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

FORM 10-Q

(Mark One)



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

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

OR



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

For the transition period from _____ to _____

Commission file number **0-22823**

QAD Inc.

(Exact name of Registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

77-0105228

(I.R.S. Employer Identification No.)

100 Innovation Place, Santa Barbara, California 93108

(Address of principal executive offices)

(805) 566-6000

(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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer ☐

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

Accelerated filer ☒

Smaller reporting company ☐

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

As of August 31, 2013, there were 12,516,681 shares of the Registrant's Class A common stock outstanding and 3,146,641 shares of the Registrant's Class B common stock outstanding.

**QAD INC.
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PART I

ITEM 1 – FINANCIAL STATEMENTS

QAD INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	July 31, 2013	January 31, 2013
Assets		
Current assets:		
Cash and equivalents	\$ 69,395	\$ 65,009
Accounts receivable, net of allowances of \$2,298 and \$2,510 at July 31, 2013 and January 31, 2013, respectively	42,733	72,564
Deferred tax assets, net	4,289	4,414
Other current assets	13,786	13,806
Total current assets	130,203	155,793
Property and equipment, net	33,280	32,526
Capitalized software costs, net	3,690	4,180
Goodwill	11,302	11,412
Deferred tax assets, net	16,291	16,431
Other assets, net	5,325	5,606
Total assets	\$ 200,091	\$ 225,948
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portion of long-term debt	\$ 380	\$ 372
Accounts payable	8,052	12,537
Deferred revenue	86,031	101,193
Other current liabilities	26,691	31,415
Total current liabilities	121,154	145,517
Long-term debt	15,279	15,474
Other liabilities	5,891	6,759
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value. Authorized 5,000,000 shares; none issued or outstanding	—	—
Common stock:		
Class A, \$0.001 par value. Authorized 71,000,000 shares; issued 14,149,675 shares and 14,148,217 shares at July 31, 2013 and January 31, 2013, respectively	14	14
Class B, \$0.001 par value. Authorized 4,000,000 shares; issued 3,536,985 shares and 3,536,822 shares at July 31, 2013 and January 31, 2013, respectively	4	4
Additional paid-in capital	150,519	149,777
Treasury stock, at cost (2,023,609 shares and 2,097,497 shares at July 31, 2013 and January 31, 2013, respectively)	(29,726)	(31,093)
Accumulated deficit	(55,399)	(52,468)
Accumulated other comprehensive loss	(7,645)	(8,036)
Total stockholders' equity	57,767	58,198
Total liabilities and stockholders' equity	\$ 200,091	\$ 225,948

See Accompanying Notes to Condensed Consolidated Financial Statements.

QAD INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(in thousands, except per share data)
(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2013	2012	2013	2012
Revenue:				
License fees	\$ 8,604	\$ 6,906	\$ 14,822	\$ 14,771
Maintenance and other	34,254	33,886	69,455	68,406
Subscription fees	4,455	3,745	8,497	6,968
Professional services	17,881	16,432	34,347	34,532
Total revenue	<u>65,194</u>	<u>60,969</u>	<u>127,121</u>	<u>124,677</u>
Costs of revenue:				
License fees	1,058	832	2,013	1,713
Maintenance, subscription and other	11,047	10,341	22,109	20,341
Professional services	16,672	15,846	33,280	31,584
Total cost of revenue	<u>28,777</u>	<u>27,019</u>	<u>57,402</u>	<u>53,638</u>
Gross profit	<u>36,417</u>	<u>33,950</u>	<u>69,719</u>	<u>71,039</u>
Operating expenses:				
Sales and marketing	15,850	14,747	31,906	30,243
Research and development	10,469	9,210	21,314	18,744
General and administrative	8,431	8,378	16,377	16,483
Amortization of intangibles from acquisitions	177	57	353	57
Total operating expenses	<u>34,927</u>	<u>32,392</u>	<u>69,950</u>	<u>65,527</u>
Operating income (loss)	1,490	1,558	(231)	5,512
Other (income) expense:				
Interest income	(73)	(164)	(170)	(327)
Interest expense	209	330	412	616
Other (income) expense, net	(809)	92	(1,082)	538
Total other (income) expense	<u>(673)</u>	<u>258</u>	<u>(840)</u>	<u>827</u>
Income before income taxes	2,163	1,300	609	4,685
Income tax expense	<u>909</u>	<u>341</u>	<u>618</u>	<u>1,882</u>
Net income (loss)	<u>\$ 1,254</u>	<u>\$ 959</u>	<u>\$ (9)</u>	<u>\$ 2,803</u>
Basic net income (loss) per share				
Class A	\$ 0.08	\$ 0.06	\$ (0.00)	\$ 0.18
Class B	\$ 0.07	\$ 0.05	\$ (0.00)	\$ 0.15
Diluted net income (loss) per share				
Class A	\$ 0.08	\$ 0.06	\$ (0.00)	\$ 0.18
Class B	\$ 0.07	\$ 0.05	\$ (0.00)	\$ 0.15
Comprehensive income:				
Foreign currency translation adjustment, net of tax	18	(75)	391	70
Total comprehensive income	<u>\$ 1,272</u>	<u>\$ 884</u>	<u>\$ 382</u>	<u>\$ 2,873</u>

See Accompanying Notes to Condensed Consolidated Financial Statements.

QAD INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended July 31,	
	2013	2012
Cash flows from operating activities:		
Net (loss) income	\$ (9)	\$ 2,803
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	3,015	2,361
Provision for doubtful accounts and sales adjustments	331	64
Change in fair value of interest rate swap	(708)	857
Stock compensation expense	2,494	2,467
Excess tax benefits from share-based payment arrangements	(81)	(123)
Changes in assets and liabilities:		
Accounts receivable	28,271	28,241
Other assets	568	267
Accounts payable	(4,258)	(2,517)
Deferred revenue	(12,914)	(16,058)
Other liabilities	(3,660)	(6,989)
Net cash provided by operating activities	13,049	11,373
Cash flows from investing activities:		
Purchase of property and equipment	(3,000)	(2,029)
Acquisition of business, net of cash acquired	—	(4,713)
Capitalized software costs	(148)	(199)
Other	31	2
Net cash used in investing activities	(3,117)	(6,939)
Cash flows from financing activities:		
Repayments of debt	(187)	(111)
Tax payments, net of proceeds, related to stock awards	(589)	(786)
Excess tax benefits from share-based payment arrangements	81	123
Repurchase of common stock	(686)	(3,899)
Cash dividends paid	(3,119)	(1,841)
Net cash used in financing activities	(4,500)	(6,514)
Effect of exchange rates on cash and equivalents	(1,046)	(1,004)
Net increase (decrease) in cash and equivalents	4,386	(3,084)
Cash and equivalents at beginning of period	65,009	76,927
Cash and equivalents at end of period	<u>\$ 69,395</u>	<u>\$ 73,843</u>
Supplemental disclosure of non-cash activities:		
Future obligations associated with dividend declaration	\$ —	\$ 1,115
Dividends paid in stock	145	334

See Accompanying Notes to Condensed Consolidated Financial Statements.

QAD INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. BASIS OF PRESENTATION

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements fairly present the financial information contained therein. These statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In management's opinion, all necessary adjustments, consisting of normal, recurring and non-recurring adjustments, have been included in the accompanying Condensed Consolidated Financial Statements to present fairly the financial position and operating results of QAD Inc. ("QAD" or the "Company"). The Condensed Consolidated Financial Statements do not include all disclosures required by accounting principles generally accepted in the United States of America for annual financial statements and should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended January 31, 2013. The Condensed Consolidated Financial Statements include the results of the Company and its wholly owned subsidiaries. The results of operations for the three and six months ended July 31, 2013 are not necessarily indicative of the results to be expected for the year ending January 31, 2014.

2. COMPUTATION OF NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2013	2012	2013	2012
	(in thousands)		(in thousands)	
Net income (loss)	\$ 1,254	\$ 959	\$ (9)	\$ 2,803
Less: Dividends declared	(1,089)	(1,110)	(2,177)	(2,187)
Undistributed net income (loss)	<u>\$ 165</u>	<u>\$ (151)</u>	<u>\$ (2,186)</u>	<u>\$ 616</u>
Net income (loss) per share – Class A Common Stock				
Dividends declared	\$ 900	\$ 920	\$ 1,799	\$ 1,810
Allocation of undistributed net income (loss)	136	(125)	(1,805)	509
Net income (loss) attributable to Class A common stock	<u>\$ 1,036</u>	<u>\$ 795</u>	<u>\$ (6)</u>	<u>\$ 2,319</u>
Weighted average shares of Class A common stock outstanding— <i>basic</i>	12,473	12,649	12,451	12,671
Weighted average potential shares of Class A common stock	430	433	-	473
Weighted average shares of Class A common stock and potential common shares outstanding— <i>diluted</i>	<u>12,903</u>	<u>13,082</u>	<u>12,451</u>	<u>13,144</u>
Basic net income (loss) per Class A common share	<u>\$ 0.08</u>	<u>\$ 0.06</u>	<u>\$ (0.00)</u>	<u>\$ 0.18</u>
Diluted net income (loss) per Class A common share	<u>\$ 0.08</u>	<u>\$ 0.06</u>	<u>\$ (0.00)</u>	<u>\$ 0.18</u>
Net income (loss) per share – Class B Common Stock				
Dividends declared	\$ 189	\$ 190	\$ 378	\$ 377
Allocation of undistributed net income (loss)	29	(26)	(381)	107
Net income (loss) attributable to Class B common stock	<u>\$ 218</u>	<u>\$ 164</u>	<u>\$ (3)</u>	<u>\$ 484</u>
Weighted average shares of Class B common stock outstanding— <i>basic</i>	3,145	3,164	3,145	3,166
Weighted average potential shares of Class B common stock	86	100	-	108
Weighted average shares of Class B common stock and potential common shares outstanding— <i>diluted</i>	<u>3,231</u>	<u>3,264</u>	<u>3,145</u>	<u>3,274</u>
Basic net income (loss) per Class B common share	<u>\$ 0.07</u>	<u>\$ 0.05</u>	<u>\$ (0.00)</u>	<u>\$ 0.15</u>
Diluted net income (loss) per Class B common share	<u>\$ 0.07</u>	<u>\$ 0.05</u>	<u>\$ (0.00)</u>	<u>\$ 0.15</u>

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Potential common shares consist of the shares issuable upon the release of restricted stock units (“RSUs”) and the exercise of stock options and stock appreciation rights (“SARs”). The Company’s unvested RSUs are not considered participating securities as they do not have rights to dividends or dividend equivalents prior to release. In addition, the Company’s unexercised stock options and SARs are not considered participating securities as they do not have rights to dividends or dividend equivalents prior to exercise.

The following table sets forth the number of potential common shares not included in the calculation of diluted earnings per share because their effects were anti-dilutive:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2013	2012	2013	2012
	(in thousands)		(in thousands)	
Class A	2,592	2,306	2,915	2,199
Class B	370	349	456	365

3. FAIR VALUE MEASUREMENTS

When determining fair value, the Company uses a three-tier value hierarchy which prioritizes the inputs used in measuring fair value. Whenever possible, the Company uses observable market data. The Company relies on unobservable inputs only when observable market data is not available. Classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability. Money market mutual funds are recorded at fair value based upon quoted market prices and are therefore included in Level 1. The asset or liability related to the interest rate swap is recorded at fair value based upon a valuation model that uses relevant observable market inputs at quoted intervals, such as forward yield curves, and is therefore included in Level 2.

The following table sets forth the financial assets and liabilities, measured at fair value, as of July 31, 2013 and January 31, 2013:

	Fair value measurement at reporting date using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (in thousands)	Significant Unobservable Inputs (Level 3)
Money market mutual funds as of July 31, 2013	\$ 50,997	\$ —	\$ —
Money market mutual funds as of January 31, 2013	\$ 44,871	\$ —	\$ —
Asset related to interest rate swap as of July 31, 2013	\$ —	\$ 324	\$ —
Liability related to interest rate swap as of January 31, 2013	\$ —	\$ (384)	\$ —

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Money market mutual funds are classified as part of “Cash and equivalents” in the accompanying Condensed Consolidated Balance Sheets. In addition, the amount of cash and equivalents included cash deposited with commercial banks of \$ 18.4 million and \$20.1 million as of July 31, 2013 and January 31, 2013, respectively.

The Company’s line of credit and note payable both bear a variable market interest rate commensurate with the Company’s credit standing. Therefore, the carrying amounts outstanding under the line of credit and note payable reasonably approximate fair value based on Level 2 inputs.

There have been no transfers between fair value measurements levels during the three months ended July 31, 2013.

Derivative Instruments

The Company entered into an interest rate swap in May 2012 to mitigate its exposure to the variability of one month LIBOR for its floating rate debt described in Note 7 “Debt” within these Notes to Condensed Consolidated Financial Statements. The fair value of the interest rate swap is reflected as an asset or liability in the Condensed Consolidated Balance Sheets and the change in fair value is reported in “Other (income) expense” in the Condensed Consolidated Statements of Operations and Comprehensive Income. The fair value of the interest rate swap is estimated as the net present value of projected cash flows based upon forward interest rates at the balance sheet date.

The fair values of the derivative instrument at July 31, 2013 and January 31, 2013 were as follows (in thousands):

	Balance Sheet Location	Asset/(Liability) Derivative	
		Fair Value	
		July 31, 2013	January 31, 2013
Derivative instrument:			
Interest rate swap	Other assets, net (Other liabilities)	\$ 324	\$ (384)
Total		<u>\$ 324</u>	<u>\$ (384)</u>

The change in fair value of the interest rate swap recognized in the Condensed Consolidated Statement of Operations and Comprehensive Income for the six months ended July 31, 2013 was \$0.7 million.

4. BUSINESS COMBINATIONS

CEBOS

On December 28, 2012, the Company acquired all of the outstanding stock of CEBOS, Ltd. ("CEBOS"), a provider of quality management and regulatory compliance software solutions, in a nontaxable transaction. CEBOS was founded in 1998 and is headquartered in Michigan, USA. The Company completed the acquisition for the purpose of expanding its product offerings and driving revenue growth. The purchase price consisted of \$3.5 million in cash and two future payments of \$750,000 each, due April 2014 and April 2015, respectively. Each future payment consists of \$250,000 guaranteed and \$500,000 contingent upon achievement of certain development and sales-based milestones. The contingent liability was estimated by assessing the probability of achieving each milestone and discounting the amount of each potential payment based on expected timing of the payment. The fair value of the liability-classified contingent consideration is remeasured at each reporting period with any changes in the fair value recorded as income or expense. The potential undiscounted amount of all future cash payments that the Company could be required to make for contingent consideration is between \$0.5 million and \$1.5 million as of July 31, 2013.

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The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date (in thousands):

Tangible assets, including cash acquired of \$0.4 million	\$ 1,423
Goodwill	2,456
Other intangible assets	3,450
Total assets acquired	7,329
Liabilities assumed	(1,233)
Deferred tax liability	(1,209)
Net assets acquired	\$ 4,887

The Company believes the amount of goodwill resulting from the purchase price allocation is attributable to the workforce of the acquired business and the expected synergistic benefits of being able to leverage CEBOS's software with the Company's existing software to provide an integrated suite to the customer bases of both the Company and CEBOS. The acquired goodwill and intangible assets are not deductible for tax purposes.

Identified intangible assets will be amortized to cost of license fees and operating expense based upon the nature of the asset ratably over the estimated useful life, as detailed in the table below (in thousands, except year amounts):

	Estimated useful life (years)	Fair value	Estimated annual amortization	Statement of operations classification
Software technology	2 - 5	\$ 1,750	\$ 320-395	Cost of license fees
Customer relationships	5	1,500	300	Amortization of intangibles from acquisitions
Trade name	5	200	40	Amortization of intangibles from acquisitions
		\$ 3,450		

The Company has evaluated and continues to reevaluate pre-acquisition contingencies relating to CEBOS that existed as of the acquisition date. The Company has preliminarily determined that certain of these pre-acquisition contingencies are probable in nature and estimable as of the acquisition date and, accordingly, has recorded its best estimates for these contingencies as a part of the purchase price allocation. Although the Company believes the assumptions and estimates made in the past have been reasonable and appropriate, they are based in part on historical experience and are inherently uncertain. The purchase price allocation process requires the Company to use significant estimates and assumptions as of the business combination date, including the estimated fair value of accounts receivable acquired. The Company continues to gather information and evaluate pre-acquisition contingencies that it has assumed. If the Company makes changes to the amounts recorded or identifies additional pre-acquisition contingencies during the remainder of the measurement period, such amounts recorded will be included in the purchase price allocation.

DynaSys

On June 6, 2012, the Company acquired France-based DynaSys S.A. ("DynaSys"), a provider of demand and supply chain planning software solutions, for \$7.5 million.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date (in thousands):

Tangible assets, including cash acquired of \$2.8 million	\$ 4,250
Goodwill	2,231
Software technology	1,800
Customer relationships	1,400
Trade name	300
Total assets acquired	9,981
Liabilities assumed	(2,032)
Deferred tax liability	(450)
Net assets acquired	\$ 7,499

The results of operations of DynaSys and CEBOS are included in the Condensed Consolidated Financial Statements from the date of acquisition. The acquisitions were not deemed material, thus pro forma supplemental information has not been provided.

5. CAPITALIZED SOFTWARE COSTS

Capitalized software costs and accumulated amortization at July 31, 2013 and January 31, 2013 were as follows:

	July 31, 2013	January 31, 2013
	(in thousands)	
Capitalized software costs:		
Acquired software technology	\$ 3,741	\$ 3,741
Capitalized software development costs (1)	1,114	1,253
	4,855	4,994
Less accumulated amortization	(1,165)	(814)
Capitalized software costs, net	<u>\$ 3,690</u>	<u>\$ 4,180</u>

(1) Capitalized software development costs include the impact of foreign currency translation.

Acquired software technology costs relate to technology purchased as a result of the Company's fiscal 2013 acquisitions of DynaSys and CEBOS, as described in Note 4 "Business Combinations" within these Notes to Condensed Consolidated Financial Statements. In addition to the acquired software technology, the Company has capitalized costs related to translations and localizations of QAD Enterprise Applications.

It is the Company's policy to write off capitalized software development costs once fully amortized. Accordingly, during the first six months of fiscal 2014, \$0.2 million of costs and accumulated amortization were removed from the balance sheet. Amortization of capitalized software costs was \$0.3 million and \$0.6 million for the three and six months ended July 31, 2013, respectively. For the three and six months ended July 31, 2012, amortization of capitalized software costs was \$0.1 million and \$0.2 million, respectively. Amortization of capitalized software costs is included in "Cost of license fees" in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Income.

The following table summarizes the estimated amortization expense relating to the Company's capitalized software costs as of July 31, 2013:

Fiscal Years	(in thousands)
2014 remaining	\$ 573
2015	1,052
2016	905
2017	734
2018	426
Total	<u>\$ 3,690</u>

6. GOODWILL AND INTANGIBLE ASSETS

Goodwill

The changes in the carrying amount of goodwill for the six months ended July 31, 2013, were as follows:

	Gross Carrying Amount	Accumulated Impairment	Goodwill, Net
		(in thousands)	
Balance at January 31, 2013	\$ 27,020	\$ (15,608)	\$ 11,412
Impact of foreign currency translation	(110)	—	(110)
Balance at July 31, 2013	<u>\$ 26,910</u>	<u>\$ (15,608)</u>	<u>\$ 11,302</u>

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The Company performed its annual goodwill impairment review during the fourth quarter of fiscal 2013. The analysis compared the Company's market capitalization to its net assets as of the test date, November 30, 2012. As the market capitalization significantly exceeded the Company's net assets, there was no indication of goodwill impairment for fiscal 2013. The Company monitors the indicators for goodwill impairment testing between annual tests. No adverse events occurred during the six months ended July 31, 2013, that would cause the Company to test goodwill for impairment.

Intangible Assets

	July 31, 2013	January 31, 2013
	(in thousands)	
Amortizable intangible assets		
Customer relationships (1)	\$ 3,014	\$ 3,049
Trade name	532	532
	3,546	3,581
Less: accumulated amortization	(629)	(279)
Net amortizable intangible assets	<u>\$ 2,917</u>	<u>\$ 3,302</u>

(1) Customer relationships include the impact of foreign currency translation.

The Company's intangible assets are related to the DynaSys and CEBOS acquisitions completed in fiscal 2013. Intangible assets are included in "Other assets, net" in the accompanying Condensed Consolidated Balance Sheets. As of July 31, 2013, all of the Company's intangible assets were determined to have finite useful lives, and therefore were subject to amortization.

Amortization of intangible assets was \$177,000 and \$353,000 for the three and six months ended July 31, 2013, respectively. Amortization of intangible assets was \$57,000 for both the three and six months ended July 31, 2012. The following table summarizes the estimated amortization expense relating to the Company's intangible assets as of July 31, 2013:

Fiscal Years	(in thousands)
2014 remaining	\$ 355
2015	709
2016	709
2017	709
2018	435
Total	<u>\$ 2,917</u>

7. DEBT

	July 31, 2013	January 31, 2013
	(in thousands)	
Note payable	\$ 15,659	\$ 15,846
Less current maturities	(380)	(372)
Long-term debt	<u>\$ 15,279</u>	<u>\$ 15,474</u>

Note Payable

Effective May 30, 2012, the Company's wholly-owned subsidiary QAD Ortega Hill, LLC entered into a variable rate credit agreement (the "2012 Mortgage") with Rabobank, N.A., to refinance a pre-existing mortgage. The 2012 Mortgage has an original principal balance of \$16.1 million and bears interest at the one month LIBOR rate plus 2.25%. One month LIBOR was 0.19% at July 31, 2013. The 2012 Mortgage matures in June 2022 and is secured by the Company's headquarters located in Santa Barbara, California. In conjunction with the 2012 Mortgage, QAD Ortega Hill, LLC entered into an interest rate swap with Rabobank, N.A. The swap agreement has an initial notional amount of \$16.1 million and a schedule matching that of the underlying loan that synthetically fixes the interest rate on the debt at 4.31% for the entire term of the 2012 Mortgage. The terms of the 2012 Mortgage provide for QAD Ortega Hill, LLC to make net monthly payments of \$88,100 consisting of principal and interest and one final payment of \$11.7 million. The unpaid balance as of July 31, 2013 was \$15.7 million.

Credit Facility

The Company has an unsecured credit agreement with Rabobank, N.A. (the “Facility”). The Facility provides for a \$20 million line of credit for working capital or other business needs and matures on July 15, 2014. The Company pays a commitment fee of 0.25% per annum of the daily average of the unused portion of the \$20 million Facility. Borrowings under the Facility bear interest at a rate equal to one month LIBOR plus 0.75%.

The Facility provides that the Company maintain certain financial and operating ratios which include, among other provisions, minimum liquidity on a consolidated basis of \$25 million in cash and equivalents at all times, a current ratio (calculated using current liabilities excluding deferred revenue) of not less than 1.3 to 1.0 determined at the end of each fiscal quarter, a leverage ratio of not more than 1.5 to 1.0 determined at the end of each fiscal quarter, and a debt service coverage ratio of not less than 1.5 to 1.0 determined at the end of each fiscal year. The Facility also contains customary covenants that could restrict the Company’s ability to incur additional indebtedness. At July 31, 2013, the effective borrowing rate would have been 0.94%.

As of July 31, 2013, there were no borrowings under the Facility and the Company was in compliance with all financial covenants.

8. ACCUMULATED OTHER COMPREHENSIVE LOSS

The components of accumulated other comprehensive loss, net of taxes, were as follows:

	Foreign Currency Translation Adjustments	Total
	(in thousands)	
Balance as of January 31, 2013	\$ (8,036)	\$ (8,036)
Other comprehensive income before reclassifications	391	391
Amounts reclassified from accumulated other comprehensive loss	—	—
Net current period other comprehensive income	391	391
Balance as of July 31, 2013	\$ (7,645)	\$ (7,645)

9. INCOME TAXES

The Company recorded income tax expense of \$0.9 million and \$0.3 million in the second quarter of fiscal 2014 and 2013, respectively. The effective tax rate increased to 42% during the second quarter of fiscal 2014 compared to 26% for the same period in the prior year. The increase in overall tax rate for the second quarter of fiscal 2014 is primarily due to a significant equity compensation shortfall. A shortfall is a result of stock-based compensation expense recorded in the financial statements being greater than the tax deduction generated by the exercise of SARs and the vesting of RSUs.

The Company recorded income tax expense of \$0.6 million and \$1.9 million in the first six months of fiscal 2014 and 2013, respectively. The effective tax rate increased to 101% from 40% for the same period in the prior year, due to a significant decline in income during the first six months of fiscal 2014 and due to the impact of the equity compensation shortfall discussed above.

The Company continues to benefit from operating in foreign locations, such as Ireland, due to the lower statutory income tax rate relative to the U.S. federal and state tax rate. This benefit is significantly reduced by withholding taxes and foreign base company sales and services income that is taxed both in the U.S. and in the foreign jurisdiction.

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The total amount of unrecognized tax benefits was \$2.6 million at July 31, 2013. The entire amount of unrecognized tax benefits, if recognized, will impact the Company's effective tax rate. This liability is classified as long-term unless the liability is expected to conclude within twelve months of the reporting date. In the next twelve months, due to potential settlements with domestic tax authorities related to tax credits, an estimated \$0.2 million of unrecognized tax benefits may be recognized.

The Company's policy is to recognize interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense. As of July 31, 2013, the Company has accrued approximately \$0.2 million of interest and penalty expense relating to unrecognized tax benefits.

In August 2013, the Company received new information from the Franchise Tax Board related to the audit of its fiscal year 2004 and fiscal year 2005 California research and development tax credit. Pursuant to Financial Accounting Standards Board Accounting Standards Codification ("ASC") 740 "Income Taxes", paragraph ASC 740-10-25-8, only information that is available at the reporting date is considered in the recognition and measurement analysis for purposes of uncertain tax positions. A change in available facts subsequent to an enterprise's reporting date, but before issuance of the financial statements, should be recognized in the period in which the change in facts occurs, even if that new information provides a better estimate of the ultimate outcome of an uncertainty. As a result, the Company may record a non-cash charge to income tax expense of up to \$2.6 million in the third quarter of fiscal 2014.

The Company files U.S. federal, state, and foreign tax returns that are subject to audit by various tax authorities. The Company is currently under audit in India for fiscal years ended March 31, 1998, 1999, 2006, 2008, 2009, 2010 and 2011 and in California for fiscal years ended 2004 and 2005. It is also under audit in South Africa and Thailand for the fiscal year ended 2012.

10. STOCKHOLDERS' EQUITY

Dividends

The following table sets forth the dividends declared and/or paid by the Company during fiscal 2014:

Declaration Date	Record Date	Payable	Dividend Class A	Dividend Class B	Amount Paid in Cash	Class A Shares Issued	Fair Value of Shares Issued
6/11/2013	6/25/2013	7/2/2013	\$ 0.072	\$ 0.06	\$ 1,089,000	—	—
4/24/2013	5/8/2013	5/15/2013	\$ 0.072	\$ 0.06	\$ 1,083,000	—	—
12/11/2012	12/26/2012	2/8/2013	\$ 0.072	\$ 0.06	\$ 947,000	10,000	\$ 145,000

Shares issued in payment of these dividends were issued out of treasury stock.

Stock Repurchase Activity

In September 2011, the Company's Board of Directors approved a stock repurchase plan in which up to one million shares could be repurchased. Since the inception of the plan, the Company has repurchased 897,000 and 103,000 shares of the Company's Class A and Class B common stock, respectively, for total cash consideration of \$12.5 million including fees. As of March 2013, all shares authorized under the plan have been repurchased and the plan was closed.

11. STOCK-BASED COMPENSATION

The Company's equity awards consist of stock options, SARs and RSUs. For a description of the Company's stock-based compensation plans, see Note 12 "Stock-Based Compensation" in Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended January 31, 2013.

Stock-Based Compensation

The following table sets forth reported stock-based compensation expense for the three and six months ended July 31, 2013 and 2012:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2013	2012	2013	2012
	(in thousands)		(in thousands)	
Cost of maintenance, subscription and other revenue	\$ 65	\$ 60	\$ 103	\$ 108
Cost of professional services	166	139	264	250
Sales and marketing	283	249	451	436
Research and development	214	197	352	350
General and administrative	822	783	1,324	1,323
Total stock-based compensation expense	<u>\$ 1,550</u>	<u>\$ 1,428</u>	<u>\$ 2,494</u>	<u>\$ 2,467</u>

Option/SAR Information

The weighted average assumptions used to value SARs granted in the six months ended July 31, 2013 and 2012 are shown in the following table:

	Six Months Ended July 31,	
	2013	2012
Expected life in years ⁽¹⁾	4.59	4.62
Risk free interest rate ⁽²⁾	1.00%	0.69%
Volatility ⁽³⁾	53%	61%
Dividend rate ⁽⁴⁾	2.42%	2.25%

- (1) The expected life of SARs granted under the stock-based compensation plans is based on historical vested stock option and SAR exercise and post-vest forfeiture patterns and includes an estimate of the expected term for stock options and SARs that were fully vested and outstanding.
- (2) The risk-free interest rate is based on the U.S. Treasury yield for a term consistent with the expected life of SARs in effect at the time of grant.
- (3) The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of the Company's common stock for a period equivalent to the expected life of the SARs, which it believes is representative of the expected volatility over the expected life of the SARs.
- (4) The Company expects to continue paying quarterly dividends at the same rate as the three months ending on July 31, 2013.

The following table summarizes the activity for outstanding stock options and SARs for the six months ended July 31, 2013:

	Stock Options/ SARs (in thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 31, 2013	2,920	\$ 11.11		
Granted	586	11.68		
Exercised	(123)	8.49		
Expired	(226)	15.21		
Forfeited	(23)	10.00		
Outstanding at July 31, 2013	<u>3,134</u>	\$ 11.03	5.2	\$ 5,858
Vested and expected to vest at July 31, 2013 ⁽¹⁾	<u>3,075</u>	\$ 11.02	5.3	\$ 5,790
Vested and exercisable at July 31, 2013	<u>1,557</u>	\$ 10.69	3.8	\$ 3,765

- (1) The expected-to-vest SARs are the result of applying the pre-vesting forfeiture rate assumptions to total outstanding SARs.

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The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the aggregate difference between the closing stock price of the Company's common stock based on the last trading day as of July 31, 2013, and the exercise price for in-the-money stock options and SARs) that would have been received by the holders if all stock options and SARs had been exercised on July 31, 2013. The total intrinsic value of stock options and SARs exercised in the six months ended July 31, 2013 was \$452,000.

The number of SARs exercised includes shares withheld on behalf of employees to satisfy minimum statutory tax withholding requirements. During the three months ended July 31, 2013, the Company withheld 8,000 shares for payment of these taxes at a value of \$97,000. During the six months ended July 31, 2013, the Company withheld 12,000 shares for payment of these taxes at a value of \$151,000.

At July 31, 2013, there was approximately \$6.2 million of total unrecognized compensation cost related to unvested SARs. This cost is expected to be recognized over a weighted-average period of approximately 2.9 years.

RSU Information

The estimated fair value of RSUs was calculated based on the closing price of the Company's common stock on the date of grant, reduced by the present value of dividends foregone during the vesting period.

The following table summarizes the activity for RSUs for the six months ended July 31, 2013:

	RSUs (in thousands)	Weighted Average Grant Date Fair Value
Restricted stock at January 31, 2013	385	\$ 10.49
Granted	226	11.15
Vested ⁽¹⁾	(130)	10.23
Forfeited	(10)	10.87
Restricted stock at July 31, 2013	<u>471</u>	<u>\$ 10.88</u>

⁽¹⁾ The number of RSUs vested includes shares withheld on behalf of employees to satisfy statutory tax withholding requirements.

The Company withholds, at the employee's election, a portion of the vested shares as consideration for the Company's payment of applicable employee income taxes. During the three months ended July 31, 2013, the Company withheld 30,000 shares for payment of these taxes at a value of \$359,000. During the six months ended July 31, 2013, the Company withheld 36,000 shares for payment of these taxes at a value of \$438,000.

Total unrecognized compensation cost related to RSUs was approximately \$4.1 million as of July 31, 2013. This cost is expected to be recognized over a weighted-average period of approximately 3.1 years.

12. COMMITMENTS AND CONTINGENCIES

Indemnifications

The Company sells software licenses and services to its customers under written agreements. Each agreement contains the relevant terms of the contractual arrangement with the customer and generally includes certain provisions for indemnifying the customer against losses, expenses and liabilities from damages that may be awarded against the customer in the event the Company's software is found to infringe upon certain intellectual property rights of a third party. The agreements generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects.

The Company believes its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the agreements. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases under the agreements, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnification provisions.

Legal Actions

The Company is subject to various legal proceedings and claims, either asserted or unasserted, which arise in the ordinary course of business. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on the Company's consolidated results of operations, financial position or liquidity.

13. BUSINESS SEGMENT INFORMATION

The Company markets its products and services worldwide, primarily to companies in the manufacturing industry, including automotive, consumer products, food and beverage, high technology, industrial products and life sciences industries. The Company sells and licenses its products through its direct sales force in four geographic regions: North America, EMEA, Asia Pacific and Latin America and through distributors where third parties can extend sales reach more effectively or efficiently. The North America region includes the United States and Canada. The EMEA region includes Europe, the Middle East and Africa. The Asia Pacific region includes Asia and Australia. The Latin America region includes South America, Central America and Mexico. The Company's Chief Operating Decision Maker, the Chief Executive Officer, reviews the consolidated results within one operating segment.

License revenue is assigned to the geographic regions based on delivery of the licenses to each region and sales effort. Maintenance and subscription revenues are allocated to the region where the end user customer is located. Services revenue is assigned based on the region where the services are performed.

	Three Months Ended		Six Months Ended	
	July 31,		July 31,	
	2013	2012	2013	2012
	(in thousands)		(in thousands)	
Revenue:				
North America ⁽¹⁾	\$ 27,538	\$ 26,211	\$ 54,104	\$ 54,729
EMEA	21,830	18,809	41,637	37,358
Asia Pacific	11,489	11,851	23,143	23,610
Latin America	4,337	4,098	8,237	8,980
	<u>\$ 65,194</u>	<u>\$ 60,969</u>	<u>\$ 127,121</u>	<u>\$ 124,677</u>

⁽¹⁾ Sales into Canada accounted for 2% and 3% of North America total revenue in the three and six months ended July 31, 2013, respectively and for 3% of North America total revenue for both the three and six months ended July 31, 2012.

ITEM 2 – MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. Any statements contained herein that are not statements of historical fact should be construed as forward looking statements, including statements that are preceded or accompanied by such words as “may,” “believe,” “could,” “anticipate,” “would,” “might,” “plan,” “expect,” “intend” and words of similar meaning or the negative of these terms or other comparable terminology. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in Part I, Item 1A entitled “Risk Factors” within our Annual Report on Form 10-K for the year ended January 31, 2013. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management’s opinions only as of the date hereof and are subject to risks, uncertainties and assumptions about our business. We undertake no obligation to revise or update or publicly release the results of any revision or update to these forward-looking statements except as required by applicable securities laws. Readers should carefully review the risk factors and other information described in other documents we file from time to time with the Securities and Exchange Commission (“SEC”).

INTRODUCTION

The following discussion should be read in conjunction with the information included within our Annual Report on Form 10-K for the year ended January 31, 2013, and the Condensed Consolidated Financial Statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

CRITICAL ACCOUNTING POLICIES

Our condensed consolidated financial statements are prepared applying certain critical accounting policies. The SEC defines “critical accounting policies” as those that require application of management’s most difficult, subjective, or complex judgments. Critical accounting policies require numerous estimates and strategic or economic assumptions that may prove inaccurate or subject to variations and may significantly affect our reported results and financial position for the period or in future periods. Changes in underlying factors, assumptions, or estimates in any of these areas could have a material impact on our future financial condition and results of operations. Our financial statements are prepared in accordance with U.S. GAAP, and they conform to general practices in our industry. We apply critical accounting policies consistently from period to period and intend that any change in methodology occur in an appropriate manner. Accounting policies currently deemed critical, including a) revenue recognition; b) accounts receivable allowances for bad debt and sales returns; c) capitalized software development costs; d) impairment assessments on goodwill and intangible assets; e) business combinations; f) valuation of deferred tax assets and tax contingency reserves; and g) stock-based compensation are further discussed in the Annual Report on Form 10-K for the fiscal year ended January 31, 2013. There have been no significant changes to our accounting policies and estimates as discussed in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013.

BUSINESS OVERVIEW

QAD is a global provider of enterprise software applications, and related services and support. We provide enterprise software applications to global manufacturing companies primarily in the automotive, consumer products, food and beverage, high technology, industrial products and life sciences industries. More than 2,000 global manufacturing companies use QAD software. QAD was founded in 1979, incorporated in California in 1986 and reincorporated in Delaware in 1997.

QAD’s enterprise resource planning (“ERP”) suite is called QAD Enterprise Applications, which is also known as MFG/PRO. QAD Enterprise Applications supports the core business processes of our global manufacturing customers and includes the following functional areas: financials, customer management, manufacturing, demand and supply chain planning, supply chain execution, service and support, enterprise asset management, analytics, interoperability, process and performance, and internationalization. We sell QAD Enterprise Applications as a base ERP product with the option of purchasing various add-on modules depending on the functionality the customer requires.

We offer two options for deploying our ERP products: On Premise and On Demand. With the On Premise model, QAD sells a perpetual license for the software and our customers deploy the software on their own computer servers. Under the perpetual licensing model, customers may separately purchase contracts for maintenance and additional services. With the On Demand model, customers subscribe to a service, and QAD provides access to the software as well as ongoing support services and management of the environment. The majority of QAD customers use the On Premise model, although the On Demand model is increasing in acceptance. As a result, we are focusing on expanding the use of the On Demand model. We also make it possible for customers to operate in a blended environment where some users can be deployed via On Premise and some users deployed via On Demand while offering the same end-user experience.

We have four principal sources of revenue:

- Licenses of our integrated suite of software applications;
- Maintenance and support, including technical support, training materials, product enhancements and upgrades;
- Subscription of our Enterprise Applications through our On Demand offering in a Software as a Service model as well as other hosted Internet applications;
- Professional services, including implementations, technical and application consulting, training, migrations and upgrades.

We operate primarily in the following four geographic regions: North America, Latin America, EMEA and Asia Pacific. In the first six months of fiscal 2014, approximately 43% of our total revenue was generated in North America, 33% in EMEA, 18% in Asia Pacific and 6% in Latin America. Over 80% of our revenue is generated from large, global customers who have operations in multiple countries. License revenue is assigned to the geographic regions based on delivery of the licenses to each region and sales effort. Maintenance and subscription revenues are allocated to the region where the end user is located. Services revenue is assigned based on the region where the services are performed. A significant portion of our revenue and expenses are derived from international operations which are primarily conducted in foreign currencies. As a result, changes in the value of foreign currencies relative to the U.S. dollar have impacted our results of operations and may impact our future results of operations. At July 31, 2013, we employed approximately 1,580 employees worldwide, of which 590 employees were based in North America, 460 employees in Asia Pacific, 460 employees in EMEA and 70 employees in Latin America.

SUMMARY OF FIRST SIX MONTHS OF FISCAL 2014

Total revenue for the first six months of fiscal 2014 was \$127.1 million, representing a \$2.4 million, or 2%, increase from the first six months of fiscal 2013. The increase in total revenue was primarily driven by higher revenue from our fiscal 2013 acquisitions of DynaSys and CEBOS and higher subscription revenue resulting from On Demand sales. Excluding the revenue contribution of our acquisitions, total revenue for the first six months of fiscal 2014 would have been relatively unchanged compared to the same period last year. Net income was approximately breakeven for the first six months of fiscal 2014 compared to net income of \$2.8 million for the first six months of fiscal 2013. Our results for the first six months of fiscal 2014 in comparison to the same period of last year were negatively impacted by several factors, including a combined net loss from DynaSys and CEBOS of \$2.3 million and a reduction in our joint development reimbursements of \$1.1 million. The net loss of DynaSys and CEBOS can be attributed to the effects of purchase accounting, prior business practices that have an effect on revenue recognition, and integration activities. We expect these acquisitions will achieve profitability in the future.

License revenue. License revenue is primarily derived from software license fees that customers pay for our base product, QAD Enterprise Applications, and any add-on modules they purchase. License revenue totaled \$14.8 million, or 12% of total revenue for the first six months of fiscal 2014 with gross margins of 86%. License revenue growth is influenced by the strength of the manufacturing industry and general economic conditions as well as the competitive position of our software products. Long sales cycles and the unpredictability in determining when license deals will close can have a material impact on our license revenues, net income and earnings per share.

Revenue recognition deferrals can have a significant impact on quarterly earnings. When we enter into a multi-element transaction with fixed fee services or when we sell licenses for additional users under a pricing model that does not satisfy VSOE requirements, we may be required to recognize license revenue ratably over the longer of the maintenance period or expected services implementation timeframe rather than recognizing license revenue upon delivery. Our executives emphasize structuring commercially sound business deals that facilitate long-term, mutually beneficial relationships with our customers and, as a result, the timing of revenues recognition may be impacted.

Our success in closing license deals for existing customers, new customers that are affiliates of existing customers and customers that have employees with historical experience working with QAD tends to be higher than with new customers that have no QAD affiliations. As a result, we place increased focus on these opportunities. With global GDP growth and the level of the PMI continuing to be below pre-fiscal 2009 levels, we believe global economic volatility will continue to shape customers' and prospects' buying decisions, making it more difficult to forecast the sales cycles for our products and the timing of large software license sales. Our license revenue has not reached pre-fiscal 2009 levels, which we believe is partially caused by economic volatility in certain parts of the world delaying customer buying decisions and partially caused by our increased focus on selling our solution via our On Demand offering.

Maintenance revenue. We offer support services 24 hours a day, seven days a week. In addition, we provide software upgrades which include additional or improved functionality when and if available. Our maintenance and other revenue totaled \$69.5 million in the first six months of fiscal 2014, representing 55% of total revenue. Maintenance revenue fluctuations are influenced by: (1) new license revenue growth; (2) annual renewal of support contracts, including the timing of securing the renewal; (3) increase in customers through acquisitions; (4) increase in prices; (5) fluctuations in currency rates; and (6) adjustments to revenue as a result of revenue recognition rules. The vast majority of our customers renew their annual support contracts. Over the last three years, our annual renewal rate of customers who subscribe to maintenance has been greater than 90%. Maintenance revenue is generally billed on an annual basis and recognized ratably over the term of the agreement, typically twelve months. We expect maintenance revenue to remain a significant source of our total revenue as a result of continuing sales of software solutions, high customer retention rates and the importance of our solutions to our customers' operations. However, revenue from maintenance and support services may be adversely impacted in future periods as we increase our sales of On Demand subscriptions because the associated maintenance and support for those services are included in subscription revenue.

Subscription revenue. The majority of our software continues to be sold via the On Premise model, which generates license revenue. Our products sold on a subscription basis include QAD Enterprise Applications On Demand ("On Demand"), QAD Supply Chain Portal and QAD Transportation Management System Content. Our subscription revenue, which is primarily generated by our On Demand product, totaled \$8.5 million, or 6% of total revenue, for the first six months of fiscal 2014. Our On Demand customers include a mix of existing customers who have converted from our On Premise model and new user implementations of our On Demand product. Subscription revenue is generally billed on a quarterly basis and recognized ratably over the term of the agreement, typically 12 to 36 months. Growing our On Demand product and offering our products as software as a service continues to be a key strategic initiative for us.

Professional services revenue. Our professional services business includes consulting and training services related to our solutions. In the first six months of fiscal 2014 our professional services revenue totaled \$34.3 million, or 27% of total revenue. Our professional services organization provides our customers with expertise and assistance in planning and implementing our software solutions. Consultants typically assist customers with the initial implementation of a system, the conversion and transfer of the customer's historical data into our software, ongoing training and education, and system upgrades. Our professional services enable customers to implement our software efficiently, support a customer's success with our solution, strengthen our customer relationships, and add to our industry-specific knowledge base for use in future implementations and product innovations. Our services margins tend to range from about breakeven to 10%. We view our services organization as a department supporting the implementation and deployment of our products and improving the overall customer experience. Services margins lower our overall operating margin as services margins are inherently lower than margins for our license, maintenance and subscription revenues.

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Although our professional services are optional, many of our customers use these services for some of their planning, implementation, or related needs. Professional services are typically rendered under time and materials-based contracts with services typically billed on an hourly basis. Professional services are sometimes rendered under fixed-fee contracts with payments due on specific dates or milestones. When we enter into multiple element arrangements where we do not have VSOE for one or more of our undelivered elements, we recognize the entire arrangement ratably over the longer of the maintenance term or implementation period. Services costs related to these engagements are expensed as incurred. As a result, our professional services margins tend to fluctuate.

Our professional services revenue typically trails our license revenue by several quarters as implementation services revenue is recognized when services are performed while license revenue is recognized upon product delivery. Services revenue growth is contingent upon license revenue growth and customer upgrade cycles, which are influenced by the strength of general economic and business conditions and the competitive position of our software products. We use our partners and subcontractors to supplement our internal professional services resources. This allows us to quickly respond to demand fluctuations while somewhat mitigating low utilization in slow times. We believe working with our partners also helps us extend our global reach by keeping a higher number of partners engaged and knowledgeable about our product. Our professional services business has competitive exposure to offshore providers, which could potentially create the risk of pricing pressure, fewer customer orders and reduced gross margins.

Cash flow and financial condition. During the first six months of fiscal 2014, we generated cash flow from operating activities of \$13.0 million. Our cash and equivalents at July 31, 2013 totaled \$69.4 million and the only debt on our balance sheet was \$15.7 million related to the mortgage on our Santa Barbara headquarters. Our primary uses of cash have been funding investment in research and development and funding operations to drive earnings growth, acquisitions, dividend payments and repurchases of common stock.

In fiscal 2014, we anticipate that our priorities for use of cash will be developing sales and services resources and continued investment in research and development to drive and support growth and profitability. We will continue to evaluate acquisition opportunities that are complementary to our product footprint and technology direction. We will also continue to assess alternative uses of cash, such as share repurchases and dividend payments. We do not anticipate a need for additional borrowing in fiscal 2014.

RESULTS OF OPERATIONS

We operate in several geographical regions as described in Note 13 “Business Segment Information” within Notes to Condensed Consolidated Financial Statements. In order to present our results of operations without the effects of changes in foreign currency, we provide certain financial information on a “constant currency basis”, which is in addition to the actual financial information presented in the following tables. In order to calculate our constant currency results, we apply the foreign currency exchange rates that were in effect during the prior period to the current period results.

Revenue

	Three Months Ended July 31, 2013	Increase (Decrease) Compared to Prior Period		Three Months Ended July 31, 2012	Six Months Ended July 31, 2013	Increase (Decrease) Compared to Prior Period		Six Months Ended July 31, 2012
		\$	%			\$	%	
<i>(in thousands)</i>								
Revenue								
License fees	\$ 8,604	\$ 1,698	25%	\$ 6,906	\$ 14,822	\$ 51	0%	\$ 14,771
Percentage of total revenue	13%			11%	12%			12%
Maintenance and other	34,254	368	1%	33,886	69,455	1,049	2%	68,406
Percentage of total revenue	53%			56%	55%			55%
Subscription fees	4,455	710	19%	3,745	8,497	1,529	22%	6,968
Percentage of total revenue	7%			6%	6%			5%
Professional services	17,881	1,449	9%	16,432	34,347	(185)	-1%	34,532
Percentage of total revenue	27%			27%	27%			28%
Total revenue	<u>\$ 65,194</u>	<u>\$ 4,225</u>	7%	<u>\$ 60,969</u>	<u>\$ 127,121</u>	<u>\$ 2,444</u>	2%	<u>\$ 124,677</u>

Total Revenue. Total revenue was \$65.2 million and \$61.0 million for the second quarter of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, total revenue for the second quarter of fiscal 2014 would have been approximately \$65.3 million, representing a \$4.3 million, or 7%, increase from the same period last year. When comparing categories within total revenue at constant rates, our current quarter results included increases in all revenue categories. Our fiscal 2013 acquisitions contributed \$2.2 million and \$1.1 million to total revenue during the second quarter of fiscal 2014 and 2013, respectively. Revenue outside the North America region as a percentage of total revenue was 58% and 57% for the second quarter of fiscal 2014 and fiscal 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, total revenue increased in all regions during the second quarter of fiscal 2014 when compared to the same quarter of last year. Our products are sold to manufacturing companies that operate mainly in the following six industries: automotive, consumer products, food and beverage, high technology, industrial products and life sciences. Given the similarities between food and beverage and consumer products as well as between high technology and industrial products, we aggregate them for management review. Revenue by industry for the second quarter of fiscal 2014 was approximately 28% in automotive, 22% in consumer products and food and beverage, 34% in high technology and industrial products and 16% in life sciences. In comparison, revenue by industry for the second quarter of fiscal 2013 was approximately 26% in automotive, 22% in consumer products and food and beverage, 35% in high technology and industrial products and 17% in life sciences.

Total revenue was \$127.1 million and \$124.7 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, total revenue for the first six months of fiscal 2014 would have been approximately \$127.8 million, representing a \$3.1 million, or 2%, increase from the same period last year. When comparing categories within total revenue at constant rates, our results for the first six months of fiscal 2014 included increases in our license, maintenance and other and subscription revenue categories and a decrease in our professional services revenue category. Our fiscal 2013 acquisitions contributed \$4.3 million and \$1.1 million to total revenue during the first six months of fiscal 2014 and 2013, respectively. Revenue outside the North America region as a percentage of total revenue was 57% for the first six months of fiscal 2014, as compared to 56% in the same period of the prior fiscal year. Excluding revenue related to our fiscal 2013 acquisitions, total revenue increased in our EMEA and Asia Pacific regions and decreased in our North America and Latin America regions during the first six months of fiscal 2014 when compared to the same six months last year. Revenue by industry for the first six months of fiscal 2014 and 2013 was approximately 28% in automotive, 22% in consumer products and food and beverage, 34% in high technology and industrial products and 16% in life sciences.

License Revenue. License revenue was \$8.6 million and \$6.9 million for the second quarter of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, license revenue for the current quarter would have been approximately \$8.7 million, representing a \$1.8 million, or 26%, increase from the same period last year. Our fiscal 2013 acquisitions contributed \$0.4 million and \$0.5 million to license revenue in the second quarter of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, license revenue increased in our North America and EMEA regions and remained relatively flat in our Latin America and Asia Pacific regions during the second quarter of fiscal 2014 when compared to the same quarter last year. One of the metrics that management uses to measure license revenue performance is the number of customers that have placed sizable license orders in the period. During the second quarter of fiscal 2014, six customers placed license orders totaling more than \$0.3 million and no orders exceeded \$1.0 million. In comparison, during the second quarter of fiscal 2013, two customers placed license orders totaling more than \$0.3 million and no orders exceeded \$1.0 million.

License revenue was consistent at \$14.8 million for the first six months of fiscal 2014 and 2013. Holding foreign currency exchange rates constant to fiscal 2013, license revenue for the first six months of fiscal 2014 would have been approximately \$14.9 million, representing a \$0.1 million, or 1%, increase from the same period last year. Our fiscal 2013 acquisitions contributed \$0.8 million and \$0.5 million to license revenue for the first six months of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, license revenue decreased in our North America and Latin America regions partially offset by increases in our EMEA and Asia Pacific regions during the first six months of fiscal 2014 when compared to the same period last year. During the first six months of fiscal 2014, eight customers placed license orders totaling more than \$0.3 million and no orders exceeded \$1.0 million. This compared to the first six months of fiscal 2013 when five customers placed license orders totaling more than \$0.3 million and no orders exceeded \$1.0 million. Our license revenue was negatively affected by revenue recognition deferrals. Seven license deals over \$0.1 million were deferred totaling \$2.6 million in the first six months of fiscal 2014. In the first six months of fiscal 2013, two license deals over \$0.1 million were deferred totaling \$0.3 million.

Maintenance and Other Revenue. Maintenance and other revenue was \$34.3 million and \$33.9 million for the second quarter of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, the first quarter of fiscal 2014 maintenance and other revenue would have been approximately \$34.4 million, representing a \$0.5 million, or 1%, increase from the same period last year. Our fiscal 2013 acquisitions contributed \$1.1 million and \$0.2 million to maintenance and other revenue in the second quarter of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, maintenance and other revenue decreased in our North America and Latin America regions, was relatively flat in our EMEA region, and increased in our Asia Pacific region during the second quarter of fiscal 2014 when compared to the same quarter of last year.

Maintenance and other revenue was \$69.5 million and \$68.4 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, maintenance and other revenue for the first six months of fiscal 2014 would have been approximately \$69.9 million, representing a \$1.5 million, or 2%, increase from the same period last year. Our fiscal 2013 acquisitions contributed \$2.0 million and \$0.2 million to maintenance and other revenue for the first six months of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, maintenance and other revenue decreased in our North America and Latin America regions, was relatively flat in our EMEA region, and increased in our Asia Pacific region during the first six months of fiscal 2014 when compared to the same period last year.

We track our rate of contract renewals by determining the number of customer sites with active contracts as of the end of the previous reporting period and compare this to the number of customers that renewed, or are in the process of renewing, their maintenance contracts as of the current period end. Our maintenance contract renewal rate has remained in excess of 90% for the second quarter and the first six months of both fiscal 2014 and 2013.

Subscription Revenue. Subscription revenue was \$4.5 million and \$3.7 million for the second quarter of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, subscription revenue for the current quarter would have been unchanged at \$4.5 million, representing a \$0.8 million, or 22%, increase from the same period last year. Subscription revenue increased in all of our regions during the second quarter of fiscal 2014 when compared to the same quarter last year. The increase in subscription revenue was primarily due to additional revenue related to our On Demand product offering. Currently, a majority of our On Demand sales are in the North America region. We expect the growth rate of subscription revenue in the future to be primarily attributable to growth in sales of our On Demand product offering.

Subscription revenue was \$8.5 million and \$7.0 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, subscription revenue for the current period would have been unchanged at \$8.5 million, representing a \$1.5 million, or 21%, increase from the same period last year. Subscription revenue increased in all of our regions during the first six months of fiscal 2014 when compared to the same period last year. The increase in subscription revenue was primarily due to additional revenue related to our On Demand product offering. Currently, a majority of our On Demand sales are in the North America region. We expect the growth of subscription revenue in the future to be primarily attributable to growth in our On Demand product offering.

Professional Services Revenue. Professional services revenue was \$17.9 million and \$16.4 million for the second quarter of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, professional services revenue for the second quarter of fiscal 2014 would have been approximately \$17.8 million, representing a \$1.4 million, or 9%, increase from the same period last year. Our fiscal 2013 acquisitions contributed \$0.7 million and \$0.4 million to professional services revenue in the second quarter of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, professional services revenue increased in our EMEA, North America and Latin America regions and decreased in our Asia Pacific region during the second quarter of fiscal 2014 compared to the same quarter last year.

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Professional services revenue was \$34.3 million and \$34.5 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, professional services revenue for the first six months of fiscal 2014 would have been approximately \$34.5 million, or flat when compared to the same period last year. Our fiscal 2013 acquisitions contributed \$1.4 million and \$0.4 million to professional services revenue for the first six months of fiscal 2014 and 2013, respectively. Excluding revenue related to our fiscal 2013 acquisitions, professional services revenue decreased in our North America, Latin America and Asia Pacific regions and increased in our EMEA region during the first six months of fiscal 2014 when compared to the same period last year. Excluding revenue related to our acquisitions, the decrease in professional services revenue relates to first quarter services revenue year over year. During the first quarter of fiscal 2013, we recognized \$1.3 million of services revenue related to one customer for which expenses had been recorded in prior periods. Conversely, during the first quarter of fiscal 2014, we deferred services revenue of \$600,000 related to two customers for which expenses were recorded in the quarter.

Total Cost of Revenue

	Three Months Ended		Increase (Decrease) Compared to Prior Period		Three Months Ended		Six Months Ended		Increase (Decrease) Compared to Prior Period		Six Months Ended	
	July 31, 2013				July 31, 2012		July 31, 2013				July 31, 2012	

Cost of License Fees. Cost of license fees was \$1.1 million and \$0.8 million for the second quarter of fiscal 2014 and fiscal 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of license fees for the second quarter of fiscal 2014 would have been unchanged at \$1.1 million, representing an increase of \$0.3 million, or 38%. The non-currency related increase in cost of license fees of \$0.3 million in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 was due to higher amortization of capitalized software costs related to our fiscal 2013 acquisitions. Cost of license fees as a percentage of license revenue was consistent at 12% for each of the second quarters of fiscal 2014 and fiscal 2013.

Cost of license fees was \$2.0 million and \$1.7 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of license fees for the first six months of fiscal 2014 would have been unchanged at \$2.0 million, representing an increase of \$0.3 million, or 18%. The non-currency related increase in cost of license fees of \$0.3 million for the first six months of fiscal 2014 compared to the first six months of fiscal 2013 was due to higher amortization of capitalized software costs related to our fiscal 2013 acquisitions. Cost of license fees as a percentage of license revenue was 14% and 12% for the first six months of fiscal 2014 and fiscal 2013, respectively.

Cost of Maintenance, Subscription and Other. Cost of maintenance, subscription and other was \$11.0 million and \$10.3 million for the second quarter of fiscal 2014 and fiscal 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of maintenance, subscription and other in the first quarter of fiscal 2014 would have been approximately \$11.1 million, representing an increase of \$0.8 million, or 8%. The non-currency related increase in cost of maintenance, subscription and other of \$0.8 million in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 was primarily due to higher subscription costs, which included higher hosting costs of \$0.3 million and higher personnel costs of \$0.2 million. Higher subscription costs were incurred to support the growth in our subscription business. In addition, cost of maintenance, subscription and other increased due to higher expenses of \$0.2 million incurred in the second quarter of fiscal 2014 related to our fiscal 2013 acquisitions. Cost of maintenance, subscription and other as a percentage of maintenance, subscription and other revenues was 29% and 27% in the second quarter of fiscal 2014 and fiscal 2013, respectively.

Cost of maintenance, subscription and other was \$22.1 million and \$20.3 million for the first six months of fiscal 2014 and fiscal 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of maintenance, subscription and other for the first six months of fiscal 2014 would have been approximately \$22.2 million, representing an increase of \$1.9 million, or 9%. The non-currency related increase in cost of maintenance, subscription and other of \$1.9 million for the first six months of fiscal 2014 compared to the first six months of fiscal 2013 was primarily due to higher subscription costs, which included higher hosting costs of \$0.5 million and higher personnel costs of \$0.5 million as a result of increased headcount of eight people. The higher subscription costs were incurred to support the growth in our subscription business. In addition, cost of maintenance, subscription and other increased due to higher expenses of \$0.4 million incurred in the first six months of fiscal 2014 related to our fiscal 2013 acquisitions. Cost of maintenance, subscription and other as a percentage of maintenance, subscription and other revenues was 28% and 27% in the first six months of fiscal 2014 and fiscal 2013, respectively.

Cost of Professional Services. Cost of professional services was \$16.7 million and \$15.8 million for the second quarter of fiscal 2014 and fiscal 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of professional services for the second quarter of fiscal 2014 would have been approximately \$16.6 million, representing an increase of \$0.8 million, or 5%. The non-currency related increase in cost of professional services of \$0.8 million in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 was primarily due to higher bonuses of \$0.4 million and higher expenses of \$0.3 million related to our fiscal 2013 acquisitions. Cost of professional services as a percentage of professional services revenues was 93% and 96% for the second quarter of fiscal 2014 and fiscal 2013 respectively.

Cost of professional services was \$33.3 million and \$31.6 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, cost of professional services for the first six months of fiscal 2014 would have been unchanged at \$33.3 million, representing an increase of \$1.7 million, or 5%. The non-currency related increase in cost of professional services of \$1.7 million in the first six months of fiscal 2014 compared to the first six months of fiscal 2013 was due to higher bonuses of \$0.6 million and higher expenses of \$1.1 million related to our fiscal 2013 acquisitions. Cost of professional services as a percentage of professional services revenues was 97% and 91% for the first six months of fiscal 2014 and fiscal 2013 respectively.

Sales and Marketing

	Three Months Ended		Increase (Decrease) Compared to Prior Period		Three Months Ended		Six Months Ended		Increase (Decrease) Compared to Prior Period		Six Months Ended			
	July 31, 2013				July 31, 2012		July 31, 2013				July 31, 2012			
			\$ %						\$ %					
(in thousands)														
Sales and marketing	\$	15,850	\$	1,103	7%	\$	14,747	\$	31,906	\$	1,663	5%	\$	30,243
Percentage of revenue		25%					24%		25%					25%

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Research and development expense was \$10.5 million and \$9.2 million for the second quarter of fiscal 2014 and fiscal 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, research and development expense for the second quarter of fiscal 2014 would have been approximately \$10.4 million, representing an increase of \$1.2 million, or 13%. The non-currency related increase in research and development expense of \$1.2 million in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 was primarily due to a reduction of our joint development reimbursements of \$0.4 million and higher personnel costs of \$0.2 million. Research and development expense for the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 was also impacted by higher expenses of \$0.5 million associated with our fiscal 2013 acquisitions.

Research and development expense was \$21.3 million and \$18.7 million for the first six months of fiscal 2014 and 2013, respectively. Holding foreign currency exchange rates constant to fiscal 2013, research and development expense for the first six months of fiscal 2014 would have been unchanged at \$21.3 million, representing an increase of \$2.6 million, or 14%. The non-currency related increase in research and development expense of \$2.6 million for the first six months of fiscal 2014 compared to the first six months of fiscal 2013 was primarily due to a reduction of our joint development reimbursements of \$1.1 million and higher personnel costs of \$0.3 million. Research and development expense for the first six months of fiscal 2014 compared to the first six months of fiscal 2013 was also impacted by higher expenses of \$1.1 million associated with our fiscal 2013 acquisitions.

As part of our vertical focus we regularly seek to engage in joint development arrangements with our customers in order to enhance specific functionality and industry experience, although the number and size of joint development arrangements may fluctuate.

General and Administrative

	Three Months Ended		Increase (Decrease) Compared to Prior Period		Three Months Ended		Six Months Ended		Increase (Decrease) Compared to Prior Period		Six Months Ended			
	July 31, 2013		\$ %		July 31, 2012		July 31, 2013		\$ %		July 31, 2012			
(in thousands)														
General and administrative	\$	8,431	\$	53	1%	\$	8,378	\$	16,337	\$	(106)	-1%	\$	16,483
Percentage of revenue	13%					14%		13%					13%	

Amortization of Intangibles from Acquisitions

Amortization of intangibles from acquisitions totaled \$177,000 and \$57,000 for the second quarter of fiscal 2014 and 2013, respectively. Amortization of intangibles from acquisitions totaled \$353,000 and \$57,000 for the first six months of fiscal 2014 and 2013, respectively. Amortization expense in fiscal 2014 and 2013 was due to the intangible assets acquired in our fiscal 2013 acquisitions.

Other (Income) Expense

Other (income) Expense														
	Three Months Ended		Increase (Decrease) Compared to Prior Period		Three Months Ended		Six Months Ended		Increase (Decrease) Compared to Prior Period		Six Months Ended			
	July 31, 2013				July 31, 2012		July 31, 2013				July 31, 2012			
		\$		%		\$		\$		\$		\$		
(in thousands)														
Other (income) expense														
Interest income	\$	(73)	\$	91	55%	\$	(164)	\$	(170)	\$	157	48%	\$	(327)
Interest expense		209		(121)	-37%		330		412		(204)	-33%		616
Other (income) expense, net		(809)		(901)	-979%		92		(1,082)		(1,620)	-301%		538
Total other (income) expense	\$	(673)	\$	(931)	-361%	\$	\$ 258	\$	(840)	\$	(1,667)	-202%	\$	827
Percentage of revenue		-1%					1%		-1%					1%

Total other (income) expense was \$(0.7) million and \$0.3 million for the second quarters of fiscal 2014 and fiscal 2013, respectively. The favorable change is primarily related to the impact of the change in the fair value of the interest rate swap of \$(1.9) million partially offset by higher foreign exchange losses of \$0.7 million and a government subsidy paid to one of our subsidiaries of \$0.2 million in the second quarter of fiscal 2013.

Total other (income) expense was \$(0.8) million and \$0.8 million for the first six months of fiscal 2014 and 2013, respectively. The favorable change is primarily related to the impact of the change in the fair value of the interest rate swap of \$(1.6) million and higher foreign exchange gains of \$(0.2) million partially offset by a government subsidy paid to one of our subsidiaries of \$0.2 million in fiscal 2013.

Interest rate swap valuations and foreign exchange gains and losses are subject to changes which are inherently unpredictable.

Income Tax Expense

	Three Months Ended	Increase (Decrease) Compared to Prior Period		Three Months Ended	Six Months Ended	Increase (Decrease) Compared to Prior Period		Six Months Ended
	July 31, 2013	\$	%	July 31, 2012	July 31, 2013	\$	%	July 31, 2012
<i>(in thousands)</i>								
Income tax expense	\$ 909	\$ 568	167%	\$ 341	\$ 618	\$ (1,264)	-67%	\$ 1,882
Percentage of revenue	1%			1%	0%			2%
Effective tax rate	42%			26%	101%			40%

We recorded income tax expense of \$0.9 million and \$0.3 million in the second quarter of fiscal 2014 and 2013, respectively. The effective tax rate increased to 42% during the second quarter of fiscal 2014 compared to 26% for the same period in the prior year. The increase in overall tax rate for the second quarter of fiscal 2014 is primarily due to a significant equity compensation shortfall. A shortfall is a result of stock-based compensation expense recorded in the financial statements being greater than the tax deduction generated by the exercise of SARs and the vesting of RSUs.

We recorded income tax expense of \$0.6 million and \$1.9 million in the first six months of fiscal 2014 and 2013, respectively. Our effective tax rate increased to 101% from 40% for the same period in the prior year, due to a significant decline in income during the first six months of fiscal 2014 and due to the impact of the equity compensation shortfall discussed above.

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We continue to benefit from operating in foreign locations, such as Ireland, due to the lower statutory income tax rate relative to the U.S. federal and state tax rate. This benefit is significantly reduced by withholding taxes and foreign base company sales and services income that is taxed both in the U.S. and in the foreign jurisdiction.

In August 2013, we received new information from the Franchise Tax Board related to the audit of our fiscal year 2004 and fiscal year 2005 California research and development tax credit. Pursuant to Financial Accounting Standards Board Accounting Standards Codification (“ASC”) 740 “Income Taxes”, paragraph ASC 740-10-25-8, only information that is available at the reporting date is considered in the recognition and measurement analysis for purposes of uncertain tax positions. A change in available facts subsequent to an enterprise’s reporting date, but before issuance of the financial statements, should be recognized in the period in which the change in facts occurs, even if that new information provides a better estimate of the ultimate outcome of an uncertainty. As a result, we may record a non-cash charge to income tax expense of up to \$2.6 million in the third quarter of fiscal 2014.

LIQUIDITY AND CAPITAL RESOURCES

Our primary source of cash is from the sale of licenses, maintenance, subscription and professional services to our customers. Our primary use of cash is payment of our operating expenses which mainly consist of employee-related expenses, such as compensation and benefits, as well as general operating expenses for facilities and overhead costs. In addition to operating expenses, we also use cash for capital expenditures, payment of dividends, stock repurchases and investment in our growth initiatives, which include acquisitions of products, technology and businesses.

At July 31, 2013, our principal sources of liquidity were cash and equivalents totaling \$69.4 million and net accounts receivable of \$42.7 million. At July 31, 2013, our cash and equivalents consisted of current bank accounts, registered money market funds and time delineated deposits. Approximately 80% of our cash and equivalents were held in U.S. dollar denominated accounts as of July 31, 2013. We have a U.S. line of credit facility with Rabobank that permits unsecured short-term borrowings of up to \$20 million. Our line of credit agreement contains customary covenants that could restrict our ability to incur additional indebtedness. Our line of credit is available for working capital or other business needs. We have not drawn on the line of credit during any of the last three fiscal years nor do we expect to draw on the line of credit during fiscal 2014.

Our primary commercial banking relationship is with Bank of America and its global affiliates. Our cash and equivalents are held by diversified financial institutions globally, and as of July 31, 2013, the portion of our cash and equivalents held by or invested through Bank of America was approximately 90%. Our largest cash concentration is in Ireland where we pool the cash generated by our EMEA subsidiaries. The majority of our cash and equivalents are held in investment accounts which are predominantly placed in money market mutual funds invested in U.S. Treasury and government securities. The remaining cash and equivalents are held in deposit accounts and certificates of deposit.

The amount of cash and equivalents held by foreign subsidiaries was \$60.6 million and \$53.3 million as of July 31, 2013 and January 31, 2013, respectively. If these funds are needed for our operations in the U.S., and if U.S. tax has not been previously provided, we would be required to accrue and pay taxes in the U.S. to repatriate these funds. Our current plans do not demonstrate a need to repatriate funds permanently reinvested in our foreign subsidiaries for our operations in the U.S. and it is not practicable to make a worldwide estimate of the amount of tax which may be payable upon distribution.

The following table summarizes our cash flows for the six months ended July 31, 2013 and 2012, respectively.

<i>(in thousands)</i>	Six Months Ended July 31, 2013	Six Months Ended July 31, 2012
Net cash provided by operating activities	\$ 13,049	\$ 11,373
Net cash used in investing activities	(3,117)	(6,939)
Net cash used in financing activities	(4,500)	(6,514)
Effect of foreign exchange rates on cash and equivalents	(1,046)	(1,004)
Net increase(decrease) in cash and equivalents	<u>\$ 4,386</u>	<u>\$ (3,084)</u>

Typical factors affecting our cash provided by operating activities include our level of revenue and earnings for the period, the timing and amount of employee bonus payments and income tax payments, and the timing of cash collections from our customers which is our largest source of operating cash flow. Net cash flows provided by operating activities was \$13.0 million for the first six months of fiscal 2014 compared to \$11.4 million for the first six months of fiscal 2013. The \$1.6 million increase in net cash flows provided by operating activities was primarily attributable to the positive cash flow effect of changes in deferred revenue of \$3.1 million and accounts payable and other liabilities of \$1.6 million. These positive cash flow effects were partially offset by a decrease in net income of \$2.8 million and a decrease in noncash charges (including depreciation and amortization, stock-based compensation, change in fair value of interest rate swap and provisions for doubtful accounts/sales adjustments) of \$0.6 million.

Capital expenditures were \$3.0 million for the first six months of fiscal 2014, primarily relating to purchases of furniture and office equipment due to office moves and costs incurred and capitalized related to our internal ERP system upgrade. This compared to \$2.0 million for the first six months of fiscal 2013. We expect capital expenditures will increase by approximately \$1 million to \$2 million in fiscal 2014 when compared to fiscal 2013. We continue to monitor our capital spending and do not believe we are delaying critical capital expenditures required to run our business.

In the first six months of fiscal 2014 we made dividend payments consisting of \$3.1 million in cash and 10,000 shares of Class A common stock with a fair value of \$0.1 million. In the first six months of fiscal 2013 we made dividend payments consisting of \$1.8 million in cash and 27,000 shares of Class A common stock with a fair value of \$0.3 million. In the second quarter of fiscal 2014 we began paying dividends in cash only. We expect to continue to pay dividends in cash only; however, on a regular basis the Board of Directors evaluates our ability to continue to pay dividends as well as the structure of any potential dividend payments.

On September 22, 2011, we announced that our Board of Directors approved a stock repurchase plan. A total of one million shares were authorized for repurchase under the plan. During the first six months of fiscal 2014 we repurchased 45,000 shares and 8,000 shares of Class A and Class B common stock, respectively. The average share price was \$13.34 and \$12.02 for Class A and Class B stock, respectively, for total cash consideration of \$0.7 million including fees. Since the inception of the plan we repurchased 897,000 and 103,000 shares of Class A and Class B common stock, respectively, for total cash consideration of \$12.5 million including fees. As of March 2013, all shares authorized under the plan had been repurchased and the plan was closed. The Board of Directors continues to evaluate our position relating to future potential repurchases on a regular basis.

We have historically calculated accounts receivable days' sales outstanding ("DSO"), using the countback, or last-in first-out, method. This method calculates the number of days of billed revenue represented by the accounts receivable balance as of period end. When reviewing the performance of our entities, DSO under the countback method is used by management. It is management's belief that the countback method best reflects the relative health of our accounts receivable as of a given quarter-end or year-end because of the cyclical nature of our billings. Our billing cycle includes high annual maintenance renewal billings at year-end that will not be recognized as earned revenue until future periods.

DSO under the countback method was relatively consistent at 53 days and 52 days at July 31, 2013 and 2012, respectively. DSO using the average method, which is calculated utilizing the accounts receivable balance and earned revenue for the most recent quarter, was 59 days and 54 days at July 31, 2013 and 2012, respectively. We believe our reserve methodology is adequate, our reserves are properly stated as of July 31, 2013, and the quality of our receivables remains good.

Cash requirements for items other than normal operating expenses are anticipated for capital expenditures, dividend payments and stock repurchases. We may require cash for acquisitions of new businesses, software products or technologies complementary to our business. We believe that our cash on hand, net cash provided by operating activities and the available borrowings under our existing credit facility will provide us with sufficient resources to meet our current and long-term working capital requirements, debt service, dividend payments, share repurchase payments and other cash needs for at least the next twelve months.

CONTRACTUAL OBLIGATIONS

A summary of future obligations under our various contractual obligations and commitments as of January 31, 2013 was disclosed in our Annual Report on Form 10-K for the year ended January 31, 2013. During the quarter ended July 31, 2013 there have been no material changes in our contractual obligations or commercial commitments outside the ordinary course of business.

Credit Facility

The Company has an unsecured credit agreement with Rabobank, N.A. (the “Facility”). The Facility provides for a \$20 million line of credit for working capital or other business needs and matures on July 15, 2014. The Company pays a commitment fee of 0.25% per annum of the daily average of the unused portion of the \$20 million Facility. Borrowings under the Facility bear interest at a rate equal to one month LIBOR plus 0.75%.

The Facility provides that we maintain certain financial and operating ratios which include, among other provisions, minimum liquidity on a consolidated basis of \$25 million in cash and equivalents at all times, a current ratio (calculated using current liabilities excluding deferred revenue) of not less than 1.3 to 1.0 determined at the end of each fiscal quarter, a leverage ratio of not more than 1.5 to 1.0 determined at the end of each fiscal quarter, and a debt service coverage ratio of not less than 1.5 to 1.0 determined at the end of each fiscal year. The Facility also contains customary covenants that could restrict our ability to incur additional indebtedness. At July 31, 2013, the effective borrowing rate would have been 0.94%.

As of July 31, 2013, there were no borrowings under the Facility and we were in compliance with all financial covenants.

Notes Payable

Effective May 30, 2012, our wholly-owned subsidiary QAD Ortega Hill, LLC entered into a variable rate credit agreement (the “2012 Mortgage”) with Rabobank, N.A., to refinance a pre-existing mortgage. The 2012 Mortgage has an original principal balance of \$16.1 million and bears interest at the one month LIBOR rate plus 2.25%. One month LIBOR was 0.19% at July 31, 2013. The 2012 Mortgage matures in June 2022 and is secured by our headquarters located in Santa Barbara, California. In conjunction with the 2012 Mortgage, QAD Ortega Hill, LLC entered into an interest rate swap with Rabobank, N.A. The swap agreement has an initial notional amount of \$16.1 million and a schedule matching that of the underlying loan that synthetically fixes the interest rate on the debt at 4.31% for the entire term of the 2012 Mortgage. The terms of the 2012 Mortgage provide for QAD Ortega Hill, LLC to make net monthly payments of \$88,100 consisting of principal and interest and one final payment of \$11.7 million. The unpaid balance as of July 31, 2013 was \$15.7 million.

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Exchange Rates. We have operations in foreign locations around the world and we are exposed to risk resulting from fluctuations in foreign currency exchange rates. The foreign currencies for which we currently have the most significant exposure are the euro, Brazilian real, British pound and Mexican peso. These foreign currency exchange rate movements could create a foreign currency gain or loss that could be realized or unrealized for us. Unfavorable movements in foreign currency exchange rates between the U.S. dollar and other foreign currencies may have an adverse impact on our operations. We did not have any foreign currency forward or option contracts or other material foreign currency denominated derivatives or other financial instruments open as of July 31, 2013.

We face two risks related to foreign currency exchange rates—translation risk and transaction risk. Translation risk relates to amounts invested in our foreign operations that are translated into U.S. dollars using period-end exchange rates. The resulting translation adjustments are recorded as a component of accumulated other comprehensive loss in the Condensed Consolidated Balance Sheets. Revenues and expenses in foreign currencies translate into higher or lower revenues and expenses in U.S. dollars as the U.S. dollar weakens or strengthens against other currencies. Furthermore, we have exposure to foreign exchange fluctuations arising from the remeasurement of non-functional currency assets, liabilities and intercompany balances into U.S. dollars for financial reporting purposes. Transaction risk is related to our international subsidiaries holding non-local currency net monetary accounts subject to revaluation into their local currency, which results in realized or unrealized foreign currency gains or losses.

For the six months ended July 31, 2013 and 2012, approximately 40% of our revenue was denominated in foreign currencies. We also incurred a significant portion of our expenses in currencies other than the U.S. dollar, approximately 45% for the six months ended July 31, 2013 and 2012. Based on a hypothetical 10% adverse movement in all foreign currency exchange rates, our operating income would be adversely affected by approximately \$0.5 million and our expenses would be adversely affected by approximately \$6.1 million, or 5%, partially offset by a positive effect on our revenue of approximately \$5.6 million, or 4%.

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For the six months ended July 31, 2013 and 2012, foreign currency transaction and remeasurement gains totaled \$250,000 and \$9,000, respectively, and are included in "Other (income) expense, net" in our Condensed Consolidated Statements of Operations and Comprehensive Income. We performed a sensitivity analysis on the net U.S. dollar and euro-based monetary accounts subject to revaluation that are held by our international subsidiaries and on the non-functional currency assets, liabilities and intercompany balances that are remeasured into U.S. dollars. A hypothetical 10% adverse movement in all foreign currency exchange rates would result in foreign currency transaction and remeasurement losses of approximately \$0.5 million and our income before taxes would be adversely affected by approximately 89%.

These estimates assume adverse shifts in all foreign currency exchange rates against the U.S. dollar, which do not always move in the same direction or in the same degrees. Actual results may differ materially from the hypothetical analysis.

Interest Rates. We invest our surplus cash in a variety of financial instruments, consisting principally of short-term marketable securities with maturities of less than 90 days at the date of purchase. Our investment securities are held for purposes other than trading. Cash balances held by subsidiaries are invested primarily in registered money market funds with local operating banks. Based on an interest rate sensitivity analysis of our cash and equivalents we estimate that a 10% adverse change in interest rates from the 2013 fiscal year-end rates would not have a material adverse effect on our cash flows or financial condition for the next fiscal year.

Our debt is comprised of a loan agreement, secured by real property, which bears interest at the one month LIBOR rate plus 2.25%. In conjunction with the loan agreement, we entered into an interest rate swap. The swap agreement has an initial notional amount and schedule matching that of the underlying loan that synthetically fixes the interest rate on the debt at 4.31%. Additionally, we have an unsecured line of credit which bears interest at the one month LIBOR rate plus 0.75%. As of July 31, 2013 there were no borrowings under our unsecured line of credit.

Our interest rate swap is accounted for using mark-to-market accounting. Accordingly, changes in the fair value of the swap each reporting period are adjusted through earnings, subjecting us to non-cash volatility in our results of operations. We prepared a sensitivity analysis using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in levels of interest rates across the entire yield curve, with all other variables held constant. Based upon the results of this analysis a 10% adverse change in interest rates from the July 31, 2013 rates would not have a material adverse effect on our cash flows or financial condition for the next fiscal year. We believe it is prudent to hedge the expected volatility of the variable rate mortgage on our corporate headquarters. The swap fixes the interest rate on our mortgage to 4.31% over the entire term of the mortgage and effectively lowers our interest rate from the previous mortgage rate of 6.5%. Although the agreement allows us to prepay the loan and exit the agreement early, we have no intention of doing so. As a result, we will have non-cash adjustments through earnings each reporting period. However, over the term of the mortgage, the net impact of these mark-to-market adjustments on earnings will be zero.

ITEM 4 – CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level to ensure that the information required to be disclosed by us in this Quarterly Report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Changes in internal control over financial reporting. There were no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

The Company is not party to any material legal proceedings. From time to time, QAD is party, either as plaintiff or defendant, to various legal proceedings and claims which arise in the ordinary course of business. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on the Company's consolidated financial position, results of operations or liquidity.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors reported in Item 1A within the Company's Annual Report on Form 10-K for the year ended January 31, 2013.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits

31.1	Certification by the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by the Chief Executive Officer and the Chief Financial Officer furnished 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 Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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.

QAD Inc.
(Registrant)

Date: September 6, 2013

By: /s/ DANIEL LENDER
Daniel Lender
Executive Vice President, Chief Financial Officer
(on behalf of the Registrant)

By: /s/ KARA BELLAMY
Kara Bellamy
Senior Vice President, Corporate Controller
(Chief Accounting Officer)

**CERTIFICATIONS UNDER
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Karl F. Lopker, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of QAD 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 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: September 6, 2013

/s/ KARL F. LOPKER

Karl F. Lopker
Chief Executive Officer
QAD Inc.

**CERTIFICATIONS UNDER
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Daniel Lender, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of QAD 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 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: September 6, 2013

/s/ DANIEL LENDER

Daniel Lender
Chief Financial Officer
QAD Inc.

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
FURNISHED 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 of QAD Inc. (the "Company") on Form 10-Q for the period ending July 31, 2013 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Karl F. Lopker, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

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

Date: September 6, 2013

/s/ KARL F. LOPKER

Karl F. Lopker
Chief Executive Officer
QAD Inc.

In connection with the Quarterly Report of QAD Inc. (the "Company") on Form 10-Q for the period ending July 31, 2013 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Daniel Lender, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

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

Date: September 6, 2013

/s/ DANIEL LENDER

Daniel Lender
Chief Financial Officer
QAD Inc.
