLC on October 17, 2008. The Company repurchased the shares with existing cash on hand, and the repurchased shares were deposited into our treasury account.

As of September 30, 2009, we have 1,163,854 shares of treasury stock at a cost of $9.0 million.

**14. STOCK-BASED COMPENSATION**

We adopted ASC 718, the fair value method of accounting for share-based payments using the modified prospective transition method as prescribed for stock-based compensation. Under the modified prospective method, compensation cost recognized includes compensation costs for all share-based payments granted and vested based on the grant date fair value estimated in accordance with the provisions of ASC 718.

ASC 718 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 month periods ended September 30, 2009 and 2008 was $0.3 million and $0.8 million, respectively. Stock-based compensation expense for the nine month periods ended September 30, 2009 and 2008 was $1.7 million and $2.4 million, respectively. Stock-based compensation expense is allocated to cost of services, sales and marketing, general and administrative or software development expense in the Condensed Consolidated Statement of Operations.

**Stock Incentive Plans**

We have issued stock options and restricted stock under the Company s 1996 Stock Incentive Plan (the 1996 Plan ), the 1999 Supplemental Stock Option Plan (the 1999 Plan ), the 2004 Stock Compensation Plan

21

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

(the 2004 Plan ), and the 2009 Stock Compensation Plan (the 2009 Plan ) all of which were approved by stockholders. The 2009 Plan superseded the 2004 Plan, as amended, the 1999 Plan, as amended, and the 1996 Plan, as amended, as of June 4, 2009, although stock options and restricted stock granted under the 1996 Plan, the 1999 Plan and the 2004 Plan 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.

**Non-Plan Stock Options**

The Company s non-plan stock options are inducement stock option grants made outside of the Company s shareholder-approved stock option plans to induce new, key employees to accept an offer of employment from the Company. Each of the currently outstanding inducement stock option grant awards are made under Inducement Stock Option Agreements with the key employee and vest with respect to 25% of the option shares upon completion of one year of service measured from the date of grant with the remaining 75% of the option shares vest in a series of 36 equal successive installments upon the completion of each additional month of service thereafter, subject to acceleration in the event of a change in control and certain termination events. These stock options have a maximum term of ten years, subject to earlier cancellation upon the termination of the employee s service with the Company in certain circumstances. Total non-plan stock options outstanding at September 30, 2009 were 485,000, an increase of 300,000 shares with an exercise price of $6.52 per share from June 30, 2009 to account for the inducement stock option grant on July 27, 2009 to Duncan W. James, the Company s newly appointed Chief Executive Officer.

**1996 Stock Incentive Plan**

Under the 1996 Plan, the Board of Directors could have granted incentive and nonqualified stock options to employees, directors and consultants. The 1996 Plan was divided into the following five separate equity programs: (i) the discretionary option grant program under which eligible persons could have been, at the discretion of the plan administrator, granted options to purchase shares of common stock; (ii) the salary investment option grant program under which eligible employees could have elected to have a portion of their base salary invested each year in special option grants; (iii) the stock issuance program under which eligible persons could have been, at the discretion of the plan administrator, 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 have automatically received option grants at periodic intervals to purchase shares of common stock; and (v) the director fee option program under which non-employee board members could have elected 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 could not have been less than the fair market value on the date of grant. The exercise price per share for a nonqualified stock option could not have been 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. Our stockholders had authorized a total of 1,766,219 shares of common stock for grant under the 1996 Plan, of which 440,650 were outstanding at September 30, 2009. There were no shares available for grant at September 30, 2009.

**1999 Supplemental Stock Option Plan**

In 1999, the QuadraMed Board of Directors approved the 1999 Plan. The 1999 Plan permitted non-statutory option grants to be made to employees, independent consultants and advisors who were not QuadraMed officers,

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

directors or Section 16 insiders. The 1999 Plan was 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 could not have been less than 100% of fair market value on the date of the grant. Options vested on a schedule determined by the Board of Directors or the Compensation Committee with a maximum option term of 10 years. QuadraMed stockholders had authorized a total of 684,849 shares of common stock for grant under the 1999 Plan, of which 158,923 were outstanding at September 30, 2009. There were no shares available for grant at September 30, 2009.

**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 replaced 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. The QuadraMed stockholders initially authorized 307,274 shares of common stock for grant under the 2004 Plan and increased the number of shares available to the 2004 Plan by 600,000 shares at the 2007 Annual Meeting of Stockholders on June 7, 2007. As a result, the QuadraMed stockholders authorized a total of 907,274 shares of common stock, for grant under the 2004 Plan, of which 708,400 were outstanding at September 30, 2009. There were no shares available for grant under this plan at September 30, 2009.

The 2004 Plan permitted 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 provided services to QuadraMed. The exercise price of all options and stock appreciation rights granted under the 2004 Plan could not be less than 100% of fair market value on the date of the grant. The 2004 Plan also featured a Non-Employee Director Option Grant Program, whereby non-employee members of the Board automatically received 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 meetings of stockholders or upon their initial election or appointment to the Board. The Director Fee Option Grant Program, formerly a part of the 2004 Plan, was removed from the 2004 Plan after approval by the Company s stockholders at the 2008 Annual Meeting of Stockholders on June 5, 2008, in connection with the technical tax-related amendments to the 2004 Plan approved at that meeting. The Director Fee Option Grant Program provided for non-employee Board members to 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.

**2009 Stock Compensation Plan**

On April 29, 2009, QuadraMed s Board of Directors approved the 2009 Stock Compensation Plan (the 2009 Plan ), with an effective date of June 1, 2009. The Company obtained stockholder approval of the 2009 Plan at its 2009 Annual Meeting of Stockholders. The 2009 Plan supersedes the 2004 Plan for new grants of equity-based compensation, and the shares of common stock remaining available for issuance under the 2004 Plan at June 1, 2009 have been rolled into the new 2009 Stock Compensation Plan. Awards previously granted under the 1996 Plan, 1999 Plan and 2004 Plan remain subject to the terms of those plans. The QuadraMed stockholders authorized a total of 650,000 shares of common stock, including the rollover shares from the 2004 Plan, for grant under the 2009 Plan, of which 9,600 were outstanding at September 30, 2009. There were 640,400 shares available for grant under this plan at September 30, 2009.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

**Employee Stock Purchase Plans**

Our 2008 Employee Stock Purchase Plan (the 2008 Purchase Plan ) was adopted by the Board of Directors on August 6, 2008 with an effective date of September 1, 2008. The 2008 Purchase Plan superseded the 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan ), which was terminated by the Board of Directors effective July 31, 2008. On June 4, 2009, the Company s Stockholders approved the 2008 Purchase Plan at its 2009 Annual Meeting of Stockholders. A total of 150,000 shares of common stock are reserved for issuance under the 2008 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 participant s entry date into a six-month purchase period or the fair market value on the purchase date.

The 2002 Purchase Plan was adopted by the Board of Directors in January 2002. A total of 140,690 shares of common stock were reserved for issuance under the 2002 Purchase Plan, pursuant to which eligible employees were 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 an offering period that may range from nine-months to forty-eight months, depending on the Company s stock price at certain intervals. Effective July 31, 2008, the 2002 Purchase Plan was terminated by the Board of Directors and replaced with the 2008 Purchase Plan.

Stock-based compensation expense relating to shares purchased on behalf of plan participants for the nine months ended September 30, 2009 and 2008 under the 2008 Employee Stock Purchase Plan totaled $15,090 and $33,840, respectively.

***Stock Options:***

Stock options generally vest ratably over four years from the date of grant and terminate ten years from the 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, 2009 | 1,563 | $ 14.26 |
| Granted | 319 | $ 6.54 |
| Cancelled | (79) | $ 24.45 |
| Options outstanding, September 30, 2009 | 1,803 | $ 12.50 |
| Options exercisable, September 30, 2009 | 1,320 | $ 13.61 |

Stock-based compensation expense for the three month periods ended September 30, 2009 and 2008 was $0.3 million and $0.8 million, respectively. Stock-based compensation expense for the nine month periods ended September 30, 2009 and 2008 was $1.7 million and $2.4 million, respectively.

The weighted average remaining contractual term and the aggregate intrinsic value for options exercisable at September 30, 2009 were 5.06 years and $0.1 million, respectively. The weighted average remaining contractual

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

term and the aggregate intrinsic value for options outstanding at September 30, 2008 were 6.11 years and $0.2 million, respectively. As of September 30, 2009, unrecognized compensation expense related to stock options totaled approximately $1.6 million, which will be recognized over a weighted average period of 1.55 years.

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

| | Nine Months Ended September 30, 2009 | Nine Months Ended September 30, 2008 |
|---|---|---|
| Expected dividend yield | | |
| Expected stock price volatility | 48.77% | 48.77% |
| Risk-free interest rate | 2.63% | 2.97% |
| Expected life of options | 5.51 years | 5.39 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 17.9% 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 September 30, 2009 and 2008 was $1.1 million and $0.4 million, respectively. For the nine months ended September 30, 2009 and 2008, the weighted average estimated fair value of options granted was $1.1 million and $0.7 million, respectively. The weighted average estimated fair value on a per share basis of the options granted during the three months ended September 30, 2009 and 2008 was $3.57 and $3.62, respectively. For the nine months ended September 30, 2009 and 2008, the weighted average estimated fair value on a per share basis of the options granted was $3.57 and $4.27, respectively.

***Restricted Share Awards:***

The Company has issued, from time to time, common stock as restricted share awards, with a zero exercise price, as provided for under the QuadraMed stock compensation plans and other contractual commitments. The grants are generally made to certain senior executives. The majority of the restrictions lapsed over three to four years. We recorded the fair value of the restricted shares on the date they are granted as deferred compensation within the Stockholders Equity section of the consolidated balance sheets. Deferred compensation has been combined with additional paid-in capital as a result of the adoption of ASC 718 for stock-based compensation. In accordance with Company policy, the Company can offer to repurchase shares of restricted stock granted to the Company s employees on the date such shares vest; however, such repurchase shall be limited to an amount sufficient to permit the applicable employee to pay taxes on such shares. The fair value of the restricted share award has been amortized as compensation expense over the period in which the restrictions lapse. During the nine months ended September 30, 2009 and 2008, there was no common stock issued as a result of restricted stock grants.

Stock-based compensation expense related to restricted share grants for the three month periods ended September 30, 2009 and 2008 was zero and $0.1 million, respectively, and compensation expense was zero and $0.3 million for the nine month periods ended September 30, 2009 and 2008, respectively.

25

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

As of September 30, 2008, there were 110,000 restricted shares subject to forfeiture at a weighted average grant date fair value of $8.85 per share. As of September 30, 2009 there were no restricted shares subject to forfeiture.

**15. EMPLOYEE BENEFIT PLANS**

Our company maintains a 401(k) Savings Plan (the Plan ). All eligible QuadraMed employees may participate in the Plan and elect to contribute up to 80% of pre-tax compensation to the Plan. Employee contributions are 100% vested at all times. At our discretion, we may match employee contributions to the Plan. Presently, we match up to 100% of the first 4% of employee contributions. The vesting of such contributions is based on the employee s years of service, becoming 100% vested after 4 years. For the three months ended September 30, 2009 and 2008, there were discretionary company contributions of approximately $0.4 million and $0.4 million, respectively. For the nine months ended September 30, 2009 and 2008, there were discretionary company contributions of approximately $1.3 million and $1.4 million, respectively.

**16. MAJOR CUSTOMERS**

For the three and nine months ended September 30, 2009, sales to the federal government, primarily to the Department of Veterans Affairs facilities, accounted for approximately 20% of our total revenues during both periods. The County of Los Angeles accounted for approximately 10% of our total revenues for both three and nine month periods ended September 30, 2009. For the three and nine months ended September 30, 2008, sales to the federal government, primarily to the Department of Veterans Affairs facilities, accounted for approximately 14% and 17%, respectively, of our total revenues, and sales to the County of Los Angeles accounted for approximately 11% of our total revenues during both periods.

The Company evaluates the significance of its contracts with its major customers on a periodic basis, and has performed this analysis as of September 30, 2009, determining that the Department of Veterans Affairs and The County of Los Angeles are its major customers. The County of Los Angeles has been a customer of the Company since 1989 pursuant to two prime agreements, which were entered into in the ordinary course of business under standard terms and have been amended and renewed numerous times since their original execution. Generally, The County of Los Angeles purchases the Company s proprietary software (from the majority of the Company s product lines, including Access Management, Care Management, Health Information Management and Financial Management), software of third-party providers and third-party hardware under these agreements. All software is licensed for a perpetual term. Also purchasable under these agreements are services including maintenance, software installation, training and consulting services related to the Company s licensed software, fees for providing management services, specialized staffing and analytical services.

On October 21, 2009, the Department of Veterans Affairs awarded the Company a Task Order contract (the Task Order ) under the existing Blanket Purchase Agreement ( BPA ) between the Company and the Department of Veterans Affairs. The Task Order has a stated value of approximately $24.1 million and includes (i) a renewal of the Department of Veterans Affairs term license for the Company s Encoder Product Suite and (ii) related training services for all Department of Veterans Affairs Medical Centers nationwide for the federal government s fiscal year 2010, which extends from October 1, 2009 to September 30, 2010. We have billed $20.5 million in annual license fees for this license period. Upon collection of amounts due from the Department of Veterans Affairs, we expect to pay approximately $9.0 million, or 44%, in royalties to our subcontractors for this contract. On October 29, 2009, the Department of Veterans Affairs paid the Company $20.5 million against the Task Order representing payment in full of the annual license fee.

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

We believe that a renewal of the BPA in 2010 will be subject to a competitive bidding process in which we expect to participate; we currently expect the Department of Veterans Affairs to issue its formal request for proposals in the fourth quarter of 2009 or first quarter of 2010. We cannot provide any assurance that the Company will be awarded a new BPA or that a new BPA will be awarded under similar terms and conditions.

**17. CRITICAL SUPPLIERS**

The Company evaluates its reliance on third-party licenses on a periodic basis. As of June 30, 2009, the Company evaluated its reliance on third-party licenses and as a result of that evaluation, the Company determined that it was materially reliant upon its licenses with InterSystems Corporation and Document Storage Systems, Inc. ( DSS ), as no other vendors provide equivalent technology or services for the Company s needs. InterSystems provides the Company with the Cache Database, Ensemble interface engine and related system tools, which are integral to certain of the Company products, particularly Affinity and QCPR. DSS is a subcontractor to the Company pursuant to the BPA with the Department of Veterans Affairs and provides Vista integration software and integration of Encoder Product Suite components from the Company, Unicor Medical ( Unicor ), and Megas Corporation ( Megas ). The Company has determined that this evaluation remains unchanged as of September 30, 2009.

**18. INCOME TAXES**

Our income tax provision for interim periods is determined using an estimated annual effective tax rate adjusted for discrete items, if any, which are taken into account in the quarterly period in which they occur. We review and update our estimated annual effective tax rate each quarter. Our income tax expense totaled approximately $0.7 million and $1.6 million for the three months ended September 30, 2009 and 2008, respectively, and $1.7 million and $3.0 million for the nine months ended September 30, 2009 and 2008, respectively. These amounts represented effective income tax rates from continuing operations of approximately 31% and 40% for the three months ended September 30, 2009 and 2008, respectively, and 31% and 40% for the nine months ended September 30, 2009 and 2008, respectively.

On January 1,2007, we implemented the provision of ASC 740 related to accounting for uncertainty in income taxes. There has been no material change to the amount of unrecognized tax benefits reported as of September 30, 2009. We are maintaining our 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 September 30, 2009, open tax years in major jurisdictions date back to 1994 due to the taxing authorities ability to adjust operating loss and tax credit carryforwards. No changes in settled tax years have occurred through September 30, 2009. The Company does not anticipate a material change to its total amount of unrecognized tax benefits within the next 12 months.

**19. LITIGATION AND OTHER MATTERS**

We are subject to litigation in the normal course of business, but management does not believe that the resolution of any pending proceedings would have a material adverse effect on our company s condensed consolidated financial position or results of operations.

Table of Contents

**QUADRAMED CORPORATION**

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

**FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

**(unaudited)**

**20. SUBSEQUENT EVENT**

On October 21, 2009, the Department of Veterans Affairs awarded the Company a Task Order contract under the existing BPA between the Company and the Department of Veterans Affairs. The Task Order has a stated value of approximately $24.1 million and includes (i) a renewal of the Department of Veterans Affairs term license for the Company s Encoder Product Suite and (ii) related training services for all Department of Veterans Affairs Medical Centers nationwide for the federal government s fiscal year 2010, which extends from October 1, 2009 to September 30, 2010. On October 29, 2009, the Department of Veterans Affairs paid the Company $20.5 million against the Task Order representing payment in full of the annual license fee.

Table of Contents

*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.

**Financial Statement Overview**

The Company experienced changes between the 2009 and 2008 periods which affect the comparability of the periods. These changes include a strategic initiative that began in February 2008 to increase overall product development capacity through a partnering arrangement with Tata Consultancy Services ( TCS ). Concurrent with this partnering arrangement, we reduced our overall workforce by 69 employees, primarily in the services and software development areas. The 2008 period includes severance costs of $0.6 million related to this workforce reduction, salary and benefits for these employees for approximately one month, and costs incurred related to the commencement of the Company s relationship with TCS. The 2009 period reflects only external consulting costs associated with the partnering services.

The 2008 period also includes a $1.1 million loss on sale of assets associated with our April 2008 sale of substantially all of the assets of our wholly owned subsidiaries, QuadraMed International Pty Limited in Australia and QuadraMed International Limited in the United Kingdom. The products contained within these subsidiaries focused on standalone lab and radiology products installed in the United Kingdom, Australia and New Zealand. The 2008 period includes four months of revenue, personnel cost, operating expenses and amortization of intangible assets associated with these products that are not included in the 2009 period.

Additionally, the 2009 period includes one-time severance and accelerated stock compensation costs totaling $1.7 million associated with changes in our executive team.

A significant difference in operating cash flows between periods relates to the timing of payments received and payments disbursed for our contract with the Department of Veterans Affairs. The license period for our Department of Veterans Affairs Task Order begins on October 1 of each year and ends on September 30 of the following year, thus spanning the fourth quarter of our calendar year through the third quarter of our following calendar year. Our annual license fee from the Department of Veterans Affairs was $18.3 million for the period October 1, 2007 to September 30, 2008 ( FY 2008 ) and $19.9 million for the period October 1, 2008 to September 30, 2009 ( FY 2009 ). These fees were billed in advance and paid in lump sum by the Department of Veterans Affairs with the FY 2008 payment received in our first quarter of 2008 and the FY 2009 payment received in our fourth quarter of 2008. Upon receipt of these payments, we in turn remitted approximately 44% of the amount received to our subcontractors (recorded as royalty expense) in accordance with the terms of our agreements with them. Thus, during our fiscal year ended December 31, 2008, we received payments totaling $38.2 million and disbursed approximately $16.7 million; in addition, we incurred approximately $1.6 million of direct internal costs related to each fiscal year of our contract with the Department of Veterans Affairs. As a result, in respect of our contract with the Department of Veterans Affairs, we had total net cash provided during 2008 of approximately $19.8 million covering the FY 2008 and FY 2009 licensing periods.

Table of Contents

Because of the aforementioned prepayment made in the fourth quarter of 2008, even though we recognized license revenue and subcontractor royalty expense during the nine months ended September 30, 2009, we did not have cash receipts from the Department of Veterans Affairs license for the period. We were awarded a one year renewal of the Department of Veterans Affairs Task Order on October 21, 2009 covering the 2009 period from October 1, 2009 to September 30, 2010.

On October 21, 2009, the Department of Veterans Affairs awarded the Company a Task Order contract under the existing BPA between the Company and the Department of Veterans Affairs. The Task Order has a stated value of approximately $24.1 million and includes (i) a renewal of the Department of Veterans Affairs term license for the Company s Encoder Product Suite and (ii) related training services for all Department of Veterans Affairs Medical Centers nationwide for the federal government s fiscal year 2010, which extends from October 1, 2009 to September 30, 2010. We have billed $20.5 million in annual license fees for this license period. Upon collection of amounts due from the Department of Veterans Affairs, we expect to pay approximately $8.8 million, or 43%, in royalties to our subcontractors for this contract. On October 29, 2009, the Department of Veterans Affairs paid the Company $20.5 million against the Task Order representing payment in full of the annual license fee.

Net income for the nine months ended September 30, 2009 was $3.8 million compared to $4.6 million for the same period in 2008. This decrease between periods primarily resulted from a decrease of $2.2 million in income from operations between periods associated primarily with a decrease in revenues, offset by a $1.3 million change in our income tax expense. Our income from operations between periods was impacted by the items described above and a $5.2 million decrease in revenue between periods. Our 2008 period included $1.4 million of revenue associated with our completion of an analysis of certain older contracts and service agreements for which amounts were previously recorded as deferred revenue. As a result of this analysis, it was determined that services had been completed and that no further service obligations were outstanding. Accordingly, the amounts previously deferred were recognized as revenue. Our 2008 period also included $1.1 million of revenue associated with a correction of an error in prior periods. Net loss attributable to common shareholders for the nine months ended September 30, 2009 was $0.4 million, or ($0.05) per basic and diluted share, compared to income of $0.4 million, or $0.05 per basic and diluted share in the 2008 period. Net (loss) income attributable to common shareholders includes a preferred stock dividend payment of $4.1 million in each of the respective periods.

As of September 30, 2009, we had $19.0 million in unrestricted cash and investments, compared to $27.9 million as of December 31, 2008. The $8.9 million decrease in cash and investment was primarily a result of the timing of cash collections from customers, in particular the Department of Veterans Affairs, and the payment of operating expenses. Our Days Sales Outstanding ( DSO ) was 69 at September 30, 2009 compared to DSO of 49 at September 30, 2008 and 51 at December 31, 2008. The increase in our DSO is related primarily to the timing of milestone billings.

Table of Contents

**Results of Operations (unaudited)**

The following table sets forth selected data for the three month periods ended September 30, 2009 and 2008. 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 September 30, | | | |
|---|---|---|---|---|
| | 2009 | | 2008 | |
| **Revenue** | | | | |
| Services | $ 5,803 | 16% | $ 5,930 | 16% |
| Maintenance | 16,849 | 47% | 18,205 | 47% |
| Installation and other | 3,064 | 9% | 3,153 | 8% |
| Services and other revenue | 25,716 | 72% | 27,288 | 71% |
| Term Licenses | 8,500 | 24% | 8,099 | 21% |
| Perpetual Licenses | 1,446 | 4% | 3,127 | 8% |
| License revenue | 9,946 | 28% | 11,226 | 29% |
| Hardware revenue | 140 | 0% | 75 | 0% |
| **Total revenue** | 35,802 | 100% | 38,589 | 100% |
| **Cost of revenue** | | | | |
| Cost of services and other revenue | 10,502 | 41% | 11,487 | 42% |
| Royalties and other | 3,592 | 36% | 3,671 | 33% |
| Amortization of acquired technology and capitalized software | 219 | 2% | 245 | 2% |
| Cost of license revenue | 3,811 | 38% | 3,916 | 35% |
| Cost of hardware revenue | 217 | 155% | 64 | 85% |
| **Total cost of revenue** | 14,530 | 41% | 15,467 | 40% |
| **Gross margin** | 21,272 | 59% | 23,122 | 60% |
| **Operating expenses** | | | | |
| General and administration | 4,876 | 14% | 5,027 | 13% |
| Software development | 9,316 | 26% | 8,328 | 22% |
| Sales and marketing | 4,247 | 12% | 4,968 | 13% |
| Loss on sale of assets | | 0% | 46 | 0% |
| Amortization of intangible assets and depreciation | 856 | 2% | 761 | 2% |
| **Total operating expenses** | 19,295 | 54% | 19,130 | 50% |
| **Income from operations** | $ 1,977 | | $ 3,992 | |

Table of Contents

The following table sets forth selected data for the nine month periods ended September 30, 2009 and 2008. 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.

| | Nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2009 | | 2008 | |
| **Revenue** | | | | |
| Services | $ 16,441 | 16% | $ 17,102 | 15% |
| Maintenance | 49,349 | 46% | 51,734 | 46% |
| Installation and other | 9,133 | 9% | 9,614 | 9% |
| Services and other revenue | 74,923 | 71% | 78,450 | 70% |
| Term Licenses | 25,925 | 24% | 23,651 | 21% |
| Perpetual Licenses | 5,454 | 5% | 9,260 | 8% |
| License revenue | 31,379 | 29% | 32,911 | 29% |
| Hardware revenue | 387 | 0% | 505 | 1% |
| **Total revenue** | 106,689 | 100% | 111,866 | 100% |
| **Cost of revenue** | | | | |
| Cost of services and other revenue | 31,615 | 42% | 34,324 | 44% |
| Royalties and other | 10,944 | 35% | 11,365 | 35% |
| Amortization of acquired technology and capitalized software | 676 | 2% | 756 | 2% |
| Cost of licenses revenue | 11,620 | 37% | 12,121 | 37% |
| Cost of hardware revenue | 361 | 93% | 328 | 65% |
| **Total cost of revenue** | 43,596 | 41% | 46,773 | 42% |
| **Gross margin** | 63,093 | 59% | 65,093 | 58% |
| **Operating expenses** | | | | |
| General and administration | 16,619 | 16% | 14,907 | 13% |
| Software development | 25,937 | 24% | 25,362 | 23% |
| Sales and marketing | 13,117 | 12% | 14,105 | 13% |
| Loss on sale of assets | | 0% | 1,161 | 1% |
| Amortization of intangible assets and depreciation | 2,387 | 2% | 2,400 | 2% |
| **Total operating expenses** | 58,060 | 54% | 57,935 | 52% |
| **Income from operations** | $ 5,033 | | $ 7,158 | |

**Revenue**

Revenue is recognized during the respective periods from various sources, including but not limited to amounts initially recorded as deferred revenue 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 September 30, 2009 was $35.8 million, a decrease of $2.8 million or 7%, compared to $38.6 million for the three months ended September 30, 2008. Total revenue for the nine months ended September 30, 2009 was $106.7 million, a decrease of $5.2 million, or 5%, from $111.9 million for the nine months ended September 30, 2008. The decrease between the three months ended September 30, 2009 and the three months ended September 30, 2008 was primarily due to fewer implementations and services completed in the 2009 period compared to 2008 for the Care and Patient Revenue Management, Smart Identity Management and Health Information Suite products as well as decreased maintenance revenue for QCPR and Care and Patient Revenue Management products. The decrease between the nine months ended

September 30, 2009 and September 30, 2008 was also related to fewer implementations and services completed between periods and decreased maintenance revenue. The three and nine month periods ended September 30, 2008 included approximately $0.4 million and $1.4 million of non-recurring revenue related to the closeout of older contracts previously included in deferred revenue. After a thorough analysis of these contracts, we determined that all services had been completed, that no further obligations were outstanding, and that all cash had been collected; consequently, we recognized license revenue of approximately $1.1 million and services revenue of approximately $0.3 million from these contracts during the nine months ended September 30, 2008. In addition, in the third quarter of 2008, approximately $1.1 million of maintenance revenue was included related to the correction of an error in revenue recognized in prior periods. The error was determined to be immaterial. If these amounts were removed from the 2008 periods, the declines in revenue from 2008 to 2009 would have been only $1.3 million for the three month period and $2.7 million for the nine month period.

*Services and other revenue.* Services and other revenue consists of professional services, such as implementation and installation services, training, maintenance (which consists of technical support and product upgrades), and reimbursable expenses. 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 our Care and Patient Revenue Management and QCPR products. These services are provided subsequent to the signing of a software license agreement and are integral to the delivery of our software licenses to our customer. Our maintenance revenue depends on both new licenses of our software products and renewals of maintenance agreements by our existing customer base.

Services revenue for the three months ended September 30, 2009 was $5.8 million compared to $5.9 million for the three months ended September 30, 2008. The net decrease of $0.1 million was principally due to fewer services completed for our Smart Identity Management products, which was partially offset by increased services for our QCPR products. Services revenue was 16% of our total revenue for both of the three month periods ended September 30, 2009 and 2008.

Services revenue for the nine month period ended September 30, 2009 of $16.4 million decreased from $17.1 million for the same period in 2008. Services revenue was 16% and 15% of our total revenue for the nine months ended September 30, 2009 and 2008, respectively. The overall decrease in services revenue between periods was primarily due to fewer services completed for our Smart Identity Management and our Care and Patient Revenue Management products, partially offset by increased services related to our QCPR products.

Maintenance revenue for the three months ended September 30, 2009 was $16.8 million compared to $18.2 million for the three months ended September 30, 2008. Maintenance revenue as a percentage of total revenue was 47% for both periods. The decrease in the three month periods was related to our QCPR product and our Care and Patient Revenue Management products. This decrease is partially attributed to the $1.1 million of one-time maintenance revenue recognized in the three months ended September 30, 2008, as described above.

Maintenance revenue for the nine months ended September 30, 2009 was $49.3 million compared to $51.7 million for the nine months ended September 30, 2008. Maintenance revenue was 46% of total revenue during both periods. The decrease in the nine month periods was due to lower QCPR maintenance revenue in the 2009 period compared to the 2008 period. Our 2008 maintenance revenue included higher amounts associated with deferred maintenance revenue acquired with our acquisition of the QCPR business from Misys that was generally recognized during the 2008 period. The sale of our Lab and Radiology products in April 2008 as well as the $1.1 million of one-time maintenance revenue recognized as described above also attributed to the decrease in the nine months ended September 30, 2009 compared to the corresponding period in 2008.

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

**Table of Contents**

implementation. The installation and other revenue for many of our other products, including Care and Patient Revenue Management and QCPR products, is recognized on a contract basis of accounting.

Installation and other services revenue decreased by $0.1 million to $3.1 million for the three months ended September 30, 2009 from $3.2 million during the three months ended September 30, 2008. The decrease resulted primarily from the timing of the completion of installations between periods. Installation and other services revenue was approximately 9% and 8% of our total revenues for the three months ended September 30, 2009 and 2008, respectively.

Installation and other services revenue for the nine months ended September 30, 2009 was $9.1 million compared to $9.6 million for the nine months ended September 30, 2008. The $0.5 million decrease between periods resulted primarily from the timing of the completion of installations for our Government and Smart Identity Management and Health Information Management Suite products between periods, offset by increases associated with our QCPR products. Installation and other services revenue was 9% of our total revenues for both periods.

*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. Overall, license revenue decreased $1.3 million, or 12%, to $9.9 million for the three months ended September 30, 2009 from $11.2 million for the three months ended September 30, 2008. License revenue was approximately 28% and 29% of our total revenue for the respective 2009 and 2008 periods. Licenses revenue was $31.3 million for the nine months ended September 30, 2009 compared to $32.9 million for the nine months ended September 30, 2008. License revenue was approximately 29% of our total revenue during both periods. The decreases in both the three and nine month periods were primarily related to completion of significant projects in 2008 for our Scheduling and Health Information Management Suite perpetual license products. A decrease in the license revenue related to the Care and Patient Revenue Management products was offset by an increase in the QCPR products. The aforementioned one-time license revenue recorded in 2008 related to the closeout of older contracts previously included in deferred revenue also attributed to approximately $1.1 million of the decrease in the nine months ended September 30, 2009 compared to the corresponding period in 2008.

Term license revenue increased 5%, or $0.4 million, to $8.5 million in the three months ended September 30, 2009 from $8.1 million in the same quarter last year. For the nine months ended September 30, 2009, term license revenue increased 9%, or $2.2 million, to $25.9 million from $23.7 million in the same period last year. The increase for the three month period was mainly attributable to project completions of Health Information Suite products sold as limited term licenses, whereas the increase for the nine month period was mainly due to increased term licenses revenue from the Government products.

Perpetual license revenue decreased 55%, or $1.7 million, to $1.4 million in the third quarter of 2009 from $3.1 million in the same quarter last year. Perpetual license revenue for the nine months ended September 30, 2009 was $5.5 million compared to $9.3 million for the nine months ended September 30, 2008, representing a decrease of approximately 41%, or $3.8 million. The decrease in the three months ended September 30, 2009 compared to the corresponding period in 2008 was primarily due to the completions of significant projects in the third quarter of 2008 for the Health Information Suite perpetual licenses and Scheduling products. Approximately $1.1 million of the decrease in the nine month period was attributed to the aforementioned one-time license revenue recognized in the 2008 periods related to the closeout of older contracts that were previously included in deferred revenue. The decrease in the nine month periods was also mainly related to the decreased completions of Scheduling and Health Information Suite perpetual license products in the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008.

*Hardware*. Hardware revenue consists of the sale of third-party hardware purchased specifically for use by our customers. Hardware revenue was $0.1 million for each of the three month periods and was less than 1% of total revenue during both three month periods.

Table of Contents

Hardware revenue for the nine months ended September 30, 2009 of $0.4 million decreased compared to $0.5 million for the same period last year. Hardware revenue was 1% or less of total revenue during both nine month periods. Our hardware revenue may fluctuate from period to period based on the completion of hardware installations for our customers; however, we do not expect hardware installations to be a significant part of our ongoing revenue.

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

| | For the Three Months Ended September 30, 2009 | For the Three Months Ended September 30, 2008 |
|---|---|---|
| Deferred revenue, beginning balance | $ 45,955 | $ 50,920 |
| Add: revenue deferred | 32,262 | 28,376 |
| Less: deferred revenue recognized | (35,213) | (34,563) |
| Deferred revenue, ending balance | $ 43,004 | $ 44,733 |

| | For the Nine Months Ended September 30, 2009 | For the Nine Months Ended September 30, 2008 |
|---|---|---|
| Deferred revenue, beginning balance | $ 53,190 | $ 36,111 |
| Add: revenue deferred | 92,982 | 112,945 |
| Less: deferred revenue recognized | (103,168) | (104,323) |
| Deferred revenue, ending balance | $ 43,004 | $ 44,733 |

Deferred revenue includes amounts billed to or received from customers for which revenue has not been recognized. Fluctuation of the deferred revenue balance depends on 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 attainment of a milestone, or the passage of time in the case of a contract recognized ratably. The majority of the Company s revenue flows through our deferred revenue accounts and is attributable to favorable payment terms such as execution payments and achievements of billing milestones prior to meeting all revenue recognition requirements. Deferred revenue tends to be greater in the first quarter of each year compared to subsequent quarters due to the issuance of annual maintenance invoices and in the fourth quarter due to the issuance of invoices related to our government solution products. The annual license term for our Department of Veterans Affairs contract begins on October 1 of each year.

The deferred revenue balance decreased approximately $10.2 million to $43.0 million at September 30, 2009 compared to $53.2 million at December 31, 2008. The September 30, 2009 balance was comprised of $12.8 million in deferred license revenue, $19.4 million in deferred maintenance revenue and $10.8 million in deferred services and other revenue. The balance as of December 31, 2008 was comprised of $28.2 million in deferred license revenue, $18.0 million in deferred maintenance revenue, and $7.0 million in deferred services and other revenue. Deferred license revenue decreased by approximately $15.4 million mainly due to license revenue recognized during the nine months ended September 30, 2009, of which $15.4 million is related to our Department of Veterans Affairs contract. The deferred revenue balance as of September 30, 2009 includes $0.3 million related to the Department of Veterans Affairs contract compared to $15.9 million as of December 31, 2008. This decrease is partially offset by a $3.8 million increase in deferred services and other. Deferred services and other revenue increased slightly during the period due to the timing of billings and services performed under contractual arrangements with our customers.

The deferred revenue balance decreased approximately $1.7 million to $43.0 million at September 30, 2009 compared to $44.7 million at September 30, 2008. The September 30, 2008 balance was comprised of $15.5

Table of Contents

million in deferred license revenue, $22.7 million in deferred maintenance revenue and $6.5 million in deferred services and other revenue. Our deferred revenue balance has decreased primarily due to the changes from annual to quarterly or monthly billings for certain maintenance contracts.

For the nine months ended September 30, 2009 and 2008, the beginning deferred balance increased $17.1 million to $53.2 million as of December 31, 2008 compared to $36.1 million as of December 31, 2007 primarily due to deferred license revenue related to our Department of Veterans Affairs contract where advance billing was permitted in the fourth quarter of 2008 whereas the deferred revenue balance as of December 31, 2007 did not include such balance. The license fee for the Department Affairs contract year 2006-2007 was billed in the first quarter 2008 and therefore was not included in the $36.1 million balance as of December 31, 2007 and was included in the $112.9 million deferred revenue added in the nine months ended September 30, 2008.

During the three months ended September 30, 2008, the Company sold approximately $0.6 million of deferred revenue associated with the disposition of its Lab and Radiology assets.

In October 2009, our deferred revenue will increase by $20.5 million associated with our billing of the annual license fees under the recently executed Department of Veterans Affairs Task Order for the federal government s fiscal year ended September 30, 2010.

**Cost of Revenue**

*Cost of services and other revenue.* Cost of services and other revenue consists of salaries and related expenses associated with services performed for customer support, installation, maintenance and consulting services as well as payments to third-party vendors. Cost of services and other revenue for the three month period ended September 30, 2009 was $10.5 million compared to $11.5 million in the corresponding period in 2008, which represent 41% and 42% as a percentage of services and other revenue for the respective periods. The $1.0 million decrease was primarily attributable to lower third-party support costs directly associated with lower maintenance revenue in 2009, decreased personnel related costs and a reduction in contract and temporary services.

Cost of services and other revenue for the nine month period ended September 30, 2009 was $31.6 million compared to $34.3 million in the corresponding period in 2008, which represent 42% and 44% as a percentage of services and other revenue for the respective periods. The $2.7 million decrease was primarily attributable to decreased personnel costs and severance, lower third-party costs directly associated with lower maintenance and services revenue in 2009 and a reduction in contract and temporary, professional services, and travel costs.

*Cost of licenses*. Cost of licenses consists primarily of third-party software costs, royalties and amortization of capitalized software and acquired technology. A significant percentage of our total cost of revenue is attributable to royalties and licenses relating to third-party software embedded within our own applications. Generally, royalties fluctuate based on revenue, the number of customers or the number of licensed users, and therefore may fluctuate on a quarter-to-quarter basis. Cost of licenses for the three month period ended September 30, 2009 was $3.8 million, compared to $3.9 million for the three month period ended September 30, 2008. As a percentage of license revenue, cost of licenses was 38% and 35% for the respective three month periods. The $0.1 million decrease between quarters is due primarily to lower royalty costs resulting from renegotiated contracts with certain vendors.

Cost of licenses for the nine month period ended September 30, 2009 was $11.6 million, compared to $12.1 million for the nine month period ended September 30, 2008. As a percentage of license revenue, cost of licenses was constant at 37% for both of the nine month periods. The $0.5 million decrease between quarters is due primarily to a lower royalty costs resulting from renegotiated contracts with certain vendors.

*Cost of hardware*. Cost of hardware consists of third-party hardware and installation costs from the sale of hardware to our customers in connection with the implementation of our software. Cost of hardware fluctuates

Table of Contents

from period to period based on our hardware revenue. Cost of hardware for the three month periods ended September 30, 2009 and 2008 was $0.2 million and $0.1 million, respectively. Cost of hardware for the nine month period ended September 30, 2009 was $0.4 million compared to $0.3 million for the nine month period ended September 30, 2008.

**Gross Margin**

Our gross margin was 59% for the three month period ended September 30, 2009 compared to 60% for the three month period ended September 30, 2008. This decline was primarily attributable to a decrease in our license margin. The decrease in license margin is a result of the mix of products sold during the 2009 period and their associated royalty costs.

Our gross margin was 59% for the nine month period ended September 30, 2009 compared to 58% for the same period in 2008. This 1% increase in gross margin is primarily driven by an increase in our services margin. The services margin increased based on the recognition of approximately $0.5 million services revenue related to our government products with no associated costs during the three months ended September 30, 2009.

**Operating Expenses**

*General and administration*. General and administration expense was $4.9 million for the three months ended September 30, 2009, compared to $5.0 million for the three months ended September 30, 2008. As a percentage of total revenue, general and administration expense was 14% and 13% for the three month periods ended September 30, 2009 and 2008, respectively. The $0.1 million decrease was primarily attributable to lower salary and wage related expenses of $0.4 million, offset by $0.2 million higher bad debt expense due to economic conditions affecting our hospital customer base, and $0.1 million higher contract and temporary costs.

General and administration expense was $16.6 million for the nine months ended September 30, 2009, compared to $14.9 million for the nine months ended September 30, 2008. As a percentage of total revenue, general and administration expense was 16% and 13% for the nine month periods ended September 30, 2009 and 2008, respectively. The $1.7 million increase was primarily attributable to $0.9 million in severance-related costs, $0.5 million of non-cash stock compensation costs associated with changes in our executive team and $0.5 million higher bad debt expense due to economic conditions affecting our hospital customer base, offset by lower professional fees.

*Software development.* Software development expense during the three months ended September 30, 2009 was $9.3 million compared to $8.3 million during the three months ended September 30, 2008. As a percentage of total revenue, software development expense was 26% and 22% for the three month periods ended September 30, 2009 and 2008, respectively. The net increase of $1.0 million was attributable primarily to contract and temporary services due to our partnering arrangement with TCS and our increased product development efforts in the 2009 periods associated with new products to address ICD-10 requirements, computer assisted coding, and other initiatives, including certification of our QCPR clinical product in connection with the Federal health care stimulus programs. These costs are offset by lower employee related employment and travel costs.

Software development expense during the nine months ended September 30, 2009 was $25.9 million compared to $25.4 million during the nine months ended September 30, 2008. As a percentage of total revenue, software development expense was 24% for the nine month periods ended September 30, 2009 compared to 23% for the same period during 2008. The net increase of $0.5 million was attributable primarily to our partnering arrangement ramp-up with TCS as discussed above offset by the $0.4 million one-time severance expense in 2008 related to the full time development employees whose activities were displaced by TCS. During 2009, we increased product development efforts associated with new products to address ICD-10 requirements, computer assisted coding, and other initiatives, including certification of our QCPR clinical product in connection with the Federal health care stimulus programs. These costs were offset by lower travel and entertainment expenses and lower expense allocations based on headcount.

Table of Contents

*Sales and marketing.* Sales and marketing expense decreased $0.8 million for the three months ended September 30, 2009 to $4.2 million, from $5.0 million for the three months ended September 30, 2008. As a percentage of total revenue, sales and marketing expenses were 12% and 13% for the three month periods ended September 30, 2009 and 2008, respectively. The net decrease was primarily attributable to lower salary and wage related expenses, commissions, advertising and marketing expenses, and professional fees.

Sales and marketing expense decreased $1.0 million for the nine months ended September 30, 2009 to $13.1 million, from $14.1 million for the nine months ended September 30, 2008. As a percentage of total revenue, sales and marketing expenses were 12% and 13% for the nine month periods ended September 30, 2009 and 2008, respectively. The net decrease was primarily attributable to lower advertising and marketing expenses and commissions, offset by higher salary and wage related expenses including severance costs related to a change in our executive team and higher professional fees.

*Amortization of intangible assets and depreciation.* Amortization of intangible assets and depreciation expense was $0.9 million and $0.8 million for the three month periods ended September 30, 2009 and 2008, respectively.

Amortization of intangible assets and depreciation expense remained consistent at $2.4 million for both of the nine month periods ended September 30, 2009 and 2008.

**Other Income (Expense)**

*Other income (expense), net.* Net other income increased $0.1 million during the three months ended September 30, 2009, compared to the corresponding quarter of 2008 as a result of interest income earned on our investments.

Net other income increased slightly during the nine months ended September 30, 2009, compared to the corresponding period of 2008 primarily due to the earn-out payment received in connection with the April 2008 sale of our lab and radiology products from our Australian and U.K. subsidiaries, offset by lower interest income earned on our cash balances and investment portfolios compared to the prior year.

**Provision for Income Taxes**

Our provision for income taxes was $0.7 million during the three months ended September 30, 2009 compared to $1.6 million for the three months ended September 30, 2008. This decrease in income tax expense is primarily the result of our lower pre-tax income for the three months ending September 30, 2009 as compared to the same period of 2008. Our income tax provision decreased to $1.7 million for the nine months ended September 30, 2009 compared to $3.0 million for the same period in 2008, again due primarily to our lower pre-tax income. Our effective tax rate also declined to 31% for both the three and nine month periods ending September 30, 2009 compared to 40% for both the three and nine month periods ending September 30, 2008. The decrease in our effective tax rate is due primarily to the federal research tax credit available to the Company for the period ending September 30, 2009. The credit had expired at the end of 2007, and was not reenacted by Congress until October of 2008.

**Liquidity and Capital Resources**

We expect that cash provided by operating activities will be our primary source for funding our operating needs. Our other sources of liquidity are cash and cash equivalents as well as short-term and long-term investments. As of September 30, 2009, we had $19.0 million in unrestricted cash equivalents and investments. In addition, we have a working capital line of credit agreement under which we may borrow up to $2.0 million. There were no borrowings outstanding under the line of credit agreement as of September 30, 2009. Any future borrowings under this line of credit will have to be secured with underlying investments held at the issuing bank.

Table of Contents

Accounts receivable were $27.4 million as of September 30, 2009 compared to $20.8 million as of December 31, 2008. Our DSO was 69 at September 30, 2009 compared to DSO of 49 at September 30, 2008 and 51 at December 31, 2008. Accounts receivable increased by $6.6 million due to the timing of significant billing milestones achieved in the third quarter of 2009 related mainly to QCPR contracts.

In addition to our billed accounts receivable, we had unbilled receivables of $6.8 million as of September 30, 2009 and $6.2 million as of December 31, 2008. Unbilled receivables relate to products or customer agreements where billing is based on specifically agreed dates or milestones while revenue is recognized on a contract basis of accounting. The increase of $0.6 million was principally due to increased implementation activities for the QCPR products and services in advance of meeting billing milestones. We expect to bill and collect the unbilled revenue as billing milestones in the specific contracts are met.

Prepaid royalty expense decreased by approximately $6.7 million to $1.1 million as of September 30, 2009 from $7.8 million as of December 31, 2008, primarily due to a decrease in royalties paid to our subcontractors related to the Department of Veterans Affairs contract. This contract requires payment to our subcontractors when we are paid by the customer. The customer paid the full $19.9 million for the fiscal year 2009 license during December 2008 creating advance payments to the subcontractors that are being recognized as expense over the annual license term.

Accrued payroll and related expenses decreased by $2.0 million to $5.2 million as of September 30, 2009 from $7.2 million as of December 31, 2008. This decrease was primarily due to payments and accruals during the period related to annual bonus and benefit related costs as of December 31, 2008 offset by approximately $1.2 million in biweekly payroll accruals as of September 30, 2009.

Other accrued liabilities decreased by $1.2 million to $3.5 million at September 30, 2009 from $4.7 million at December 31, 2008. The decrease was primarily due to timing differences associated with the payments for professional fees, legal fees and royalties.

The Company s Condensed Consolidated Statement of Cash Flows is summarized below (in thousands):

| | For the Three Months Ended September 30, | |
|---|---|---|
| | **2009** | **2008** |
| Cash (used in) provided by operating activities | $ (2,045) | $ 2,394 |
| Cash provided by (used in) investing activities | 467 | (414) |
| Cash used in financing activities | (1,322) | (980) |
| Effect of exchange rate changes | 26 | (193) |
| Net (decrease) increase in cash and cash equivalents | $ (2,874) | $ 807 |

| | For the Nine Months Ended September 30, | |
|---|---|---|
| | **2009** | **2008** |
| Cash (used in) provided by operating activities | $ (3,671) | $ 14,532 |
| Cash (used in) provided by investing activities | (5,278) | 1,292 |
| Cash used in financing activities | (4,024) | (7,309) |
| Effect of exchange rate changes | 203 | (224) |
| Net (decrease) increase in cash and cash equivalents | $ (12,770) | $ 8,291 |

Cash (used in) provided by operating activities is primarily driven by our operating income or loss, the timing of receipt of customer payments, and the timing of our payments to vendors and employees. During the three months ended September 30, 2009, $2.0 million was used by operating activities, as compared to the same period in 2008 when $2.4 million was provided by operating activities. The difference is driven primarily by a decrease in operating results between periods with $1.8 million lower gross margin. Finally, working capital changes used $2.2 million more cash during the 2009 period than in 2008, primarily due to milestone billings and the timing of collections during the current year compared to the prior year.

During the nine months ended September 30, 2009, $3.7 million was used by operating activities, as compared to the same period in 2008 when $14.5 million was provided by operating activities. Net income in 2009 was $3.8 million, including non-cash charges of $7.4 million, and net working capital changes that used $14.8 million of cash. The net working capital changes were driven primarily by the timing of payments from the Department of Veterans Affairs offset by our payments to the subcontractors as previously discussed in the financial statement overview section and higher payments under our arrangement with TCS due to the ramp-up period in 2008 compared to a full nine month period incurred in 2009. In addition, we paid $0.5 million against our outstanding note payable to a former executive and incurred approximately $1.3 million of severance payments related to changes in our executive team. Net income for the first nine months of 2008 of $4.6 million included non-cash charges for depreciation, amortization and stock compensation of $9.0 million, and a non-cash loss on the sale of assets of $1.2 million.

Cash flows provided by investing activities was $0.5 million during the three months ended September 30, 2009, primarily due to $1.0 million in net proceeds from the sale of available for sale securities offset by $0.6 million used for capital purchases. During the three months ended September 30, 2008, cash flow of $0.4 million was used in investing activities primarily due to $0.6 million of capital purchases offset by a $0.2 million decrease in restricted cash.

Cash used in investing activities was $5.3 million during the nine months ended September 30, 2009, primarily due to the $4.1 million in net purchase of available for sale securities and $1.1 million of capital purchases. During the nine months ended September 30, 2008, $1.3 million was provided by investing activities primarily due to the net proceeds of $1.8 million from the sale of available for sale securities and a $0.8 million decrease in restricted cash, offset by $1.4 million of capital purchases.

Cash used in financing activities was $1.3 million for the three months ended September 30, 2009 compared to cash used of $1.0 million for the three months ended September 30, 2008. The increase in cash used in financing activities was primarily due to $0.4 million of proceeds received in 2008 from the issuance of common stock as a result of exercise of employee stock options which did not occur during the same period in 2009.

Cash used in financing activities was $4.0 million for the nine months ended September 30, 2009 compared to cash used of $7.3 million for the nine months ended September 30, 2008. The decrease in cash used between periods was primarily due to the use of $3.7 million to repurchase shares of our outstanding common stock during 2008 through a repurchase program conducted in accordance with Rules 10b5-1 and 10b-18 under the Securities Exchange Act of 1934.

Our capital expenditures are expected to be between $2.0 million and $3.0 million for 2009, primarily related to purchases of computer equipment and enterprise software required for internal purposes.

Other than our operating needs, our most significant ongoing cash requirements are for the payment of dividends on our Series A Preferred Stock, which pays a 5.5% per annum dividend, or $5.5 million per year. These dividends are paid in equal quarterly installments of $1.375 million, payable when declared on January 15, April 15, July 15 and October 15 of each year. We expect to use our existing available cash and operating cash flow for the payment of preferred stock dividends.

We believe that our present cash position and our future cash generated from operations will be sufficient to meet anticipated cash requirements over the next twelve months. We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, specifically the timing of when we recognize revenue, our accounts receivable collections and the timing

Table of Contents

of other payments. In addition, cash used in investing activities may fluctuate due to our software development efforts, any acquisition or disposition we may undertake, and costs associated with our investments in fixed assets and information technology. We periodically evaluate strategic business opportunities, and should a strategic opportunity arise that would require a more significant use of cash, we would expect to finance such opportunity through available cash, new or existing financing arrangements, or the issuance of additional shares of stock. There can be no assurances however that adequate sources of liquidity will be available to us to finance such strategic business opportunities when they arise.

**Recent Accounting Pronouncements**

See Note 3 to our Condensed Consolidated Financial Statements for a discussion of the impact of new accounting pronouncements.

**Critical Accounting Policies**

There have been no changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2008 as filed with the SEC on March 11, 2009.

**Legal Proceedings**

We are subject to litigation in the normal course of business, but management does not believe that the resolution of any pending proceedings would have a material adverse effect on our condensed consolidated financial position or results of operations.

**Commitments**

The following table summarizes financial data for our contractual obligations and other commercial commitments, including interest obligations, as of September 30, 2009 (in thousands):

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1-3 years | 4-5 years | After 5 years |
| **Contractual Obligations** | | | | | |
| Accrued dividends | $ 1,375 | $ 1,375 | $ | $ | $ |
| Operating leases (1) | 7,636 | 3,770 | 3,604 | 262 | |
| Total contractual obligations | $ 9,011 | $ 5,145 | $ 3,604 | $ 262 | $ |
| **Other Commercial Commitments** | | | | | |
| Term deposit for bank guarantee | $ 76 | $ | $ 76 | $ | $ |
| Standby letters of credit (2) | 1,445 | 1,328 | 117 | | |
| Total commercial commitments | $ 1,521 | $ 1,328 | $ 193 | $ | $ |

(1) The less than 1 year amount of $3.8 million includes $0.2 million for the San Rafael, California facility that was shut down during the fourth quarter of 2004 as a result of the relocation of our headquarters to Reston, Virginia. The accrued exit costs associated with this facility will be fully recognized in December 2009.

(2) The less than 1 year amount of $1.3 million includes a $1.2 million letter of credit in favor of two customers under their contracts. The remainder represents security deposits for leased facilities.

Table of Contents

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

**Interest Rate Risk**

Our exposure to market risk for changes in interest rates primarily relates to our investment portfolio. It is our intent to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk, and reinvestment risk. We invest in high-quality issuers, including money market funds, corporate debt securities, and debt securities issued by the U. S. government and U.S. governmental agencies. We do not invest in derivative financial or foreign investments.

The table below presents fair values of principal amounts and weighted average interest rates for our investment portfolio as of September 30, 2009 (in thousands, except average interest rates):

| | Aggregate Fair Value |
|---|---|
| *Cash and cash equivalents:* | |
| Cash (1) | $ 6,305 |
| Money Market funds | 1,574 |
| Total cash and cash equivalents | $ 7,879 |
| *Short-term investments:* | |
| Certificates of Deposit | $ 7,452 |
| Debt issued by the US government | 198 |
| Total short-term investments | $ 7,650 |
| *Investments:* | |
| Debt securities issued by the US government | $ 3,506 |
| Total long-term investments | $ 3,506 |

| | Aggregate Fair Value | Weighted Average Interest Rate |
|---|---|---|
| *Summary:* | | |
| Cash | $ 6,305 | 0.42% |
| Money Market funds | 1,574 | 0.23% |
| Certificates of Deposit | 7,452 | 1.16% |
| Debt issued by US government | 3,704 | 3.90% |
| | $ 19,035 | |

(1) Excluded from the fair value of the principal amounts of cash is $1.5 million, which is restricted cash that is held in escrow for rental properties, and meeting customer performance expectations.

**Performance of Equity Markets**

The performance of the equity markets can have an effect on our operations as certain of our variable life insurance policies have premiums invested in equity securities.

**Foreign Currency Risk**

Our primary market risk exposure relates to changes in foreign currency exchange rates and potentially adverse effects of differing tax structures. Changes in foreign exchange rates did not materially impact our results of operations. For the nine months ended September 30, 2009, approximately 4% of total revenue was denominated in currencies other than the U. S. dollar and approximately 5% of our total direct and operating costs were incurred in currencies other than the U. S. dollar.

Table of Contents

*Item 4. Controls and Procedures*

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

We have established disclosure controls and other procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission s rules and forms. The Company s disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Act is accumulated and communicated to the Company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

As of September 30, 2009, an evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer (the CEO ) and the Chief Financial Officer (the CFO ), of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon this evaluation, the Company s CEO and CFO have concluded that the Company s disclosure controls and procedures were effective and provided reasonable assurance as of the date of such evaluation.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2009, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

## PART II. OTHER INFORMATION

***Item 1A. Risk Factors***

The Company believes there have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, filed with the SEC on March 11, 2009 (the 2008 Form 10-K ) and the revised risk factor previously disclosed in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, filed with the SEC on August 6, 2009 (the Second Quarter Form 10-Q ). You should carefully consider such risk factors as presented in the 2008 Form 10-K , the revised risk factor as presented in the Second Quarter Form 10-Q and other information set forth in this Quarterly Report on Form 10-Q, including our financial statements and the related notes.

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

On July 27, 2009, we issued inducement stock options to purchase 300,000 shares of our common stock with an exercise price of $6.52 per share to Duncan W. James, our Chief Executive Officer, as an inducement to his employment by the Company. These options vest with respect to 25% of the option shares upon completion of one year of service measured from the date of grant; the remaining 75% of the option shares vest in a series of 36 equal successive installments upon the completion of each additional month of service thereafter, subject to acceleration in the event of a change in control and certain termination events. These stock options have a maximum term of ten years, subject to earlier cancellation upon the termination of Mr. James service with the Company in certain circumstances.

These inducement stock options were issued outside of our stock plans in connection with the offer of employment to Mr. James. The offer and sale of the inducement stock options to Mr. James was made pursuant to the exemption set forth in Section 4(2) of the Securities Act of 1933 for transactions not involving a public offering, and regulations promulgated thereunder.

***Item 6. Exhibits***

The exhibits listed on the accompanying Exhibit Index are filed as part of this Quarterly Report on Form 10-Q.

Table of Contents

## SIGNATURES

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

| | | |
|---|---|---|
| | QUADRAMED CORPORATION | |
| Date: November 5, 2009 | By: | /s/ DUNCAN W. JAMES<br>**Duncan W. James**<br><br>**Chief Executive Officer** |
| Date: November 5, 2009 | By: | /s/ DAVID L. PIAZZA<br>**David L. Piazza**<br><br>**Chief Financial Officer** |

Table of Contents

**EXHIBIT INDEX**

| Exhibit Number | Exhibit Description |
|---|---|
| 4.1** | Form of Common Stock certificate, as amended October 27, 2009. |
| 4.2** | Form of Preferred Stock certificate for the Series A Cumulative Mandatory Convertible Preferred Shares, as amended October 27, 2009. |
| 31.1** | Certification of the Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2** | Certification of the Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2** | Certification of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002. |

** Filed herewith