HEALTHSTREAM INC
Form 10-Q
May 12, 2008

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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 March 31, 2008
Commission File No.: 000-27701
HealthStream, Inc.
(Exact name of registrant as specified in its charter)

Tennessee	**62-1443555**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
209 10th Avenue South, Suite 450 Nashville, Tennessee	**37203**
(Address of principal executive offices)	(Zip Code)

(615) 301-3100
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

As of May 7, 2008, 22,274,692 shares of the registrant s common stock were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2008 (Unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,753,365	$ 3,599,346
Restricted cash	50,508	13,504
Interest receivable	14,813	17,340
Accounts receivable, net of allowance for doubtful accounts of $57,743 and $72,895 at March 31, 2008 and December 31, 2007, respectively	7,170,857	8,668,093
Accounts receivable unbilled	1,160,134	1,051,198
Deferred tax assets, current	360,312	360,312
Prepaid development fees, net of amortization	810,326	991,732
Other prepaid expenses and other current assets	1,130,804	976,883
Total current assets	15,451,119	15,678,408
Property and equipment:		
Equipment	12,000,349	11,812,721
Leasehold improvements	1,763,167	1,800,633
Furniture and fixtures	1,587,114	1,597,768
	15,350,630	15,211,122
Less accumulated depreciation and amortization	(11,279,708)	(10,827,932)
	4,070,922	4,383,190
Capitalized software feature enhancements, net of accumulated amortization of $1,725,791 and $1,453,720 at March 31, 2008 and December 31, 2007, respectively	4,346,171	4,458,644
Goodwill	21,146,864	21,146,864
Intangible assets, net of accumulated amortization of $8,939,165 and $8,682,555 at March 31, 2008 and December 31, 2007, respectively	5,447,977	5,704,587
Deferred tax assets, noncurrent	1,629,550	1,629,550
Other assets	310,840	360,214
Total assets	$ 52,403,443	$ 53,361,457
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 395,957	$ 1,741,917
Accrued liabilities	2,714,959	3,519,055
Accrued compensation and related expenses	705,092	727,280
Registration liabilities	44,507	7,243
Commercial support liabilities	313,936	265,050

Deferred revenue	10,589,665	9,492,970
Current portion of long term debt	711,008	706,698
Current portion of capital lease obligations	88,339	124,099
Total current liabilities	15,563,463	16,584,312
Long term debt, less current portion	851,661	1,031,037
Capital lease obligations, less current portion	22,002	32,490
Commitments and contingencies		
Shareholders equity:		
Common stock, no par value, 75,000,000 shares authorized; 22,331,523 and 22,315,485 shares issued and outstanding at March 31, 2008 and December 31, 2007, respectively	97,313,535	97,126,520
Accumulated deficit	(61,347,218)	(61,412,902)
Total shareholders equity	35,966,317	35,713,618
Total liabilities and shareholders equity	$ 52,403,443	$ 53,361,457

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2008	**2007**
Revenues, net	$ 11,421,700	$ 8,101,339
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization).	4,527,773	2,915,014
Product development	1,284,432	1,078,651
Sales and marketing	2,552,275	1,734,427
Depreciation	521,497	356,196
Amortization	724,550	499,703
Other general and administrative expenses	1,767,276	1,608,284
Total operating costs and expenses	11,377,803	8,192,275
Income (loss) from operations	43,897	(90,936)
Other income (expense):		
Interest and other income	46,129	147,560
Interest and other expense	(24,342)	(8,009)
Total other income	21,787	139,551
Income before income taxes	65,684	48,615
Income tax provision		4,066
Net income	$ 65,684	$ 44,549
Net income per share:		
Basic	$ 0.00	$ 0.00
Diluted	$ 0.00	$ 0.00
Weighted average shares of common stock outstanding:		
Basic	22,086,945	21,935,787
Diluted	22,727,096	22,603,095

See accompanying notes to the condensed consolidated financial statements.

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HEALTHSTREAM, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)
THREE MONTHS ENDED MARCH 31, 2008

	Common Stock			
	Shares	**Amount**	**Accumulated Deficit**	**Total Shareholders Equity**
Balance at December 31, 2007	22,315,485	$ 97,126,520	$ (61,412,902)	$ 35,713,618
Net income			65,684	65,684
Stock based compensation		152,934		152,934
Exercise of stock options	16,038	34,081		34,081
Balance at March 31, 2008	22,331,523	$ 97,313,535	$ (61,347,218)	$ 35,966,317

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2008	**2007**
OPERATING ACTIVITIES:		
Net income	$ 65,684	$ 44,549
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	521,497	356,196
Amortization	724,550	499,703
Stock based compensation expense	152,934	146,617
Realized loss on disposal of property and equipment	7,472	
Changes in operating assets and liabilities, excluding effects of acquisition:		
Accounts and unbilled receivables	1,388,300	1,672,713
Restricted cash	(37,004)	117,142
Interest receivable	2,527	49,911
Prepaid development fees	(14,464)	(223,370)
Other prepaid expenses and other current assets	(153,921)	(52,718)
Other assets	49,375	188,617
Accounts payable	(1,345,960)	(415,565)
Accrued liabilities and accrued compensation and related expenses	(817,090)	(716,103)
Registration liabilities	37,264	(108,987)
Commercial support liabilities	48,886	7,328
Deferred revenue	1,096,695	920,293
Net cash provided by operating activities	1,726,745	2,486,326
INVESTING ACTIVITIES:		
Acquisition, net of cash acquired	(9,194)	(11,936,748)
Proceeds from maturities and sales of investments in marketable securities		2,500,000
Purchases of investments in marketable securities		(800,000)
Payments associated with capitalized software feature enhancements	(159,597)	(524,876)
Purchases of property and equipment	(216,702)	(299,107)
Net cash used in investing activities	(385,493)	(11,060,731)
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	34,081	1,350
Payments on promissory note	(175,066)	
Payments on capital lease obligations	(46,248)	(44,918)
Borrowings under revolving credit facility		1,500,000
Payments under revolving credit facility		(1,500,000)
Net cash used in financing activities	(187,233)	(43,568)

Net increase (decrease) in cash and cash equivalents	1,154,019	(8,617,973)
Cash and cash equivalents at beginning of period	3,599,346	10,725,780
Cash and cash equivalents at end of period	$ 4,753,365	$ 2,107,807

See accompanying notes to the condensed consolidated financial statements.

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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 months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The balance sheet at December 31, 2007 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, 2007 (included in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission).

2. RECENT ACCOUNTING PRONOUNCEMENTS

On September 20, 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. On February 12, 2008, the FASB issued FASB Staff Position SFAS No. 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2). FSP 157-2 amended SFAS No. 157, to delay the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). FSP 157-2 defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP 157-2. The Company became subject to the remaining provisions of SFAS No. 157 on January 1, 2008. The adoption of SFAS No. 157 did not have any impact on our financial condition, results of operations, or cash flow.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). This new standard provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The FASB believes that SFAS No. 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new Statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS No. 157 and SFAS No. 107, Disclosures about Fair Value of Financial Instruments. The Company adopted SFAS No. 159 on January 1, 2008. The Company did not elect the fair value option, therefore the adoption of SFAS No. 159 did not have any impact on our financial condition, results for operations, or cash flow.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS No. 141(R)). SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141(R) changes the accounting for acquisition-related restructuring cost accruals and the recognition of changes in the acquirer s income tax valuation allowance, and no longer permits the capitalization of certain acquisition costs. In addition the Statement establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. This Statement is effective beginning January 1, 2009 for the Company. Management is currently evaluating the impact that adoption of this new standard will have on the

Company s financial position, results of operations, and cash flows.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51 (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective beginning January 1, 2009 for the Company. Management is currently evaluating the impact that adoption of this new standard will have on the Company s financial position, results of operations or cash flows.

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HEALTHSTREAM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. INCOME TAXES

Income taxes are accounted for under the provisions of SFAS No. 109, Accounting for Income Taxes (SFAS No. 109). Under SFAS No. 109, deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. Under the provisions of SFAS No. 109, management evaluates all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character within the carryback or carryforward period available under the tax law. SFAS No. 109 identifies four possible sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards: 1) future reversals of existing taxable temporary differences, 2) future taxable income exclusive of reversing temporary differences and carryforwards, 3) taxable income in prior carryback year(s) if carryback is permitted under the tax law, and 4) tax-planning strategies that would, if necessary, be implemented to realize deductible temporary differences or carryforwards prior to their expiration. Management reviews the realizability of deferred tax assets each period and has established a valuation allowance for the portion of its net deferred tax assets that are not more likely than not expected to be realized.

The Company s effective tax rate for the quarters ended March 31, 2008 and March 31, 2007 is substantially less than the statutory rate because a significant portion of our taxable income has been offset through utilization of our net operating loss carryforwards. The Company s effective tax rate could change in the future based on our projections of taxable income, changes in federal or state tax rates, or changes in state apportionment factors, as well as changes in the valuation allowance applied to the Company s deferred tax assets.

The Company accounts for income tax uncertainties under the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). As of March 31, 2008 and December 31, 2007, the Company s condensed consolidated balance sheets did not reflect a liability for uncertain tax positions, nor any accrued penalties or interest associated with income tax uncertainties. The Company is subject to income taxation at the federal and various state levels. The Company is subject to U.S. federal tax examinations for tax years through 2007, subject to the statute of limitations. The Company has no income tax examinations in process.

4. STOCK BASED COMPENSATION

The Company maintains two stock incentive plans and an Employee Stock Purchase Plan. We account for our stock based compensation plans under the provisions of SFAS No. 123(R), Share-Based Payments, which requires companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments, including stock options. We use the Black Scholes option pricing model for calculating the fair value of awards issued under our stock based compensation plans. We did not grant stock options during the three months ended March 31, 2008. During the three months ended March 31, 2007, we granted 436,000 stock options with a weighted average grant date fair value of $2.43. The fair value of stock based awards granted during the three months ended March 31, 2007 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

Risk-free interest rate	4.45 -- 4.50%
Expected dividend yield	0.0%
Expected life (in years)	5
Expected forfeiture rate	30%
Volatility	75%

Total stock based compensation expense recorded for the three months ended March 31, 2008 and 2007, which is recorded in our statement of operations, is as follows:

	Three months ended March 31,

	2008	2007
Cost of revenues (excluding depreciation and amortization)	$ 10,800	$ 10,488
Product development	33,248	38,851
Sales and marketing	50,214	36,132
Other general and administrative	58,672	61,146
Total stock based compensation expense	$ 152,934	$ 146,617

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HEALTHSTREAM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATION

On March 12, 2007, the Company acquired all of the stock of The Jackson Organization, Research Consultants, Inc. (TJO). TJO provides healthcare organizations a wide range of quality and satisfaction surveys, data analyses of survey results, and other research-based measurement tools. Consideration paid to the sellers of TJO included approximately $11.5 million in cash and 252,616 shares of our common stock. The Company also incurred direct, incremental expenses associated with the acquisition of approximately $689,000, of which approximately $9,000 was paid during the first quarter of 2008 in connection with completion of the valuation of acquired intangible assets. All of the shares of common stock issued in the acquisition are being held in an escrow account for eighteen months from the acquisition date, subject to any claims for indemnification pursuant to the stock purchase agreement. Of the cash consideration portion, approximately $750,000 is being held in escrow pending satisfaction of certain items pursuant to the stock purchase agreement. There have been no claims against the stock escrow and cash escrow accounts as of March 31, 2008. The results of operations for TJO have been included in the Company s statement of operations beginning March 12, 2007.

The following unaudited combined results of operations give effect to the operations of TJO as if the acquisition had occurred as of January 1, 2007. These unaudited combined results of operations include certain adjustments arising from the acquisition such as adjustment for TJO shareholder compensation, amortization of intangible assets, elimination of acquisition costs incurred by TJO, and the elimination of interest income associated with cash paid for TJO by the Company. The pro forma combined 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.

	Three months ended March 31, 2007	
Revenue	$	10,651,478
Net income	$	251,632
Net income per share:		
Basic	$	0.01
Diluted	$	0.01

6. 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 1.6 million at both March 31, 2008 and March 31, 2007.

The following table sets forth the computation of basic and diluted net income per share for three months ended March 31, 2008 and 2007:

Three months ended

	March 31, 2008	March 31, 2007
Numerator:		
Net income	$ 65,684	$ 44,549
Denominator:		
Weighted average shares outstanding:		
Basic	22,086,945	21,935,787
Employee stock options and escrowed shares	640,151	667,308
Diluted	22,727,096	22,603,095
Net income per share:		
Basic	$ 0.00	$ 0.00
Diluted	$ 0.00	$ 0.00

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HEALTHSTREAM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. BUSINESS SEGMENTS

We provide our services to healthcare organizations, pharmaceutical and medical device companies, and other members within the healthcare industry. Our services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). 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, 2007.

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 following is our business segment information as of and for the three months ended March 31, 2008 and 2007.

	Three months ended	
	March 31, 2008	March 31, 2007
Revenues		
Learning	$ 7,496,706	$ 6,478,559
Research	3,924,994	1,622,780
Total net revenue	$ 11,421,700	$ 8,101,339
Income (loss) from operations		
Learning	$ 1,839,437	$ 1,575,554
Research	28,863	(42,982)
Unallocated	(1,824,403)	(1,623,508)
Total income (loss) from operations	$ 43,897	$ (90,936)

	March 31, 2008	December 31, 2007
Segment assets		
Learning *	$ 15,343,047	$ 17,270,540
Research *	26,275,665	26,284,097
Unallocated	10,784,731	9,806,820
Total assets	$ 53,403,443	$ 53,361,457

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

8. GOODWILL

We account for goodwill under the provisions of SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). We test goodwill for impairment using a discounted cash flow model. 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. 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 in which such a determination is made.

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HEALTHSTREAM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. GOODWILL (continued)

On March 12, 2007, we acquired TJO. The amount of goodwill related to the acquisition of TJO at March 31, 2007 represented a preliminary estimate, and was subsequently adjusted based on the final purchase price allocation. There were no changes in the carrying amount of goodwill during the three months ended March 31, 2008.

	Learning	Research	Total
Balance at January 1, 2008	$ 3,306,688	$ 17,840,176	$ 21,146,864
Changes in carrying value of goodwill			
Balance at March 31, 2008	$ 3,306,688	$ 17,840,176	$ 21,146,864

	Learning	Research	Total
Balance at January 1, 2007	$ 3,306,688	$ 7,010,705	$ 10,317,393
Changes in carrying value of goodwill		8,976,906	8,976,906
Balance at March 31, 2007	$ 3,306,688	$ 15,987,611	$ 19,294,299

9. 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 $256,610 and $168,581 for the three months ended March 31, 2008 and 2007, respectively.

Identifiable intangible assets are comprised of the following:

	As of March 31, 2008			As of December 31, 2007		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Customer related	$ 9,915,000	$ (4,688,193)	$ 5,226,807	$ 9,915,000	$ (4,470,224)	$ 5,444,776
Content	3,500,000	(3,500,000)		3,500,000	(3,500,000)	
Other	972,142	(750,972)	221,170	972,142	(712,331)	259,811

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