

HEALTHSTREAM INC  
Form 10-Q  
August 09, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**  
**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act  
of 1934**  
**For the quarterly period ended June 30, 2010**  
**Commission File No.: 000-27701**  
**HealthStream, Inc.**  
(Exact name of registrant as specified in its charter)

**Tennessee**

**62-1443555**

(State or other jurisdiction of  
incorporation or organization)

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

**209 10th Avenue South, Suite 450  
Nashville, Tennessee**

**37203**

(Address of principal executive offices)

(Zip Code)

**(615) 301-3100**

(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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting  
company

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

As of August 6, 2010, 21,822,375 shares of the registrant's common stock were outstanding.

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**HEALTHSTREAM, INC.**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>June 30, 2010 (Unaudited)</b>	<b>December 31, 2009</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 18,771,651	\$ 12,287,059
Restricted cash	36,574	65,855
Accounts receivable, net of allowance for doubtful accounts of \$132,794 and \$140,559 at June 30, 2010 and December 31, 2009, respectively	9,831,503	9,577,409
Accounts receivable unbilled	1,751,113	1,638,326
Deferred tax assets, current	2,830,477	2,830,477
Prepaid royalties, net of amortization	1,473,826	2,084,154
Prepaid development fees, net of amortization	477,009	419,189
Other prepaid expenses and other current assets	1,231,212	988,390
 Total current assets	 36,403,365	 29,890,859
Property and equipment:		
Equipment	14,567,272	14,121,140
Leasehold improvements	2,058,550	2,004,822
Furniture and fixtures	1,699,437	1,689,350
	18,325,259	17,815,312
Less accumulated depreciation and amortization	(15,943,441)	(14,881,423)
	2,381,818	2,933,889
 Capitalized software feature enhancements, net of accumulated amortization of \$4,905,119 and \$3,993,689 at June 30, 2010 and December 31, 2009, respectively	 4,292,139	 4,181,858
Goodwill	21,146,864	21,146,864
Intangible assets, net of accumulated amortization of \$7,569,633 and \$7,096,196 at June 30, 2010 and December 31, 2009, respectively	3,317,509	3,790,946
Deferred tax assets, noncurrent	7,034,404	8,626,400
Other assets	337,724	431,464
 Total assets	 \$ 74,913,823	 \$ 71,002,280
 <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 539,287	\$ 1,552,101
Accrued liabilities	2,580,770	3,322,794
Accrued compensation and related expenses	860,683	1,401,604
Commercial support liabilities	265,712	350,792

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Deferred revenue	15,423,635	12,233,876
Current portion of long term debt		306,942
Current portion of capital lease obligations	7,430	8,905
Total current liabilities	19,677,517	19,177,014
Other long term liabilities	493,229	
Capital lease obligations, less current portion		4,362
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value, 75,000,000 shares authorized; 21,822,375 and 21,623,350 shares issued and outstanding at June 30, 2010 and December 31, 2009, respectively	97,174,365	96,406,765
Accumulated deficit	(42,431,288)	(44,585,861)
Total shareholders' equity	54,743,077	51,820,904
Total liabilities and shareholders' equity	\$ 74,913,823	\$ 71,002,280

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****HEALTHSTREAM, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

	<b>Three Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Revenues, net	\$ 16,660,469	\$ 14,583,522
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	5,906,377	5,228,069
Product development	1,722,929	1,447,422
Sales and marketing	3,049,817	2,601,702
Other general and administrative expenses	2,398,065	2,194,327
Depreciation and amortization	1,235,918	1,250,065
Total operating costs and expenses	14,313,106	12,721,585
Income from operations	2,347,363	1,861,937
Other income (expense):		
Interest and other income	5,784	7,321
Interest and other expense	(10,101)	(9,391)
Total other expense	(4,317)	(2,070)
Income before income taxes	2,343,046	1,859,867
Income tax provision	995,337	131,750
Net income	\$ 1,347,709	\$ 1,728,117
Net income per share:		
Basic	\$ 0.06	\$ 0.08
Diluted	\$ 0.06	\$ 0.08
Weighted average shares of common stock outstanding:		
Basic	21,795,558	21,382,802
Diluted	22,432,931	21,626,406

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****HEALTHSTREAM, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Revenues, net	\$ 31,497,721	\$ 28,202,729
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	11,368,360	10,495,901
Product development	3,249,094	2,981,846
Sales and marketing	6,010,686	5,315,093
Other general and administrative expenses	4,483,934	4,095,803
Depreciation and amortization	2,626,260	2,516,365
Total operating costs and expenses	27,738,334	25,405,008
Income from operations	3,759,387	2,797,721
Other income (expense):		
Interest and other income	8,499	16,277
Interest and other expense	(21,317)	(19,232)
Total other expense	(12,818)	(2,955)
Income before income taxes	3,746,569	2,794,766
Income tax provision	1,591,996	189,120
Net income	\$ 2,154,573	\$ 2,605,646
Net income per share:		
Basic	\$ 0.10	\$ 0.12
Diluted	\$ 0.10	\$ 0.12
Weighted average shares of common stock outstanding:		
Basic	21,735,661	21,382,429
Diluted	22,281,538	21,596,805

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**HEALTHSTREAM, INC.****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)  
SIX MONTHS ENDED JUNE 30, 2010**

	<b>Common Stock</b>		<b>Accumulated</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Deficit</b>	<b>Shareholders</b>
				<b>Equity</b>
Balance at December 31, 2009	21,623,350	\$ 96,406,765	\$ (44,585,861)	\$ 51,820,904
Net income			2,154,573	2,154,573
Stock based compensation expense		332,550		332,550
Exercise of stock options	199,025	435,050		435,050
Balance at June 30, 2010	21,822,375	\$ 97,174,365	\$ (42,431,288)	\$ 54,743,077

See accompanying notes to the condensed consolidated financial statements.

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**Table of Contents****HEALTHSTREAM, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 2,154,573	\$ 2,605,646
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,626,260	2,516,365
Stock based compensation expense	332,550	296,401
Provision for doubtful accounts		125,000
Deferred income taxes	1,591,996	
Realized loss on disposal of property and equipment		419
Changes in operating assets and liabilities:		
Accounts and unbilled receivables	(366,881)	(1,380,679)
Restricted cash	29,281	(5,271)
Prepaid royalties	610,328	(303,087)
Prepaid development fees	(237,196)	(93,281)
Other prepaid expenses and other current assets	(242,822)	390,399
Other assets	93,740	58,152
Accounts payable	(1,012,814)	(519,839)
Accrued liabilities and accrued compensation and related expenses	(1,282,945)	471,844
Commercial support liabilities	(85,080)	(170,508)
Other long term liabilities	493,229	
Deferred revenue	3,189,759	1,941,780
Net cash provided by operating activities	7,893,978	5,933,341
<b>INVESTING ACTIVITIES:</b>		
Payments associated with capitalized software feature enhancements	(1,021,710)	(665,048)
Purchases of property and equipment, net	(509,947)	(721,804)
Net cash used in investing activities	(1,531,657)	(1,386,852)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from exercise of stock options	435,050	1,240
Payments on long-term debt	(306,942)	(359,846)
Payments on capital lease obligations	(5,837)	(13,916)
Net cash provided by (used in) financing activities	122,271	(372,522)
Net increase in cash and cash equivalents	6,484,592	4,173,967
Cash and cash equivalents at beginning of period	12,287,059	4,106,612

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Cash and cash equivalents at end of period	\$ 18,771,651	\$ 8,280,579
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See accompanying notes to the condensed consolidated financial statements.

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**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( US GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, condensed consolidated financial statements do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions have been eliminated in consolidation. Operating results for the three and six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The balance sheet at December 31, 2009 is consistent with the audited financial statements at that date but does not include all of the information and footnotes required by US GAAP for a complete set of financial statements. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2009 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 26, 2010).

**2. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2009, the Financial Accounting Standards Board ( FASB ) issued revised guidance on the accounting for revenue arrangements with multiple deliverables. The revised guidance changes when individual deliverables in a multiple element arrangement can be treated as separate units of accounting, and also changes the manner in which the transaction consideration is allocated across the separately identified deliverables. The adoption of the guidance did not have an effect on the Company's financial position, results of operations, or cash flows.

**3. INCOME TAXES**

Income taxes are accounted for using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. During the six months ended June 30, 2010 and 2009, the Company recorded a provision for income taxes of \$1,591,996 and \$189,120, respectively. The Company's effective tax rate for the six months ended June 30, 2010 was 42.5%. The Company's effective tax rate primarily reflects the statutory corporate income tax rate, the net effect of state taxes, and the effect of various permanent tax differences. The Company's effective tax rate for the six months ended June 30, 2009 was substantially less than the statutory rate because the Company previously maintained a valuation allowance for its net operating loss ( NOL ) carryforwards and other deferred tax assets. The Company released substantially all of its valuation allowance against its deferred tax assets at December 31, 2009.

**4. STOCK BASED COMPENSATION**

The Company maintains two stock incentive plans. The Company accounts for its stock based compensation plans using the fair-value based method for costs related to share-based payments, including stock options. The Company uses the Black Scholes option pricing model for calculating the fair value of awards issued under its stock based compensation plans. During the six months ended June 30, 2010, the Company granted 319,000 stock options with a weighted average grant date fair value of \$2.07. During the six months ended June 30, 2009, the Company granted 289,000 stock options with a weighted average grant date fair value of \$1.17. The fair value of stock based awards granted during the six months ended June 30, 2010 and 2009 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

	Six Months Ended			
	2010		2009	
Risk-free interest rate	2.39	2.49%	1.73	3.22%
Expected dividend yield		0.0%		0.0%
Expected life	5 - 7 years		5 - 7 years	

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Expected forfeiture rate	0-10%	0-20%
Volatility	55%	60%

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**Table of Contents****HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****4. STOCK BASED COMPENSATION (continued)**

Total stock based compensation expense recorded for the three and six months ended June 30, 2010 and 2009, which is recorded in the condensed consolidated statements of income, is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Cost of revenues (excluding depreciation and amortization)	\$ 9,634	\$ 8,299	\$ 18,768	\$ 13,491
Product development	31,865	27,903	63,952	62,989
Sales and marketing	42,274	49,110	86,052	87,751
Other general and administrative	85,997	65,473	163,778	132,170
Total stock based compensation expense	\$ 169,770	\$ 150,785	\$ 332,550	\$ 296,401

**5. NET INCOME PER SHARE**

Basic net income per share is computed by dividing the net income available to common shareholders for the period by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares, composed of incremental common shares issuable upon the exercise of stock options and warrants, escrowed or restricted shares, and shares subject to vesting are included in diluted net income per share only to the extent these shares are dilutive. Common equivalent shares are dilutive when the average market price during the period exceeds the exercise price of the underlying shares. The total number of common equivalent shares excluded from the calculations of diluted net income per share, due to their anti-dilutive effect, was approximately 0.4 million and 0.6 million for the three and six months ended June 30, 2010, respectively, and approximately 2.3 million and 2.2 million for the three and six months ended June 30, 2009, respectively.

The following table sets forth the computation of basic and diluted net income per share for the three and six months ended June 30, 2010 and 2009:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Numerator:				
Net income	\$ 1,347,709	\$ 1,728,117	\$ 2,154,573	\$ 2,605,646
Denominator:				
Weighted average shares outstanding:				
Basic	21,795,558	21,382,802	21,735,661	21,382,429
Employee stock options	637,373	243,604	545,877	214,376
Diluted	22,432,931	21,626,406	22,281,538	21,596,805
Net income per share:				
Basic	\$ 0.06	\$ 0.08	\$ 0.10	\$ 0.12

Diluted	\$	0.06	\$	0.08	\$	0.10	\$	0.12
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On June 23, 2010, the Company announced the formation of SimVentures, a collaborative arrangement between HealthStream and Laerdal Medical. SimVentures will offer products and services aimed at accelerating the global adoption of simulation-based learning by healthcare providers with a focus on improving clinical competencies and patient outcomes. The Company will receive 50 percent of the profits and losses generated from the collaborative arrangement. A legal entity was not formed as part of the joint venture, therefore, the Company will account for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. SimVentures is currently in the product development phase, and sales activity is expected to commence during 2011. During the second quarter of 2010, the Company recorded approximately \$180,000 of expenses related to the collaborative arrangement, which are primarily recorded in the product development category within the statement of income.

**7. BUSINESS SEGMENTS**

The Company primarily provides services to healthcare organizations, and to a lesser extent, to pharmaceutical and medical device companies and other members within the healthcare industry. The Company's services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). The accounting policies of the segments are the same as those described in the summary of significant accounting policies in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The Company measures segment performance based on operating income before income taxes and prior to the allocation of certain corporate overhead expenses, interest income, interest expense, and depreciation. The three and six months ended June 30, 2010 includes approximately \$180,000 of expenses associated with SimVentures, and is included in the Unallocated section of the tables below.

The following is the Company's business segment information as of and for the three and six months ended June 30, 2010 and 2009.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues				
Learning	\$ 11,239,362	\$ 9,315,512	\$ 21,542,266	\$ 18,309,122
Research	5,421,107	5,268,010	9,955,455	9,893,607
Total net revenue	\$ 16,660,469	\$ 14,583,522	\$ 31,497,721	\$ 28,202,729
Income from operations				
Learning	\$ 4,127,322	\$ 2,441,212	\$ 7,347,667	\$ 4,488,377
Research	465,853	1,287,190	625,424	1,860,347
Unallocated	(2,245,812)	(1,866,465)	(4,213,704)	(3,551,003)
Total income from operations	\$ 2,347,363	\$ 1,861,937	\$ 3,759,387	\$ 2,797,721
Segment assets *			June 30, 2010	December 31, 2009
Learning			\$ 17,143,867	\$ 18,185,466
Research			26,226,231	26,209,873

Unallocated	31,543,725	26,606,941
Total assets	\$ 74,913,823	\$ 71,002,280

\* Segment assets include restricted cash, accounts and unbilled receivables, prepaid and other current assets, other assets, capitalized software feature enhancements, certain property and equipment, and intangible assets. Cash and cash equivalents are not allocated to individual segments, and are included within Unallocated. A significant portion of property and equipment assets are also included within Unallocated.



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Special Cautionary Notice Regarding Forward-Looking Statements**

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report and our audited consolidated financial statements and the notes thereto for the year ended December 31, 2009, appearing in our Annual Report on Form 10-K that was filed with the Securities and Exchange Commission ( SEC ) on March 26, 2010 (the 2009 Form 10-K ). Statements contained in this Quarterly Report on Form 10-Q that are not historical fact are forward-looking statements that the Company intends to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Statements that are predictive in nature, that depend on or refer to future events or conditions, or that include words such as anticipates, believes, could, estimates, expects, intends, may, predicts, projects, should, will, would, and similar expressions are forward-looking statements. The Company cautions that forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause actual results, performance, or achievements to be materially different from any future results, performance, or achievements expressed or implied by the forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. In evaluating any forward-looking statement, you should specifically consider the information regarding forward-looking statements and the information set forth under the caption Item 1A. Risk Factors in our 2009 Form 10-K and the information regarding forward-looking statements in our earnings releases, as well as other cautionary statements contained elsewhere in this report, including the matters discussed in Critical Accounting Policies and Estimates. We undertake no obligation beyond that required by law to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future. You should read this report and the documents that we reference in this report and have filed as exhibits to this report completely and with the understanding that our actual future results may be materially different from what we expect.

**Overview**

We primarily provide our services to healthcare organizations and to a lesser extent, to pharmaceutical and medical device companies and other participants within the healthcare industry. Our services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). HealthStream Learning products and services include our Internet-based HealthStream Learning Center® ( HLC ), authoring tools, courseware subscriptions, online training and content development, online sales training courses, live events, HospitalDirect® and other products focused on education and training to serve professionals that work within healthcare organizations. HealthStream Research provides a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on patients, employees, physicians, and members of the community. Our learning solutions help healthcare organizations improve their required regulatory training, while also offering an opportunity to train their employees in multiple clinical areas. Our research products provide customers valuable insight into measuring quality and satisfaction of physicians, patients, employees, and members of the community.

Key financial and operational indicators for the second quarter of 2010 include:

Revenues of \$16.7 million in the second quarter of 2010, up 14% over the second quarter of 2009

Operating income of \$2.3 million in the second quarter of 2010, up 26% over the second quarter of 2009

Net income of \$1.3 million and earnings per diluted share (EPS) of \$0.06 per share in the second quarter of 2010 which includes an income tax provision of \$1.0 million, or \$0.04 per diluted share, compared to net income of \$1.7 million and EPS of \$0.08 per diluted share in the second quarter of 2009 which included an income tax provision of \$132,000.

SimVentures, a new collaborative arrangement formed between HealthStream and Laerdal Medical

**Critical Accounting Policies and Estimates**

Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ( US GAAP ). These accounting principles require us to make certain estimates, judgments and assumptions during the preparation of our financial statements. We believe the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected.

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The accounting policies and estimates that we believe are the most critical in fully understanding and evaluating our reported financial results include the following:

Revenue recognition

Accounting for income taxes

Product development costs and related capitalization

Goodwill, intangibles, and other long-lived assets

Allowance for doubtful accounts

Accrual for service credits

Stock based compensation

Nonmonetary exchange of content rights and deferred service credits

In many cases, the accounting treatment of a particular transaction is specifically dictated by US GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would not produce a materially different result. See Notes to Consolidated Financial Statements in our 2009 Form 10-K, which contains additional information regarding our accounting policies and other disclosures required by US GAAP. There have been no changes in our critical accounting policies and estimates from those reported in our 2009 Form 10-K.

### **Revenues and Expense Components**

The following descriptions of the components of revenues and expenses apply to the comparison of results of operations.

*Revenues.* Revenues for our HealthStream Learning business segment primarily consist of the following products and services: provision of services through our Internet-based HLC, authoring tools, a variety of courseware subscriptions (add-on courseware), implementation and consulting services, maintenance of third party content, content development, online sales training courses (RepDirect<sup>®</sup>), HospitalDirec<sup>®</sup>t, and a variety of other educational activities for physicians, nurses and other professionals within healthcare organizations. Revenues for our HealthStream Research business segment consist of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on patients, physicians, employees, and other members of the community.

*Cost of Revenues (excluding depreciation and amortization).* Cost of revenues (excluding depreciation and amortization) consists primarily of salaries and employee benefits, stock based compensation, employee travel and lodging, materials, outsourced phone survey support, contract labor, hosting costs, and other direct expenses associated with revenues, as well as royalties paid by us to content providers based on a percentage of revenues. Personnel costs within cost of revenues are associated with individuals that facilitate product delivery, provide services, conduct, process and manage phone and paper-based surveys, handle customer support calls or inquiries, manage the technology infrastructure for our hosted applications, manage content and survey services, coordinate content maintenance services, and provide training or implementation services.

*Product Development.* Product development expenses consist primarily of salaries and employee benefits, contract labor, stock based compensation, content acquisition costs before technological feasibility is achieved, costs associated with the development of content and expenditures associated with maintaining, developing and operating our training, delivery and administration platforms. In addition, product development expenses are associated with the development of new software feature enhancements and new products. Personnel costs within product development include our systems, application development, and quality assurance teams, product managers, and other personnel associated with content and product development. A significant portion of the SimVentures expenses are also included within product development.

*Sales and Marketing Expenses.* Sales and marketing expenses consist primarily of salaries, commissions and employee benefits, stock based compensation, employee travel and lodging, advertising, trade shows, promotions, and related marketing costs. Personnel costs within sales and marketing include our Learning and Research sales teams, strategic account management, consultants, and marketing personnel, as well as our account management group.

*Other General and Administrative Expenses.* Other general and administrative expenses consist primarily of salaries and employee benefits, stock based compensation, employee travel and lodging, facility costs, office expenses, fees for professional services, and other operational expenses. Personnel costs within general and administrative expenses include individuals associated with normal corporate functions (accounting, legal, human resources, administrative, internal information systems, and executive management) as well as personnel who maintain our accreditation status with various organizations.

*Depreciation and Amortization.* Depreciation and amortization consist of fixed asset depreciation, amortization of intangibles considered to have definite lives, amortization of content development fees, and amortization of capitalized software feature enhancements.

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*Other Income/Expense, Net.* The primary component of other income is interest income related to interest earned on cash, cash equivalents and investments in marketable securities. The primary component of other expense is interest expense related to a promissory note, capital leases and our revolving credit facility.

**Three Months Ended June 30, 2010 Compared to Three Months Ended June 30, 2009**

*Revenues.* Revenues increased approximately \$2.1 million, or 14.2%, to \$16.7 million for the three months ended June 30, 2010 from \$14.6 million for the three months ended June 30, 2009. Revenues for 2010 consisted of \$11.2 million, or 68% of total revenue, for HealthStream Learning and \$5.4 million, or 32% of total revenue, for HealthStream Research. In 2009, revenues consisted of \$9.3 million, or 64% of total revenue, for HealthStream Learning and \$5.3 million, or 36% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased \$1.9 million, or 20.7%, over the second quarter of 2009. Revenues from our Internet-based subscription learning products increased by \$2.3 million over the prior year second quarter, and were comprised of revenue increases from the HLC of \$1.2 million and from courseware subscriptions of \$1.1 million. Revenues from our Internet-based subscription products increased 28% over the prior year second quarter due to a higher number of subscribers and more courseware consumption by subscribers. Our HLC subscriber base increased to 2,113,000 fully-implemented subscribers and 2,258,000 contracted subscribers at June 30, 2010 compared to 1,863,000 fully-implemented subscribers and 1,945,000 contracted subscribers at June 30, 2009.

Revenues associated with implementation, development, and consulting services decreased \$248,000 from the prior year second quarter, impacted primarily by lower revenues associated with fewer project-based activities.

Revenues for HealthStream Research increased \$153,000, or 2.9%, over the second quarter of 2009. Revenues from recurring patient surveys increased by \$344,000, or 10.7%, over the prior year second quarter. Revenues from surveys conducted on annual or bi-annual cycles namely employee, physician, and community surveys decreased by \$191,000, primarily due to declines in physician and community surveys, which more than offset an increase in employee surveys.

*Cost of Revenues (excluding depreciation and amortization).* Cost of revenues increased approximately \$678,000, or 13.0%, to \$5.9 million for the three months ended June 30, 2010 from \$5.2 million for the three months ended June 30, 2009. Cost of revenues as a percentage of revenues was 35.5% of revenues for the three months ended June 30, 2010 compared to 35.8% of revenues for the three months ended June 30, 2009.

Cost of revenues for HealthStream Learning increased approximately \$299,000 to \$3.2 million and approximated 28.5% and 31.2% of revenues for the three months ended June 30, 2010 and 2009, respectively. The overall expense increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, while the decline as a percentage of revenue is attributable to the growth in subscription based revenues over the prior year second quarter. Cost of revenues for HealthStream Research increased approximately \$380,000 to \$2.7 million and approximated 49.8% and 44.0% of revenues for the three months ended June 30, 2010 and 2009, respectively. The increase in cost of revenues for HealthStream Research is primarily the result of costs associated with the growth in patient survey revenues over the prior year second quarter. Additional costs were also incurred during the second quarter of 2010 to complete projects on schedule in light of unprecedented snow storms experienced in the Baltimore area.

*Product Development.* Product development expenses increased approximately \$276,000, or 19.0%, to \$1.7 million for the three months ended June 30, 2010 from \$1.4 million for the three months ended June 30, 2009. Product development expenses as a percentage of revenues were 10.3% and 9.9% of revenues for the three months ended June 30, 2010 and 2009, respectively.

Product development expenses for HealthStream Learning decreased approximately \$68,000 and approximated 10.5% and 13.4% of revenues for the three months ended June 30, 2010 and 2009, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year second quarter. Product development expenses for HealthStream Research increased approximately \$187,000 and approximated 7.2% and 3.8% of revenues for the three months ended June 30, 2010 and 2009, respectively. This increase is primarily due to additional personnel associated with product management and with developing and supporting our survey reporting platform, Insights Online. The unallocated portion of product development expenses approximated \$156,000 for the second quarter of 2010 and is associated with SimVentures.

*Sales and Marketing.* Sales and marketing expenses, including personnel costs, increased approximately \$448,000, or 17.2%, to \$3.0 million for the three months ended June 30, 2010 from \$2.6 million for the three months ended June 30, 2009. Sales and marketing expenses approximated 18.3% and 17.8% of revenues for the three months ended June 30, 2010 and 2009, respectively.

Sales and marketing expenses for HealthStream Learning increased \$25,000 and approximated 16.3% and 19.4% of revenues for the three months ended June 30, 2010 and 2009, respectively. Sales and marketing expenses for HealthStream Research increased approximately \$393,000, and approximated 20.4% and 13.6% of revenues for the three months ended June 30, 2010 and 2009, respectively. The expense increase for HealthStream Research resulted from additional sales personnel, travel expenses and commissions. The additional sales

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personnel were hired during the second half of 2009. Our historical experience is that new sales personnel take several quarters to build a pipeline and generate new sales, a process we believe is occurring.

*Other General and Administrative.* Other general and administrative expenses increased approximately \$204,000, or 9.3%, to \$2.4 million for the three months ended June 30, 2010 from \$2.2 million for the three months ended June 30, 2009. Other general and administrative expenses as a percentage of revenues approximated 14.4% and 15.0% for the three months ended June 30, 2010 and 2009, respectively.

Other general and administrative expenses for HealthStream Learning and HealthStream Research decreased \$58,000 and \$48,000, respectively, compared to the prior year second quarter. The unallocated corporate portion of other general and administrative expenses increased \$310,000 over the prior year quarter, primarily associated with contract labor, professional fees, and rent expense.

*Depreciation and Amortization.* Depreciation and amortization decreased approximately \$14,000, or 1.1%, and approximated \$1.2 million for the three months ended June 30, 2010 and 2009, respectively. The decrease resulted from lower depreciation expense, and was partially offset by increased amortization of capitalized software features over the prior year second quarter.

*Provision for Income Taxes.* The Company recorded a provision for income taxes of approximately \$1.0 million for the three months ended June 30, 2010 compared to \$132,000 for the three months ended June 30, 2009. The Company's effective tax rate for the second quarter of 2010 was 42.5%. During the second quarter of 2009, the Company maintained a valuation allowance on its deferred tax assets, and recorded no deferred income tax expense. Substantially all of the valuation allowance was released during the fourth quarter of 2009. Income tax expense for the second quarter of 2009 consisted of the federal alternative minimum tax and state income taxes.

*Net Income.* Net income was approximately \$1.3 million for the three months ended June 30, 2010, compared to \$1.7 million for the three months ended June 30, 2009. Net income per diluted share was \$0.06 per share for the three months ended June 30, 2010 compared to \$0.08 per diluted share for the three months ended June 30, 2009.

**Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009**

*Revenues.* Revenues increased approximately \$3.3 million, or 11.7%, to \$31.5 million for the six months ended June 30, 2010 from \$28.2 million for the six months ended June 30, 2009. Revenues for 2010 consisted of \$21.5 million, or 68% of total revenue, for HealthStream Learning and \$10.0 million, or 32% of total revenue, for HealthStream Research. In 2009, revenues consisted of \$18.3 million, or 65% of total revenue, for HealthStream Learning and \$9.9 million, or 35% of total revenue, for HealthStream Research.

Revenues for HealthStream Learning increased \$3.2 million, or 17.7%, over 2009. Revenues from our Internet-based subscription learning products increased by \$4.1 million over the prior year, and were comprised of revenue increases from the HLC of \$2.3 million and from courseware subscriptions of \$1.8 million. Revenues from our Internet-based subscription products increased 26.0% over the prior year due to a higher number of subscribers and more courseware consumption by subscribers. Revenues associated with implementation, development, and consulting services decreased \$764,000 from the prior year period, impacted primarily by lower revenues associated with fewer project-based activities. Additionally, revenues from live events, study guides, and other project-based activities collectively declined \$155,000 from the prior year due to a de-emphasis on providing these services.

Revenues for HealthStream Research increased \$62,000, or 0.6%, over 2009. Revenues from recurring patient surveys increased by \$528,000, or 8.3%, over the prior year. Revenues from surveys conducted on annual or bi-annual cycles namely employee, physician, and community surveys decreased by \$466,000, primarily due to fewer projects than the prior year, as well as changes in the timing and size of the projects.

*Cost of Revenues (excluding depreciation and amortization).* Cost of revenues increased approximately \$872,000, or 8.3%, to \$11.4 million for the six months ended June 30, 2010 from \$10.5 million for the six months ended June 30, 2009. Cost of revenues as a percentage of revenues was 36.1% of revenues for the six months ended June 30, 2010 compared to 37.2% of revenues for the six months ended June 30, 2009. Cost of revenues for HealthStream Learning increased approximately \$406,000 to \$6.3 million and approximated 29.4% and 32.3% of revenues for the six months ended June 30, 2010 and 2009, respectively. The overall expense increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, but was partially offset by expense decreases associated with declines in implementation, development, and consulting service revenues. The decline as a

percentage of revenue is attributable to the growth in subscription based revenues over the prior year. Cost of revenues for HealthStream Research increased approximately \$467,000 to \$5.0 million and approximated 50.7% and 46.3% of revenues for the six months ended June 30, 2010 and 2009, respectively. The increase in cost of revenues for HealthStream Research is primarily the result of costs associated with the growth in patient survey revenues over the prior year. Additional costs were also incurred during the second quarter of 2010 to complete projects on schedule in light of unprecedented snow storms experienced in the Baltimore area.



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*Product Development.* Product development expenses increased approximately \$267,000, or 9.0%, to \$3.3 million for the six months ended June 30, 2010 from \$3.0 million for the six months ended June 30, 2009. Product development expenses as a percentage of revenues were 10.3% and 10.6% of revenues for the six months ended June 30, 2010 and 2009, respectively.

Product development expenses for HealthStream Learning decreased approximately \$103,000 and approximated 11.1% and 13.6% of revenues for the six months ended June 30, 2010 and 2009, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year, while the expense decrease is the result of lower contract labor costs compared to the prior year. Product development expenses for HealthStream Research increased approximately \$214,000 and approximated 7.1% and 5.0% of revenues for the six months ended June 30, 2010 and 2009, respectively. This increase is primarily due to additional personnel associated with product management and with developing and supporting our survey reporting platform, Insights Online. The unallocated portion of product development expenses approximated \$156,000 for 2010 and is associated with SimVentures.

*Sales and Marketing.* Sales and marketing expenses, including personnel costs, increased approximately \$696,000, or 13.1%, to \$6.0 million for the six months ended June 30, 2010 from \$5.3 million for the six months ended June 30, 2009. Sales and marketing expenses approximated 19.1% and 18.8% of revenues for the six months ended June 30, 2010 and 2009, respectively.

Sales and marketing expenses for HealthStream Learning increased \$96,000 and approximated 17.4% and 19.9% of revenues for the six months ended June 30, 2010 and 2009, respectively. Sales and marketing expenses for HealthStream Research increased approximately \$576,000, and approximated 21.1% and 15.5% of revenues for the six months ended June 30, 2010 and 2009, respectively. The expense increase for HealthStream Research resulted from additional sales personnel, travel expenses and commissions. The additional sales personnel were hired during the second half of 2009. Our historical experience is that new sales personnel take several quarters to build a pipeline and generate new sales, a process we believe is occurring. These expense increases also impacted the increase as a percentage of revenues for HealthStream Research.

*Other General and Administrative.* Other general and administrative expenses increased approximately \$388,000, or 9.5% to \$4.5 million for the six months ended June 30, 2010 from \$4.1 million for the six months ended June 30, 2009. Other general and administrative expenses as a percentage of revenues approximated 14.2% and 14.5% for the six months ended June 30, 2010 and 2009, respectively.

Other general and administrative expenses for both HealthStream Learning and HealthStream Research decreased \$86,000, respectively, compared to the prior year. The unallocated corporate portion of other general and administrative expenses increased \$560,000 over the prior year quarter, primarily associated with contract labor, professional fees, rent expense, and other expenses.

*Depreciation and Amortization.* Depreciation and amortization increased approximately \$110,000, or 4.4%, to \$2.6 million for the six months ended June 30, 2010 from \$2.5 million for the six months ended June 30, 2009. The increase resulted from increased amortization of capitalized software features over the prior year, and was partially offset by lower depreciation expense.

*Provision for Income Taxes.* The Company recorded a provision for income taxes of approximately \$1.6 million for the six months ended June 30, 2010 compared to \$189,000 for the six months ended June 30, 2009. The Company's effective tax rate for 2010 was 42.5%. During the first half of 2009, the Company maintained a valuation allowance on its deferred tax assets, and recorded no deferred income tax expense. Substantially all of the valuation allowance was released during the fourth quarter of 2009. Income tax expense for 2009 consisted of the federal alternative minimum tax and state income taxes.

*Net Income.* Net income was approximately \$2.2 million for the six months ended June 30, 2010, compared to \$2.6 million for the six months ended June 30, 2009. Net income per share was \$0.10 per share for the six months ended June 30, 2010 compared to \$0.12 per share for the six months ended June 30, 2009.

**Liquidity and Capital Resources**

Net cash provided by operating activities was approximately \$7.9 million and \$5.9 million during the six months ended June 30, 2010 and 2009, respectively. Our primary sources of cash were generated from receipts from the sales of our products and services. In addition, we received \$560,000 of cash associated with a renewed lease for our

Nashville, Tennessee office, which is classified on the balance sheet under accrued liabilities and other long term liabilities. Our days sales outstanding ( DSO ) which we calculate by dividing the accounts receivable balance, excluding unbilled and other receivables, by average daily revenues for the quarter, approximated 53 days for the second quarter of 2010 compared to 58 days for the second quarter of 2009 and 72 days for the first quarter of 2010. The decrease in DSO compared to the first quarter of 2010 is a result of the collection of outstanding balances with several customers that were billed in advance during the first quarter of 2010 for annual fees rather than on a monthly subscription basis. The primary uses of cash to fund our operations for the six months ended June 30, 2010 and 2009 included personnel expenses, sales commissions, royalty payments, payments for contract labor and other direct expenses associated with delivery of our products and services, and general corporate expenses.

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Net cash used in investing activities was approximately \$1.5 million and \$1.4 million for the six months ended June 30, 2010 and 2009, respectively. The primary uses of cash for the six months ended June 30, 2010 were associated with capitalized software feature enhancements of \$1.0 million and property and equipment purchases of \$510,000. The primary uses of cash for the six months ended June 30, 2009 were associated with property and equipment purchases of \$722,000 and capitalized software feature enhancements of \$665,000. These uses of cash were associated with technology investments in our platform products.

Cash provided by financing activities was approximately \$122,000 for the six months ended June 30, 2010, while approximately \$373,000 of cash was used during the six months ended June 30, 2009. The primary uses of cash for the six months ended June 30, 2010 and 2009 related to payments under a promissory note and capital lease obligations. The primary source of cash from financing activities for the six months ended June 30, 2010 resulted from proceeds associated with the exercise of employee stock options.

Our revenues increased and our operating income improved over the prior year period, and our balance sheet reflects positive working capital of \$16.7 million at June 30, 2010 compared to \$10.7 million at December 31, 2009. The improvement in working capital is primarily associated with increases in cash and cash equivalents resulting from the net cash provided by operating activities mentioned above. Current assets increased approximately \$6.5 million during the first six months of 2010 primarily due to increases in cash balances, while current liabilities increased approximately \$500,000 during the first six months of 2010 resulting primarily from increases in deferred revenue, but was partially offset by reductions in accounts payable and accrued liabilities. Our primary source of liquidity is \$18.8 million of cash and cash equivalents. We also have a \$15.0 million revolving credit facility loan agreement, all of which was available at June 30, 2010.

We believe that our existing cash and cash equivalents, restricted cash, related interest receivable, cash generated from operations, and available borrowings under our revolving credit facility will be sufficient to meet anticipated cash needs for working capital, new product development and capital expenditures for at least the next 12 months. As part of our growth strategy, we review possible acquisitions that complement our products and services. We anticipate that future acquisitions, if any, would be effected through a combination of stock and cash consideration. We may need to raise additional capital through the issuance of equity or debt securities and/or borrowings under our revolving credit facility, or another facility, to finance any future acquisitions. The issuance of our stock as consideration for an acquisition would have a dilutive effect and could adversely affect our stock price. The credit markets have been experiencing extreme volatility and disruption, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. Failure to generate sufficient cash flow from operations or raise additional capital when required in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

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

We are exposed to market risk from changes in interest rates. We do not have any foreign currency exchange rate risk or commodity price risk. As of June 30, 2010, our outstanding indebtedness included approximately \$7,000 of capital lease obligations. We may become subject to interest rate market risk associated with any future borrowings under our revolving credit facility. The interest rate under the revolving credit facility is based on 30 Day LIBOR plus a margin of either 190 or 220 basis points determined in accordance with a pricing grid, but has a minimum interest rate of not less than three percent. We are also exposed to market risk with respect to our cash balances. At June 30, 2010, the Company had cash and cash equivalents totaling approximately \$18.8 million. Current investment rates of return approximate 0.10%. Assuming a 0.10% rate of return on \$18.8 million, a hypothetical 10% decrease in interest rates would decrease interest income and decrease net income on an annualized basis by approximately \$1,900.

The above market risk discussion and the estimated amounts presented are forward-looking statements of market risk assuming the occurrence of certain adverse market conditions. Actual results in the future may differ materially from those projected as a result of actual developments in the market.

**Table of Contents****Item 4T. Controls and Procedures****Evaluation of Controls and Procedures**

HealthStream's chief executive officer and principal financial officer have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of the end of the period covered by this Quarterly Report. Based on that evaluation, the chief executive officer and principal financial officer have concluded that HealthStream's disclosure controls and procedures were effective to ensure that the information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and the information required to be disclosed in the reports the Company files or submits under the Exchange Act was accumulated and communicated to the Company's management, including its chief executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Control Over Financial Reporting**

There was no change in HealthStream's internal control over financial reporting that occurred during the period covered by this Quarterly Report that has materially affected, or that is reasonably likely to materially affect, HealthStream's internal control over financial reporting.

**PART II OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On February 23, 2010, the Company's Board of Directors authorized the Company to purchase up to \$4,000,000 of its common stock over a one year period. The table below sets forth activity under the stock repurchase plan for the quarter ended June 30, 2010:

Period	(a) Total number of shares (or units)	(b) Average price paid per share (or unit)	(c) Total number of shares (or units) purchased as part of publicly announced plans or programs	(d) Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
Month # 4 (April 1 April 30)		\$		\$ 4,000,000
Month # 5 (May 1 May 31)				4,000,000
Month # 6 (June 1 June 30)				4,000,000
Total		\$		\$ 4,000,000

**Item 6. Exhibits**

(a) Exhibits

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- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURE**

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.

HEALTHSTREAM, INC.

August 9, 2010

By: /s/ Gerard M. Hayden, Jr.  
Gerard M. Hayden, Jr.  
Chief Financial Officer

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**HEALTHSTREAM, INC.  
EXHIBIT INDEX**

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