WEBMD CORP /NEW/
Form 10-Q
November 09, 2004

**Table of Contents**

## SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended September 30, 2004**

**or**

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

**For the transition period from _____ to _____**

**Commission file number 0-24975**

# WEBMD CORPORATION

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

| | |
|---|---|
| **Delaware** | **94-3236644** |
| *(State or other jurisdiction of incorporation or organization)* | *(I.R.S. Employer Identification Number)* |

**669 River Drive, Center 2**

**Elmwood Park, New Jersey 07407-1361**
*(Address of principal executive offices)*

**(201) 703-3400**

*(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 (the Exchange Act ) 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 x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes x No o

As of November 4, 2004, there were 312,644,362 shares of the

registrant s Common Stock outstanding.

**WEBMD CORPORATION**

**QUARTERLY REPORT ON FORM 10-Q**

**For the period ended September 30, 2004**

**TABLE OF CONTENTS**



WebMD®, dakota imaging™, Digital Office Manager®, $DIM_{DX}$®, Envoy®, ExpressBill®, Intergy®, Medifax®, Medifax-EDI®, Medscape®, MEDPOR®, Medpulse®, POREX®, Publishers Circle®, The Little Blue Book™, The Little Yellow Book™, The Medical Manager®, ULTIA™, ViPS℠, WebMD Health Hub™ and WellMed® are trademarks of WebMD Corporation or its subsidiaries.

**Table of Contents**

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. These forward-looking statements are not based on historical facts, but rather reflect management s current expectations concerning future results and events. These forward-looking statements generally can be identified by use of expressions such as believe, expect, anticipate, intend, plan, foresee, likely, will or other similar words or phras statements that describe our objectives, plans or goals are, or may be deemed to be, forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be different from any future results, performance and achievements expressed or implied by these statements. In addition to the risk factors described in Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Our Future Financial Condition or Results of Operations beginning on page 36, the following important risks and uncertainties could affect future results, causing those results to differ materially from those expressed in our forward-looking statements:

- the failure to achieve sufficient levels of customer utilization and market acceptance of new or updated products and services,
- the inability to successfully deploy new or updated applications,
- difficulties in forming and maintaining relationships with customers and strategic partners,
- the inability to attract and retain qualified personnel, and
- general economic, business or regulatory conditions affecting the healthcare, information technology, Internet and plastic industries being less favorable than expected.

These factors and the risk factors described in Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Our Future Financial Condition or Results of Operations beginning on page 36 are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could have material adverse effects on our future results. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Table of Contents

# PART I

## FINANCIAL INFORMATION

**ITEM 1.** ***Financial Statements***

### WEBMD CORPORATION

### CONSOLIDATED BALANCE SHEETS
**(In thousands, except share and per share data)**

| | September 30, 2004 | December 31, 2003 |
|---|---|---|
| | (Unaudited) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 108,204 | $ 63,298 |
| Short-term investments | 25,784 | 207,383 |
| Accounts receivable, net | 203,288 | 181,173 |
| Inventory | 12,579 | 12,158 |
| Current portion of prepaid content and distribution services | 16,221 | 18,116 |
| Other current assets | 24,978 | 25,973 |
| Total current assets | 391,054 | 508,101 |
| Marketable debt securities | 515,096 | 451,290 |
| Marketable equity securities | 3,373 | 4,744 |
| Property and equipment, net | 83,071 | 77,278 |
| Prepaid content and distribution services | 19,020 | 31,992 |
| Goodwill | 959,799 | 844,448 |
| Intangible assets, net | 270,426 | 184,130 |
| Other assets | 35,800 | 33,323 |
| | $ 2,277,639 | $ 2,135,306 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 10,777 | $ 10,390 |
| Accrued expenses | 207,271 | 208,430 |
| Deferred revenue | 104,794 | 86,708 |
| Total current liabilities | 322,842 | 305,528 |
| 3 1/4% convertible subordinated notes due 2007 | 299,999 | 299,999 |
| 1.75% convertible subordinated notes due 2023 | 350,000 | 350,000 |
| Other long-term liabilities | 974 | 1,182 |
| Commitments and contingencies | | |
| Convertible redeemable exchangeable preferred stock, $0.0001 par value; 10,000 shares authorized, issued and outstanding at September 30, 2004 | 98,240 | |

| | | |
|---|---|---|
| Stockholders equity: | | |
| Preferred stock, $0.0001 par value; 4,990,000 shares authorized; no shares issued | | |
| Common stock, $0.0001 par value; 900,000,000 shares authorized; 391,879,504 shares issued at September 30, 2004; 384,751,705 shares issued at December 31, 2003 | 39 | 38 |
| Additional paid-in capital | 11,767,066 | 11,726,734 |
| Deferred stock compensation | (7,232) | (4,683) |
| Treasury stock, at cost; 79,394,471 shares at September 30, 2004; 76,576,865 shares at December 31, 2003 | (370,125) | (347,858) |
| Accumulated deficit | (10,192,534) | (10,212,054) |
| Accumulated other comprehensive income | 8,370 | 16,420 |
| Total stockholders equity | 1,205,584 | 1,178,597 |
| | $ 2,277,639 | $ 2,135,306 |

See accompanying notes.

Table of Contents

**WEBMD CORPORATION**

**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(In thousands, except per share data, unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Revenue | $299,615 | $250,635 | $852,710 | $705,584 |
| Costs and expenses: | | | | |
| Cost of operations | 168,571 | 149,270 | 495,174 | 410,556 |
| Development and engineering | 14,392 | 11,334 | 38,479 | 32,654 |
| Sales, marketing, general and administrative | 84,762 | 72,450 | 245,054 | 209,917 |
| Depreciation, amortization and other | 15,189 | 11,097 | 40,922 | 52,961 |
| Legal expense | 2,325 | 493 | 6,577 | 493 |
| Restructuring and integration charge | 4,535 | | 4,535 | |
| Interest income | 4,512 | 6,401 | 14,506 | 16,434 |
| Interest expense | 4,843 | 4,703 | 14,429 | 10,444 |
| Other income, net | 94 | 3,039 | 578 | 4,340 |
| Income from continuing operations before income tax provision | 9,604 | 10,728 | 22,624 | 9,333 |
| Income tax provision | 1,435 | 1,273 | 2,979 | 3,261 |
| Income from continuing operations | 8,169 | 9,455 | 19,645 | 6,072 |
| Loss from discontinued operations, net of income taxes | | 3,366 | | 33,611 |
| Net income (loss) | $ 8,169 | $ 6,089 | $ 19,645 | $ (27,539) |
| Basic income (loss) per common share: | | | | |
| Income from continuing operations | $ 0.03 | $ 0.03 | $ 0.06 | $ 0.02 |
| Loss from discontinued operations | | (0.01) | | (0.11) |
| Net income (loss) | $ 0.03 | $ 0.02 | $ 0.06 | $ (0.09) |
| Diluted income (loss) per common share: | | | | |
| Income from continuing operations | $ 0.02 | $ 0.03 | $ 0.06 | $ 0.02 |
| Loss from discontinued operations | | (0.01) | | (0.10) |
| Net income (loss) | $ 0.02 | $ 0.02 | $ 0.06 | $ (0.08) |
| Weighted-average shares outstanding used in computing income (loss) per common share: | | | | |
| Basic | 312,366 | 305,471 | 311,379 | 304,121 |
| Diluted | 333,978 | 328,463 | 333,048 | 326,396 |

See accompanying notes.

Table of Contents

**WEBMD CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands, unaudited)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2004** | **2003** |
| **Cash flows from operating activities:** | | |
| Net income (loss) | $ 19,645 | $ (27,539) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Loss from discontinued operations | | 33,611 |
| Depreciation, amortization and other | 40,922 | 52,961 |
| Amortization of debt issuance costs | 2,255 | 1,505 |
| Non-cash content and distribution services | 14,893 | 18,224 |
| Non-cash stock-based compensation | 7,241 | 10,948 |
| Gain on investments | (457) | (3,222) |
| Gain on sale of property and equipment | (121) | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (8,001) | 3,580 |
| Inventory | (417) | (1,144) |
| Prepaid content and distribution services | (26) | (537) |
| Accounts payable | (874) | (775) |
| Accrued expenses | (8,189) | (12,174) |
| Deferred revenue | 9,284 | (2,228) |
| Other, net | 3,045 | 5,685 |
| Net cash provided by continuing operations | 79,200 | 78,895 |
| Net cash provided by discontinued operations | | 5,130 |
| Net cash provided by operating activities | 79,200 | 84,025 |
| **Cash flows from investing activities:** | | |
| Proceeds from maturities and sales of available-for-sale securities | 384,238 | 11,322 |
| Proceeds from maturities and redemptions of held-to-maturity securities | | 157,919 |
| Purchases of available-for-sale securities | (274,600) | (7,754) |
| Purchases of held-to-maturity securities | | (590,113) |
| Proceeds received from sale of property and equipment | 417 | |
| Purchases of property and equipment | (24,889) | (13,643) |
| Proceeds received from sale of discontinued operations | | 46,500 |
| Cash paid in business combinations, net of cash acquired | (225,375) | (133,471) |
| Other changes in equity of discontinued operations | | 1,754 |
| Net cash used in continuing operations | (140,209) | (527,486) |
| Net cash used in discontinued operations | | (2,529) |
| Net cash used in investing activities | (140,209) | (530,015) |
| **Cash flows from financing activities:** | | |
| Proceeds from issuance of common stock | 30,528 | 35,367 |
| Payments of notes payable and other | (433) | (211) |
| Net proceeds from issuance of convertible debt | | 339,125 |
| Net proceeds from issuance of preferred stock | 98,115 | |
| Purchases of treasury shares | (22,267) | (18,125) |

| | | |
|---|---|---|
| Net cash provided by continuing operations | 105,943 | 356,156 |
| Net cash used in discontinued operations | | (6,546) |
| Net cash provided by financing activities | 105,943 | 349,610 |
| Effect of exchange rates on cash | (28) | 711 |
| Net increase (decrease) in cash and cash equivalents | 44,906 | (95,669) |
| Changes in cash attributable to discontinued operations | | 3,945 |
| Cash and cash equivalents at beginning of period | 63,298 | 175,596 |
| Cash and cash equivalents at end of period | $ 108,204 | $ 83,872 |

See accompanying notes.

Table of Contents

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(In thousands, except share and per share data, unaudited)**

**1. Summary of Significant Accounting Policies**
**Basis of Presentation**

The unaudited consolidated financial statements of WebMD Corporation (the Company ) have been prepared by management and reflect all adjustments (consisting of only normal recurring adjustments) that, in the opinion of management, are necessary for a fair presentation of the interim periods presented. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for any subsequent period or for the entire year ending December 31, 2004. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted under the Securities and Exchange Commission s rules and regulations.

The unaudited consolidated financial statements and notes included herein should be read in conjunction with the Company s audited consolidated financial statements and notes for the year ended December 31, 2003, which were included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission.

**Accounting Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company is subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in the Company s business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in the preparation of the Company s financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as the Company s operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in reported results of operations; if material, the effects of changes in estimates are disclosed in the notes to the consolidated financial statements. Significant estimates and assumptions by management affect: the allowance for doubtful accounts, the carrying value of inventory, the carrying value of prepaid content and distribution services, the carrying value of long-lived assets (including goodwill and intangible assets), the amortization period of long-lived assets (excluding goodwill), the carrying value, capitalization and amortization of software development costs, the carrying value of short-term and long-term investments, the provision for income taxes and related deferred tax accounts, certain accrued expenses, revenue recognition, contingencies, litigation and the value attributed to warrants issued for services.

**Inventory**

Inventory is stated at the lower of cost or market value using the first-in, first-out basis. Cost includes raw materials, direct labor and manufacturing overhead. Market value is based on current replacement cost for raw materials and supplies and on net realizable value for work-in-process and finished goods. Inventory consisted of the following as of September 30, 2004 and December 31, 2003:

| | September 30, 2004 | December 31, 2003 |
|---|---|---|
| Raw materials and supplies | $ 3,767 | $ 3,142 |
| Work-in-process | 1,423 | 1,394 |
| Finished goods and other | 7,389 | 7,622 |
| | $12,579 | $12,158 |

Table of Contents

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Accounting for Stock-Based Compensation**

The Company accounts for its stock-based employee compensation plans using the intrinsic value method under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and related interpretations. No stock-based employee compensation cost is reflected in net income (loss) with respect to options granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Stock-based awards to non-employees are accounted for based on provisions of SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), and EITF 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. The following table illustrates the effect on net income (loss) and net income (loss) per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Net income (loss) as reported | $ 8,169 | $ 6,089 | $ 19,645 | $(27,539) |
| Add: Stock-based employee compensation expense included in reported net income (loss) (including stock-based employee compensation expense related to discontinued operations) | 2,800 | 3,570 | 7,241 | 11,128 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards | (17,536) | (23,024) | (54,477) | (60,403) |
| Pro forma net loss | $ (6,567) | $(13,365) | $(27,591) | $(76,814) |
| Net income (loss) per common share: | | | | |
| Basic as reported | $ 0.03 | $ 0.02 | $ 0.06 | $ (0.09) |
| Diluted as reported | $ 0.02 | $ 0.02 | $ 0.06 | $ (0.08) |
| Basic and diluted pro forma | $ (0.02) | $ (0.04) | $ (0.09) | $ (0.25) |

The pro forma results above are not intended to be indicative of or a projection of future results. Pro forma information regarding net income (loss) has been determined as if employee stock options granted subsequent to December 31, 1994 were accounted for under the fair value method of SFAS No. 123. The fair value for 2004 options was estimated at the date of grant using the Black-Scholes option pricing model employing weighted average assumptions that were substantially consistent with the 2003 assumptions except with respect to the volatility assumption, which was 0.6 for options granted during the nine months ended September 30, 2004. The 2003 assumptions were included in Note 15 to the consolidated financial statements contained in the Company s 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The Company has elected to follow APB No. 25 and related interpretations in accounting for employee stock options because the alternative fair value accounting method provided for under SFAS No. 123 requires the use of option valuation models that were not developed for use in valuing employee stock options. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the

8

Table of Contents

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

fair value estimates, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company s employee stock options.

**Net Income (Loss) Per Common Share**

Basic income (loss) per common share and diluted income (loss) per common share are presented in conformity with SFAS No. 128, Earnings Per Share ( SFAS No. 128 ). In accordance with SFAS No. 128, basic income (loss) per common share has been computed using the weighted-average number of shares of common stock outstanding during the period. Diluted income (loss) per common share has been computed using the weighted-average number of shares of common stock outstanding during the period, increased to consider the effect of potentially dilutive securities. The following table presents the calculation of basic and diluted income (loss) per common share (shares in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Basic and diluted income (loss): | | | | |
| Income from continuing operations | $ 8,169 | $ 9,455 | $ 19,645 | $ 6,072 |
| Loss from discontinued operations | | (3,366) | | (33,611) |
| Net income (loss) | $ 8,169 | $ 6,089 | $ 19,645 | $ (27,539) |
| Weighted-average shares Basic | 312,366 | 305,471 | 311,379 | 304,121 |
| Effect of dilutive securities: | | | | |
| Employee stock options and warrants | 10,974 | 22,992 | 14,070 | 22,275 |
| Convertible redeemable exchangeable preferred stock | 10,638 | | 7,599 | |
| Adjusted weighted-average shares after assumed conversions Diluted | 333,978 | 328,463 | 333,048 | 326,396 |
| Basic income (loss) per common share: | | | | |
| Income from continuing operations | $ 0.03 | $ 0.03 | $ 0.06 | $ 0.02 |
| Loss from discontinued operations | | (0.01) | | (0.11) |
| Net income (loss) | $ 0.03 | $ 0.02 | $ 0.06 | $ (0.09) |
| Diluted income (loss) per common share: | | | | |
| Income from continuing operations | $ 0.02 | $ 0.03 | $ 0.06 | $ 0.02 |
| Loss from discontinued operations | | (0.01) | | (0.10) |
| Net income (loss) | $ 0.02 | $ 0.02 | $ 0.06 | $ (0.08) |

The Company has excluded convertible subordinated notes and restricted stock, as well as certain outstanding warrants and stock options, from the calculation of diluted income (loss) per common share because such securities were either anti-dilutive or were not convertible into common stock in accordance with their terms during the periods presented. The following table presents the total number of shares that could potentially dilute basic income (loss) per common share in the future that were not included in the

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

computation of diluted income (loss) per common share during the periods presented (shares in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Options, warrants and restricted stock | 90,397 | 81,973 | 87,357 | 83,133 |
| Convertible notes | 55,129 | 55,129 | 55,129 | 55,129 |
| | 145,526 | 137,102 | 142,486 | 138,262 |

**Reclassifications**

Certain reclassifications have been made to the prior period financial statements to conform with the current period presentation.

**2. Business Combinations and Significant Transactions**
**2004 Acquisitions**

On August 11, 2004, the Company completed its acquisition of VIPS, Inc. ( ViPS ), a privately held provider of information technology, decision support solutions and consulting services to government, Blue Cross Blue Shield and commercial healthcare payers. ViPS develops and provides a broad range of solutions for claims processing, provider performance measurement, quality improvement, fraud detection, disease management and predictive modeling. The total purchase consideration for ViPS was approximately $166,604 comprised of $165,204 in cash, net of cash acquired, and $1,400 of estimated acquisition costs, subject to customary post-closing adjustments. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of $66,342 and intangible assets subject to amortization of $92,700 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of $56,300 relating to customer relationships with estimated useful lives ranging from ten to fifteen years, $36,000 relating to acquired technology with estimated useful lives of five years and $400 relating to a trade name with an estimated useful life of one year. The financial information of ViPS has been included in the financial statements of the Company from August 11, 2004, the closing date of the acquisition, and is included in the Transaction Services segment.

On July 16, 2004, the Company acquired Epor, Inc. ( Epor ), a privately held company based in Los Angeles, California. Epor manufactures porous plastic implant products for use in aesthetic and reconstructive surgery of the head and face. The total purchase consideration for Epor was approximately $2,547. The financial information of Epor has been included in the financial statements of the Company from July 16, 2004, the closing date of the acquisition, and is included in the Plastic Technologies segment.

On April 30, 2004, the Company acquired Dakota Imaging, Inc. ( Dakota ), a privately held provider of automated healthcare claims processing technology and business process outsourcing services. Dakota s technology and services assist its customers in reducing costly manual processing of healthcare documents and increase auto-payment of medical claims through advanced data scrubbing. The Company paid approximately $39,717 in cash at closing and has agreed to pay up to an additional $25,000 in cash over a three-year period beginning in April 2005 if certain financial milestones are achieved. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of $28,380 and intangible assets subject to amortization of $13,100 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of $4,500 relating to customer relationships with estimated useful lives of ten years and $8,600 relating to acquired technology with an estimated life of five years. The financial information of Dakota has been included in the financial statements of the Company from April 30, 2004, the closing date of the acquisition, and is included in the Transaction Services segment.

During the nine months ended September 30, 2004, the Company acquired one physician services company for an aggregate cost of $70, which was paid in cash, and agreed to pay up to $30 beginning in 2005 if the acquired company meets certain financial milestones. In connection with the preliminary allocation of the purchase price, intangible assets subject to amortization of $85 were recorded, principally related to customer relationships and non-compete agreements. The financial information of this company has been included in the financial statements of the Company from the acquisition closing date and is included in the Physician Services segment.

**2003 Acquisitions**

On December 22, 2003, the Company completed its acquisition of Medifax-EDI, Inc. ( Medifax ), a privately held company based in Nashville, Tennessee. Medifax provides real-time medical eligibility transaction services and other claims management solutions to hospitals, medical centers, physician practices and other medical organizations throughout the United States. These services enable healthcare providers to verify insurance coverage for their patients on a real-time basis. The total purchase consideration was approximately $277,519, comprised of $276,065 in cash and $1,454 of estimated acquisition costs, for all of the outstanding capital stock of Medifax. Prior to closing, Medifax distributed its Pharmacy Services companies to its owner and these companies were not included in the transaction. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the preliminary allocation of the purchase price, goodwill of $179,090 and intangible assets subject to amortization of $92,700 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible assets are comprised of $72,600 relating to customer relationships with estimated useful lives of fifteen years, $8,600 relating to acquired technology with an estimated useful life of five years, $8,400 relating to payer connections with estimated useful lives of fifteen years and $3,100 relating to a tradename with an estimated useful life of one year. The financial information of Medifax has been included in the financial statements of the Company from December 22, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On September 25, 2003, the Company completed its acquisition of a privately held dental clearinghouse based in Hartford, Connecticut. The Company paid $5,805 in cash for all of the outstanding capital stock of the acquired company and agreed to pay up to an additional $4,200 beginning in 2005 if certain revenue related milestones are achieved. The additional payment may be made over a three-year period by issuing shares of the Company s common stock or in cash. The additional payment may exceed $4,200 if all or a portion of the additional payment is made by issuing shares of the Company s stock and if the value of the Company s stock exceeds certain price levels. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of $3,482 and an intangible asset subject to amortization of $2,392 were recorded. The Company does not expect that the goodwill or intangible assets will be deductible for tax purposes. The intangible asset is acquired technology with an estimated useful

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

life of five years. The financial information of the acquired company has been included in the financial statements of the Company from September 25, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On July 17, 2003, the Company completed its acquisition of Advanced Business Fulfillment, Inc. ( ABF ), a privately held company based in St. Louis, Missouri. ABF provides healthcare paid-claims communications services for third-party administrators and health insurers. ABF s services allow its customers to outsource print-and-mail activities for the distribution of checks, remittance advice and explanations of benefits. The total purchase consideration for ABF was approximately $112,891, comprised of $108,368 in cash and $4,523 of acquisition costs for all of the outstanding capital stock of ABF. Additionally, the Company agreed to pay up to an additional $150,000 beginning in April 2004 if certain financial milestones are achieved. The additional payment may be made over a three-year period by issuing shares of the Company s common stock or, at the Company s option in certain circumstances, in cash. The additional payment may exceed $150,000 if all or a portion of the additional payment is made by issuing shares of the Company s stock and if the value of the Company s stock exceeds certain price levels at the time of payment. During April 2004, the Company paid $17,455 in cash as a result of the achievement of certain financial milestones. This payment resulted in an increase to goodwill. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of $61,128 and intangible assets subject to amortization of $47,000 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of $41,000 relating to customer relationships with estimated useful lives of ten years, $4,900 relating to acquired unpatented technologies with estimated useful lives of nine months to six years and $1,100 relating to a trade name with an estimated useful life of three years. The financial information of the acquired company has been included in the financial statements of the Company from July 17, 2003, the closing date of the acquisition, and is included in the Transaction Services segment.

On May 29, 2003, the Company acquired The Little Blue Book ( LBB ), a company which maintains a database containing practice information for over 380,000 physicians, and publishes a pocket-sized reference book containing physician information. The total purchase consideration for LBB was approximately $10,535, comprised of $10,400 in cash and acquisition costs of $135. Additionally, the Company will pay up to $2,500 if LBB meets certain financial milestones during the years ending December 31, 2003 and 2004. During April 2004, the Company paid $1,500 in cash as a result of the achievement of certain financial milestones. This payment resulted in an increase to goodwill. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of $8,545 and intangible assets subject to amortization of $2,815 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of $1,787 relating to a trade name with an estimated useful life of seven years, $761 relating to customer relationships with estimated useful lives of five years and $267 relating to acquired technology with an estimated useful life of three years. The financial information of LBB has been included in the financial statements of the Company from May 29, 2003, the closing date of the acquisition, and is included in the Portal Services segment.

On April 30, 2003, the Company acquired the assets and assumed certain liabilities of a company which provides healthcare benefit decision support tools and solutions to its clients through online technology. The total purchase consideration for this acquisition was approximately $4,052, comprised of $4,000 in cash and acquisition costs of $52. The acquisition was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the tangible and intangible assets

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

acquired and the liabilities assumed on the basis of their respective fair values. In connection with the allocation of the purchase price, goodwill of $4,070 and an intangible asset subject to amortization of $710 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible asset represents the fair value of customer relationships with estimated useful lives of five years. The financial information of the acquired business has been included in the financial statements of the Company from April 30, 2003, the closing date of the acquisition, and is included in the Portal Services segment.

In 2003, the Company acquired seven practice services companies for an aggregate cost of $2,182, which was paid in cash. Additionally, the Company has agreed to pay up to $675 beginning in 2004 if some of the acquired companies meet certain financial milestones. During the three months ended September 30, 2004, the Company paid $50 in cash as a result of the achievement of certain financial milestones. These acquisitions were accounted for using the purchase method of accounting and, accordingly, the purchase prices were allocated to assets acquired and liabilities assumed based on their respective fair values. In connection with the allocation of the purchase prices, goodwill of $1,519 and intangible assets subject to amortization of $1,054 were recorded. The Company expects that substantially all of the goodwill recorded will be deductible for tax purposes. The intangible assets are comprised of $351 related to non-compete agreements with estimated useful lives of three to five years and $703 related to customer relationships with estimated useful lives of nine years. The financial information of these companies has been included in the financial statements of the Company from the respective acquisition closing dates and is included in the Physician Services segment.

**Unaudited Pro Forma Information**

The following unaudited pro forma financial information for the nine months ended September 30, 2004 and 2003 gives effect to the acquisitions of ABF, Medifax and ViPS, including the amortization of intangible assets, as if they had occurred on January 1, 2003. The information is provided for illustrative purposes only and is not necessarily indicative of the operating results that would have occurred if the transactions had been consummated on the date indicated, nor is it necessarily indicative of future operating results of the consolidated companies, and should not be construed as representative of these results for any future period. The remaining acquisitions in 2004 and 2003 have been excluded as the pro forma impact of such acquisitions was not significant to the nine months ended September 30, 2004 and September 30, 2003.

| | Nine Months Ended September 30, 2004 | Nine Months Ended September 30, 2003 |
|---|---|---|
| Revenue | $ 892,048 | $ 833,200 |
| Income from continuing operations | $ 22,455 | $ 14,050 |
| Net income (loss) | $ 22,455 | $ (19,561) |
| Basic income (loss) per common share: | | |
| Income from continuing operations | $ 0.07 | $ 0.05 |
| Net income (loss) | $ 0.07 | $ (0.06) |
| Diluted income (loss) per common share: | | |
| Income from continuing operations | $ 0.07 | $ 0.04 |
| Net income (loss) | $ 0.07 | $ (0.06) |

**Significant Transactions**

As more fully discussed in Note 3 to the consolidated financial statements contained in the Company s 2003 Annual Report on Form 10-K, the Company entered into an agreement for a strategic

13

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

alliance with Time Warner, Inc. in May 2001. Under the agreement, the Company is the primary provider of healthcare content, tools and services for use on certain America Online properties. The original term of the agreement was for three years, ending in May 2004. The Company had a right to extend the agreement for an additional three-year term if the Company s revenue share did not exceed certain thresholds during the original three-year term. These thresholds were not met and the Company exercised its right to extend the contract term until May 2007. Under the terms of the extension, the Company s revenue share will be subject to a minimum annual guarantee.

As more fully discussed in Note 3 to the consolidated financial statements contained in the Company s 2003 Annual Report on Form 10-K, the Company entered into a strategic relationship with Microsoft in April 2001, including an agreement to program the MSN health channel. That agreement has been amended to change the expiration date from June 30, 2004 to December 31, 2004.

**3. Discontinued Operations**

On August 1, 2003, the Company completed the sale of two operating units of Porex, Porex Bio Products, Inc. ( Porex Bio ) and Porex Medical Products, Inc. ( Porex Medical ) to enable Porex to focus on its porous materials businesses. Accordingly, the historical financial information of these operating units has been reclassified as discontinued operations in the accompanying consolidated financial statements for the prior year period. The operating units were sold in two separate transactions for an aggregate sales price of $46,500. An impairment charge of $33,113 was recorded in the results for the quarter ended June 30, 2003 to reduce the long-lived assets of Porex Bio and Porex Medical to fair value. The write-down consisted of $27,564 of goodwill, $4,162 of trade name and patent intangibles and $1,387 of other long-lived assets consisting primarily of manufacturing equipment. The impairment charge was based on the fair value of the divested businesses as determined by the expected proceeds from disposition. During the three months ended September 30, 2003, the Company recorded a loss on disposal of $3,491, primarily representing certain costs related to the disposition. Summarized operating results for the discontinued units through August 1, 2003 were as follows:

| | For the Period July 1, 2003 through August 1, 2003 | For the Period January 1, 2003 through August 1, 2003 |
|---|---|---|
| Revenue | $ 4,739 | $ 31,004 |
| Income (loss) from operations | $ 125 | $ (30,120) |
| Loss on disposal | $ (3,491) | $ (3,491) |
| Loss from discontinued operations | $ (3,366) | $ (33,611) |

**4. Restructuring and Integration Charge**

After the mergers with Medical Manager Corporation, CareInsite, Inc. and OnHealth Network Company in September 2000, the Company s Board of Directors approved a restructuring and integration plan, with the objective of eliminating duplication and redundancies that resulted from these and certain prior acquisitions and consolidating the Company s operational infrastructure. The Company s restructuring and integration efforts continued in 2001, and a plan to include the impact of eliminating functions resulting from the Company s acquisition of Medscape in December 2001 was initiated. During the three months ended September 30, 2004, the Company recorded an incremental restructuring charge, with respect to the 2000 restructuring plan, of $4,535 in connection with the settlement of a lawsuit against the landlord of a property that the Company leased in 2000, but never occupied, for its then Santa Clara, California operations. The remainder of the settlement cost was previously expensed as part of the 2000

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

restructuring plan. Under the terms of the settlement, the original lease, which provided for aggregate remaining lease payments of approximately $45,000 over the next eight years, was terminated and the Company will make a cash payment to the landlord of approximately $23,000 during the three months ending December 31, 2004. The Company s remaining obligations related to its 2000 and 2001 restructuring plans are not material to the Company s financial position and have been included in accrued expenses in the accompanying consolidated balance sheet.

**5. Convertible Redeemable Exchangeable Preferred Stock**

On March 19, 2004, the Company issued $100,000 of Convertible Redeemable Exchangeable Preferred Stock (the Preferred Stock ) in a private transaction to CalPERS/ PCG Corporate Partners, LLC ( CalPERS/ PCG Corporate Partners ). CalPERS/ PCG Corporate Partners is a private equity fund managed by the Pacific Corporate Group and principally backed by California Public Employees Retirement System, or CalPERS.

The Preferred Stock has a liquidation preference of $100,000 in the aggregate and is convertible into 10,638,297 shares of the Company s common stock in the aggregate, representing a conversion price of $9.40 per share of common stock. The Company may not redeem the Preferred Stock prior to March 2007. Thereafter, the Company may redeem any portion of the Preferred Stock at 105% of its liquidation preference; provided that any redemption by the Company prior to March 2008 shall be subject to the condition that the average closing sale prices of the Company s common stock is at least $13.16 per share, subject to adjustment. The Company is required to redeem all shares of the Preferred Stock then outstanding in March 2012, at a redemption price equal to the liquidation preference of the Preferred Stock, payable in cash or, at the Company s option, in shares of the Company s common stock.

If the average closing sales price of the Company s common stock during the three-month period ended on the fourth anniversary of the issuance date is less than $7.50 per share, holders of the Preferred Stock will have a right to exchange the Preferred Stock into the Company s 10% Subordinated Notes ( 10% Notes ) due March 2010. The 10% Notes may be redeemed, in whole or in part, at any time thereafter at the Company s option at a price equal to 105% of the principal amount of the 10% Notes being redeemed.

Holders of the Preferred Stock will not receive any dividends unless the holders of common stock do, in which case holders of the Preferred Stock will be entitled to receive ordinary dividends in an amount equal to the ordinary dividends the holders of the Preferred Stock would have received had they converted such Preferred Stock into common stock immediately prior to the record date for such dividend distribution. So long as the Preferred Stock remains outstanding, the Company is required to pay to CalPERS/ PCG Corporate Partners, on a quarterly basis, an aggregate annual fee of 0.35% of the face amount of the then outstanding Preferred Stock.

Holders of the Preferred Stock have the right to vote, together with the holders of the Company s common stock on an as converted to common stock basis, on matters that are put to a vote of the holders common stock. The Certificate of Designations for the Preferred Stock also provides that the Company will not, without the prior approval of holders of 75% of the shares of Preferred Stock then outstanding, voting as a separate class, issue any additional shares of the Preferred Stock, or create any other class or series of capital stock that ranks senior to or on a parity with the Preferred Stock.

**6. Convertible Subordinated Notes**

*1.75% Convertible Subordinated Notes Due 2023*

On June 25, 2003, the Company issued $300,000 aggregate principal amount of 1.75% Convertible Subordinated Notes due 2023 (the 1.75% Notes ) in a private offering. On July 7, 2003, the Company

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

issued an additional $50,000 aggregate principal amount of the 1.75% Notes. Unless previously redeemed or converted, the 1.75% Notes will mature on June 15, 2023. Interest on the 1.75% Notes accrues at the rate of 1.75% per annum and is payable semiannually on June 15 and December 15, commencing December 15, 2003. The Company will also pay contingent interest of 0.25% per annum of the average trading price of the 1.75% Notes during specified six-month periods, commencing on June 20, 2010, if the average trading price of the 1.75% Notes for specified periods equals 120% or more of the principal amount of the 1.75% Notes.

The 1.75% Notes are convertible into an aggregate of 22,742,040 shares of the Company s common stock (representing a conversion price of $15.39 per share) if the sale price of the Company s common stock exceeds 120% of the conversion price for specified periods and in certain other circumstances. The 1.75% Notes are redeemable by the Company after June 15, 2008 and prior to June 20, 2010, subject to certain conditions, including the sale price of the Company s common stock exceeding certain levels for specified periods. If the 1.75% Notes are redeemed by the Company during this period, the Company will be required to make additional interest payments. After June 20, 2010, the 1.75% Notes are redeemable at any time for cash at 100% of their principal amount. Holders of the 1.75% Notes may require the Company to repurchase their 1.75% Notes on June 15, 2010, June 15, 2013 and June 15, 2018, for cash at 100% of the principal amount of the 1.75% Notes, plus accrued interest. Upon a change in control, holders may require the Company to repurchase their 1.75% Notes for, at the Company s option, cash or shares of the Company s common stock, or a combination thereof, at a price equal to 100% of the principal amount of the 1.75% Notes being repurchased.

The Company incurred issuance costs related to the 1.75% Notes of approximately $10,875, which are included in other assets in the accompanying consolidated balance sheets. The issuance costs are being amortized to interest expense in the accompanying consolidated statements of operations, using the effective interest method over the period from issuance through June 15, 2010, the earliest date on which holders can demand redemption.

*3 1/4% Convertible Subordinated Notes Due 2007*

On April 1, 2002, the Company issued $300,000 aggregate principal amount of 3 1/4% Convertible Subordinated Notes due 2007 (the 3 1/4% Notes ) in a private offering. Interest on the 3 1/4% Notes accrues at the rate of 3 1/4% per annum and is payable semiannually on April 1 and October 1. Unless previously redeemed or converted, the 3 1/4% Notes will mature on April 1, 2007. At the time of issuance, the 3 1/4% Notes were convertible into an aggregate of approximately 32,386,916 shares of the Company s common stock (representing a conversion price of $9.26 per share), subject to adjustment in certain circumstances. During the three months ended June 30, 2003, $1 principal amount of the 3 1/4% Notes was converted into 107 shares of the Company s common stock in accordance with the provisions of the 3 1/4% Notes. As of September 30, 2004, the 3 1/4% Notes were convertible into an aggregate of approximately 32,386,808 shares of the Company s common stock. The 3 1/4% Notes are redeemable at the Company s option, at any time on or after April 5, 2005. The redemption price, as a percentage of principal amount, is 101.3% beginning April 5, 2005 and 100.65% beginning April 1, 2006.

The Company incurred issuance costs related to the 3 1/4% Notes of $8,000, which are included in other assets in the accompanying consolidated balance sheets. The issuance costs are being amortized using the effective interest method over the term of the 3 1/4% Notes. The amortization of the issuance costs is included in interest expense in the accompanying consolidated statements of operations.

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**7. Stockholders Equity**

*Preferred Stock*

On September 23, 2004, two related proposals were approved at the Company s annual meeting of stockholders. The first proposal reduced the number of authorized shares of the Company s Convertible Redeemable Exchangeable Preferred Stock from 5,000,000 to 10,000 (the amount outstanding). The other proposal authorized the Company s Board of Directors to approve the issuance of up to 4,990,000 shares of preferred stock from time to time in one or more series, to establish from time to time the number of shares to be included in any such series, and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations and restrictions thereof. No shares have been issued pursuant to that authority and the 10,000 shares of Convertible Redeemable Exchangeable Preferred Stock are the only shares of preferred stock of the Company that are outstanding.

*Stock Repurchase Program*

On March 29, 2001, the Company announced a stock repurchase program (the Program ). Under the Program, the Company was originally authorized to use up to $50,000 to purchase shares of its common stock from time to time beginning on April 2, 2001, subject to market conditions. The maximum aggregate amount of purchases under the Program was subsequently increased to $100,000, $150,000 and $200,000 on November 2, 2001, November 7, 2002 and August 19, 2004, respectively. As of September 30, 2004, the Company had repurchased a total of 25,130,962 shares at a cost of approximately $128,625 under the Program, of which 2,817,606 shares were repurchased during the nine months ended September 30, 2004 for an aggregate purchase price of $22,267 and 2,271,356 shares were repurchased during the three months ended September 30, 2004 for an aggregate purchase price of $17,390. As of September 30, 2003, the Company had repurchased a total of 22,060,656 shares at a cost of approximately $104,167 under the Program, of which 2,069,496 shares were repurchased during the nine months ended September 30, 2003 for an aggregate purchase price of $18,125. No shares were repurchased during the three months ended September 30, 2003. These repurchased shares are reflected as treasury stock in the accompanying consolidated balance sheets. As of September 30, 2004, the Company had $71,375 available to repurchase shares of its common stock under the Program.

**8. Segment Information**

Segment information has been prepared in accordance with the Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information ( SFAS No. 131 ). The accounting policies of the segments are consistent with those described in the summary of significant accounting policies in Note 1 to the consolidated financial statements contained in the Company s 2003 Annual Report on Form 10-K. Inter-segment revenues represent sales of Transaction Services products into the Physician Services customer base and are reflected at rates comparable to those charged to third parties for comparable products. The performance of the Company s business is monitored based on income or loss before restructuring, taxes, non-cash and other items. Non-cash and other items include depreciation, amortization, gain on investments, other income, costs and expenses related to the investigation by the United States Attorney for the District of South Carolina and the SEC ( legal expense ), non-cash expenses related to content, advertising and distribution services acquired in exchange for the Company s equity securities in acquisitions and strategic alliances, and stock compensation expense primarily related to stock options issued and assumed in connection with acquisitions and restricted stock issued to employees.

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has aligned its business into four operating segments as follows:

*Transaction Services or WebMD Business Services* (formerly known as WebMD Envoy) provides healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers, together with related technology solutions. WebMD Business Services transmits transactions electronically between healthcare payers and providers and provides healthcare payers with transaction processing technology, decision support solutions, consulting services and outsourcing services, including document management services for transaction processing and print-and-mail services for the distribution of checks, remittance advice and explanation of benefits. WebMD Business Services also provides automated patient billing services to healthcare providers, including statement printing and mailing services.

*Physician Services or WebMD Practice Services* develops and markets integrated physician practice management systems, including administrative, financial and clinical applications and services, under The Medical Manager, Intergy, ULTIA and Medical Manager Network Services brands. These systems and services allow physician offices to automate their scheduling, billing and other administrative tasks, to transmit transactions electronically, to maintain electronic medical records and to automate documentation of patient encounters.

*Portal Services or WebMD Health* provides online healthcare information, educational services and related resources for consumers, both directly and through its relationships with leading general consumer Internet portals. WebMD Health, through its Medscape subsidiary, also provides online healthcare information, educational programs and related resources for healthcare professionals, including online continuing medical education, or CME. WebMD Health also provides online content for use by media and healthcare partners on their Web sites. WebMD Health develops and sells online and offline channels of communication and sponsorship programs to pharmaceutical, biotech, medical device and consumer products companies. In addition, WebMD Health provides a suite of online tools and related services to employers and health plans for use by their employees and plan members.

*Plastic Technologies or Porex* develops, manufactures and distributes proprietary porous plastic products and components used in healthcare, industrial and consumer applications, as well as in finished products used in the medical device and surgical markets.

**Table of Contents**

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Summarized financial information for each of the Company s operating segments and a reconciliation to net income (loss) are presented below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| **Revenues** | | | | |
| Transaction services | $174,643 | $131,977 | $504,459 | $365,491 |
| Physician services | 76,924 | 75,487 | 219,703 | 224,295 |
| Portal services | 37,017 | 31,164 | 95,178 | 79,882 |
| Plastic technologies | 19,385 | 19,093 | 58,543 | 55,015 |
| Inter-segment eliminations | (8,354) | (7,086) | (25,173) | (19,099) |
| | $299,615 | $250,635 | $852,710 | $705,584 |
| **Income (loss) before restructuring, taxes, non-cash and other items** | | | | |
| Transaction services | $ 31,750 | $ 21,767 | $ 90,514 | $ 68,160 |
| Physician services | 5,856 | 3,686 | 8,978 | 16,342 |
| Portal services | 10,040 | 8,712 | 22,208 | 18,922 |
| Plastic technologies | 5,823 | 5,690 | 17,140 | 15,857 |
| Corporate | (15,170) | (12,809) | (42,703) | (37,652) |
| Interest income | 4,512 | 6,401 | 14,506 | 16,434 |
| Interest expense | (4,843) | (4,703) | (14,429) | (10,444) |
| | 37,968 | 28,744 | 96,214 | 87,619 |
| **Restructuring, taxes, non-cash and other items** | | | | |
| Depreciation, amortization and other | (15,189) | (11,097) | (40,922) | (52,961) |
| Non-cash content and distribution services and stock compensation | (6,409) | (9,465) | (22,134) | (29,172) |
| Legal expense | (2,325) | (493) | (6,577) | (493) |
| Restructuring and integration charge | (4,535) | | (4,535) | |
| Other income, net | 94 | 3,039 | 578 | 4,340 |
| Income tax provision | (1,435) | (1,273) | (2,979) | (3,261) |
| Income from continuing operations | 8,169 | 9,455 | 19,645 | 6,072 |
| Loss from discontinued operations | | (3,366) | | (33,611) |
| Net income (loss) | $ 8,169 | $ 6,089 | $ 19,645 | $ (27,539) |

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Investments**

As of September 30, 2004 and December 31, 2003, the Company s short-term investments and marketable debt securities consisted of certificates of deposit, municipal bonds, asset backed securities, Federal Agency Notes and U.S. Treasury Notes and marketable equity securities consisted of equity investments in publicly traded companies. As of September 30, 2004 and December 31, 2003, all of the Company s marketable securities were classified as available-for-sale. The following table summarizes the amortized cost basis and estimated fair value of the Company s investments:

| | September 30, 2004 | | December 31, 2003 | |
|---|---|---|---|---|
| | **Cost Basis** | **Fair Value** | **Cost Basis** | **Fair Value** |
| Short-term investments | $ 25,901 | $ 25,784 | $205,962 | $207,383 |
| Marketable debt securities long-term | 514,922 | 515,096 | 445,810 | 451,290 |
| Marketable equity securities long-term | 1,492 | 3,373 | 1,773 | 4,744 |

The amortized cost and estimated fair value by maturity of securities are shown in the following table. Securities are classified according to their contractual maturities without consideration of principal amortization, potential prepayments or call options. Accordingly, actual maturities may differ from contractual maturities.

| | Cost or Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 25,901 | $ 25,784 |
| Due after one year through five years | 514,922 | 515,096 |
| Total | $540,823 | $540,880 |

**10. Comprehensive Income (Loss)**

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income (loss), such as changes in unrealized holding gains (losses) on available-for-sale marketable securities and foreign currency translation adjustments. The following table presents the components of other comprehensive income (loss) for the three and nine months ended September 30, 2004 and 2003:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Foreign currency translation gains (losses) | $ 233 | $ 109 | $ (116) | $ 1,621 |
| Unrealized losses on securities: | | | | |
| Unrealized holding gains (losses) | 3,321 | 3,043 | (7,477) | 1,415 |
| Less: reclassification adjustment for net gains realized in net income (loss) | 94 | 3,039 | 457 | 3,222 |

| | | | | |
|---|---|---|---|---|
| Net unrealized gains (losses) on securities | 3,227 | 4 | (7,934) | (1,807) |
| Other comprehensive income (loss) | 3,460 | 113 | (8,050) | (186) |
| Net income (loss) | 8,169 | 6,089 | 19,645 | (27,539) |
| Comprehensive income (loss) | $11,629 | $6,202 | $11,595 | $(27,725) |

The foreign currency translation gains (losses) are not currently adjusted for income taxes as they relate to permanent investments in non-U.S. subsidiaries.

Table of Contents

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**11. Goodwill and Other Intangible Assets**

The changes in the carrying amount of goodwill for the year ended December 31, 2003 and the nine months ended September 30, 2004 are as follows:

| | Transaction Services | Physician Services | Portal Services | Plastic Technologies | Total |
|---|---|---|---|---|---|
| Balance as of January 1, 2003 | $341,967 | $182,085 | $23,705 | $38,286 | $586,043 |
| Goodwill recorded during the period | 244,021 | 1,469 | 12,731 | | 258,221 |
| Adjustments to finalize purchase price allocations | | (745) | 407 | | (338) |
| Effects of exchange rates | | | | 522 | 522 |
| Balance as of December 31, 2003 | 585,988 | 182,809 | 36,843 | 38,808 | 844,448 |
| Goodwill recorded during the period | 112,177 | 50 | 1,500 | 2,024 | 115,751 |
| Adjustments to finalize purchase price allocations | (321) | | (116) | | (437) |
| Effects of exchange rates | | | | 37 | 37 |
| Balance as of September 30, 2004 | $697,844 | $182,859 | $38,227 | $40,869 | $959,799 |

Intangible assets subject to amortization consisted of the following as of September 30, 2004 and December 31, 2003:

| | September 30, 2004 | | | December 31, 2003 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net | Gross Carrying Amount | Accumulated Amortization | Net |
| Customer lists | $386,004 | $(214,785) | $171,219 | $325,160 | $(206,163) | $118,997 |
| Trade names | 30,716 | (24,902) | 5,814 | 30,316 | (19,756) | 10,560 |
| Technology and patents | 235,918 | (152,332) | 83,586 | 191,318 | (146,905) | 44,413 |
| Non-compete agreements | 11,560 | (1,753) | 9,807 | 11,019 | (859) | 10,160 |
| Total | $664,198 | $(393,772) | $270,426 | $557,813 | $(373,683) | $184,130 |

Amortization expense was $7,949 and $20,089 for the three and nine months ended September 30, 2004, respectively, and $3,553 and $32,811 for the three and nine months ended September 30, 2003, respectively. Aggregate amortization expense for intangible assets is estimated to be:

| | |
|---|---|
| Year ending December 31, 2004 (October 1st to December 31st) | 9,354 |
| 2005 | 32,896 |
| 2006 | 29,670 |
| 2007 | 28,859 |
| 2008 | 28,372 |
| Thereafter | 141,275 |

Table of Contents

**WEBMD CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. Commitments and Contingencies**

The United States Attorney for the District of South Carolina is conducting an investigation of the Company. Based on the information available to the Company as of the date of this Quarterly Report, the Company believes that the investigation relates principally to issues of financial accounting improprieties for Medical Manager Corporation, a predecessor of the Company (by its merger into the Company in September 2000), and the Company s Medical Manager Health Systems subsidiary; however, the Company cannot be sure of the investigation s exact scope or how long it may continue. The Company intends to continue to fully cooperate with the authorities in this matter. The Company understands that the SEC is also conducting a formal investigation into this matter. While the Company is not able to estimate, at this time, the amount of the expenses that it will incur in connection with the investigations, it expects that they may continue to be significant. For the three and nine months ended September 30, 2004, those expenses are reflected as Legal Expense in the accompanying consolidated statements of operations.

In the normal course of business, the Company and its subsidiaries are involved in various other claims and legal proceedings. While the ultimate resolution of these matters, including those discussed in Part II, Item 1 of this Quarterly Report and in the Company s 2003 Annual Report on Form 10-K under the heading Legal Proceedings, has yet to be determined, the Company does not believe that their outcome will have a material adverse effect on the Company s consolidated financial position or results of operations.

**Table of Contents**

**ITEM 2.** ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

*This Item 2 contains forward-looking statements with respect to possible events, outcomes or results that are, and are expected to continue to be, subject to risks, uncertainties and contingencies, including those identified in this Item. See Cautionary Statement Regarding Forward-Looking Statements on page 3.*

**Overview**

Management s discussion and analysis of financial condition and results of operations, or MD&A, is provided as a supplement to the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report and to provide an understanding of our results of operations, financial condition, and changes in financial condition. Our MD&A is organized as follows:

*Introduction.* This section provides a general description of WebMD, a brief discussion of our operating segments and background information on certain trends, strategies and other matters discussed in this MD&A.

*Critical Accounting Policies and Estimates.* This section discusses those accounting policies that both are considered important to our financial condition and results of operations, and require us to exercise subjective or complex judgments in their application. In addition, all of our significant accounting policies, including our critical accounting policies, are summarized in Note 1 to the Consolidated Financial Statements contained in our 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

*Results of Operations and Results of Operations by Operating Segment.* These sections provide our analysis and outlook for the significant line items on our consolidated statements of operations, on both a company-wide and a segment-by-segment basis.

*Liquidity and Capital Resources.* This section provides an analysis of our liquidity and cash flows, as well as a discussion of our outstanding debt and commitments, that existed as of September 30, 2004.

*Factors That May Affect Our Future Financial Condition or Results of Operations.* This section describes circumstances or events that could have a negative effect on our financial condition or results of operations, or that could change, for the worse, existing trends in some or all of our businesses. The factors discussed in this section are in addition to factors that may be described elsewhere in this Quarterly Report.

**Introduction**

WebMD Corporation is a Delaware corporation that was incorporated in December 1995 and commenced operations in January 1996 as Healtheon Corporation. We changed our name to Healtheon/ WebMD Corporation in November 1999 and to WebMD Corporation in September 2000. Our common stock has traded on the Nasdaq National Market under the symbol HLTH since February 11, 1999.

*Operating Segments*

We have aligned our business into four operating segments as follows:

*Transaction Services or WebMD Business Services (formerly known as WebMD Envoy).* We provide healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers, together with related technology solutions. We transmit transactions electronically between healthcare payers and providers and provide healthcare payers with transaction processing technology, decision support solutions, consulting services and outsourcing services, including document management services for transaction processing and print-and-mail services for the distribution of checks, remittance advice and explanation of benefits. We

**Table of Contents**

also provide automated patient billing services to healthcare providers, including statement printing and mailing services.

*Physician Services or WebMD Practice Services.* We develop and market integrated physician practice management systems, including administrative, financial and clinical applications and services, under The Medical Manager, Intergy, ULTIA and Medical Manager Network Services brands. These systems and services allow physician offices to automate their scheduling, billing and other administrative tasks, to transmit transactions electronically, to maintain electronic medical records and to automate documentation of patient encounters.

*Portal Services or WebMD Health.* We provide online healthcare information, educational services and related resources for consumers, both directly and through our relationships with leading general consumer Internet portals. WebMD Health, through its Medscape subsidiary, also provides online healthcare information, educational programs and related resources for healthcare professionals, including online continuing medical education, or CME. We also provide online content for use by media and healthcare partners in their Web sites. We develop and sell online and offline channels of communication and sponsorship programs to pharmaceutical, biotech, medical device and consumer products companies. In addition, we provide a suite of online tools and related services to employers and health plans for use by their employees and plan members.

*Plastic Technologies or Porex.* We develop, manufacture and distribute proprietary porous plastic products and components used in healthcare, industrial and consumer applications, as well as in finished products used in the medical device and surgical markets.

*Background Information on Certain Trends and Strategies*

*Implementation of the HIPAA Transaction Standards.* Under the Healthcare Insurance Portability and Accountability Act of 1996, or HIPAA, Congress mandated a package of interlocking administrative simplification rules, including rules to establish standards and requirements for the electronic transmission of certain healthcare transactions, which we refer to as the Transaction Standards. The compliance date for the Transaction Standards was October 16, 2003. The Transaction Standards are applicable to the portions of our business involving the processing of healthcare transactions among physicians, payers, patients and other healthcare industry participants, including WebMD Business Services and Medical Manager Network Services. In order to implement the Transaction Standards, WebMD Business Services has made and continues to make significant changes to its systems and the software it uses internally. Similarly, the implementation has required payers and providers to simultaneously implement changes to their systems and/or internal procedures. As a result, this implementation process and related testing has been an immense challenge for the healthcare industry, including WebMD. As a leading clearinghouse for healthcare transactions and a leading vendor of physician office management information systems, WebMD has been the focus of a great deal of scrutiny in the implementation process and has received some criticism for difficulties encountered by our customers and for delays in correcting some of those problems. Given the nature and scope of the changes being implemented, the large number of healthcare industry participants involved and our position in the industry, we expected that there would be some processing problems and delays. We continue to work diligently to identify and resolve problems as they occur.

*Diversification of WebMD Business Services; Cross-Selling Opportunities.* We are continuing our efforts to transform WebMD Business Services (whose name was recently changed from WebMD Envoy) from an electronic transactions clearinghouse to a provider of healthcare reimbursement cycle management services for healthcare providers and claims management services for healthcare payers. The new name is intended to reflect this transformation, which in turn is intended to allow us to provide the benefits of economies of scale to our customers in various stages of the healthcare reimbursement cycle. In order to be more efficient, many healthcare payers are focusing upon core activities building cost-effective provider networks, marketing their services to employers, and adjudicating claims payment and are outsourcing pre- and post-adjudication administrative activities, such as printing and mailing checks and explanation of benefits and other document management activities, including conversion of paper claims to

Table of Contents

electronic form. By outsourcing these services to us, payers can reduce operating costs and capital expenditures. Our acquisitions of Advanced Business Fulfillment and Medifax-EDI in 2003 and Dakota Imaging in April 2004 support our ability to provide more comprehensive business process outsourcing services. Through ViPS, which we acquired in August 2004, we provide healthcare payers with information technology solutions and related services for claims processing, provider performance measurement, quality improvement, fraud detection, disease management and predictive modeling.

We expect that, over time, the revenue and earnings from providing electronic clearinghouse services for healthcare transactions, on their own, may decline. However, we believe that the revenue and earnings of our business process outsourcing and other transaction-related services, in conjunction with our clearinghouse services, is likely to offset any such decline. We are working to cross-sell our additional services to healthcare payers. However, we believe that it is possible that, in the first half of 2005, revenue from clearinghouse services will decline faster than we are able to increase the revenue from our additional services, in part because of the length of the implementation cycle for the additional services. We intend to continue the transformation of WebMD Business Services by developing or acquiring additional transaction-related services and updating our existing ones. Our strategy is to continue to increase the value we are able to provide our payer and provider customers in all aspects of their adoption and implementation of information technology solutions for healthcare transactions.

*Introduction of New Clinical Software.* Healthcare providers record, use and share various types of clinical data about their patients, including patient histories, examination notes, lab results, medication orders and referrals. Much of this data is currently recorded in handwritten or printed form on paper records, often referred to as patient charts. As the amount of patient information maintained by a practice increases, so do the logistical challenges of moving paper charts from site to site and physician to physician. Many healthcare organizations are finding that the most promising solution to this challenge is the use of electronic medical records. These systems allow providers to share patient charts and other medical records, access them simultaneously and view them from remote locations. WebMD Practice Services has recently released a new suite of clinical software called Intergy EHR. We believe that, in light of the increasing importance of clinical software to healthcare providers, WebMD Practice Services success in retaining existing practice management system customers and attracting new customers may depend, in substantial part, on their response to Intergy EHR.

*WebMD Health IPO.* WebMD has announced that it plans to establish WebMD Health, its Portal Services segment, as a publicly traded company. WebMD stated that, based on the recommendations of its outside advisors, WebMD has decided to take the steps necessary for a sale of approximately 10% of the equity of WebMD Health in an initial public offering. WebMD expects to file a registration statement for the WebMD Health IPO in early 2005, following the release of its year-end financial statements, subject to the Board s evaluation of market conditions at that time. WebMD does not anticipate making any decisions until after the IPO is completed regarding whether any additional equity will be sold or any other subsequent transaction will occur. WebMD s Board of Directors has formed a special committee, consisting of Martin Wygod, Mark Adler and Neil Dimick, to provide oversight of the preparations for the WebMD Health IPO.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of WebMD s financial condition and results of operations are based upon our Consolidated Financial Statements and Notes to Consolidated Financial Statements, which were prepared in conformity with U.S. generally accepted accounting principles. The preparation of the consolidated financial statements requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base our estimates on historical experience, current business factors, and various other assumptions that we believe are necessary to form a basis for making judgments about the carrying values of assets and liabilities and disclosure of contingent assets and liabilities. We are subject to uncertainties such as the impact of future events, economic, environmental and political factors, and changes in our business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in preparation of our financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in reported results of operations; if material, the effects of changes in estimates are disclosed in the notes to our consolidated financial statements.

We evaluate our estimates on an ongoing basis, including those related to revenue recognition, short-term and long-term investments, deferred tax assets, income taxes, collectibility of customer receivables, prepaid content and distribution services, long-lived assets including goodwill and other intangible assets, software development costs, inventory valuation, certain accrued expenses, accruals related to our restructuring program, contingencies, litigation and the value attributed to warrants issued for services.

We believe the following reflects our critical accounting policies and our more significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue.* Our revenue recognition policies for each reportable segment are as follows:

*Transaction Services or WebMD Business Services.* Healthcare payers and providers pay us fees for our services, generally on a per transaction basis or monthly basis. We recognize revenue as we perform the service. Healthcare payers and providers also pay us one-time implementation and annual maintenance fees. We recognize revenue from these fees ratably over the term of the respective agreements. Healthcare payers also pay us fees for utilizing our software products and related post-contract customer support agreements, which we generally recognize ratably over the term of the maintenance and license agreements. Certain governmental agencies pay us fees for software maintenance and consulting services, which we recognize as we perform those services.

*Physician Services or WebMD Practice Services.* Healthcare providers pay us one-time fees for the purchase of our practice management systems. We recognize revenue from these one-time fees when we enter into noncancelable agreements with our customers, the products have been delivered and there are no uncertainties regarding product acceptance and delivery, no significant future performance obligations exist, fees are fixed and determinable and collectability is probable. Amounts received in advance of meeting these criteria are deferred until we meet these criteria. Revenue from multiple-element software arrangements is recognized using the residual method as vendor specific objective evidence ( VSOE ) of fair value exists for the undelivered elements, but not for all of the delivered elements. The residual method requires revenue to be allocated to the undelivered elements based on the fair value of such elements, as indicated by VSOE. VSOE is based on the price charged when an element is sold separately. Healthcare providers also pay us fees for maintenance and support of their practice management system, including the hardware and software. We recognize revenue from these fees ratably over the contract period, typically in one year or less. Healthcare providers also pay us fees for transmitting transactions to payers and patients. We recognize revenue from these fees, which are generally paid on a monthly or per transaction basis, as we provide the service.

*Portal Services or WebMD Health.* Customers pay us for advertising, sponsorship, healthcare management tools, content syndication and distribution, and e-commerce transactions related to our online distribution channels and the online and offline distribution channels of our strategic partners. In addition, in connection with our Medscape portal, our customers