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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended December 31, 2013**

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number: 001-12537**

**QUALITY SYSTEMS, INC.**

*(Exact name of registrant as specified in its charter)*

**California**

*(State or other jurisdiction of incorporation or organization)*

**18111 Von Karman Avenue, Suite 700, Irvine, California**

*(Address of principal executive offices)*

**95-2888568**

*(IRS Employer Identification No.)*

**92612**

*(Zip Code)*

**(949) 255-2600**

*(Registrant's telephone number, including area code)*

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

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

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

Large accelerated filer

Non-accelerated filer  *(Do not check if a smaller reporting company)*

Accelerated filer

Small reporting company

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

The number of outstanding shares of the Registrant's common stock as of January 27, 2014 was 60,210,487 shares.

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QUALITY SYSTEMS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

QUALITY SYSTEMS, INC.  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except per share data)  
(Unaudited)

	December 31, 2013	March 31, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 82,101	\$ 105,999
Restricted cash	4,079	5,488
Marketable securities	11,888	12,012
Accounts receivable, net	126,298	148,257
Inventories	928	710
Income taxes receivable	15,270	—
Deferred income taxes, net	12,181	12,140
Other current assets	12,048	12,720
<b>Total current assets</b>	<b>264,793</b>	<b>297,326</b>
Equipment and improvements, net	24,266	21,887
Capitalized software costs, net	40,267	39,781
Intangibles, net	35,006	27,550
Goodwill	72,107	45,761
Other assets	11,338	10,750
<b>Total assets</b>	<b>\$ 447,777</b>	<b>\$ 443,055</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,797	\$ 11,501
Deferred revenue	72,726	65,207
Accrued compensation and related benefits	13,692	11,915
Income taxes payable	—	1,480
Dividends payable	10,687	10,418
Other current liabilities	27,747	26,508
<b>Total current liabilities</b>	<b>129,649</b>	<b>127,029</b>
Deferred revenue, net of current	2,087	1,219
Deferred compensation	4,557	3,809
Other noncurrent liabilities	11,740	3,949
<b>Total liabilities</b>	<b>148,033</b>	<b>136,006</b>
Commitments and contingencies (Note 12)		
Shareholders' equity:		
Common stock \$0.01 par value; authorized 100,000 shares; issued and outstanding 60,210 and 59,543 shares at December 31, 2013 and March 31, 2013, respectively	602	595
Additional paid-in capital	193,960	179,743
Accumulated other comprehensive loss	(235)	(11)
Retained earnings	105,417	126,722
<b>Total shareholders' equity</b>	<b>299,744</b>	<b>307,049</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 447,777</b>	<b>\$ 443,055</b>

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

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(In thousands, except per share data)  
(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Software and hardware	\$ 14,114	\$ 21,899	\$ 45,648	\$ 71,463
Implementation and training services	5,046	7,266	19,430	27,847
System sales	19,160	29,165	65,078	99,310
Maintenance	39,763	39,463	118,684	116,746
Electronic data interchange services	16,637	15,209	49,874	44,056
Revenue cycle management and related services	16,178	15,015	47,660	43,902
Other services	17,116	15,658	48,168	44,920
Maintenance, EDI, RCM and other services	89,694	85,345	264,386	249,624
Total revenues	108,854	114,510	329,464	348,934
<b>Cost of revenue:</b>				
Software and hardware	27,398	4,660	37,111	16,055
Implementation and training services	7,466	7,221	21,572	23,873
Total cost of system sales	34,864	11,881	58,683	39,928
Maintenance	5,642	5,259	16,206	14,811
Electronic data interchange services	10,276	9,852	31,722	28,251
Revenue cycle management and related services	11,736	10,918	34,144	32,344
Other services	8,537	8,686	26,054	26,021
Total cost of maintenance, EDI, RCM and other services	36,191	34,715	108,126	101,427
Total cost of revenue	71,055	46,596	166,809	141,355
Gross profit	37,799	67,914	162,655	207,579
<b>Operating expenses:</b>				
Selling, general and administrative	36,864	35,532	110,538	110,045
Research and development costs	13,175	7,786	26,404	22,634
Amortization of acquired intangible assets	1,219	1,212	3,673	3,665
Impairment of goodwill and other assets	5,873	—	5,873	—
Total operating expenses	57,131	44,530	146,488	136,344
Income (loss) from operations	(19,332)	23,384	16,167	71,235
Interest income (expense), net	121	13	(53)	(14)
Other income (expense), net	18	(122)	(391)	(115)
Income (loss) before income taxes	(19,193)	23,275	15,723	71,106
Provision for (benefit of) income taxes	(6,606)	7,649	5,244	24,292
Net income (loss)	\$ (12,587)	\$ 15,626	\$ 10,479	\$ 46,814
<b>Other comprehensive income (loss):</b>				
Foreign currency translation (net of \$0 tax)	21	10	(172)	—
Unrealized loss on AFS securities (net of \$0 tax)	(51)	—	(51)	—
Comprehensive income (loss)	\$ (12,617)	\$ 15,636	\$ 10,256	\$ 46,814
<b>Net income (loss) per share:</b>				
Basic	\$ (0.21)	\$ 0.26	\$ 0.18	\$ 0.79
Diluted	\$ (0.21)	\$ 0.26	\$ 0.17	\$ 0.79
<b>Weighted-average shares outstanding:</b>				
Basic	60,173	59,400	59,823	59,343
Diluted	60,173	59,405	59,984	59,411
Dividends declared per common share	\$ 0.175	\$ 0.175	\$ 0.525	\$ 0.525

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

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)  
(Unaudited)

	Nine Months Ended December 31,	
	2013	2012
<b>Cash flows from operating activities:</b>		
Net income	\$ 10,479	\$ 46,814
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation	5,897	5,075
Amortization of capitalized software costs	9,353	7,261
Amortization of other intangibles	6,340	5,694
Provision for bad debts	2,791	4,324
Share-based compensation	1,832	1,966
Deferred income tax expense (benefit)	896	(1,255)
Excess tax benefit from share-based compensation	(62)	(75)
Change in fair value of contingent consideration	(384)	998
Impairment of goodwill and other assets	25,971	—
<b>Changes in assets and liabilities, net of amounts acquired:</b>		
Accounts receivable	23,451	(8,665)
Inventories	(174)	(197)
Income taxes receivable	(15,270)	715
Other current assets	2,478	(878)
Other assets	(1,444)	(1,543)
Accounts payable	(6,842)	1,285
Deferred revenue	2,585	(20,111)
Accrued compensation and related benefits	1,777	(3,275)
Income taxes payable	(701)	—
Other current liabilities	454	10,596
Deferred compensation	748	(43)
Other non-current liabilities	295	(3,965)
<b>Net cash provided by operating activities</b>	<b>70,470</b>	<b>44,721</b>
<b>Cash flows from investing activities:</b>		
Additions to capitalized software costs	(18,914)	(20,148)
Additions to equipment and improvements	(7,448)	(7,159)
Purchase of Mirth	(35,033)	—
Purchase of Poseidon	—	(2,033)
Purchase of Matrix	—	(5,073)
<b>Net cash used in investing activities</b>	<b>(61,395)</b>	<b>(34,413)</b>
<b>Cash flows from financing activities:</b>		
Excess tax benefit from share-based compensation	62	75
Proceeds from exercise of stock options	2,200	763
Dividends paid	(31,515)	(41,535)
Payment of contingent consideration related to acquisitions	(3,720)	(2,353)
<b>Net cash used in financing activities</b>	<b>(32,973)</b>	<b>(43,050)</b>
Net decrease in cash and cash equivalents	(23,898)	(32,742)
Cash and cash equivalents at beginning of period	105,999	134,444
<b>Cash and cash equivalents at end of period</b>	<b>\$ 82,101</b>	<b>\$ 101,702</b>

**QUALITY SYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)**  
(In thousands)  
(Unaudited)

	Nine Months Ended December 31,	
	2013	2012
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for income taxes, net of refunds	\$ 20,443	\$ 24,691
Effective September 9, 2013, the Company acquired Mirth in a transaction summarized as follows:		
Fair value of assets acquired	\$ 62,771	
Cash paid	(35,033)	
Common stock issued at fair value	(7,882)	
Fair value of contingent consideration	(13,307)	
Liabilities assumed	\$ 6,549	
Effective May 1, 2012, the Company acquired Poseidon in a transaction summarized as follows:		
Fair value of assets acquired		\$ 2,551
Cash paid		(2,033)
Purchase price holdback		(500)
Liabilities assumed		\$ 18
Effective April 16, 2012, the Company acquired Matrix in a transaction summarized as follows:		
Fair value of assets acquired		\$ 14,587
Cash paid		(5,073)
Common stock issued at fair value		(3,953)
Purchase price holdback		(853)
Fair value of contingent consideration		(2,862)
Fair value of non-compete agreement (liability)		(1,100)
Liabilities assumed		\$ 746

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

**QUALITY SYSTEMS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(In thousands, except shares and per share data)  
(Unaudited)

**1. Summary of Significant Accounting Policies**

**Principles of Consolidation.** The consolidated financial statements include the accounts of Quality Systems, Inc. and its wholly-owned subsidiaries, which consist of NextGen Healthcare Information Systems, LLC ("NextGen"), NextGen RCM Services, LLC, Opus Healthcare Solutions, LLC ("Opus"), ViaTrack Systems, LLC ("ViaTrack"), Matrix Management Solutions, LLC ("Matrix"), QSI Management, LLC and Quality Systems India Healthcare Private Limited ("QSIH") (collectively, the "Company"). Mirth Corporation ("Mirth") is included in the consolidated financial statements from the date of acquisition (September 9, 2013). All intercompany accounts and transactions have been eliminated.

**Basis of Presentation.** The accompanying unaudited consolidated financial statements as of December 31, 2013 and for the three and nine months ended December 31, 2013 and 2012 have been prepared in accordance with the requirements of Form 10-Q and Article 10 of the Securities and Exchange Commission Regulation S-X and therefore do not include all information and notes which would be presented were such consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). These consolidated financial statements should be read in conjunction with the audited consolidated financial statements presented in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2013. Amounts related to disclosures of March 31, 2013 balances within these interim consolidated financial statements were derived from the aforementioned Form 10-K. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the results of operations and cash flows for the periods presented. The results of operations for such interim periods are not necessarily indicative of results of operations to be expected for the full year.

References to amounts in the consolidated financial statement sections are in thousands, except shares and per share data, unless otherwise specified.

**Revenue Recognition.** The Company generates revenue from the sale of licensing rights to its software products directly to end-users and value-added resellers ("VARs"). The Company also generates revenue from sales of hardware and third-party software, implementation, training, electronic data interchange ("EDI"), post-contract support (maintenance) and other services, including revenue cycle management ("RCM"), performed for clients who license its products.

A typical system contract contains multiple elements of the above items. Revenue earned on software arrangements involving multiple elements is allocated to each element based on the relative fair values of those elements. The fair value of an element is based on vendor-specific objective evidence ("VSOE"). The Company limits its assessment of VSOE for each element to either the price charged when the same element is sold separately or the price established by management having the relevant authority to do so for an element not yet sold separately. VSOE calculations are updated and reviewed quarterly or annually depending on the nature of the product or service. The Company generally establishes VSOE for the related undelivered elements based on the bell-shaped curve method. VSOE is established on maintenance for the Company's largest clients based on stated renewal rates only if the rate is determined to be substantive and falls within the Company's customary pricing practices.

When evidence of fair value exists for the delivered and undelivered elements of a transaction, discounts for individual elements are aggregated and the total discount is allocated to the individual elements in proportion to the elements' fair value relative to the total contract fair value.

When evidence of fair value exists for the undelivered elements only, the residual method is used. Under the residual method, the Company defers revenue related to the undelivered elements in a system sale based on VSOE of fair value of each of the undelivered elements and allocates the remainder of the contract price net of all discounts to revenue recognized from the delivered elements. If VSOE of fair value of any undelivered element does not exist, all revenue is deferred until VSOE of fair value of the undelivered element is established or the element has been delivered.

Provided that fees are fixed or determinable and collection is considered probable, revenue from licensing rights and sales of hardware and third-party software is generally recognized upon physical or electronic shipment and transfer of title. In certain transactions where collection risk is high, the revenue is deferred until collection occurs or becomes probable. If the fee is not fixed or determinable, then the revenue recognized in each period (subject to application of other revenue recognition criteria) will be the lesser of the aggregate amounts due and payable or the amount of the arrangement fee that would have been recognized if the fees were being recognized using the residual method. Fees which are considered fixed or determinable at the inception of the Company's arrangements must be negotiated at the outset of an arrangement and generally be based on the specific volume of products to be delivered without being subject to change based on variable pricing mechanisms such as the number of units copied or distributed or the expected number of users.

Revenue from implementation and training services is recognized as the corresponding services are performed. Maintenance revenue is recognized ratably over the contractual maintenance period.

Contract accounting is applied where services include significant modification, development or customization.

The Company ensures that the following criteria have been met prior to recognition of revenue:



- the price is fixed or determinable;
- the customer is obligated to pay and there are no contingencies surrounding the obligation or the payment;
- the customer's obligation would not change in the event of theft or damage to the product;
- the customer has economic substance;
- the amount of returns can be reasonably estimated; and
- the Company does not have significant obligations for future performance in order to bring about resale of the product by the customer.

The Company has historically offered short-term rights of return in certain sales arrangements. If the Company is able to estimate returns for these types of arrangements, revenue is recognized, net of an allowance for returns, and these arrangements are recorded in the consolidated financial statements. If the Company is unable to estimate returns for these types of arrangements, revenue is not recognized in the consolidated financial statements until the rights of return expire, provided also, that all other criteria for revenue recognition have been met.

Revenue related to sales arrangements that include hosting or the right to use software stored on the Company's hardware is recognized in accordance to the same revenue recognition criteria discussed above only if the customer has the contractual right to take possession of the software without incurring a significant penalty and it is feasible for the customer to either host the software themselves or through another third-party. Otherwise, the arrangement is accounted for as a service contract in which the entire arrangement is deferred and recognized over the period that the hosting services are being performed.

From time to time, the Company offers future purchase discounts on its products and services as part of its sales arrangements. Such discounts that are incremental to the range of discounts reflected in the pricing of the other elements of the arrangement, that are incremental to the range of discounts typically given in comparable transactions, and that are significant, are treated as an additional element of the contract to be deferred. Amounts deferred related to future purchase options are not recognized until either the customer exercises the discount offer or the offer expires.

RCM service revenue is derived from services fees, which include amounts charged for ongoing billing and other related services, and are generally billed to the customer as a percentage of total collections. The Company does not recognize revenue for services fees until these collections are made, as the services fees are not fixed or determinable until such time.

Revenue is divided into two categories, "system sales" and "maintenance, EDI, RCM and other services." Revenue in the system sales category includes software license fees, third-party hardware and software and implementation and training services related to purchase of the Company's software systems. Revenue in the maintenance, EDI, RCM and other services category includes maintenance, EDI, RCM services, consulting services, annual third-party license fees, hosting services, Software as a Service ("SaaS") fees and other services revenue.

**Goodwill.** The Company tests goodwill for impairment annually during its first fiscal quarter, referred to as the annual test date. The Company will also test for impairment between annual test dates if an event occurs or circumstances change that would indicate the carrying amount may be impaired. Impairment testing for goodwill is performed at a reporting-unit level, which is defined as an operating segment or one level below an operating segment (referred to as a component). A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. An impairment loss would generally be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit.

During the quarter ended December 31, 2013, the Company recorded a charge of \$4,342 related to impairment of the goodwill at the Hospital Solutions Division, which reduced the amount of goodwill associated with the division to zero. See Note 4 for additional information.

**Intangible Assets.** Intangible assets consist of customer relationships, trade names and contracts and certain software technology. These intangible assets are recorded at fair value and are stated net of accumulated amortization. The Company currently amortizes the intangible assets over periods ranging from six months to nine years using a method that reflects the pattern in which the economic benefits of the intangible asset are consumed. The Company assesses the recoverability of intangible assets at least annually or whenever adverse events or changes in circumstances indicate that impairment may have occurred. If the future undiscounted cash flows expected to result from the use of the related assets are less than the carrying value of such assets, impairment has been incurred and a loss is recognized to reduce the carrying value of the intangible assets to fair value, which is determined by discounting estimated future cash flows.

During the quarter ended December 31, 2013, the Company recorded a charge of \$12,554 related to impairment of the customer relationships and software technology intangible assets at the Hospital Solutions Division, which reduced the net carrying value of such intangible assets associated with the division to zero. See Note 4 for additional information.

**Software Development Costs.** Development costs incurred in the research and development of new software products and enhancements to existing software products for external use are expensed as incurred until technological feasibility has been established. After technological feasibility is established, any additional external software development costs are capitalized and amortized on a straight-line basis over the estimated economic life of the related product, which is typically three years. The Company provides support services on the current and prior two versions of its software. Management performs an annual review of the estimated economic life and the recoverability of such capitalized software costs. If 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.

During the quarter ended December 31, 2013, the Company recorded a charge of \$9,075 related to the write down of capitalized software development costs at the Hospital Solutions Division, which reduced the net carrying amount of capitalized software costs associated with the division to zero. See Note 4 for additional information.

**Share-Based Compensation.** The following table shows total share-based compensation expense included in the consolidated statements of comprehensive income (loss) for the three and nine months ended December 31, 2013 and 2012:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
<b>Costs and expenses:</b>				
Cost of revenue	\$ 90	\$ 51	\$ 253	\$ 200
Research and development costs	100	76	231	209
Selling, general and administrative	517	456	1,348	1,557
Total share-based compensation	707	583	1,832	1,966
Income tax benefit	(233)	(174)	(585)	(621)
Decrease in net income	\$ 474	\$ 409	\$ 1,247	\$ 1,345

**Recent Accounting Standards.** New accounting pronouncements implemented by the Company during the current year or requiring implementation in future periods are discussed below or in the notes, where applicable.

In February 2013, the FASB issued Accounting Standards Update No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (ASU 2013-02)*. The new standard requires an entity to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income by component. The adoption of this guidance had no impact on the Company's consolidated financial statements, but may have an effect on the required disclosures for future reporting periods.

## 2. Fair Value Measurements

The following tables set forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis at December 31, 2013 and March 31, 2013:

	Balance at December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
<b>ASSETS</b>				
Cash and cash equivalents (1)	\$ 82,101	\$ 82,101	\$ —	\$ —
Restricted cash	4,079	4,079	—	—
Marketable securities (2)	11,888	11,888	—	—
	<u>\$ 98,068</u>	<u>\$ 98,068</u>	<u>\$ —</u>	<u>\$ —</u>
<b>LIABILITIES</b>				
Contingent consideration related to acquisitions	\$ 14,539	\$ —	\$ —	\$ 14,539
	<u>\$ 14,539</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 14,539</u>

	Balance at March 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
<b>ASSETS</b>				
Cash and cash equivalents (1)	\$ 105,999	\$ 105,999	\$ —	\$ —
Restricted cash	5,488	5,488	—	—
Marketable securities (2)	12,012	12,012	—	—
	<u>\$ 123,499</u>	<u>\$ 123,499</u>	<u>\$ —</u>	<u>\$ —</u>
<b>LIABILITIES</b>				
Contingent consideration related to acquisitions	\$ 5,336	\$ —	\$ —	\$ 5,336
	<u>\$ 5,336</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,336</u>

(1) Cash equivalents consists of money market funds.

(2) Marketable securities consist of fixed-income securities.

The Company's contingent consideration liability is accounted for at fair value on a recurring basis and is adjusted to fair value when the carrying value differs from fair value. Key assumptions include discount rates and probability-adjusted achievement of revenue and strategic targets that are not observable in the market. The categorization of the framework used to measure fair value of the contingent consideration liability is considered Level 3 due to the subjective nature of the unobservable inputs used. The fair values of the contingent consideration liability related to the acquisitions of Sphere Health Systems, Inc. ("Sphere"), IntraNexus, Inc. ("IntraNexus"), Matrix, and Mirth were estimated based on the probability of achieving certain business milestones and management's forecast of expected revenues.

The following table presents activity in the Company's financial assets and liabilities measured at fair value using significant unobservable inputs (Level 3), as of and for the nine months ended December 31, 2013:

	Total Liabilities
Balance as of April 1, 2013	\$ 5,336
Acquisitions (Note 3)	13,307
Earnout payments	(3,720)
Fair value adjustments	(384)
Balance as of December 31, 2013	<u>\$ 14,539</u>

#### **Non-Recurring Fair Value Measurements**

The Company has certain assets, including goodwill and other intangible assets, which are measured at fair value on a non-recurring basis and are adjusted to fair value only if an impairment charge is recognized. The categorization of the framework used to measure fair value of the assets is considered Level 3 due to the subjective nature of the unobservable inputs used. During the nine months ended December 31, 2013, there were no adjustments to fair value of such assets, except for the impairment charge related to the Hospital Solutions Division's goodwill and other assets (see Note 4) and the intangible assets acquired from Mirth as discussed in Note 3.

#### **3. Business Combinations**

On September 9, 2013, the Company acquired 100% of the outstanding capital stock of Mirth, a global leader in health information technology that helps clients achieve interoperability. The acquisition will enhance the Company's current enterprise interoperability initiatives and broaden its accountable and collaborative care, population health, disease management and clinical data exchange offerings. The preliminary Mirth purchase price totaled \$56,222, which includes share-based contingent consideration with an estimated fair value of \$13,307 payable over a three year period subject to achievement of certain strategic milestones. The goodwill arising from the acquisition of Mirth represents the opportunity for the Company to sell Mirth-powered health information technology solutions as a complement to its other products as well as other expected market participant synergies going forward and is expected to be deductible for income tax purposes over a period of 15 years. Mirth operates under the NextGen Division.

The Company accounted for the Mirth acquisition as a purchase business combination. The preliminary purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The fair values of acquired assets and liabilities assumed represent management's estimate of fair value and are considered preliminary. The estimated fair values may be further adjusted as additional information obtained about facts and circumstances that existed as of the acquisition date becomes available during the twelve-month period after the acquisition date ("measurement period"). Any changes in the values allocated to tangible

and identified intangible assets acquired and liabilities assumed during the measurement period may result in material adjustments to goodwill. During the third quarter of fiscal 2014, the Company recorded a \$0.2 million measurement period adjustment relating to a change in estimated working capital.

The estimated fair value of the acquired tangible and intangible assets and liabilities assumed were determined using multiple valuation approaches depending on the type of tangible or intangible asset acquired, including but not limited to the income approach, the excess earnings method and the relief from royalty method approach.

The total preliminary purchase price for the Mirth acquisition is summarized as follows:

	<b>Mirth</b>
Cash paid	\$ 35,033
Common stock issued at fair value	7,882
Contingent consideration	13,307
Total purchase price	<u>\$ 56,222</u>

The following table summarizes the preliminary purchase price allocation for the Mirth acquisition:

	<b>Mirth</b>
Fair value of the net tangible assets acquired and liabilities assumed:	
Current assets (including accounts receivable of \$4,283)	\$ 4,905
Equipment and improvements	828
Accounts payable and accrued liabilities	(747)
Deferred revenues	(5,802)
Total net tangible assets acquired and (liabilities) assumed	(816)
Fair value of identifiable intangible assets acquired:	
Trade name	1,350
Customer relationships	2,800
Software technology	22,200
Goodwill	30,688
Total identifiable intangible assets acquired	57,038
Total purchase price	<u>\$ 56,222</u>

The pro forma effects of the Mirth acquisition would not have been material to the Company's results of operations and are therefore not presented.

#### 4. Goodwill

The Company does not amortize goodwill as it has been determined to have an indefinite useful life.

Goodwill by division consists of the following:

	March 31, 2013	Acquisitions	Impairment	December 31, 2013
QSI Dental Division (1)	\$ 7,289	\$ —	\$ —	\$ 7,289
NextGen Division	1,840	30,688	—	32,528
Hospital Solutions Division	4,342	—	(4,342)	—
RCM Services Division	32,290	—	—	32,290
Total goodwill	<u>\$ 45,761</u>	<u>\$ 30,688</u>	<u>\$ (4,342)</u>	<u>\$ 72,107</u>

(1) QSI Dental Division goodwill is presented on a basis consistent with that of the management reporting structures within QSI. For the purposes of testing goodwill for impairment annually and as otherwise may be required; however, the QSI Dental Division goodwill is allocated to all business units that derive cash flows from the products associated with the acquired goodwill. For all periods presented in this report, the allocation resulted in substantially all of such goodwill being ascribed to the NextGen Division.

Approximately 70% of the goodwill balance as of December 31, 2013 is expected to be deductible for income tax purposes over the periods prescribed by the Internal Revenue Code ("IRC").

As reported in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2013, a goodwill impairment charge of \$17,400 was recognized during the fourth quarter of fiscal 2013 relating to the Hospital Solutions Division (the "Hospital reporting unit" or "Hospital"), which reduced the book value of goodwill associated with the division to \$4,342. At that time, although triggering events occurred for the potential impairment of intangible assets, management concluded there was no impairment to such assets.

During the third quarter of fiscal 2014, management identified additional factors, including a further decline in revenues and operating results, key management turnover and other qualitative indicators of potential impairment, which warranted a reassessment of the Hospital reporting unit's multi-year forecast. Based upon such reassessment, the Company concluded that it was more likely than not that the fair value of the Hospital reporting unit was less than its carrying amount. Accordingly, management re-evaluated the Hospital reporting unit's residual goodwill balance for potential impairment. In the course of such assessment, other long-term assets of the Hospital reporting unit were also evaluated for potential impairment as described below.

The Company performed step one of the goodwill impairment test to estimate the fair value of the Hospital reporting unit based on a discounted cash flow analysis considering various scenarios as well as market approach. The step one analysis indicated that the fair value of the Hospital reporting unit was lower than the carrying value. The failure of step one triggered step two of the impairment test, which required the Company to determine the implied fair value of the Hospital reporting unit's assets and liabilities in the same manner of determining such amounts in a business combination.

Based on the Company's assessment of the fair value of the Hospital reporting unit's assets and liabilities, the Company concluded that the net carrying amount of all assets and liabilities approximated their respective fair values, other than capitalized software development costs, customer relationships intangible assets and acquired software technology intangible assets. The capitalized software development costs and intangible assets were deemed to have zero fair value based on the following analysis:

- **Capitalized software development costs** - such costs represent the capitalized portion of research and development costs applicable to the Hospital reporting unit, net of cumulative amortization of such costs. Management performed an assessment of the recoverability of such capitalized software costs and determined that the capitalized amounts are not recoverable based on a negative net realizable value expected to be generated from the Hospital reporting unit's software. As a result, the remaining net capitalized software costs of \$9,075 were deemed to be impaired and were fully written off.
- **Intangible assets** - the Company determined that the acquired software technology intangible asset class represents the primary long-term asset of the Hospital reporting unit. The Company then estimated the expected future undiscounted cash flows associated with this asset class, including the residual value of other long-term assets of this business unit. Based upon such cash flow estimates, the Company deemed the customer relationships and acquired software technology intangible assets to have no fair value, and an impairment charge of \$12,554 was recognized to reduce the carrying value of this asset class to zero.

The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. As a result of the step two analysis, the Company concluded that the carrying value of goodwill exceeded the reporting unit's implied fair value and that the implied fair value of the goodwill balance was zero as of the measurement date. Accordingly, a goodwill impairment charge of \$4,342 was recognized to reduce the value of Hospital goodwill to zero as of December 31, 2013.

Key assumptions underlying the estimation of the fair value of the Hospital reporting unit include: a) the near-term continuation of recent results of operations for the Division, b) management's detailed reassessment of the strategies of the Hospital reporting unit and the actions required to achieve those strategies, and c) the technology roadmap pertinent to the Hospital reporting unit. The Company remains committed to the hospital market and continues to invest in implementation and training, infrastructure and support, customer service and software development. The Company intends to maintain the sufficiency of these investments while effectively managing the operating efficiencies of the Hospital reporting unit.

In aggregate, the Hospital reporting unit's impairment charge relating to goodwill, capitalized software development costs, customer relationships and acquired software technology intangible assets was \$25,971 for the third quarter of fiscal 2014, as summarized below:

	Goodwill	Intangible Assets	Capitalized Software Costs	Total
<b>Cost of revenue:</b>				
Software and hardware - Hospital Solutions Division	\$ —	\$ —	\$ 9,075	\$ 9,075
Software and hardware - unallocated corporate expenses	—	11,023	—	11,023
Total impairment in cost of revenue	—	11,023	9,075	20,098
<b>Operating expenses:</b>				
Impairment of goodwill and other assets - unallocated corporate expenses	4,342	1,531	—	5,873
Total impairment in operating expenses	4,342	1,531	—	5,873
Total impairment of goodwill and other assets	\$ 4,342	\$ 12,554	\$ 9,075	\$ 25,971

Although goodwill and acquired intangible assets are allocated to the Hospital Solutions Division for the purposes of impairment testing, such assets are deemed corporate assets and the related impairment charges for such assets are recorded as unallocated corporate expenses. The classification of the impairment charge between cost of revenue and operating expenses is consistent with the historic accounting for costs associated with each impaired asset class.

## 5. Intangible Assets

In connection with the Mirth acquisition, the Company recorded \$26,350 of intangible assets related to trade name, customer relationships and software technology. The Company is amortizing the trade name and customer relationships over five years and the software technology over seven years. The weighted average amortization period for the total amount of intangible assets acquired is 6.7 years.

Approximately 95% of the acquired intangible assets are expected to be deductible for income tax purposes over the periods prescribed by the IRC.

The Company's definite-lived intangible assets, other than capitalized software development costs, are summarized as follows:

	December 31, 2013			
	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Gross carrying amount	\$ 22,050	\$ 3,368	\$ 23,510	\$ 48,928
Accumulated amortization	(10,857)	(1,449)	(1,616)	(13,922)
Net intangible assets	\$ 11,193	\$ 1,919	\$ 21,894	\$ 35,006
	March 31, 2013			
	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Gross carrying amount	\$ 23,156	\$ 2,018	\$ 20,509	\$ 45,683
Accumulated amortization	(10,028)	(1,112)	(6,993)	(18,133)
Net intangible assets	\$ 13,128	\$ 906	\$ 13,516	\$ 27,550

Activity related to the intangible assets for the nine months ended December 31, 2013 and 2012 is summarized as follows:

	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Balance as of April 1, 2013	\$ 13,128	\$ 906	\$ 13,516	\$ 27,550
Acquisition	2,800	1,350	22,200	26,350
Amortization (1)	(3,204)	(337)	(2,799)	(6,340)
Impairment (2)	(1,531)	—	(11,023)	(12,554)
Balance as of December 31, 2013	\$ 11,193	\$ 1,919	\$ 21,894	\$ 35,006

	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Balance as of April 1, 2012	\$ 7,805	\$ 162	\$ 15,292	\$ 23,259
Acquisition	9,450	1,250	1,150	11,850
Amortization (1)	(3,075)	(424)	(2,195)	(5,694)
Balance as of December 31, 2012	\$ 14,180	\$ 988	\$ 14,247	\$ 29,415

(1) Amortization of the customer relationships and the trade name & contracts intangible assets is included in operating expenses and amortization of the software technology intangible assets is included in cost of revenue for software and hardware.

(2) Refer to Note 4 for details on the impairment charge recorded in the current period

The following table represents the remaining estimated amortization of definite-lived intangible assets as of December 31, 2013:

For the year ended March 31,		
2014 (remaining three months)		\$ 1,985
2015		7,171
2016		7,024
2017		6,553
2018		4,301
2019 and beyond		7,972
Total		\$ 35,006

## 6. Capitalized Software Costs

The Company's capitalized software development costs are summarized as follows:

	December 31, 2013	March 31, 2013
Gross carrying amount	\$ 98,587	\$ 94,676
Accumulated amortization	(58,320)	(54,895)
Net capitalized software costs	\$ 40,267	\$ 39,781

Activity related to net capitalized software costs for the nine months ended December 31, 2013 and 2012 is summarized as follows:

	2013	2012
Balance as of April 1	\$ 39,781	\$ 19,994
Capitalized	18,914	20,148
Amortization	(9,353)	(7,261)
Impairment (1)	(9,075)	—
Balance as of December 31	\$ 40,267	\$ 32,881

(1) Refer to Note 4 for details on the impairment charge recorded in the current period

The following table presents the remaining estimated amortization of capitalized software costs as of December 31, 2013. The estimated amortization is comprised of (i) amortization of released products and (ii) the expected amortization for products that are not yet available for sale based on their estimated economic lives and projected general release dates.

For the year ended March 31,	
2014 (remaining three months)	\$ 2,600
2015	10,200
2016	8,500
2017	8,300
2018	5,700
2019 and beyond	4,967
Total	<u>\$ 40,267</u>

## 7. Composition of Certain Financial Statement Captions

Accounts receivable include amounts related to maintenance and services that were billed but not yet rendered at each period end. Undelivered maintenance and services are included as a component of the deferred revenue balance on the accompanying consolidated balance sheets.

	December 31, 2013	March 31, 2013
Accounts receivable, gross	\$ 136,386	\$ 160,080
Allowance for doubtful accounts	(10,088)	(11,823)
Accounts receivable, net	<u>\$ 126,298</u>	<u>\$ 148,257</u>

Inventories are summarized as follows:

	December 31, 2013	March 31, 2013
Computer systems and components	\$ 928	\$ 710
Inventories	<u>\$ 928</u>	<u>\$ 710</u>

Equipment and improvements are summarized as follows:

	December 31, 2013	March 31, 2013
Computer equipment	\$ 36,224	\$ 31,633
Furniture and fixtures	9,251	8,416
Leasehold improvements	9,975	7,125
	55,450	47,174
Accumulated depreciation and amortization	(31,184)	(25,287)
Equipment and improvements, net	<u>\$ 24,266</u>	<u>\$ 21,887</u>

Current and non-current deferred revenue are summarized as follows:

	December 31, 2013	March 31, 2013
Maintenance	\$ 16,337	\$ 12,085
Implementation services	33,476	36,899
Annual license services	10,051	9,906
Undelivered software, subscriptions and other	12,862	6,317
Deferred revenue	<u>\$ 72,726</u>	<u>\$ 65,207</u>
Deferred revenue, net of current	<u>\$ 2,087</u>	<u>\$ 1,219</u>

Accrued compensation and related benefits are summarized as follows:

	December 31, 2013	March 31, 2013
Payroll, bonus and commission	\$ 4,805	\$ 3,842
Vacation	8,887	8,073
Accrued compensation and related benefits	<u>\$ 13,692</u>	<u>\$ 11,915</u>



Other current and non-current liabilities are summarized as follows:

	December 31, 2013	March 31, 2013
Contingent consideration and other liabilities related to acquisitions	\$ 8,241	\$ 8,426
Care services liabilities	4,079	5,488
Accrued consulting	2,766	2,602
Accrued EDI expense	2,506	1,452
Users group meeting deposits	2,236	—
Self insurance reserve	1,589	1,336
Accrued royalties	1,285	1,331
Deferred rent	911	689
Sales tax payable	464	869
Accrued travel	271	384
Outside commission payable	267	461
Customer deposits	60	262
Other accrued expenses	3,072	3,208
Other current liabilities	<u>\$ 27,747</u>	<u>\$ 26,508</u>
Contingent consideration and other liabilities related to acquisitions	\$ 6,798	\$ 1,382
Deferred rent	3,705	2,448
Income tax payable	1,237	—
Other liabilities	—	119
Other non-current liabilities	<u>\$ 11,740</u>	<u>\$ 3,949</u>

## 8. Income Taxes

The provision for (benefit of) income taxes for the three months ended December 31, 2013 and 2012 was approximately \$(6.6) million and \$7.6 million, respectively. The effective tax rates were 34.4% and 32.9% for the three months ended December 31, 2013 and 2012, respectively. The effective rate for the three months ended December 31, 2013 increased as compared to the same prior year period primarily due to the increase of the blended state effective tax rates and the non-deductible portion of the impairment charge, offset by the net benefit from the federal research and development tax credit and a benefit in qualified production activities deduction. The federal research and development tax credit statute expired on December 31, 2011, and in January 2013, was retroactively enacted through December 31, 2013.

The provision for income taxes for the nine months ended December 31, 2013 and 2012 was approximately \$5.2 million and \$24.3 million, respectively. The effective tax rates were 33.4% and 34.2% for the nine months ended December 31, 2013 and 2012, respectively. The effective rate for the nine months ended December 31, 2013 decreased as compared to the same prior year period due to a net benefit from the federal research and development tax credit and a benefit in qualified production activities deduction, offset by the non-deductible portion of the impairment charge. The federal research and development tax credit statute expired on December 31, 2011, and in January 2013, was retroactively enacted through December 31, 2013.

### *Uncertain tax positions*

As of December 31, 2013, the Company had recorded a liability of \$1.2 million for unrecognized tax benefits related to various federal, state and local income tax matters. If recognized, this amount would reduce the Company's effective tax rate. The tax liability for the nine months ended December 31, 2013 increased from the same prior year period by \$0.6 million due to additional local income tax contingent liability and certain tax positions related to acquired companies.

The Company is no longer subject to U.S. federal income tax examinations for tax years before 2012. With few exceptions, the Company is no longer subject to state income tax examinations for tax years before 2008. The Company does not anticipate that total unrecognized tax benefits will significantly change due to the settlement of audits or the expiration of statute of limitations within the next twelve months.

## 9. Earnings per Share

The Company provides presentation of "basic" and "diluted" earnings per share ("EPS"). Shares discussed below are in thousands.

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Net income (loss)	\$ (12,587)	\$ 15,626	\$ 10,479	\$ 46,814
Basic net income (loss) per share:				
Weighted-average shares outstanding — Basic	60,173	59,400	59,823	59,343
Basic net income (loss) per common share	\$ (0.21)	\$ 0.26	\$ 0.18	\$ 0.79
Net income (loss)	\$ (12,587)	\$ 15,626	\$ 10,479	\$ 46,814
Diluted net income (loss) per share:				
Weighted-average shares outstanding — Basic	60,173	59,400	59,823	59,343
Effect of potentially dilutive securities	—	5	161	68
Weighted-average shares outstanding — Diluted	60,173	59,405	59,984	59,411
Diluted net income (loss) per common share	\$ (0.21)	\$ 0.26	\$ 0.17	\$ 0.79

The computation of diluted net income per share does not include 1,386 and 1,347 options to acquire shares of common stock for the three and nine months ended December 31, 2013, respectively, because their inclusion would have an anti-dilutive effect on net income per share.

The computation of diluted net income per share does not include 1,250 and 1,027 options to acquire shares of common stock for the three and nine months ended December 31, 2012, respectively, because their inclusion would have an anti-dilutive effect on net income per share.

## 10. Share-Based Awards

### *Employee Stock Option Plans*

In September 1998, the Company's shareholders approved a stock option plan (the "1998 Plan") under which 8,000,000 shares of common stock were reserved for the issuance of options. The 1998 Plan provides that employees, directors and consultants of the Company may, at the discretion of the Board of Directors or a duly designated compensation committee, be granted options to purchase shares of common stock. The exercise price of each option granted was determined by the Board of Directors at the date of grant, and options under the 1998 Plan expire no later than 10 years from the grant date. Options granted will generally become exercisable in accordance with the terms of the agreement pursuant to which they were granted. Certain option grants to directors became exercisable three months from the date of grant. Upon an acquisition of the Company by merger or asset sale, each outstanding option may be subject to accelerated vesting under certain circumstances. The 1998 Plan terminated on December 31, 2007. As of December 31, 2013, there were 20,000 outstanding options related to the 1998 Plan.

In October 2005, the Company's shareholders approved a stock option and incentive plan (the "2005 Plan") under which 4,800,000 shares of common stock were reserved for the issuance of awards, including stock options, incentive stock options and non-qualified stock options, stock appreciation rights, restricted stock, unrestricted stock, restricted stock units, performance shares, performance units (including performance options) and other share-based awards. The 2005 Plan provides that employees, directors and consultants of the Company may, at the discretion of the Board of Directors or a duly designated compensation committee, be granted awards to acquire shares of common stock. The exercise price of each option award shall be determined by the Board of Directors at the date of grant in accordance with the terms of the 2005 Plan, and under the 2005 Plan awards expire no later than 10 years from the grant date. Options granted will generally become exercisable in accordance with the terms of the agreement pursuant to which they were granted. Upon an acquisition of the Company by merger or asset sale, each outstanding option may be subject to accelerated vesting under certain circumstances. The 2005 Plan terminates on May 25, 2015, unless terminated earlier by the Board of Directors. As of December 31, 2013, there were 1,364,101 outstanding options and 2,618,977 shares available for future grant related to the 2005 Plan.

A summary of stock option transactions during the nine months ended December 31, 2013 follows:

	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding, April 1, 2013	1,159,183	\$ 30.54	5.5	
Granted	469,000	18.76	7.5	
Exercised	(111,272)	19.78	0.6	\$ 142
Forfeited/Canceled	(132,810)	31.58	5.2	
Outstanding, December 31, 2013	<u>1,384,101</u>	\$ 27.75	6.1	\$ 1,210
Vested and expected to vest, December 31, 2013	<u>1,298,337</u>	\$ 27.86	6.0	\$ 1,109
Exercisable, December 31, 2013	<u>356,911</u>	\$ 32.29	4.6	\$ 3

The Company utilizes the Black-Scholes valuation model for estimating the fair value of share-based compensation with the following assumptions:

	Nine Months Ended December 31, 2013	Nine Months Ended December 31, 2012
Expected life	4.9 years	5.0 years
Expected volatility	43.4% - 43.7%	41.3% - 45.1%
Expected dividends	3.1% - 3.9%	2.4% - 4.0%
Risk-free rate	1.0% - 1.5%	0.7% - 0.8%

The weighted-average grant date fair value of stock options granted during the nine months ended December 31, 2013 and 2012 was \$5.19 and \$8.37 per share, respectively.

The Company issues new shares to satisfy option exercises. Based on historical experience of option cancellations, the Company has estimated an annualized forfeiture rate of 8.4% and 6.2% for employee options for the nine months ended December 31, 2013 and 2012, respectively, and 0.0% for director options for the nine months ended December 31, 2013 and 2012. Forfeiture rates are adjusted over the requisite service period when actual forfeitures differ, or are expected to differ, from the estimate.

During the nine months ended December 31, 2013, a total of 469,000 options to purchase shares of common stock were granted under the 2005 Plan at an exercise price equal to the market price of the Company's common stock on the date of grant. A summary of stock options granted under the 2005 Plan during fiscal years 2014 and 2013 is as follows:

Option Grant Date	Number of Shares	Exercise Price	Vesting Terms (1)	Expires
August 15, 2013	85,000	\$ 20.85	Five years	August 15, 2021
July 30, 2013	28,000	\$ 22.59	Five years	July 30, 2021
May 29, 2013	356,000	\$ 17.95	Five years	May 29, 2021
Fiscal year 2014 option grants	<u>469,000</u>			
January 23, 2013	40,000	\$ 19.00	Five years	January 23, 2021
November 5, 2012	5,000	\$ 17.68	Five years	November 5, 2020
September 25, 2012	20,000	\$ 18.42	Five years	September 25, 2020
May 24, 2012	346,000	\$ 29.17	Five years	May 24, 2020
May 24, 2012	30,000	\$ 29.17	Four years	May 24, 2020
May 23, 2012	115,500	\$ 29.45	Five years	May 23, 2020
Fiscal year 2013 option grants	<u>556,500</u>			

(1) Options vest in equal annual installments on each grant anniversary date commencing one year following the date of grant.

### Performance-Based Awards

On May 22, 2013, the Board of Directors approved its fiscal year 2014 equity incentive program for certain employees to be awarded options to purchase the Company's common stock. The maximum number of options available under the equity incentive program plan is 600,000, of which 210,000 are reserved for the Company's named executive officers and 390,000 for non-executive employees of the Company. Under the program, executive officers are eligible to receive cash bonuses and options based on meeting certain target increases in revenue, EPS and operating income growth for fiscal year 2014. Under the program, non-executive employees are eligible to receive options based on meeting certain target increases in revenue and EPS growth for fiscal year 2014 and the recommendations of senior management. The options shall be issued pursuant to the 2005 Plan, have an exercise price equal to the closing price of the Company's shares on the date of grant, a term of eight years and vesting in five equal annual installments commencing one year following the date of grant.

Compensation expense associated with the performance based awards under the Company's equity incentive plans are initially based on the number of options expected to vest after assessing the probability that certain performance criteria will be met. Cumulative adjustments are recorded quarterly to reflect subsequent changes in the estimated outcome of performance-related conditions. The Company utilized the Black-Scholes option valuation model with the assumptions below to calculate stock compensation expense related to the performance based awards. Stock compensation expense recorded for these awards was not significant for the nine months ended December 31, 2013 and 2012, respectively.

	Nine Months Ended December 31, 2013	Nine Months Ended December 31, 2012
Expected life	4.9 years	5.0 years
Expected volatility	37.7% - 43.5%	41.7% - 45.0%
Expected dividends	3.2% - 3.7%	2.5% - 4.0%
Risk-free rate	1.4% - 1.8%	0.6% - 0.7%

Non-vested stock option award activity, including employee stock options and performance-based awards, during the nine months ended December 31, 2013 is summarized as follows:

	Non-Vested Number of Shares	Weighted- Average Grant-Date Fair Value per Share
Outstanding, April 1, 2013	804,340	\$ 9.89
Granted	469,000	5.19
Vested	(113,340)	10.01
Forfeited/Canceled	(132,810)	9.80
Outstanding, December 31, 2013	<u>1,027,190</u>	<u>\$ 7.71</u>

As of December 31, 2013, \$5,986 of total unrecognized compensation costs related to stock options is expected to be recognized over a weighted-average period of 3.6 years. This amount does not include the cost of new options that may be granted in future periods or any changes in the Company's forfeiture percentage. The total fair value of options vested during the nine months ended December 31, 2013 and 2012 was \$1,134 and \$1,641, respectively.

### Restricted Stock

On May 22, 2013, the Board of Directors approved its 2014 Director Compensation Program, pursuant to which each non-employee director is to be awarded shares of restricted stock upon election or re-election to the Board of Directors. Additionally, as part of the 2014 equity incentive program, each executive officer received, as a component of his or her base salary, a grant of restricted stock. The shares of restricted stock are awarded under the 2005 Plan. Such shares of restricted stock vest in two equal, annual installments on the first and second anniversaries of the grant date and are nontransferable for one year following vesting. The weighted-average grant date fair value for the restricted stock was estimated using the market price of the common stock on the date of grant. The fair value of the restricted stock is amortized on a straight-line basis over the vesting period.

The Company recorded compensation expense related to restricted stock of approximately \$473 and \$450 for the nine months ended December 31, 2013 and 2012, respectively. Restricted stock activity for the nine months ended December 31, 2013 is summarized as follows:

	Number of Shares	Weighted- Average Grant-Date Fair Value per Share
Outstanding, April 1, 2013	30,385	\$ 27.09
Granted	57,324	20.75
Vested	(15,635)	30.38
Canceled	(3,000)	24.81
Outstanding, December 31, 2013	<u>69,074</u>	<u>\$ 20.93</u>

As of December 31, 2013, \$1,109 of total unrecognized compensation costs related to restricted stock is expected to be recognized over a weighted-average period of 1.6 years. This amount does not include the cost of new restricted stock that may be granted in future periods.

#### 11. Concentration of Credit Risk

The Company had cash deposits at U.S. banks and financial institutions which exceeded federally insured limits at December 31, 2013. The Company is exposed to credit loss for amounts in excess of insured limits in the event of non-performance by the institutions; however, the Company does not anticipate non-performance by these institutions.

#### 12. Commitments, Guarantees and Contingencies

##### *Commitments and Guarantees*

The Company's software license agreements include a performance guarantee that the Company's software products will substantially operate as described in the applicable program documentation for a period of 365 days after delivery. To date, the Company has not incurred any significant costs associated with its performance guarantee or other related warranties and does not expect to incur significant warranty costs in the future. Therefore, no accrual has been made for potential costs associated with these warranties. Certain arrangements also include performance guarantees related to response time, availability for operational use, and other performance-related guarantees. Certain arrangements also include penalties in the form of maintenance credits should the performance of the software fail to meet the performance guarantees. To date, the Company has not incurred any significant costs associated with these warranties and does not expect to incur significant warranty costs in the future. Therefore, no accrual has been made for potential costs associated with these warranties.

The Company has historically offered short-term rights of return in certain sales arrangements. If the Company is able to estimate returns for these types of arrangements and all other criteria for revenue recognition have been met, revenue is recognized and these arrangements are recorded in the consolidated financial statements. If the Company is unable to estimate returns for these types of arrangements, revenue is not recognized in the consolidated financial statements until the rights of return expire, provided also, that all other criteria of revenue recognition have been met.

Certain standard sales agreements contain a money back guarantee providing for a performance guarantee that is already part of the software license agreement as well as training and support. The money back guarantee also warrants that the software will remain robust and flexible to allow participation in the federal health incentive programs. The specific elements of the performance guarantee pertain to aspects of the software, which the Company has already tested and confirmed to consistently meet using the Company's existing software without any modifications or enhancements. To date, the Company has not incurred any costs associated with this guarantee and does not expect to incur significant costs in the future. Therefore, no accrual has been made for potential costs associated with this guarantee.

The Company's standard sales agreements contain an indemnification provision pursuant to which it shall indemnify, hold harmless, and reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any United States patent, any copyright or other intellectual property infringement claim by any third-party with respect to its software. As the Company has not incurred any significant costs to defend lawsuits or settle claims related to these indemnification agreements, the Company believes that its estimated exposure on these agreements is currently minimal. Accordingly, the Company has no liabilities recorded for these indemnification obligations.

##### *Hussein Litigation*

On October 7, 2013, a complaint was filed against the Company and certain of the Company's officers and directors in the Superior Court of the State of California for the County of Orange, captioned Ahmed D. Hussein v. Sheldon Razin, Steven Plochocki, Quality Systems, Inc. and Does 1-10, inclusive, No. 30-2013-00679600-CU-NP-CJC, by Ahmed Hussein, a former director and significant shareholder of the Company. The complaint generally alleges fraud and deceit, constructive fraud, negligent misrepresentation and breach of fiduciary duty in connection with statements made to the Company's shareholders regarding the Company's financial condition and projected future performance. The complaint

seeks actual damages, exemplary and punitive damages and costs. The Company believes that plaintiff's claims are without merit and intends to defend against them vigorously.

#### **Federal Securities Class Action**

On November 19, 2013, a complaint was filed against the Company and certain of the Company's officers and directors in the United States District Court for the Central District of California, captioned Deerfield Beach Police Pension Fund, individually and on behalf of all others similarly situated, v. Quality Systems, Inc., Steven T. Plochocki, Paul A. Holt and Sheldon Razin, No. SACV13-01818-CJC-JPRx, by the Deerfield Beach Police Pension Fund, a shareholder of the Company. The complaint is a putative class action filed on behalf of the shareholders of the Company other than the defendants. The complaint, which is substantially similar to the litigation described above under the caption "Hussein Litigation," generally alleges that statements made to the Company's shareholders regarding the Company's financial condition and projected future performance were false and misleading in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and that the individual defendants are liable for such statements because they are controlling persons under Section 20(a) of the Exchange Act. The complaint seeks compensatory damages, court costs and attorneys' fees. The Company believes that plaintiff's claims are without merit and intends to defend against them vigorously.

#### **Shareholder Derivative Litigation**

On January 24, 2014, a complaint was filed against the Company and certain of the Company's officers and current and former directors in the United States District Court for the Central District of California, captioned Timothy J. Foss, derivatively on behalf of himself and all others similarly situated, vs. Craig A. Barbarosh, George H. Bristol, James C. Malone, Peter M. Neupert, Morris Panner, D. Russell Pflueger, Steven T. Plochocki, Sheldon Razin, Lance E. Rosenzweig and Quality Systems, Inc., No. SACV14-00110-DOC-JPPx, by Timothy J. Foss, a shareholder of the Company. The complaint arises from the same allegations described above under the captions "Hussein Litigation" and "Federal Securities Class Action" and generally alleges breach of fiduciary duties, abuse of control and gross mismanagement by the Company's directors, in addition to unjust enrichment and insider selling by individual directors. The complaint seeks compensatory damages, restitution and disgorgement of all profits, court costs, attorneys' fees and implementation of enhanced corporate governance procedures. The Company believes that plaintiff's claims are without merit and intends to defend against them vigorously.

### **13. Operating Segment Information**

The Company has four reportable segments that are evaluated regularly by its chief decision making group (Chief Executive Officer, Chief Financial Officer and Chief Operating Officer) in deciding how to allocate resources and in assessing performance.

Operating segment data is as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
<b>Revenue:</b>				
QSI Dental Division	\$ 5,082	\$ 5,088	\$ 15,137	\$ 14,886
NextGen Division	83,881	85,757	250,117	259,277
Hospital Solutions Division	2,483	7,365	12,683	26,903
RCM Services Division	17,408	16,300	51,527	47,868
Consolidated revenue	<u>\$ 108,854</u>	<u>\$ 114,510</u>	<u>\$ 329,464</u>	<u>\$ 348,934</u>
<b>Operating income (loss):</b>				
QSI Dental Division	\$ 396	\$ 1,265	\$ 2,605	\$ 2,413
NextGen Division	22,614	30,906	82,600	93,643
Hospital Solutions Division (1)	(14,035)	(1,334)	(20,866)	(152)
RCM Services Division	2,486	2,090	8,012	5,732
Unallocated corporate expense (1)	(30,793)	(9,543)	(56,184)	(30,401)
Consolidated operating income (loss)	<u>\$ (19,332)</u>	<u>\$ 23,384</u>	<u>\$ 16,167</u>	<u>\$ 71,235</u>

(1) Refer to Note 4 for details on the impairment charge recorded in the current period

Management evaluates performance based upon stand-alone segment operating income. Because assets by segment are not reported to or used by the Company's chief decision making group to allocate resources, or to assess performance, total assets by segment are not disclosed.

Effective April 1, 2013, the Company reorganized certain overhead related departments to unallocated corporate expense from the operating segments in an effort to centralize shared services functions and to be consistent with disaggregated financial information used by the Company's chief decision making group. The Company concluded the impact of the reorganization to prior year operating income was not material to the operating segments or unallocated corporate expense and is therefore not restated.

### **14. Subsequent Events**

On January 22, 2014, the Board of Directors approved a quarterly cash dividend of \$0.175 per share on the Company's outstanding shares of common stock, payable to shareholders of record as of March 14, 2014 with an expected distribution date on or about April 4, 2014.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. All statements included or incorporated by reference in this Quarterly Report on Form 10-Q, other than statements that are purely historical, are forward-looking statements. Words such as "anticipate," "expect," "intend," "plan," "believe," "seek," "estimate," "will," "should," "would," "could," "may," and similar expressions also identify forward-looking statements. These forward-looking statements include, without limitation, discussions of our product development plans, business strategies, future operations, financial condition and prospects, developments in and the impacts of government regulation and legislation, including, without limitation, The American Recovery and Reinvestment Act ("ARRA") and The Patient Protection and Affordable Care Act, and market factors influencing our results. Our expectations, beliefs, objectives, intentions and strategies regarding our future results are not guarantees of future performance and are subject to risks and uncertainties, both foreseen and unforeseen, that could cause actual results to differ materially from results contemplated in our forward-looking statements. These risks and uncertainties include, but are not limited to, our 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 affect our ability to achieve our goals, and interested persons are urged to review any risks that may be described in "Item 1A. Risk Factors" as set forth herein and other risk factors appearing in our most recent Annual Report on Form 10-K for the fiscal year ended March 31, 2013 ("Annual Report"), as supplemented by additional risk factors, if any, in our interim filings on our Quarterly Reports on Form 10-Q, as well as in our other public disclosures and filings with the Securities and Exchange Commission ("SEC"). Because of these risk factors, as well as other variables affecting our financial condition and results of operations, past financial performance may not be a reliable indicator of future performance and historical trends should not be used to anticipate results or trends in future periods. We assume no obligation to update any forward-looking statements. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of the filing of this Quarterly Report on Form 10-Q.

This management's discussion and analysis of financial condition and results of operations ("MD&A") is provided as a supplement to the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q in order to enhance your understanding of our results of operations and financial condition and should be read in conjunction with, and is qualified in its entirety by, the consolidated financial statements and related notes thereto included elsewhere in this Quarterly Report on Form 10-Q. 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.

This MD&A contains certain non-GAAP (Generally Accepted Accounting Principles) financial measures which are provided only as supplemental information that may be useful to investors and management regarding the Company's financial condition and results. These non-GAAP measures, such as cash from net income (as adjusted), are not in accordance with or a substitute for, U.S. GAAP.

Our MD&A is organized as follows:

- *Management Overview.* This section provides a general description of our Company and operating segments, a discussion as to how we derive our revenue, background information on certain trends and developments affecting our Company, a summary of our acquisition transactions and a discussion on management's strategy for driving revenue growth.
- *Critical Accounting Policies and Estimates.* This section discusses those accounting policies that are considered important to the evaluation and reporting of our financial condition and results of operations, and whose application requires us to exercise subjective or complex judgments in making estimates and assumptions. In addition, all of our significant accounting policies, including our critical accounting policies, are summarized in Note 1, "Summary of Significant Accounting Policies," of our notes to consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.
- *Company Overview.* This section provides a more detailed description of our Company, its operating segments, and the products and services we offer.
- *Overview of Results of Operations and Results of Operations by Operating Divisions.* These sections provide our analysis and outlook for the significant line items on our consolidated statements of income, as well as other information that we deem meaningful to understand our results of operations on both a consolidated basis and an operating division basis.
- *Liquidity and Capital Resources.* This section provides an analysis of our liquidity and cash flows.
- *New Accounting Pronouncements.* This section provides a summary of the most recent authoritative accounting standards and guidance that have either been recently adopted by our Company or may be adopted in the future.



## Management Overview

Quality Systems, Inc. and its wholly-owned subsidiaries operate as four business divisions (each, a "Division") which are comprised of: (i) the QSI Dental Division, (ii) the NextGen Division, (iii) the Hospital Solutions Division (formerly Inpatient Solutions) and (iv) the RCM Services Division (formerly Practice Solutions). In fiscal year 2011, we opened a captive entity in India called Quality Systems India Healthcare Private Limited ("QSIH"). We primarily derive revenue by developing and marketing healthcare information systems that automate certain aspects of medical and dental practices, networks of practices such as physician hospital organizations ("PHOs") and management service organizations ("MSOs"), ambulatory care centers, community health centers and medical and dental schools along with comprehensive systems implementation, maintenance and support and add on complementary services such as revenue cycle management ("RCM") and electronic data interchange ("EDI"). Our systems and services provide our clients with the ability to redesign patient care and other workflow processes while improving productivity through the facilitation of managed access to patient information. Utilizing our proprietary software in combination with third-party hardware and software solutions, our products enable the integration of a variety of administrative and clinical information operations.

The turbulence in the worldwide economy has impacted almost all industries. While healthcare is not immune to economic cycles, we believe it is more heavily influenced by US-based regulatory and national health projects than by the economic cycles of our economy. The impact of the current economic conditions on our existing and prospective clients has been mixed. While we continue to see organizations that are doing fairly well operationally, some organizations, especially those with a large dependency on Medicaid populations, have been impacted by the challenging financial conditions faced by many state governments. Various factors have had, and are anticipated to continue to have, a meaningful impact on the U.S. healthcare industry, including the Obama Administration's broad healthcare reform efforts (particularly the HITECH portion of the American Recovery and Reinvestment Act and the Patient Protection and Affordable Care Act), the individual state responses to the government-requested Medicaid expansion to address new insureds, and the increasing focus of private businesses on moving their employee health benefit offerings to a more wellness-based health platform.

We have benefited and hope to continue to benefit from the increased demands on healthcare providers for greater efficiency and lower costs, financial incentives from the ARRA to physicians who adopt electronic health records, as well as increased adoption rates for electronic health records and other technology in the healthcare arena. We also believe that healthcare reform and the movement towards pay for performance/quality initiatives will also stimulate demand for robust electronic health record solutions as well as new health information technology solutions from bundled billing capabilities to patient engagement and population health management.

While we expect to benefit from the increasing demands for greater efficiency as well as government support for increased adoption of electronic health records, the market for physician based electronic health records software is becoming increasingly saturated while physician group practices are rapidly being consolidated by hospital, insurance payers and other entities. Hospital software providers are leveraging their position with their hospital customers to gain market share with hospital owned physician practices. Insurance providers and large physician groups are also consolidating physician offices creating additional opportunity for ambulatory software providers such as NextGen. Our strategy is to focus addressing upcoming needs of accountable care organizations around interoperability, patient engagements, population health, and data analytics.

In September 2013, we acquired Mirth Corporation ("Mirth"), an industry leader within the health information exchange ("HIE") market with technologies and services delivering vendor agnostic interoperability capability to the healthcare community. This acquisition also provides expanded capabilities around population health management and data analytics, which will be used as a foundation to continue enhancing our existing products as well as developing new product and service offerings for accountable care organizations.

We believe that our core strength lies in the central role our software products and services play in the delivery of healthcare by the primary physician in an ambulatory setting. We intend to remain at the forefront of upcoming new regulatory requirements including ICD-10 and meaningful use requirements for stimulus payments. We believe that the expanded requirements for continued eligibility for incentive payments under meaningful use rules will result in an expanded replacement market for electronic health records software. We intend to continue the development and enhancement of our software solutions to support healthcare reform and the transition from fee for service to pay for performance/quality initiatives such as accountable care organizations. Key elements of our future software development will be to expand our interoperability capabilities to enhance the competitiveness of our software offerings, continue to integrate our ambulatory and inpatient products, make our products more intuitive and easy to use, and to enhance our ability to deliver our software over the cloud with the latest technology.

We also want to continue investments in our infrastructure, including but not limited to adding new clients through maintaining and expanding sales, marketing and product development activities and expanding our relationship with existing clients through delivery of add-on and complementary products and services while continuing our gold-standard commitment of service in support of our client satisfaction programs. These investments in our infrastructure will continue while maintaining reasonable expense discipline. We believe that our growing customer base that is using our software on a daily basis is a strategic asset, and we intend to expand our product and service offerings towards this customer base in order to leverage this strategic asset.

## Critical Accounting Policies and Estimates

The discussion and analysis of our consolidated financial statements and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these

consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate estimates (including but not limited to those related to revenue recognition, uncollectible accounts receivable, capitalizable software development costs, intangible assets and self-insurance accruals) for reasonableness. We base our estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that may not be readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We describe our significant accounting policies in Note 2, "Summary of Significant Accounting Policies," of our Notes to Consolidated Financial Statements included in our Annual Report. We discuss our critical accounting policies and estimates in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of our Annual Report. There have been no material changes in our significant accounting policies or critical accounting policies and estimates since the end of fiscal year 2013.

## **Company Overview**

Quality Systems, Inc. was incorporated in California in 1974. Our principal offices are located at 18111 Von Karman Ave., Suite 700, Irvine, California, 92612. We operate on a fiscal year ending on March 31.

The Company was founded with an early focus on providing information systems to dental group practices. This focus area would later become the QSI Dental Division. In the mid-1980s, we capitalized on the increasing focus on medical cost containment and further expanded our information processing systems to serve the ambulatory market. In the mid-1990s, we made two acquisitions that accelerated our penetration of the ambulatory market and formed the basis for the NextGen Division. In the last few years, we acquired several companies, which operate under the Hospital Solutions Division, as part of our strategy to expand into the small and specialty hospital market. More recently, we acquired Mirth, which operates under the NextGen Division, and is expected to enhance our current enterprise interoperability initiatives and broaden our accountable and collaborative care, population health, disease management and clinical data exchange offerings. Today, we serve the dental, ambulatory, hospital and RCM services markets through our QSI Dental Division, NextGen Division, Hospital Solutions Division and RCM Services Division.

The Divisions have historically operated as stand-alone operations, with each Division maintaining its own distinct product lines, product platforms, development, implementation and support teams and branding. However, there are a growing number of customers who are simultaneously utilizing software or services from more than one of our Divisions. In an effort to encourage this cross selling of our products and services between Divisions, we are in the process of further integrating our ambulatory and inpatient products to provide a more robust and comprehensive platform to offer our customers. The Divisions also share the resources of our "corporate office," which includes a variety of accounting and other administrative functions.

In September 2012, we announced certain organizational changes to achieve greater efficiency and integration in our operations as well as to enhance our ability to cross sell products and services to our customers. The changes consolidated Sales, Marketing, Information Technology, and Software Development responsibilities into separate Company-wide roles. We also announced the hiring of a Chief Operating Officer, reporting directly to the Chief Executive Officer, responsible for the operations of the Company across all Divisions. We are continuing to evaluate the organizational structure of the Company with the objective to achieve greater synergies and further integration of our products and services.

The QSI Dental Division, NextGen Division and Hospital Solutions Division develop and market software that is designed to automate and streamline a number of the administrative functions required for operating a medical, dental, or hospital practice, such as patient scheduling and billing. It is important to note that since in both the medical and dental environments, practice management software systems have already been implemented by the vast majority of practices, we actively compete for the replacement market. These Divisions also develop and market software that automates patient records in physician practices, community health centers and hospital settings. In this patient records area of our business, we are typically competing to replace paper-based patient record alternatives as opposed to replacing previously purchased systems. The Hospital Solutions Division develops and markets financial management and billing software products, which perform administrative functions required for operating small and specialty hospitals as well as clinical offerings such as multi-disciplinary clinical documentation and computerized physician order entry. The RCM Services Division provides technology solutions and outsourcing services to cover the full spectrum of healthcare providers' RCM needs, with a primary focus on outsourced billing and collection services.

In January 2011, QSIH was formed in Bangalore, India to function as our India-based captive to offshore technology application development and business processing services. Our employee base in Bangalore has since grown to over 250 employees with a primary focus on software development activities.

We continue to pursue product and service enhancement initiatives within each of our Divisions. The majority of such expenditures are currently targeted to the product lines and client base of the NextGen Division.

The following table reflects our reported segment revenue and segment revenue growth by Division for the three and nine months ended December 31, 2013 and 2012:

	Segment Revenue Breakdown			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
QSI Dental Division	4.7%	4.4%	4.6%	4.3%
NextGen Division	77.0%	75.0%	76.0%	74.3%
Hospital Solutions Division	2.3%	6.4%	3.8%	7.7%
RCM Services Division	16.0%	14.2%	15.6%	13.7%
Consolidated	100.0%	100.0%	100.0%	100.0%

	Segment Revenue Growth			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
QSI Dental Division	(0.1)%	4.6 %	1.7 %	2.9%
NextGen Division	(2.2)%	(0.2)%	(3.5)%	6.7%
Hospital Solutions Division	(66.3)%	(25.8)%	(52.9)%	4.8%
RCM Services Division	6.8 %	35.0 %	7.6 %	27.0%
Consolidated	(4.9)%	1.5 %	(5.6)%	8.8%

**QSI Dental Division.** The QSI Dental Division, co-located with our corporate headquarters in Irvine, California, focuses on developing, marketing and supporting software suites sold to dental group organizations located throughout the United States. The QSI Dental Division sells additional licenses to its legacy products as existing clients expand their operations, and sells its Web-based SaaS model practice management and clinical software solutions to new customers. This software solution, QSIDental™ Web, is marketed primarily to multi-location dental group practices in which the QSI Dental Division has historically been a dominant player. Further, QSI Dental sells its Electronic Dental Chart in conjunction with NextGen PM ("Practice Management") and EHR ("Electronic Health Record") and is marketed as NextGen EDR ("Electronic Dental Record") to Federally Qualified Health Centers ("FQHC") and other safety net entities further defined below.

The QSI Dental Division participates jointly with the NextGen Division in providing software and services to safety-net clinics like FQHCs and other "safety net" health centers, including Public Health Centers, Community Health Centers, Free Clinics, as well as Rural and Tribal Health Centers. FQHCs are community-based organizations and are funded by the federal government, which provide medical and dental services to underprivileged and underserved communities. The Patient Protection and Affordable Care Act, which was signed into law in March 2010, reserved \$11 billion over a multi-year period for FQHCs, creating unprecedented opportunities for FQHCs growth and the formation of new FQHCs. When combined and used in tandem, NextGen EHR, NextGen EDR, and NextGen Practice Management provides a unique product in this marketplace - an integrated patient record accessible by both physicians and dentists. On May 3, 2013, NextGen EDR version 4.3 was ONC-ATCB certified by the Certification Commission for Health Information (CCHIT®) as a complete EHR and complies with all clinical quality measures for Eligible Providers. The additional software NextGen EDR version 4.3 relied on to demonstrate compliance was NextGen EHR version 5.8.

The QSI Dental Division's legacy practice management software suite uses a UNIX® operating system. Its Clinical Product Suite ("CPS") can be fully integrated with the client server-based practice management software offered from each of our Divisions. When integrated and delivered with the NextGen Practice Management solution, CPS is re-branded as NextGen EDR. CPS/EDR incorporates a wide range of clinical tools including, but not limited to, periodontal charting and digital imaging of X-ray and inter-oral camera images as part of the electronic patient record. The QSI Dental Division also develops, markets, and provides EDI services to dental practices, including electronic submission of claims to insurance providers as well as automated patient statements.

**NextGen Division.** The NextGen Division, with headquarters in Horsham, Pennsylvania and a significant location in Atlanta, Georgia, provides integrated clinical, financial and connectivity solutions for ambulatory and dental provider organizations. The NextGen Division's major product categories include the NextGen Ambulatory product suite and NextGen Community Connectivity.

The NextGen Ambulatory product suite streamlines patient care with standardized, real-time clinical and administrative workflows within a physician's practice, and major product categories include NextGen EHR, NextGen PM, NextGen Dashboard, NextGen Mobile, and NextGen NextPen. NextGen Community Connectivity consists of NextGen Health Information Exchange ("NextGen HIE," formerly Community Health Solution), NextGen Patient Portal ("NextMD.com"), and NextGen Health Quality Measures ("NextGen HQM"). The NextGen Division also

offers hosting services, NextGuard – Data Protection services, and consulting services, such as strategic governance models and operational transformation, technical consulting such as data conversions or interface development. The NextGen Division products utilize Microsoft Windows technology and can operate in a client-server environment as well as via private intranet, the Internet, or in an ASP environment. The NextGen Division also provides EDI services, which include electronic submission of claims to insurance providers as well as automated patient statements.

On September 9, 2013, we acquired Mirth, a global leader in health information technology that helps clients achieve interoperability. Operating results associated with Mirth products and services are included in the NextGen Division. The acquisition of Mirth will enhance our current enterprise interoperability initiatives and broaden our accountable and collaborative care, population health, disease management and clinical data exchange offerings. Mirth offers a wide variety of products and services utilized by both users of Mirth open code technology as well as a large base of domestic and international paying customers.

**Hospital Solutions Division.** The Hospital Solutions Division, with its primary location in Austin, Texas, provides integrated clinical, financial and connectivity solutions for rural, community and specialty hospitals. This Hospital Solutions Division also develops and markets an equivalent revenue cycle management and clinical information systems software products for the small and specialty hospital market, which perform the administrative functions required for operating hospitals.

In the last few years, we have acquired companies that were established developers of software and services for the inpatient market to operate under the Hospital Solutions Division. On May 1, 2012, we acquired The Poseidon Group ("Poseidon"), a provider of emergency department software. On July 26, 2011, we acquired CQI Solutions, Inc. ("CQI"), a provider of hospital systems for surgery management. On April 29, 2011, we acquired IntraNexus, Inc. ("IntraNexus"), a provider of Web-based integrated clinical and hospital information systems. On February 10, 2010, we acquired Opus Healthcare Solutions, LLC ("Opus"), a provider of Web-based clinical solutions to hospital systems and integrated health networks nationwide and on August 12, 2009 we acquired Sphere Health Systems, Inc. ("Sphere"), a provider of financial information systems to the small hospital inpatient market. These acquisitions are part of our long term strategy to expand in the small and specialty hospital market and to add new clients by taking advantage of cross selling opportunities between the ambulatory and inpatient markets.

**RCM Services Division.** The RCM Services Division, with locations in St. Louis, Missouri, North Canton, Ohio, South Jordan, Utah and Hunt Valley, Maryland, provides technology solutions and consulting services to cover the full spectrum of healthcare providers' RCM needs, from patient access through claims denials, with a primary focus on billing and collection services. The RCM Services Division combines a Web-delivered SaaS model and the NextGen PM software platform to execute its service offerings. Execution of the plan to transition our client base onto the NextGen platform is being implemented. On April 15, 2012, we acquired Matrix Management Solutions, LLC ("Matrix"). Since 1998, North Canton, Ohio-based Matrix, a value-added reseller for NextGen Healthcare, has provided RCM services, healthcare information technology solutions and training, implementation and support centered on NextGen technology, to its clients nationwide. The acquisition has enabled our RCM Services Division to expand its footprint among private and hospital-based physicians and groups by leveraging Matrix's RCM expertise.

## Overview of Our Results

- Consolidated revenue decreased 5.6% in the nine months ended December 31, 2013 as compared to the prior year period. The decrease reflects a 34.5% decline in system sales revenue, mitigated by 5.9% growth in recurring services revenue (i.e. maintenance, EDI, RCM and other services revenues).
- Consolidated gross profit as a percentage of revenue decreased to 49.4% for the nine months ended December 31, 2013 compared to 59.5% in the prior year period. The decline is primarily the result of \$20.1 million in impairment charges recorded to cost of software revenue in the current period, as well as a shift in the mix of revenue towards recurring services and a decline in the profit margin on system sales revenue due to a higher proportion of lower-margin implementation services. For the nine months ended December 31, 2013, recurring services revenue comprised 80.2% of consolidated revenue, as compared to 71.5% in the prior year period.
- Consolidated operating income decreased 77.3% in the nine months ended December 31, 2013 as compared to the prior year period primarily due to a 21.6% decrease in consolidated gross profit, of which 9.6% of the decrease relates to the \$20.1 million impairment charge recorded to cost of revenue. Additionally, operating income further decreased due to the \$5.9 million impairment charge recorded to operating expenses and a \$3.8 million increase in research and development costs as compared to the same prior year period.

## Impairment of Goodwill and Other Assets

As reported in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013, a goodwill impairment charge of \$17.4 million was recognized during the fourth quarter of fiscal 2013 relating to the Hospital Solutions Division (the "Hospital reporting unit" or "Hospital"), which reduced the book value of goodwill associated with the division to \$4.3 million. At that time, although triggering events occurred for the potential impairment of intangible assets, management concluded there was no impairment to such assets.

During the third quarter of fiscal 2014, management identified certain factors, including a further decline in revenues and operating results, key management turnover and other qualitative indicators of potential impairment, which warranted a reassessment of the Hospital reporting unit's multi-year forecast. Based upon such reassessment, we concluded that it was more likely than not that the fair value of the Hospital reporting unit was less than its carrying amount. Accordingly, management re-evaluated the Hospital reporting unit's residual goodwill balance for potential impairment. In the course of such assessment, other long-term assets of the Hospital reporting unit were also evaluated for potential impairment as described below.

We performed step one of the goodwill impairment test to estimate the fair value of the Hospital reporting unit based on a discounted cash flow analysis considering various scenarios as well as market approach. The step one analysis indicated that the fair value of the Hospital reporting unit was lower than the carrying value. The failure of step one triggered step two of the impairment test, which required that we determine the implied fair value of the Hospital reporting unit's assets and liabilities in the same manner of determining such amounts in a business combination.

Based on our assessment of the fair value of the Hospital reporting unit's assets and liabilities, we concluded that the net carrying amount of all assets and liabilities approximated their respective fair values, other than capitalized software development costs, customer relationships intangible assets and acquired software technology intangible assets. The capitalized software development costs and intangible assets were deemed to have zero fair value based on the following analysis:

- **Capitalized software development costs** - such costs represent the capitalized portion of research and development costs applicable to Hospital, net of cumulative amortization of such costs. Management performed an assessment of the recoverability of such capitalized software costs and determined that the capitalized amounts are not recoverable based on a negative net realizable value expected to be generated from the Hospital reporting unit's software. As a result, the remaining net capitalized software costs of \$9.1 million were deemed to be impaired and were fully written off.
- **Intangible assets** - we determined that the acquired software technology intangible asset class represents the primary long-term asset of the Hospital reporting unit. We then estimated the expected future undiscounted cash flows associated with this asset class, including the residual value of other long-term assets of this business unit. Based upon such cash flow estimates, we deemed the customer relationships and acquired software technology to have no fair value, and an impairment charge of \$12.6 million was recognized to reduce the carrying value of this asset class to zero.

The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. As a result of the step two analysis, we concluded that the carrying value of goodwill exceeded the Hospital reporting unit's implied fair value and that the implied fair value of the goodwill balance was zero as of the measurement date. Accordingly, a goodwill impairment charge of \$4.3 million was recognized to reduce the value of Hospital reporting unit's goodwill to zero as of December 31, 2013.

Key assumptions underlying the estimation of the fair value of the Hospital reporting unit include: a) the near-term continuation of recent results of operations for the Division, b) our detailed reassessment of the strategies of this Division and the actions required to achieve those strategies, and c) the technology roadmap pertinent to this Division. We remain committed to the hospital market and continue to invest in implementation and training, infrastructure and support, customer service and software development. We intend to maintain the sufficiency of these investments while effectively managing the operating efficiencies of the Hospital reporting unit.

In aggregate, the Hospital reporting unit's impairment charge relating to goodwill, capitalized software development costs, customer relationships and acquired software technology intangible assets was \$26.0 million for the third quarter of fiscal 2014, as summarized below (in thousands):

	Goodwill	Intangible Assets	Capitalized Software Costs	Total
<b>Cost of revenue:</b>				
Software and hardware - Hospital Solutions Division	\$ —	\$ —	\$ 9,075	\$ 9,075
Software and hardware - unallocated corporate expenses	—	11,023	—	11,023
Total impairment in cost of revenue	—	11,023	9,075	20,098
<b>Operating expenses:</b>				
Impairment of goodwill and other assets - unallocated corporate expenses	4,342	1,531	—	5,873
Total impairment in operating expenses	4,342	1,531	—	5,873
Total impairment of goodwill and other assets	\$ 4,342	\$ 12,554	\$ 9,075	\$ 25,971

Although goodwill and acquired intangible assets are allocated to the Hospital Solutions Division for the purposes of impairment testing, such assets are deemed corporate assets and the related impairment charges for such assets are recorded as unallocated corporate expenses. The classification of the impairment charge between cost of revenue and operating expenses is consistent with the historic accounting for costs associated with each impaired asset class.

### ***QSI Dental Division***

- QSI Dental Division revenue increased 1.7% in the nine months ended December 31, 2013. Divisional operating income (excluding unallocated corporate expenses) was \$2.6 million in the nine months ended December 31, 2013, an increase of 8.0% as compared to the same prior year period. The increase in operating income was primarily the result of a \$0.7 million reduction in selling, general and administrative expenses due to various cost saving initiatives in the current period. It should be noted that the QSI Dental Division's new software solution ("QSIDental Web") is being sold as a SaaS solution for which revenue is recognized over a longer period of time rather than upfront. Revenue recognized from QSIDental Web was not significant in the nine months ended December 31, 2013.
- The QSI Dental Division is well-positioned to sell to the FQHCs market and intends to continue leveraging the NextGen Division's sales force to sell its dental electronic medical records software to practices that provide both medical and dental services, such as FQHCs, which are receiving grants as part of the ARRA.
- Our goal for the QSI Dental Division is to maximize profit performance given the constraints represented by a relatively weak purchasing environment in the dental group practice market while taking advantage of opportunities with the new QSIDental Web product.

### ***NextGen Division***

- NextGen Division revenue decreased 3.5% in the nine months ended December 31, 2013, as compared to the same prior year period. This variance reflects a 28.8% decline in system sales revenue, mitigated by 8.2% growth in recurring service revenue, including an increase of 5.9% in maintenance, 14.1% in EDI revenue and 7.9% in other services revenue. System sales at the NextGen Division has declined in recent quarters partly as a result of greater penetration of EHR software among medium and large size practice groups. Consolidation of practice groups by hospitals has also put increased competitive pressure on the NextGen Division versus hospital based vendors.
- NextGen Division operating income (excluding unallocated corporate expenses) decreased by 11.8% in the nine months ended December 31, 2013, as compared to the same prior year period. The decrease in operating income is primarily the result of a decrease in total revenue, as well as the decline in gross profit due to a shift in the mix of revenue towards lower-margin recurring services revenue.
- Our acquisition of Mirth on September 9, 2013 added approximately \$3.2 million in revenue for the NextGen Division from the date of acquisition through December 31, 2013. During the same period, Mirth results did not significantly impact the NextGen Division's operating income.
- Our goals include taking maximum advantage of benefits related to the ARRA and continuing to further enhance our existing products, including continued efforts to maintain our status as a qualified vendor under the ARRA, expanding our software and service offerings supporting pay-for-performance initiatives around accountable care organizations, bringing greater ease of use and intuitiveness to our software products, expanding our interoperability capabilities, integrating our inpatient and ambulatory software products and further development and enhancements of our portfolio of specialty focused templates within our EHR software. We intend to remain at the forefront of upcoming new regulatory requirements, including ICD-10 and meaningful use requirements for stimulus payments. We believe that the expanded requirements for continued eligibility for incentive payments under meaningful use rules will result in an expanded replacement market for electronic health records software. We also intend to continue selling additional software and services to existing clients, expanding penetration of connectivity and other services to new and existing clients, and capitalizing on growth and cross selling opportunities within the RCM Services Division. We believe that our acquisition of Mirth will provide improved capabilities around interoperability and improved competitiveness in our markets, as well as providing new customers and expanded markets for the NextGen Division.
- The next significant versions of our ambulatory software products achieved general release during the quarter ended December 31, 2013. Combined with a trend towards shorter development cycles, we expect that these releases will result in lower rates of future capitalization and significantly higher rates of amortization relative to previously capitalized software development costs reflected in our recent historical operating results. Refer to Note 6, "Capitalized Software Costs" of our notes to the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for an estimate of future amortization of capitalized software costs as of December 31, 2013.
- The NextGen Division's growth is attributed to a strong brand name and reputation within a growing marketplace for electronic health records and investments in sales and marketing activities, including new marketing campaigns, trade show attendance and other expanded advertising and marketing expenditures. We have also recently expanded our relationship with certain value added resellers with significant resources both domestically and internationally.

### ***Hospital Solutions Division***

- Hospital Solutions Division revenue decreased 52.9% in the nine months ended December 31, 2013. Revenue was negatively impacted by a 79.2% decline in system sales, as well as lower maintenance revenue and higher accruals for anticipated sales credits.
- Divisional operating loss (excluding unallocated corporate expenses) was \$(20.9) million for the nine months ended December 31, 2013 as compared to \$(0.2) million for the same prior year period. The significant decline in operating results is primarily due to \$9.1 million out of the total \$26.0 million impairment charge recognized to this Division related to the write-off of capitalized software development costs.

- The Hospital Solutions Division has incurred losses in the last several quarters and is expected to continue to incur losses for the foreseeable future while we continue to invest in implementation and training, support, and development to support our customer base and maximize customer satisfaction. Our expectations about the future performance of this Division resulted in the full impairment of significant long-term assets of this Division as described above. Along with recording an impairment charge, we have also ceased capitalization and amortization of software development costs at this Division. For the last full quarter preceding the impairment, total capitalized software costs were approximately \$1.2 million and total amortization of previously capitalized amounts was approximately \$0.6 million.

#### ***RCM Services Division***

- RCM Services Division revenue increased 7.6% in the nine months ended December 31, 2013. The RCM Services Division benefited from organic growth achieved through cross selling RCM services to existing NextGen Division clients and well as new clients added during the nine months ended December 31, 2013.
- Operating income as a percentage of revenue increased to approximately 15.5% of revenue in the nine months ended December 31, 2013 versus 12.0% of revenue in the same prior year period primarily as a result of an increase in the RCM Services Division's revenue and gross profit compared to the prior year period.
- The Company believes that a significant opportunity exists to continue cross selling RCM services to existing customers. The portion of the NextGen Division's existing customers who are using the RCM Services Division's services is less than 10%. Management is actively pursuing efforts to achieve faster growth from expanded efforts to leverage the existing NextGen Division's sales force towards selling RCM services. We also believe that the increased complexity related to the billing and collections process, which goes into effect with ICD-10 in October of 2014, will create additional opportunities for our RCM Services Division.
- Actual and expected customer turnover may impact short term revenue for the division. However, we are encouraged by increased sales activity and a growing sales pipeline of RCM services.

#### ***Corporate expenses (costs unallocated to the operating segments)***

- Historically, amortization expense associated with customer relationships and acquired software technology intangible assets has been recorded as an unallocated corporate expense. As a result of the impairment of these intangible assets related to the Hospital Division, recent historical amortization expense of approximately \$0.9 million per quarter will no longer impact Corporate expenses.

As a result of the Mirth acquisition, we anticipate an increase in certain expenses as compared to our recent historical operating results, specifically:

- Amortization of acquired intangible assets - refer to Note 5, "Intangibles Assets" of our notes to the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for remaining estimated amortization of definite-lived intangible assets as of December 31, 2013.
- Acquisition related expenses (including fair value adjustments) - the preliminary purchase accounting valuation of the Mirth acquisition resulted in a discount of \$5.2 million related to share-based purchase consideration. Such discount is currently expected to be amortized over a three year period ending September 2016. This amortization will be reflected as a component of our selling, general and administrative operating expenses.

The following table sets forth, for the periods indicated, the percentage of net revenue represented by each item in our consolidated statements of income (loss) (certain percentages below may not sum due to rounding):

(Unaudited)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Software and hardware	13.0 %	19.1%	13.9%	20.5%
Implementation and training services	4.6	6.3	5.9	8.0
System sales	17.6	25.5	19.8	28.5
Maintenance	36.5	34.5	36.0	33.5
Electronic data interchange services	15.3	13.3	15.1	12.6
Revenue cycle management and related services	14.9	13.1	14.5	12.6
Other services	15.7	13.7	14.6	12.9
Maintenance, EDI, RCM and other services	82.4	74.5	80.2	71.5
Total revenues	100.0	100.0	100.0	100.0
<b>Cost of revenue:</b>				
Software and hardware	25.2	4.1	11.3	4.6
Implementation and training services	6.9	6.3	6.5	6.8
Total cost of system sales	32.1	10.4	17.8	11.4
Maintenance	5.2	4.6	4.9	4.2
Electronic data interchange services	9.4	8.6	9.6	8.1
Revenue cycle management and related services	10.8	9.5	10.4	9.3
Other services	7.8	7.6	7.9	7.5
Total cost of maintenance, EDI, RCM and other services	33.2	30.3	32.8	29.1
Total cost of revenue	65.3	40.7	50.6	40.5
Gross profit	34.7	59.3	49.4	59.5
<b>Operating expenses:</b>				
Selling, general and administrative	33.9	31.0	33.6	31.5
Research and development costs	12.1	6.8	8.0	6.5
Amortization of acquired intangible assets	1.1	1.1	1.1	1.1
Impairment of goodwill and other assets	5.4	0.0	1.8	0.0
Total operating expenses	52.5	38.9	44.5	39.1
Income (loss) from operations	(17.8)	20.4	4.9	20.4
Interest income (expense), net	0.1	0.0	0.0	0.0
Other income (expense), net	0.0	(0.1)	(0.1)	0.0
Income (loss) before income taxes	(17.7)	20.3	4.8	20.4
Provision for (benefit of) income taxes	(6.1)	6.7	1.6	7.0
Net income (loss)	(11.6)%	13.6%	3.2%	13.4%

#### **Comparison of the Three Months Ended December 31, 2013 and December 31, 2012**

**Net Income (Loss).** Our net loss for the three months ended December 31, 2013 was \$(12.6) million, or \$(0.21) per share, on both a basic and fully diluted basis. In comparison, we earned net income of \$15.6 million, or \$0.26 per share, on both a basic and fully diluted basis for the three months ended December 31, 2012. The change in net income (loss) for the three months ended December 31, 2013 was primarily attributed to the following:

- a 34.3% decline in consolidated system sales revenue related to a number of factors, including higher adoption rates by large physician groups resulting in a lower number of new opportunities, the consolidation of physician offices by hospitals and other large enterprises thereby reducing the number of potential opportunities, and an extension of the deadline to adopt stage two meaningful use requirements until calendar 2014.
- a decline in consolidated gross profit of \$30.1 million (44.3%) resulting from \$20.1 million in impairment charges recorded to cost of software revenue in the current period and the decrease in consolidated system sales, mitigated by a growth in gross profit of 18.7% for EDI revenue and 8.4% for RCM services revenue.



- a \$12.6 million (28.3%) increase in total operating expenses compared to the prior year period. This increase is primarily due to \$5.9 million in impairment charges recorded to operating expenses in the current period and a 69.2% increase in research and development expenses in the current period primarily due to the inclusion of a full quarter of research and development costs for Mirth and lower capitalized software costs resulting from the recent releases of the next versions of ambulatory software products.
- a reduction of \$14.3 million in the provision for income taxes, principally reflecting the net loss and deductibility of the impairment charge in the current period.

**Revenue.** Revenue for the three months ended December 31, 2013 decreased 4.9% to \$108.9 million from \$114.5 million for the three months ended December 31, 2012. NextGen Division revenue decreased 2.2% to \$83.9 million compared to \$85.8 million in the three months ended December 31, 2012, RCM Services Division revenue increased 6.8% to \$17.4 million from \$16.3 million, and the Hospital Solutions Division revenue decreased 66.3% during that same period to \$2.5 million from \$7.4 million. Revenue for the QSI Dental Division remained consistent compared to the same prior year period.

**System Sales.** Revenue earned from our company-wide sales of systems for the three months ended December 31, 2013 decreased 34.3% to \$19.2 million from \$29.2 million in the same prior year period.

The decrease in system sales was driven primarily by lower sales of software to both new and existing clients for both the NextGen and Hospital Solutions Divisions. For the NextGen Division, revenue from system sales decreased 25.3%, or \$6.2 million, to \$18.3 million during the three months ended December 31, 2013 from \$24.5 million during the same prior year period.

The following table breaks down our reported system sales into software, hardware and third-party software, and implementation and training services components on a consolidated and divisional basis for the three months ended December 31, 2013 and 2012 (in thousands):

	Software	Hardware, Third Party Software	Implementation and Training Services	Total System Sales
<b>Three Months Ended December 31, 2013</b>				
QSI Dental Division	\$ 650	\$ 382	\$ 256	\$ 1,288
NextGen Division	13,530	1,118	3,652	18,300
Hospital Solutions Division	(1,951)	287	1,138	(526)
RCM Services Division	98	—	—	98
Consolidated	\$ 12,327	\$ 1,787	\$ 5,046	\$ 19,160
<b>Three Months Ended December 31, 2012</b>				
QSI Dental Division	\$ 872	\$ 424	\$ 301	\$ 1,597
NextGen Division	18,174	943	5,407	24,524
Hospital Solutions Division	1,181	204	1,510	2,895
RCM Services Division	101	—	48	149
Consolidated	\$ 20,328	\$ 1,571	\$ 7,266	\$ 29,165

NextGen Division software license revenue decreased 25.6% in the three months ended December 31, 2013 versus the same period last year. The NextGen Division's software revenue accounted for 73.9% of divisional system sales revenue during the three months ended December 31, 2013 compared to 74.1% during the same period a year ago. Software license revenue continues to be an area of primary emphasis for the NextGen Division.

Hospital Solutions Division software license revenue decreased \$3.1 million in the three months ended December 31, 2013 versus the same period last year due to higher accruals for anticipated sales credits, combined with significantly lower software sales.

Our decline in software revenue was related to a number of factors including higher adoption rates by large physician groups which resulted in a smaller number of new opportunities, the consolidation of physician offices by hospitals and other large enterprises thereby reducing the number of potential opportunities, and an extension to the deadline to adopt stage two meaningful use requirements until calendar 2014.

We believe there are other trends which may positively impact future systems sales. Many of our existing large enterprise customers have plans to grow, which will create future revenue opportunities as these customers purchase additional software and services to support their growth plans. We also expect to benefit from the growth of a replacement market driven by an expected consolidation of electronic health records vendors. Finally, we believe many new opportunities will be created by the evolution of healthcare from a pay for services reimbursement model to a pay for performance model around the management of patient populations. Additionally, the Mirth acquisition provided us with new products and services around HIE and interoperability, which we intend to utilize to drive future growth. It is difficult to assess the relative impact as well as the timing of positive and negative trends, however, we believe we are well positioned to support the ever increasing need for healthcare information technology.

During the three months ended December 31, 2013, 6.1% of the NextGen Division's system sales revenue was represented by hardware and third-party software compared to 3.8% during same period a year ago. The number of clients who purchase hardware and third-party software and the dollar amount of hardware and third-party software revenue fluctuates each quarter depending on the needs of clients. The inclusion of hardware and third-party software in the NextGen Division's sales arrangements is typically at the request of our clients.

Implementation and training revenue related to system sales at the NextGen Division decreased 32.5% in the three months ended December 31, 2013 compared to the same prior year period primarily due to a decline in the amount of new system sales in the division. Implementation and training revenue related to system sales at the Hospital Solutions Division decreased 24.6%, in the three months ended December 31, 2013 as compared to the same prior year period. The amount of implementation and training services revenue is dependent on several factors, including timing of client implementations, the availability of qualified staff and the mix of services being rendered. It should be noted that we have experienced a decline in the level of systems sales in recent quarters which in turn have resulted in a decline in the amount of implementation services sold. We have not reduced our staffing levels in spite of the decline in revenue as we believe that the demand for services is going to increase especially as our customers implement the newest release of our core ambulatory software products, which support new ICD-10 billing requirements that are mandated to be effective October 2014.

**Maintenance, EDI, RCM and Other Services.** For the three months ended December 31, 2013, our company-wide revenue from maintenance, EDI, RCM and other services grew 5.1% to \$89.7 million from \$85.3 million in the same prior year period. The increase is primarily due to an increase in maintenance and EDI revenue from the NextGen Division and RCM revenue from the RCM Services Division.

Total NextGen Division maintenance revenue for the three months ended December 31, 2013 grew 4.8% to \$35.3 million from \$33.7 million for the same prior year period while NextGen Division EDI revenue grew 8.8% to \$15.2 million compared to \$14.0 million in the same prior year period. Other services revenue for the NextGen Division, which consists primarily of third-party annual software license renewals, consulting services, SaaS fees and hosting services, increased 11.1% to \$15.0 million in the three months ended December 31, 2013 from \$13.5 million in the same prior year period.

QSI Dental Division maintenance, EDI and other services revenue for the three months ended December 31, 2013 and 2012 was \$3.8 million and \$3.5 million, respectively. For the three months ended December 31, 2013, RCM revenue for the RCM Services Division increased to \$16.2 million compared to \$15.0 million in the same prior year period. For the Hospital Solutions Division, maintenance and other services revenue for the three months ended December 31, 2013 decreased 32.7% as compared to the same prior year period primarily due to a decrease in maintenance revenue primarily due to higher accruals for anticipated sales credits and decreases in the amount of maintenance services provided to existing customers.

The following table details maintenance, EDI, RCM and other services revenue by category on a consolidated and divisional basis for the three months ended December 31, 2013 and 2012 (in thousands):

	Maintenance	EDI	RCM	Other	Total
<b>Three Months Ended December 31, 2013</b>					
QSI Dental Division	\$ 2,090	\$ 1,328	\$ —	\$ 376	\$ 3,794
NextGen Division	35,343	15,242	—	14,996	65,581
Hospital Solutions Division	2,187	37	—	785	3,009
RCM Services Division	143	30	16,178	959	17,310
Consolidated	\$ 39,763	\$ 16,637	\$ 16,178	\$ 17,116	\$ 89,694
<b>Three Months Ended December 31, 2012</b>					
QSI Dental Division	\$ 1,963	\$ 1,170	\$ —	\$ 358	\$ 3,491
NextGen Division	33,726	14,005	—	13,502	61,233
Hospital Solutions Division	3,552	—	—	918	4,470
RCM Services Division	222	34	15,015	880	16,151
Consolidated	\$ 39,463	\$ 15,209	\$ 15,015	\$ 15,658	\$ 85,345

Maintenance revenue for the NextGen Division increased by \$1.6 million for the three months ended December 31, 2013 as compared to the same prior year period, primarily as a result of net additional licenses from both new and existing clients.

The NextGen Division's EDI revenue growth has come from new clients and from further penetration of the division's existing client base while the growth in RCM revenue is primarily attributable to organic growth. We intend to continue to promote maintenance, EDI and RCM services to both new and existing clients.

**Cost of Revenue.** Cost of revenue for the three months ended December 31, 2013 increased to \$71.1 million from \$46.6 million in the same prior year period and the cost of revenue as a percentage of revenue increased to 65.3% from 40.7%. The increase in the cost of revenue as a percentage of revenue is primarily due to \$20.1 million in impairment charges recorded to cost of software revenue in the current period, as well as a change in the mix of revenues toward recurring services revenue, which have historically experienced a lower profit margin than system sales, and a decrease in the margins on system sales due to a higher proportion of lower-margin implementation services.

The following table details revenue and cost of revenue on a consolidated and divisional basis for the three months ended December 31, 2013 and 2012 (in thousands):

	Three Months Ended December 31,			
	2013	%	2012	%
<b>QSI Dental Division</b>				
Revenue	\$ 5,082	100.0 %	\$ 5,088	100.0%
Cost of revenue	2,596	51.1 %	2,507	49.3%
Gross profit	\$ 2,486	48.9 %	\$ 2,581	50.7%
<b>NextGen Division</b>				
Revenue	\$ 83,881	100.0 %	\$ 85,757	100.0%
Cost of revenue	30,177	36.0 %	27,979	32.6%
Gross profit	\$ 53,704	64.0 %	\$ 57,778	67.4%
<b>Hospital Solutions Division</b>				
Revenue	\$ 2,483	100.0 %	\$ 7,365	100.0%
Cost of revenue	14,070	566.7 %	4,055	55.1%
Gross profit	\$ (11,587)	(466.7)%	\$ 3,310	44.9%
<b>RCM Services Division</b>				
Revenue	\$ 17,408	100.0 %	\$ 16,300	100.0%
Cost of revenue	12,130	69.7 %	11,384	69.8%
Gross profit	\$ 5,278	30.3 %	\$ 4,916	30.2%
Unallocated cost of revenue	\$ 12,082	N/A	\$ 671	N/A
<b>Consolidated</b>				
Revenue	\$ 108,854	100.0 %	\$ 114,510	100.0%
Cost of revenue	71,055	65.3 %	46,596	40.7%
Gross profit	\$ 37,799	34.7 %	\$ 67,914	59.3%

Gross profit margins for the NextGen Division, QSI Dental Division and the Hospital Solutions Division decreased for the three months ended December 31, 2013 compared to the same prior year period primarily due to a significant decrease in total system sales (consisting of software and hardware sales and training and implementation services). Additionally, the gross profit margin for both the Hospital Solutions Division and the unallocated cost of revenue include the impact of the impairment charge on current period cost of revenue, which totaled \$9.1 million and \$11.0 million, respectively. Gross profit margin for the RCM Services Division remained consistent compared to the same prior year period.

The following table details the individual components of cost of revenue and gross profit as a percentage of total revenue on a consolidated and divisional basis for the three months ended December 31, 2013 and 2012:

	Hardware, Third Party Software	Payroll and Related Benefits	EDI	Other	Total Cost of Revenue	Gross Profit
<b>Three Months Ended December 31, 2013</b>						
QSI Dental Division	5.5%	21.2%	13.6%	10.8%	51.1%	48.9 %
NextGen Division	1.2%	12.6%	10.5%	11.7%	36.0%	64.0 %
Hospital Solutions Division	13.2%	144.2%	0.8%	408.5%	566.7%	(466.7)%
RCM Services Division	0.0%	46.0%	0.6%	23.1%	69.7%	30.3 %
Consolidated	1.4%	21.4%	8.9%	33.6%	65.3%	34.7 %
<b>Three Months Ended December 31, 2012</b>						
QSI Dental Division	6.5%	19.7%	13.1%	10.0%	49.3%	50.7 %
NextGen Division	1.2%	12.6%	9.7%	9.1%	32.6%	67.4 %
Hospital Solutions Division	2.8%	32.8%	0.0%	19.5%	55.1%	44.9 %
RCM Services Division	0.0%	46.2%	0.7%	22.9%	69.8%	30.2 %
Consolidated	1.3%	19.0%	7.9%	12.5%	40.7%	59.3 %

During the three months ended December 31, 2013, hardware and third-party software constituted a slightly higher portion of cost of revenue compared to the same prior year period in the NextGen Division. The number of clients who purchase hardware and third-party software and the dollar amount of hardware and third-party software purchased fluctuates each quarter depending on the needs of our clients. Gross profit

for the Hospital Solutions Division decreased to (466.7)% for the three months ended December 31, 2013 as compared to 44.9% for the same prior year period primarily due to the current period impairment charge of \$9.1 million recorded to cost of revenue, as well as significant declines in system sales revenues, implementation and training, and maintenance gross profit. The change in maintenance gross profit was primarily a result of increased accruals for anticipated sales credits in the current period.

Our payroll and benefits expense associated with delivering our products and services increased to 21.4% of consolidated revenue in the three months ended December 31, 2013 compared to 19.0% during the same period last year. The absolute level of consolidated payroll and benefit expenses increased from \$21.7 million in the three months ended December 31, 2012 to \$23.3 million in the three months ended December 31, 2013. The increase is primarily due to a) a \$1.2 million increase in payroll and benefits expenses within the Hospital Solutions Division, resulting from increased headcount compared to the prior year period and b) a \$0.5 million increase within the RCM Services Division, as RCM is a service business which inherently has higher payroll costs as a percentage of revenue. The amount of share-based compensation expense included in cost of revenue was not significant for the three months ended December 31, 2013 and 2012.

Other cost of revenue, which primarily consists of third-party annual license, hosting costs and outsourcing costs, increased to 33.6% of total revenue during the three months ended December 31, 2013 as compared to 12.5% for the same period a year ago. Other expenses as a percentage of revenue increased significantly due to the impact of the current period impairment charge on cost of revenue, as well as the mix of other services revenue sold compared to the prior year period.

As a result of the foregoing events and activities, our gross profit percentage decreased to 34.7% for the three months ended December 31, 2013 versus 59.3% for the same prior year period.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the three months ended December 31, 2013 increased 3.8% to \$36.9 million as compared to \$35.5 million for the prior year period. The increase in these expenses is primarily due the inclusion of Mirth, which was acquired on September 9, 2013. The increase in selling, general and administrative expenses, including the impact of Mirth, consists primarily of:

- \$1.0 million increase in salaries and related benefit expenses
- \$0.5 million increase in sales commissions
- \$0.4 million increase in legal expenses
- \$0.7 million million increase in rent and other facilities costs; and
- \$0.9 million net increase in other selling and administrative expenses; partially offset by
- \$2.1 million decrease in bad debt expense as a result of improved collections and fewer customers with specific reserves for bad debt

Share-based compensation expense was approximately \$0.5 million for both the three months ended December 31, 2013 and 2012, and is included in the aforementioned amounts. Selling, general and administrative expenses as a percentage of revenue increased from 31.0% in the three months ended December 31, 2012 to 33.9% in the three months ended December 31, 2013.

**Research and Development Costs.** Research and development costs for the three months ended December 31, 2013 and 2012 were \$13.2 million and \$7.8 million, respectively. Research and development costs as a percentage of revenue increased to 12.1% in the three months ended December 31, 2013 from 6.8% for the prior year period. The increase in research and development expenses is primarily due to the reduction in capitalized software costs in the current period resulting from the recent releases of the next versions of ambulatory software products, the inclusion of a full quarter of research and development costs for Mirth, as well as the continued investment in enhancements to our specialty template development, preparation for ICD-10 requirements, new products including NextGen Knowledge Base Model ("KBM"), NextGen Mobile, NextGen NextPen, NextGen Community Connectivity consisting of NextGen HIE, NextGen Patient Portal ("NextMD.com"), and NextGen Health Quality Measures ("NextGen HQM"), and other enhancements to our existing products.

Additions to capitalized software costs offset increases in research and development costs. For the three months ended December 31, 2013 and 2012, our additions to capitalized software were \$3.6 million and \$6.0 million, respectively, as we continue to enhance our software to meet the Meaningful Use definitions under the ARRA as well as further integrate both ambulatory and inpatient products. The decrease in capitalized software is primarily due to the recent releases of the next versions of ambulatory software products as mentioned above, as well as the cessation of software development costs capitalization at the Hospital Solutions Division as a result of the recent impairment charge. For the three months ended December 31, 2013 and 2012, total research and development expenditures including costs expensed and costs capitalized was \$16.8 million and \$13.8 million, respectively. We intend to continue to invest heavily in research and development as we develop a new integrated inpatient and outpatient, web-based software platform as well as continue to bring additional functionality and features to the medical community. Share-based compensation expense included in research and development costs was not significant for the three months ended December 31, 2013 and 2012.

**Amortization of Acquired Intangible Assets.** Amortization included in operating expenses related to acquired intangible assets remained consistent at \$1.2 million for both the three months ended December 31, 2013 and 2012.

**Impairment of Goodwill and Other Assets.** Refer to "Overview of Our Results - Impairment of Goodwill and Other Assets" above for details on the \$26.0 million impairment charge recorded in the current period of which \$5.9 million was recorded to operating expenses and \$20.1 million was recorded to cost of software revenue.

**Interest and Other Income (Expense).** Total interest and other income (expense) was \$0.1 million and \$(0.1) million for the three months ended December 31, 2013 and 2012, respectively. Interest and other income (expense) consists primarily of dividends and interest earned on our investments along with foreign currency gains or losses for the period.

Our investment policy is determined by our Board of Directors. We currently maintain our cash in very liquid short term assets including tax exempt and taxable money market funds, Certificates of Deposit and short term Municipal Bonds with maturities of 365 days or less at the time of purchase. Our Board of Directors continues to review alternate uses for our cash including, but not limited to, payment of a special dividend, initiation of a stock buyback program, an expansion of our investment policy and other items. Additionally, it is possible that we will utilize some or all of our cash to fund acquisitions or other similar business activities. Any or all of these programs could significantly impact our investment income in future periods.

**Provision for (benefit of) Income Taxes.** The provision for (benefit of) income taxes for the three months ended December 31, 2013 and 2012 was \$(6.6) million and \$7.6 million, respectively. The effective tax rates were 34.4% and 32.9% for the three months ended December 31, 2013 and 2012, respectively. The effective rate for the three months ended December 31, 2013 increased as compared to the same prior year period primarily due the increase of the blended state effective tax rates and the non-deductible portion of the impairment charge, offset by the net benefit from the federal research and development tax credit and a benefit in qualified production activities deduction. The federal research and development tax credit statute expired on December 31, 2011, and in January 2013, was retroactively enacted through December 31, 2013.

#### **Comparison of the Nine Months Ended December 31, 2013 and December 31, 2012**

**Net Income.** Our net income for the nine months ended December 31, 2013 was \$10.5 million, or \$0.18 and \$0.17 per share, on a basic and fully diluted basis, respectively. In comparison, we earned \$46.8 million, or \$0.79 per share, on both a basic and fully diluted basis for the nine months ended December 31, 2012. The change in net income for the nine months ended December 31, 2013 was primarily attributed to the following:

- a 34.5% decline in consolidated system sales revenue related to a number of factors, including higher adoption rates by large physician groups resulting in a lower number of new opportunities, the consolidation of physician offices by hospitals and other large enterprises thereby reducing the number of potential opportunities, and an extension of the deadline to adopt stage two meaningful use requirements until calendar 2014.
- a decline in consolidated gross profit of \$44.9 million (21.6%) resulting from \$20.1 million in impairment charges recorded to cost of software revenue in the current period and the decrease in consolidated system sales, mitigated by a growth in gross profit of 14.8% for EDI and 16.9% for RCM services.
- a \$10.1 million (7.4%) increase in total operating expenses compared to the same prior year period. This increase is primarily due to \$5.9 million in impairment charges recorded to operating expenses in the current period and a 16.7% increase in research and development expenses in the current period primarily due to the inclusion of research and development costs for Mirth and lower capitalized software costs resulting from the recent releases of the next versions of ambulatory software products.
- a reduction of \$19.0 million in the provision for income taxes, principally reflecting a lower level of taxable income and the deductibility of the impairment charge in the current period.

**Revenue.** Revenue for the nine months ended December 31, 2013 decreased 5.6% to \$329.5 million from \$348.9 million for the nine months ended December 31, 2012. NextGen Division revenue decreased 3.5% to \$250.1 million from \$259.3 million in the nine months ended December 31, 2012, QSI Dental Division revenue increased 1.7% to \$15.1 million from \$14.9 million, RCM Services Division revenue increased 7.6% to \$51.5 million from \$47.9 million, and Hospital Solutions Division revenue decreased 52.9% to \$12.7 million from \$26.9 million in the same prior year period.

**System Sales.** Revenue earned from our company-wide sales of systems for the nine months ended December 31, 2013 decreased 34.5% to \$65.1 million from \$99.3 million in the same prior year period.

The decrease in system sales was due to both lower sales of software to both new and existing clients, as well as a decline in implementation revenue. NextGen Division sales in this category decreased 28.8%, or \$23.7 million, to \$58.6 million during the nine months ended December 31, 2013 from \$82.2 million during the same prior year period while the Hospital Solutions Division experienced a 79.2%, or \$9.9 million, decrease in category revenue to \$2.6 million in the nine months ended December 31, 2013 as compared to \$12.5 million in the same prior year period.

The following table breaks down our reported system sales into software, hardware and third-party software, and implementation and training services components on a consolidated and divisional basis for the nine months ended December 31, 2013 and 2012 (in thousands):

	Software	Hardware, Third Party Software	Implementation and Training Services	Total System Sales
<b>Nine Months Ended December 31, 2013</b>				
QSI Dental Division	\$ 1,641	\$ 984	\$ 990	\$ 3,615
NextGen Division	41,275	3,514	13,780	58,569
Hospital Solutions Division	(2,530)	470	4,660	2,600
RCM Services Division	294	—	—	294
Consolidated	\$ 40,680	\$ 4,968	\$ 19,430	\$ 65,078
<b>Nine Months Ended December 31, 2012</b>				
QSI Dental Division	\$ 1,654	\$ 1,285	\$ 1,085	\$ 4,024
NextGen Division	57,718	3,965	20,572	82,255
Hospital Solutions Division	5,593	919	5,991	12,503
RCM Services Division	327	2	199	528
Consolidated	\$ 65,292	\$ 6,171	\$ 27,847	\$ 99,310

NextGen Division software license revenue decreased 28.5% in the nine months ended December 31, 2013 versus the same period last year. The Division's software revenue accounted for 70.5% of divisional system sales revenue during the nine months ended December 31, 2013 compared to 70.2% during the same period a year ago. Software license revenue continues to be an area of primary emphasis for the NextGen Division.

Hospital Solutions Division software license revenue decreased \$8.1 million in the nine months ended December 31, 2013 versus the same period last year due to higher accruals for anticipated sales credits, combined with significantly lower software sales.

Our decline in software revenue was related to a number of factors including higher adoption rates by large physician groups which resulted in a smaller number of new opportunities, the consolidation of physician offices by hospitals and other large enterprises thereby reducing the number of potential opportunities, and an extension to the deadline to adopt stage two meaningful use requirements until calendar 2014.

We believe there are other trends which may positively impact future systems sales. Many of our existing large enterprise customers have plans to grow which will create future revenue opportunities as these customers purchase additional software and services to support their growth plans. We also expect to benefit from the growth of a replacement market driven by an expected consolidation of electronic health records vendors. Finally, we believe many new opportunities will be created by the evolution of healthcare from a pay for services reimbursement model to a pay for performance model around the management of patient populations. Additionally, the Mirth acquisition provided us with new products and services around HIE and interoperability, which we intend to utilize to drive future growth. It is difficult to assess the relative impact as well as the timing of positive and negative trends, however, we believe we are well positioned to support the ever increasing need for healthcare information technology.

During the nine months ended December 31, 2013, 6.0% of the NextGen Division's system sales revenue was represented by hardware and third-party software compared to 4.8% during the same period a year ago. The number of clients who purchase hardware and third-party software and the dollar amount of hardware and third-party software revenue fluctuates each quarter depending on the needs of clients. The inclusion of hardware and third-party software in the NextGen Division's sales arrangements is typically at the request of our clients.

Implementation and training revenue related to system sales at the NextGen Division decreased 33.0% in the nine months ended December 31, 2013 compared to the same prior year period. Implementation and training revenue related to system sales at the Hospital Solutions Division decreased 22.2%, in the nine months ended December 31, 2013 as compared to the same prior year period. The amount of implementation and training services revenue is dependent on several factors, including timing of client implementations, the availability of qualified staff and the mix of services being rendered. It should be noted that we have experienced a decline in the level of systems sales in recent quarters which in turn have resulted in a decline in the amount of implementation services sold. We have not reduced our staffing levels in spite of the decline in revenue as we believe that the demand for services is going to increase especially as our customers implement the newest release of our core ambulatory software products, which support new ICD-10 billing requirements that are mandated to be effective October 2014.

**Maintenance, EDI, RCM and Other Services.** For the nine months ended December 31, 2013, our company-wide revenue from maintenance, EDI, RCM and other services grew 5.9% to \$264.4 million from \$249.6 million in the same prior year period. The increase is primarily due to an increase in maintenance, EDI and other services revenue from the NextGen Division and RCM revenue from the RCM Services Division.

Total NextGen Division maintenance revenue for the nine months ended December 31, 2013 grew 5.9% to \$104.3 million from \$98.5 million for the same prior year period while NextGen Division EDI revenue grew 14.1% to \$45.6 million compared to \$40.0 million in the same prior year period. Other services revenue for the NextGen Division, which consists primarily of third-party annual software license renewals,

consulting services, SaaS fees and hosting services, increased 8.1% to \$41.7 million in the nine months ended December 31, 2013 from \$38.6 million in the same prior year period. Other services revenue benefited from a strong increase in consulting revenue to existing NextGen Division customers.

QSI Dental Division maintenance, EDI and other services revenue for the nine months ended December 31, 2013 and 2012 was \$11.5 million and \$10.9 million, respectively. For the nine months ended December 31, 2013, RCM revenue for the RCM Services Division grew \$3.8 million, or 8.6%, to \$47.7 million compared to \$43.9 million in the same prior year period. For the Hospital Solutions Division, maintenance and other services revenue for the nine months ended December 31, 2013 decreased 30.0% as compared to the same prior year period primarily due to a decrease in maintenance revenue primarily due to higher accruals for anticipated sales credits and decreases in the amount of maintenance services provided to existing customers.

The following table details maintenance, EDI, RCM and other services revenue by category on a consolidated and divisional basis for the nine months ended December 31, 2013 and 2012 (in thousands):

	Maintenance	EDI	RCM	Other	Total
<b>Nine Months Ended December 31, 2013</b>					
QSI Dental Division	\$ 6,275	\$ 4,104	\$ —	\$ 1,143	\$ 11,522
NextGen Division	104,264	45,591	—	41,693	191,548
Hospital Solutions Division	7,634	112	—	2,337	10,083
RCM Services Division	511	67	47,660	2,995	51,233
Consolidated	<u>\$ 118,684</u>	<u>\$ 49,874</u>	<u>\$ 47,660</u>	<u>\$ 48,168</u>	<u>\$ 264,386</u>
<b>Nine Months Ended December 31, 2012</b>					
QSI Dental Division	\$ 5,869	\$ 3,904	\$ —	\$ 1,089	\$ 10,862
NextGen Division	98,481	39,956	—	38,585	177,022
Hospital Solutions Division	11,778	—	—	2,622	14,400
RCM Services Division	618	196	43,902	2,624	47,340
Consolidated	<u>\$ 116,746</u>	<u>\$ 44,056</u>	<u>\$ 43,902</u>	<u>\$ 44,920</u>	<u>\$ 249,624</u>

Maintenance revenue for the NextGen Division increased by \$5.8 million for the nine months ended December 31, 2013 as compared to the same prior year period, primarily as a result of net additional licenses from both new and existing clients.

The NextGen Division's EDI revenue growth has come from new clients and from further penetration of the division's existing client base while the growth in RCM revenue is primarily attributable to organic growth. We intend to continue to promote maintenance, EDI and RCM services to both new and existing clients.

**Cost of Revenue.** Cost of revenue for the nine months ended December 31, 2013 increased 18.0% to \$166.8 million from \$141.4 million in the same prior year period and the cost of revenue as a percentage of revenue increased to 50.6% from 40.5%. The increase in the cost of revenue as a percentage of revenue is primarily due to \$20.1 million in impairment charges recorded to cost of software revenue in the current period, as well as a higher percentage of lower margin revenue streams such as EDI and RCM services, and slight cost increases across all revenue categories.

The following table details revenue and cost of revenue on a consolidated and divisional basis for the nine months ended December 31, 2013 and 2012 (in thousands):

	Nine Months Ended December 31,			
	2013	%	2012	%
<b>QSI Dental Division</b>				
Revenue	\$ 15,137	100.0 %	\$ 14,886	100.0%
Cost of revenue	7,551	49.9 %	7,556	50.8%
Gross profit	\$ 7,586	50.1 %	\$ 7,330	49.2%
<b>NextGen Division</b>				
Revenue	\$ 250,117	100.0 %	\$ 259,277	100.0%
Cost of revenue	87,449	35.0 %	85,326	32.9%
Gross profit	\$ 162,668	65.0 %	\$ 173,951	67.1%
<b>Hospital Solutions Division</b>				
Revenue	\$ 12,683	100.0 %	\$ 26,903	100.0%
Cost of revenue	22,697	179.0 %	12,835	47.7%
Gross profit	\$ (10,014)	(79.0)%	\$ 14,068	52.3%
<b>RCM Services Division</b>				
Revenue	\$ 51,527	100.0 %	\$ 47,868	100.0%
Cost of revenue	35,422	68.7 %	33,608	70.2%
Gross profit	\$ 16,105	31.3 %	\$ 14,260	29.8%
Unallocated cost of revenue	\$ 13,690	N/A	\$ 2,030	N/A
<b>Consolidated</b>				
Revenue	\$ 329,464	100.0 %	\$ 348,934	100.0%
Cost of revenue	166,809	50.6 %	141,355	40.5%
Gross profit	\$ 162,655	49.4 %	\$ 207,579	59.5%

Gross profit margins for the NextGen Division and the Hospital Solutions Division decreased for the nine months ended December 31, 2013 compared to the same prior year period primarily due to a significant decrease in total system sales (consisting of both software and hardware sales and training and implementation services). Additionally, the gross profit margin for both the Hospital Solutions Division and the unallocated cost of revenue include the impact of the impairment charge on current period cost of revenue, which totaled \$9.1 million and \$11.0 million, respectively. Gross profit margin in the QSI Dental Division and RCM Services Division increased for the nine months ended December 31, 2013 as compared to the same prior year period primarily due to improved recurring revenue profit margins during the current period.

The following table details the individual components of cost of revenue and gross profit as a percentage of total revenue on a consolidated and divisional basis for the nine months ended December 31, 2013 and 2012:

	Hardware, Third Party Software	Payroll and Related Benefits	EDI	Other	Total Cost of Revenue	Gross Profit
<b>Nine Months Ended December 31, 2013</b>						
QSI Dental Division	4.9%	20.8%	13.5%	10.7%	49.9%	50.1 %
NextGen Division	1.3%	12.4%	11.0%	10.3%	35.0%	65.0 %
Hospital Solutions Division	3.6%	68.5%	0.5%	106.4%	179.0%	(79.0)%
RCM Services Division	0.0%	44.7%	0.7%	23.3%	68.7%	31.3 %
Consolidated	1.3%	20.0%	9.1%	20.2%	50.6%	49.4 %
<b>Nine Months Ended December 31, 2012</b>						
QSI Dental Division	6.8%	19.8%	13.9%	10.3%	50.8%	49.2 %
NextGen Division	1.5%	11.9%	9.1%	10.4%	32.9%	67.1 %
Hospital Solutions Division	3.6%	24.3%	0.0%	19.8%	47.7%	52.3 %
RCM Services Division	0.0%	45.4%	1.0%	23.8%	70.2%	29.8 %
Consolidated	1.7%	17.8%	7.5%	13.5%	40.5%	59.5 %

During the nine months ended December 31, 2013, hardware and third-party software constituted a lower portion of cost of revenue compared to the same prior year period in the NextGen Division. The number of clients who purchase hardware and third-party software and the dollar amount of hardware and third-party software purchased fluctuates each quarter depending on the needs of our clients.



Our payroll and benefits expense associated with delivering our products and services increased to 20.0% of consolidated revenue in the nine months ended December 31, 2013 compared to 17.8% during the same period last year. The absolute level of consolidated payroll and benefit expenses grew from \$62.1 million in the nine months ended December 31, 2012 to \$65.8 million in the nine months ended December 31, 2013. The increase is primarily due to a) a \$2.1 million increase in payroll and benefits expenses within the Hospital Solutions Division, resulting from increased headcount compared to the prior year period and b) a \$1.3 million increase within the RCM Services Division, as RCM is a service business which inherently has higher payroll costs as a percentage of revenue. The amount of share-based compensation expense included in cost of revenue was not significant for nine months ended December 31, 2013 and 2012.

Other cost of revenue, which primarily consists of third-party annual license, hosting costs and outsourcing costs, increased to 20.2% of total revenue during the nine months ended December 31, 2013 as compared to 13.5% for the same period a year ago. Other expenses as a percentage of revenue increased significantly due to the impact of the current period impairment charge on cost of revenue, as well as the mix of other services revenue sold compared to the prior year period.

As a result of the foregoing events and activities, our gross profit percentage decreased to 49.4% for the nine months ended December 31, 2013 versus 59.5% for the same prior year period.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for the nine months ended December 31, 2013 increased 0.4% to \$110.5 million as compared to \$110.0 million for the prior year period. The slight increase in these expenses resulted primarily from:

- \$0.9 million increase in salaries and related benefit expenses
- \$0.6 million increase in proxy contest related expenses; and
- \$0.5 million net increase in other selling and administrative expenses; partially offset by
- \$1.5 million decrease in bad debt expense as a result of improved collections and fewer customers with specific reserves for bad debt

Share-based compensation expense was approximately \$1.3 million and \$1.6 million for the nine months ended December 31, 2013 and 2012, respectively, and is included in the aforementioned amounts. Selling, general and administrative expenses as a percentage of revenue increased from 31.5% in the nine months ended December 31, 2012 to 33.6% in the nine months ended December 31, 2013.

**Research and Development Costs.** Research and development costs for the nine months ended December 31, 2013 and 2012 were \$26.4 million and \$22.6 million, respectively. Research and development costs as a percentage of revenue increased to 8.0% in the nine months ended December 31, 2013 from 6.5% for the prior year period. The increase in research and development expenses is primarily due to the reduction in capitalized software costs in the current year period resulting from the recent releases of the next versions of ambulatory software products, the inclusion of research and development costs for Mirth, as well as the continued investment in enhancements to our specialty template development, preparation for ICD-10 requirements, new products including NextGen KBM, NextGen Mobile, NextGen NextPen, NextGen Community Connectivity consisting of NextGen HIE, NextMD.com, and NextGen HQM, and other enhancements to our existing products.

Additions to capitalized software costs offset increases in research and development costs. For the nine months ended December 31, 2013 and 2012, our additions to capitalized software were \$18.9 million and \$20.1 million, respectively, as we continue to enhance our software to meet the Meaningful Use definitions under the ARRA as well as further integrate both ambulatory and inpatient products. The decrease in capitalized software is primarily due to the recent releases of the next versions of ambulatory software products as mentioned above, as well as the cessation of software development costs capitalization at the Hospital Solutions Division as a result of the recent impairment charge. For the nine months ended December 31, 2013 and 2012, total research and development expenditures including costs expensed and costs capitalized was \$45.3 million and \$42.7 million, respectively. We intend to continue to invest heavily in research and development expenses as we develop a new integrated inpatient and outpatient, web-based software platform as well as continue to bring additional functionality and features to the medical community. Share-based compensation expense included in research and development costs was not significant for the nine months ended December 31, 2013 and 2012.

**Amortization of Acquired Intangible Assets.** Amortization included in operating expenses related to acquired intangible assets remained consistent at \$3.7 million for both the nine months ended December 31, 2013 and 2012.

**Impairment of Goodwill and Other Assets.** Refer to "Overview of Our Results - Impairment of Goodwill and Other Assets" above for details on the \$26.0 million impairment charge recorded in the current period of which \$5.9 million was recorded to operating expenses and \$20.1 million was recorded to cost of software revenue.

**Interest and Other Income (Expense).** Total interest and other expense was \$(0.4) million and \$(0.1) million for the nine months ended December 31, 2013 and 2012, respectively. Interest and other income consist primarily of dividends and interest earned on our investments along with foreign currency gains or losses for the period.

**Provision for Income Taxes.** The provision for income taxes for the nine months ended December 31, 2013 and 2012 was \$5.2 million and \$24.3 million, respectively. The effective tax rate was 33.4% and 34.2% for the nine months ended December 31, 2013 and 2012, respectively. The effective rate for the nine months ended December 31, 2013 decreased as compared to the same prior year period due to a

net benefit from the federal research and development tax credit and a benefit in qualified production activities deduction, offset by the non-deductible portion of the impairment charge. The federal research and development tax credit statute expired on December 31, 2011, and in January 2013, was retroactively enacted through December 31, 2013.

### Liquidity and Capital Resources

The following table presents selected financial statistics and information for the nine months ended December 31, 2013 and 2012 (dollar amounts in thousands):

	Nine Months Ended December 31,	
	2013	2012
Cash and cash equivalents and marketable securities	\$ 93,989	\$ 106,689
Net decrease in cash and cash equivalents and marketable securities	\$ (24,022)	\$ (32,742)
Net income	\$ 10,479	\$ 46,814
Net cash provided by operating activities	\$ 70,470	\$ 44,721
Number of days of sales outstanding (1)	106	121

(1) Days sales outstanding is equal to net accounts receivable divided by average daily revenue.

### Cash Flows from Operating Activities

Cash provided by operations has historically been our primary source of cash and has primarily been driven by our net income as adjusted to exclude non-cash expenses, such as impairment charges, depreciation, amortization of intangibles and capitalized software costs, provisions for bad debts and inventory obsolescence, share-based compensation, changes in fair value of contingent consideration and deferred taxes.

The following table summarizes our consolidated statements of cash flows for the nine months ended December 31, 2013 and 2012 (in thousands):

	Nine Months Ended December 31,	
	2013	2012
Net income	\$ 10,479	\$ 46,814
Non-cash expenses	52,634	23,988
Cash from net income (as adjusted)	63,113	70,802
Change in accounts receivable	23,451	(8,665)
Change in other assets and liabilities	(16,094)	(17,416)
Net cash provided by operating activities	\$ 70,470	\$ 44,721

Net cash provided by operating activities for the nine months ended December 31, 2013 and 2012 was approximately \$70.5 million and \$44.7 million, respectively. The majority of our cash from operations for the nine months ended December 31, 2013 is the result of a \$23.5 million decrease in accounts receivable and a \$4.2 million reduction in net income taxes paid, offset slightly by cash from net income and changes in other assets and liabilities. The increase in cash flows attributable to accounts receivable activity is primarily due to an additional emphasis on working capital management in the current period as reflected by a reduction of days sales outstanding ("DSO") in comparison to the prior year period. Specifically, DSO decreased to 106 days for the three months ended December 31, 2013, as compared to 121 days in the same prior year period.

Based on our results for the nine months ended December 31, 2013, we anticipate being able to continue generating significant cash from operations for the remainder of fiscal year 2014.

### Cash Flows from Investing Activities

Net cash used in investing activities for the nine months ended December 31, 2013 and 2012 was approximately \$61.4 million and \$34.4 million, respectively. The \$27.0 million increase in net cash used in investing activities is primarily due to \$35.0 million of cash paid for the acquisition of Mirth in the current period, partially offset by \$7.1 million net cash paid for the acquisitions of Matrix and Poseidon in the same prior year period.

### Cash Flows from Financing Activities

Net cash used in financing activities for the nine months ended December 31, 2013 and 2012 was \$33.0 million and \$43.1 million, respectively. During the nine months ended December 31, 2013, we received proceeds of \$2.2 million from the exercise of stock options, paid \$31.5 million in dividends to shareholders and paid \$3.7 million in contingent consideration related to acquisitions compared to proceeds of \$0.8 million from the exercise of stock options, payment of \$41.5 million in dividends to shareholders and payment of \$2.4 million in contingent consideration related to acquisitions during the same prior year period.

Further, we recorded a reduction in our tax benefit from share-based compensation of \$0.1 million for both the nine months ended December 31, 2013 and 2012 related to tax deductions received from stock option exercises. The benefit was recorded as additional paid in capital.

### **Cash and Cash Equivalents and Marketable Securities**

At December 31, 2013, we had combined cash and cash equivalents and marketable securities totaling \$94.0 million, reflecting a decrease of \$24.0 million from the comparable balance as of March 31, 2013. This decrease principally reflects the \$35.0 million expended for the purchase of Mirth in September 2013, mitigated by the continued decrease in DSO and emphasis on working capital management in the current year.

We may use a portion of our cash, cash equivalents and marketable securities towards future acquisitions, although the timing and amount of funds to be used has not been determined. We intend to expend some of these funds for the development of products complementary to our existing product line as well as new versions of certain of our products. These developments are intended to take advantage of more powerful technologies and to increase the integration of our products. Such expenditures will be funded from cash on hand and cash flows from operations.

In January 2007, our Board of Directors adopted a policy whereby we intend to pay a regular quarterly dividend on our outstanding common stock, subject to further review and approval and the establishment of record and distribution dates by our Board of Directors prior to the declaration of each such quarterly dividend. We anticipate that future quarterly dividends, if and when declared by our Board of Directors pursuant to this policy, would likely be distributable on or about the fifth day of each January, April, July and October. The Board of Directors has historically shown a strong commitment to the payment of a regular dividend and will continue to evaluate the continued payment of dividends based on our operating cash flows and future capital requirements.

On January 22, 2014, the Board of Directors approved a quarterly cash dividend of \$0.175 per share on our outstanding shares of common stock, payable to shareholders of record as of March 14, 2014 with an expected distribution date on or about April 4, 2014.

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Record Date	Payment Date	Per Share Dividend	
May 22, 2013	June 14, 2013	July 5, 2013	\$	0.175
July 24, 2013	September 13, 2013	October 4, 2013		0.175
October 23, 2013	December 13, 2013	January 3, 2014		0.175
Fiscal year 2014			\$	0.525
May 24, 2012	June 15, 2012	July 3, 2012	\$	0.175
July 25, 2012	September 14, 2012	October 5, 2012		0.175
October 25, 2012	December 14, 2012	December 28, 2012		0.175
January 23, 2013	March 15, 2013	April 5, 2013		0.175
Fiscal year 2013			\$	0.700

Management believes that its cash, cash equivalents and marketable securities on hand at December 31, 2013, together with its cash flows from operations, will be sufficient to meet its working capital and capital expenditure requirements, as well as any dividends to be paid in the ordinary course of business, for the next twelve months. Our Board of Directors will continue to evaluate the strategic use of our cash towards payment of dividends in light of both working capital and capital expenditure requirements.

### **Contractual Obligations**

The following table summarizes our significant contractual obligations at December 31, 2013 and the effect that such obligations are expected to have on our liquidity and cash in future periods:

Contractual Obligations	Total	2014 (remaining three months)	For the year ended March 31,					2019 and beyond
			2015	2016	2017	2018		
Operating lease obligations	\$ 29,224	\$ 2,111	\$ 7,602	\$ 7,087	\$ 5,187	\$ 4,469	\$ 2,768	
Contingent consideration and other acquisition related liabilities	1,271	—	646	313	312	—	—	
<b>Total</b>	<b>\$ 30,495</b>	<b>\$ 2,111</b>	<b>\$ 8,248</b>	<b>\$ 7,400</b>	<b>\$ 5,499</b>	<b>\$ 4,469</b>	<b>\$ 2,768</b>	

#### Recent Accounting Pronouncements

Refer to Note 1, "Summary of Significant Accounting Policies," of our notes to consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for a discussion of new accounting standards.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

There is little to no market risk as we currently maintain our cash in very liquid short term assets including tax exempt and taxable money market funds and short-term U.S. Treasury securities with maturities of 90 days or less at the time of purchase.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Security Exchange Act of 1934, as amended, the "Exchange Act") as of December 31, 2013, the end of the period covered by this Quarterly Report on Form 10-Q (the "Evaluation Date"). They have concluded that, as of the Evaluation Date, these disclosure controls and procedures were effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities and would be disclosed on a timely basis. The Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed, and are effective, to give reasonable assurance that the information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the rules and forms of the SEC. They have also concluded that the our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that are filed or submitted under the Exchange Act are accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

#### **Changes in Internal Control over Financial Reporting**

On September 9, 2013, we completed our acquisition of Mirth Corporation. In conducting our evaluation of the effectiveness of our internal controls over financial reporting as of December 31, 2013, we have elected to exclude Mirth Corporation from our evaluation for fiscal year 2014 as permitted under existing SEC rules. We are currently in the process of integrating Mirth Corporation's historical internal controls over financial reporting with the rest of the Company. The integration may lead to changes in future periods, but we do not expect these changes to materially affect our internal controls over financial reporting. We expect to complete this integration in fiscal year 2015.

During the quarter ended December 31, 2013, there were no other changes in our "internal control over financial reporting" (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management, including our Chief Executive Officer and Chief Financial Officer, has concluded that our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at that reasonable assurance level. However, management can provide no assurance that our disclosure controls and procedures or our internal control over financial reporting can prevent all errors and all fraud under all circumstances. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On October 7, 2013, a complaint was filed against us and certain of our officers and directors in the Superior Court of the State of California for the County of Orange, captioned *Ahmed D. Hussein v. Sheldon Razin, Steven Plochocki, Quality Systems, Inc. and Does 1-10, inclusive*, No. 30-2013-00679600-CU-NP-CJC, by Ahmed Hussein, a former director and significant shareholder of ours. The complaint generally alleges fraud and deceit, constructive fraud, negligent misrepresentation and breach of fiduciary duty in connection with statements made to our shareholders regarding our financial condition and projected future performance. The complaint seeks actual damages, exemplary and punitive damages and costs.

On November 19, 2013, a complaint was filed against the Company and certain of the Company's officers and directors in the United States District Court for the Central District of California, captioned *Deerfield Beach Police Pension Fund, individually and on behalf of all others similarly situated, v. Quality Systems, Inc., Steven T. Plochocki, Paul A. Holt and Sheldon Razin*, No. SACV13-01818-CJC-JPRx, by the Deerfield Beach Police Pension Fund, a shareholder of the Company. The complaint is a putative class action filed on behalf of the shareholders of the Company other than the defendants. The complaint, which is substantially similar to the litigation initiated by Mr. Hussein described above, generally alleges that statements made to the Company's shareholders regarding the Company's financial condition and projected future performance were false and misleading in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and that the individual defendants are liable for such statements because they are controlling persons under Section 20(a) of the Exchange Act. The complaint seeks compensatory damages, court costs and attorneys' fees.

On January 24, 2014, a complaint was filed against the Company and certain of the Company's officers and current and former directors in the United States District Court for the Central District of California, captioned *Timothy J. Foss, derivatively on behalf of himself and all others similarly situated, vs. Craig A. Barbarosh, George H. Bristol, James C. Malone, Peter M. Neupert, Morris Panner, D. Russell Pflueger, Steven T. Plochocki, Sheldon Razin, Lance E. Rosenzweig and Quality Systems, Inc.*, No. SACV14-00110-DOC-JPPx, by Timothy J. Foss, a shareholder of the Company. The complaint arises from the same allegations described above related to the complaints filed by Mr. Hussein and the Deerfield Beach Police Pension Fund and generally alleges breach of fiduciary duties, abuse of control and gross mismanagement by the Company's directors, in addition to unjust enrichment and insider selling by individual directors. The complaint seeks compensatory damages, restitution and disgorgement of all profits, court costs, attorneys' fees and implementation of enhanced corporate governance procedures.

In addition to the above, we have experienced legal claims by customers regarding product and contract disputes and from time to time, claims by other third parties asserting that we have infringed their intellectual property rights. We believe that these claims, including those filed by Mr. Hussein, the Deerfield Beach Police Pension Fund and the shareholder derivative action, are without merit and intend to defend against them vigorously; however, we could incur substantial costs and diversion of management resources even if we are ultimately successful in the defense of such claims. Litigation is inherently uncertain and always difficult to predict. We refer you to the discussion of infringement and litigation risks in our "Item 1A. Risk Factors" section of our Annual Report and "Item 1A. Risk Factors" section of our Quarterly Report filed on Form 10-Q for the quarter-ended September 30, 2013.

### ITEM 1A. RISK FACTORS

Our business is subject to many risks and uncertainties, which may materially and adversely affect our future business, prospects, financial condition and results of operations. These risk factors are disclosed in "Item 1A. Risk Factors" in our Annual Report, "Item 1A. Risk Factors" in our Quarterly Report filed on Form 10-Q for the quarter-ended September 30, 2013 and the risk factors set forth below, which supplement the risk factors previously disclosed.

***We could suffer further charges due to asset impairment that could reduce our income.*** We test our goodwill for impairment annually during our first fiscal quarter, and on interim dates should events or changes in circumstances indicate the carrying value of goodwill may not be recoverable in accordance with the relevant accounting guidance. During the quarter ended March 31, 2013, we recorded a \$17.4 million goodwill impairment charge relating to our Hospital Solutions Division and during the quarter ended December 31, 2013, we recorded a \$26.0 million impairment charge relating to certain long-lived assets of our Hospital Solutions Division (see "Management's Discussion and Analysis of Financial Condition and Results of Operations" section for additional information regarding this charge). Declines in business performance or other factors could cause the fair value of any of our operating segments to be revised downward, resulting in further impairment charges. If the financial outlook for any of our operating segments warrants additional impairments of goodwill, the resulting write-downs could materially affect our reported net earnings

***We face risks related to litigation advanced by a former director and shareholder of ours, a putative class action and a shareholder derivative claim.*** On October 7, 2013, a complaint was filed against us and certain of our officers and directors in the Superior Court of the State of California for the County of Orange, captioned *Ahmed D. Hussein v. Sheldon Razin, Steven Plochocki, Quality Systems, Inc. and Does 1-10, inclusive*, No. 30-2013-00679600-CU-NP-CJC, by Ahmed Hussein, a former director and significant shareholder of ours. The complaint generally alleges fraud and deceit, constructive fraud, negligent misrepresentation and breach of fiduciary duty in connection with statements

made to our shareholders regarding our financial condition and projected future performance. On November 19, 2013, a complaint was filed against the Company and certain of the Company's officers and directors in the United States District Court for the Central District of California, captioned Deerfield Beach Police Pension Fund, individually and on behalf of all others similarly situated, v. Quality Systems, Inc., Steven T. Plochocki, Paul A. Holt and Sheldon Razin, No. SACV13-01818-CJC-JPRx, by the Deerfield Beach Police Pension Fund, a shareholder of the Company. The complaint is a putative class action filed on behalf of the shareholders of the Company other than the defendants. The complaint, which is substantially similar to the complaint filed by Mr. Hussein described above, generally alleges that statements made to the Company's shareholders regarding the Company's financial condition and projected future performance were false and misleading in violation of the Exchange Act, and that the individual defendants are liable for such statements because they are controlling persons under Section 20(a) of the Exchange Act. On January 24, 2014, a complaint was filed against the Company and certain of the Company's officers and current and former directors in the United States District Court for the Central District of California, captioned Timothy J. Foss, derivatively on behalf of himself and all others similarly situated, vs. Craig A. Barbarosh, George H. Bristol, James C. Malone, Peter M. Neupert, Morris Panner, D. Russell Pflueger, Steven T. Plochocki, Sheldon Razin, Lance E. Rosenzweig and Quality Systems, Inc., No. SACV14-00110-DOC-JPPx, by Timothy J. Foss, a shareholder of the Company. The complaint arises from the same allegations described above related to the complaints filed by Mr. Hussein and the Deerfield Beach Police Pension Fund and generally alleges breach of fiduciary duties, abuse of control and gross mismanagement by the Company's directors, in addition to unjust enrichment and insider selling by individual directors. Although we believe the claims to be without merit, our operating results and share price may be negatively impacted due to the negative publicity, expenses incurred in connection with our defense, management distraction, and/or other factors related to this litigation. In addition, litigation of this nature may negatively impact our ability to attract and retain customers and strategic partners, as well as qualified board members and management personnel.

## **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

## **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

## **ITEM 4. MINE SAFETY DISCLOSURES**

Not Applicable

## **ITEM 5. OTHER INFORMATION**

None.

## ITEM 6. EXHIBITS

### Exhibit Number Description

31.1*	Certification of Principal Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Principal Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation
101.LAB**	XBRL Taxonomy Extension Label
101.PRE**	XBRL Taxonomy Extension Presentation

\* Filed herewith.

\*\* XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of section 11 or 12 of the Securities and Exchange Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise is not subject to liability under these section.



## SIGNATURES

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

Date: January 28, 2014

By: QUALITY SYSTEMS, INC.  
/s/ Steven T. Plochocki  
Steven T. Plochocki  
Chief Executive Officer (Principal Executive Officer)

Date: January 28, 2014

By: /s/ Paul A. Holt  
Paul A. Holt  
Chief Financial Officer (Principal Accounting Officer)

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER REQUIRED BY  
RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Steven T. Plochocki, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Quality Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 28, 2014

By: /s/ Steven T. Plochocki

Steven T. Plochocki  
Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER REQUIRED BY  
RULE 13A-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Paul A. Holt, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Quality Systems, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 28, 2014

By: /s/ Paul A. Holt  
Paul A. Holt  
Chief Financial Officer  
(Principal Accounting Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Quality Systems, Inc. (the "Company") for the quarterly period ended December 31, 2013 (the "Report"), the undersigned hereby certify in their capacities as Chief Executive Officer and Chief Financial Officer of the Company, respectively, pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: January 28, 2014

By: /s/ Steven T. Plochocki

Steven T. Plochocki

Chief Executive Officer (Principal Executive Officer)

Date: January 28, 2014

By: /s/ Paul A. Holt

Paul A. Holt

Chief Financial Officer (Principal Accounting Officer)

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signatures that appear in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.