

HEALTHSTREAM INC
Form 10-Q
November 13, 2006

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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 September 30, 2006
Commission File No.: 000-27701
HealthStream, Inc.
(Exact name of registrant as specified in its charter)**

Tennessee
(State or other jurisdiction of
incorporation or organization)

62-1443555
(I.R.S. Employer Identification No.)

209 10th Avenue South, Suite 450
Nashville, Tennessee
(Address of principal executive offices)

37203
(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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 November 9, 2006, 21,927,687 shares of the registrant's common stock were outstanding.

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

HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2006 (Unaudited) | December 31, 2005 (Note 1) |
|--|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,060,229 | \$ 5,726,151 |
| Investments in short term marketable securities | 6,100,000 | 6,175,000 |
| Restricted cash | 111,520 | 238,538 |
| Interest receivable | 57,492 | 54,524 |
| Accounts receivable, net of allowance for doubtful accounts of \$101,058 at September 30, 2006 and \$115,090 at December 31, 2005 | 4,401,126 | 4,691,402 |
| Accounts receivable unbilled | 1,014,777 | 706,011 |
| Prepaid development fees and content rights, net of amortization | 1,256,651 | 684,351 |
| Other prepaid expenses and other current assets | 647,747 | 488,324 |
| Total current assets | 20,649,542 | 18,764,301 |
| Property and equipment: | | |
| Equipment | 8,015,477 | 7,446,451 |
| Leasehold improvements | 1,658,686 | 1,281,460 |
| Furniture and fixtures | 1,098,389 | 1,011,877 |
| | 10,772,552 | 9,739,788 |
| Less accumulated depreciation and amortization | (8,608,978) | (7,636,306) |
| | 2,163,574 | 2,103,482 |
| Capitalized software feature enhancements, net of accumulated amortization of \$484,775 at September 30, 2006 and \$249,276 at December 31, 2005 | 1,717,702 | 584,180 |
| Goodwill | 10,317,393 | 10,317,393 |
| Intangible assets, net of accumulated amortization of \$7,629,078 at September 30, 2006 and \$7,247,828 at December 31, 2005 | 2,883,064 | 3,264,314 |
| Other assets | 853,042 | 182,470 |
| Total assets | \$ 38,584,317 | \$ 35,216,140 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 885,648 | \$ 933,895 |
| Accrued liabilities | 1,969,938 | 1,487,568 |
| Accrued compensation and related expenses | 633,131 | 639,468 |
| Registration liabilities | 95,036 | 231,142 |
| Commercial support liabilities | 375,006 | 1,239,124 |
| Deferred revenue | 5,352,962 | 4,502,924 |
| Current portion of capital lease obligations | 179,326 | 166,022 |

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| | | |
|---|---------------|---------------|
| Total current liabilities | 9,491,047 | 9,200,143 |
| Capital lease obligations, less current portion | 151,695 | 215,856 |
| Other long-term liabilities | 525,000 | |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common stock, no par value, 75,000,000 shares authorized; 21,927,687 and 21,574,904 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 94,994,881 | 93,799,932 |
| Accumulated deficit | (66,578,306) | (67,999,791) |
| Total shareholders' equity | 28,416,575 | 25,800,141 |
| Total liabilities and shareholders' equity | \$ 38,584,317 | \$ 35,216,140 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

| | Three Months Ended September | |
|--|-------------------------------------|--------------|
| | 30, | |
| | 2006 | 2005 |
| Revenues, net | \$ 7,480,532 | \$ 6,830,640 |
| Operating costs and expenses: | | |
| Cost of revenues (excluding depreciation and amortization) | 2,378,223 | 2,392,075 |
| Product development | 891,188 | 719,930 |
| Sales and marketing | 1,647,892 | 1,340,084 |
| Depreciation | 374,946 | 373,697 |
| Amortization of intangibles, content fees and software feature enhancements. | 384,504 | 278,496 |
| Other general and administrative expenses | 1,509,354 | 1,244,556 |
| Total operating costs and expenses | 7,186,107 | 6,348,838 |
| Income from operations | 294,425 | 481,802 |
| Other income (expense): | | |
| Interest and other income | 175,414 | 81,914 |
| Interest and other expense | (9,936) | (9,958) |
| Total other income | 165,478 | 71,956 |
| Income before income taxes | 459,903 | 553,758 |
| Income tax benefit | (14,436) | |
| Net income | \$ 474,339 | \$ 553,758 |
| Net income per share: | | |
| Basic | \$ 0.02 | \$ 0.03 |
| Diluted | \$ 0.02 | \$ 0.02 |
| Weighted average shares of common stock outstanding: | | |
| Basic | 21,618,616 | 21,212,310 |
| Diluted | 22,363,500 | 22,356,561 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

| | Nine Months Ended September | |
|---|------------------------------------|---------------|
| | 30, | |
| | 2006 | 2005 |
| Revenues, net | \$ 23,226,872 | \$ 19,319,462 |
| Operating costs and expenses: | | |
| Cost of revenues (excluding depreciation and amortization) | 8,114,882 | 6,887,196 |
| Product development | 2,617,556 | 2,099,549 |
| Sales and marketing | 5,309,726 | 4,131,547 |
| Depreciation | 1,039,589 | 1,183,808 |
| Amortization of intangibles, content fees and software feature enhancements | 1,030,842 | 846,674 |
| Other general and administrative expenses | 4,142,906 | 3,672,579 |
| Total operating costs and expenses | 22,255,501 | 18,821,353 |
| Income from operations | 971,371 | 498,109 |
| Other income (expense): | | |
| Interest and other income | 480,102 | 259,854 |
| Interest and other expense | (27,924) | (21,842) |
| Total other income | 452,178 | 238,012 |
| Income before income taxes | 1,423,549 | 736,121 |
| Income tax provision | 2,064 | 15,000 |
| Net income | \$ 1,421,485 | \$ 721,121 |
| Net income per share: | | |
| Basic | \$ 0.07 | \$ 0.03 |
| Diluted | \$ 0.06 | \$ 0.03 |
| Weighted average shares of common stock outstanding: | | |
| Basic | 21,459,321 | 20,984,144 |
| Diluted | 22,323,903 | 21,962,594 |

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)
NINE MONTHS ENDED SEPTEMBER 30, 2006

| | Common Stock | | | Total |
|---|---------------------|---------------|--------------------------------|---------------------------------|
| | Shares | Amount | Accumulated Deficit | Shareholders' Equity |
| Balance at December 31, 2005 | 21,574,904 | \$ 93,799,932 | \$ (67,999,791) | \$ 25,800,141 |
| Net income | | | 1,421,485 | 1,421,485 |
| Stock-based compensation | | 543,714 | | 543,714 |
| Issuance of common stock to Employee Stock Purchase Plan | 68,102 | 162,083 | | 162,083 |
| Exercise of stock options | 284,681 | 489,152 | | 489,152 |
| Balance at September 30, 2006 | 21,927,687 | \$ 94,994,881 | \$ (67,578,306) | \$ 28,416,575 |

See accompanying notes to the condensed consolidated financial statements .

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| | Nine Months Ended September | |
|---|------------------------------------|-------------|
| | 30, | |
| | 2006 | 2005 |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 1,421,485 | \$ 721,121 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 1,039,590 | 1,183,808 |
| Amortization of intangibles, content fees, and software feature enhancements. | 1,030,842 | 846,674 |
| Stock-based compensation | 543,714 | |
| Provision for doubtful accounts | | 15,000 |
| Realized loss on disposal of property & equipment | 621 | 6,096 |
| Changes in operating assets and liabilities: | | |
| Accounts and unbilled receivables | (18,490) | (367,020) |
| Restricted cash | 127,018 | 15,799 |
| Interest receivable | (2,968) | 2,315 |
| Prepaid development fees and content rights | (607,227) | (323,055) |
| Other prepaid expenses and other current assets | (159,423) | 119,235 |
| Other assets | (151,782) | 34,759 |
| Accounts payable | (48,247) | 142,346 |
| Accrued liabilities and compensation | 201,866 | (152,060) |
| Registration liabilities | (136,106) | (13,527) |
| Commercial support liabilities | (864,118) | 536,638 |
| Deferred revenue | 745,038 | 170,904 |
| Net cash provided by operating activities | 3,121,813 | 2,939,033 |
| INVESTING ACTIVITIES: | | |
| Acquisition, net of cash acquired | | (9,351,360) |
| Proceeds from maturities and sales of investments in marketable securities | 12,785,000 | 15,875,000 |
| Purchase of investments in marketable securities | (12,703,816) | (5,750,000) |
| Purchase of capitalized software feature enhancements | (1,369,020) | (281,653) |
| Purchase of property and equipment | (1,012,210) | (656,894) |
| Net cash used in investing activities | (2,300,046) | (164,907) |
| FINANCING ACTIVITIES: | | |
| Exercise of stock options | 489,152 | 646,349 |
| Issuance of common stock to Employee Stock Purchase Plan | 162,083 | 159,445 |
| Payments on capital lease obligations | (138,924) | (59,014) |
| Net cash provided by financing activities | 512,311 | 746,780 |
| Net increase in cash and cash equivalents | 1,334,078 | 3,520,906 |
| Cash and cash equivalents at beginning of period | 5,726,151 | 2,257,372 |

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| | | |
|--|--------------|--------------|
| Cash and cash equivalents at end of period | \$ 7,060,229 | \$ 5,778,278 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Capital lease obligations incurred | \$ 88,067 | \$ 326,817 |
| Interest paid | \$ 27,814 | \$ 15,631 |
| Income taxes paid | \$ 6,544 | \$ 15,000 |
| Issuance of common stock in connection with acquisition of company | \$ | \$ 1,343,149 |
| Effects of acquisition: | | |
| Estimated fair value of tangible assets acquired | \$ | \$ 718,357 |
| Estimated fair value of liabilities assumed | | (655,907) |
| Purchase price in excess of net tangible assets acquired | | 10,649,870 |
| Less fair value of stock issued | | (1,343,149) |
| Cash paid | | 9,369,171 |
| Less cash acquired | | (17,811) |
| Net cash paid for acquisition | \$ | \$ 9,351,360 |

See accompanying notes to the condensed consolidated financial statements.

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 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 generally accepted accounting principles 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 nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

As of September 30, 2006, we have classified capitalized software feature enhancements as a separate long term asset in our financial statements based on our increased investments in software feature enhancements during 2006. We have made a corresponding reclassification to the December 31, 2005 balance sheet to present separately capitalized software feature enhancements which were previously included within Prepaid expenses and other current assets and Other assets. We have also reclassified our purchases associated with capitalized software feature enhancements to present those purchases in the investing activities section within the statement of cash flows for the nine months ended September 30, 2005.

Other than as discussed above, the balance sheet at December 31, 2005 is consistent with the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States 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, 2005 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission).

2. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in the financial statements, and requires companies to use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold should be measured in order to determine the tax benefit to be recognized in the financial statements. FIN 48 is effective in fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that the adoption of FIN 48 will have on its consolidated financial statements.

3. STOCK-BASED COMPENSATION

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), Share-Based Payments. Statement 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and requires companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments, including stock options. The Company adopted Statement 123(R) on January 1, 2006 and implemented it using the modified-prospective method for transition purposes, therefore prior period financial results have not been restated. The modified-prospective method requires compensation expense to be recorded for all unvested share-based payments outstanding prior to adoption and for all share-based payments issued subsequent to adoption using a fair value approach. We use the Black Scholes option pricing model for calculating the fair value of awards issued under our stock-based compensation plans.

Total stock-based compensation expense recorded, as a result of adopting Statement 123(R), for the three and nine months ended September 30, 2006, which is recorded in our statements of operations, is as follows:

| Three months ended September 30, 2006 | Nine months ended September 30, 2006 |
|--|---|
| | |

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| | | | | |
|--|----|---------|----|---------|
| Cost of revenues (excluding depreciation and amortization) | \$ | 12,587 | \$ | 42,346 |
| Product development | | 32,767 | | 104,431 |
| Sales and marketing | | 30,178 | | 95,538 |
| Other general and administrative | | 90,549 | | 301,399 |
| Total stock-based compensation expense | \$ | 166,081 | \$ | 543,714 |

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. STOCK-BASED COMPENSATION (continued)**

Prior to adopting Statement 123(R), we accounted for our stock-based compensation plans under the intrinsic value-based method of accounting prescribed by APB 25 and related interpretations. The following pro forma table reflects our net income and net income per share had the fair value provisions of SFAS No. 123 Accounting for Stock-Based Compensation been followed during the three and nine months ended September 30, 2005:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|--|---|
| Net income as reported | \$ 553,758 | \$ 721,121 |
| Add: Stock-based employee compensation expense included in reported net income, net of related taxes | | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (111,339) | (475,897) |
| Pro forma net income | \$ 442,419 | \$ 245,224 |
| Basic net income per share as reported | \$ 0.03 | \$ 0.03 |
| Basic net income per share pro forma | \$ 0.02 | \$ 0.01 |
| Diluted net income per share as reported | \$ 0.02 | \$ 0.03 |
| Diluted net income per share pro forma | \$ 0.02 | \$ 0.01 |

Stock Option Plans

Our 2000 Stock Incentive Plan (2000 Plan) and 1994 Employee Stock Option Plan (1994 Plan) (the 2000 Plan and the 1994 Plan are collectively referred to as the Plan) authorize the grant of options or other forms of stock-based compensation to employees, officers, directors and others, and such grants must be approved by the Compensation Committee of the Board of Directors. The terms of both plans are substantially similar. Options granted under the Plan have terms of no more than ten years, with certain restrictions. The Plan allows the Compensation Committee of the Board of Directors to determine the vesting period of each grant. The vesting period of the options granted ranges from immediate vesting (generally associated with professional consulting boards and directors options) to annual vesting over four years, beginning one year after the grant date (generally for employee and officer options). As of September 30, 2006, 2,126,123 shares of unissued common stock remained reserved for future grants under the Plan. The Company issues new shares of common stock when options are exercised.

The fair value of stock-based awards granted during the nine months ended September 30, 2006 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

| | |
|--------------------------|---------------|
| Risk-free interest rate. | 4.55 -- 5.07% |
| Expected dividend yield | 0.0% |
| Expected life (in years) | 5 to 8 |
| Expected forfeiture rate | 0-15% |
| Volatility | 75% |

Risk-free interest rate is based on the U.S. Treasury rate in effect at the time of the option grant having a term equal to the expected life of the option.

Expected dividend yield is zero because the Company has not made any dividend payments in its history and does not plan to pay dividends in the foreseeable future.

Expected life is the period of time the option is expected to remain outstanding, and is based on historical experience. The contractual option life ranges from eight to ten years.

Expected forfeiture rate is the estimated percentage of options granted that are not expected to become fully vested. This estimate is based on historical experience, and will be adjusted as necessary to match the actual forfeiture experience.

Volatility is the measure of the amount by which the price is expected to fluctuate. We estimate volatility based on the actual historical volatility of our common stock, and we believe future volatility will be similar to our past experience. We amortize the fair value of all stock-based awards on a straight-line basis over the requisite service period, which generally is the vesting period.

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. STOCK-BASED COMPENSATION (continued)**

A summary of stock option activity and various other information relative to stock options for the nine months ended September 30, 2006 is presented in the table below.

| | Common Shares | Weighted- Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|-----------------------------------|------------------|---|---|---------------------------------|
| Outstanding at December 31, 2005 | 2,794,415 | \$ 3.41 | | |
| Granted | 516,420 | 2.99 | | |
| Exercised | (284,681) | 1.72 | | |
| Expired | (69,725) | 4.81 | | |
| Forfeited | (148,750) | 2.37 | | |
| Outstanding at September 30, 2006 | 2,807,679 | \$ 3.52 | 4.4 years | \$ 2,230,148 |
| Exercisable at September 30, 2006 | 1,878,429 | \$ 3.86 | 3.2 years | \$ 1,638,743 |

The aggregate intrinsic value in the table above represents the total difference between the Company's closing stock price on September 29, 2006 (the last trading day of the quarter) of \$3.47 and the option exercise price, multiplied by the number of in-the-money options as of September 30, 2006. As of September 30, 2006, total unrecognized compensation expense related to non-vested stock options was \$1,256,542, net of estimated forfeitures, with a weighted average expense recognition period of 2.9 years.

Other information relative to option activity during the three and nine month periods ended September 30, 2006 and 2005 is as follows:

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Weighted average grant date fair value of stock options granted | \$ 1.90 | \$ 2.24 | \$ 1.97 | \$ 2.01 |
| Total fair value of stock options vested | \$ 36,005 | \$ 6,175 | \$ 569,151 | \$ 335,107 |
| Total intrinsic value of stock options exercised | \$ | \$ 166,276 | \$ 661,127 | \$ 408,574 |
| Cash proceeds from exercise of stock options | \$ | \$ 167,834 | \$ 489,152 | \$ 646,349 |

Employee Stock Purchase Plan

Our Employee Stock Purchase Plan (Purchase Plan) incorporates the provisions of Section 423 of the Internal Revenue Code. Under the Purchase Plan, 1,000,000 shares of common stock have been reserved for purchase by employees. The Purchase Plan provides for annual offer periods of twelve months to eligible employees. Under the Purchase Plan, eligible employees can purchase through payroll deductions, the lower of up to 15% of their eligible base compensation or 2,500 shares of common stock, at a price equivalent to 85% of the lower of the beginning or end of year common stock price. As of September 30, 2006, there were 623,774 shares available for issuance under the

Purchase Plan. In accordance with the provisions of Statement 123(R), the Company recognized \$11,508 and \$52,808 of stock-based compensation expense for the Purchase Plan during the three and nine months ended September 30, 2006, respectively.

4. BUSINESS COMBINATION

On March 28, 2005, the Company acquired all of the stock of Data Management & Research, Inc. (DMR) for approximately \$10.7 million, consisting of \$9.1 million in cash and 479,234 shares of our common stock, of which 319,489 shares were released from escrow on September 28, 2006. The Company also incurred direct, incremental expenses associated with the acquisition of approximately \$0.4 million. Goodwill recorded in connection with the acquisition will generate deductible amortization for federal income tax purposes. DMR provides healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools focused on physicians, patients, and employees. The results of operations for DMR have been included in the Company's statement of operations effective March 29, 2005. The purchase price allocation on the statement of cash flows for the nine months ended September 30, 2005 was preliminary and was finalized during the fourth quarter of 2005. The final purchase price allocation is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission, and reflects total cash paid for the acquisition of DMR of \$9,524,076.

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. BUSINESS COMBINATION (continued)**

The following unaudited results of operations give effect to the operations of DMR as if the acquisition had occurred as of January 1, 2005. These unaudited results of operations include certain adjustments arising from the acquisition such as owner compensation and amortization expense. The pro forma results of operations do not purport to represent what the Company's results of operations would have been had such transactions in fact occurred at the beginning of the period presented or to project the Company's results of operations in any future period.

| | Nine months ended September 30, 2005 |
|-----------------------|--|
| Revenue | \$ 20,729,665 |
| Net income | \$ 1,194,482 |
| Net income per share: | |
| Basic | \$ 0.06 |
| Diluted | \$ 0.05 |

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 2.1 million and 1.9 million for the three and nine months ended September 30, 2006, respectively, and approximately 1.1 million and 1.3 million for the three and nine months ended September 30, 2005, respectively.

The following table sets forth the computation of basic and diluted net income per share for the three and nine months ended September 30, 2006 and 2005:

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Numerator: | | | | |
| Net income | \$ 474,339 | \$ 553,758 | \$ 1,421,485 | \$ 721,121 |
| Denominator: | | | | |
| Weighted average shares outstanding: | | | | |
| Basic | 21,618,616 | 21,212,310 | 21,459,321 | 20,984,144 |
| Employee stock options and other | 744,884 | 1,144,251 | 864,582 | 978,450 |
| Diluted | 22,363,500 | 22,356,561 | 22,323,903 | 21,962,594 |

| | | | | | | | |
|-----------------------|----|------|----|------|----|------|---------|
| Net income per share: | | | | | | | |
| Basic | \$ | 0.02 | \$ | 0.03 | \$ | 0.07 | \$ 0.03 |
| Diluted | \$ | 0.02 | \$ | 0.02 | \$ | 0.06 | \$ 0.03 |

6. BUSINESS SEGMENTS

We have two reportable segments, services provided to healthcare organizations and professionals (HCO) and services provided to pharmaceutical and medical device companies (PMD). On March 28, 2005, we acquired DMR, a company focused on offering healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools. Accordingly, DMR has been included in our HCO business segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in our Annual Report on Form 10-K for the year ended December 31, 2005. We manage and operate our business segments based on the markets they serve and the products and services provided to those markets.

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. BUSINESS SEGMENTS (continued)**

The following is our business segment information as of and for the three and nine months ended September 30, 2006 and 2005. We measure segment performance based on operating income (loss) before income taxes and prior to the allocation of corporate overhead expenses, interest income, interest expense, and depreciation. The unallocated component below includes corporate functions, such as accounting, human resources, legal, marketing, administrative, and executive personnel, as well as depreciation, a portion of amortization, and certain other expenses, which are not currently allocated in measuring segment performance.

| | Three months ended | |
|-------------------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 |
| Revenues | | |
| HCO | \$ 6,446,955 | \$ 5,553,391 |
| PMD | 1,033,577 | 1,277,249 |
| Total net revenue | \$ 7,480,532 | \$ 6,830,640 |
| Income (loss) from operations | | |
| HCO | \$ 2,594,030 | \$ 2,286,189 |
| PMD | (209,075) | 7,222 |
| Unallocated | (2,090,530) | (1,811,609) |
| Total income from operations | \$ 294,425 | \$ 481,802 |
| | | |
| | Nine months ended | |
| | September 30, 2006 | September 30, 2005 |
| Revenues | | |
| HCO | \$ 18,563,982 | \$ 14,793,345 |
| PMD | 4,662,890 | 4,526,117 |
| Total net revenue | \$ 23,226,872 | \$ 19,319,462 |
| Income (loss) from operations | | |
| HCO | \$ 7,077,802 | \$ 5,636,286 |
| PMD | (288,653) | 325,930 |
| Unallocated | (5,817,778) | (5,464,107) |
| Total income from operations | \$ 971,371 | \$ 498,109 |

7. GOODWILL

We account for goodwill under the provisions of SFAS No. 142, Goodwill and Other Intangible Assets. We test goodwill for impairment using a discounted cash flow model. The technique used to determine the fair value of our reporting units is sensitive to estimates and assumptions associated with cash flow from operations and its growth, discount rates, and reporting unit terminal values. If these estimates or their related assumptions change in the future, we may be required to record impairment charges, which could adversely impact our operating results for the period

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in which such a determination is made. We perform our annual impairment evaluation of goodwill during the fourth quarter of each year and as changes in facts and circumstances indicate impairment exists.

On March 28, 2005, we acquired DMR. The amount of goodwill related to the acquisition of DMR at September 30, 2005 represented a preliminary estimate, and was subsequently adjusted based on the final purchase price allocation, which was completed during the fourth quarter of 2005. There were no changes in the carrying amount of goodwill during the nine months ended September 30, 2006.

| | HCO | PMD | Total |
|---------------------------------------|--------------|--------------|---------------|
| Balance at January 1, 2006 | \$ 8,993,666 | \$ 1,323,727 | \$ 10,317,393 |
| Changes in carrying value of goodwill | | | |
| Balance at September 30, 2006 | \$ 8,993,666 | \$ 1,323,727 | \$ 10,317,393 |
| | | | |
| | HCO | PMD | Total |
| Balance at January 1, 2005 | \$ 1,982,961 | \$ 1,323,727 | \$ 3,306,688 |
| Changes in carrying value of goodwill | 6,999,869 | | 6,999,869 |
| Balance at September 30, 2005 | \$ 8,982,830 | \$ 1,323,727 | \$ 10,306,557 |

Table of Contents**HEALTHSTREAM, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. INTANGIBLE ASSETS**

All identifiable intangible assets have been evaluated in accordance with SFAS No. 142 and are considered to have finite useful lives. Intangible assets with finite lives are being amortized over their estimated useful lives, ranging from one to eight years. Amortization of intangible assets was \$127,083 and \$381,249 for the three and nine months ended September 30, 2006, respectively, and \$127,083 and \$439,024 for the three and nine months ended September 30, 2005, respectively.

Identifiable intangible assets are comprised of the following:

| | As of September 30, 2006 | | | As of December 31, 2005 | | |
|------------------|--------------------------|-----------------------------|---------------------|-------------------------|-----------------------------|---------------------|
| | Gross Amount | Accumulated Amortization | Net | Gross Amount | Accumulated Amortization | Net |
| Customer related | \$ 6,340,000 | \$ (3,580,993) | \$ 2,759,007 | \$ 6,340,000 | \$ (3,262,243) | \$ 3,077,757 |
| Content | 3,500,000 | (3,500,000) | | 3,500,000 | (3,500,000) | |
| Other | 672,142 | (548,085) | 124,057 | 672,142 | (485,585) | 186,557 |
| Total | \$ 10,512,142 | \$ (7,629,078) | \$ 2,883,064 | \$ 10,512,142 | \$ (7,247,828) | \$ 3,264,314 |

Estimated amortization expense for the periods and years ending December 31, is as follows:

| | |
|---|---------------------|
| October 1, 2006 through December 31, 2006 | \$ 127,083 |
| 2007 | 508,333 |
| 2008 | 444,891 |
| 2009 | 425,000 |
| 2010 and thereafter | 1,377,757 |
| Total | \$ 2,883,064 |

9. CONTENT RIGHTS AND DEFERRED SERVICE CREDITS

During the second quarter of 2006, we completed updates and maintenance required to publish certain courseware owned by one of our customers and were provided the right to distribute and resell such courseware to our Internet-based customers. In exchange for receipt of an exclusive license to distribute and resell this courseware, we provided the customer with service credits that can be used to make future purchases of our products and services. We accounted for this transaction in accordance with Accounting Principles Board Opinion No. 29 Accounting for Nonmonetary Transactions. The value assigned to the content rights and the deferred service credits was \$904,167, which represents the estimated fair value of the assets relinquished. The content rights are classified within prepaid development fees and other assets, and the service credits are classified within accrued liabilities and other long-term liabilities on our condensed consolidated balance sheet as of September 30, 2006.

The service credits will be issued annually through December 31, 2008, and expire twenty-four months after issuance. Any unused credits will be forfeited. As of September 30, 2006, we were obligated to issue remaining credits of \$799,167 through December 31, 2008. Additional service credits may be provided in the future if the customer provides additional courseware rights to us. The content rights are being amortized on a straight-line basis through December 31, 2008. Revenues for services provided in exchange for service credits will be recognized in accordance with our revenue recognition policies.

10. INCOME TAXES

Taxable income for the year is expected to be reduced by available net operating loss carryforwards to the extent allowed by current tax regulations. We expect to achieve taxable income for the full year of 2006, and have recorded a

tax provision of \$2,064 associated with the alternative minimum tax based on taxable income for the nine months ended September 30, 2006. The \$14,436 tax benefit recorded during the three months ended September 30, 2006 resulted from a tax credit for federal income tax overpayments.

11. SUBSEQUENT EVENT

HCA Information Technology & Services, Inc., a subsidiary of HCA, Inc., entered into a new four-year agreement with us for our enterprise-wide learning services, which became effective October 1, 2006. The agreement includes an optional one-year renewal following the expiration of the initial four-year term.

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

This Quarterly Report includes various forward-looking statements that are subject to risks and uncertainties. Forward-looking statements include without limitation, statements preceded by, followed by, or that otherwise include the words believes, expects, anticipates, intends, estimates or similar expressions. For those statements, HealthStream Inc. claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

The following important factors, in addition to those discussed elsewhere in this Quarterly Report and in our Annual Report on Form 10-K, could affect our future financial results and could cause actual results to differ materially from those expressed in forward-looking statements contained in this document:

- our ability to effectively implement our growth strategy, as well as manage growth of our operations and infrastructure, including effective identification and integration of acquisitions;

- variability and length of our sales cycle;

- our ability to accurately forecast results of operations due to certain revenue components being subject to significant fluctuations and an increase in the percentage of our business subject to renewal;

- our ability to adequately address our customers' needs in products and services;

- the pressure on healthcare organizations and pharmaceutical/medical device companies to reduce costs to customers could result in financial pressures on customers to cut back on our services;

- our ability to maintain and continue our competitive position against current and potential competitors;

- our ability to develop enhancements to our existing products and services, achieve widespread acceptance of new features, or keep pace with technological developments;

- our ability to obtain proper distribution rights from content partners to support growth in courseware subscriptions;

- our ability to achieve profitability on a consistent basis;

- fluctuations in quarterly operating results caused by a variety of factors including the timing of sales, subscription revenue recognition and customer subscription renewals;

- loss of a significant customer and concentration of a significant portion of our revenue with a relatively small number of customers;

- our ability to adequately develop and maintain our network infrastructure, computer systems, software and related security;

- the effect of governmental regulation on us, our business partners and our customers, including, without limitation, changes in federal, state and international laws or other regulations regarding education, training and Internet transactions; and

- other risk factors detailed in our Annual Report on Form 10-K and other filings with the Securities and Exchange Commission.

Overview

HealthStream was incorporated in 1990 and began marketing its Internet-based solutions in March 1999. The Company focuses on being a facilitator of training and information tools for entities in the healthcare industry. Revenues from the healthcare organizations business unit (HCO) are derived from the following categories: provision of services through our Internet-based HealthStream Learning Center, courseware subscriptions, survey and research services, a variety of complementary online products, and maintenance and support of installed learning management products. Revenues from the pharmaceutical and medical device company business unit (PMD) are derived from live event development, online training and content development, and other educational and training services.

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Key financial indicators for the third quarter of 2006 include:

Revenues of approximately \$7.5 million in the third quarter of 2006, up 9.5%, or \$650,000, over the third quarter of 2005

Net income of approximately \$474,000 in the third quarter of 2006 (includes \$166,000 of stock-based compensation expense), compared to \$554,000 in the third quarter of 2005

Earnings per share of \$0.02 (basic and diluted) in the third quarter of 2006, compared to \$0.03 (basic) and \$0.02 (diluted) in the third quarter of 2005

1,334,000 fully implemented subscribers on our Internet-based HLC at September 30, 2006, up from 1,130,000 at September 30, 2005

New four-year agreement with HCA signed on September 29, 2006, which became effective October 1, 2006

Continuing our business relationship with HCA for our enterprise-wide learning services is a significant achievement for us. For the nine months ended September 30, 2006, revenues from learning and survey products provided to HCA represented approximately 12 percent of our revenues, compared to approximately 14 percent of revenues for the year ended December 31, 2005. Due to pricing changes under the new agreement, we expect our fourth quarter renewal rate based on annual contract value to decline and to range between 70 and 80 percent. We do not anticipate any changes in number of subscribers for HCA.

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.

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

Product development costs and related capitalization

Goodwill, intangibles, and other long-lived assets

Allowance for doubtful accounts

Stock-based compensation

Nonmonetary exchanges

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 Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission, which contains additional information regarding our accounting policies and other disclosures required by US GAAP. On January 1, 2006, we adopted SFAS No. 123(R), Share-Based Payments using a modified-prospective approach. Also, as a result of our issuance of service credits in exchange for content rights, we recorded an asset and deferred liability resulting from this nonmonetary transaction. Other than the adoption of Statement 123(R) and our accounting for nonmonetary exchanges, there have been no changes in our critical accounting policies and estimates from those reported in our Annual Report on Form 10-K for the year ended December 31, 2005.

Stock-based Compensation

As described further in the Notes to Condensed Consolidated Financial Statements, we began recognizing compensation expense, using a fair-value based method, for costs related to share-based payments, including stock options on January 1, 2006. Measurement of such compensation expense requires significant estimation and assumptions, however we believe that the Black Scholes option pricing model we use for calculating the fair value of our stock-based compensation plans provides measurement in a framework that is widely adopted.

During the three and nine months ended September 30, 2006, we recorded \$166,081 and \$543,714, respectively, of stock-based compensation expense resulting from the adoption of Statement 123(R). We typically grant stock options to our management group on an annual basis, or when new members of the management group begin their employment. We grant stock options to members of our board of directors in conjunction with our annual shareholders meeting, or as new members are added on a pro rata basis based on the time elapsed since our annual shareholders meeting. We expect to continue this practice for the foreseeable future, however we may adjust the size of the annual grant. As of September 30, 2006, total future compensation cost related to non-vested awards not yet recognized was \$1,256,542, net of estimated forfeitures, with a weighted average expense recognition period of 2.9 years. We estimate that stock-based

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compensation expense will range between \$600,000 and \$700,000 for 2006. Actual results could differ from this estimate depending on the timing and size of new awards granted, changes in the market price or volatility of our common stock, changes in risk-free interest rates, or if actual forfeitures vary significantly from our estimates.

Nonmonetary Exchange of Content Rights and Deferred Service Credits

As described further in the Notes to Condensed Consolidated Financial Statements, we recorded content rights and deferred service credits in connection with a nonmonetary exchange with one of our customers. In order to account for this transaction, we had to estimate the fair value of the related assets and service credits, assess whether the value assigned to the content was recoverable, and amortize the related assets over their estimated useful lives. Our future operating results will be impacted by the amortization of the content rights, and by the customer's utilization of the service credits. We will also need to review these assets periodically to determine whether they are recoverable during the remaining useful life. Revenues for services provided in exchange for service credits will be recognized in accordance with our revenue recognition policies.

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 HCO business unit currently consist of the provision of services through our Internet-based HealthStream Learning Center (HLC), authoring tools, survey and research services, a variety of courseware subscriptions (add-on courseware), maintenance and support services for our installed learning management products, maintenance of content and competency tools. Revenues for our PMD business unit consist of live event development, online training and content development, online sales training courses, live educational activities for nurses and technicians conducted within healthcare organizations, continuing education activities at association meetings, and HospitalDirect®.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues consists primarily of salaries and employee benefits, stock-based compensation, employee travel and lodging, materials, 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, handle customer support calls or inquiries, manage our web sites, 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, 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 software feature enhancements and new products. Personnel costs within product development include our systems team, product managers, and other personnel associated with content and 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. Annually, we host a national users' group in Nashville, TN known as The Summit, the costs of which are included in sales and marketing expenses. Personnel costs within sales and marketing include our sales and marketing team, strategic account management personnel, as well as our account management group. Our account management personnel work to ensure our products and services are fully utilized by our customers, providing consultations with new and prospective customers, as well as supporting the contract renewal process for existing hospital customers.

Depreciation and Amortization. Depreciation and amortization consist of fixed asset depreciation, amortization of intangibles considered to have finite lives, amortization of content or license fees, and amortization of capitalized software feature enhancements.

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

and executive management) as well as accreditation professionals.

Other Income/Expense. 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 capital leases and other obligations.

Table of Contents**Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005**

Revenues. Revenues increased approximately \$650,000, or 9.5%, to \$7.5 million for the three months ended September 30, 2006 from \$6.8 million for the three months ended September 30, 2005. Revenues for 2006 consisted of approximately \$6.5 million for HCO and \$1.0 million for PMD. In 2005, revenues consisted of \$5.5 million for HCO and \$1.3 million for PMD. The increase in HCO revenues included \$636,000 of growth from our Internet-based HLC subscriber base and \$341,000 of growth in survey and research revenues from the acquisition of Data Management & Research, Inc. (DMR) in March 2005. Our subscriber base increased by 18%, to approximately 1,334,000 fully implemented subscribers at September 30, 2006 from approximately 1,130,000 fully implemented subscribers at September 30, 2005. Revenues from our Internet-based subscription products represented approximately 64% of total revenues for the three months ended September 30, 2006 compared to 60% of total revenues for the three months ended September 30, 2005. PMD revenues decreased approximately \$244,000 compared to the prior year quarter, primarily associated with our live event business, while revenues from other project-based services and online training content increased moderately compared to the prior year quarter. The decrease in live event revenues is due to fewer large scale events when compared to the prior year quarter.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased slightly and approximated \$2.4 million for both the three months ended September 30, 2006 and September 30, 2005. Cost of revenues as a percentage of revenues decreased to 31.8% of revenues for the three months ended September 30, 2006 from 35.0% of revenues for the three months ended September 30, 2005. This improvement resulted from a change in revenue mix, to a higher percentage of our revenues being derived from our HCO business, which has a lower cost of revenues as a percentage of revenues compared to our PMD business.

Cost of revenues for HCO decreased approximately \$82,000 and approximated 21.4% and 26.3% of revenues for the three months ended September 30, 2006 and 2005, respectively. The decline in cost of revenues for HCO resulted from lower personnel expenses and lower royalties paid by us due to changes in the mix of courseware subscription revenues. The reduction in HCO cost of revenues as a percentage of revenues is the result of increased revenues from our higher margin Internet-based HLC and our survey and research products. Cost of revenues for PMD increased approximately \$52,000 over the prior year quarter and approximated 80.3% and 60.9% of revenues for the three months ended September 30, 2006 and 2005, respectively. The increase in cost of revenues for PMD resulted from increased product support costs and increased royalties paid by us, which were partially offset by a decrease in personnel expenses and related travel. The increase in PMD cost of revenues as a percentage of revenues is primarily associated with the reduction in live event revenues and lower margins on certain online development projects.

Gross Margin (excluding depreciation and amortization). Gross margin (which we define as revenues less cost of revenues divided by revenues) improved to 68.2% for the three months ended September 30, 2006 from 65.0% for the three months ended September 30, 2005. This improvement is a result of the changes in revenue mix and increases in HCO revenues, but was somewhat reduced by the unfavorable margins from the PMD business. Gross margins for HCO were 78.6% and 73.7% for the three months ended September 30, 2006 and 2005, respectively. The improvement for HCO resulted from the increase in revenues associated with higher margin products as discussed above. Gross margins for PMD were 19.7% and 39.1% for the three months ended September 30, 2006 and 2005, respectively. The decrease for PMD resulted from the decrease in live event revenues and increase in cost of revenues on certain online development projects as discussed above.

Product development. Product development expenses increased approximately \$171,000, or 23.8%, to \$891,000 for the three months ended September 30, 2006 from \$720,000 for the three months ended September 30, 2005. This increase primarily resulted from additional personnel to support new product development and the ongoing maintenance and operation of our Internet-based platform. New product development efforts primarily consist of additional features and new courseware integration associated with our Internet-based platform. We are currently redesigning our Internet-based HLC platform, and expect to release our next generation version in the fourth quarter of 2006. Stock-based compensation expense included in product development was approximately \$33,000 during the three months ended September 30, 2006 compared to none for the three months ended September 30, 2005. Product development expenses as a percentage of revenues increased to 11.9% of revenues for the three months ended September 30, 2006 from 10.5% for the three months ended September 30, 2005.

Product development expenses for HCO increased approximately \$193,000 compared to the prior year quarter and approximated 11.8% and 10.2% of HCO revenues for the three months ended September 30, 2006 and 2005, respectively. The increase for HCO is associated with additional personnel to support new platform feature development integration associated with the next generation version of our platform and the ongoing maintenance and operation of our current platform. Product development expenses for PMD decreased slightly compared to the prior year quarter, and approximated 9.3% and 6.8% of PMD revenues for the three months ended September 30, 2006 and 2005, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately \$308,000, or 23.0%, to \$1.6 million for the three months ended September 30, 2006 from \$1.3 million for the three months ended September 30, 2005. This increase occurred primarily within our HCO business unit and resulted from increases in sales and account management personnel and related travel, as well as increased marketing expenses. We have increased our account management team over the past year to address the needs

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of our larger customers. Stock-based compensation expense included in sales and marketing was approximately \$30,000 during the three months ended September 30, 2006 compared to none for the three months ended September 30, 2005. Sales and marketing expenses approximated 22.0% and 19.6% of revenues for the three months ended September 30, 2006 and 2005, respectively.

Sales and marketing expenses for HCO increased \$393,000 and approximated 20.4% and 16.6% of revenues for the three months ended September 30, 2006 and 2005, respectively. The increase for HCO is due to additional sales and account management personnel and increased marketing expenses discussed above. Sales and marketing expenses for PMD decreased approximately \$89,000, and approximated 27.5% and 29.2% of revenues for the three months ended September 30, 2006 and 2005, respectively. The decrease is due to lower commissions and the elimination of a sales management position and related expenses.

Depreciation and Amortization. Depreciation and amortization increased approximately \$107,000, or 16.4%, to \$759,000 for the three months ended September 30, 2006 from \$652,000 for the three months ended September 30, 2005. The increase resulted from amortization of content fees.

Other General and Administrative. Other general and administrative expenses increased approximately \$265,000, or 21.3%, to \$1.5 million for the three months ended September 30, 2006 from \$1.2 million for the three months ended September 30, 2005. This increase primarily resulted from stock-based compensation expense, increased personnel expenses and employee recruiting costs, and other corporate support expenses. Other general and administrative expenses as a percentage of revenues increased to 20.2% for the three months ended September 30, 2006 from 18.2% for the three months ended September 30, 2005, due to these expense increases.

Other Income/Expense. Other income/expense increased approximately \$94,000, or 130.0%, to income of \$165,000 for the three months ended September 30, 2006 from income of \$72,000 for the three months ended September 30, 2005. The increase resulted from an increase in interest income from investments in marketable securities, attributable to both increased invested balances and higher rates of return.

(Benefit) Provision for Income Taxes. The income tax benefit of \$14,000 during the three months ended September 30, 2006 is comprised of a refund due to us, which resulted from the difference in our prior year income tax provision and actual taxes paid.

Net Income. Net income was approximately \$474,000 for the three months ended September 30, 2006 compared to \$554,000 for the three months ended September 30, 2005. This decline is a result of the factors mentioned above, noting that \$166,000 of stock-based compensation was expensed during the three months ended September 30, 2006 with no comparable expense in the same period during 2005.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Revenues. Revenues increased approximately \$3.9 million, or 20.2%, to \$23.2 million for the nine months ended September 30, 2006 from \$19.3 million for the nine months ended September 30, 2005. Revenues for 2006 consisted of \$18.6 million for HCO and \$4.6 million for PMD. In 2005, revenues consisted of \$14.8 million for HCO and \$4.5 million for PMD. The increase in HCO revenues resulted from growth in survey and research services associated with the DMR acquisition in March 2005 totaling \$2.2 million, of which approximately \$793,000 is the result of organic growth. Revenues from our Internet-based HLC subscriber base increased \$1.7 million over the prior year resulting from the overall increase in our subscriber base. Revenues from our content maintenance services increased approximately \$122,000. These HCO revenue increases were partially offset by declines in revenues from maintenance and support fees associated with our installed learning management product of \$181,000. PMD revenue increases over the prior year were primarily associated with growth from our clinical education programs and sales of online training content. These increases were partially offset by a decline in project based content development services. On a pro forma basis, taking into consideration the effect of the DMR acquisition as if the acquisition occurred on January 1, 2005, pro forma revenues for the nine months ended September 30, 2005 would have been \$20.7 million.

Cost of Revenues. Cost of revenues increased approximately \$1.2 million, or 17.8%, to \$8.1 million for the nine months ended September 30, 2006 from \$6.9 million for the nine months ended September 30, 2005. Cost of revenues as a percentage of revenues decreased to 34.9% of revenues for the nine months ended September 30, 2006 from 35.6% of revenues for the nine months ended September 30, 2005. The increase in cost of revenues resulted from

higher direct costs associated with the PMD business, as well as incremental expenses associated with the increase in survey and research revenues.

Cost of revenues for HCO increased approximately \$73,000 and approximated 21.1% and 26.0% of revenues for the nine months ended September 30, 2006 and 2005, respectively. Cost of revenue increases for HCO resulted from the additional expenses associated with the increase in survey and research revenues, and was partially offset by lower personnel expenses due to fewer personnel needed to support our competency tools and content maintenance. Cost of revenues for PMD increased by \$1.1 million over the prior year and approximated 78.9% and 57.2% of revenues for the nine months ended September 30, 2006 and 2005, respectively. The increase for PMD is primarily associated with a significant live event held during the second quarter of 2006, which resulted in a financial loss of approximately \$200,000, as well as an increase in royalties paid by us associated with an increase in online training content revenues.

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Gross Margin. Gross margin (which we define as revenues less cost of revenues divided by revenues) was 65.1% and 64.4% for the nine months ended September 30, 2006 and 2005, respectively. Gross margins for HCO were 78.9% and 74.0% for the nine months ended September 30, 2006 and 2005, respectively. Gross margins for PMD were 21.1% and 42.8% for the nine months ended September 30, 2006 and 2005, respectively. The significant decline for PMD resulted from the increase in cost of revenues discussed above.

Product development. Product development expenses increased approximately \$518,000, or 24.7%, to \$2.6 million for the nine months ended September 30, 2006 from \$2.1 million for the nine months ended September 30, 2005. This increase is related to additional personnel expenses and stock-based compensation expense. Product development expenses as a percentage of revenues were 11.3% and 10.9% of revenues for the nine months ended September 30, 2006 and 2005, respectively.

Product development expenses for HCO increased approximately \$617,000 compared to the prior year and approximated 12.1% and 11.0% of revenues for the nine months ended September 30, 2006 and 2005, respectively. The increase for HCO resulted from additional personnel to support new product development and software feature development and integration associated with the next generation version of our platform, product management, and the ongoing maintenance and operation of our current platform. Product development expenses for PMD decreased modestly and approximated 5.6% and 6.3% of revenues for the nine months ended September 30, 2006 and 2005, respectively. The unallocated corporate portion of product development decreased as more resources were allocated to the HCO business.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately \$1.2 million, or 28.5%, to \$5.3 million for the nine months ended September 30, 2006 from \$4.1 million for the nine months ended September 30, 2005. Sales and marketing expenses approximated 22.9% and 21.4% of revenues for the nine months ended September 30, 2006 and 2005, respectively. Sales and marketing expenses for HCO increased approximately \$1.3 million and approximated 22.8% and 19.8% of HCO revenues for the nine months ended September 30, 2006 and 2005, respectively. HCO increases resulted from additional personnel expenses and travel associated with our account management group, increased spending associated with The Summit, incremental expenses associated with DMR personnel, and increases in marketing expenses. Sales and marketing expenses for PMD decreased \$122,000 and approximated 19.6% and 22.9% of revenues for the nine months ended September 30, 2006 and 2005, respectively. This decrease is associated with the elimination of a sales management position and lower commissions, but was partially offset by the addition of account management personnel to support our PMD customer base.

Depreciation and Amortization. Depreciation and amortization increased approximately \$40,000, or 2.0%, to \$2.1 million for the nine months ended September 30, 2006 from \$2.0 million for the nine months ended September 30, 2005. Amortization increases were associated with content fees and capitalized software feature enhancements. Amortization of capitalized software enhancements will continue to increase when our next generation platform is launched later in 2006. Depreciation declines resulted from certain property and equipment reaching the end of their estimated useful lives and fewer capital expenditures needed to replace equipment, which somewhat offset the increase in amortization.

Other General and Administrative. Other general and administrative expenses increased approximately \$470,000, or 12.8%, to \$4.1 million for the nine months ended September 30, 2006 from \$3.7 million for the nine months ended September 30, 2005. This increase is primarily associated with stock-based compensation expense, employee recruiting costs, and other corporate support expenses. Other general and administrative expenses as a percentage of revenues decreased to 17.8% for the nine months ended September 30, 2006 from 19.0% for the nine months ended September 30, 2005. The percentage decrease is a result of the increases in revenues.

Other Income/Expense. Other income/expense increased approximately \$214,000, or 90.0%, to \$452,000 for the nine months ended September 30, 2006 from \$238,000 for the nine months ended September 30, 2005. The increase resulted from an increase in interest income on investments in marketable securities, attributable to both increased invested balances and higher rates of return.

Net Income. Net income increased \$700,000 to \$1.4 million for the nine months ended September 30, 2006 from \$721,000 for the nine months ended September 30, 2005. This improvement is a result of the factors mentioned above, noting that \$544,000 of stock-based compensation was expensed during the nine months ended September 30,

2006 with no comparable expense in the same period during 2005. On a pro forma basis, as if the DMR acquisition occurred on January 1, 2005, pro forma net income would have been \$1.2 million for the nine months ended September 30, 2005.

Liquidity and Capital Resources

Since our inception, we have financed our operations largely through proceeds from our initial public offering, private placements of equity securities, loans from related parties and, to an increasing extent, from revenues generated from the sale of our products and services.

Net cash provided by operating activities was approximately \$3.1 million during the nine months ended September 30, 2006 compared to \$2.9 million during the nine months ended September 30, 2005. The significant uses of cash during 2006 include personnel expenses and direct expenses to support our business and delivery of our products and services, payment of royalties by us to content partners, payments associated with commercial support grants, payment of year-end 2005 bonuses to employees, purchases of content, and payments

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associated with other routine operating expenses. These uses of cash were offset by cash receipts from customers and interest income. Days sales outstanding, or the number of days it takes to collect accounts receivable, improved to approximately 52 days for the nine months ended September 30, 2006 from approximately 60 days for the nine months ended September 30, 2005. The improvement in days sales outstanding is the result of improved collection cycles from our HCO customers. The Company calculates days sales outstanding by dividing the accounts receivable balance (excluding unbilled and other receivables) by average daily revenues for the period. During the nine months ended September 30, 2005, cash generated from operating activities resulted from cash receipts from customers and receipts of commercial support grants which exceeded cash used to fund our operating expenses and content purchases.

Net cash used in investing activities was approximately \$2.3 million during the nine months ended September 30, 2006 compared to \$165,000 during the nine months ended September 30, 2005. During 2006, our primary use of cash was for purchases of capitalized software feature enhancements and property and equipment. During 2005, our primary use of cash was for the acquisition of DMR and purchases of capitalized software feature enhancements and property and equipment, and was partially offset by the proceeds from sales of investments in marketable securities. Cash provided by financing activities was approximately \$512,000 for the nine months ended September 30, 2006 compared to \$747,000 during the nine months ended September 30, 2005. The decrease from the prior year period primarily related to lower receipts from stock option exercises and increased capital lease payments. Cash receipts from both years resulted from both stock option exercises and purchases under our Employee Stock Purchase Plan. As of September 30, 2006, our primary source of liquidity was \$13.3 million of cash and cash equivalents, restricted cash, investments in marketable securities, and interest receivable. The Company has a \$7.0 million revolving credit facility loan agreement. As of September 30, 2006, we had not borrowed against the line of credit and had no indebtedness other than capital lease obligations.

We believe that our existing cash and cash equivalents, restricted cash, investments in marketable securities and related interest receivable, 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 are actively reviewing possible acquisitions that complement our products and services. We anticipate that any acquisitions would be effected through a combination of stock and cash consideration. We may need to raise additional capital through the issuance of equity securities and/or borrowings under our revolving credit facility to finance any acquisitions. The issuance of stock as consideration for an acquisition would have a dilutive effect and could adversely affect our stock price. There can be no assurance that sources of financing will be available to us on acceptable terms to consummate any acquisitions. Failure to generate sufficient cash flow from operations or raise additional capital when required during or following any potential acquisitions in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

Commitments and Contingencies

We expect that capital expenditures and content purchases will range between \$0.6 and \$1.2 million for the remainder of 2006. We expect to fund these capital expenditures with existing cash and investments, from cash generated from operations, and if needed, from our revolving credit facility. We may also enter into capital lease agreements for some of these asset purchases.

Our strategic alliances have typically provided for payments to content and distribution partners and development partners based on revenues, and we expect to continue similar arrangements in the future. We have capital lease obligations and operating lease commitments for our operating facilities in Nashville, TN, Franklin, TN, and Denver, CO, and a closed facility in Dallas, TX.

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 commodity price risk. As of September 30, 2006, we had no outstanding indebtedness other than approximately \$331,000 of capital lease obligations, which include fixed interest rates. In the future, we may be exposed to interest rate risk associated with borrowing under our revolving credit facility, which bears interest at a variable rate based on the 30 Day LIBOR Rate plus 150 basis points. We are also exposed to market risk with respect to the cash and cash equivalents and marketable

securities in which we invest. At September 30, 2006, we had approximately \$13.3 million of cash and cash equivalents, restricted cash, investments in marketable securities, and accrued interest that was invested in a combination of short term investments. Current investment rates of return approximate 5.0-5.25%. Assuming a 5.0% rate of return on \$13.3 million, a hypothetical 10% decrease in interest rates would decrease interest income and decrease net income on an annualized basis by approximately \$66,500.

We manage our investment risk by investing in corporate debt securities, foreign corporate debt and secured corporate debt securities with minimum acceptable credit ratings. For certificates of deposit and corporate obligations, ratings must be A2/A or better; A1/P1 or better for commercial paper; A2/A or better for taxable or tax advantaged auction rate securities and AAA or better for tax free auction rate securities. We also require that all securities must mature within 24 months from the original settlement date, the average portfolio shall not

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exceed 18 months, and the greater of 10% or \$5.0 million shall mature within 90 days. Further, our investment policy also limits concentration exposure and other potential risk areas.

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.

Item 4. 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 as of the end of the period covered by this quarterly report 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 principal 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 1A. Risk Factors**

Any failure to successfully release and deploy the new version of our Internet-based HLC platform could harm our business.

A new version of our Internet-based HLC platform will be released during the fourth quarter of 2006. It is common within the software industry for new releases of software or feature enhancements to contain defects or errors that are discovered during the period immediately following the release. Although we rigorously test and apply quality assurance processes to our products prior to their release, we cannot assure that all defects or errors have been identified. If serious defects or errors are detected after the release of our next generation platform, we may experience incremental costs to correct such errors and experience delays in transitioning our customer base to the new platform version. This could also result in the potential loss of customers, lower revenues, and increased expenses, which could harm our business.

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.

By: /s/ Susan A. Brownie
Susan A. Brownie
Chief Financial Officer

November 13, 2006

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