
**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, 2012

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 28, 2013 was 59,534,835 shares.

QUALITY SYSTEMS, INC.

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FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2012

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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, 2012	March 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 101,702	\$ 134,444
Restricted cash	5,155	1,962
Marketable securities	4,987	4,987
Accounts receivable, net	151,495	145,756
Inventories	3,912	3,715
Income taxes receivable	1,864	2,628
Deferred income taxes, net	10,127	10,127
Other current assets	7,276	9,090
Total current assets	286,518	312,709
Equipment and improvements, net	20,930	17,841
Capitalized software costs, net	32,881	19,994
Intangibles, net	29,415	23,259
Goodwill	63,161	60,776
Other assets	7,315	5,773
Total assets	\$ 440,220	\$ 440,352
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 6,563	\$ 4,532
Deferred revenue	63,001	83,108
Accrued compensation and related benefits	8,595	11,870
Dividends payable	—	10,354
Other current liabilities	27,750	19,568
Total current liabilities	105,909	129,432
Deferred revenue, net of current	1,307	1,293
Deferred income taxes, net	4,096	5,351
Deferred compensation	3,454	3,497
Other noncurrent liabilities	4,368	5,602
Total liabilities	119,134	145,175
Commitments and contingencies (Note 12)		
Shareholders' equity:		
Common stock \$0.01 par value; authorized 100,000 shares; issued and outstanding 59,535 and 59,180 shares at December 31, 2012 and March 31, 2012, respectively	595	592
Additional paid-in capital	179,306	169,033
Accumulated other comprehensive loss	(45)	(45)
Retained earnings	141,230	125,597
Total shareholders' equity	321,086	295,177
Total liabilities and shareholders' equity	\$ 440,220	\$ 440,352

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

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
Revenues:				
Software and hardware	\$ 21,899	\$ 35,074	\$ 71,463	\$ 95,845
Implementation and training services	7,266	6,555	27,847	18,121
System sales	29,165	41,629	99,310	113,966
Maintenance	39,463	36,245	116,746	102,961
Electronic data interchange services	15,209	12,101	44,056	36,178
Revenue cycle management and related services	15,015	11,147	43,902	34,170
Other services	15,658	11,643	44,920	33,566
Maintenance, EDI, RCM and other services	85,345	71,136	249,624	206,875
Total revenues	114,510	112,765	348,934	320,841
Cost of revenue:				
Software and hardware	4,660	4,622	16,055	13,423
Implementation and training services	7,221	5,994	23,873	15,119
Total cost of system sales	11,881	10,616	39,928	28,542
Maintenance	5,259	4,412	14,811	12,260
Electronic data interchange services	9,852	7,890	28,251	23,816
Revenue cycle management and related services	10,918	8,405	32,344	25,687
Other services	8,686	7,011	26,021	18,977
Total cost of maintenance, EDI, RCM and other services	34,715	27,718	101,427	80,740
Total cost of revenue	46,596	38,334	141,355	109,282
Gross profit	67,914	74,431	207,579	211,559
Operating expenses:				
Selling, general and administrative	35,532	33,096	110,045	94,651
Research and development costs	7,786	8,277	22,634	22,462
Amortization of acquired intangible assets	1,212	543	3,665	1,545
Total operating expenses	44,530	41,916	136,344	118,658
Income from operations	23,384	32,515	71,235	92,901
Interest income (expense), net	13	55	(14)	212
Other expense	(122)	(218)	(115)	(400)
Income before provision for income taxes	23,275	32,352	71,106	92,713
Provision for income taxes	7,649	11,247	24,292	32,129
Net income	\$ 15,626	\$ 21,105	\$ 46,814	\$ 60,584
Other comprehensive income (loss):				
Foreign currency translation (net of \$0 tax)	10	(9)	—	(7)
Unrealized loss on AFS securities (net of \$0 tax)	—	(12)	—	(35)
Comprehensive income	\$ 15,636	\$ 21,084	\$ 46,814	\$ 60,542
Net income per share:				
Basic	\$ 0.26	\$ 0.36	\$ 0.79	\$ 1.03
Diluted	\$ 0.26	\$ 0.36	\$ 0.79	\$ 1.03
Weighted-average shares outstanding:				
Basic	59,400	58,847	59,343	58,623
Diluted	59,405	59,128	59,411	58,943
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,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 46,814	\$ 60,584
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	5,075	3,853
Amortization of capitalized software costs	7,261	5,994
Amortization of other intangibles	5,694	3,175
Provision for bad debts	4,324	3,839
Share-based compensation	1,966	2,465
Deferred income tax benefit	(1,255)	—
Excess tax benefit from share-based compensation	49	(2,457)
Change in fair value of contingent consideration	998	—
Loss on disposal of equipment and improvements	—	71
Changes in assets and liabilities, net of amounts acquired:		
Accounts receivable	(8,665)	(22,312)
Inventories	(197)	(1,261)
Income taxes receivable	715	(5,053)
Other current assets	(878)	1,972
Other assets	(1,543)	303
Accounts payable	1,285	1,367
Deferred revenue	(20,111)	13,336
Accrued compensation and related benefits	(3,275)	749
Income taxes payable	—	(1,073)
Other current liabilities	10,596	(7,574)
Deferred compensation	(43)	637
Other non-current liabilities	(3,965)	3,127
Net cash provided by operating activities	44,845	61,742
Cash flows from investing activities:		
Additions to capitalized software costs	(20,148)	(9,577)
Additions to equipment and improvements	(7,159)	(7,372)
Proceeds for disposal of equipment and improvements	—	11
Cash acquired from purchase of ViaTrack	—	10
Purchase of ViaTrack	—	(5,710)
Cash acquired from purchase of CQI	—	222
Purchase of CQI	—	(2,737)
Purchase of IntraNexus	—	(3,279)
Purchase of Poseidon	(2,033)	—
Purchase of Matrix	(5,073)	—
Net cash used in investing activities	(34,413)	(28,432)
Cash flows from financing activities:		
Excess tax benefit from share-based compensation	(49)	2,457
Proceeds from exercise of stock options	763	7,346
Dividends paid	(41,535)	(30,684)
Payment of contingent consideration related to acquisitions	(2,353)	—
Net cash used in financing activities	(43,174)	(20,881)
Net (decrease) increase in cash and cash equivalents	(32,742)	12,429
Cash and cash equivalents at beginning of period	134,444	116,617
Cash and cash equivalents at end of period	\$ 101,702	\$ 129,046

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

	Nine Months Ended December 31,	
	2012	2011
Supplemental disclosures of cash flow information:		
Cash paid during the period for income taxes, net of refunds	\$ 24,691	\$ 38,254
Non-cash investing and financing activities:		
Unrealized gain (loss) on marketable securities, net of tax	\$ —	\$ (34)
Common stock issued at fair value for ViaTrack earnout settlement	\$ 3,001	\$ —
Common stock issued at fair value for Opus earnout settlement	\$ —	\$ 11,888
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	
Effective November 14, 2011, the Company acquired ViaTrack in a transaction summarized as follows:		
Fair value of net assets acquired		\$ 11,048
Cash paid		(5,710)
Common stock issued at fair value		(1,068)
Purchase price holdback		(1,187)
Fair value of contingent consideration		(2,958)
Liabilities assumed		\$ 125
Effective July 26, 2011, the Company acquired CQI in a transaction summarized as follows:		
Fair value of assets acquired		\$ 11,417
Cash paid		(2,737)
Common stock issued at fair value		(2,864)
Purchase price holdback		(600)
Fair value of contingent consideration		(2,346)
Liabilities assumed		\$ 2,870
Effective April 29, 2011, the Company acquired IntraNexus in a transaction summarized as follows:		
Fair value of assets acquired		\$ 4,524
Cash paid		(3,279)
Purchase price holdback		(125)
Fair value of contingent consideration		(800)
Liabilities assumed		\$ 320

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 consists 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"). All intercompany accounts and transactions have been eliminated.

Basis of Presentation. The accompanying unaudited consolidated financial statements as of December 31, 2012 and for the three and nine months ended December 31, 2012 and 2011 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, 2012. Amounts related to disclosures of March 31, 2012 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.

On July 27, 2011, the Company's Board of Directors approved a two-for-one stock split (the "stock split") of the Company's outstanding shares of common stock. Shareholders of record at the close of business on October 6, 2011 received one additional share for every outstanding share held on the record date. The additional shares were distributed on October 26, 2011. All share and per share data provided herein gives effect to this stock split, applied retroactively.

Revenue Recognition. The Company generates revenue from the sale of licensing rights to its software products directly to end-users and value-added resellers, or 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 has established VSOE for the related undelivered elements based on the bell-shaped curve method. Maintenance VSOE for the Company's largest clients is 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, then 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 the 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 of 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 include the following characteristics:

- The fee 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.

- Payment terms must not be considered extended. If a significant portion of the fee is due more than 12 months after delivery or after the expiration of the license, the fee is presumed not fixed or determinable.

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 software 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. When 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 reported 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, 2012, certain events and circumstances indicated the possibility that the carrying amount of goodwill could potentially be impaired. See Note 4.

Share-Based Compensation. The following table shows total share-based compensation expense included in the consolidated statements of comprehensive income for the three and nine months ended December 31, 2012 and 2011:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
Costs and expenses:				
Cost of revenue	\$ 51	\$ 71	\$ 200	\$ 190
Research and development costs	76	56	209	133
Selling, general and administrative	456	677	1,557	2,142
Total share-based compensation	583	804	1,966	2,465
Income tax benefit	(174)	(298)	(621)	(916)
Decrease in net income	\$ 409	\$ 506	\$ 1,345	\$ 1,549

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 the first quarter of fiscal 2013, the Company adopted new accounting guidance intended to simplify goodwill impairment testing. Under the revised guidance, entities testing goodwill for impairment have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test would be required. Under the revised guidance, an entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The revised guidance does not change how goodwill is calculated or assigned to reporting units, nor does it revise the requirement to test goodwill annually for impairment. In addition, the revised guidance does not amend the requirement to test goodwill for impairment between annual tests if events or circumstances warrant; however, it does revise the examples of events and circumstances that an entity should consider. The adoption did not have a material impact on the Company's financial position, results of operations or cash flows and is discussed further within this footnote.

In the first quarter of fiscal 2013, the Company adopted guidance regarding the presentation of comprehensive income. The new standard requires the presentation of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The adoption of this guidance did not have a material impact on the Company's financial statements.

In the first quarter of fiscal 2013, the Company adopted additional guidance on fair value measurements intended to clarify the application of the existing guidance and disclosure requirements, as well as change certain fair value measurement principles and require additional disclosures surrounding these fair value measurements. The adoption of this guidance did not have a material impact on the Company's financial statements.

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, 2012 and March 31, 2012:

	Balance at December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
ASSETS				
Cash and cash equivalents (1)	\$ 101,702	\$ 101,702	\$ —	\$ —
Restricted cash	5,155	5,155	—	—
Marketable securities (2)	4,987	4,987	—	—
	<u>\$ 111,844</u>	<u>\$ 111,844</u>	<u>\$ —</u>	<u>\$ —</u>
LIABILITIES				
Contingent consideration related to acquisitions	\$ 5,062	\$ —	\$ —	\$ 5,062
	<u>\$ 5,062</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,062</u>

	Balance at March 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
ASSETS				
Cash and cash equivalents (1)	\$ 134,444	\$ 134,444	\$ —	\$ —
Restricted cash	1,962	1,962	—	—
Marketable securities (2)	4,987	4,987	—	—
	<u>\$ 141,393</u>	<u>\$ 141,393</u>	<u>\$ —</u>	<u>\$ —</u>
LIABILITIES				
Contingent consideration related to acquisitions	\$ 6,556	\$ —	\$ —	\$ 6,556
	<u>\$ 6,556</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 6,556</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 for Sphere Health Systems, Inc. ("Sphere"), IntraNexus, Inc. ("IntraNexus"), CQI Solutions, Inc. ("CQI"), ViaTrack, and Matrix were estimated based on the probability of achieving certain business milestones and management's forecast of expected revenues. See Note 3.

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, 2012:

	Total Liabilities
Balance as of April 1, 2012	\$ 6,556
Acquisitions (Note 3)	2,862
Earnout payments (1)	(5,354)
Fair value adjustments	998
Balance as of December 31, 2012	<u>\$ 5,062</u>

(1) Earnout payments comprised of \$2,353 in cash and \$3,001 in common stock

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, 2012, there were no adjustments to fair value of such assets, except for the intangible assets acquired from Matrix and The Poseidon Group, Inc. ("Poseidon") as discussed further below.

3. Business Combinations

On May 1, 2012, the Company acquired Poseidon, a leading provider of hospital emergency department documentation and web-based electronic medical record solutions. The Poseidon purchase price totaled \$2,533. Poseidon operates under the Hospital Solutions Division.

On April 16, 2012, the Company acquired Matrix, a provider of revenue cycle management services, healthcare IT solutions and training, implementation and support centered around the NextGen Division's suite of practice management software and electronic health record solutions. The Matrix purchase price totaled \$13,841. The purchase price included contingent consideration payable over an 18-month period with a fair value of \$2,862, which shall not exceed \$4,000. The goodwill associated with this acquisition is deductible for tax purposes. Matrix operates under the RCM Services Division.

The Company accounted for the Matrix and Poseidon acquisitions as purchase business combinations. The purchase price for each was allocated to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the applicable acquisition date. The fair value of the assets acquired and liabilities assumed represent management's estimate of fair value. 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 purchase price for the Matrix and Poseidon acquisitions during the nine months ended December 31, 2012 are summarized as follows:

	Matrix	Poseidon
Cash paid	\$ 5,073	\$ 2,033
Purchase price holdback	853	500
Common stock issued at fair value	3,953	—
Contingent consideration	2,862	—
Future payments for non-compete agreement	1,100	—
Total purchase price	<u>\$ 13,841</u>	<u>\$ 2,533</u>

The following table summarizes the final purchase price allocations for the Matrix and Poseidon acquisitions:

	Matrix	Poseidon
Fair value of the net tangible assets acquired and liabilities assumed:		
Current assets (including accounts receivable of \$1,287 and \$111 for Matrix and Poseidon, respectively)	1,755	143
Equipment and improvements and other long-term assets	966	39
Accounts payable and accrued liabilities	(746)	—
Deferred revenues	—	(18)
Total net tangible assets acquired and liabilities assumed	<u>1,975</u>	<u>164</u>
Fair value of identifiable intangible assets acquired:		
Trade Name	150	—
Customer relationships	8,650	800
Software technology	—	1,150
Non-compete agreement	1,100	—
Goodwill	1,966	419
Total identifiable intangible assets acquired	<u>11,866</u>	<u>2,369</u>
Total purchase price	<u>\$ 13,841</u>	<u>\$ 2,533</u>

The pro forma effects of the Matrix and Poseidon acquisitions 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, 2012	Acquisitions	December 31, 2012
QSI Dental Division			
ViaTrack Systems, LLC	\$ 7,289	\$ —	\$ 7,289
Total QSI Dental Division goodwill	7,289	—	7,289
NextGen Division			
NextGen Healthcare Information Systems, LLC	1,840	—	1,840
Total NextGen Division goodwill	1,840	—	1,840
Hospital Solutions Division			
The Poseidon Group, Inc.	—	419	419
CQI Solutions, Inc.	4,863	—	4,863
IntraNexus, Inc.	1,903	—	1,903
Opus Healthcare Solutions, Inc.	13,537	—	13,537
Sphere Health Systems, Inc.	1,020	—	1,020
Total Hospital Solutions Division goodwill	21,323	419	21,742
RCM Services Division			
Matrix Management Solutions, LLC	—	1,966	1,966
Practice Management Partners, Inc.	19,485	—	19,485
Healthcare Strategic Initiatives	10,839	—	10,839
Total RCM Services Division goodwill	30,324	1,966	32,290
Total goodwill	\$ 60,776	\$ 2,385	\$ 63,161

During the quarter ended December 31, 2012, certain events and circumstances indicated the possibility that the carrying amount of goodwill of the Hospital Solutions Division (“Hospital reporting unit”) could potentially be impaired. The primary factor giving rise to this consideration was the recent operating performance of the Hospital reporting unit which reported a net loss from operations for both the quarters ended September 30, 2012 and December 31, 2012. Prior to these periods, the Hospital reporting unit had consistently generated income from operations. In the quarter ended September 30, 2012, the Hospital reporting unit began experiencing a decline in operating performance attributable to the aggregation of several factors, including: a) higher costs related to the expansion of implementation and support infrastructure; b) increased investment in selling, general, and administrative costs; c) a reduction in maintenance revenue; d) comparatively lower system sales revenues, and e) higher levels of sales credits. As of September 30, 2012, the circumstances that gave rise to the operating loss for the quarter then ended did not appear to be long-term in nature. However, prior to the end of the quarter ended December 31, 2012, the Company anticipated that the Hospital reporting unit would incur a sequential operating loss. Such expectation indicated that the goodwill of the Hospital reporting unit could potentially be impaired.

Based upon the above, the Company performed an assessment of the fair value of all of its reporting units, which concluded that all reporting units have a fair value in excess of 100% of their respective carrying amounts, with the exception of the Hospital reporting unit, which had an excess of fair value over its carrying amount of approximately 30%. Total goodwill in this division as of December 31, 2012 is \$21.7 million. As a result, the Company concluded that no goodwill impairment existed in any of its reporting units as of December 31, 2012. The Company will continue to monitor the operating performance of its reporting units in future periods, however, for evidence of additional indicators of potential impairment.

The assessment of fair value of all of our reporting units during the quarter ended December 31, 2012 was based upon discounted cash flow analysis and a market approach, in which the valuation of comparable business enterprises is considered. The total of the values ascribed to the components of our business was also evaluated in light of our market capitalization, as of the valuation date.

Key assumptions affecting the results of the discounted cash flow analysis include our future revenues and operating margins. For the Hospital Solutions Division, revenue-related assumptions include sustained growth in revenues from future systems sales and improvements in operating efficiency, over time. We believe that sustained growth in our system sales will be achievable if we are able to effectively execute our growth strategies, including the expanded use of the NextGen Division sales force to cross sell hospital products to both new and existing NextGen Division customers. We also believe that we will be able to generate operational improvements and efficiencies in our implementation of new customers and that there continues to be meaningful opportunity in the Hospital Solutions Division market. Though we have confidence in our assumptions and

the future performance of the Hospital Solutions Division, if the Hospital Solutions Division fails to achieve sustained revenue growth and improved operating margins, the fair value of the reporting unit could be negatively impacted, resulting in an impairment of goodwill and/or other intangible assets.

5. Intangible Assets

In connection with the Poseidon acquisition, the Company recorded \$1,950 of intangible assets related to customer relationships and software technology. The Company is amortizing the customer relationships over five years and the software technology over five years.

In connection with the Matrix acquisition, the Company recorded \$9,900 of intangible assets related to a trade name, customer relationships and non-compete agreements. The Company is amortizing the trade name over six months, the customer relationships over five years and the non-compete agreements over four years.

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

	December 31, 2012			
	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Gross carrying amount	\$ 23,156	\$ 2,018	\$ 20,509	\$ 45,683
Accumulated amortization	(8,976)	(1,030)	(6,262)	(16,268)
Net intangible assets	\$ 14,180	\$ 988	\$ 14,247	\$ 29,415

	March 31, 2012			
	Customer Relationships	Trade Name & Contracts	Software Technology	Total
Gross carrying amount	\$ 13,706	\$ 768	\$ 19,359	\$ 33,833
Accumulated amortization	(5,901)	(606)	(4,067)	(10,574)
Net intangible assets	\$ 7,805	\$ 162	\$ 15,292	\$ 23,259

Activity related to the intangible assets for the nine months ended December 31, 2012 and 2011 is summarized as follows:

	Customer Relationships	Trade Name & Contracts	Software Technology	Total
	Balance as of April 1, 2012	\$ 7,805	\$ 162	\$ 15,292
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

	Customer Relationships	Trade Name & Contracts	Software Technology	Total
	Balance as of April 1, 2011	\$ 6,327	\$ 208	\$ 10,355
Acquisition	3,500	130	7,240	10,870
Amortization (1)	(1,420)	(125)	(1,630)	(3,175)
Balance as of December 31, 2011	\$ 8,407	\$ 213	\$ 15,965	\$ 24,585

(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.

The following table represents the remaining estimated amortization of definite-lived intangible assets as of December 31, 2012:

For the year ended March 31,	
2013 (remaining three months)	\$ 1,864
2014	7,391
2015	6,335
2016	5,998
2017 and beyond	7,827
Total	<u>\$ 29,415</u>

6. Capitalized Software Costs

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

	December 31, 2012	March 31, 2012
Gross carrying amount	\$ 85,369	\$ 65,221
Accumulated amortization	(52,488)	(45,227)
Net capitalized software costs	<u>\$ 32,881</u>	<u>\$ 19,994</u>

Activity related to net capitalized software costs for the nine months ended December 31, 2012 and 2011 is summarized as follows:

	2012	2011
Balance as of April 1	\$ 19,994	\$ 15,150
Capitalized	20,148	9,577
Amortization	(7,261)	(5,994)
Balance as of December 31	<u>\$ 32,881</u>	<u>\$ 18,733</u>

The following table represents the remaining estimated amortization of capitalized software costs as of December 31, 2012:

For the year ended March 31,	
2013 (remaining three months)	\$ 2,841
2014	13,387
2015	9,931
2016	5,547
2017 and beyond	1,175
Total	<u>\$ 32,881</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, 2012	March 31, 2012
Accounts receivable, gross	\$ 160,745	\$ 154,237
Allowance for doubtful accounts	(9,250)	(8,481)
Accounts receivable, net	<u>\$ 151,495</u>	<u>\$ 145,756</u>

Inventories are summarized as follows:

	December 31, 2012	March 31, 2012
Computer systems and components	\$ 3,912	\$ 3,709
Miscellaneous parts	—	6
Inventories	<u>\$ 3,912</u>	<u>\$ 3,715</u>

Equipment and improvements are summarized as follows:

	December 31, 2012	March 31, 2012
Computer equipment	\$ 29,936	\$ 24,936
Furniture and fixtures	7,445	6,358
Leasehold improvements	6,983	4,906
	44,364	36,200
Accumulated depreciation and amortization	(23,434)	(18,359)
Equipment and improvements, net	<u>\$ 20,930</u>	<u>\$ 17,841</u>

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

	December 31, 2012	March 31, 2012
Maintenance	\$ 12,543	\$ 12,742
Implementation services	38,110	55,235
Annual license services	8,854	11,730
Undelivered software and other	3,494	3,401
Deferred revenue	<u>\$ 63,001</u>	<u>\$ 83,108</u>
Deferred revenue, net of current	<u>\$ 1,307</u>	<u>\$ 1,293</u>

Accrued compensation and related benefits are summarized as follows:

	December 31, 2012	March 31, 2012
Payroll, bonus and commission	\$ 746	\$ 4,890
Vacation	7,849	6,980
Accrued compensation and related benefits	<u>\$ 8,595</u>	<u>\$ 11,870</u>

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

	December 31, 2012	March 31, 2012
Contingent consideration and other liabilities related to acquisitions	\$ 7,640	\$ 5,482
Care services liabilities	5,155	1,962
Accrued Consulting and Outside Services	2,928	880
Users Group Meeting (UGM) deposits	2,106	—
Accrued royalties	1,635	1,974
Accrued EDI expense	1,250	2,588
Self insurance reserve	942	934
Sales tax payable	765	527
Deferred rent	728	610
Outside commission payable	498	520
Accrued travel	415	509
Customer deposits	136	1,297
Other accrued expenses	3,552	2,285
Other current liabilities	<u>\$ 27,750</u>	<u>\$ 19,568</u>
Deferred rent	\$ 2,510	\$ 2,476
Contingent consideration and other liabilities related to acquisitions	1,720	2,989
Other liabilities	138	137
Other non-current liabilities	<u>\$ 4,368</u>	<u>\$ 5,602</u>

8. Income Tax

The provision for income taxes for the three months ended December 31, 2012 and 2011 was approximately \$7.6 million and \$11.2 million, respectively. The effective tax rates were 32.9% and 34.8% for the three months ended December 31, 2012 and 2011, respectively. The effective tax rate decreased as compared to the prior year period as a result of increased benefit of discrete items, principally as the result of the lower level of taxable income in the current period. In addition, the effective tax rate reflects a reduction in the Company's composite state effective tax rate for the three months ended December 31, 2012, largely offset by the absence of a research and development tax credit in such period, due to the expiration of the applicable federal statute on December 31, 2011.

The provision for income taxes for the nine months ended December 31, 2012 and 2011 was approximately \$24.3 million and \$32.1 million, respectively. The effective tax rates were 34.2% and 34.7% for the nine months ended December 31, 2012 and 2011, respectively. The effective tax rate decreased slightly due to a reduction in the Company's composite state effective tax rate, largely offset by the absence of a research and development tax benefit in the current year, as described above.

Uncertain tax positions

As of December 31, 2012, the Company had recorded a liability of \$563 for unrecognized tax benefits related to various federal and state income tax matters. If recognized, this amount would reduce the Company's effective tax rate. The tax liability decreased from the prior year period by \$174 due to changes in contingent liability reserves and certain tax positions related to acquired companies.

The Company's income tax returns filed for tax years 2010 through 2012 and 2008 through 2012 are subject to examination by the federal and state taxing authorities, respectively. The Company is not currently under examination by the Internal Revenue Service. The Company is under routine examination by six state income tax authorities. 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 dual 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,	
	2012	2011	2012	2011
Net income	\$ 15,626	\$ 21,105	\$ 46,814	\$ 60,584
Basic net income per share:				
Weighted-average shares outstanding — Basic	59,400	58,847	59,343	58,623
Basic net income per common share	\$ 0.26	\$ 0.36	\$ 0.79	\$ 1.03
<hr/>				
Net income	\$ 15,626	\$ 21,105	\$ 46,814	\$ 60,584
Diluted net income per share:				
Weighted-average shares outstanding — Basic	59,400	58,847	59,343	58,623
Effect of potentially dilutive securities	5	281	68	320
Weighted-average shares outstanding — Diluted	59,405	59,128	59,411	58,943
Diluted net income per common share	\$ 0.26	\$ 0.36	\$ 0.79	\$ 1.03

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.

The computation of diluted net income per share does not include 364 and 346 options to acquire shares of common stock for the three and nine months ended December 31, 2011, respectively, because their inclusion would have an anti-dilutive effect on net income per share.

10. Share-Based Awards

All share and per share data provided within this footnote is adjusted for the effect of the stock split, as discussed in Note 1.

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, 2012, there were 40,000 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, 2012, there were 1,226,711 outstanding options and 2,915,963 shares available for future grant related to the 2005 Plan.

A summary of stock option transactions during the nine months ended December 31, 2012 follows:

	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding, April 1, 2012	988,337	\$ 32.09	5.4	
Granted	516,500	28.65	7.4	
Exercised	(45,366)	16.83	0.5	\$ 24
Forfeited/Canceled	(192,760)	32.61	5.9	
Outstanding, December 31, 2012	1,266,711	\$ 31.18	5.7	\$ 21
Vested and expected to vest, December 31, 2012	1,212,844	\$ 31.11	5.7	\$ 21
Exercisable, December 31, 2012	362,636	\$ 27.30	3.4	\$ 21

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, 2012	Nine Months Ended December 31, 2011
Expected life	5.0 years	4.3 years
Expected volatility	41.3% - 45.1%	41.2%
Expected dividends	2.4% - 4.0%	1.6%
Risk-free rate	0.7% - 0.8%	1.8%

The weighted average grant date fair value of stock options granted during the nine months ended December 31, 2012 and 2011 was \$8.37 and \$13.32 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 6.2% and 3.9% for employee options for the nine months ended December 31, 2012 and 2011, respectively, and 0.0% for director options for the nine months ended December 31, 2012 and 2011. 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, 2012, a total of 516,500 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 2013 and 2012 is as follows:

Option Grant Date	Number of Shares	Exercise Price	Vesting Terms (1)	Expires
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	516,500			
May 31, 2011	459,400	\$ 43.04	Five years	May 31, 2019
Fiscal year 2012 option grants	459,400			

(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 24, 2012, the Board of Directors approved its fiscal year 2013 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 220,000 are reserved for the Company's named executive officers and 380,000 for non-executive employees of the Company. Under the program, executives are eligible to receive cash bonuses and options based on meeting certain target increases in EPS performance and revenue and operating income growth during fiscal year 2013. Under the program, the non-executive employees are eligible to receive options based on satisfying certain management established criteria and recommendations of senior management. The options shall be issued pursuant to one of the Company's shareholder approved option plans, 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 and recorded stock compensation expense related to the performance based awards of approximately \$419 during the nine months ended December 31, 2011. Stock compensation expense related to the performance based awards was not significant for the nine months ended December 31, 2012. See the assumptions used below.

	Nine Months Ended December 31, 2012	Nine Months Ended December 31, 2011
Expected life	5.0 years	4.3 years
Expected volatility	41.7% - 45.0%	41.2% - 42.2%
Expected dividends	2.5% - 4.0%	1.4% - 1.9%
Risk-free rate	0.6% - 0.7%	0.8% - 1.8%

Non-vested stock option award activity, including employee stock options and performance-based awards, during the nine months ended December 31, 2012 is summarized as follows:

	Non-Vested Number of Shares	Weighted- Average Grant-Date Fair Value per Share
Outstanding, April 1, 2012	778,319	\$ 10.76
Granted	516,500	8.37
Vested	(197,984)	8.29
Forfeited/Canceled	(192,760)	10.45
Outstanding, December 31, 2012	904,075	\$ 10.01

As of December 31, 2012, \$6,662 of total unrecognized compensation costs related to stock options is expected to be recognized over a weighted-average period of 3.7 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, 2012 and 2011 was \$1,641 and \$1,767, respectively.

Restricted Stock

On May 24, 2012, the Board of Directors approved its 2013 Director Compensation Program, whereby each non-employee director is to be awarded shares of restricted stock upon election or re-election to the Board of Directors. 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 \$450 and \$394 for the nine months ended December 31, 2012 and 2011, respectively. Restricted stock activity for the nine months ended December 31, 2012 follows:

	Number of Shares	Weighted- Average Grant-Date Fair Value per Share
Outstanding, April 1, 2012	30,001	\$ 36.32
Granted	20,939	19.13
Vested	(17,667)	31.95
Outstanding, December 31, 2012	<u>33,273</u>	<u>\$ 26.79</u>

As of December 31, 2012, \$680 of total unrecognized compensation costs related to restricted stock is expected to be recognized over a weighted-average period of 1.9 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, 2012. 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.

The Company has entered into marketing assistance agreements with existing users of the Company's products which provide the opportunity for those users to earn commissions if they host specific site visits upon the Company's request for prospective clients that directly result in a purchase of the Company's software by the visiting prospects. Amounts earned by existing users under this program are treated as a selling expense in the period when earned.

13. Operating Segment Information

The Company has four reportable segments that are evaluated regularly by its chief decision making group 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,	
	2012	2011	2012	2011
Revenue:				
QSI Dental Division	\$ 5,088	\$ 4,863	\$ 14,886	\$ 14,469
NextGen Division	85,757	85,900	259,277	243,015
Hospital Solutions Division	7,365	9,928	26,903	25,671
RCM Services Division	16,300	12,074	47,868	37,686
Consolidated revenue	<u>\$ 114,510</u>	<u>\$ 112,765</u>	<u>\$ 348,934</u>	<u>\$ 320,841</u>
Operating income:				
QSI Dental Division	\$ 1,265	\$ 620	\$ 2,413	\$ 2,518
NextGen Division	30,906	35,240	93,643	98,875
Hospital Solutions Division	(1,334)	3,406	(152)	8,919
RCM Services Division	2,090	1,238	5,732	4,377
Unallocated corporate expense (1)	(9,543)	(7,989)	(30,401)	(21,788)
Consolidated operating income	<u>\$ 23,384</u>	<u>\$ 32,515</u>	<u>\$ 71,235</u>	<u>\$ 92,901</u>

(1) Unallocated corporate expense includes eliminations relating to QSIH revenues and related expenses included in the results of operating segments. For the nine months ended December 31, 2012 and 2011, eliminations were not significant.

Management evaluates performance based upon stand-alone segment operating income. Because the Company does not evaluate performance based upon return on assets at the operating segment level, assets are not tracked internally by segment. Therefore, segment asset information is not presented.

14. Subsequent Events

On January 23, 2013, 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 15, 2013 with an expected distribution date on or about April 5, 2013.

In January 2013, Congress enacted a tax law to extend the Federal research and development tax credit ("R&D Credit") retroactive to January 1, 2012 and through December 31, 2013. As a result of the timing of this legislative change, the Company was not entitled to recognize any portion of the expected tax benefit relating to the 2012 R&D Credit for the nine months ended December 31, 2012. The full expected fiscal year benefit of this credit will be recognized in the provision for income taxes in the quarter ended March 31, 2013.

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, 2012 ("Annual Report"), as supplemented by additional risk factors, if any, in our interim filings on our Quarterly Report 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 operation, or 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.

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 HIT 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. 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 continue to integrate our ambulatory and inpatient products, making our products more intuitive and easy to use, and enhancing 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 product development, sales, marketing, implementation and support, to continue efforts to make infrastructure investments within an overall context of maintaining reasonable expense discipline, to add new clients through maintaining and expanding sales, marketing and product development activities and to expand 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. 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, software development cost, 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 2012.

As described in Note 1 "Summary of Significant Accounting Policies" of our Notes to Consolidated Financial Statements included in this report, we determined during the quarter ended December 31, 2012 that certain events and circumstances indicated the possibility that the carrying amount of goodwill of the Hospital Solutions Division ("Hospital reporting unit") could potentially be impaired.

The primary factor giving rise to this consideration is the recent operating performance of the Hospital reporting unit which reported a net loss from operations for both the quarters ended September 30, 2012 and December 31, 2012. Prior to these periods, the Hospital reporting unit had consistently generated income from operations. In the quarter ended September 30, 2012, the Hospital reporting unit began experiencing a decline in operating performance attributable to the aggregation of several factors, including: a) higher costs related to the expansion of implementation and support infrastructure; b) increased investment in selling, general, and administrative costs; and c) a reduction in maintenance revenue; d) comparatively lower systems sales revenues; and e) higher levels of sales credits. As of September 30, 2012, the circumstances that gave rise to the operating loss for the quarter then ended did not appear to be long-term in nature. However, prior to the end of the quarter ended December 31, 2012, the Company anticipated that the Hospital reporting unit would incur a sequential operating loss. Such expectation indicated that goodwill of the Hospital reporting unit could potentially be impaired.

Based upon the above, we performed an assessment of the fair value of all of our reporting units, which concluded that all reporting units have a fair value in excess of 100% of their respective carrying amounts, with the exception of the Hospital reporting unit, which had an excess of fair value over its carrying amount of approximately 30%. Total goodwill in this division as of December 31, 2012 is \$21.7 million. As a result, we concluded that no goodwill impairment existed in any of our reporting units as of December 31, 2012. We will continue to monitor the operating performance of our reporting units in future periods, however, for evidence of additional indicators of potential impairment.

The assessment of fair value of all of our reporting units during the quarter ended December 31, 2012 was based upon discounted cash flow analysis and a market approach, in which the valuation of comparable business enterprises is considered. The total of the values ascribed to the components of our business was also evaluated in light of our market capitalization, as of the valuation date.

Key assumptions affecting the results of the discounted cash flow analysis include our future revenues and operating margins. For the Hospital Solutions Division, revenue-related assumptions include sustained growth in revenues from future systems sales and improvements in operating efficiency, over time. We believe that sustained growth in our system sales will be achievable if we are able to effectively execute our growth strategies, including the expanded use of the NextGen Division sales force to cross sell hospital products to both new and existing NextGen Division customers. We also believe that we will be able to generate operational improvements and efficiencies in our implementation of new customers and that there continues to be meaningful opportunity in the Hospital Solutions Division market. Though we have confidence in our assumptions and the future performance of the Hospital Solutions Division, if the Hospital Solutions Division fails to achieve sustained revenue growth and improved operating margins, the fair value of the reporting unit could be negatively impacted, resulting in an impairment of goodwill and/or other intangible assets.

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-1980's, we capitalized on the increasing focus on medical cost containment and further expanded our information processing systems to serve the medical market. In the mid-1990's, we made two acquisitions that accelerated our penetration of the medical market and formed the basis for the NextGen Division. Today, we serve the dental markets through our QSI Dental Division, physician practice, inpatient and RCM services through 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. 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 practice management 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 Division's also develop and market software that automates patient records in physician practices, community health centers (CHC's) 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 an equivalent practice management software product, which performs administrative functions required for operating a small hospital as well as physician documentation and computerized physician order entry (CPOE) charting. The RCM Services Division provides technology solutions and consulting services to cover the full spectrum of healthcare providers' RCM needs, with a primary focus on 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.

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

The following table reflects our reported segment revenue and segment revenue growth by Division for the three and nine months ended December 31, 2012 and 2011:

	Segment Revenue Breakdown			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
QSI Dental Division	4.4%	4.3%	4.3%	4.5%
NextGen Division	75.0%	76.2%	74.3%	75.8%
Hospital Solutions Division	6.4%	8.8%	7.7%	8.0%
RCM Services Division	14.2%	10.7%	13.7%	11.7%
Consolidated	100.0%	100.0%	100.0%	100.0%

	Segment Revenue Growth			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
QSI Dental Division	4.6 %	12.5 %	2.9%	1.0%
NextGen Division	(0.2)%	24.0 %	6.7%	26.0%
Hospital Solutions Division	(25.8)%	71.6 %	4.8%	101.2%
RCM Services Division	35.0 %	(3.4)%	27.0%	3.8%
Consolidated	1.5 %	22.7 %	8.8%	25.2%

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 organizations located throughout the United States. In addition, the QSI Dental Division supports a growing number of dental organizations using its Software as a Service ("SaaS") model-based financial and clinical software, as well as a number of medical clients that use the QSI Dental Division's UNIX®-based legacy medical practice management software product. This SaaS software, formerly called NextDDS™, has undergone a name change and is now "QSIDental™ Web". The name change was undertaken to give the product stronger identification in the marketplace as a web-based solution.

In July 2009, we licensed source code that allows us to deliver hosted, Web-based SaaS model practice management and clinical software solutions to the dental industry. This software solution, QSIDental Web, is being marketed primarily to the multi-location dental group practice market in which the QSI Dental Division has historically been a dominant player. QSIDental Web moves the QSI Dental Division to the forefront of the emergence of Internet-based applications and cloud computing and represents a significant growth opportunity for the Division to sell to both its existing client base and new clients.

The QSI Dental Division participates jointly with the NextGen Division in providing software and services to safety-net clinics like Federally Qualified Health Centers ("FQHC") 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 Ambulatory EHR, NextGen Electronic Dental Record and NextGen Practice Management provides a unique product in this marketplace - an integrated patient record accessible by both physicians and dentists.

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 Healthcare practice management solution, CPS is re-branded as NextGen EDR (Electronic Dental Record). 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 Electronic Health Records ("NextGen^{ehr}"), NextGen Practice Management ("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.

Hospital Solutions Division. The Hospital Solutions Division, with its primary location in Austin, Texas, provides integrated clinical, financial and connectivity solutions for rural and community hospitals. This Hospital Solutions Division also develops and markets an equivalent practice management software product for the small hospital market, which performs the administrative functions required for operating a small hospital.

In the last few years, we have continued to acquire 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, Inc. ("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. 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 strategy to continue to expand in the small 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 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 IT solutions and training, implementation and support centered on NextGen® technology, to its clients nationwide. The acquisition will enable 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 increased 8.8% in the nine months ended December 31, 2012 as compared to the prior year period. Revenue was positively impacted by growth in all of our service revenue categories, which in total grew 20.7%. The increase in consolidated revenue however was largely offset by a decline in system sales revenue which declined by 12.9%.
- Consolidated gross profit decreased to 59.5% for the nine months ended December 31, 2012 compared to 65.9% in the prior year period. The decline was attributable to a 32.8% decrease in software and hardware gross profit, partially offset by increases of 32.3%, 27.8% and 36.2%, respectively, in implementation, EDI and RCM services gross profit.

- Consolidated operating income decreased 23.3% in the nine months ended December 31, 2012 as compared to the prior year period primarily due to the following factors: (a) a change in the mix of revenue towards lower margin service revenue, (b) higher selling, general and administrative expenses, which was primarily a result of increased headcount and selling-related expenses at the NextGen Division and (c) higher corporate-related expenses.

QSI Dental Division

- QSI Dental Division revenue increased 2.9% in the nine months ended December 31, 2012 and divisional operating income (excluding unallocated corporate expenses) decreased 4.1% as compared to the same prior year period. The decline in operating income is the result of a decrease in system sales and higher selling, general and administrative expenses 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 which spreads revenue over a longer period of time rather than being recognized upfront. Revenue recognized from QSIDental Web was not significant in the nine months ended December 31, 2012.
- 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 increased 6.7% in the nine months ended December 31, 2012 and divisional operating income (excluding unallocated corporate expenses) decreased 5.3% as compared to the same prior year period. NextGen revenue was positively impacted by growth in service revenue which grew by 20.0%, largely offset by a decline in system sales revenue which declined by 13.8%.
- Recurring revenue, which consists primarily of maintenance and EDI revenue, increased 16.4% to \$138.4 million and accounted for 53.4% of total NextGen Division revenue for the nine months ended December 31, 2012. In the same period a year ago, recurring revenue of \$118.9 million represented 48.9% of total NextGen Division revenue.
- During the nine months ended December 31, 2012, we added staffing resources in anticipation of growth from the ARRA and the future of healthcare reform and accountable care organizations. 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, integrating our inpatient and ambulatory software products, further development and enhancements of our portfolio of specialty focused templates within our EHR software, developing new products for targeted markets, continuing to add new clients, 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 and the Hospital Solutions Division.
- 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 increased 4.8% in the nine months ended December 31, 2012. Revenue was negatively impacted by lower system sales as well as slightly lower maintenance revenue and higher levels of sales credits. The decline in revenue was partially offset by higher implementation revenue compared to the prior period.
- Divisional operating income (excluding unallocated corporate expenses) decreased to a loss of \$0.2 million for the nine months ended December 31, 2012 as compared to income of \$8.9 million for the same prior year period. Operating income was negatively impacted by increases in implementation costs related to expanding infrastructure to support a growing customer base, lower software revenue and a \$3.0 million increase in selling, general and administrative expenses during the period.
- Our acquisition of Poseidon in May 2012 did not significantly impact the Hospital Solutions Division results for the period.
- The Hospital Solutions Division has benefited from being able to offer both financial and CCHIT® certified clinical software, which has been packaged together. The Hospital Solutions Division has also benefited from cross sell opportunities with existing NextGen Division customers, including hospitals that are owned or affiliated with physician offices.
- We intend to continue to invest in implementation and training, support, and development to support our growing customer base, however improved operating results for the division will require effective execution by the division including effectively expanding implementation and support capabilities and successful cross selling of Hospital Solutions to new and existing customers.

RCM Services Division

- RCM Services Division revenue increased 27.0% in the nine months ended December 31, 2012. Divisional operating income (excluding unallocated corporate expenses) increased 30.9% to \$5.7 million in the nine months ended December 31, 2012 as compared to \$4.4 million for the same prior year period. Our acquisition of Matrix in April 2012 added approximately \$9.2 million in revenue for the current period.
- 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, 2012. The division also benefited from the cross sale of software and services to its existing customers. Systems sales to existing RCM Services customers are credited to the division.
- The Company believes that a significant opportunity exists to cross sell revenue cycle management services to existing NextGen Division customers. The portion of existing NextGen Division customers who are using the RCM Services Division's RCM services is less than 15%. There is also a significant opportunity to expand the RCM Services Division's services into the Hospital Solution and Dental Division's customers as well. Management is actively pursuing efforts to achieve faster growth from expanded efforts to leverage the existing NextGen Division's sales force towards selling revenue cycle management services.
- Actual and expected customer turnover may result in a near term decline in revenues for the Division. However, we are encouraged by increased sales activity and a growing sales pipeline of RCM services.
- Operating income as a percentage of revenue increased to approximately 12.0% of revenue in the nine months ended December 31, 2012 versus 11.6% of revenue in the same prior year period primarily as a result of a significant increase in the RCM Services Division's revenue compared to the prior year period, partially offset by higher selling, general and administrative expenses during the current period.

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

(Unaudited)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
Revenues:				
Software and hardware	19.1%	31.1%	20.5%	29.9%
Implementation and training services	6.3	5.8	8.0	5.6
System sales	25.5	36.9	28.5	35.5
Maintenance	34.5	32.1	33.5	32.1
Electronic data interchange services	13.3	10.7	12.6	11.3
Revenue cycle management and related services	13.1	9.9	12.6	10.7
Other services	13.7	10.3	12.9	10.5
Maintenance, EDI, RCM and other services	74.6	63.1	71.6	64.6
Total revenues	100.0	100.0	100.0	100.0
Cost of revenue:				
Software and hardware	4.1	4.1	4.6	4.2
Implementation and training services	6.3	5.3	6.8	4.7
Total cost of system sales	10.4	9.4	11.4	8.9
Maintenance	4.6	3.9	4.2	3.8
Electronic data interchange services	8.6	7.0	8.1	7.4
Revenue cycle management and related services	9.5	7.5	9.3	8.0
Other services	7.6	6.2	7.5	5.9
Total cost of maintenance, EDI, RCM and other services	30.3	24.6	29.1	25.1
Total cost of revenue	40.7	34.0	40.5	34.1
Gross profit	59.3	66.0	59.5	65.9
Operating expenses:				
Selling, general and administrative	31.0	29.3	31.5	29.5
Research and development costs	6.8	7.3	6.5	7.0
Amortization of acquired intangible assets	1.1	0.5	1.1	0.5
Total operating expenses	38.9	37.2	39.1	37.0
Income from operations	20.4	28.8	20.4	29.0
Interest income (expense), net	0.0	0.0	0.0	0.1
Other income (expense), net	(0.1)	(0.2)	0.0	(0.1)
Income before provision for income taxes	20.3	28.7	20.4	29.0
Provision for income taxes	6.7	10.0	7.0	10.0
Net income	13.6%	18.7%	13.4%	19.0%

Comparison of the Three Months Ended December 31, 2012 and December 31, 2011

Net Income. Our net income for the three months ended December 31, 2012 was \$15.6 million, or \$0.26 per share on both a basic and fully diluted basis. In comparison, we earned \$21.1 million, or \$0.36 per share on both a basic and fully diluted basis for the three months ended December 31, 2011. The change in net income for the three months ended December 31, 2012 was primarily attributed to the following:

- a 43.4% decrease in consolidated software and hardware gross profit as a result of reduced software revenue; and
- an increase in selling, general and administrative expenses and amortization of acquired intangibles; partially offset by
- an increase in recurring revenue based gross profit, including maintenance, RCM and EDI which grew 7.5%, 49.4% and 27.2%, respectively, compared to the prior year period

Revenue. Revenue for the three months ended December 31, 2012 increased 1.5% to \$114.5 million from \$112.8 million for the three months ended December 31, 2011. NextGen Division revenue remained relatively consistent at \$85.8 million compared to \$85.9 million in the three months ended December 31, 2011, QSI Dental Division revenue increased 4.6% to \$5.1 million from \$4.9 million, RCM Services

Division revenue increased 35.0% to \$16.3 million from \$12.1 million, and Hospital Solutions Division revenue decreased 25.8% during that same period to \$7.4 million from \$9.9 million.

System Sales. Revenue earned from our company-wide sales of systems for the three months ended December 31, 2012 decreased 29.9% to \$29.2 million from \$41.6 million in the same prior year period.

Our decrease in revenue from sales of systems was principally the result of a 29.3% decrease in revenue at our NextGen Division, which decreased \$10.2 million to \$24.5 million during the three months ended December 31, 2012 from \$34.7 million during the same prior year period. The decrease was driven by a decrease in software revenue, partially offset by a slight increase in implementation and training services revenue. Our decline in software revenue was related to a number of factors including higher adoption rates by large physician groups which results 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 drive 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 EHR 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. We are developing new products around these new opportunities which are expected to help drive future growth. It is difficult to assess the relative impact as well as the timing of positive and negative trends, however, we believe the long term opportunities for the Company are significant.

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, 2012 and 2011 (in thousands):

	Software	Hardware, Third Party Software	Implementation and Training Services	Total System Sales
Three Months Ended December 31, 2012				
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
Three Months Ended December 31, 2011				
QSI Dental Division	\$ 703	\$ 466	\$ 233	\$ 1,402
NextGen Division	28,641	1,037	4,989	34,667
Hospital Solutions Division	3,728	397	1,285	5,410
RCM Services Division	102	—	48	150
Consolidated	\$ 33,174	\$ 1,900	\$ 6,555	\$ 41,629

NextGen Division software license revenue decreased 36.5% in the three months ended December 31, 2012 versus the same period last year. The NextGen Division's software revenue accounted for 74.1% of divisional system sales revenue during the three months ended December 31, 2012 compared to 82.6% during the same period a year ago. Software license revenue continues to be an area of primary emphasis for the NextGen Division.

During the three months ended December 31, 2012, 3.8% of the NextGen Division's system sales revenue was represented by hardware and third-party software compared to 3.0% 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 increased 8.4% in the three months ended December 31, 2012 compared to the same prior year period. Implementation and training revenue related to system sales at the Hospital Solutions Division increased 17.5%, in the three months ended December 31, 2012 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. The number of implementation and training staff increased during the three months ended December 31, 2012 versus the same prior year period in order to accommodate the increased amount of implementation services sold in conjunction with software sales. It should be noted however 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, specifically in the NextGen Division. We intend to address the fluctuation in demand for services by managing the use of third parties for implementation services. We have historically relied on third parties for a portion of our implementations in order to manage customer requirements.

Maintenance, EDI, RCM and Other Services. For the three months ended December 31, 2012, our company-wide revenue from maintenance, EDI, RCM and other services grew 20.0% to \$85.3 million from \$71.1 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 three months ended December 31, 2012 grew 11.5% to \$33.7 million from \$30.2 million for the same prior year period while NextGen Division EDI revenue grew 28.8% to \$14.0 million compared to \$10.9 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 33.5% to \$13.5 million in the three months ended December 31, 2012 from \$10.1 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 three months ended December 31, 2012 and 2011 was \$3.5 million and \$3.5 million, respectively. For the three months ended December 31, 2012, RCM revenue for the RCM Services Division increased to \$15.0 million compared to \$11.1 million in the same prior year period. RCM revenue was positively impacted by the acquisition of Matrix which contributed \$3.3 million in the current period. For the Hospital Solutions Division, maintenance and other services revenue for the three months ended December 31, 2012 decreased 1.1% as compared to the same prior year period primarily due to a decrease in maintenance revenue.

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, 2012 and 2011 (in thousands):

	Maintenance	EDI	RCM	Other	Total
Three Months Ended December 31, 2012					
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	<u>\$ 39,463</u>	<u>\$ 15,209</u>	<u>\$ 15,015</u>	<u>\$ 15,658</u>	<u>\$ 85,345</u>
Three Months Ended December 31, 2011					
QSI Dental Division	\$ 1,946	\$ 1,230	\$ —	\$ 285	\$ 3,461
NextGen Division	30,246	10,871	—	10,116	51,233
Hospital Solutions Division	4,029	—	—	489	4,518
RCM Services Division	24	—	11,147	753	11,924
Consolidated	<u>\$ 36,245</u>	<u>\$ 12,101</u>	<u>\$ 11,147</u>	<u>\$ 11,643</u>	<u>\$ 71,136</u>

Maintenance revenue for the NextGen Division increased by \$3.5 million for the three months ended December 31, 2012 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 the Matrix acquisition. We intend to continue to promote maintenance, EDI and RCM services to both new and existing clients. Growth in other services revenue is primarily due to increases in third-party annual software licenses, consulting services, SaaS fees and hosting services revenue.

Cost of Revenue. Cost of revenue for the three months ended December 31, 2012 increased 21.6% to \$46.6 million from \$38.3 million in the same prior year period and the cost of revenue as a percentage of revenue increased to 40.7% from 34.0% driven primarily by a higher percentage of lower margin revenue streams such as implementation and RCM services as well as slight cost increases across all revenue categories.

The following table details revenue and cost of revenue on a consolidated and divisional basis for the three months ended December 31, 2012 and 2011 (in thousands):

	Three Months Ended December 31,			
	2012	%	2011	%
QSI Dental Division				
Revenue	\$ 5,088	100.0%	\$ 4,863	100.0%
Cost of revenue	2,507	49.3%	2,314	47.6%
Gross profit	\$ 2,581	50.7%	\$ 2,549	52.4%
NextGen Division				
Revenue	\$ 85,757	100.0%	\$ 85,900	100.0%
Cost of revenue	27,979	32.6%	23,804	27.7%
Gross profit	\$ 57,778	67.4%	\$ 62,096	72.3%
Hospital Solutions Division				
Revenue	\$ 7,365	100.0%	\$ 9,928	100.0%
Cost of revenue	4,055	55.1%	2,879	29.0%
Gross profit	\$ 3,310	44.9%	\$ 7,049	71.0%
RCM Services Division				
Revenue	\$ 16,300	100.0%	\$ 12,074	100.0%
Cost of revenue	11,384	69.8%	8,685	71.9%
Gross profit	\$ 4,916	30.2%	\$ 3,389	28.1%
Unallocated cost of revenue	\$ 671	N/A	\$ 652	N/A
Consolidated				
Revenue	\$ 114,510	100.0%	\$ 112,765	100.0%
Cost of revenue	46,596	40.7%	38,334	34.0%
Gross profit	\$ 67,914	59.3%	\$ 74,431	66.0%

Gross profit margins at the QSI Dental Division for the three months ended December 31, 2012 decreased to 50.7% from 52.4% for the same prior year period. Gross profit margins at the NextGen Division for three months ended December 31, 2012 decreased to 67.4% compared to 72.3% for the same prior year period primarily due to decreased software sales. Gross margin in the Hospital Solutions Division decreased to 44.9% for the three months ended December 31, 2012 as compared to 71.0% for the same prior year period due to growth in implementation and training revenue which carries lower profit margins compared to software. Implementation and training revenue in the Hospital Solutions Division represented approximately 20.5% of total Hospital Solutions Division revenue compared to 12.9% in the year ago period. Gross margin in the RCM Services Division increased to 30.2% for the three months ended December 31, 2012 as compared to 28.1% for 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, 2012 and 2011:

	Hardware, Third Party Software	Payroll and Related Benefits	EDI	Other	Total Cost of Revenue	Gross Profit
Three Months Ended December 31, 2012						
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%
Three Months Ended December 31, 2011						
QSI Dental Division	7.4%	24.1%	6.6%	9.5%	47.6%	52.4%
NextGen Division	1.0%	12.3%	7.1%	7.3%	27.7%	72.3%
Hospital Solutions Division	4.3%	16.0%	0.0%	8.7%	29.0%	71.0%
RCM Services Division	0.0%	47.6%	2.3%	22.0%	71.9%	28.1%
Consolidated	1.5%	16.9%	6.0%	9.6%	34.0%	66.0%

During the three months ended December 31, 2012, 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 19.0% of consolidated revenue in the three months ended December 31, 2012 compared to 16.9% during the same period last year. The absolute level of consolidated payroll and benefit expenses grew from \$19.1 million in the three months ended December 31, 2011 to \$21.7 million in the three months ended December 31, 2012, an increase of 13.8%, or approximately \$2.6 million. Of the \$2.6 million increase, approximately \$1.8 million of the increase is related to the RCM Services Division as RCM is a service business, which inherently has higher percentage of payroll costs as a percentage of revenue. Increases of approximately \$0.2 million in the NextGen Division and \$0.8 million for the Hospital Solutions Division are primarily due to headcount additions and increased payroll and benefits expense associated with delivering products and services. Payroll and benefit expenses related to the QSI Dental Division decreased \$0.2 million period over period. The amount of share-based compensation expense included in cost of revenue was not significant for the three months ended December 31, 2012 and 2011.

Other cost of revenue, which primarily consists of third-party annual license, hosting costs and outsourcing costs, increased to 12.5% of total revenue during the three months ended December 31, 2012 as compared to 9.6% for the same period a year ago. Other expenses increased as a percentage of revenue primarily due to a lower percentage of revenue from software licenses which do not carry a significant amount of other expenses.

As a result of the foregoing events and activities, our gross profit percentage decreased to 59.3% for the three months ended December 31, 2012 versus 66.0% for the same prior year period.

We are diligently managing our operating expenditures, balancing our goals of achieving high operating efficiency while maintaining our ongoing commitment to investing in our future. Due to the uncertainties in the timing of our sales arrangements, our sales mix, the acquisition and training of qualified personnel and other issues, we cannot accurately predict if related headcount and/or payroll expense as a percentage of revenue will increase or decrease in the future.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the three months ended December 31, 2012 increased 7.4% to \$35.5 million as compared to \$33.1 million for the prior year period. The increase in these expenses resulted primarily from:

- \$0.9 million increase in salaries and related benefit expenses primarily as a result of headcount additions;
- \$0.4 million increase in support services, depreciation and maintenance fees related to the April 1, 2012 go-live of our enterprise resource planning ("ERP") system;
- \$0.3 million of acquisition related expenses, including fair value adjustments;
- \$0.2 million increase in bad debt expense; and
- \$0.6 million net increase in other selling and administrative expenses.

Share-based compensation expense was approximately \$0.5 million and \$0.7 million for the three months ended December 31, 2012 and 2011, respectively, and is included in the aforementioned amounts. Selling, general and administrative expenses as a percentage of revenue increased from 29.3% in the three months ended December 31, 2011 to 31.0% in the three months ended December 31, 2012.

Going forward, we will continue to diligently manage our operating expenditures, balancing our goals of achieving high operating efficiency while maintaining our ongoing commitment to investing in our future. We do not anticipate significant increases in expenditures for trade shows, advertising and the employment of additional sales and administrative staff at the NextGen Division until additional revenue growth is achieved. While we expect selling, general and administrative expenses to increase on an absolute basis, we cannot accurately predict the impact these additional expenditures will have on selling, general and administrative expenses as a percentage of revenue.

Research and Development Costs. Research and development costs for the three months ended December 31, 2012 and 2011 were \$7.8 million and \$8.3 million, respectively. Research and development costs as a percentage of revenue decreased to 6.8% in the three months ended December 31, 2012 from 7.3% for the prior year period. The decrease in research and development expenses was primarily due to the achievement of technological feasibility for one of our major projects intended to bring greater integration between our ambulatory and inpatient software products and solutions, therefore allowing us to begin to capitalize costs related to this project in the current year. We also continue to invest significantly in enhancements to our specialty template development, preparation for ICD10 requirements, new products including NextGen Mobile, NextGen NextPen, NextGen Community Connectivity consisting of NextGen Health Information Exchange ("NextGen HIE," formerly Community Health Solution), 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, 2012 and 2011, our additions to capitalized software were \$6.0 million and \$3.4 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 increase in capitalized software added in the current quarter was primarily the result of greater investment in the hospital business unit. For the three months ended December 31, 2012 and 2011, total research and development expenditures including costs expensed and costs capitalized were \$13.8 million and \$11.7 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, 2012 and 2011.

Amortization of Acquired Intangible Assets. Amortization included in operating expenses related to acquired intangible assets for the three months ended December 31, 2012 and 2011 were \$1.2 million and \$0.5 million, respectively.

Interest and Other Income (Expense). Total interest and other expense for the three months ended December 31, 2012 was \$0.1 million of expense as compared to \$0.2 million of expense for the three months ended December 31, 2011. Interest and other income consist 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 and short-term U.S. Treasury securities with maturities of 90 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 to include investments with longer maturities of greater than 90 days, 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 Income Taxes. The provision for income taxes for the three months ended December 31, 2012 and 2011 were \$7.6 million and \$11.2 million, respectively. The effective tax rates were 32.9% and 34.8% for the three months ended December 31, 2012 and 2011, respectively. The effective rate for the three months ended December 31, 2012 decreased compared to the prior year period as a result of increased benefit of discrete items, principally the result of the lower level of taxable income in the current period. In addition, the effective tax rate reflects a reduction in the Company's composite state effective tax rate for the three months ended December 31, 2012, largely offset by the absence of a research and development tax credit in such period, due to the expiration of the applicable federal statute on December 31, 2011.

In January 2013, Congress enacted a tax law to extend the Federal research and development tax credit retroactive to January 1, 2012 and through December 31, 2013. As a result of the timing of this legislative change, we were not entitled to recognize any portion of the expected tax benefit relating to the 2012 federal research and development tax credit for the three months ended December 31, 2012. The full expected benefit of this credit for our current fiscal year will be recognized in the provision for income taxes in the three month period ended March 31, 2013.

Comparison of the Nine Months Ended December 31, 2012 and December 31, 2011

Net Income. Our net income for the nine months ended December 31, 2012 was \$46.8 million, or \$0.79 per share on both a basic and fully diluted basis. In comparison, we earned \$60.6 million, or \$1.03 per share on both a basic and fully diluted basis for the nine months ended December 31, 2011. The change in net income for the nine months ended December 31, 2012 was primarily attributed to the following:

- a 32.8% decrease in consolidated software and hardware gross profit as a result of reduced software revenue; and
- an increase in selling, general and administrative expenses, research and development costs and amortization of acquired intangibles; partially offset by
- an increase in implementation services gross profit of 32.3% compared to the prior year period; and
- an increase in recurring revenue based gross profit, including maintenance, RCM and EDI which grew 12.4%, 36.2% and 27.8%, respectively, compared to the prior year period

Revenue. Revenue for the nine months ended December 31, 2012 increased 8.8% to \$348.9 million from \$320.8 million for the nine months ended December 31, 2011. NextGen Division revenue increased 6.7% to \$259.3 million from \$243.0 million in the nine months ended December 31, 2011, QSI Dental Division revenue increased 2.9% to \$14.9 million from \$14.5 million, RCM Services Division revenue increased 27.0% to \$47.9 million from \$37.7 million, and Hospital Solutions Division revenue increased 4.8% to \$26.9 million from \$25.7 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, 2012 decreased 12.9% to \$99.3 million from \$114.0 million in the same prior year period.

Our decrease in revenue from sales of systems was principally the result of a 13.8% decrease in system sales revenue at our NextGen Division and a 6.5% decrease at our Hospital Solutions Division. NextGen Division sales in this category decreased \$13.2 million to \$82.2 million during the nine months ended December 31, 2012 from \$95.4 million during the same prior year period while the Hospital Solutions Division experienced a \$0.9 million decrease in category revenue to \$12.5 million in the nine months ended December 31, 2012 as compared to \$13.4 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, partially offset by increased implementation revenue at both the NextGen and Hospital Solutions Divisions.

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, 2012 and 2011 (in thousands):

	Software	Hardware, Third Party Software	Implementation and Training Services	Total System Sales
Nine Months Ended December 31, 2012				
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	<u>\$ 65,292</u>	<u>\$ 6,171</u>	<u>\$ 27,847</u>	<u>\$ 99,310</u>
Nine Months Ended December 31, 2011				
QSI Dental Division	\$ 1,996	\$ 1,312	\$ 893	\$ 4,201
NextGen Division	78,870	3,336	13,232	95,438
Hospital Solutions Division	8,658	890	3,827	13,375
RCM Services Division	783	—	169	952
Consolidated	<u>\$ 90,307</u>	<u>\$ 5,538</u>	<u>\$ 18,121</u>	<u>\$ 113,966</u>

NextGen Division software license revenue decreased 26.8% in the nine months ended December 31, 2012 versus the same period last year. The Division's software revenue accounted for 70.2% of divisional system sales revenue during the nine months ended December 31, 2012 compared to 82.6% during the same period a year ago. Software license revenue continues to be an area of primary emphasis for the NextGen Division. 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 EHR 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. We are developing new products around these new opportunities which are expected to help drive future growth. It is difficult to assess the relative impact as well as the timing of positive and negative trends, however, we believe the Company is well positioned to support the ever increasing need for healthcare information technology.

During the nine months ended December 31, 2012, 4.8% of the NextGen Division's system sales revenue was represented by hardware and third-party software compared to 3.5% 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 increased 55.5% in the nine months ended December 31, 2012 compared to the same prior year period. Implementation and training revenue related to system sales at the Hospital Solutions Division increased 56.5%, in the nine months ended December 31, 2012 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. The number of implementation and training staff increased during the nine months ended December 31, 2012 versus the same prior year period in order to accommodate the increased amount of implementation services sold in conjunction with software sales. In order to achieve growth in this area, additional staffing increases and additional training facilities are anticipated, though actual future increases in revenue and staff will depend upon the availability of qualified staff, business mix and conditions and our ability to retain current staff members.

Maintenance, EDI, RCM and Other Services. For the nine months ended December 31, 2012, our company-wide revenue from maintenance, EDI, RCM and other services grew 20.7% to \$249.6 million from \$206.9 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 and Hospital Solutions Divisions.

Total NextGen Division maintenance revenue for the nine months ended December 31, 2012 grew 14.0% to \$98.5 million from \$86.4 million for the same prior year period while NextGen Division EDI revenue grew 22.8% to \$40.0 million compared to \$32.5 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 34.7% to \$38.6 million in the nine months ended December 31, 2012 from \$28.6 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, 2012 and 2011 was \$10.9 million and \$10.3 million, respectively. For the nine months ended December 31, 2012, RCM revenue for the RCM Services Division grew \$9.7 million, or 28.5%, to \$43.9 million compared to \$34.2 million in the same prior year period. RCM revenue was positively impacted by the acquisition of Matrix which contributed \$9.2 million in the current year. For the Hospital Solutions Division, maintenance and other services revenue for the nine months ended December 31, 2012 increased 17.1% as compared to the same prior year period primarily due to the addition of new customers as well as contributions by the IntraNexus, CQI and Poseidon acquisitions.

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, 2012 and 2011 (in thousands):

	Maintenance	EDI	RCM	Other	Total
Nine Months Ended December 31, 2012					
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>
Nine Months Ended December 31, 2011					
QSI Dental Division	\$ 5,713	\$ 3,640	\$ —	\$ 915	\$ 10,268
NextGen Division	86,403	32,538	—	28,636	147,577
Hospital Solutions Division	10,757	—	—	1,539	12,296
RCM Services Division	88	—	34,170	2,476	36,734
Consolidated	<u>\$ 102,961</u>	<u>\$ 36,178</u>	<u>\$ 34,170</u>	<u>\$ 33,566</u>	<u>\$ 206,875</u>

Maintenance revenue for the NextGen Division increased by \$12.1 million for the nine months ended December 31, 2012 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 attributable to both organic growth as well as the addition in revenue from the Matrix acquisition. We intend to continue to promote maintenance, EDI and RCM services to both new and existing clients. Growth in other services revenue is primarily due to increases in third-party annual software licenses, consulting services, SaaS fees and hosting services revenue.

Cost of Revenue. Cost of revenue for the nine months ended December 31, 2012 increased 29.3% to \$141.4 million from \$109.3 million in the same prior year period and the cost of revenue as a percentage of revenue increased to 40.5% from 34.1% driven primarily by a higher percentage of lower margin revenue streams such as implementation and RCM services as well as 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, 2012 and 2011 (in thousands):

	Nine Months Ended December 31,			
	2012	%	2011	%
QSI Dental Division				
Revenue	\$ 14,886	100.0%	\$ 14,469	100.0%
Cost of revenue	7,556	50.8%	6,672	46.1%
Gross profit	\$ 7,330	49.2%	\$ 7,797	53.9%
NextGen Division				
Revenue	\$ 259,277	100.0%	\$ 243,015	100.0%
Cost of revenue	85,326	32.9%	67,509	27.8%
Gross profit	\$ 173,951	67.1%	\$ 175,506	72.2%
Hospital Solutions Division				
Revenue	\$ 26,903	100.0%	\$ 25,671	100.0%
Cost of revenue	12,835	47.7%	6,887	26.8%
Gross profit	\$ 14,068	52.3%	\$ 18,784	73.2%
RCM Services Division				
Revenue	\$ 47,868	100.0%	\$ 37,686	100.0%
Cost of revenue	33,608	70.2%	26,583	70.5%
Gross profit	\$ 14,260	29.8%	\$ 11,103	29.5%
Unallocated cost of revenue (1)	\$ 2,030	N/A	\$ 1,631	N/A
Consolidated				
Revenue	\$ 348,934	100.0%	\$ 320,841	100.0%
Cost of revenue	141,355	40.5%	109,282	34.1%
Gross profit	\$ 207,579	59.5%	\$ 211,559	65.9%

(1) Relates to the amortization of acquired software technology intangible assets

Gross profit margins at the QSI Dental Division for the nine months ended December 31, 2012 decreased to 49.2% from 53.9% for the same prior year period. Gross profit margins at the NextGen Division for nine months ended December 31, 2012 decreased to 67.1% compared to 72.2% for the same prior year period primarily due to decreased software sales. Gross margin in the Hospital Solutions Division decreased to 52.3% for the nine months ended December 31, 2012 as compared to 73.2% for the same prior year period due to growth in implementation and training revenue which carries lower profit margins compared to software. Gross margin in the RCM Services Division remained relatively consistent at 29.8% for the nine months ended December 31, 2012 as compared to 29.5% for 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 nine months ended December 31, 2012 and 2011:

	Hardware, Third Party Software	Payroll and Related Benefits	EDI	Other	Total Cost of Revenue	Gross Profit
Nine Months Ended December 31, 2012						
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%
Nine Months Ended December 31, 2011						
QSI Dental Division	7.4%	22.0%	8.5%	8.2%	46.1%	53.9%
NextGen Division	1.2%	12.0%	7.7%	6.9%	27.8%	72.2%
Hospital Solutions Division	3.7%	15.4%	0.0%	7.7%	26.8%	73.2%
RCM Services Division	0.0%	45.8%	2.1%	22.6%	70.5%	29.5%
Consolidated	1.5%	16.7%	6.5%	9.4%	34.1%	65.9%

During the nine months ended December 31, 2012, hardware and third-party software constituted a 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.

Our payroll and benefits expense associated with delivering our products and services increased to 17.8% of consolidated revenue in the nine months ended December 31, 2012 compared to 16.7% during the same period last year. The absolute level of consolidated payroll and benefit expenses grew from \$53.5 million in the nine months ended December 31, 2011 to \$62.1 million in the nine months ended December 31, 2012, an increase of 16.2%, or approximately \$8.6 million. Of the \$8.6 million increase, approximately \$4.5 million of the increase is related to the RCM Services Division as RCM is a service business, which inherently has higher percentage of payroll costs as a percentage of revenue. Increases of \$1.8 million in the NextGen Division, \$2.6 million for the Hospital Solutions Division are primarily due to headcount additions and increased payroll and benefits expense associated with delivering products and services. Payroll and benefit expenses related to the QSI Dental Division decreased \$0.3 million period over period. The amount of share-based compensation expense included in cost of revenue was not significant for nine months ended December 31, 2012 and 2011.

Other cost of revenue, which primarily consists of third-party annual license, hosting costs and outsourcing costs, increased to 13.5% of total revenue during the nine months ended December 31, 2012 as compared to 9.4% for the same period a year ago. Other expenses increased as a percentage of revenue primarily due to a lower percentage of revenue from software licenses which do not carry a significant amount of other expenses.

As a result of the foregoing events and activities, our gross profit percentage decreased to 59.5% for the nine months ended December 31, 2012 versus 65.9% for the same prior year period.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the nine months ended December 31, 2012 increased 16.3% to \$110.0 million as compared to \$94.7 million for the prior year period. The increase in these expenses resulted primarily from:

- \$5.9 million increase in salaries and related benefit expenses primarily as a result of headcount additions;
- \$1.2 million increase in support services, depreciation and maintenance fees related to the April 1, 2012 go-live of our ERP system;
- \$1.4 million of acquisition related expenses, including fair value adjustments;
- \$0.5 million increase in bad debt expense;
- \$1.3 million of proxy contest related expenses; and
- \$5.0 million net increase in other selling and administrative expenses.

Share-based compensation expense was approximately \$1.6 million and \$2.1 million for the nine months ended December 31, 2012 and 2011 and is included in the aforementioned amounts. Selling, general and administrative expenses as a percentage of revenue increased from 29.5% in the nine months ended December 31, 2011 to 31.5% in the nine months ended December 31, 2012.

Research and Development Costs. Research and development costs for the nine months ended December 31, 2012 and 2011 were \$22.6 million and \$22.5 million, respectively. Research and development costs as a percentage of revenue decreased to 6.5% in the nine months ended December 31, 2012 from 7.0% for the prior year period. The slower growth in research and development expenses was primarily due to the achievement of technological feasibility for a major project, allowing us to begin to capitalize costs related to this project in the current period, offset by continued investment in enhancements to our specialty template development, preparation for ICD10 requirements, new products including NextGen Mobile, NextGen NextPen, NextGen Community Connectivity consisting of NextGen Health Information Exchange ("NextGen HIE," formerly Community Health Solution), 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 nine months ended December 31, 2012 and 2011, our additions to capitalized software were \$20.1 million and \$9.6 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 increase in capitalized software added in the nine months ended December 31, 2012 included \$3.0 million paid for the source code of a pharmacy system which supports Hospital Division customers as well as greater investment in the hospital business unit. For the nine months ended December 31, 2012 and 2011, total research and development expenditures including costs expensed and costs capitalized were \$42.7 million and \$32.1 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, 2012 and 2011.

Amortization of Acquired Intangible Assets. Amortization included in operating expenses related to acquired intangible assets for the nine months ended December 31, 2012 and 2011 were \$3.7 million and \$1.5 million, respectively.

Interest and Other Income (Expense). Total interest and other expense was \$0.1 million in expense for the nine months ended December 31, 2012 and \$0.2 million in expense for the nine months ended December 31, 2011. 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, 2012 and 2011 were \$24.3 million and \$32.1 million, respectively. The effective tax rate was 34.2% and 34.7% for the nine months ended December 31, 2012 and 2011, respectively. The effective rate for the nine months ended December 31, 2012 decreased slightly due to increased benefit of discrete items, principally as a result of the lower level of taxable income in the current period. In addition, the effective tax rate reflects a reduction in the

Company's composite state effective tax rate for the nine months ended December 31, 2012, largely offset by the absence of a research and development tax credit in such period, due to the expiration of the applicable federal statute on December 31, 2011.

In January 2013, Congress enacted a tax law to extend the Federal research and development tax credit retroactive to January 1, 2012 and through December 31, 2013. As a result of the timing of this legislative change, we were not entitled to recognize any portion of the expected tax benefit relating to the 2012 federal research and development tax credit for the nine months ended December 31, 2012. The full expected benefit of this credit for our current fiscal year will be recognized in the provision for income taxes in the three month period ended March 31, 2013 and therefore be reflected in the annual effective tax rate for our full fiscal year.

Liquidity and Capital Resources

The following table presents selected financial statistics and information for the nine months ended December 31, 2012 and 2011 (dollar amounts in thousands):

	Nine Months Ended December 31,	
	2012	2011
Cash and cash equivalents	\$ 101,702	\$ 129,046
Net (decrease) increase in cash and cash equivalents	\$ (32,742)	\$ 12,429
Net income	\$ 46,814	\$ 60,584
Net cash provided by operating activities	\$ 44,845	\$ 61,742
Number of days of sales outstanding (1)	121	129

(1) Days sales outstanding is equal to 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 plus adjustments to add back non-cash expenses, including 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, 2012 and 2011 (in thousands):

	Nine Months Ended December 31,	
	2012	2011
Net income	\$ 46,814	\$ 60,584
Non-cash expenses	24,112	16,940
Change in deferred revenue	(20,111)	13,336
Change in accounts receivable	(8,665)	(22,312)
Change in other assets and liabilities	2,695	(6,806)
Net cash provided by operating activities	\$ 44,845	\$ 61,742

Net Income. As referenced in the above table, net income makes up the majority of our cash generated from operations for the nine months ended December 31, 2012 and 2011.

Non-Cash Expenses. Non-cash expenses include depreciation, amortization of intangibles and amortization of capitalized software costs, provisions for bad debts, share-based compensation, changes in fair value of contingent consideration and deferred taxes. Total non-cash expenses were \$24.1 million and \$16.9 million for the nine months ended December 31, 2012 and 2011, respectively.

The \$7.2 million increase in non-cash expenses for the nine months ended December 31, 2012 as compared to the same prior year period is related to increases of approximately \$1.2 million in depreciation, \$1.3 million of amortization of capitalized software costs, \$0.5 million of bad debt expense, \$2.5 million of amortization of other intangibles, \$2.5 million of excess tax benefit from share-based compensation and \$1.0 million in fair value adjustments for contingent consideration, offset by a \$0.5 million decrease in share-based compensation and a \$1.3 million increase in deferred income tax benefit.

Deferred Revenue. Cash from operations was negatively impacted by a decrease in deferred revenues of approximately \$20.1 million for the nine months ended December 31, 2012 versus an increase of \$13.3 million in the same prior year period. The decline in deferred revenue was primarily due to lower deferred implementation services, which was related to a decline in system sales during the period. Deferred implementation revenue was also impacted by a change in the Company's standard payment terms for implementation services. During the quarter ended March 31, 2012, the Company modified its standard payment terms for implementation services sold in conjunction with software to separate license fee payments from services and to bill for services as such services are provided. This change results in implementation

service fees not being recorded as both accounts receivable and deferred revenue upon the execution of a contract. In future periods, deferred implementation and training revenue is not expected to be as significant due to this change in standard payment terms.

Accounts Receivable. Accounts receivable grew by approximately \$8.7 million and \$22.3 million for the nine months ended December 31, 2012 and 2011, respectively. The increase in accounts receivable is due to the following factors:

- Consolidated revenue grew 8.8% to \$348.9 million compared to \$320.8 million in the prior comparable period;
- Accounts receivable growth was partially offset by a smaller amount of services sold in advance of being rendered. This is a result of the Company modifying its standard payment terms for implementation services sold in conjunction with software to separate license fee payments from services and instead billing for services as services are incurred. This change results in implementation service fees not being recorded as both accounts receivable and deferred revenue upon the execution of a contract; and
- The turnover of accounts receivable measured in terms of days sales outstanding (“DSO”) decreased from 129 days to 121 days during the nine months ended December 31, 2012 as compared the same prior year period. The decrease in DSO is primarily due to a change in the mix of revenue towards services versus systems sales which generally has a faster turnover of accounts receivable. DSO was also impacted by a smaller amount of services sold in advance as discussed above.

Provided turnover of accounts receivable, deferred revenue and profitability remain consistent with the 2012 fiscal year, we anticipate being able to continue generating cash from operations during fiscal year 2013 primarily from our net income.

Other Assets and Liabilities. Cash from operations in the nine months ended December 31, 2012 was positively impacted by a net \$2.7 million increase in other assets and liabilities compared to a net decrease of \$6.8 million for the nine months ended December 31, 2011. For the nine months ended December 31, 2012, the \$2.7 million change in other assets and liabilities is primarily the result of an increase in accounts payable of \$1.3 million, an increase of \$6.6 million in other current and non-current liabilities primarily due to the contingent consideration related to the acquisitions in the current period, partially offset by a decrease in accrued compensation of \$3.3 million, driven primarily by a reduction in performance-based bonuses and commission accruals, and a \$1.9 million net decrease in all other assets and liabilities.

Cash Flows from Investing Activities

Net cash used in investing activities for the nine months ended December 31, 2012 and 2011 was \$34.4 million and \$28.4 million, respectively. The \$6.0 million increase in net cash used in investing activities during the nine months ended December 31, 2012 as compared to the same prior year period is primarily due to net cash paid for the acquisitions of Matrix and Poseidon of \$5.1 million and \$2.0 million, respectively, in addition to increases of \$20.1 million and \$7.2 million, respectively, for capitalized software and equipment and improvements. The prior year period cash flows from investing activities primarily consists of net cash paid for the acquisitions of IntraNexus, CQI and ViaTrack of \$3.3 million, \$2.5 million and \$5.7 million, respectively, in addition to increases of \$9.6 million and \$7.4 million, respectively, for capitalized software and equipment and improvements.

Cash Flows from Financing Activities

Net cash used in financing activities for the nine months ended December 31, 2012 and 2011 was \$43.2 million and \$20.9 million, respectively. During the nine months ended December 31, 2012, we received proceeds of \$0.8 million from the exercise of stock options, paid \$41.5 million in dividends to shareholders and paid \$2.4 million in contingent consideration related to acquisitions compared to receiving proceeds of \$7.3 million from the exercise of stock options and payments of \$30.7 million in dividends to shareholders during the same prior year period.

We recorded a reduction in our tax benefit from share-based compensation of \$2.5 million during the nine months ended December 31, 2011 related to tax deductions received from stock option exercises. The benefit was recorded as additional paid in capital. The tax benefit from share-based compensation was not significant for the nine months ended December 31, 2012.

Cash and Cash Equivalents and Marketable Securities

At December 31, 2012, we had cash and cash equivalents of \$101.7 million. We may use a portion of these funds 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. We anticipate capital expenditures will increase in fiscal year 2013 and 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 of the months of October, January, April and July.

On January 23, 2013, 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 15, 2013 with an expected distribution date on or about April 5, 2013.

Our Board of Directors declared the following dividends during the periods presented (stock split adjusted):

Declaration Date	Record Date	Payment Date	Per Share Dividend	
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
Fiscal year 2013			\$	0.525
May 25, 2011	June 17, 2011	July 5, 2011	\$	0.175
July 27, 2011	September 19, 2011	October 5, 2011	\$	0.175
October 26, 2011	December 20, 2011	January 5, 2012	\$	0.175
January 25, 2012	March 20, 2012	April 5, 2012	\$	0.175
Fiscal year 2012			\$	0.700

Management believes that its cash and cash equivalents on hand at December 31, 2012, together with its marketable securities and cash flows from operations, if any, 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 remainder of fiscal year 2013.

Contractual Obligations

The following table summarizes our significant contractual obligations, all of which relate to operating leases, at December 31, 2012 and the effect that such obligations are expected to have on our liquidity and cash in future periods. The table below does not include the cash settlement portion of contingent consideration obligations as the Company determined such amounts were not significant for disclosure purposes.

For the year ended March 31,	
2013 (remaining three months)	\$ 2,053
2014	7,238
2015	6,167
2016	5,528
2017 and beyond	8,170
	<u>\$ 29,156</u>

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, 2012, 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 April 1, 2012, we implemented a corporate-wide Enterprise Resource Planning ("ERP") system. Our new ERP system will standardize and automate business processes, improve operational and financial performance, and enhance internal controls. The implementation of our new ERP system has resulted in changes to our business processes and internal controls over financial reporting. The key controls surrounding the ERP system are being identified and are subject to our Sarbanes-Oxley testing.

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

We have experienced legal claims by customers regarding product and contract disputes and by other third parties asserting that we have infringed their intellectual property rights. We believe that these claims are without merit and intend to defend against them vigorously; however, we could incur substantial costs and diversion of management resources defending any such claim, even if we are ultimately successful in the defense of such matter. 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.

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 and the risk factor set forth below, which supplements and/or updates the risk factors previously disclosed.

We could suffer 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 provisions of ASC 350, *Intangibles - Goodwill and Other*. Although no goodwill impairment exists in any of our operating segments at this time, declines in business performance or other factors could cause the fair value of one or more of our operating segments to be revised downward. For example, our Hospital Solutions Division has experienced recent declines in operating performance due to several factors, including higher costs related to the expansion of implementation and support infrastructure, increased sales and administrative costs, a reduction in maintenance revenue, lower system sales revenues and higher levels of sales credits. If the Hospital Solutions Division or any of our other operating segments fail to achieve sustained revenue growth and improved operating margins, the fair value of such operating segments could be negatively impacted, resulting in an impairment charge that could materially affect our reported net earnings.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE AND SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number Description

10.1ü	Form of Indemnification Agreement is incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on January 28, 2013.
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

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

* 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.

QUALITY SYSTEMS, INC.

Date: February 5, 2013

By: /s/ Steven T. Plochocki

Steven T. Plochocki

Chief Executive Officer (Principal Executive Officer)

Date: February 5, 2013

By: /s/ Paul A. Holt

Paul A. Holt

Chief Financial Officer (Principal Accounting Officer)

EXHIBIT 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**

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: February 5, 2013

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: February 5, 2013

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, 2012 (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: February 5, 2013

By: /s/ Steven T. Plochocki

Steven T. Plochocki

Chief Executive Officer (Principal Executive Officer)

Date: February 5, 2013

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.