UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

[ X ] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended March 31, 1999

OR

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

For the transition period from _____ to

Commission file number 0-13801

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

| California | 95-2888568 |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

17822 East 17th Street, Tustin, California 92780
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: (714) 731-7171

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

| Title of each class | Name of each exchange on which registered: |
|---|---|
| Common Stock, par value $.01 per share | NA |

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

State the aggregate market value of the voting stock held by non-affiliates of the registrant as of May 28, 1999: $18,986,000

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of May 28, 1999: 6,213,666.

## DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of the Form 10-K is incorporated by reference from Registrant's Definitive Proxy Statement for its 1999 annual meeting which is to be filed with the Commission on or before July 29, 1999.

PART I.

## Item 1. BUSINESS.

Except for the historical information contained herein, the matters discussed in this Annual Report on Form 10-K, including discussions of the Registrant's product development plans, business strategies and market factors influencing the Registrant's results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by the Registrant as a result of various factors, both foreseen and unforeseen, including, but not limited to, the Registrant's ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution; consolidation within the Registrant's target marketplace and among the Registrant's competitors; and, competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact the Registrant's ability to achieve its goals and interested persons are urged to review the risks described under "Item 1. Business. Risk Factors." and in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." as well as in the Registrant's other public disclosures and filings with the Securities and Exchange Commission.

### COMPANY OVERVIEW.

Quality Systems, Inc. ("QSI") and its wholly-owned subsidiaries, Clinitec International, Inc. ("Clinitec") and MicroMed Healthcare Information Systems, Inc. ("MicroMed"), (collectively, the "Company") develop and market healthcare information systems that automate medical and dental group practices, physician hospital organizations ("PHOs"), management service organizations ("MSOs"), community health centers and dental schools. In response to the growing need for more comprehensive, cost-effective information solutions for physician and dental practices, the Company's systems provide its clients with the ability to redesign patient care and other workflow processes, improve productivity, reduce information processing and administrative costs, and provide multi-site access to patient information. The Company's proprietary software systems include general patient information, electronic medical records, appointment scheduling, billing, insurance claims submission and processing, managed care plan implementation and referral management, treatment outcome studies, treatment planning, drug formularies, dental charting, and letter generation. In addition to providing fully integrated software information solutions to its clients, the Company offers comprehensive hardware and software installation services, maintenance and support services, system training services, and electronic insurance claims submission services.

The Company currently has an installed base of more than 500 healthcare information systems serving PHOs, MSOs, group practices, specialty practices, dental schools and other healthcare organizations, each of which consists of from one to 250 physicians or dentists. The Company believes that as healthcare providers are increasingly required to reduce costs while maintaining the quality of healthcare, the Company will be able to capitalize on its strategy of providing fully integrated information systems and superior client service.

QSI is a California Corporation formed in 1974 and was founded with an early focus on providing information systems and services primarily for

dental group practices. QSI's initial "turnkey" systems were designed to improve productivity while reducing information processing costs and personnel requirements. In the mid-1980's, QSI capitalized on the opportunity presented by the increasing pressure of cost containment on physicians and healthcare organizations and further expanded its information processing systems into the broader medical market. Today, QSI primarily develops and provides integrated character-based healthcare information systems utilizing a UNIX* operating system for both the medical and dental markets ("Legacy Product"). These expandable systems operate on a stand-alone basis or in a networked environment.

Augmenting its medical practice management software system, QSI added Clinitec's electronic medical records software, NextGen**, to its product line in 1995 and completed its acquisition of Clinitec in May 1996 (see "Item 1. Business. Acquisitions."). NextGen allows healthcare providers to create and maintain medical records using a series of user-definable clinical "templates." Data is generally captured using a light pen or a mouse, and entries are then turned into sentences and/or paragraphs to create documentation. NextGen also supports the scanning and annotation of paper documents, photographs and X-rays, and contains many other advanced features. NextGen is marketed both in conjunction with the Company's practice management software offerings as well as on a stand-alone basis where NextGen may interface with other practice management systems. With the addition of NextGen, the Company believes that it currently provides a comprehensive information management solution for the medical marketplace.

During fiscal 1998, the Company released a new product, the Clinical Product Suite ("CPS"), a comprehensive dental solution designed specifically for the large dental group practice environment. CPS integrates the dental Legacy Product with a computer-based clinical information system that incorporates a wide range of clinical tools, including electronic charting of dental procedures, treatment plans and existing conditions; periodontal charting, via light-pen, voice-activation, or keyboard entry, for full periodontal examinations and PSR scoring; digital imaging of x-ray and intra-oral camera images; computer-based patient education modules; full access to patient information, treatment plans, and insurance plans; and document and image scanning for digital storage and linkage to the electronic patient record. CPS incorporates a Windows-based client/server technology consisting of one or more file servers together with any combination of one or more desktop, laptop, or pen-based PC workstations. The file server(s) used in connection with CPS utilize a Windows NT*** operating system. Based on the server configuration chosen, CPS is scalable from one to hundreds of workstations.

Further augmenting its medical practice management system product line, the Company purchased MicroMed in May 1997 (see "Item 1. Business. Acquisitions."). MicroMed develops and markets proprietary medical practice management systems. MicroMed's practice management system ("Windows Product") has been developed with a client/server architecture; a GUI design utilizing either Windows 95***, Windows 98*** or Windows NT operating system platforms; and, a platform independent relational database that is ANSI SQL-compliant. MicroMed's product is designed to provide a flexible, enterprise-wide solution employing a master patient index.

*  UNIX is a registered trademark of AT&T Corporation.
**  NextGen is a registered trademark of Clinitec International, Inc.
***  Microsoft Windows, Windows NT, Windows 95 and Windows 98 are registered Trademarks of Microsoft Corporation.

## ACQUISITIONS.

### CLINITEC.

Clinitec was formed in 1994 to develop and market electronic medical records software systems. In April 1995, QSI entered into a strategic relationship with Clinitec providing QSI with certain marketing rights to Clinitec's products. In May 1995, as part of this relationship, QSI acquired a 25% equity interest in Clinitec for $1.0 million in cash. In May 1996, QSI acquired the remaining 75% of Clinitec for approximately $4.9 million in cash plus 309,846 shares of QSI Common Stock. For purposes of the acquisition, the shares were valued at approximately $6.9 million, or $22.25 per share, for a total purchase price of approximately $11.8 million for the remaining 75% ownership interest. For accounting purposes, the acquisition was treated as a purchase transaction during the fiscal year ended March 31, 1997.

Clinitec's proprietary software products are relatively new and Clinitec has sold only a limited quantity of these products to date. There can be no assurance that Clinitec's products will achieve broad market acceptance.

### MICROMED.

MicroMed was formed in 1993 to develop and market medical practice management software systems. In May 1997, the Company purchased substantially all of the assets of MicroMed for $10.5 million. The purchase price consisted of an initial cash payment of $4.8 million paid upon the May 1997 closing of the transaction with an additional payment of $5.7 million due no later than June 29, 1998. The additional payment, paid on June 29, 1998, consisted of $3.8 million in cash and 245,454 shares of QSI Common Stock valued at $1.8 million, or $7.48 per share. For accounting purposes, the acquisition was treated as a purchase transaction during the fiscal year ended March 31, 1998.

MicroMed's proprietary software products are relatively new and MicroMed has sold only a limited quantity of these products to date. There can be no assurance that MicroMed's products will achieve broad market acceptance or will successfully compete with other Windows-based practice management software products.

## INDUSTRY BACKGROUND.

To compete in the changing healthcare environment, physicians and other outpatient care providers are increasingly joining and affiliating with other physicians, managed care organizations, hospitals and other enterprises to form larger healthcare organizations such as PHOs, MSOs and health maintenance organizations ("HMOs"). These organizations are designed to take advantage of anticipated economies of scale associated with managing healthcare services for large patient populations across inpatient and outpatient settings while achieving improved quality, reduced costs and strengthened negotiating positions with managed care entities. Similarly, the dental profession has recently seen consolidation of dental practices driven by many of the same factors as in the medical profession. The consolidation occurring among medical and dental providers, respectively, has created business organizations which require more sophisticated computer information systems.

As the managed care environment continues to expand as many experts expect, more healthcare provider organizations enter into contracts, and often multiple contracts, which define the terms under which care is

administered. The expansion in the number of managed care and third-party payor organizations, as well as additional government regulation and changes in reimbursement models, has greatly increased the complexity of pricing policies, billing procedures and reimbursement policies impacting medical and dental practices. To operate effectively, healthcare provider organizations must efficiently manage patient care and other workflow processes which increasingly extend across multiple care locations and business entities.

To compete under the constraints of managed care while maintaining quality of services, healthcare provider organizations have placed increasing demands on their information systems. Initially, these information systems automated financial and administrative functions. As it became necessary to manage patient flow processes, the need arose to integrate "back-office" data with such clinical information as patient test results and office visits. Particularly for larger organizations and group practices, the Company believes information systems must allow enterprise-wide exchange of patient information incorporating administrative, financial and clinical information from multiple entities, while focusing on the primary care provider. In addition, large healthcare organizations increasingly require information systems that can deliver high-performance in environments with multiple concurrent computer users.

Many existing healthcare information systems, including numerous systems currently utilized by the solo practitioner and small group practices, were designed for limited administrative tasks such as billing and scheduling and can neither accommodate multiple computing environments nor operate effectively across multiple locations and entities. As the healthcare industry continues to evolve, physician and dental groups and other healthcare organizations will increasingly require systems that compile structured clinical information from multiple sources and enable measurement of treatment outcomes and management of clinical processes. The Company believes that systems which integrate this patient clinical data with administrative, financial and other practice management data to maintain patient flow while continuing to reduce costs and improve quality of care are best positioned to succeed in the evolving managed care environment.

As healthcare organizations transition to new computer platforms and newer technologies, experts believe such organizations will be migrating toward the implementation of enterprise-wide, patient-centered computing systems embedded with automated patient medical records. These organizations cannot afford significant downtime or re-education, nor can they prudently risk choosing a system which has not proven its ability to handle high volume processing with continuous dependability. The Company believes, therefore, that successful systems vendors in the market most likely will have a sufficient installed base and adequate resources to offer high quality, fully integrated products together with the value-added services needed to expand and support growing clients throughout this evolutionary process.

## PRODUCTS.

In response to the growing need for more comprehensive, cost-effective healthcare information solutions for physician and dental practices, the Company's systems provide its clients with the ability to redesign patient care and other workflow processes while improving productivity through multi-site and multi-user access to patient information. Utilizing proven third-party hardware solutions combined with the Company's proprietary

software configured to maximize the efficiency of a healthcare organization's information processing requirements, the Company's solutions enable an integration of a variety of administrative and clinical information operations. Leveraging over 20 years of experience in the healthcare information services industry, the Company believes that it continues to distinguish its solutions by providing its clients with sophisticated, full-featured software systems along with comprehensive systems implementation, maintenance and support.

PRACTICE MANAGEMENT SYSTEMS.

The Legacy Product consists primarily of proprietary healthcare software applications together with third-party hardware and other non-industry specific software. The systems range in capacity from one to hundreds of users, allowing the Company to address the needs of both small and large organizations. The systems are modular in design and may be expanded to grow with changing client requirements.

The software configuration for a typical Legacy Product system includes a basic medical or dental application and additional software to meet identified needs of each client. The basic Legacy Product software automates many aspects of group practice management, including general patient registration, appointment scheduling, billing, insurance claims submission and processing, and treatment planning. Add-on applications include such modules as outside referral management for managed care, patient eligibility, electronic insurance claims and electronic patient statements processing, and various proprietary and third party accounting and word processing packages.

A typical Legacy Product system also consists of third party hardware components, including one or more central processing units, disk drives, magnetic tape units, video display terminals, PCs, and printers together with telecommunications equipment, which the client often purchases as a turnkey system from the Company. The Legacy Product system primarily uses the IBM RS6000* central processing unit and IBM'S AIX** version of the UNIX operating system as a platform for its application software enabling a wide range of flexible and functional systems. The hardware components, as well as the requisite operating system licenses, are purchased from manufacturers or distributors of those components. QSI assembles and tests the hardware components and incorporates the Legacy Product software and other third party packages into completed systems tailored to accommodate particular client requirements. The Company continually evaluates the hardware components of its systems with a view toward utilizing hardware that is functional, reliable and cost-effective.

The Windows Product expands the Company's practice management system product line which historically has been primarily character-based software solutions, as have most of the products offered by the Company's competitors. The Windows Product has been developed using a GUI client/server platform for compatibility with Windows 95, Windows 98 and Windows NT operating systems and a relational database that is ANSI SQL-compliant. The Windows Product, which has been designed initially for healthcare provider networks, is scalable and includes a master patient

* RS6000 is a registered trademark of International Business Machines Corporation.
** AIX is a registered trademark of International Business Machines Corporation.

index, enterprise-wide appointment scheduling with referral tracking, clinical support, and centralized or decentralized patient financial management based on either a managed care or fee-for-service model.

The Windows Product is designed to be used on any computer that supports Windows 95, Windows 98 or Windows NT operating systems. The system's three-tiered architecture allows work to be performed on the database server, the application server and the client workstation. To date, the Company generally has made hardware recommendations for the Windows Product to its clients based upon information provided by each client. However, the client is responsible for the ultimate selection, installation, and integration of the hardware which each client purchases directly from third party suppliers other than the Company.

In December 1996, the Company announced the release of an Internet dental practice management product, QSINET, that includes such features as patient registration, scheduling, collections and receivables tracking, treatment planning, and management reporting. QSINET connects dental groups to the extensive and growing electronic commerce network enabling users to process insurance claims and patient statements more rapidly and also allows the practice to communicate with its patients via e-mail for appointment reminders, treatment recalls, and other patient notifications. The system can be accessed anywhere at any time using a personal computer with Internet access. In addition, the Company has also provided an Intranet solution to several of its clients based on the QSINET product. The Company does not generally provide any hardware in connection with its Internet/intranet products.

CLINICAL SYSTEMS.

Clinitec provides software applications that are complimentary to, and interface with, the Company's medical practice management offerings. The applications incorporated into the Company's practice management solutions (such as scheduling, eligibility, billing and claims processing) are augmented by clinical information captured by Clinitec's NextGen, including services rendered and diagnoses used for billing purposes. NextGen was developed with a client/server architecture and a graphical user interface ("GUI") utilizing Microsoft Windows 95, Windows 98 or Windows NT on each workstation and either Windows NT, UNIX or Novell* on the server. NextGen maintains data using an industry standard relational database engine such as Microsoft SQL Server**, INFORMIX*** or Oracle****. The system is scalable from one to hundreds of workstations.

NextGen stores and maintains clinical data including:

- - Data captured using user-customized input "templates";
- - Scanned or electronically acquired images, including X-rays and photographs;
- - Data electronically acquired through interfaces with clinical instruments;
- - Other records, documents or notes, including electronically captured handwriting and annotations; and,
- - Digital voice recordings.

* Novell is a registered trademark of Novell, Inc.
** Microsoft is a registered trademark and SQL Server is a trademark of Microsoft Corporation.
*** INFORMIX is a registered trademark of Informix Corporation.
**** Oracle is a registered trademark of Oracle Corporation.

NextGen also offers a workflow module, prescription management, automatic document and letter generation, patient education, referral tracking, interfaces to billing and lab systems, physician alerts and reminders, and powerful reporting and data analysis tools.

NextGen is sold either as a combination of software and services, or as a turnkey system including computer hardware, which can include network servers, PC workstations, tape back-up units, printers, scanners and requisite operating system software. Computer hardware for turnkey systems is purchased for resale by the Company from third party manufacturers or distributors.

The Company's dental charting software system, the Clinical Product Suite, is a comprehensive dental solution designed specifically for the large dental group practice environment. CPS integrates the dental Legacy Product with a computer-based clinical information system that incorporates a wide range of clinical tools, including:

- - Electronic charting of dental procedures, treatment plans and existing conditions;
- - Periodontal charting, via light-pen, voice-activation, or keyboard entry, for full periodontal examinations and PSR scoring;
- - Digital imaging of x-ray and intra-oral camera images;
- - Computer-based patient education modules, viewable chair-side to enhance case presentation;
- - Full access to patient information, treatment plans, and insurance plans via a fully integrated interface with the dental Legacy Product; and,
- - Document and image scanning for digital storage and linkage to the electronic patient record.

The result is a comprehensive clinical information management system that saves time, reduces costs, improves case presentation, and enhances the delivery of dental services and quality of care. Clinical information is managed and maintained electronically thus forming an electronic patient record that allows for the implementation of the "chartless" office.

CPS incorporates a Windows-based client/server technology consisting of one or more file servers together with any combination of one or more desktop, laptop, or pen-based PC workstations. The file server(s) used in connection with CPS utilize a Windows NT operating system and the hardware is typically a Pentium* based single or multi-processor platform. Based on the server configuration chosen, CPS is scalable from one to hundreds of workstations. A typical configuration may also include redundant disk storage, magnetic tape units, intra and extra oral cameras, digital x-ray components, digital scanners, conventional and flat screen displays, and printers. The hardware components, including the requisite operating system licenses, are purchased from third party manufacturers or distributors either directly by the customer or by the Company for resale to the customer.

## SALES AND MARKETING.

The Company sells and markets its products nationwide through a direct sales force. The Company's sales and marketing employees identify and contact prospective clients by a variety of means, including referrals from existing clients and contacts at professional society meetings and seminars

* Pentium is a registered trademark of Intel Corporation

with persons involved in group practices as well as trade journal advertising, direct mail advertising, and telemarketing.

These sales employees are knowledgeable about medical and dental group healthcare entities, as well as computer applications. Typically, sales employees make presentations to potential clients by demonstrating the system and its capabilities on the prospective client's premises. In addition for certain of its products, the Company performs remote demonstrations by utilizing a prospective client's PC or by sending the prospective client a telecommunications kit including a terminal.

The Company's sales cycle can vary significantly and typically ranges from three to 12 months from initial contact to contract execution. Systems are normally delivered to a customer within 30 to 60 days of receipt of a system order, and therefore, the Company does not believe data pertaining to backlog is meaningful. As part of the fees paid by its clients, the Company receives up-front licensing fees and a monthly or quarterly service fee based on system configuration.

Several clients have purchased the Company's practice management system and, in turn, are providing either time-share or billing services to local single and group practice practitioners. Under the time-share or billing service agreements, the client provides the use of its system for a fee to one or more practitioners. Although the Company does not receive a fee directly from the client's customers, implementation of such arrangements has resulted in the purchase of additional system capacity by the client offering the services, as well as new system purchases made by the client's customers should such customers decide to perform the practice management functions in-house.

The Company continues to concentrate its sales and marketing efforts on medical and dental practices, dental schools, physician clinics, MSOs, PHOs and community health centers. MSOs and PHOs to which the Company has sold systems provide use of the Company's software to those group and single physician practices associated with the organization or hospital on either a service basis or by directing the Company to contract with those practices for the sale of stand-alone systems.

The Company has also entered into marketing assistance agreements with certain of its clients pursuant to which the clients allow the Company to demonstrate to potential clients the use of systems on the existing clients' premises. In addition, the Company has established certain of its clients as dealers for its systems. Through this arrangement to date, the dealer markets and sells the Legacy Product to prospects in a local territory. These prospects are generally smaller healthcare facilities than those actively pursued by the Company. The Company's PC-based Legacy Products are well suited to this dealer marketing. In addition, the dealer typically provides a variety of ongoing services for its clients. Dealers are compensated based on system size and profitability, and the services which they perform in place of the Company.

The Company often assists prospective clients in identifying third party sources for financing the purchase of the Company's systems. The financing usually is obtained by the client directly from institutional lenders and typically takes the form of a loan from the institution secured by the system to be purchased or a leasing arrangement.

The Company has numerous clients and does not believe that the loss of any single client would have a material adverse effect on the Company. No

client accounted for ten percent or more of net revenues during fiscal years ended March 31, 1999, 1998 or 1997.

## CUSTOMER SERVICE AND SUPPORT.

The Company believes its success is attributable in part to its exceptional customer service and support. The Company offers support to its clients seven days a week, 24 hours a day. All of the Legacy Product systems have a dedicated computer port for dial-up remote access facilitating rapid response by technicians to system inquiries. Most inquiries can be resolved without the need to dispatch technicians to the client location. These support services also provide the Company with the opportunity to monitor changes in each client's information processing requirements and to recommend the purchase of system hardware or software enhancements designed to satisfy these additional requirements. The Company believes that its commitment to provide extensive support has contributed significantly to the development of its business.

The Company's continuing system support staff is comprised of specialists who are knowledgeable in the area of hardware and software technology as well as in the day-to-day operations of a group practice. This system support ranges from correcting minor procedural problems in the client's system to performing complex database reconstructions or software updates. The Company also utilizes an automated on-line support system for the Legacy Product which assists clients in resolving minor problems and facilitates automated electronic retrieval of problems and symptoms following a client's call to the automated support system. Additionally, this on-line support system maintains a complete call record at both the client's facility and the Company.

The Company offers its clients support services for most system components, including hardware (generally, except for the Windows Product to date) and software maintenance, for a fixed monthly or quarterly fee. The Company also subcontracts, in certain instances, with IBM to perform specific hardware maintenance tasks under the Company's direction. This arrangement has provided the Company with economies of scale associated with IBM's service infrastructure while still maintaining service standards.

## IMPLEMENTATION AND TRAINING.

The Company provides implementation and training services and believes that its system delivery, implementation and support services are key elements of successful client relationships. When a client signs a contract for the purchase of a system, a client manager/implementation specialist, trained in medical and/or dental group practice procedures, is assigned to assure that the client is fully informed of system options and that the proper system configuration is installed. This information is determined through discussions with the client and observation of the client's practice. Once the set of software features is established, the software configuration unique to a given client can be created in an automated fashion.

Before activation of the client's practice management system, Company personnel typically convert, or assist in conversion of, the relevant client data onto the system. Usually, the data is converted electronically from another computer system enabling a quick, cost-effective and accurate conversion. The system is then subjected to extensive testing which includes processing representative data using the client's system configuration.

One or more Company trainers experienced in group practice procedures are assigned to conduct an intensive training program for the client's employees. The program may include a combination of computer assisted instruction ("CAI") for certain of the Company's products, remote training techniques and training classes conducted by Company staff at the client's office(s). CAI consists of workbooks, computer interaction and self-paced instruction. CAI is also offered to clients, for an additional charge, after the initial training program is completed for the purpose of training new and additional employees. Remote training allows a trainer at the Company office to train one or more people at a client site via telephone and computer connection, thus allowing an interactive and office-specific mode of training without the expense and time required for travel. The Company also provides ongoing training for certain of its products through electronic classrooms where employees at different locations from the same or different clients can simultaneously interact on-line with a trainer. In addition, the Company's on-line "help" documentation feature facilitates client training as well as ongoing support.

## COMPETITION.

The market for medical group practice management systems is intensely competitive and the Company faces significant competition from a number of different sources. The industry is highly fragmented and includes numerous competitors, none of which the Company believes dominates the overall market for medical group practice management systems. In addition, several of the Company's competitors have significantly greater financial, technical, product development and marketing resources than the Company. The Company believes its principal competitive advantages are the features and capabilities of its products and services, its high level of customer support and its extensive experience in the industry. The Windows Product is relatively new and only limited numbers of Windows Product systems have been sold to date. There can be no assurance that the Windows Product will achieve broad market acceptance or will successfully compete with other Windows-based practice management software products.

To date, the Company has not encountered substantial competition for its dental practice management and clinical products in the Company's primary niche market of dental group practices consisting of six or more dentists.

The Company is anticipating that market competition in this dental group practice niche market will increase as new competitors enter the marketplace. The Company believes that numerous firms sell computerized data processing systems to group dental practices consisting of five or fewer dentists.

The market for electronic medical records systems is highly competitive and subject to rapid changes in technology. The Company expects that market competition will increase as new competitors enter the marketplace. The industry is highly fragmented and includes numerous competitors, none of which the Company believes dominates the electronic medical records market. Many of the Company's competitors have substantially greater name recognition and technical, marketing and financial resources. The Company believes its principal competitive advantages are the features and flexibility of its NextGen products. There can be no assurance that future competition or new product introductions in the electronic medical records market will not have a material adverse effect on the Company's business, financial condition and results of operations. In addition, the NextGen software products are relatively new and only limited numbers of these systems have been sold to date. There can be no assurance that the NextGen

products will achieve broad market acceptance.

Competitive pressures and other factors, such as new product introductions by the Company or its competitors, may result in price erosion that could have a material adverse effect on the Company's business, financial condition and results of operations.

Furthermore, the Company also competes in all of its markets indirectly and to varying degrees with other major healthcare related companies, information management companies and systems integrators generally, and other software developers which may more directly enter the markets in which the Company competes. There can be no assurance that future competition will not have a material adverse effect on the Company's business, financial condition and results of operations.

PRODUCT ENHANCEMENT AND DEVELOPMENT.

The healthcare information management and computer software and hardware industries are characterized by rapid technological change requiring the Company to engage in continuing efforts to improve its systems. During fiscal years 1999, 1998 and 1997 the Company expended approximately $4.8 million, $4.9 million and $2.8 million, respectively, on research and development activities including capitalized software amounts of $1.2 million, $1.9 million and $850,000, respectively. In addition, many of the Company's product enhancements have resulted from software development work performed under contracts with its clients. To the extent that the Company fails to achieve technological advances comparable to those made by others in the computer and healthcare information management industries, its products and services may become obsolete.

GOVERNMENTAL REGULATION.

The healthcare industry is subject to changing political, economic and regulatory influences that may affect the procurement processes and operation of healthcare facilities. During the past several years, the healthcare industry has been subject to an increase in governmental regulation of, among other things, reimbursement rates and certain capital expenditures. In the past, various legislators have announced that they intend to examine proposals to reform certain aspects of the U.S. healthcare system including proposals which may increase governmental involvement in healthcare, lower reimbursement rates and otherwise change the operating environment for the Company's clients. Healthcare providers may react to these proposals, and the uncertainty surrounding such proposals, by curtailing or deferring investments, including those for the Company's systems and related services. On the other hand, changes in the regulatory environment have increased and may continue to increase the needs of healthcare organizations for cost-effective data management and thereby enhance the overall market for healthcare management information systems. The Company cannot predict what impact, if any, such proposals or healthcare reforms might have on the Company's business, financial condition and results of operations.

In addition, the Company's software may be subject to regulation by the U.S. Food and Drug Administration (the "FDA") as a medical device. Such regulation could require the registration of the applicable manufacturing facility and software and hardware products; application of detailed record-keeping and manufacturing standards; and, FDA approval or clearance prior to marketing. An approval or clearance could create delays in marketing, and the FDA could require supplemental filings or object to

certain of these applications, the result of which could have a material adverse effect on the Company's business, financial condition and results of operations.

## EMPLOYEES.

As of May 31, 1999, the Company employed 228 persons of which 224 were full-time employees. Systems analysts, programmers and qualified sales and marketing personnel are in short supply and, consequently, competition for such individuals is intense. The Company believes that its future success depends in part upon recruiting and retaining qualified marketing and technical personnel as well as other employees. The Company considers its employee relations to be good.

## RISK FACTORS.

### COMPETITION.

The market for healthcare information systems is intensely competitive and the Company faces significant competition from a number of different sources. The electronic medical records market, in particular, is subject to rapid changes in technology and the Company expects that competition in this portion of the market will increase as new competitors enter the marketplace. In addition, several of the Company's competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than the Company.

The industry is highly fragmented and includes numerous competitors, none of which the Company believes dominates the overall market for either group practice management or clinical systems. Furthermore, the Company also competes indirectly and to varying degrees with other major healthcare related companies, information management companies generally, and other software developers which may more directly enter the markets in which the Company competes.

There can be no assurance that future competition or new product introductions will not have a material adverse effect on the Company's business, results of operations and financial condition. Competitive pressures and other factors, such as new product introductions by the Company or its competitors, may result in price or market share erosion that could have a material adverse effect on the Company's business, results of operations and financial condition.

In addition, the Company believes that once a healthcare provider has chosen a particular healthcare information system vendor, the provider will, for a period of time, be more likely to rely on that vendor for its future information system requirements. Furthermore, if the healthcare industry continues to undergo further consolidation as it has recently experienced, each sale of the Company's systems will assume even greater importance to the Company's business, results of operations and financial condition. The Company's inability to make initial sales of its systems to either newly formed groups and/or healthcare providers that are replacing or substantially modifying their healthcare information systems could have a material adverse effect on the Company's business, results of operations and financial condition. If new systems sales do not materialize, maintenance service revenues can be expected to decrease over time due to the effect of failure to capture new maintenance revenues therefrom in combination with attrition of existing maintenance revenues associated with the Company's current clients whose systems become obsolete or are replaced by competitors' products.

FLUCTUATION IN QUARTERLY OPERATING RESULTS.

The Company's revenues and operating results have in the past fluctuated, and may in the future fluctuate, from quarter to quarter and period to period, as a result of a number of factors including, without limitation: the size and timing of orders from clients; the length of sales cycles and installation processes; the ability of the Company's clients to obtain financing for the purchase of the Company's products; changes in pricing policies or price reductions by the Company or its competitors; the timing of new product announcements and product introductions by the Company or its competitors; the availability and cost of system components; the financial stability of major clients; market acceptance of new products, applications and product enhancements; the Company's ability to develop, introduce and market new products, applications and product enhancements and to control costs; the Company's success in expanding its sales and marketing programs; deferrals of client orders in anticipation of new products, applications or product enhancements; changes in Company strategy; personnel changes; and general economic factors.

The Company's products are generally shipped as orders are received and accordingly, the Company has historically operated with minimal backlog. As a result, sales in any quarter are dependent on orders booked and shipped in that quarter and are not predictable with any degree of certainty. Furthermore, the Company's systems can be relatively large and expensive and individual systems sales can represent a significant portion of the Company's revenues for a quarter such that the loss of even one such sale can have a significant adverse impact on the Company's quarterly profitability. Clients often defer systems purchases until the Company's quarter end, so quarterly results generally cannot be predicted and frequently are not known until the quarter has concluded. The Company's initial contact with a potential customer depends in significant part on the customer's decision to replace, or substantially modify, its existing information system. How and when to implement, replace or substantially modify an information system are major decisions for healthcare providers. Accordingly, the sales cycle for the Company's systems can vary significantly and typically ranges from three to 12 months from initial contact to contract execution/shipment and the installation cycle is typically two to four months from contract execution/shipment to completion of installation. Because a significant percentage of the Company's expenses are relatively fixed, a variation in the timing of systems sales and installations can cause significant variations in operating results from quarter to quarter. As a result, the Company believes that interim period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, the Company's historical operating results are not necessarily indicative of future performance for any particular period.

Through March 31, 1998, the Company recognized revenue in accordance with the provisions of the American Institute of Certified Public Accountants ("AICPA") Statement of Position No. 91-1, "Software Revenue Recognition" ("SOP 91-1"). The AICPA has recently adopted Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP 97-2"), that supersedes SOP 91-1 and became effective for the Company on April 1, 1998. There can be no assurance that application and subsequent interpretations of this pronouncement by the Company, its independent auditors or the Securities and Exchange Commission will not further modify the Company's revenue recognition policies, or that such modifications would not have a material adverse effect on the operating results reported in any particular quarter. There can be no assurance that the Company will not be required to adopt

changes in its licensing or services practices to conform to SOP 97-2, or that such changes, if adopted, would not result in delays or cancellations of potential sales of the Company's products.

Due to all of the foregoing factors, it is possible that in some future quarter the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's Common Stock would likely be materially adversely affected.

ACQUISITIONS.

During the past several years, the Company has made two significant acquisitions of relatively new companies, each of which has products utilizing newer technology than the Company's Legacy Product and each company having a limited sales history. Acquisitions involve a number of special risks, including possible adverse effects on the Company's operating results, diversion of management's attention, failure to retain key acquired personnel, amortization of acquired intangible assets, and risks associated with unanticipated events or liabilities, some or all of which could have a material adverse effect on the Company's business, results of operations and financial condition. Customer dissatisfaction or performance problems at a single acquired business can also have an adverse effect on the reputation of the Company.

DEPENDENCE ON PRINCIPAL PRODUCT AND NEW PRODUCT DEVELOPMENT.

The Company currently derives substantially all of its net revenues from sales of its healthcare information systems and related services. The Company believes that a primary factor in the market acceptance of its systems has been its ability to meet the needs of users of healthcare information systems. The Company's future financial performance will depend in large part on the Company's ability to continue to meet the increasingly sophisticated needs of its clients through the timely development, successful introduction and implementation of new and enhanced versions of its systems and other complementary products. The Company has historically expended a significant amount of its net revenues on product development and believes that significant continuing product development efforts will be required to sustain the Company's growth.

There can be no assurance that the Company will be successful in its product development efforts, that the market will continue to accept the Company's existing or new products, or that products or product enhancements will be developed and implemented in a timely manner, meet the requirements of healthcare providers, or achieve market acceptance. If new products or product enhancements do not achieve market acceptance, the Company's business, results of operations and financial condition could be materially adversely affected. At certain times in the past, the Company has also experienced delays in purchases of its products by clients anticipating the launch of new products by the Company. There can be no assurance that material order deferrals in anticipation of new product introductions will not occur.

TECHNOLOGICAL CHANGE.

The software market generally is characterized by rapid technological change, changing customer needs, frequent new product introductions and evolving industry standards. The introduction of products incorporating new technologies and the emergence of new industry standards could render the Company's existing products obsolete and unmarketable. There can be no

assurance that the Company will be successful in developing and marketing new products that respond to technological changes or evolving industry standards. New product development depends upon significant research and development expenditures which depend ultimately upon sales growth. Any material weakness in revenues or research funding could impair the Company's ability to respond to technological advances in the marketplace and remain competitive. If the Company is unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, the Company's business, results of operations and financial condition will be materially adversely affected.

In response to increasing market demand, the Company is currently developing new generations of certain of its software products designed for the client-server and Internet/intranet environments. There can be no assurance that the Company will successfully develop these new software products or that these products will operate successfully on the principal client-server operating systems, which include UNIX, Microsoft Windows, Windows NT, Windows 95 and Windows 98, or that any such development, even if successful, will be completed concurrently with or prior to introduction by competitors of products designed for the client-server and Internet/intranet environments. Any such failure or delay could adversely affect the Company's competitive position or could make the Company's current products obsolete.

YEAR 2000 ISSUES.

The Company is aware of issues associated with the programming code in existing computer systems as the millennium approaches. In particular, software applications that use only two digits to identify a year in the date field may fail or create errors in the year 2000 ("Year 2000 Issues"). Year 2000 Issues create risk for the Company from unforeseen problems in computer systems that the Company sells to customers on a nationwide basis which are used, among other things, to process their financial transactions and schedule patients ("Company Products"), as well as systems that the Company uses internally to provide certain services to its customers and to process its own financial transactions ("Internal Use Systems"). The potential costs and uncertainties associated with Year 2000 Issues will depend upon a number of factors, including the Company's proprietary and third party developed software, hardware (hardware and third party developed software will hereinafter be referred to collectively as "Third Party Products") and the nature of the industry in which the Company operates.

The nature of the Company's business and its relationships with its customers make it difficult to assess the magnitude of the Company's potential exposure as a result of Year 2000 Issues. Company Products and Third Party Products sold by the Company may fail to operate properly or as expected due to Year 2000 Issues. Such failures could result in system failures or miscalculations causing disruptions of customers' operations, including among other things, an inability to process transactions, send invoices, conduct communications, treat patients or engage in similar normal business activities. In addition, Company Products and Third Party Products are often used in conjunction with other vendors' products and services and the Company must rely on these other vendors to complete the material remediation efforts necessary with regards to Year 2000 Issues in connection with such products and services. Should such vendors be unable to complete such remediation efforts in a timely manner, the use of such products and services on the same system as Company Products and Third

Party Products may result in system failures. As a result of one or more of the above potential system failures, certain of the Company's customers may assert breach of warranty or other claims against the Company relating to Year 2000 functionality. The assertion of such claims may have a material adverse impact upon the Company's business, results of operations and financial condition. Furthermore, the efforts and resources devoted to Year 2000 Issues of current and potential customers of the Company could result in the deferral, delay or cancellation by customers of current installations of and plans to purchase systems from the Company.

Internal Use Systems, including both information systems and non-information systems, may not operate properly or as expected due to Year 2000 Issues. Year 2000 Issues could result in system failures or miscalculations causing disruption of the Company's operations, including among other things, an inability to process its own and certain of its customers' financial transactions, send invoices, conduct communications, or engage in similar normal business activities. The failure of one or more Internal Use Systems as a result of Year 2000 Issues may have a material adverse impact upon the Company's business, results of operations and financial condition.

LITIGATION.

The pending Federal and state securities actions and the derivative action are in the early states of procedure (see "Item 3. Legal Proceedings."). Consequently, at this time it is not reasonably possible to estimate the damage, or the range of damages, if any, that the Company might incur in connection with such actions. However, the uncertainty associated with substantial unresolved litigation may be expected to have an adverse impact on the Company's business. In particular, such litigation could impair the Company's relationships with existing customers and its ability to obtain new customers. Defending such litigation will likely result in a diversion of management's time and attention away from business operations, which could have a material adverse effect on the Company's business, results of operations and financial condition. Such litigation may also have the effect of discouraging potential acquirors from bidding for the Company or reducing the consideration such acquirors would otherwise be willing to pay in connection with an acquisition.

PROPRIETARY TECHNOLOGY.

The Company is heavily dependent on the maintenance and protection of its intellectual property and relies largely on license agreements, confidentiality procedures, and employee nondisclosure agreements to protect its intellectual property. The Company's software is not patented and existing copyright laws offer only limited practical protection. There can be no assurance that the legal protections and precautions taken by the Company will be adequate to prevent misappropriation of the Company's technology or that competitors will not independently develop technologies equivalent or superior to the Company's. Further, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States and are often not enforced as vigorously as those in the United States.

The Company does not believe that its operations or products infringe on the intellectual property rights of others. However, there can be no assurance that others will not assert infringement or trade secret claims against the Company with respect to its current or future products or that any such assertion will not require the Company to enter into a license

agreement or royalty arrangement with the party asserting the claim. As competing healthcare information systems increase in complexity and overall capabilities and the functionality of these systems further overlaps, providers of such systems may become increasingly subject to infringement claims. Responding to and defending any such claims may distract the attention of Company management and have a material adverse effect on the Company's business, results of operations and financial condition. In addition, claims may be brought against third parties from which the Company purchases software, and such claims could adversely affect the Company's ability to access third party software for its systems.

ABILITY TO MANAGE GROWTH.

The Company has experienced periods of growth and increased personnel, which has placed, and may continue to place, a significant strain on the Company's resources. The Company also anticipates expanding its overall software development, marketing, sales, client management and training capacity. In the event the Company is unable to identify, hire, train and retain qualified individuals in such capacities within a reasonable timeframe, such failure could have a material adverse effect on the Company. In addition, the Company's ability to manage future increases, if any, in the scope of its operations or personnel will depend on significant expansion of its research and development, marketing and sales, management, and administrative and financial capabilities. The failure of the Company's management to effectively manage expansion in its business could have a material adverse effect on the Company's business, results of operations and financial condition.

DEPENDENCE UPON KEY PERSONNEL.

The Company's future performance also depends in significant part upon the continued service of its key technical and senior management personnel, many of whom have been with the Company for a significant period of time. The Company does not maintain key man life insurance on any of its employees. Because the Company has a relatively small number of employees when compared to other leading companies in the same industry, its dependence on maintaining its employees is particularly significant. The Company is also dependent on its ability to attract and retain high quality personnel, particularly highly skilled software engineers for applications development. The industry is characterized by a high level of employee mobility and aggressive recruiting of skilled personnel. There can be no assurance that the Company's current employees will continue to work for the Company. Loss of services of key employees could have a material adverse effect on the Company's business, results of operations and financial condition. Furthermore, the Company may need to grant additional stock options to key employees and provide other forms of incentive compensation to attract and retain such key personnel.

PRODUCT LIABILITY.

Certain of the Company's products provide applications that relate to patient clinical information. Any failure by the Company's products to provide accurate and timely information could result in claims against the Company. The Company maintains insurance to protect against claims associated with the use of its products, but there can be no assurance that its insurance coverage would adequately cover any claim asserted against the Company. A successful claim brought against the Company in excess of its insurance coverage could have a material adverse effect on the Company's business, results of operations and financial condition. Even

unsuccessful claims could result in the Company's expenditure of funds in litigation and management time and resources.

There can be no assurance that the Company will not be subject to product liability claims, that such claims will not result in liability in excess of its insurance coverage, that the Company's insurance will cover such claims or that appropriate insurance will continue to be available to the Company in the future at commercially reasonable rates. Such claims could have a material adverse affect on the Company's business, results of operations and financial condition.

UNCERTAINTY IN HEALTHCARE INDUSTRY; GOVERNMENT REGULATION.

The healthcare industry is subject to changing political, economic and regulatory influences that may affect the procurement processes and operation of healthcare facilities. During the past several years, the healthcare industry has been subject to an increase in governmental regulation of, among other things, reimbursement rates and certain capital expenditures. In the past, various legislators have announced that they intend to examine proposals to reform certain aspects of the U.S. healthcare system including proposals which may increase governmental involvement in healthcare, lower reimbursement rates and otherwise change the operating environment for the Company's clients. Healthcare providers may react to these proposals and the uncertainty surrounding such proposals by curtailing or deferring investments, including those for the Company's systems and related services. Cost-containment measures instituted by healthcare providers as a result of regulatory reform or otherwise could result in greater selectivity in the allocation of capital funds. Such selectivity could have an adverse effect on the Company's ability to sell its systems and related services. The Company cannot predict what impact, if any, such proposals or healthcare reforms might have on its business, results of operations and financial condition.

The Company's software may be subject to regulation by the FDA as a medical device. Such regulation could require the registration of the applicable manufacturing facility and software/hardware products, application of detailed record-keeping and manufacturing standards, and FDA approval or clearance prior to marketing. An approval or clearance could create delays in marketing, and the FDA could require supplemental filings or object to certain of these applications, the result of which could have a material adverse effect on the Company's business, results of operations and financial condition.

## Item 2. Properties.

The Company's principal administrative, data processing, marketing and development operations are located in approximately 19,000 square feet of leased space in Tustin, California under a lease which expires in March 2000. In addition, the Company leases approximately 13,000 square feet of space in Santa Ana, California to house its assembly and warehouse operations, approximately 15,000 square feet of space in Horsham, Pennsylvania, the principal office for Clinitec, approximately 12,000 square feet of space in Atlanta, Georgia, the principal office for MicroMed, and an aggregate of 4,000 square feet of space in Florida, Kansas, Minnesota, Texas, Wisconsin and Washington to house additional sales, training and service operations. These leases, including options, have expiration dates ranging from month-to-month to August 2000. The Company believes that its facilities are adequate for its current needs and that suitable additional or substitute space is available, if needed, at commercially reasonable rates.

## Item 3. LEGAL PROCEEDINGS.

On April 22, 1997, a purported class action entitled JOHN P. CAVENY v. QUALITY SYSTEMS, INC., ET AL. was filed in the Superior Court of the State of California for the County of Orange, in which Mr. Caveny, on behalf of himself and all others who purchased the Company's Common Stock between June 26, 1995 and July 3, 1996, alleges that the Company, and Sheldon Razin, Robert J. Beck, Gregory S. Flynn, Abe C. LaLande, Donn Neufeld, Irma G. Carmona, John A. Bowers, Graeme H. Frehner, and Gordon L. Setran (all of the foregoing individuals were either officers, directors or both during the period from June 26, 1995 through July 3, 1996), as well as other defendants not affiliated with the Company, violated California Corporations Code Sections 25400 and 25500, California Civil Code Sections 1709 and 1710, and California Business and Professions Code Sections 17200 et. seq., by issuing positive statements about the Company that allegedly were knowingly false, in part, in order to assist the Company and the individual defendants in selling Common Stock at an inflated price in the Company's March 5, 1996 public offering and at other points during the class period. The complaint seeks compensatory and punitive damages in unspecified amounts, disgorgement, declaratory and injunctive relief, and attorneys' fees.

On May 14, 1997, a second purported class action entitled WENDY WOO v. QUALITY SYSTEMS, INC., ET AL. was filed in the same court. This complaint, which has been consolidated with the Caveny lawsuit, essentially repeats the allegations in the Caveny lawsuit and seeks identical relief.

The Company and the other named defendants successfully demurred to the plaintiffs' claim under California Civil Code Sections 1709 and 1710, and that claim, which served as the only basis for plaintiffs' request for punitive damages, has been dismissed from both actions.

On January 25, 1999, the court denied plaintiffs' motion to certify the class representative and class legal counsel. Plaintiffs have appealed that decision.

The Company and its named officers and directors deny all remaining allegations of wrongdoing made against them in these suits, consider the allegations groundless and without merit, and intend to vigorously defend against these actions.

On July 1, 1997, a third purported class action entitled WADE CHENEY v. QUALITY SYSTEMS, INC., ET AL. was filed in the United States District Court of the Central District of California, Southern Division. The complaint makes essentially the same factual allegations as in the Caveny and Woo complaints, and purports to state claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and under Section 20(a) of said Act. By Court order dated August 13, 1997, this action was stayed temporarily and the Court reserved jurisdiction to lift the stay after all matters are final in the Caveny and Woo actions or if otherwise appropriate, and on August 15, 1997 the case was removed from the Court's active caseload. The Company denies all allegations of wrongdoing made in this suit, considers the allegations groundless and without merit, and if the stay is ever lifted, the Company intends to vigorously defend against this action.

On March 23, 1999, a purported class action and derivative complaint entitled IRVING ROSENZWEIG v. SHELDON RAZIN, ET AL. was filed in the Superior Court of the State of California for the County of Orange, in

which Mr. Rosenzweig, on behalf of himself and all non-director shareholders, and derivatively on behalf of the Company, alleges that Sheldon Razin, John Bowers, William Bowers, Patrick Cline, Janet Razin and Gordon Setran (all of the foregoing individuals are directors of the Company) breached their fiduciary duties by allegedly entrenching themselves in their positions of control, failing to ensure that third-party offers involving the Company were fully and fairly considered, and/or failing to conduct a reasonable inquiry to assure the maximization of shareholder value. The complaint seeks declaratory and injunctive relief, an accounting of monetary damages allegedly suffered by plaintiff and the purported class, and attorneys' fees.

The named directors deny all allegations of wrongdoing made against them in this suit, consider the allegations groundless and without merit, and intend to vigorously defend against the action.

The Company is a party to various other legal proceedings incidental to its business, none of which are considered by the Company to be material.

## Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted to a vote of security holders during the fourth quarter of fiscal year 1999.

## Executive Officers of the Registrant.

The executive officers of the Company as of March 31, 1999 were as follows:

| Name | Age | Position |
|---|---|---|
| Sheldon Razin | 61 | Chairman of the Board, Chief Executive Officer, President and Director |
| Patrick B. Cline | 38 | Executive Vice President and Director; and, President and Chief Operating Officer of Clinitec |
| Greg Flynn | 41 | Executive Vice President Corporate Sales and Marketing |
| Don L. Jackson | 38 | Vice President Marketing |
| Robert G. McGraw | 41 | Vice President Chief Financial Officer |
| Donn Neufeld | 42 | Vice President Software and Operations |
| Stephen K. Puckett | 34 | Executive Vice President; and, President and Chief Operating Officer of MicroMed |
| David Razin | 35 | Vice President Business Development |
| Janet Razin | 59 | Vice President, Corporate Secretary and Director |

Executive officers of the Company are elected by, and serve at the discretion of, the Board of Directors. Additional information regarding the Company's executive officers is set forth below.

Sheldon Razin is the founder of the Company and has served as its Chairman of the Board of Directors and Chief Executive Officer since the Company's inception. He also has served as the Company's President since its inception except for the period from August 1990 to August 1991. Additionally, Mr. Razin served as Treasurer from the Company's inception until October 1982. Prior to founding the Company, he held various technical and managerial positions with Rockwell International Corporation and was a founder of the Company's predecessor, Quality Systems, a sole proprietorship engaged in the development of software for commercial and space applications and in management consulting work. Mr. Razin holds a

B.S. degree in Mathematics from the Massachusetts Institute of Technology. Mr. Razin is the husband of Janet Razin and the father of David Razin.

Patrick B. Cline has served as a Director and Executive Vice President of the Company since May 1996. Mr. Cline is a co-founder of Clinitec and has served as its President since its inception in January 1994 and as its Chief Operating Officer since May 1996 when it was acquired by QSI. Mr. Cline served as Clinitec's Chairman of the Board of Directors and Chief Executive Officer from January 1994 until May 1996. Prior to co-founding Clinitec, Mr. Cline served, from July 1987 to January 1994, as Vice President of Sales and Marketing with Script Systems, a subsidiary of InfoMed, a healthcare information systems company. From January 1994 to May 1994, after the founding of Clinitec, Mr. Cline continued to serve, on a part time basis, as Script Systems' Vice President of Sales and Marketing. Mr. Cline has held senior positions in the healthcare information systems industry since 1981.

Greg Flynn has served as the Company's Executive Vice President Corporate Sales and Marketing since August 1998 after serving as Vice President of Sales and Marketing from January 1996 to August 1998. Prior to January 1996, Mr. Flynn served as Vice President Administration since June 1992. In these capacities, Mr. Flynn has been responsible for numerous functions related to sales and the ongoing management of the Company. Previously, Mr. Flynn served as the Company's Vice President Corporate Communications. Since joining the Company in January 1982, Mr. Flynn has held a variety of increasingly responsible management positions within the organization. He holds a B.A. degree in English from the University of California, Santa Barbara.

Don L. Jackson joined the Company in June 1998 as its Vice President of Marketing. Prior to joining the Company, Mr. Jackson was the Vice President of Sales and Marketing of Wyndgate Technologies, a developer of information systems for blood banks and transfusion management. From February 1992 to May 1997, Mr. Jackson held several senior management positions with Henry Schein, Inc., Practice Management Technologies Division, a leading provider of computer-based solutions to the dental, medical, and veterinary markets. From 1985 to 1992, Mr. Jackson was Executive Vice President of FoxMeyer's Retail Services Business unit, a developer and distributor of retail pharmacy point of sale computer systems. Mr. Jackson holds an M.B.A. from Southern Methodist University and a B.A. in Computer Science from the University of Texas at Austin.

Robert G. McGraw joined the Company in February 1996 as its Vice President Chief Financial Officer. Prior to joining the Company, Mr. McGraw was the Chief Financial Officer of CVD Financial Corporation, an asset-based commercial lender, from March 1994 to February 1996. He was an independent financial consultant from August 1989 to February 1991 and from March 1992 to February 1994. From March 1991 to February 1992, Mr. McGraw was Chief Financial Officer of MGV International, Inc., a diversified middle market company with a personal computer manufacturing plant and wholesale distribution operations. Mr. McGraw is a Certified Public Accountant and holds an M.B.A. from the University of California, Los Angeles, and a B.A. in Business Economics from the University of California, Santa Barbara.

Donn Neufeld has served as the Company's Vice President Software and Operations since January 1996 and as Vice President Operations from June 1986 until January 1996. From April 1981 until June 1986, Mr. Neufeld held the position of Manager of Customer Support. He joined the Company in December 1980 as part of the System Generation Department. Prior to joining

the Company, Mr. Neufeld was a System Analyst/Programmer at Loma Linda University Medical Center.

Stephen K. Puckett has served as an Executive Vice President of the Company since May 1997. Mr. Puckett is the founder of MicroMed and has served as its President since its inception in February 1993 and as its Chief Operating Officer since May 1997 when it was acquired by the Company. Mr. Puckett served as MicroMed's Chairman of the Board of Directors and Chief Executive Officer from February 1993 until May 1997. Prior to founding MicroMed, Mr. Puckett gained his healthcare expertise at Gerber Alley and Andersen Consulting in Atlanta, Georgia. Mr. Puckett holds a B.S. degree in Industrial Management from the Georgia Institute of Technology.

David Razin has served as Vice President Business Development of the Company since August 1997. Before being named to this position, Mr. Razin served from 1995 to 1997 as Director of Product Development. In that position, Mr. Razin oversaw the development of the Company's Legacy Products, EDI services network and Internet/intranet applications. From 1988 to 1995, Mr. Razin held the position of Manager of Client Managing and Training. Prior to that, Mr. Razin held various positions in software development from 1985 to 1988. David Razin is the son of Sheldon and Janet Razin.

Janet Razin has served as a Director, Vice President and Corporate Secretary since the Company's inception and served as the Company's Controller until November 1981. She served as Vice President Chief Financial Officer from October 1982 until October 1984. Prior to joining the Company, she was a computer programmer for Rockwell International Corporation. Mrs. Razin holds a B.A. degree in Mathematics from Northeastern University. Mrs. Razin is the wife of Sheldon Razin and the mother of David Razin.

PART II.

## Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock is traded on the Nasdaq National Market under the symbol "QSII". The following table sets forth for the quarters indicated the high and low sales prices as reported by NASDAQ. The quotations reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions.

| Quarter Ended | High | Low |
|---|---|---|
| June 30, 1997 | 7.75 | 5.50 |
| September 30, 1997 | 7.75 | 6.00 |
| December 31, 1997 | 9.13 | 5.63 |
| March 31, 1998 | 8.56 | 5.94 |
| June 30, 1998 | 11.25 | 7.25 |
| September 30, 1998 | 9.28 | 3.50 |
| December 31, 1998 | 5.00 | 3.00 |
| March 31, 1999 | 4.94 | 3.50 |

At May 12, 1999, there were approximately 167 holders of record of the Company's Common Stock. The Company estimates the number of beneficial holders of its Common Stock to be in excess of 1,400.

In June 1998, in connection with the acquisition of MicroMed, the Company issued 245,454 of unregistered shares of its Common Stock as part of its final payment for this acquisition (see "Item 1. Business. Acquisitions."). The shares were valued at $1.8 million, or $7.48 per share. The shares were issued pursuant to an exception from registration provided by Regulation D under the Securities Act of 1933, as amended, involving a sale to less than 35 non-accredited investors.

Through May 28, 1999, the Company has not paid cash dividends on shares of it's Common Stock. The Company anticipates that all future earnings, if any, will be retained for use in the Company's business and it does not anticipate paying any cash dividends in the future. Payment of future dividends, if any, will be at the discretion of the Company's Board of Directors after taking into account various factors, including the Company's financial condition, operating results, current and anticipated cash needs and plans for expansion.

## Item 6. SELECTED FINANCIAL DATA.

The following selected financial data with respect to the Company's Consolidated Statements of Operations Data for each of the five years in the period ended March 31, 1999 and the Consolidated Balance Sheet Data as of the end of each such fiscal year are derived from the audited financial statements of the Company. The following information should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." included elsewhere herein.

Consolidated Statements of Operations Data
(In thousands, except for per share data)

| | Year Ended March 31, | | | | |
|---|---|---|---|---|---|
| | 1999 | 1998 | 1997 | 1996 | 1995 |
| Net Revenues | $33,816 | $31,216 | $20,127 | $16,732 | $12,049 |
| Cost of Products and Services | 15,834 | 13,509 | 10,089 | 7,929 | 6,060 |
| Gross Profit | 17,982 | 17,707 | 10,038 | 8,803 | 5,989 |
| Selling, General and Administrative | 13,495 | 12,485 | 7,736 | 3,897 | 3,536 |
| Research and Development | 3,603 | 3,072 | 1,978 | 1,567 | 1,467 |
| Purchased In-Process Research and Development(1) | - | 10,200 | 8,300 | - | - |
| Income (Loss) from Operations (3) | 884 | (8,050) | (7,976) | 3,339 | 986 |
| Investment Income | 413 | 971 | 1,285 | 482 | 429 |
| Income (Loss) before Provision for (Benefit from) Income Taxes (3) | 1,297 | (7,079) | (6,691) | 3,821 | 1,415 |
| Provision for (Benefit from) Income Taxes (2) | 713 | (2,463) | 784 | 1,528 | 453 |
| Net Income (Loss) (3) | $ 584 | $(4,616) | $(7,475) | $ 2,293 | $ 962 |
| Net Income (Loss) per Share: | | | | | |
| Basic (3) | $ 0.09 | $ (0.77) | $ (1.26) | $ 0.49 | $ 0.22 |
| Diluted (3) | $ 0.09 | $ (0.77) | $ (1.26) | $ 0.48 | $ 0.21 |
| Weighted Average Shares Outstanding: | | | | | |
| Basic | 6,176 | 5,981 | 5,937 | 4,640 | 4,472 |
| Diluted | 6,185 | 5,981 | 5,937 | 4,776 | 4,606 |

Consolidated Balance Sheet Data
(in thousands)

| | March 31, | | | | |
|---|---|---|---|---|---|
| | 1999 | 1998 | 1997 | 1996 | 1995 |
| Cash and Cash Equivalents and Short-Term Investments(4) | $14,441 | $17,080 | $22,735 | $28,944 | $ 7,322 |
| Working Capital | 18,166 | 15,453 | 25,613 | 30,196 | 8,032 |
| Total Assets | 40,218 | 40,916 | 37,866 | 37,272 | 12,668 |
| Total Liabilities | 10,554 | 13,475 | 5,596 | 4,571 | 3,480 |
| Shareholders' Equity(4) | $29,664 | $27,441 | $32,270 | $32,701 | $ 9,188 |

(1) In May 1996, the Company acquired Clinitec (see "Item 1. Business. Acquisitions.") which was treated as a purchase transaction for accounting purposes. In connection with this treatment, the Company incurred an $8.3 million charge for purchased in-process research and development during the year ended March 31, 1997.

In May 1997, the Company acquired MicroMed (see "Item 1. Business. Acquisitions.") which was treated as a purchase transaction for accounting purposes. In connection with this treatment, the Company incurred a $10.2 million charge for purchased in-process research and development during the year ended March 31, 1998.

(2) The provision for income taxes for the year ended March 31, 1997 differs from the Company's combined Federal and State statutory rates primarily due to the non-deductible charge for purchased in-process research and development incurred in connection with the acquisition of Clinitec in May 1996.

(3) Includes a charge of $10.2 million and $8.3 million for purchased in-process research and development for the years ended March 31, 1998 and 1997, respectively. Excluding the charge, on a pro forma basis, income from operations and income before provision for (benefit from) income taxes would have been $2.2 million and $3.1 million, respectively, for fiscal 1998 and $324,000 and $1.6 million, respectively for fiscal 1997. The income tax benefit related to the charge for purchased in-process research and development for the years ended March 31, 1998 and 1997 was $3.9 million and $0, respectively. Excluding the charge and related income tax benefit, on a pro forma basis, net income and basic and diluted income per share would have been $1.7 million, $0.29 and $0.28, respectively, for fiscal 1998 and $825,000, $0.14 and $0.14, respectively, for fiscal 1997.

(4) In March 1996, the Company completed a secondary public offering of one million shares of Common Stock resulting in net cash proceeds of $20.2 million.

## Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Except for the historical information contained herein, the matters discussed in this Annual Report on Form 10-K, including discussions of the Company's product development plans, business strategies and market factors influencing the Company's results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by the Company as a result of various factors, both foreseen and unforeseen, including, but not limited to, the Company's ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution, consolidation, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact the Company's ability to achieve its goals, and interested persons are urged to review the risks described in "Item 1. Business. Risk Factors." and in "Management's Discussion and Analysis of Financial Condition and Results of Operations." set forth below, as well as in the Company's other public disclosures and filings with the Securities and Exchange Commission.

The following discussion should be read in conjunction with, and is qualified in its entirety by, the Consolidated Financial Statements and related notes thereto included elsewhere herein. Historical results of operations, percentage margin fluctuations and any trends that may be inferred from the discussion below are not necessarily indicative of the operating results for any future period.

### RESULTS OF OPERATIONS.

The following table sets forth for the periods indicated the percentage of net revenues represented by each item in the Company's Consolidated Statements of Operations. The Consolidated Statements of Operations include the operations of Clinitec from May 17, 1996 (the date of its acquisition) through March 31, 1999 and the operations of MicroMed from May 15, 1997 (the date of its acquisition) through March 31, 1999.

| | Year Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| Net Revenues: | | | |
| Sales of computer systems, upgrades and supplies | 55.8% | 64.9% | 58.7% |
| Maintenance and other services | 44.2 | 35.1 | 41.3 |
| | 100.0 | 100.0 | 100.0 |
| Cost of Products and Services | 46.8 | 43.3 | 50.1 |
| Gross Profit | 53.2 | 56.7 | 49.9 |
| Selling, General and Administrative Expenses | 39.9 | 40.0 | 38.5 |
| Research and Development Costs | 10.7 | 9.8 | 9.8 |
| Purchased In-Process Research and Development | - | 32.7 | 41.2 |
| Income (Loss) from Operations | 2.6 | (25.8) | (39.6) |
| Investment Income | 1.2 | 3.1 | 6.4 |
| Income (Loss) before Provision for (Benefit from) Income Taxes | 3.8 | (22.7) | (33.2) |
| Provision for (Benefit from) Income Taxes | 2.1 | (7.9) | 3.9 |
| Net Income (Loss) | 1.7% | (14.8)% | (37.1)% |

FOR THE YEARS ENDED MARCH 31, 1999 AND 1998.

For the year ended March 31, 1999, the Company's net income was $584,000, or $0.09 per share on a basic and diluted basis. In comparison, after recognizing a $10.2 million charge for purchased in-process research and development in connection with the MicroMed acquisition, the Company incurred a net loss of $(4.6) million, or $(0.77) per share on a basic and diluted basis, for the year ended March 31, 1998. Excluding the charge, net of the related income tax benefit, net income for the year ended March 31, 1998 would have been $1.7 million, or $0.29 per share and $0.28 per share on a basic and diluted basis, respectively.

Net Revenues. Net revenues for the year ended March 31, 1999 increased 8.3% to $33.8 million from $31.2 million for the year ended March 31, 1998. Sales of computer systems, upgrades and supplies decreased 6.9% to $18.9 million from $20.3 million while net revenues from maintenance and other services grew 36.5% to $14.9 million from $10.9 million during the comparable periods. The decrease in net revenues from sales of computer systems, upgrades and supplies was principally due to the impact of adopting SOP 97-2 as of April 1, 1998 resulting in the deferral of certain revenues from system contracts executed and shipped during the year ended March 31, 1999 combined with the effect of a slight decrease in new system sales during fiscal 1999. The increase in maintenance and other services net revenue resulted principally from an increase in revenues from the Company's increased client base together with an increase in revenues generated from the Company's electronic data interchange services.

Cost of Products and Services. Cost of products and services for the year ended March 31, 1999 increased 17.2% to $15.8 million from $13.5 million for the year ended March 31, 1998 while cost of products and services as a percentage of net revenues increased to 46.8% from 43.3% during the comparable periods. The increase in cost of products and services in amount during the 1999 fiscal year as compared to the 1998 fiscal year resulted from a combination of the effects of: the increase in maintenance and other service revenues; increased product development, customer service, support, and training personnel at both Clinitec and MicroMed during the 1999 fiscal year; a change in the mix of new systems sales toward systems with higher hardware content in the fiscal 1999 year; and, the impact of the acquisition of MicroMed. The increase in the cost of products and services as a percentage of net revenues for the year ended March 31, 1999 as compared to the year ended March 31, 1998 resulted primarily from a combination of the overall increase in the costs associated with the above-described infrastructure expansion growing at a proportionately greater rate on a year to year basis than the growth in net revenues together with an increase in the percentage of revenues from new systems sales with higher hardware content. Systems sales with significant hardware components generally yield lower margins than those systems sales without significant hardware components. The mixture of sales with and without significant hardware components fluctuates from period to period.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the year ended March 31, 1999 increased 8.1% to $13.5 million from $12.5 million for the year ended March 31, 1998 primarily as a result of: the inclusion of such MicroMed expenses for the entire year ended March 31, 1999 as compared to the inclusion of such MicroMed expenses for only that portion of the corresponding year ended

March 31, 1998 following the May 1997 MicroMed acquisition; an additional $236,000 provision for doubtful accounts relating to one of MicroMed's customers; an increase in Clinitec's and MicroMed's selling efforts, sales personnel and administrative infrastructure offset in part by a decrease in such infrastructure at QSI. In addition, primarily as a result of the less mature Clinitec and MicroMed infrastructures, selling, general and administrative expenses as a percentage of net revenues remained relatively unchanged at 39.9% and 40.0% for the respective years despite an increase in net revenues.

Research and Development Costs. Research and development costs for the year ended March 31, 1999 increased 17.3% to $3.6 million from $3.1 million for the year ended March 31, 1998. The increase is the result of increased research and development efforts by Clinitec and MicroMed as well as consolidation of MicroMed's research and development costs for the entire 1999 fiscal year as compared to consolidating such expenses only for that portion of the corresponding 1998 fiscal year following the May 1997 purchase of the MicroMed business. Research and development costs as a percentage of net revenues increased to 10.7% as compared to 9.8% for the respective fiscal years as a result of the effect of costs associated with the increased research and development efforts growing at a proportionately greater rate than net revenues during the comparable years.

Purchased In-Process Research and Development. In connection with the acquisition of MicroMed in May 1997, the purchase price allocated to in-process research and development for which technological feasibility had not been established was $10.2 million. In accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," software development costs must be expensed until technological feasibility has been established. Accordingly, the purchase price allocated to MicroMed's purchased in-process research and development was expensed during the year ended March 31, 1998. There was no similar acquisition transaction during the year ended March 31, 1999.

Investment Income. Investment income for the year ended March 31, 1999 decreased 57.5% to $413,000 from $971,000 for the year ended March 31, 1998. The Company had an investment in a fund which traded in special situation securities. During the year ended March 31, 1999, the investment was liquidated and the Company incurred a loss of $241,000 after recognizing an unrealized gain of $120,000 during fiscal 1998 relating to this investment. Over the life of this investment, the Company incurred a net gain of $22,000 in connection therewith. Also contributing to the change in investment income for the fiscal 1999 year as compared to the fiscal 1998 year was a decrease in average funds available for investment during the year ended March 31, 1999. The decrease in available funds is primarily the result of the timing and amounts of the cash payments in May 1997 and June 1998 made to acquire MicroMed, together with amounts used to fund the growth of Clinitec and MicroMed.

Provision for (Benefit from) Income Taxes. The provision for income taxes for the year ended March 31, 1999 was $713,000 as compared to a benefit of $2.5 million for the year ended March 31, 1998. The provision for and benefit from income taxes for the years ended March 31, 1999 and 1998, respectively, differ from the combined statutory rates primarily due to the effect of varying state tax rates together with the impact of non-deductible amortization of certain intangible assets acquired in the May 1996 acquisition of Clinitec.

FOR THE YEARS ENDED MARCH 31, 1998 AND 1997.

The Company incurred a net loss of $(4.6) million, or $(0.77) on a basic and diluted per share basis, for the year ended March 31, 1998 as compared to a net loss of $(7.5) million, or $(1.26) on a basic and diluted per share basis, for the year ended March 31, 1997. During fiscal 1998, the Company recognized a $6.3 million charge, net of the related $3.9 million tax benefit, for purchased in-process research and development in connection with the MicroMed acquisition. Similarly, during fiscal 1997, the Company recognized an $8.3 million charge, net of the related $0 tax benefit, for purchased in-process research and development in connection with the Clinitec acquisition. Excluding the charge, net of the related income tax benefit, for purchased in-process research and development, on a pro forma basis, net income and basic and diluted income per share for fiscal 1998 would have been $1.7 million, $0.29 and $0.28, respectively, and $825,000, $0.14 and $0.14, respectively, for fiscal 1997.

Net Revenues. Net revenues for the year ended March 31, 1998 increased 55.1% to $31.2 million from $20.1 million for the year ended March 31, 1997. Sales of computer systems, upgrades and supplies for the year ended March 31, 1998 increased 71.7% to $20.3 million from $11.8 million for the year ended March 31, 1997 after the consolidation of MicroMed's net revenues in fiscal 1998. Without the inclusion of MicroMed's revenues, the Company's sales of computer systems, upgrades and supplies increased 36.6% in fiscal 1998 as compared to fiscal 1997. Net revenues from maintenance and other services during the year ended March 31, 1998 grew 31.6% to $10.9 million from $8.3 million for the year ended March 31, 1997 resulting primarily from an increase in revenues from the Company's larger client base for recurring maintenance and other services together with the consolidation of MicroMed's revenues in fiscal 1998.

Cost of Products and Services. Cost of products and services for the year ended March 31, 1998 increased 33.9% to $13.5 million from $10.1 million for the year ended March 31, 1997 while costs of products and services as a percentage of net revenues decreased to 43.3% from 50.1% during the comparable periods. The increase in the amount of costs of products and services during the year ended March 31, 1998 as compared to the year ended March 31, 1997 resulted primarily from increased systems sales and an increase in customer service, support, and training personnel during fiscal 1998 plus the addition of such costs for MicroMed's personnel. The decrease in costs of products and services as a percentage of net revenues resulted primarily from the inclusion of MicroMed in fiscal 1998. To date, MicroMed's systems sales have not included any significant amount of hardware content. Systems sales without significant hardware content generally yield higher margins than systems sales that include a significant amount of hardware content. The mixture of sales with and without significant hardware content fluctuates from period to period and there can be no assurance that the mixture of such sales attained in the year ended March 31, 1998, which contributed materially to the decrease in cost of products and services as a percentage of net revenues, will be achieved in future periods. Without the inclusion of MicroMed, costs of products and services increased 27.7% in fiscal 1998 over fiscal 1997 and as a percentage of net revenues decreased to 48.1% from 50.1%. The increase in the amount and decrease in percentage before the inclusion of MicroMed resulted primarily from higher systems sales.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the year ended March 31, 1998 increased 61.4% to $12.5 million from $7.7 million for the year ended March 31, 1997

representing 40.0% and 38.5% of net revenues, respectively. The increase in selling, general and administrative expenses in both amount and as a percentage of net revenues was primarily the result of an increase in the Company's selling efforts, including sales personnel, and administrative infrastructure together with the consolidation of MicroMed's selling, general and administrative expenses during fiscal 1998. Without the inclusion of MicroMed's selling, general and administrative expenses, such expenses increased 32.7% over fiscal 1997 and decreased to 38.3% from 38.5% as a percentage of net revenues. Before the inclusion of MicroMed, the increase in the amount of selling, general and administrative expenses resulted primarily from an increase in Clinitec's selling efforts, including sales personnel, and administrative infrastructure together with a smaller increase in such costs for QSI.

Research and Development Costs. Research and development costs for the year ended March 31, 1998 increased 55.3% to $3.1 million from $2.0 million for the year ended March 31, 1997 primarily due to an increase in such efforts for QSI and Clinitec together with the consolidation of MicroMed's research and development costs during fiscal 1998. Research and development costs as a percentage of net revenues remained unchanged at 9.8% for both periods. Without the inclusion of MicroMed, such costs increased 34.1% and remained relatively unchanged at 9.9% as a percentage of net revenues.

Purchased In-Process Research and Development. In connection with the acquisitions of MicroMed in May 1997 and Clinitec in May 1996, the purchase price allocated to in-process research and development for which technological feasibility had not been established was $10.2 million and $8.3 million, respectively. In accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," software development costs must be expensed until technological feasibility has been established. Accordingly, the purchase price allocated to in-process research and development in each of fiscal 1998 and 1997 was expensed during the respective fiscal years.

Investment Income. Investment income for the year ended March 31, 1998 decreased 24.4% to $1.0 million from $1.3 million for the year ended March 31, 1997 primarily as a result of a decrease in funds available for investment during fiscal 1998 after payment of the purchase price in connection with the MicroMed acquisition together with amounts used to fund the growth of Clinitec and MicroMed.

Provision for (Benefit from) Income Taxes. The benefit from income taxes for the year ended March 31, 1998 was $2.5 million, resulting in an effective income tax rate of 34.8%. The provision for income taxes for the year ended March 31, 1997 was $784,000 and differs from the combined Federal and state statutory rates primarily due to the non-deductible charge for purchased in-process research and development as well as non-deductible amortization of certain intangibles acquired in the non-taxable Clinitec purchase transaction. The MicroMed acquisition was a taxable transaction and, accordingly, the related purchased in-process research and development is deductible for income tax purposes.

LIQUIDITY AND CAPITAL RESOURCES.

Cash and cash equivalents decreased $1.9 million, $5.7 million and $6.0 million for the years ended March 31, 1999, 1998 and 1997 primarily as a result of payments made in connection with the Clinitec and MicroMed acquisitions.

Net cash provided by operating activities was $3.3 million, $2.2 million and $520,000 for the years ended March 31, 1999, 1998 and 1997, respectively. Net cash provided by operations for the year ended March 31, 1999 consisted principally of net income before depreciation and amortization, increases in accounts payable and deferred service revenue, and a decrease in inventories offset by an increase in accounts receivable. Net cash provided by operations for the year ended March 31, 1998 consisted primarily of the Company's net loss adjusted for the principal non-cash operating expenses of depreciation, amortization and the $10.2 million charge for purchased in-process research and development incurred in connection with the acquisition of MicroMed together with increases in deferred service revenue and other current liabilities offset in part by an increase in accounts receivable and deferred income tax benefits. Net cash provided by operations for the year ended March 31, 1997 consisted primarily of the Company's net loss adjusted for the principal non-cash operating expenses of depreciation, amortization and the $8.3 million charge for purchased in-process research and development incurred in connection with the acquisition of Clinitec, offset by an increase in accounts receivable. The increase in accounts receivable during each of the fiscal years resulted primarily from increased sales and the timing of sales in each period.

Net cash used in investing activities was $5.1 million, $7.8 million and $6.6 million for the years ended March 31, 1999, 1998 and 1997, respectively. Net cash used in investing activities for the years ended March 31, 1999 and 1998 was principally impacted by the $3.8 million and $5.3 million, respectively, paid in connection with the MicroMed acquisition. Net cash used in investing activities for the year ended March 31, 1997 was principally impacted by QSI's purchase of the remaining 75% ownership interest in Clinitec during fiscal 1997 for $4.9 million in cash and 309,846 shares of Common Stock. Net cash used for additions to equipment, improvements and capitalized software for the years ended March 31, 1999, 1998 and 1997 were $1.7 million, $2.7 million and $1.7 million, respectively, which were offset in part for the years ended March 31, 1999 and 1997 by cash provided from net sales of short-term investments of $467,000 and $352,000, respectively. There were no short-term investment sales or purchases during the year ended March 31, 1998.

Net cash used in financing activities for the years ended March 31, 1999 and 1998 was $197,000 and $223,000, respectively, which includes $247,000 and $271,000 used in each fiscal year to repurchase 52,400 shares and 40,100 shares, respectively, of the Company's Common Stock. Net cash provided by financing activities was $61,000 for the year ended March 31, 1997. Net cash provided by (used in) financing activities for the years ended March 31, 1999, 1998 and 1997 also includes the proceeds from the exercise of employee stock options.

In March 1996, QSI raised $20.2 million to be used for general corporate purposes, including the financing of product sales growth, development of new products, working capital requirements, an increase in its ownership interest in Clinitec (see "Item 1. Business. Acquisitions."), and the possible acquisitions of complementary businesses and technologies. The

Company continues to evaluate potential investment opportunities and in May 1997 acquired substantially all of the assets of MicroMed (see "Item 1. Business. Acquisitions.") for an initial cash payment of $4.8 million with an additional cash and common stock payment of $5.7 million paid on June 29, 1998. Except for the acquisition of MicroMed and the Company's intention to expend funds on capitalized software in connection with complementary products to its existing product line, alternative versions of certain of its products for the client/server environment to take advantage of more powerful technologies and to enable a more seamless integration of the Company's products, the Company has no other significant capital commitments and currently anticipates that additions to equipment and improvements for fiscal 2000 will be comparable to fiscal 1999.

At March 31, 1999, the Company had cash and cash equivalents of $14.2 million and short-term investments of $245,000. The Company believes that it's cash and cash equivalents and short-term investments on hand at March 31, 1999, together with the cash flows from operations, if any, will be sufficient to meet it's working capital and capital expenditure requirements for the next year.

## YEAR 2000 COMPLIANCE.

### INTRODUCTION.

The Company is aware of issues associated with the programming code in existing computer systems as the millennium approaches. In particular, software applications that use only two digits to identify a year in the date field may fail or create errors in the year 2000 ("Year 2000 Issues"). Year 2000 Issues create risk for the Company from unforeseen problems in computer systems that the Company sells to customers on a nationwide basis which are used, among other things, to process their financial transactions and schedule patients ("Company Products"), as well as systems that the Company uses internally to provide certain services to its customers and to process it's own financial transactions ("Internal Use Systems"). The potential costs and uncertainties associated with Year 2000 Issues will depend upon a number of factors, including the Company's proprietary and third party developed software, hardware (hardware and third party developed software will hereinafter be referred to collectively as "Third Party Products") and the nature of the industry in which the Company operates.

Company Products and Third Party Products sold by the Company may fail to operate properly or as expected due to Year 2000 Issues. Such failures could result in system failures or miscalculations causing disruptions of customers' operations, including among other things, an inability to process transactions, send invoices, conduct communications, schedule and treat patients or engage in similar normal business activities. Further, products and services used by the Company's customers, but not supplied by the Company, could fail to operate properly or as expected due to Year 2000 Issues. Customers' efforts to plan for such events could result in the deferral, delay or cancellation by customers of current installations of and plans to purchase systems from the Company. Similarly, Internal Use Systems, including both information systems and non-information systems, may not operate properly or as expected due to Year 2000 Issues. Year 2000 Issues could result in system failures or miscalculations causing disruption of the Company's operations, including among other things, an inability to process its own and certain of its customers financial transactions, send invoices, conduct communications, or engage in similar normal business activities.

STATE OF READINESS.

The Company has undertaken various initiatives intended to address Year 2000 Issues. The Company has identified individuals and/or working groups to (1) develop and implement the Company's definition of Year 2000 readiness; (2) assess Company Products, Third Party Products and Internal Use Systems for possible Year 2000 Issues; (3) monitor development, testing and remediation efforts with respect to Company Products, Third Party Products and Internal Use Systems; (4) monitor and coordinate the Company's deployment plans and results with respect to Year 2000 releases of Company Products, Third Party Products and Internal Use Systems; and, (5) develop contingency plans with respect to Company Products, Third Party Products and Internal Use Systems. Although the Company's efforts to address Year 2000 Issues do not fall precisely into sequential phases, generally these efforts are comprised of an assessment phase, a development phase (only with respect to Company Products and certain proprietary Internal Use Systems), a deployment or remediation phase, and a contingency planning phase.

Company Products. The Windows Product, NextGen and CPS are designed to be Year 2000 compliant and contain no known Year 2000 Issues when configured and used in accordance with the related documentation, and provided that the underlying operating system of the host machine and any other software used with or in the host machine are also Year 2000 compliant. However, there can be no assurance that such products do not contain undetected errors or defects associated with Year 2000 Issues.

The Company's Legacy Product has required significant development and remediation efforts in connection with Year 2000 Issues with many of these efforts commencing in 1997. In November 1998, the Company began general deployment of Version 9 of its Legacy Product which version has been designed to be Year 2000 compliant. The Company continues to test and monitor performance of Version 9 in customer environments and expects to deliver and deploy maintenance releases in the ordinary course of business throughout the rest of calendar 1999. In addition, the Company continues to progress through the development cycles with respect to certain ancillary products associated with the Legacy Product with deployment of these ancillary products expected to be completed by December 31, 1999.

The Company estimates that as of March 31, 1999, it has completed approximately 90% of its development efforts in connection with Year 2000 Issues associated with the Legacy Product and certain associated ancillary products. In addition at March 31, 1999, approximately 75% of the Company's Legacy Product customers have contracted to install Version 9 of which approximately 50% have been installed as of that date. The Company expects to have substantially all of its Version 9 installations completed by November 30, 1999. Based on the Company's assessment to date, the Company believes continuing efforts will be required to assist customers in deploying and testing Version 9 in many of the customers' unique environments. The Company also expects an increase in service and support effort levels as the year 2000 approaches and into the early months of the year 2000.

Third Party Products Sold by the Company. The Company works closely with vendors of significant Third Party Products sold by the Company and has communicated with them to determine the extent to which their products and services are, or will be, Year 2000 compliant. In addition, Company Products have been tested, and the Company plans to continue testing Company Products, with certain Third Party Products. Based upon its current assessments, the Company believes that it has received adequate assurances

that significant Third Party Product vendors expect to successfully address their significant identified Year 2000 Issues on a timely basis. Due to uncertainties associated with Third Party Product vendors, the Company is unable to predict whether a material adverse effect on the Company's business, results of operations and financial condition may result form Year 2000 Issues related to Third Party Products despite the Company's current assessment to the contrary.

Internal Use Systems. Based upon the Company's assessment efforts to date, the Company believes that certain Internal Use Systems will require replacement or modification due to Year 2000 Issues. The Company's assessment efforts are ongoing. As of March 31, 1999, the Company believes that its has substantially completed its assessment review of many of its major Internal Use Systems.

Certain of the Internal Use Systems are proprietary and were developed by the Company. Company personnel have used similar techniques to identify Year 2000 Issues with its Company Products and proprietary Internal Use Systems. The proprietary Internal Use Systems will either be modified by Company personnel or replaced with third party developed systems which the Company believes will not fail as a result of Year 2000 Issues. The Company has communicated with developers and/or vendors of certain of its third party developed Internal Use Systems to determine the extent to which those products and services are, or will be, Year 2000 compliant. Based upon its current assessments, the Company believes that it has received adequate assurances that significant third party developed Internal Use Systems are, or will be, Year 2000 compliant in a timely manner to enable the Company to implement any required upgrades prior to Year 2000 Issues being encountered in its Internal Use Systems.

As of March 31, 1999, the Company has replaced or completed modification of some of its Internal Use Systems and plans to have all such systems replaced or modifications completed by December 31, 1999.

Contingency Plans. The Company is currently engaged in, but has not completed, contingency planning to address company-wide personnel, resource, technical and communication matters in connection with foreseeable scenarios that may develop from Year 2000 Issues despite the Company's current and planned remediation efforts. The Company expects that its development, remediation, testing, deployment and contingency planning efforts with respect to Company Products, Third Party Products and Internal Use Systems will continue up to and beyond December 31, 1999. The Company's contingency planning includes possible (1) failure by the Company and its vendors to complete efforts to avoid or minimize the impact of Year 2000 Issues on a timely basis; (2) failure of customers to be ready for, or cooperate with, the deployment of Year 2000 compliant Company Products on a timely basis; and, (3) delay, deferral or cancellation by customers of current installations and prospective purchase decisions with respect to Company Products. A reasonably likely "worst case" scenario has not yet been identified, but it is anticipated that such scenario would include the failure of significant communications and computing infrastructures by the Company, its customers and its suppliers together with failures of infrastructures encompassing utilities, transportation, banking and government.

COSTS.

The total cost to address the Company's Year 2000 Issues are not expected to be material to the Company's financial condition. The Company does not separately track all of its internal personnel costs incurred in connection with identifying and resolving Year 2000 Issues. Excluding internal costs, the Company expects that total expenditures to address Year 2000 Issues will approximate $150,000, of which approximately $30,000 has been incurred as of March 31, 1999. To date, all of these expenditures have been funded from operations and it is anticipated that all remaining expenditures will also be funded from operations.

## Item 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable.

## Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The Financial Statements of the Company identified in the Index to Financial Statements appearing under "Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K." of this report are incorporated herein by reference to Item 14.

## Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

# PART III.

## Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Except for information concerning the Company's executive officers which is included under the caption "Executive Officers of the Registrant." following Part I, Item 4 of this report, the information required by Item 10 is incorporated herein by reference from the Company's definitive proxy statement scheduled to be filed with the Securities and Exchange Commission on or before July 29, 1999 for the Company's 1999 annual shareholders' meeting.

## Item 11. EXECUTIVE COMPENSATION.

The information required by Item 11 is incorporated herein by reference from the Company's definitive proxy statement scheduled to be filed with the Securities and Exchange Commission on or before July 29, 1999 for the Company's 1999 annual shareholders' meeting.

## Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The information required by Item 12 is incorporated herein by reference from the Company's definitive proxy statement scheduled to be filed with the Securities and Exchange Commission on or before July 29, 1999 for the Company's 1999 annual shareholders' meeting.

## Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The information required by Item 13 is incorporated herein by reference from the Company's definitive proxy statement scheduled to be filed with the Securities and Exchange Commission on or before July 29, 1999 for the Company's 1999 annual shareholders' meeting.

PART IV.

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.



INDEX TO EXHIBITS

INDEX TO EXHIBITS
(continued)

| Exhibit | | Sequential Page No. |
|---|---|---|
| 3.2.2 | Text of Sections 2 and 3 of Article II of the Bylaws of the Registrant is hereby incorporated by reference to Exhibit 3.2.2 to the Registrant's Quarterly report on Form 10-QSB for the period ended December 31, 1996, File No. 0-13801. | |
| 3.2.3 | Certificate of Amendment of Bylaws of the Registrant. | 75 |
| 10.2* | 1989 Incentive Stock Option Plan is hereby incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-8, File No. 33-31949. | |
| 10.2.1* | Form of Incentive Stock Option Agreement is hereby incorporated by reference to Exhibit 10.2 to the Registrant's Registration Statement on Form S-1, File No. 333-00161. | |
| 10.2.2* | Form of Non-Qualified Stock Option Agreement is hereby incorporated by reference to Exhibit 10.3 to the Registrant's Registration Statement on Form S-1, File No. 333-00161. | |
| 10.3* | Form of Incentive Stock Option Agreement is hereby incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1, File No. 2-80056. | |
| 10.4* | 1993 Deferred Compensation Plan, is hereby incorporated by reference to Exhibit 10.5 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1994, File No. 0-13801. | |
| 10.4.2* | Profit Sharing and Retirement Plan, as amended, is hereby incorporated by reference to Exhibit 10.4.2 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1994, File No. 0-13801. | |
| 10.4.3* | Profit Sharing and Retirement Plan, as amended, amendments No. 2 and 3, are hereby incorporated by reference to Exhibit 10.4.3 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1996, File No. 0-13801. | |

INDEX TO EXHIBITS
(continued)

| Exhibit | | Sequential Page No. |
|---|---|---|
| 10.5 | Lease Agreement dated March 11, 1993 between the Registrant and Craig Development Corporation, is hereby incorporated by reference to Exhibit 10.35 to the Registrant's Annual Report on Form 10-K for the year ended March 31, 1993, File No. 0-13801. | |
| 10.6 | Lease agreement dated September 12, 1994 between the Registrant and Koll/Realty Orangewood Business Center General Partnership, is hereby incorporated by reference to Exhibit 10.8 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1995, File No. 0-13801. | |
| 10.7 | Series "A" Convertible Preferred Stock Purchase Agreement, as amended, dated April 21, 1995 between the Registrant and Clinitec International, Inc., is hereby incorporated by reference to Exhibit 10.11 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1995, File No. 0-13801. | |
| 10.8 | Form of Indemnification Agreement is hereby incorporated by reference to Exhibit 10.10 to the Registrant's Registration Statement on Form S-1, File No. 333-00161. | |
| 10.9 | Marketing agreement, as amended, dated April 1, 1995 between the Registrant and Clinitec International, Inc., is hereby incorporated by reference to Exhibit 10.12 to the Registrant's Annual Report on Form 10-KSB for the year ended March 31, 1995, File No. 0-13801. | |
| 10.10 | Agreement and Plan of Merger, dated May 16, 1996, by and among Quality Systems, Inc., CII Acquisition Corporation, Clinitec International, Inc. and certain shareholders of Clinitec International, Inc. and certain exhibits is hereby incorporated by reference to Exhibit 2 to the Registrant's Current Report on Form 8-K, dated May 17, 1996 and filed May 30, 1996. | |
| 10.11* | Employment agreement dated May 16, 1996 by and between CII Acquisition Corporation and Patrick Cline is hereby incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K/A dated May 17, 1996 and filed June 21, 1996. | |

INDEX TO EXHIBITS
(continued)



* This exhibit is a management contract or a compensatory plan or arrangement.

INDEX TO EXHIBITS
(continued)

(b) Reports on Form 8-K:

On February 13, 1999, the Registrant filed a Current Report on Form 8-K dated February 9, 1999 disclosing the extension of the authorization by Registrant's Board of Directors for management to repurchase on the open market up to ten percent of the outstanding shares of the Registrant's Common Stock at various times through February 28, 2000, subject to applicable laws and regulations. The timing and amount of any repurchase is at the discretion of the Registrant's management based upon its view of prevailing economic and market conditions. The Registrant's management could, in the exercise of its judgment, decide not to effect any repurchases, or to repurchase fewer shares than authorized, whether as a result of market factors or because of applicable laws and regulations. No financial statements were filed in connection with the Current Report on Form 8-K dated February 9, 1999.

SIGNATURES.

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

QUALITY SYSTEMS, INC.

By: /s/SHELDON RAZIN Date: June 8, 1999

SHELDON RAZIN
Chairman of the Board of
Directors and President

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/SHELDON RAZIN<br>SHELDON RAZIN | Chairman of the Board of Directors and President (Principal Executive Officer) | June 8, 1999 |
| /s/JANET RAZIN<br>JANET RAZIN | Vice President, Secretary and Director | June 8, 1999 |
| /s/ROBERT MCGRAW<br>ROBERT MCGRAW | Vice President, Chief Financial Officer (Principal Financial and Accounting Officer) | June 8, 1999 |
| /s/JOHN BOWERS, M.D.<br>JOHN BOWERS, M.D. | Director | June 8, 1999 |
| /s/WILLIAM BOWERS<br>WILLIAM BOWERS | Director | June 8, 1999 |
| /s/PATRICK CLINE<br>PATRICK CLINE | Director | June 8, 1999 |
| /s/DONALD COOK<br>DONALD COOK | Director | June 8, 1999 |
| /s/GORDON SETRAN<br>GORDON SETRAN | Director | June 8, 1999 |

## INDEPENDENT AUDITORS' REPORT

Board of Directors and Shareholders
Quality Systems, Inc.

We have audited the accompanying consolidated balance sheets of Quality Systems, Inc. and subsidiaries as of March 31, 1999 and 1998, and the related consolidated statements of operations and comprehensive operations, shareholders' equity and cash flows for each of the three years in the period ended March 31, 1999. Our audits also included the financial statement schedule listed in the Index of Item 14. (a) (2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Quality Systems, Inc. and subsidiaries as of March 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 1999 in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP
Costa Mesa, California
May 28, 1999

QUALITY SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

| ASSETS | March 31, 1999 | March 31, 1998 |
|---|---|---|
| Current Assets: | | |
| Cash and cash equivalents | $14,196 | $16,107 |
| Short-term investments | 245 | 973 |
| Accounts receivable, less allowance for doubtful accounts of $754 and $521, respectively | 12,488 | 9,946 |
| Inventories | 772 | 1,328 |
| Other current assets | 1,019 | 574 |
| Total current assets | 28,720 | 28,928 |
| Equipment and Improvements, net | 1,783 | 1,790 |
| Capitalized Software Costs, net | 2,144 | 2,183 |
| Deferred Tax Asset | 3,254 | 3,105 |
| Excess of Cost Over Net Assets of Acquired Business, net of accumulated amortization of $954 and $613, respectively | 2,452 | 2,793 |
| Other Assets | 1,865 | 2,117 |
| Total assets | $40,218 | $40,916 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current Liabilities: | | |
| Accounts payable | $ 1,813 | $ 1,327 |
| Acquisition obligation | - | 5,676 |
| Deferred service revenue | 4,484 | 2,244 |
| Other current liabilities | 4,257 | 4,228 |
| Total liabilities | 10,554 | 13,475 |
| Commitments and Contingencies | | |
| Shareholders' Equity: | | |
| Common stock, $0.01 par value, 20,000 shares authorized, 6,214 and 5,988 shares issued and outstanding, respectively | 62 | 60 |
| Additional paid-in capital | 35,568 | 33,931 |
| Accumulated deficit | (5,966) | (6,550) |
| Total shareholders' equity | 29,664 | 27,441 |
| Total liabilities and shareholders' equity | $40,218 | $40,916 |

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE OPERATIONS
(in thousands, except per share amounts)

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| Net Revenues: | | | |
| Sales of computer systems, upgrades and supplies | $18,875 | $20,273 | $11,809 |
| Maintenance and other services | 14,941 | 10,943 | 8,318 |
| | 33,816 | 31,216 | 20,127 |
| Cost of Products and Services | 15,834 | 13,509 | 10,089 |
| Gross Profit | 17,982 | 17,707 | 10,038 |
| Selling, General and Administrative Expenses | 13,495 | 12,485 | 7,736 |
| Research and Development Costs | 3,603 | 3,072 | 1,978 |
| Purchased In-Process Research and Development | - | 10,200 | 8,300 |
| Income (Loss) from Operations | 884 | (8,050) | (7,976) |
| Investment Income | 413 | 971 | 1,285 |
| Income (Loss) before Provision for (Benefit from) Income Taxes | 1,297 | (7,079) | (6,691) |
| Provision for (Benefit from) Income Taxes | 713 | (2,463) | 784 |
| Net Income (Loss) and Comprehensive Income (Loss) | $ 584 | $(4,616) | $(7,475) |
| Net Income (Loss) per Share, basic and diluted | $ 0.09 | $ (0.77) | $ (1.26) |

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)

| | Common Shares Issued | | Additional Paid-in Capital | Unrealized Loss on Available-for-Sale Securities | Retained Earnings (Accumulated Deficit) |
|---|---|---|---|---|---|
| | Number | Amount | | | |
| Balance at April 1, 1996 | 5,653 | $ 56 | $ 27,148 | $ (44) | $ 5,541 |
| Shares Issued in Acquisition of Clinitec International, Inc. | 310 | 3 | 6,891 | - | - |
| Exercise of Stock Options | 34 | 1 | 60 | - | - |
| Tax Benefit Resulting from Stock Options | - | - | 45 | - | - |
| Disposition of Available-for-Sale Securities, net of $34 tax provision | - | - | - | 44 | - |
| Net Loss | - | - | - | - | (7,475) |
| Balance at March 31, 1997 | 5,997 | 60 | 34,144 | - | (1,934) |
| Exercise of Stock Options | 31 | - | 48 | - | - |
| Tax Benefit Resulting from Stock Options | - | - | 10 | - | - |
| Purchases of Common Stock | (40) | - | (271) | - | - |
| Net Loss | - | - | - | - | (4,616) |
| Balance at March 31, 1998 | 5,988 | 60 | 33,931 | - | (6,550) |
| Shares Issued in Acquisition of MicroMed Healthcare Information Systems, Inc. | 245 | 3 | 1,833 | - | - |
| Exercise of Stock Options | 33 | - | 50 | - | - |
| Purchases of Common Stock | (52) | (1) | (246) | - | - |
| Net Income | - | - | - | - | 584 |
| Balance at March 31, 1999 | 6,214 | $ 62 | $ 35,568 | $ - | $ (5,966) |

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| Cash Flows from Operating Activities: | | | |
| Net income (loss) | $ 584 | $ (4,616) | $ (7,475) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Purchased in-process research and development | - | 10,200 | 8,300 |
| Depreciation and amortization | 2,465 | 1,895 | 1,139 |
| (Gain) loss on short-term investments and other | 261 | (90) | (85) |
| Equity in loss of Clinitec International, Inc. | - | - | 31 |
| Deferred income taxes | (592) | (3,336) | 102 |
| Changes, net of amounts acquired, in: | | | |
| Accounts receivable | (2,542) | (3,175) | (1,594) |
| Inventories | 556 | (257) | (202) |
| Other current assets | (2) | 116 | (208) |
| Accounts payable | 486 | (72) | (613) |
| Deferred service revenue | 2,240 | 590 | 401 |
| Income taxes payable and taxes related to equity accounts | 344 | 397 | 291 |
| Other current liabilities | (453) | 590 | 433 |
| Net Cash Provided By Operating Activities | 3,347 | 2,242 | 520 |
| Cash Flows from Investing Activities: | | | |
| Proceeds from sales of short-term investments | 542 | - | 402 |
| Purchases of short-term investments | (75) | - | (50) |
| Additions to equipment and improvements, net | (521) | (810) | (855) |
| Additions to capitalized software costs | (1,204) | (1,861) | (850) |
| Purchase of ownership interests in Clinitec International, Inc. | - | - | (4,946) |
| Purchase of net assets of MicroMed Healthcare Information Systems, Inc. | (3,840) | (5,327) | - |
| Change in other assets | 37 | 234 | (302) |
| Net Cash Used In Investing Activities | (5,061) | (7,764) | (6,601) |

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(in thousands)

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| Cash Flows from Financing Activities: | | | |
| Purchases of Common Stock | $ (247) | $ (271) | $ - |
| Proceeds from exercise of stock options | 50 | 48 | 61 |
| Net Cash Provided By (Used In) Financing Activities | (197) | (223) | 61 |
| Net Decrease in Cash and Cash Equivalents | (1,911) | (5,745) | (6,020) |
| Cash and Cash Equivalents, beginning of year | 16,107 | 21,852 | 27,872 |
| Cash and Cash Equivalents, end of year | $ 14,196 | $ 16,107 | $ 21,852 |

Supplemental Information - During fiscal 1999, 1998 and 1997 the Company made income tax payments of $951, $485 and $431, respectively.

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| Detail of businesses acquired in purchase transactions: | | | |
| Purchased In-Process Research and Development | $ - | $ 10,200 | $ 8,300 |
| Fair Value of Assets Acquired | - | 1,480 | 3,999 |
| Liabilities Assumed | - | (677) | (459) |
| Common Stock Issued in Acquisition | (1,836) | - | (6,894) |
| Acquisition Obligation | 5,676 | (5,676) | - |
| Cash Paid for the Acquisition, net of cash acquired | $ 3,840 | $ 5,327 | $ 4,946 |

See notes to consolidated financial statements.

QUALITY SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - DESCRIPTION OF BUSINESS

Quality Systems, Inc. ("QSI") and its wholly-owned subsidiaries, Clinitec International, Inc. ("Clinitec") and MicroMed Healthcare Information Systems, Inc. ("MicroMed"), (collectively the "Company") develop and market proprietary computer information systems for medical and dental group practices, community health centers, physician hospital organizations, management service organizations, and dental schools. The Company's proprietary software systems include general patient information, appointment scheduling, billing, insurance claims submission and processing, managed care plan implementation and referral management, treatment outcome studies, treatment planning, drug formularies, electronic medical records, dental charting and letter generation. In addition to providing fully integrated solutions, the Company provides its clients with comprehensive hardware and software maintenance and support services, system training services and electronic claims submission services.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation - QSI acquired a 100% ownership interest in Clinitec on May 17, 1996 and MicroMed on May 15, 1997, respectively, (see Note 10). Accordingly, the accompanying consolidated financial statements include all of the accounts of QSI for the periods presented, the accounts of Clinitec for the period commencing May 17, 1996 through March 31, 1999, and the accounts of MicroMed for the period commencing May 15, 1997 through March 31, 1999. All significant inter-company amounts have been eliminated.

Revenue Recognition - In October 1997, the American Institute of Certified Public Accounts issued Statement of Position ("SOP") 97-2, "Software Revenue Recognition" ("SOP 97-2"), which was later amended in part by SOP 98-4, "Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition" ("SOP 98-4"). As of April 1, 1998, the Company has adopted SOP 97-2, as amended by SOP 98-4. SOP 97-2 provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions and supersedes the guidance contained in SOP 91-1 which the Company has heretofore been following. The Company generates revenues from licensing rights to use its software products directly to end-users. The Company also generates revenues from sales of hardware and third party software, and implementation, training, software customization and post-contract support ("maintenance") services performed for customers who license the Company's products. A typical system contract contains multiple elements of two or more of the above items. In accordance with SOP 97-2, revenue is allocated to each element of the contract based on evidence of each element's fair market value. Provided the fees are fixed and determinable and collection is considered probable, revenue from licensing rights and sales of hardware and third party software are recognized upon shipment. Revenue from implementation, training and software customization services is recognized as the corresponding services are performed. Maintenance revenue is recognized ratably over the contractual maintenance period. The adoption of SOP 97-2 has, in certain circumstances, resulted in the deferral of some portion of contract revenues that would have otherwise been recognized under SOP 91-1. For the year ended March 31, 1999, the impact was to reduce net revenues by $1.2 million, income from operations by $797,000 and net income by $482,000, or $0.08 per share on a basic and diluted basis.

Cash Equivalents - The Company considers all highly liquid interest earning deposits purchased with an original maturity of three months or less to be cash equivalents.

Short-Term Investments - The Company classifies its short-term investments into one of the following categories:

Held to maturity - Debt securities for which the Company has the intent and the ability to hold to maturity.

Trading - Debt securities that do not meet the "intent-to-hold" criteria and equity securities, both of which are bought and held principally for the purpose of being sold in the near term.

Available-for-sale - Debt securities that do not meet the "intent-to-hold" criteria and which are not classified as trading securities, as well as all equity securities not otherwise classified as trading securities.

Held to maturity securities are carried in the balance sheet at cost (unless there are declines in the values of individual securities that are not due to temporary declines), and realized gains and losses are recorded in the statement of operations in the period that they are earned or incurred. Trading securities are carried in the balance sheet at fair market value and unrealized gains and losses are recorded in the statement of operations. Available-for-sale securities are carried in the balance sheet at fair market value; realized gains and losses are recorded in the statement of operations when they are earned or incurred, and unrealized gains and losses, net of tax effect, are recognized as a component of shareholders' equity. Realized gains and losses from investment transactions are determined on a first-in, first-out basis.

Accounts Receivable - Many of the Company's system sales are financed by third-party sources while the Company provides credit for most maintenance contract sales. The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses which have been within management's expectations.

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

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

Software Development Costs - Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. After technological feasibility is established, any additional development costs are capitalized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Such costs are

generally amortized over the lesser of three years or the economic life of the related product. The Company performs an annual review of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

Excess of Cost Over Net Assets of Acquired Business and Intangible Assets - Excess of costs over net assets of acquired business and intangible assets are being amortized using the straight-line method over ten years and five years, respectively. The Company performs an annual review of the recoverability of such unamortized amounts. At the time a determination is made that any portion of such unamortized amounts are not recoverable based on the estimated cash flows to be generated, the excess amount is written off.

Income Taxes - Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of assets and liabilities for financial and tax reporting. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred taxes also are recognized for operating losses that are available to offset future taxable income and tax credits that are available to offset future income taxes. Valuation allowances are established as a reduction of net deferred tax assets when management cannot determine that the recoverability of such assets is probable.

Earnings per Share - Pursuant to SFAS No 128, "Earnings Per Share," ("SFAS No. 128"), the Company provides dual presentation of "basic" and "diluted" earnings per share ("EPS"). SFAS No. 128 replaced "primary" and "fully diluted" EPS under Accounting Principles Board ("APB") Opinion No. 15.

Basic EPS excludes dilution from common stock equivalents and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from common stock equivalents, similar to fully diluted EPS, but uses only the average stock price during the period as part of the computation.

The following table reconciles the weighted average shares outstanding for basic and diluted net income (loss) per share for the periods presented.

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| | (in thousands except per share amounts) | | |
| Net income (loss) | $ 584 | $(4,616) | $(7,475) |
| Basic income (loss) per common share: | | | |
| Weighted average of common shares outstanding | 6,176 | 5,981 | 5,937 |
| Basic income (loss) per common share | $ 0.09 | $ (0.77) | $ (1.26) |
| Diluted income (loss) per share: | | | |
| Weighted average of common shares outstanding | 6,176 | 5,981 | 5,937 |
| Weighted average of common shares equivalents- Weighted average options outstanding | 9 | - | - |
| Weighted average number of common and common equivalent shares | 6,185 | 5,981 | 5,937 |
| Diluted income (loss) per common share | $ 0.09 | $ (0.77) | $ (1.26) |

Stock-Based Compensation - The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25").

Comprehensive Income (Loss) - In fiscal 1999, the Company adopted SFAS No. 130, "Reporting Comprehensive Income" ("SFAS No. 130"). This statement establishes standards for the reporting of comprehensive income and its components. Comprehensive income, as defined, includes all changes in equity (net assets) during a period, from non-owner sources. For the years ended, March 31, 1999, 1998, and 1997, there were no significant differences between net income (loss) and comprehensive income (loss).

Segment Disclosures - In fiscal 1999, the Company adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131"). The Company adopted SFAS No. 131 effective with the fiscal year ended March 31, 1999. SFAS No. 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to shareholders. SFAS No. 131 also establishes standards for related disclosures about major customers, products and services, and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision making group, in making decisions how to allocate resources and assess performance.

The Company views its operations and manages its business as principally one segment, healthcare information solutions, that includes software, hardware and related services. Substantially all of the Company's

operations are in the United States. No one customer accounted for 10% or more of the Company's revenues in fiscal 1999, 1998, or 1997. As a result, the financial information disclosed herein represents all of the material financial information related to the Company's principal operating segment.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results in future periods could differ from those estimates made in the current year.

Reclassifications - Certain amounts in the accompanying financial statements have been reclassified to conform with the March 31, 1999 presentation.

NOTE 3 - CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

At March 31, 1999 and 1998, the Company had cash equivalents of $12.9 million and $14.7 million, respectively, invested in a major national brokerage firm's institutional fund that specializes in U.S. government securities and commercial paper with high credit ratings.

At March 31, 1999 and 1998, all short-term investments consist of trading securities. The March 31, 1998 amount includes an investment of $762,000 in a fund which traded in special situation securities. This investment was liquidated during fiscal 1999. The Company bears no off-balance sheet risk on its investments.

Investment income for each of the three years ended March 31, 1999 consists of the following:

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| | (in thousands) | | |
| Interest Income | $ 674 | $ 884 | $ 1,240 |
| Net Gains (Losses) on Short-Term Investments -- | | | |
| Realized | (220) | 146 | 102 |
| Unrealized | (38) | (58) | (26) |
| Other | (3) | (1) | (31) |
| | $ 413 | $ 971 | $ 1,285 |

NOTE 4 - CAPITALIZED SOFTWARE COSTS

Capitalized software costs at March 31, 1999 and 1998 were net of accumulated amortization of $2.0 million and $1.1 million, respectively.

Information related to net capitalized software costs is as follows:

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| | (in thousands) | | |
| Beginning of year | $ 2,183 | $ 1,041 | $ 599 |
| Capitalized | 1,204 | 1,861 | 850 |
| Amortization | (1,243) | (719) | (408) |
| End of year | $ 2,144 | $ 2,183 | $ 1,041 |

NOTE 5 - COMPOSITION OF CERTAIN FINANCIAL STATEMENT CAPTIONS

| | March 31, 1999 | March 31, 1998 |
|---|---|---|
| | (in thousands) | |
| INVENTORIES: | | |
| Computer systems and components | $ 529 | $ 1,019 |
| Replacement parts for certain client systems, net of accumulated amortization of $652 and $1,018, respectively | 194 | 260 |
| Miscellaneous parts and supplies | 49 | 49 |
| | $ 772 | $ 1,328 |
| EQUIPMENT AND IMPROVEMENTS: | | |
| Computers and electronic test equipment | $ 2,870 | $ 2,540 |
| Furniture and fixtures | 899 | 830 |
| Vehicles | 72 | 72 |
| Leasehold improvements | 198 | 193 |
| | 4,039 | 3,635 |
| Accumulated depreciation and amortization | (2,256) | (1,845) |
| | $ 1,783 | $ 1,790 |
| OTHER ASSETS: | | |
| Intangible assets, net of accumulated amortization of $841 and $490, respectively | $ 929 | $ 1,280 |
| Other | 936 | 837 |
| | $ 1,865 | $ 2,117 |
| OTHER CURRENT LIABILITIES: | | |
| Accrued payroll and related expenses | $ 1,369 | $ 1,184 |
| Deferred compensation | 821 | 685 |
| Income taxes payable | 897 | 553 |
| Other accrued expenses | 1,170 | 1,806 |
| | $ 4,257 | $ 4,228 |

NOTE 6 - INCOME TAXES

The income tax provision (benefit) consists of the following components:

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| | (in thousands) | | |
| Federal- | | | |
| Current taxes | $ 1,095 | $ 672 | $ 523 |
| Deferred taxes | (473) | (2,832) | 81 |
| | 622 | (2,160) | 604 |
| State- | | | |
| Current taxes | 210 | 201 | 159 |
| Deferred taxes | (119) | (504) | 21 |
| | 91 | (303) | 180 |
| | $ 713 | $ (2,463) | $ 784 |

The income tax provision (benefit) differs from an amount computed at the Federal statutory rate as follows:

| | Years Ended March 31, | | |
|---|---|---|---|
| | 1999 | 1998 | 1997 |
| | (in thousands) | | |
| Federal income tax provision (benefit) at statutory rate (34%) | $ 441 | $ (2,407) | $ (2,275) |
| Increases (decreases) resulting from: | | | |
| Non-deductible purchased in-process research and development | - | - | 2,822 |
| Non-deductible amortization of purchased intangible assets | 161 | 144 | 120 |
| State income taxes | 96 | (201) | 127 |
| Other | 15 | 1 | (10) |
| | $ 713 | $ (2,463) | $ 784 |

The net deferred tax benefits in the accompanying consolidated balance sheets include the following components:

| | March 31, 1999 | March 31, 1998 |
|---|---|---|
| | (in thousands) | |
| Deferred tax assets - | | |
| Short-term investments | $ 10 | $ - |
| Accounts receivable | 298 | 254 |
| Inventories | 56 | 54 |
| Accumulated depreciation | - | 21 |
| Purchased in-process research and development | 3,388 | 3,646 |
| Intangible assets | 83 | 39 |
| Accrued compensation | 280 | 255 |
| Accrued liability for deferred compensation | 277 | 241 |
| Deferred revenue | 297 | 19 |
| State income taxes | 54 | 42 |
| Net operating loss carryforward | 84 | - |
| | 4,827 | 4,571 |
| Deferred tax liabilities - | | |
| Short-term investments | - | (5) |
| Inventories | (21) | (16) |
| Equipment and improvements | (12) | - |
| Accumulated depreciation | (76) | (64) |
| Capitalized software | (490) | (537) |
| Deferred revenue | (209) | (522) |
| | (808) | (1,144) |
| | $ 4,019 | $ 3,427 |

The deferred tax assets and liabilities have been shown net in the accompanying balance sheets based on the long-term or short-term nature of the items which give rise to the deferred amount.

NOTE 7 - EMPLOYEE BENEFIT PLANS

QSI, Clinitec and MicroMed each have a profit sharing and retirement plan (collectively, the "Retirement Plans") for the benefit of substantially all of their employees. Participating employees may defer up to 15% of their compensation per year. The Company's annual contribution is determined by the Company's Board of Directors and the Retirement Plans may be amended or discontinued at the discretion of the Board of Directors. Contributions of $53,000, $43,000 and $33,000 were made to the Retirement Plans for the fiscal years ended March 31, 1999, 1998 and 1997, respectively.

During the fiscal year ended March 31, 1994, QSI initiated a deferred compensation plan (the "Deferral Plan") for the benefit of officers and key employees. Participating employees may defer all or a portion of their compensation for a Deferral Plan year. In addition, the Company may, but is not required to, make contributions into the Deferral Plan on behalf of participating employees. Each participating employee's deferred compensation and share of Company contributions has been invested in a life

insurance policy which has death benefit and mutual fund features. Investment decisions are made by each participating employee from a family of mutual funds. The Company is the owner and beneficiary of the life insurance policies and has an obligation to pay the greater of the death benefit or the net cash surrender value upon each employee's death or termination. The net cash surrender value of the life insurance policies and the related Company obligation for deferred compensation was $821,000 and $685,000 at March 31, 1999 and 1998, respectively. The Company made contributions of $8,000, $8,000 and $10,000 to the Deferral Plan for the fiscal years ended March 31, 1999, 1998 and 1997, respectively.

NOTE 8 - EMPLOYEE STOCK OPTION PLANS

During fiscal 1990, the Company's shareholders approved a stock option plan (the "1989 Plan") under which 1,000,000 shares of Common Stock have been reserved for the issuance of options. The 1989 Plan provides that salaried officers, key employees and non-employee directors of the Company may, at the discretion of the Board of Directors, be granted options to purchase shares of Common Stock at an exercise price not less than 85% of their fair market value on the option grant date. Upon an acquisition of the Company by merger or asset sale, each outstanding option will be subject to accelerated vesting under certain circumstances. The 1989 Plan terminates on June 30, 1999, unless sooner terminated by the Board. At March 31, 1999, 449,000 shares were available for future grant under the 1989 Plan.

In September 1998, the Company's shareholders approved a stock option plan (the "1998 Plan") under which 1,000,000 shares of Common Stock have been reserved for the issuance of options. The 1998 Plan provides that employees, directors and consultants of the Company, at the discretion of the Board of Directors, be granted options to purchase shares of Common Stock. The exercise price of each option granted shall be determined by the Company's Board of Directors at the date of grant. Upon an acquisition of the Company by merger or asset sale, each outstanding option will be subject to accelerated vesting under certain circumstances. The 1998 Plan terminates on December 31, 2007, unless sooner terminated by the Board. At March 31, 1999, no options have been granted under the 1998 Plan.

A summary of option transactions under the 1989 Plan for the three years ended March 31, 1999 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding, April 1, 1996 (21,625 exercisable at a weighted average price of $1.57) | 130,100 | $ 4.28 |
| Granted (weighted average fair value of $3,188,000) | 279,500 | 18.80 |
| Exercised | (34,125) | 1.77 |
| Cancelled | (107,975) | 15.59 |
| Outstanding, March 31, 1997 (43,000 exercisable at a weighted average price of $2.98) | 267,500 | 15.20 |
| Granted (weighted average fair value of $662,000) | 164,831 | 7.37 |
| Exercised | (30,250) | 1.60 |
| Cancelled | (182,549) | 21.08 |
| Outstanding, March 31, 1998 (50,500 exercisable at a weighted average price of $3.45) | 219,532 | 6.31 |
| Granted (weighted average fair value of $123,000) | 60,000 | 7.26 |
| Exercised | (33,000) | 1.50 |
| Cancelled | (66,250) | 7.56 |
| Outstanding, March 31, 1999 (53,821 exercisable at a weighted average price of $7.09) | 180,282 | $ 7.04 |

The outstanding stock options vest ratably over a four-year period commencing from the respective option grant dates. Stock options outstanding at March 31, 1999 are summarized as follows:

| Options Outstanding - Range of Exercise Prices | Number Outstanding at March 31, 1999 | Weighted Average Remaining Contractual Life (Yrs.) | Weighted Average Exercise Price |
|---|---|---|---|
| $ 3.69 - $ 5.50 | 20,750 | 4.4 | $ 4.36 |
| 6.38 - 10.06 | 158,532 | 3.2 | 7.29 |
| 23.50 | 1,000 | 1.8 | 23.50 |
| $ 3.69 - $23.50 | 180,282 | 3.4 | $ 7.04 |

| Options Exercisable - Range of Exercise Prices | Number Exercisable at March 31, 1999 | Weighted Average Exercise Price |
|---|---|---|
| $ 3.69 - $ 5.50 | 938 | $ 3.75 |
| 6.38 - 10.06 | 52,133 | 6.91 |
| 23.50 | 750 | 23.50 |
| $ 3.69 - $23.50 | 53,821 | $ 7.09 |

The Company continues to account for its stock-based awards using the intrinsic value method in accordance with APB No. 25. Accordingly, no compensation expense has been recognized in the financial statements for employee stock arrangements. SFAS No. 123, "Accounting for Stock-Based Compensation," ("SFAS No. 123") requires the disclosure of pro forma net income (loss) and pro forma net income (loss) per share had the Company adopted the fair value method as of the beginning of fiscal 1996. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values.

The Company's calculations were made using the Black-Scholes option pricing model with the following assumptions: expected life -- twelve months following full vesting; stock volatility -- ranging from 44% to 81% in fiscal 1999, ranging from 47% to 59% in fiscal 1998, and ranging from 68% to 101% in fiscal 1997; risk free interest rates -- 5.5% in fiscal 1999, 5.9% in fiscal 1998, and 6.5% in fiscal 1997; and, no dividends during the expected term. The Company's calculations are based on a single option valuation approach and forfeitures are recognized as they occur. If the computed fair values of the fiscal 1999, 1998 and 1997 awards had been amortized to expense over the vesting period of the awards, pro forma net income would have been $410,000, or $0.06 per share, in fiscal 1999; the pro forma net loss would have been $(4,801,000), or $(0.80) per share, in fiscal 1998; and the pro forma net loss would have been $(7,991,000), or $(1.35) per share, in fiscal 1997. These amounts are based on calculated values for option awards in fiscal 1999, 1998 and 1997 of $123,000, $662,000 and $3,188,000, respectively. The impact of stock and options granted prior to fiscal 1996 has been excluded from the pro forma calculations; accordingly, the fiscal 1999, 1998 and 1997 pro forma adjustments are not indicative of future period pro forma adjustments, when the calculation may apply to all applicable stock options.

NOTE 9 - COMMITMENTS AND CONTINGENCIES

Litigation - On April 22, 1997, a purported class action was filed in California Superior Court on behalf of all persons who purchased the Company's Common Stock between June 26, 1995 and July 3, 1996. The complaint alleges that the Company and certain of its officers and directors, as well as other defendants not affiliated with the Company, violated sections of the California Corporations Code by issuing positive statements about the Company that allegedly were knowingly false, in part, in order to assist the Company and certain of its officers and directors in selling Common Stock at an inflated price in the Company's March 5, 1996 public offering and at other points during the period specified. On May 14, 1997, a second purported class action was filed in the same court essentially repeating the allegations of the April 22, 1997 suit. On July 1, 1997, a third purported class action was filed in the United States District Court repeating essentially the same factual allegations as the April 22, 1997 suit and purports to state claims under the Federal securities laws. On March 23, 1999, a purported class action and derivative complaint was filed in California Superior Court on behalf of the Company's non-director shareholders alleging that certain of the Company's directors

breached their fiduciary duties principally by failing to assure the maximization of shareholder value. The Company and its named officers and directors deny all allegations of wrongdoing made against them in these suits, consider the allegations groundless and without merit, and intend to vigorously defend against these actions.

The Company is a party to various claims, legal actions and complaints arising in the ordinary course of business. The Company believes such matters are without merit, or involve such amounts that unfavorable disposition would not have a material adverse effect on the Company's financial statements.

Rental Commitments - The Company leases its facilities and offices under non-cancelable operating lease agreements expiring at various dates through August 2000. The Company has rental commitments under these agreements in fiscal 2000 and 2001 of $592,000 and $12,000, respectively. Total rental expense for all operating leases was $807,000, $672,000 and $451,000 for the years ended March 31, 1999, 1998 and 1997, respectively.

NOTE 10 - ACQUISITIONS

Clinitec - In April 1995, QSI entered into a strategic relationship with Clinitec, a developer of electronic medical records software systems. In May 1995 in connection with this strategic relationship, QSI acquired a 25% ownership interest in Clinitec for $1.0 million in cash. On May 16, 1996, QSI and Clinitec executed an Agreement and Plan of Merger, which was effected on May 17, 1996, whereby QSI acquired the remaining 75% of Clinitec that it did not already own for $4.9 million in cash and 309,846 shares of QSI Common Stock. For purposes of the acquisition, the shares were valued at $6.9 million, or $22.25 per share, for a total purchase price of $11.8 million for this remaining 75% ownership interest. On May 17, 1996, in accordance with the terms of the transaction, Clinitec was merged with and into a newly formed, wholly-owned subsidiary of the Company.

The acquisition was recorded as a purchase transaction. In connection with this treatment, the $11.8 million paid in May 1996 together with the Company's then existing $1.0 million investment in Clinitec and $484,000 of assumed Clinitec liabilities was allocated to $1.9 million of acquired identified assets, $8.3 million of acquired in-process research and development, and $3.1 million of purchase price in excess of assets acquired. At the May 1996 acquisition date, the technological feasibility of the acquired in-process research and development had not been established and, accordingly, the allocated value was charged to operations during the year ended March 31, 1997. If the Clinitec acquisition had been consummated as of the beginning of the year ended March 31, 1997, the impact on pro forma revenues, net loss and net loss per share would not have been material for the year ended March 31, 1997.

MicroMed - On May 15, 1997, the Company acquired substantially all of the assets of MicroMed, a developer and marketer of proprietary information systems utilizing a graphical user interface client/server platform for medical group practices. The purchase price consisted of an initial cash payment of $4.8 million paid at the closing of the transaction and an additional payment of $5.7 million due no later than June 29, 1998. The additional payment, paid on June 29, 1998, consisted of $3.8 million in

cash and 245,454 shares of QSI Common Stock valued at $1.8 million, or $7.48 per share. The shares of Common Stock may not be sold or otherwise transferred in any manner until June 1999.

The acquisition was recorded as a purchase transaction. In connection with this treatment, the $10.6 million paid, by the Company, including related acquisition costs, together with a $550,000 loan payable by MicroMed to the Company as of the acquisition date and $677,000 of assumed MicroMed liabilities was allocated to $1.3 million of acquired identified assets, $10.2 million of acquired in-process research and development, and $264,000 of purchase price in excess of assets acquired. The technological feasibility of the acquired in-process research and development had not been established at the dates the purchase price was allocated and, accordingly, the allocated value was charged to operations during the year ended March 31, 1998. If the MicroMed acquisition had been consummated as of the beginning of the year ended March 31, 1997, the impact on pro forma revenues, net loss and net loss per share would not have been material for each of the years ended March 31, 1997 and 1998.

NOTE 11 - SHAREHOLDER RIGHTS PLAN

Each share of the Company's Common Stock includes a Right to purchase from the Company one share of Common Stock for $40, subject to adjustment. These Rights expire on November 25, 2006 and may not be exercised and will not detach or trade separately from the Common Stock except as described below.

The Rights will detach from the Common Stock and may be exercised only if a person or group without prior consent of the Company's board becomes the beneficial owner of 15% or more of the Common Stock ("Stock Acquisition"). Existing shareholder positions as of November 22, 1996 of 15% or more of the outstanding Common Stock do not trigger the Rights unless the respective shareholders acquire additional shares without prior board consent. If a Stock Acquisition occurs, the Rights flip-in and each Right entitles its holder (other than shareholders who have caused the Stock Acquisition) to purchase, at the Right's then current exercise price, Common Stock (or, if the number of shares of authorized common stock is insufficient to permit the full exercise of the Rights, cash, property or other securities of the Company) having a formula value equal to twice the Right's exercise price. In addition, if at any time following a Stock Acquisition, (i) the Company is acquired in a merger or other business combination transaction in which the Company is not the surviving corporation, or (ii) 50% or more of the Company's assets or earnings power is sold or transferred, the Rights flip-over and each unexercised Right will entitle the holder to purchase, at the Right's then current exercise price, common shares of the successor having a formula value equal to twice the Right's exercise price. The Rights may be redeemed by the Company at any time prior to ten days following the date the Company's board becomes aware of a Stock Acquisition (which period may be extended by the Company's Board of Directors at any time while the Rights are still redeemable). Upon the occurrence of a flip-in or flip-over event, if the Rights are not redeemed, the Rights would result in substantial dilution to any person who has caused the Stock Acquisition or who attempts to merge or consolidate with the Company. As a result, the Rights may deter potential attempts to acquire control of the Company without the approval of the Company's Board of Directors.

NOTE 12 - STOCK REPURCHASE PLAN

In February 1997, the Company's Board of Directors authorized the repurchase on the open market of up to 10% of the shares of the Company's outstanding Common Stock at various times through February 1998, subject to compliance with applicable laws and regulations. On February 9, 1998, the Company's Board of Directors extended this authorization through February 9, 1999 and on February 9, 1999 further extended this authorization through February 28, 2000. The timing and amount of any repurchase is at the discretion of the Company's management. Repurchased shares are immediately cancelled. As of March 31, 1999, the Company has repurchased 92,500 shares at a cash cost of $518,000. The Company's management could, in the exercise of its judgment, decide not to effect any additional repurchases, or to repurchase fewer shares than authorized.

QUALITY SYSTEMS, INC.

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

ALLOWANCE FOR DOUBTFUL ACCOUNTS
(in thousands)

| Column A Description | Column B Balance at beginning of period | Column C - Additions (1) Charged to costs and expenses | Column C - Additions (2) Charged to other accounts | Column D Deductions | Column E Balance at end of Period |
|---|---|---|---|---|---|
| Fiscal Year Ended: | | | | | |
| March 31, 1999 | $ 521 | $ 954 | $ - | $ 721 | $ 754 |
| March 31, 1998 | 297 | 339 | - | 115 | 521 |
| March 31, 1997 | $ 126 | $ 171 | $ 85(I) | $ 85 | $ 297 |

(I)Acquired in connection with the purchase of Clinitec International, Inc. on May 17, 1996.

Exhibit 3.2.3

Exhibit 3.2.3

CERTIFICATE OF AMENDMENT OF BYLAWS.

The undersigned hereby certifies that she is the duly elected and acting Secretary of Quality Systems, Inc., a California corporation ("QSI"), and that the following amendment was duly adopted by the Board of Directors of QSI at a duly called and noticed meeting thereof, held on the ninth of September, 1998:

WHEREAS, Article III, Section 2 of the Bylaws of the Corporation currently provides that the authorized number of directors of the Corporation shall be not less than five (5) and not more than nine (9), with the exact number of directors having been fixed within those limits at six (6); and

WHEREAS, the exact number of directors, within the limits specified, may be altered from time to time by an amendment of the last sentence of Article III, Section 2 of the Bylaws duly adopted by the Board of Directors or the shareholders; and

WHEREAS, it is deemed to be advisable and in the best interests of this Corporation and its shareholders that this Board of Directors adopt an amendment to the last sentence of Article III, Section 2 of the Bylaws so as to increase the actual number of directors to seven (7) from six (6);

NOW, THEREFORE, BE IT RESOLVED, that the last sentence of Article III, Section 2 of the Bylaws of the Corporation be, and hereby is, amended to read in its entirety as follows:

"The exact number of directors shall be seven (7) until changed as provided in this Section 2."

and that the foregoing amendment has not been rescinded, modified or revoked and is in full force and effect.

Executed in Tustin, California this ninth day of September, 1998.

/s/ JANET M. RAZIN

Janet M Razin, Secretary

Exhibit 21

Exhibit 21

QUALITY SYSTEMS, INC.

List of Subsidiaries

1. Clinitec International, Inc., a California Corporation, is a wholly-owned subsidiary of Quality Systems, Inc.

2. MicroMed Healthcare Information Systems, Inc., a California Corporation, is a wholly-owned subsidiary of Quality Systems, Inc.

Exhibit 23.1

Exhibit 23.1

INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statements Number 2-82773, 33-31949, 333-63131 and 333-67115 on Form S-8 of our report dated May 28, 1999, appearing in this Annual Report on Form 10-K for Quality Systems, Inc. for the year ended March 31, 1999.

/s/ Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
Costa Mesa, California
June 7, 1999

Exhibit 27.1

| YEAR | YEAR |
|---|---|
| MAR-31-1999 | MAR-31-1998 |
| MAR-31-1999 | MAR-31-1998 |
| 14,196,000 | 16,107,000 |
| 245,000 | 973,000 |
| 12,488,000 | 9,946,000 |
| 0 | 0 |
| 772,000 | 1,328,000 |
| 28,720,000 | 28,928,000 |
| 4,039,000 | 3,635,000 |
| (2,256,000) | (1,845,000) |
| 40,218,000 | 40,916,000 |
| 10,554,000 | 13,475,000 |
| 0 | 0 |
| 0 | 0 |
| 0 | 0 |
| 62,000 | 60,000 |
| 29,602,000 | 27,381,000 |
| 40,218,000 | 40,916,000 |
| 18,875,000 | 20,273,000 |
| 33,816,000 | 31,216,000 |
| 0 | 0 |
| 15,834,000 | 13,509,000 |
| 17,098,000 | 25,757,000 |
| 0 | 0 |
| 0 | 0 |
| 1,297,000 | (7,079,000) |
| 713,000 | (2,463,000) |
| 584,000 | (4,616,000) |
| 0 | 0 |
| 0 | 0 |
| 0 | 0 |
| 584,000 | (4,616,000) |
| 0.09 | (0.77) |
| 0.09 | (0.77) |