IDT CORP
Form 10-K
October 15, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[ü] Annual report pursuant to section 13 or 15(d) of the securities exchange act of 1934 for the fiscal year ended July 31, 2007, or

[ ] Transition report pursuant to section 13 or 15(d) of the securities exchange act of 1934.

Commission File Number: 1-16371

IDT Corporation

(Exact name of registrant as specified in its charter)

Delaware	**22-3415036**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

520 Broad Street Newark, New Jersey 07102

(Address of principal executive offices, zip code)

(973) 438-1000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Class B common stock, par value $.01 per share	New York Stock Exchange
Common stock, par value $.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ü] No [ ]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [ü]

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 [ü] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ü]

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

Large accelerated filer [ ] Accelerated filer [ü] Non-accelerated filer [ ]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the closing price on January 31, 2007 (the last business day of the registrant s most recently completed second fiscal quarter) of the Class B common stock of $13.45 and of the common stock of $13.93, as reported on the New York Stock Exchange, was approximately $607 million.

As of October 5, 2007, the registrant had outstanding 56,043,551 shares of Class B common stock, 9,816,988 shares of Class A common stock, and 14,996,273 shares of common stock. Excluded from these numbers are 7,217,652 shares of Class B common stock and 10,078,587 shares of common stock held in treasury by IDT Corporation.

DOCUMENTS INCORPORATED BY REFERENCE

The definitive proxy statement relating to the registrant s Annual Meeting of Stockholders, to be held December 18, 2007, is incorporated by reference into Part III of this Form 10-K to the extent described therein.

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IDT Corporation

Annual Report on Form 10-K

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Part I

As used in this Annual Report, unless the context otherwise requires, the terms the Company, IDT, we, us, and our refer to IDT Corporation, a Delaware corporation, its predecessor, International Discount Telecommunications, Corp., a New York corporation, and its subsidiaries, collectively. Each reference to a fiscal year in this Annual Report refers to the fiscal year ending in the calendar year indicated (for example, fiscal 2007 refers to the fiscal year ended July 31, 2007).

Item 1. Business.

OVERVIEW

We are a multinational holding company with operations that span several industries. Our principal businesses consist of:

- IDT Telecom, through which we provide telecommunications services and products worldwide to retail and wholesale customers, including prepaid and rechargeable calling cards, consumer local and long distance service, prepaid wireless phone services and wholesale carrier services;
- IDT Energy, which operates our Energy Services Company, or ESCO, in New York State;
- IDT Carmel, our receivables portfolio management and collection businesses;
- IDT Local Media, which is primarily comprised of CTM Brochure Display, our brochure distribution company, and the WMET AM radio station in the Washington, D.C. metropolitan area; and
- IDT Internet Mobile Group, under which we operate our Zedge websites and platform geared toward content for mobile devices, and Zedge Studios, which is focused on creating and distributing proprietary and licensed content for traditional and internet/mobile distribution.

We hold assets and operate other smaller or early-stage initiatives and operations under our IDT Capital subsidiary, including IDT Spectrum, which holds a significant number of Federal Communications Commission, or FCC, licenses for commercial fixed wireless spectrum in the United States, Ethnic Grocery Brands, our grocery distribution business, IDT Global Services, which is primarily comprised of call center operations, and certain real estate investments.

IDT began operations in 1990 offering international call re-origination services. As we grew, we shifted our focus to carrying international telecommunications traffic for other carriers at competitive rates, utilizing a least-cost-routing system, and then began providing those services to retail customers through the introduction of prepaid calling cards in 1997, and the launch of consumer long-distance services in 1993. Via Net2Phone, we introduced VoIP services in 1996.

Throughout our history, IDT has invested in a number of non-telecom businesses, including in the entertainment industry. We sold IDT Entertainment to affiliates of Liberty Media Corporation in fiscal 2007.

We conduct our business through the following reportable segments:

- Prepaid Products;
- Consumer Phone Services;
- Wholesale Telecommunications Services; and
- IDT Energy.

Prepaid Products, Consumer Phone Services and Wholesale Telecommunications Services comprise IDT Telecom. All other operating segments that are not reportable individually are called IDT Capital.

IDT Telecom. IDT Telecom s business consists principally of:

- our Prepaid Products segment, which sells prepaid and rechargeable calling cards and wireless services;
- our Consumer Phone Services segment, which sells consumer local, long distance and mobile phone services; and

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our Wholesale Telecommunications Services segment, which sells telecommunications services to wholesale customers.

IDT Telecom, particularly the Prepaid Products segment, is facing extraordinary competitive and other pressures, which have caused a decline in its revenues and an increase in its operating and net losses. IDT Telecom s competitors continue to aggressively price their services. In addition, there has been a gradual shift in demand away from calling cards and into wireless products, which has further eroded pricing power in our calling card business. Furthermore, we believe that many of our calling card competitors do not operate in accordance with relevant regulations and do not provide their customers with all services purchased. We have commenced legal action and a lobbying campaign in an attempt to level the playing field in the calling card industry.

Our Prepaid Products segment markets and sells prepaid and rechargeable calling cards in the United States and abroad, providing telephone services to more than 230 countries and territories. Our prepaid calling cards are marketed primarily to ethnic and immigrant communities in the United States, Europe, Latin America and Asia that generate high levels of international call volume.

In the United States, our prepaid calling cards are mainly distributed to retail outlets, including local groceries, convenience stores, newsstands and gas stations, through our 51%-owned U.S. calling card distribution partnership, Union Telecard Alliance, LLC, or UTA. UTA utilizes a network of more than 1,000 sub-distributors, ranging from large companies to sole proprietors that sell to retail outlets throughout the United States. In addition to UTA s sub-distributors network, UTA is in the early stages of developing its own direct-to-retailer distribution network in order to increase revenues and margins by, among other things, driving sales with an increased brand identity. We believe that the development of UTA s direct-to-retailer distribution network may take significant time, and there is no assurance UTA can successfully or cost-effectively build such a network or that the development of this distribution network may not otherwise adversely affect our business.

Our Prepaid Products segment also markets private label retail and promotional calling cards primarily to retail chains.

We sold approximately 220 million prepaid calling cards during fiscal 2007. Our Prepaid Products segment generated $936.7 million in revenues and had an operating loss of $81.5 million in fiscal 2007.

Our Prepaid Products segment markets our prepaid calling cards in Europe, Latin America, Asia Pacific and Africa.

Our Prepaid Products segment also includes TúYo Mobile, the wireless unit of IDT Telecom that operates as a Mobile Virtual Network Operator, or MVNO, which markets wireless services utilizing another company s network.

Our Consumer Phone Services segment operates in the United States, and continued to operate during a portion of fiscal 2007 in parts of Europe until the business was sold. In the United States, we offer bundled local and long distance phone service in 11 states, marketed under the brand name IDT America. As of July 31, 2007, we provided such services to approximately 78,000 customers. We also provided stand-alone long distance service to approximately 207,000 customers in the United States as of July 31, 2007. Beginning in fiscal 2006, due to changes in the U.S. regulatory environment, we significantly curtailed marketing efforts for our consumer phone services business in the United States, but continue to provide services. This has resulted in a sharp decline in our revenues and customer base from this business. Our United Kingdom-based consumer phone services business, marketed under the Toucan brand name, was sold to Pipex Communications plc in early fiscal 2007. Our Netherlands consumer phone services business, also marketed under the Toucan brand name, was also sold in early fiscal 2007, resulting in our exit from the consumer phone service business in Europe. In fiscal 2007, Consumer Phone Services had revenues of $148.8 million and an operating income of $69.9 million, which includes the $44.7 million gain on the sale of our Toucan business.

Our Wholesale Telecommunications Services segment carries our international telecommunications traffic and the international traffic of other telecommunications companies. This segment also acts as the sales channel for

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all telecommunications services sold to our wholesale customers, which number approximately 620 worldwide. In fiscal 2007, Wholesale Telecommunications Services had revenues of $645.1 million and an operating loss of $35.2 million.

Beginning in fiscal 2007, our Prepaid Products and Wholesale Telecommunications Services segments also include our Voice over IP, or VoIP, business, which consists primarily of our Net2Phone subsidiary. Net2Phone provides VoIP communications services to resellers, consumers, cable operators and service providers globally.

In fiscal 2007, IDT Telecom s revenues represented 86.0% of our total consolidated revenues.

IDT Energy. IDT Energy operates our energy services company, or ESCO, which resells natural gas and electrical power to residential consumers and select small business customers throughout seven utility markets in New York State. As an ESCO, IDT Energy does not own electrical power generation, transmission or distribution facilities, or natural gas production pipeline or distribution facilities, but instead purchases natural gas through wholesale suppliers and various utility companies, and buys electricity in the wholesale market in time-specific, bulk or block quantities, usually at fixed prices. IDT Energy also manages internally all of its energy procurement from its numerous suppliers and its supply.

In fiscal 2007, IDT Energy had revenues of $190.8 million, representing 9.5% of our total consolidated revenues, and operating income of $11.4 million.

IDT Capital. IDT Capital is responsible for developing, incubating and, in some cases, operating our newer businesses, as well as overseeing certain existing non-core businesses. IDT Capital consists primarily of:

- IDT Carmel, which operates our management and collection of aged receivables businesses;
- IDT Local Media, which is primarily comprised of CTM Brochure Display, our brochure distribution company, and WMET 1160 AM, our Washington, D.C.-based radio station;
- IDT Internet Mobile Group, under which we operate our Zedge websites and platform geared toward content for mobile devices, and Zedge Studios, which is focused on creating and distributing proprietary and licensed content for traditional and internet/mobile distribution; and
- Other smaller holdings and operations including call center operations, a grocery distribution business, real estate investments, as well as IDT Spectrum, through which we hold a significant number of Federal Communications Commission, or FCC, licenses for commercial fixed wireless spectrum in the United States.

In fiscal 2007, IDT Capital had revenues of $91.3 million, representing 4.5% of our total consolidated revenues, and an operating loss of $53.6 million.

Additional Information. Financial information by segment is presented below under the heading Business Segment Information in the Notes to our Consolidated Financial Statements in this Annual Report.

Our main offices are located at 520 Broad Street, Newark, New Jersey 07102. The telephone number at our headquarters is (973) 438-1000 and our web site is www.idt.net.

We make available free of charge through the investor relations page of our web site (www.idt.net/ir) our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to these reports, and all beneficial ownership reports on Forms 3, 4 and 5 filed by directors, officers and beneficial owners of more than 10% of our equity as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission. We have adopted codes of business conduct and ethics for all of our employees, including our principal executive officer, principal financial officer and principal accounting officer. Copies of the codes of business conduct and ethics are available on our web site.

Our web site and the information contained therein or incorporated therein are not incorporated into this Annual Report on Form 10-K or our other filings with the Securities and Exchange Commission.

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KEY EVENTS IN OUR HISTORY

We entered the telecommunications business in 1990, providing international call re-origination service. In 1993, we began reselling the long distance services of other carriers. In 1995, we began selling access to the favorable international telephone rates we received as a result of our calling volume to other long distance carriers.

We completed an initial public offering of our common stock on March 15, 1996. Our common stock was quoted on the NASDAQ National Market until February 26, 2001, when it was listed on the New York Stock Exchange, where it now trades under the symbol IDT.C. On May 31, 2001, we distributed a stock dividend of one share of our Class B common stock for each outstanding share of our common stock, Class A common stock and Class B common stock. On June 1, 2001, our Class B common stock was listed on the New York Stock Exchange and now trades under the symbol IDT.

We entered the Internet telephony market in 1996 with our introduction, through Net2Phone, of PC2Phone, the first commercial service to connect voice calls between personal computers and telephones over the Internet.

We began marketing prepaid calling cards in January 1997.

In August 1999, Net2Phone completed an initial public offering of its common stock, and completed a follow-on offering in December 1999. In connection with the second offering, we sold 2.2 million shares of Net2Phone common stock for proceeds of $115.0 million.

In August 2000, we completed the sale of 14.9 million shares of Net2Phone common stock to AT&T for approximately $1.1 billion in cash.

In November 2004, we launched our retail energy business that provides natural gas and electricity to residential and select small business customers throughout New York State.

In March 2006, we consummated a merger with Net2Phone, in which we acquired all outstanding shares of Net2Phone that were not acquired by us in a tender offer. In connection with the tender offer and the merger, IDT paid a total consideration of $97.1 million for 46.6 million shares of Net2Phone common stock.

Also, in March 2006, we sold our Russian telecom business, Corbina Telecom, to a Moscow-based consortium of private equity investors. Net proceeds for the transaction after banking and other transaction-related costs were $129.9 million in cash.

RECENT DEVELOPMENTS

IDT Entertainment

In the first quarter of fiscal 2007, we completed the sale of our IDT Entertainment segment to Liberty Media Corporation for (i) 14.9 million shares of our Class B common stock and Liberty Media s approximate 4.8% interest in IDT Telecom, (ii) $229.5 million in cash, subject to certain working capital adjustments, (iii) the repayment of $58.7 million of IDT Entertainment s intercompany indebtedness payable to IDT and (iv) the assumption of all of IDT Entertainment s existing indebtedness. We agreed to repay Liberty Media $9.5 million for working capital adjustments, of which $1.0 million was paid in fiscal 2007 and the remaining $8.5 million was paid in the first quarter of fiscal 2008. We are also eligible to receive additional consideration from Liberty Media based upon any appreciation in the value of IDT Entertainment over the five-year period following the closing of the transaction or a shorter period under specified circumstances (Contingent Value), equal to 25% of the excess, if any, of the net equity value of IDT Entertainment over $453 million. However, we would have to pay Liberty Media up to $3.5 million if the Contingent Value does not exceed $439 million.

Toucan

In the first quarter of fiscal 2007, we sold our United Kingdom-based consumer phone services business, which we marketed under the Toucan brand name, to Pipex Communications plc in exchange for $38.4 million in cash (including the assumption of intercompany obligations owed to IDT and its subsidiaries) and 43.2 million Pipex ordinary shares which we later sold for $7.9 million. Toucan was launched in November 2003 and marketed local, long distance, broadband and wireless communications services to customers in the United Kingdom and the Netherlands. Our Netherlands consumer phone services business, also marketed under the Toucan brand name, was sold in early fiscal 2007, resulting in our exit from the consumer phone service business in Europe.

IDT Carmel

In the second quarter of fiscal 2007, FFPM Carmel Holdings I, LLC, which is 99% owned by IDT Carmel Portfolio Management, LLC, a subsidiary of the Company s IDT Capital division, and 1% owned by First Financial Portfolio Management, Inc. (FFPM), committed to purchase 12 monthly forward flow credit card debt portfolios from a major commercial bank. The total investment of the Company will depend on the size of the portfolios provided by the selling bank, to a maximum commitment of $125 million for the 12 monthly portfolios. As of July 31, 2007, our maximum remaining outstanding commitment was $52 million. FFPM manages the portfolios, subject to IDT Carmel Portfolio Management s approval rights over major decisions. During fiscal 2007, (i) IDT Carmel Portfolio Management purchased debt portfolios with a face value of $997.6 million for $78.4 million, including $57.3 million of credit card debt through FFPM Carmel Holdings I, LLC, and (ii) IDT Carmel s principal collections and proceeds from resale of debt portfolios totaled $28.1 million. The carrying value of the receivables in the portfolio management business as of July 31, 2007 was $51.1 million.

IDT Internet Mobile Group

In the second quarter of fiscal 2007, we formed our Internet Mobile Group and acquired 90% of Norway-based Zedge.net, a social networking community for mobile users and provider of free mobile content, for cash of $2.1 million and an aggregate of $1.3 million to be paid in equal installments in December 2007 and December 2008. In addition, in December 2006 we invested $7.0 million in Zedge preferred shares. In June 2007, the Company acquired for IDT Internet Mobile Group a controlling interest in IDW Publishing for $2.5 million, which is net of cash acquired of $1.6 million. IDW is an independent comics publisher pre-eminent in the horror and action genres, boasting such high-profile titles as *The Transformers, 30 Days of Night, CSI, Star Trek, 24,* and *Scarface*.

IDT Telecom

In the third quarter of fiscal 2007, UTA and IDT Telecom commenced a civil anti-fraud lawsuit against certain of their competitors in the U.S. pre-paid calling card market. The lawsuit alleges, among other things, that the defendants are systematically falsely selling minutes that consumers cannot obtain from the calling cards that they have purchased. The complaint alleges that the defendants deceptive practice causes consumers to lose more than one million dollars per day. To date, three of the named defendants have agreed to a settlement of the lawsuit and agreed to work to change what we deem to be unlawful and deceptive practices in the prepaid calling card industry.

In the first quarter of fiscal 2008, we reached a settlement with respect to our previously disclosed litigation with Aerotel involving an alleged patent infringement. The settlement provides for a payment of $15 million in cash to Aerotel, which we paid in the first quarter of fiscal 2008, and making available to Aerotel calling cards or PINs over time with potential termination costs of up to $15 million, subject to certain other conditions. In connection with this settlement, we accrued an expense in the fourth quarter of fiscal 2007.

OTHER CHANGES

Towards the end of the third quarter of fiscal 2006, we initiated a company-wide cost savings program to better align our infrastructure to our current business needs. As of July 31, 2007, this program resulted in the termination of approximately 880 employees. These terminations resulted in approximately $25.0 million and $20.0 million in severance costs in fiscal 2007 and 2006, respectively. We expect to realize cost savings of approximately $45 million to $50 million on an annualized basis related to these terminations.

STRATEGY

We intend to, where appropriate, make strategic acquisitions and dispositions with respect to our telecommunications businesses. From time to time, we evaluate potential acquisitions and disposition of companies, technologies, products and customer accounts. We intend to expand our geographic penetration of our prepaid calling cards, particularly in Latin America, Asia and Eastern Europe, as well as invest in the growth of TúYo Mobile. We have placed our consumer phone service business in harvest mode, wherein we seek to

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retain existing customers but do not actively market to new customers, and to maximize its profits by managing costs associated with this business. We intend to expand our wholesale carrier business by launching higher-margin services, such as SMS and VoIP services. Additionally, we intend to continue expanding our direct relationships with mobile network providers, reflecting our belief that the trend of voice traffic transitioning from landline to mobile networks will continue. We also plan to leverage our existing sales channels by expanding customer relationships to include sales of our new products.

We also intend to make strategic investments and acquisitions to complement and/or expand our IDT Capital segment, which may include the purchase of businesses and/or assets in the local media and other industries, as well as additional purchases of consumer debt businesses and/or portfolios, which we are aggressively pursuing. In considering investments and acquisitions, we search for opportunities to profitably grow our existing businesses, to add qualitatively to the range of businesses in the IDT portfolio and to achieve operational synergies. In addition, we intend to seek opportunities in new businesses, particularly businesses where we believe we can achieve synergies and optimize our systems, infrastructure and operational expertise.

IDT TELECOM

Our Telecom business currently provides our customers with a variety of services, including:

- prepaid debit and rechargeable calling cards;
- mobile wireless services;
- consumer phone services; and
- wholesale carrier services.

Prepaid Product Services

Prepaid Debit and Rechargeable Calling Cards

We sell prepaid debit and rechargeable calling cards under the IDT, Entrix, DSA and PT-1 brand names, providing telephone access to more than 230 countries and territories. We also sell select cards under the Net2Phone brand name, including the Net2Phone Direct and PennyTalk calling cards. We sell more than 1,000 different prepaid calling cards in the United States, and more than 350 different cards abroad, with specific cards featuring favorable rates to specific international destinations.

Our prepaid calling cards are marketed primarily to the ethnic and immigrant communities in the United States, Europe, Asia and Latin America that tend to generate high levels of international volume. Specifically, a large portion of our U.S. calling cards are purchased by the Hispanic community resulting in a significant proportion (76% in fiscal 2007, 72.1% in fiscal 2006 and 69.2% in fiscal 2005) of our international prepaid calling card minutes being terminated in Latin America.

Our prepaid calling card business has traditionally been strongest in the northeastern United States because of UTA s extensive local distribution network and of our competitive rates to countries that immigrants in the northeastern United States tend to call, such as Colombia, Mexico and the Dominican Republic. In fiscal 2007, prepaid calling card sales in the northeastern United States were approximately 36% of our total U.S. prepaid calling card sales, as compared to 27.9% in fiscal 2006 and 31.1% in fiscal 2005. The fluctuations are based on the expansion of our operation in areas of the United States outside of the Northeast and the disparate impact of competition, including the unfair competition discussed elsewhere in the report, on operation in different areas.

We primarily market our prepaid calling cards to retail outlets in the United States through UTA, a joint venture which is owned 51% by us and 49% by the Gomez Family Trust. UTA utilizes a network of more than 1,000 sub-distributors that sell to retail outlets throughout most of the United States. UTA develops marketing and distribution strategies for our prepaid calling card products, including card design, pricing and market expansion opportunities. UTA generated $569.5 million in revenues from its sale of IDT calling cards, representing 97.8% of UTA s total revenues, in fiscal 2007.

In addition to UTA s network of sub-distributors, UTA is in the early stages of developing its own direct-to-retailers distribution network in an attempt to increase revenues and margins by, among other things, driving sales with an increased brand identity. We believe that the development of UTA s direct-to retailer distribution network may take significant time, and there is no assurance UTA can successfully or cost-effectively build such a network or that the development of this distribution network may not otherwise adversely affect our business.

We also sell prepaid calling cards in Europe, Latin America and Asia, as discussed in detail in the International Operations section below. Although calling card revenue is comparatively low in Latin America and Asia, we believe that these will continue to be growth areas for our calling card business.

Our Prepaid Products segment markets a variety of prepaid calling cards, including:

- Customized (Private Label) Retail Calling Cards. We market these prepaid calling cards to major national retailers, who sell them primarily in high-traffic stores. We print these prepaid calling cards with the retailer s name and logo and provide them to the retailer, who in turn sells the cards to its customers.
- IDT-Branded Retail Calling Cards. These prepaid calling cards are printed with the IDT logo and design and are sold to small and medium-sized retail chains, such as supermarkets, drug stores and convenience stores, for resale to their customers.

Our rechargeable calling cards, marketed to consumers and business customers nationwide, can be used by U.S. callers to call internationally from any phone, including a cell phone. In addition, callers can use the cards to make calls from over 30 countries around the world through international toll-free services. At the customer s request, an account is automatically recharged with a credit card that the customer provides at the time of initial card activation.

During fiscal 2007, our Prepaid Products segment worldwide generated $936.7 million in revenues, as compared with $1.195 billion in fiscal 2006 and $1.246 billion in fiscal 2005. Our calling card businesses account for over 97% of the revenues of our Prepaid Products segment. During fiscal 2007, we sold 85.3% of our prepaid products in the United States, as compared to 86.8% and 86.0% in the United States in fiscal 2006 and fiscal 2005, respectively.

We believe that the following factors are advantages that we have against our competition that we seek to exploit, and if a level playing field is established in the industry (see Competition section below), we believe these advantages will enable us to achieve a significant market share:

- our ability to offer customers attractive pricing, due to our extensive network of interconnection and termination arrangements, purchasing power and least-cost-routing system;
- our prepaid platform, which is a proprietary database that keeps track of the remaining balance on each calling card, and which enables us to process a large number of cards and transactions simultaneously and provide multilingual, multi-currency and multi-function cards;
- our extensive distribution channel, which covers a wide variety of retail outlets worldwide;
- the quality and dependability of the telephone service we provide; and
- our understanding of, and commitment to, the ethnic prepaid calling card market.

In all of our IDT Telecom businesses, particularly the calling cards business, competitors continue to aggressively price their services. In addition, there has been a gradual shift in demand away from calling cards and into wireless products, which has further eroded pricing power in our calling card business. In our wholesale markets as well, we have generally had to pass along portions of our per-minute cost savings to our customers in the form of lower prices. These trends have impacted our telecom businesses, and as a result we have generally experienced declines in our revenues, profits and overall per-minute price realizations.

The declines in minutes predominantly in our U.S. calling card business occurred despite the implementation of price cuts to several destinations. Historically, there had been an inverse relationship between our pricing and calling volume as we increased prices, minutes of use would decrease with an increase in minutes following lowering of prices. However, during fiscal 2007, we did not experience an increase in minutes-of-use or sales of new cards, despite our aggressive lower pricing.

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The breakdown in this price/volume relationship in our U.S. calling card business and a concurrent analysis of our major markets led us to investigate the calling cards of our major competitors. We believe that certain of our competitors were significantly overstating the number of minutes delivered by their cards. Accordingly, on March 8, 2007, we filed a civil anti-fraud action in the federal district court in Newark, New Jersey, claiming that these competitors have been misleading calling card customers, and as a result, negatively impacting our market share, resulting in a reduction of our revenues and profits. Although the judge in this case decided not to grant the preliminary injunction we requested, which decision was affirmed on appeal, we are continuing to pursue this lawsuit. In addition, we have commenced a lobbying campaign in an attempt to level the playing field in the calling card industry. We are uncertain, even with the potential of fair competition, whether we will be able to regain revenues lost over the past number of quarters.

Mobile Wireless Services

TúYo Mobile is the wireless unit of IDT Telecom that operates as a Mobile Virtual Network Operator, or MVNO, which markets wireless services utilizing another company s network. TúYo aims to take advantage of IDT Telecom s existing prepaid platform infrastructure and competitive international termination rates to provide low cost wireless phone service to the U.S. Hispanic community, which currently comprises the largest proportion of our calling card customer base. The service was also launched as a response to the ongoing and intensifying trend of wireless substitution in the prepaid market segment, wherein traditional calling card users have been transitioning from wireline phones to mobile phones to make their calls.

TúYo Mobile launched commercial operations in November 2005. Although TúYo Mobile is an early growth-stage company, it had approximately 100,000 active subscribers as of July 31, 2007. TúYo s handsets are presently distributed through third party cellular distributors, and through local ethnic markets affiliated with UTA s distribution, and is currently participating in a multi-state trial with a major US big box retailer. Túyo handsets are subsidized by the Company in the form of commission credits to the distributors. Wireless top up cards, used to add minutes of use to existing handsets, are also sold at these locations as well as in electronic PIN distribution only outlets (like Blackstone terminals).

In March 2007, TúYo Mobile launched its newest calling feature, Conecta2. This calling feature allows callers in Mexico, Argentina, Chile, Colombia and the Dominican Republic to call TúYo Mobile subscribers in the United States for free, while the subscriber pays TúYo Mobile s international rates plus airtime for the call. The Conecta2 service also provides TúYo Mobile subscribers with a toll free access number in their participating country of choice.

During fiscal 2007, our TúYo Mobile generated $24.0 million in revenues, as compared with $4.8 million in fiscal 2006. TúYo Mobile represents approximately 2.6% of the total revenues of our Prepaid Products segment.

Consumer Phone Services

We currently provide our bundled local/long distance phone service in 11 states, marketed under the brand name IDT America. Our bundled local/long distance service, offered primarily to residential customers, includes unlimited local, regional toll and domestic long distance calling and popular calling features. A second plan is available, providing unlimited local service with IDT long distance included for as low as 3.9 cents per minute. With either plan, competitive international rates and/or additional features can be added for additional monthly fees. We also offer stand-alone long distance service throughout the United States. Due to changes in the U.S. regulatory environment in 2005 that affected our cost of providing bundled local/long distance phone services (as discussed below under the heading Interconnection and Unbundled Network Elements) and increased competition, we significantly curtailed marketing activities for the service, and as a result, the revenues and number of customers have declined significantly.

Consumer Phone Services generated revenues of $148.8 million in fiscal 2007, as compared to $262.1 million in 2006 and $333.8 million in 2005. As of July 31, 2007, we had approximately 78,000 active customers for our bundled local/long distance plans and approximately 207,000 customers for our metered long distance plans. Our highest customer concentrations are in large urban areas, with the greatest number of customers located in New York, New Jersey, Pennsylvania and California.

Wholesale Telecommunications Services

Our Wholesale Telecommunications Services segment carries our international telecommunications traffic and the international traffic of other telecommunications companies. This segment also acts as the sales channel for all telecommunications services sold to our wholesale customers.

By utilizing our proprietary least-cost-routing system and capitalizing on our own high volume of international long distance telephone traffic generated by our calling card business, aggressive purchasing strategies and extensive experience in provisioning circuits, we are able to provide major carriers and niche carriers alike with rates that we believe are often lower than those traditionally available through other carriers. Wholesale telecommunications services revenues were $645.1 million in fiscal 2007, as compared with revenues of $597.7 million in fiscal 2006 and $592.9 million in fiscal 2005.

During fiscal 2007, IDT Telecom s wholesale carrier services business continued operating as a full service telecommunications provider. IDT Telecom terminates over 16 billion international minutes per year (over 20 billion minutes overall), making IDT one of the largest carriers of international minutes worldwide. Within our wholesale carrier services business, our Mobile Operator Services group provides mobile operators with data and voice products, and our VoIP Services group provides carriers with a quick and efficient expansion into the VoIP marketplace. Our strategy enables us to manage costs on a carrier-by-carrier basis, while diversifying our portfolio of product offerings to various regions around the world. Due to the acquisition of Net2Phone in fiscal 2006 and its network integration into IDT Telecom, we are now able to better serve the needs of wholesale carrier customers who seek IP products and services.

We believe that a direct connection from one of our switches to a Tier 1 provider (which are the largest recognized licensed carriers in each country) both increases the quality of a call and reduces cost. We also believe that establishing such connections enables us to generate more traffic with higher margins to that foreign locale. During fiscal 2008, we intend to continue to expand our existing direct relationships with Tier 1 providers, particularly in Asia and Africa. Additionally, we intend to continue expanding our direct relationships with mobile network providers, reflecting our belief that the trend of voice traffic transitioning from landline to mobile networks will continue. We also plan to leverage our existing sales channels by expanding customer relationships to include sales of our new products.

In addition to offering competitive rates to our carrier customers, we have also emphasized our ability to offer the high quality connections that these providers often require. To that end, we have broadened our wholesale carrier services offerings to include higher-priced, premium services in which we guarantee higher quality connections, based upon a set of predetermined quality-measuring criteria. These services meet a growing need for some of our customers, who are providing services to high-value, quality-conscious retail customers. As of July 31, 2007, our wholesale carrier services business had approximately 620 customers. Including vendors, IDT has over 840 carrier relationships globally.

Through Net2Phone, we also sell VoIP communications products and services. In March 2006, we consummated a merger with Net2Phone in which Net2Phone became our wholly owned subsidiary. Beginning in the first quarter of fiscal 2007, Voice over IP was no longer reported as a separate segment; rather it was included in the results for IDT Telecom.

Net2Phone s network has now been fully integrated into IDT Telecom. Our short-term focus is on streamlining our global network through the hybridization of the Net2Phone and IDT networks. We continue to market using the Net2Phone brand name where we believe we can realize a competitive advantage through this established name.

International Operations

We maintain our European corporate and carrier operations in London, England, and our retail calling card business headquarters in Dublin, Ireland. IDT Europe operates satellite offices in Germany, France, the Netherlands, Belgium, Switzerland, Czech Republic, Spain, Sweden, Greece, Italy, Bosnia and Denmark.

In Europe, we market our prepaid calling cards in the United Kingdom, the Netherlands, Spain, Germany, Belgium, France, Ireland, Italy, Luxemburg, Sweden, Switzerland, Denmark, Norway, Portugal, Austria and Greece, seeking to capitalize on the opportunity presented by immigration from underdeveloped countries to Europe s developed nations. Because the immigrant market is fragmented, and due to the large number of markets in which we compete, we offer over 250 different prepaid calling cards in Europe. We also market our prepaid calling cards in Israel.

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We recently launched IDT Mobile in the Netherlands, United Kingdom and Belgian markets. IDT Mobile sells international wireless minutes in Europe on prepaid SIM cards.

We also provide wholesale carrier services to European telecom companies, including foreign state-owned or state sanctioned post, telephone or telegraph companies and Tier-1 carriers, new and emerging telephone companies, and value-added service providers.

Our European operations generated $353.6 million of revenues in fiscal 2007, a 15.9% decrease over the $420.5 million of revenues generated during fiscal 2006. Our European operations revenues constituted 20.4% of our Telecom revenues in fiscal 2007, as compared to 20.5% in fiscal 2006 and 19.6% in fiscal 2005. During fiscal 2007, prepaid calling cards constituted 29.8% of our European operations revenues, while wholesale carrier services represented 65.2%.

We believe there is a significant market for prepaid calling cards in Asia Pacific. We maintain Asia Pacific headquarters in Hong Kong and African headquarters in Johannesburg, South Africa. IDT Asia Pacific operates satellite offices in Singapore, the Philippines, India and Japan. We began our Asia Pacific regional operations in 2003, offering wholesale carrier services in the region and prepaid calling card distribution in Hong Kong. We have since expanded our prepaid calling card operations into Singapore, the Philippines, India, Japan and Korea. In fiscal 2007, we generated $12.9 million in revenues from the sale of calling cards in the Asia Pacific region.

We also believe there is a lucrative market for prepaid calling cards in Latin America and in Africa. We maintain Latin American headquarters in Buenos Aires, Argentina. IDT Latin America currently sells cards in Argentina, Brazil, Peru, Chile, and Uruguay. We have, additionally, launched consumer phone services and VoIP services in Argentina, Brazil and Peru, and expect to launch VoIP and consumer phone services in Chile during fiscal 2008, as well as expand our geographic penetration into more countries such as Colombia and El Salvador. In fiscal 2007, we generated $19.6 million in revenues from the sale of calling cards in Latin America.

Sales Marketing and Distribution

We market our prepaid calling cards primarily to retail outlets in the United States through an exclusive distribution agreement with our majority-owned subsidiary, UTA. In addition to UTA s sub-distributors, UTA is in the early stages of developing its own direct-to-retailer distribution network in order to increase revenues and margins by, among other things, driving sales with an increased brand identity. We believe that our direct-to-retailer distribution network may take significant time to develop, and there is no assurance we can build such a network. In addition, our customized retail calling cards and our IDT-branded retail calling cards are also marketed to retail chains and outlets primarily through our own internal sales force, although from time to time we may utilize third-party agents or brokers to acquire accounts. We market our consumer phone services primarily through direct television and print advertising in targeted markets, although such marketing has been significantly scaled back in the United States since fiscal 2005. In Europe, we sell our prepaid calling cards and our customized retail and IDT-branded retail calling cards through independent distributors and our own internal sales force. Wholesale carrier services are sold through IDT s internal wholesale sales team. TúYo Mobile products are marketed through retail stores, national, regional and local wireless distributors and through UTA s distribution channels. These sales are supported by a combination of print, radio and television advertising.

Telecommunication Network Infrastructure

We maintain a global telecommunications switching and transmission infrastructure that enables us to provide an array of telecommunications services to our customers worldwide. Our network is continuously monitored by our Network Operations Centers in the United States and Europe.

We have historically made significant expenditures designed to expand and optimize our global telecommunications network. After our acquisition of Net2Phone in March 2006, we greatly expanded the VoIP capabilities of our network by integrating the Net2Phone network into the IDT Telecom network. Due to this expansion of the VoIP capabilities of our network and a decrease in demand in traffic, we decommissioned a U.S.-based switch. We now operate a total of six international gateway switches, four in the United States and two in the United Kingdom. We are in the process of decommissioning one of the U.K.-based international

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gateway switches in order to more efficiently service the decreased traffic. In addition, we have extensive soft-switching capacity in the United States, United Kingdom, Argentina, Peru, Brazil and Hong Kong. We also maintain points of presence, or POPs, providing interconnect capabilities in numerous countries. Our global network is connected through leased and owned fiber connections.

Our near-term focus is on reducing costs by streamlining our global network through the hybridization of the Net2Phone and IDT networks, expanding our soft-switching capacity, and expanding our VoIP traffic.

IDT ENERGY

In November 2004, we launched our retail energy business, which has since experienced significant growth. Today, IDT Energy operates as an energy service company, or ESCO, that resells natural gas and electricity to customers throughout seven utility markets in New York State, including those currently served by Con Ed, Orange and Rockland, Central Hudson, National Fuel, National Grid, Keyspan, and Rochester Gas and Electric.

As an ESCO, IDT Energy does not own electrical power generation, transmission, or distribution facilities, or natural gas production, pipeline or distribution facilities, but instead purchases natural gas through wholesale suppliers and various utility companies, and buys electricity in the wholesale market in time-specific, bulk or block quantities, usually at fixed prices. The vast majority of our electricity is purchased through the New York State competitive wholesale markets for capacity, energy and ancillary services administrated by the New York Independent System Operator. Independent System Operators, or ISOs, and Regional Transmission Organizations, or RTOs, perform real-time load balancing for each of the electrical power grids in which we operate. Similarly, load balancing is performed by the utilities or Local Distribution Companies, or LDCs, for each of the natural gas markets in which we operate. Load balancing ensures that the amount of electricity and natural gas we purchase is equal to the amount necessary to service our customers demands at any specific point in time. We are charged or credited by the ISOs, RTOs and LDCs for balancing the electricity and natural gas purchased and sold for our account.

We manage the differences between the actual electricity and natural gas demands of our customers and our bulk or block purchases by buying and selling any shortfall or excess in the spot market, and through monthly cash settlements and/or adjustments to future deliveries in accordance with the load balancing performed by the utilities, LDCs and the New York ISO.

The electricity and natural gas we sell is generally metered and delivered to our customers by the local utilities. As such, IDT Energy does not maintain any maintenance or service staff for customer locations, as such services are provided by the local incumbent utility. These utilities may also provide billing and collection services for the majority of our customers on our behalf.

The ESCO business, particularly for the natural gas segment, is a seasonal business. Approximately 77% of annual natural gas revenues are generated during the Company s second and third fiscal quarters when heat load is highest. The load curve for electricity is not as seasonal as natural gas, but is higher during the Company s first and fourth fiscal quarters when air conditioning usage peaks. Electric revenues in the first and fourth quarters represent approximately 57% of annual electric revenues. Commodity prices are generally higher during these peak demand seasons, and, therefore contribute to the seasonal fluctuation in revenues.

We market our energy services primarily through direct marketing methods, including D2D (Door-to-Door) sales, outbound telemarketing, and Internet signup. The aggressive customer growth experienced can be attributed to IDT Energy s successful expansion into many of the LDCs that comprise New York State. Additionally, the outsourced vendors that are relied upon for customer acquisition have significantly expanded their sales and support staff. The New York PSC published web site in March 2007 quotes that approximately 13.8% of eligible New York customers migrated from a utility to an ESCO. According to these statistics, IDT has captured approximately 15.7% of the migrated customers. Many of its customers reside in Con Edison territory with IDT capturing approximately 36.3% of the migrated customers.

In fiscal 2007, IDT Energy generated revenues of $190.8 million and operating income of $11.4 million, as compared with revenues of $112.8 million and operating income of $1.1 million in fiscal 2006 and revenues of

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$12.0 million and an operating loss of $1.6 million in fiscal 2005. As of July 31, 2007, IDT Energy serviced approximately 300,000 meters in New York State, as compared to approximately 200,000 meters serviced at the end of fiscal 2006.

IDT CAPITAL

IDT Capital is responsible for developing, incubating and, in some cases, operating our newer businesses, as well as overseeing certain existing non-core businesses. IDT Capital consists primarily of our acquisition and collection of aged receivables operation that operates under the names IDT Carmel Portfolio Holdings and IDT Carmel, our IDT Local Media unit (which is primarily comprised of CTM Brochure Display and WMET radio), IDT Internet Mobile Group (which is comprised of our Zedge platform consisting of Zedge.net and Zedge.com and Zedge Studios), Ethnic Grocery Brands, call center operations, and other smaller holdings and operations including real estate initiatives. During fiscal 2007, IDT Capital generated $91.3 million in revenues and an operating loss of $53.6 million, as compared with revenues of $58.9 million and $37.8 million in fiscal 2006 and fiscal 2005, respectively. Operating losses of IDT Capital were $68.8 million in fiscal 2006 and $55.0 million in fiscal 2005.

IDT Carmel

IDT Carmel was launched in fiscal 2006, initially as a natural outgrowth of our internal collection activities, and is engaged in the acquisition and resolution of charged-off debt portfolios, and debt collection services. The company acquires portfolio assets at a discount to face value and services such portfolios in an effort to maximize ultimate cash recoveries. IDT Carmel also provides debt collection services for debt portfolios owned by third parties for a service fee. IDT Carmel also outsources some of its portfolios for collection by other agencies.

IDT Carmel s initial entry into the third-party charged-off consumer receivables market has been focused on portfolios of credit-card issuers.

IDT Carmel Group is comprised of IDT Carmel Holdings, Inc. and its two wholly owned subsidiaries IDT Carmel Portfolio Management LLC (engaged in portfolio acquisitions) and IDT Carmel, Inc. (engaged in servicing and collecting debt portfolios).

On January 9, 2007, FFPM Carmel Holdings I, LLC, which is 99% owned by IDT Carmel Portfolio Management and 1% owned by First Financial Portfolio Management, Inc., committed to purchase 12 monthly forward flow credit card debt portfolios from a major commercial bank.

During fiscal 2007, (i) IDT Carmel Portfolio Management purchased debt portfolios for $78.4 million, including $57.3 million of credit card debt through FFPM Carmel Holdings I, LLC and (ii) IDT Carmel s principal collections and proceeds on resale of debt portfolios totaled $28.1 million. The carrying value of the receivables in the portfolio management business as of July 31, 2007 is $51.1 million.

During fiscal 2007, Carmel grew to 40 employees at its Newark, New Jersey main office, its Jerusalem, Israel branch, and its Minneapolis, Minnesota satellite office (scheduled to become a collection branch during fiscal 2008). Carmel also completed the build-up of its upper management team by recruiting industry-experienced executives. During fiscal 2007, Carmel continued to make progress toward the expected closing during fiscal 2008 of the second stage of its two-part acquisition from JKW Financial, LLC of the assets of JKW s wholly owned subsidiaries, People First Recoveries, LLC and Big Ten Capital Management, LLC, that is anticipated to result in the addition of 140 employees and three branch offices in Minneapolis, Minnesota.

IDT Local Media

IDT Local Media includes CTM Brochure Display, Inc., our brochure distribution company, WMET 1160 AM, our Washington, D.C.-based radio station, and other smaller initiatives involving local level advertising.

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During fiscal 2006, these businesses were pooled together as IDT Local Media, to better align our internal management focus on local level advertising with these various business units. In fiscal 2007, IDT Local Media had revenues of $22.6 million an operating loss of $2.2 million.

CTM is a distributor of travel and entertainment brochures in central and eastern United States, Puerto Rico and Canada. In fiscal 2007, CTM serviced over 3,000 clients and maintained more than 11,000 display racks, in over 30 states and provinces. CTM s display stands are located in travel and entertainment venues, including hotels, resorts, interstate highway rest areas, airports and local attractions. Through its local sales force, CTM sells brochure slots in these stands to local advertisers, maintains the stands and ensures placement and replenishment of brochures in the appropriate slots. In fiscal 2007, CTM generated revenues of $19.7 million and operating income of $1.3 million.

In accordance with IDT Local Media s plan to complement its traditional marketing services with new media internet based services, in September 2006 we acquired Local Pull, a nascent online directory listing business which creates customized search listings that are distributed to the leading local search engines. In fiscal 2007, the new media initiatives generated revenues of $1.1 million, which included Local Pull revenues of $0.4 million. We continue to seek acquisition candidates and partnerships with companies that could benefit from and leverage IDT Local Media s core competency of selling to many disparate local businesses via our telesales and direct sales channels.

We own and operate WMET 1160 AM, a radio station serving the Washington, D.C. metropolitan area, the nation s eighth-largest radio market, including the corridor from Baltimore, Maryland to Richmond, Virginia. WMET is primarily a reseller of radio broadcast time to outside parties. In this format, WMET earns revenues through the rental of airtime slots as well as the sale of advertising. In fiscal 2007, WMET generated revenues of $1.3 million and an operating loss of $1.4 million.

IDT Internet Mobile Group

In the second quarter of fiscal 2007, we formed our Internet Mobile Group, under which we operate our Zedge websites and platform geared toward content for mobile devices and Zedge Studios. In December 2006, we acquired 90% of the Norway based mobile Internet community Zedge.net. Zedge is a worldwide distribution platform and destination for free user-generated content for mobile devices. As of October 1, 2007, there were approximately 5.8 million registered users of Zedge.net. In June 2007, the Company acquired for IDT Internet Mobile Group a controlling interest in IDW Publishing, an independent comics publisher pre-eminent in the horror and action genres, boasting such high-profile titles as *The Transformers, 30 Days of Night, CSI, Star Trek, 24*, and *Scarface* that focuses on creating and distributing proprietary and license content for traditional and internet/mobile distribution. IDW is operated by the Zedge Studios division of IDT Internet Mobile Group.

COMPETITION

IDT Telecom

We believe that the principal competitive factor affecting our telecom business is the price of our services. Additionally, our ability to compete is dependent upon the quality and reliability of our services and our customer care. We also rely heavily upon our ability to innovate, which drives the continuing evolution of our suite of product and services offerings, enabling us to provide our customers with the services they seek. Many of our current and potential competitors have greater name recognition and greater financial, marketing, personnel and other resources than we do, as well as other competitive advantages. We anticipate that price competition will remain intense in all of our Telecom market segments.

Calling Card Services

We believe success in providing our calling card services is dependent on our ability to provide low rates and reliable service to our customers, while efficiently distributing our calling cards to a geographically and culturally diverse customer base. The calling card industry is notable for its relative lack of regulation compared to the rest of the telecommunications industry, and for its ease of market entry. As calling rates continue to decline and competition increases, thereby reducing the influence of pricing as a differentiating competitive factor, we will increasingly compete on the basis of our call quality, customer service and distribution capabilities.

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We compete with other providers of calling cards as well as established carriers and numerous small or regional operators, and with providers of alternative telecommunications services. Many of the largest telecommunications providers, including AT&T, Verizon and Sprint, currently market prepaid calling cards, which in certain cases compete with our cards. In marketing prepaid calling cards to customers outside the United States, we compete with large foreign state-owned or state sanctioned post, telephone or telegraph companies. We believe that our interconnect and termination agreements, network infrastructure and least-cost-routing system provide us with the ability to offer low-cost, high quality services, while our distribution network provides us with access to customers, and that these factors represent competitive advantages. However, as some of our competitors have significantly greater financial resources and name recognition, and are capable of providing comparable call quality and service levels, our ability to maintain and/or to capture additional market share will remain dependent upon our ability to continue to provide competitively priced services.

In all of our IDT Telecom businesses, competitors continue to aggressively price their services and there has been a gradual shift in demand away from calling cards and into wireless products, which has further eroded pricing power. These trends have impacted our telecom businesses, and as a result we have generally experienced sharp declines in both our revenues and overall per-minute price realizations.

We also believe that many of our calling card competitors in the United States are significantly overstating the number of minutes delivered by their cards. Accordingly, on March 8, 2007, we filed a civil anti-fraud action in the federal district court in Newark, New Jersey, claiming that these competitors have been misleading calling card customers, and as a result, negatively impacting our market share, resulting in a reduction of our revenues and profits. Although the judge in this case decided not to grant the preliminary injunction we requested, which decision was affirmed on appeal, we are continuing to pursue this lawsuit. We are uncertain, even with the potential of fair competition, whether we will be able to regain revenues lost over the past number of quarters.

TúYo Mobile

Competition in the MVNO market has been fierce, and a number of other start-ups also target the Hispanic demographic, including Movida Communications, DEXA Wireless and Azteca Mobile.

Wholesale Carrier Services

The wholesale carrier business has numerous entities competing for the same customers, primarily on the basis of price, products and quality of service. We believe that the industry consolidation will affect our wholesale carrier business by, among other things, reducing the number of customers to whom we can sell.

In the wholesale carrier services business, we compete with:

- interexchange carriers and other long distance resellers and providers, including large carriers such as AT&T, Verizon and Qwest;
- foreign state-owned or state-sanctioned post, telephone or telegraph companies such as Telefonica, France Telecom and KDD;
- on-line, spot-market trading exchanges for voice minutes, such as Arbinet;
- other VoIP providers;
- other providers of international long distance services; and
- alliances between large multinational carriers that provide wholesale carrier services.

We believe that our extensive network of interconnect and termination agreements, as well as the significant volume of traffic to specific locations generated by our wholesale and calling card businesses, provide us with a competitive advantage and the ability to offer quality services at competitive prices. However, we have generally had to pass along portions of our per-minute cost savings to our customers in the form of lower prices.

Consumer Phone and Related Services

We offer consumer long distance phone services to residential and business customers in the United States. In 11 states we also offer local and long distance phone services bundled at a flat monthly rate. The U.S. consumer phone services industry is characterized by intense competition, with numerous providers competing

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diversion of management s attention from other initiatives and/or day-to-day operations to effectively execute our growth strategy; and

inability to generate sufficient revenue, profit, and cash flow from acquisitions, joint ventures, collaborative arrangements or other growth investments to offset our investment costs.

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Our ability to accurately forecast revenue for certain products and services may be hindered by customer scheduling.

As revenues from our subscription business continue to increase, a larger portion of our revenues will be predictable; however, quarterly performance may be more subject to fluctuations. Our HealthStream Research/Patient Experience Solutions products and services are typically contracted by healthcare organizations for multi-year terms, but the frequency, sample size, and timing of survey cycles can vary from quarter to quarter and year to year. The contract structure for some Research/Patient Experience Solutions products gives customers latitude about when to initiate a survey, which can affect quarterly or annual revenue forecasts. Also, other project-based products, such as certain content development, and professional services, are subject to the customers involvement in the provision of the product or service. The timing and magnitude of these project-based product and service contracts may vary widely from quarter to quarter and year to year, and thus may affect our ability to accurately forecast quarterly and annual financial performance.

Our ability to accurately forecast revenue may be affected by lengthy and widely varying sales cycles.

The period from our initial contact with a potential customer and their first purchase of our solution typically ranges from three to nine months, and in some cases has extended much further. The range in the sales cycle can be impacted by multiple factors, including an increasing trend towards more formal request for proposal processes and more competition within our industry, as well as formal budget timelines which impact timing of purchases by target customers. New products tend to have a longer and more unpredictable revenue ramp period. As a result of these factors, we have only limited ability to forecast the timing and type of initial sales. This, in turn, makes it more difficult to forecast quarterly and annual financial performance.

We may not be able to maintain our competitive position against current and potential competitors, especially those with significantly greater financial, technical, marketing, or other resources.

Several of our competitors and many potential competitors have longer operating histories and significantly greater financial, technical, marketing, or other resources than we do. We encounter direct competition from both large and small e-learning companies and other companies focused on workforce development management in the healthcare industry. We also face competition from larger survey and research companies. Given the profile and growth of the healthcare industry and the growing need for education, training, simulation, research, and information, it is likely that additional competitors will emerge. We believe we maintain a competitive advantage against our competitors by offering a comprehensive array of products and services; however, our lack of market diversification resulting from our concentration on the healthcare industry may make us susceptible to losing market share to our competitors who also offer a complete e-learning solution to a cross-section of industries. These companies may be able to respond more quickly than we can to new or changing opportunities, technologies, standards or customer requirements. Further, most of our customer agreements are for terms ranging from one to four or five years, with no obligation to renew. The short terms of these agreements may enable customers to more easily shift to one of our competitors.

The failure to maintain and strengthen our relationships with strategic partners or significant changes in the terms of the agreements we have with them may have an adverse impact on our ability to successfully market our products and services.

We have entered into contracts with strategic partners, including content, technology, and retail channel vendors. Our ability to increase the sales of our products and services depends in part upon maintaining and strengthening relationships with these current and future strategic partners. Most of these contracts are on a non-exclusive basis. Certain strategic partners may offer products and services from multiple distinct companies, including, in some instances, products or services which may compete with our products and services. Moreover, under contracts with some of our strategic partners, we may be bound by provisions that restrict our ability to market and sell our products and services to certain potential customers. The success of these contractual arrangements will depend in part upon the strategic partners own competitive, marketing, and strategic considerations, including the relative advantages for such strategic partners in using alternative products being developed and marketed by them or our competitors, rather than our products and services.

We cannot guarantee that we will be able to maintain and strengthen our relationships with strategic partners, that we will be successful in effectively integrating such partners products and technology into our own, or that such relationships will be successful in generating additional revenue. If any of these strategic partners have negative experiences with our products and services, or seek to amend the financial or other terms of the contracts we have with them, we may need to increase our organizational focus on the types of services and solutions they sell and alter our development, integration, and/or distribution strategies, which may divert our planned efforts and resources from other projects.

Lastly, we could be subject to claims and liability, as a result of the activities, products, or services of these strategic partners, and/or our acts or omissions with regard to these strategic partners. Even if these claims do not result in liability to us, investigating and defending these claims could be expensive, time-consuming and result in suspension of or interference with certain offerings to our clients and/or adverse publicity that could harm our business.

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We may not be able to retain proper distribution rights from our content partners, and this could affect projected growth in courseware subscription revenue.

Most of our agreements with content providers are for initial terms of two to three years. The content partners may choose not to renew their agreements with us or may terminate the agreements early if we do not fulfill our contractual obligations. If a significant number of our content providers terminate or fail to renew their agreements with us on acceptable terms, it could result in a reduction in the number of courses we are able to distribute, causing decreased revenues. Most of our agreements with our content partners are non-exclusive, and our competitors offer, or could offer, training and continuing education content that is similar to or the same as ours. If publishers and authors, including our current content partners, offer information to users or our competitors on more favorable terms than those offered to us, or increase our license fees, our competitive position and our profit margins and prospects could be harmed. In addition, the failure by our content partners to deliver high-quality content and to revise their content in response to user demand and evolving healthcare advances and trends could result in customer dissatisfaction and inhibit our ability to attract and retain subscribers of our courseware offerings.

We may not be able to develop new products and services, or enhancements to our existing products and services, or be able to achieve widespread acceptance of new products, services or features, or keep pace with technological developments.

Our growth strategy depends in part on our ability to generate revenue growth through sales to new customers as well as increasing sales of additional courseware subscriptions and other products and services to existing customers. Our identification of additional features, content, products and services may not result in timely development of complementary products. In addition, the success of certain new products and services may be dependent on continued growth in our base of SaaS-based customers and we are not able to accurately predict the volume or speed with which existing and new customers will adopt such new products and services. Because healthcare training continues to change and evolve, we may be unable to accurately predict and develop new products, features, content and other products to address the needs of the healthcare industry. Further, the new products, services and enhancements we develop may introduce significant defects into or otherwise negatively impact our core software platform. While all new products and services are subject to testing and quality control, all software and software-based services are subject to errors and malfunctions. If we release new products, services and/or enhancements with bugs, defects or errors or that cause bugs, defects or errors in existing products, it could result in lost revenues, reduced ability to meet contractual obligations and would be detrimental to our business and reputation. If new products, features, or content are not accepted or integrated by new or existing customers, we may not be able to recover the cost of this development and our financial performance will be harmed. Continued growth of our SaaS-based customer population is dependent on our ability to continue to provide relevant products and services in a timely manner. The success of our business will depend on our ability to continue providing our products and services as well as enhancing our courseware, product and service offerings that address the needs of healthcare organizations.

We may be unable to continue to license our third party software, on which a portion of our product and service offerings rely, or we may experience errors in this software, which could increase our costs and decrease our revenue.

We use technology components in some of our products that have been licensed from third parties. Future licenses to these technologies may not be available to us on commercially reasonable terms, or at all. The loss of or inability to obtain or maintain any of these licenses could result in delays in the introduction of new products and services or could force us to discontinue offering portions of our workforce development or research/patient experience solutions until equivalent technology, if available, is identified, licensed and integrated. The operation of our products would be impaired if errors occur in third party technology or content that we incorporate, and we may incur additional costs to repair or replace the defective technology or content. It may be difficult for us to correct any errors in third party products because the products are not within our control. Accordingly, our revenue could decrease and our costs could increase in the event of any errors in this technology. Furthermore, we may become subject to legal claims related to licensed technology based on product liability, infringement of intellectual property or other legal theories. Even if these claims do not result in liability to us, investigating and defending these claims could be expensive, time-consuming and result in suspension of or interference with certain offerings to our clients and/or adverse publicity that could harm our business.

Financial Risks

A significant portion of our revenue is generated from a relatively small number of customers.

We derive a substantial portion of our revenues from a relatively small number of customers. A termination of our agreements with any of our significant customers or a failure of these customers to renew their contracts on favorable terms, or at all, could have a material adverse effect on our business.

A significant portion of our business is subject to renewal each year. Therefore, renewals have a significant impact on our revenue and operating results.

For the year ended December 31, 2013, approximately 72% of our net revenue was derived from our subscription-based solution products. Our subscription-based customers have no obligation to renew their subscriptions for our products or services after the expiration of the subscription agreement, and in fact, some customers have elected not to renew their subscription. In addition, our customers may renew at a lower pricing or activity level. Historically, we have reported renewal rates of our core platform, the HLC, and during the year ended December 31, 2013, we renewed 97% of the annual HLC contract value up for renewal and 97% of the

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HLC subscribers which were up for renewal. Our customers renewal rates may decline or fluctuate as a result of a number of factors, including but not limited to their dissatisfaction with our service, a dissipation or cessation of their need for one or more of our products or services, pricing or competitive product offerings. If we are unable to renew a substantial portion of the contracts that are up for renewal or maintain our pricing, our revenue could be adversely affected, which would have a material adverse affect on our results of operations and financial position. For example, the requirement mandated by CMS for healthcare organizations to transition to the ICD-10 coding system by October 2014 has generated significant demand for our ICD-10 training courseware. Subscriptions of ICD-10 courseware positively influenced the Company s revenue and operating income during 2013, and are expected to do the same during 2014. As ICD-10 subscriptions begin to expire during 2014 and 2015, customers may choose not to renew their subscriptions on similar terms or at all, which could result in a revenue decline in 2015 compared to 2014. HealthStream Research/Patient Experience Solutions product and service contracts typically range from one to three years in length, and customers are not obligated to renew their contract with us after their contract expires. If our customers do not renew their arrangements for our services, or if their activity levels decline, our revenue may decline and our business will suffer.

We may be unable to accurately predict the timing of revenue recognition from sales activity as it is often dependent on achieving certain events or performance milestones, and this inability could impact our operating results.

Our ability to recognize revenue is dependent upon several factors including the transfer of customer-specific information such as unique subscriber IDs, which are required for us to implement customers on our SaaS-based platform and certain platform applications. Accordingly, if customers do not provide us with the specified information in a timely manner, our ability to recognize revenue will be delayed, which could adversely impact our operating results. In addition, implementation completion and acceptance of our SaaS-based platform and certain platform applications by our customers must be achieved, survey responses must be received and tabulated, and delivery of courseware is required in connection with subscription-based products for us to recognize revenue.

Because we recognize revenue from subscriptions for our products and services over the term of the subscription period, downturns or upturns in sales may not be immediately reflected in our operating results.

We recognize approximately 72% of our revenue from customers monthly over the terms of their subscription agreements, which have initial contract terms ranging from one to four or five years. As a result, much of the revenue we report in each quarter is related to subscription agreements entered into during previous quarters. Consequently, a decline in new or renewed subscription agreements in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our products and services may not be fully reflected in our results of operations until future periods. Additionally, our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term. Finally, the majority of costs associated with our sales cycles are incurred up front before revenue recognition commences, and therefore periods of strong sales performance may increase our costs in the near term negatively affecting our financial performance.

We may not be able to meet our strategic business objectives unless we obtain additional financing, which may not be available to us on favorable terms, or at all.

We expect our current cash and investment balances, revolving credit facility, and cash flows from operations to be sufficient to meet our cash requirements through at least 2014. However, we may need to raise additional funds in order to:

- develop new, or enhance existing, services or products;
- respond to competitive pressures;
- finance working capital requirements;
- acquire complementary businesses, technology, content or products; or

otherwise effectively execute our growth strategy.

At December 31, 2013, we had approximately $108.2 million in cash, cash equivalents, and marketable securities. We also have up to $20.0 million of availability under a revolving credit facility, subject to certain covenants, which expires in July 2014. We expect to incur between $9.0 and $12.0 million of capital expenditures, software development and content purchases during 2014. We actively review possible business acquisitions to complement or enhance our products and services. We may not have adequate cash and investments or availability under our revolving credit facility to consummate one or more of these acquisitions. The capital markets have been experiencing extreme volatility and disruption, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, our ability to fund expansion, take advantage of available opportunities, develop or enhance services or products or otherwise respond to competitive pressures would be significantly limited. If we raise additional funds by issuing equity or convertible debt securities, the percentage ownership of our existing shareholders may be reduced.

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We have significant goodwill and identifiable intangible assets recorded on our balance sheet that may be subject to impairment losses that would reduce our reported assets and earnings.

As of December 31, 2013, our balance sheet included goodwill of $35.7 million and identifiable intangible assets of $8.9 million. There are inherent uncertainties in the estimates, judgments and assumptions used in assessing recoverability of goodwill and intangible assets. Economic, legal, regulatory, competitive, reputational, contractual, and other factors could result in future declines in the operating results of our business units or market value declines that do not support the carrying value of goodwill and identifiable intangible assets. If the value of our goodwill and/or intangible assets is impaired, accounting rules require us to reduce their carrying value and report an impairment charge, which would reduce our reported assets and earnings for the period in which an impairment is recognized.

The current uncertain economic environment may have a negative impact on our customers and us which could have a significant impact on our revenue, operating results and financial condition.

It is difficult to predict the full magnitude and duration of the current uncertain economic environment and its related impact on our customers, suppliers and our company. For example, our customers may experience fluctuations or declines in their business and as a consequence, some customers may choose to invest less in information technology assets for their business which, in turn, could have an impact on us. The potential negative effects on us include, but are not limited to, reductions in our renewal and revenue growth rates, shorter contract terms, pricing pressures, and delays in payments from customers that increase our accounts receivable resulting in a deterioration of our cash flow and working capital position. We continue to monitor general economic conditions, however, and depending on the severity and/or duration of any economic downturn, these circumstances could have a material adverse effect on our revenue, results from operations and financial condition.

We may not be able to demonstrate compliance with Sarbanes-Oxley Section 404 in a timely manner, and the correction of any deficiencies identified during upcoming annual audits may be costly and could harm our business.

Sarbanes-Oxley Section 404 requires our management to report on, and requires our independent public accounting firm to attest to, the effectiveness of our internal controls over financial reporting. The rules governing the standards to be met are complex and will require significant process review, documentation and testing, as well as possible remediation efforts for any identified deficiencies. This process of review, documentation, testing and remediation will result in increased expenses and require significant attention from management and other internal and external resources. Any material weaknesses identified during this process may preclude us from asserting the effectiveness of our internal controls. This may negatively affect our stock price if we cannot effectively remediate the issues identified in a timely manner.

Changes in generally accepted accounting principles (GAAP) and other accounting regulations and interpretations could require us to delay recognition of revenue and/or accelerate the recognition of expenses, resulting in lower earnings.

While we believe we correctly account for and recognize revenue and expenses, any changes in GAAP or other accounting regulations and interpretations concerning revenue and expense recognition could decrease our revenue or increase our expenses. Changes to regulations concerning revenue recognition could require us to alter our current revenue accounting practices and cause us to either defer revenue into a future period, or to recognize lower revenue in a current period. Likewise, changes to regulations concerning expense recognition could require us to alter our current expense accounting practices and cause us to defer recognition of expense into a future period, or to recognize increased expenses in a current period. Changes to either revenue recognition or expense recognition accounting practices could affect our financial performance.

Risks Related to Sales, Marketing and Competition

Our operating margins could be affected if our ongoing refinement to pricing models for our products and services is not accepted by our customers and the market.

We continue to make changes in our pricing and our product and service offerings to increase revenue and to meet the needs of our customers. We cannot predict whether our current pricing and products and services, or any ongoing refinements we make will be accepted by our existing customer base or by prospective customers. If our customers and potential customers decide not to accept our current or future pricing or product and service offerings, it could have a material adverse effect on our business.

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Risks Related to Operations

We may be unable to adequately develop our systems, processes and support in a manner that will enable us to meet the demand for our services.

We have provided our online products and services since 1999 and continue to develop our ability to provide our solutions on both a subscription and transactional basis over the Internet. Our future success will depend on our ability to effectively develop and maintain the infrastructure, including procurement of additional hardware and software, and implement the services, including customer support, necessary to meet the demand for our products and services. Our inability from time to time to successfully develop the necessary systems and implement the necessary services on a timely basis has resulted in our customers experiencing some delays, interruptions and/or errors in their service. Such delays or interruptions may cause customers to become dissatisfied with our service and move to competing providers of traditional and online training and education services. If this happens, our revenue and reputation could be adversely affected, which would have a material adverse effect on our financial condition.

Our business operations could be significantly disrupted if we lose members of, or fail to integrate, our management team.

Our future performance is substantially dependent on the continued services of our management team and our ability to retain and motivate them. The loss of the services of any of our officers or senior managers could harm our business, as we may not be able to find suitable replacements. We do not have employment agreements with any of our key personnel, other than our chief executive officer, and we do not maintain any key person life insurance policies.

We may not be able to hire and retain a sufficient number of qualified employees and, as a result, we may not be able to effectively execute our growth strategy or maintain the quality of our services.

Our future success will depend on our ability to attract, train, motivate, and retain other highly skilled technical, managerial, marketing, customer support, and survey personnel. Competition for certain personnel is intense, especially for developers, web designers and sales personnel, and we may be unable to successfully attract sufficiently qualified personnel. We have in the past and continue to experience difficulty hiring qualified personnel in a timely manner for these positions. The pool of qualified technical personnel, in particular, is limited in Nashville, Tennessee, where our headquarters are located. Our interviewing center is located in Laurel, Maryland, and we may experience difficulty in maintaining and recruiting qualified individuals to perform these services. We will also need to maintain or increase the size of our staff to support our anticipated growth, without compromising the quality of our offerings or customer service. Our inability to locate, hire, integrate and retain qualified personnel in sufficient numbers may reduce the quality of our services and impair our ability to grow.

We may not be able to upgrade our hardware and software technology infrastructure quickly enough to effectively meet demand for our services or our operations needs.

We must continue to obtain reasonably priced, commercially available hardware and operating software as well as continue to enhance our software and systems to accommodate the increased use of our platform, the increased courseware and content in our library, and the resulting increase in operational demands on our business. Decisions about hardware and software enhancements are based in part on estimated forecasts of the growth in demand for our services. This growth in demand for our services is difficult to forecast and the potential audience for our services is widespread and dynamic. If we are unable to increase the data storage and processing capacity of our systems at least as fast as the growth in demand, our customers may encounter delays or disruptions in their service. Unscheduled downtime could harm our business and also could discourage current and potential customers from using or continuing to use our services and reduce future revenue. If we are unable to acquire, update, or enhance our technology infrastructure and systems quickly enough to effectively meet increased operational demands on our business, that may also have a material adverse effect on our financial condition.

Our network infrastructure and computer systems and software may fail.

An unexpected event (including but not limited to a telecommunications failure, fire, earthquake, or other catastrophic loss) at our Internet service providers facilities or at our on-site data facility could cause the loss of critical data and prevent us from offering our products and services for an unknown period of time. System downtime could negatively affect our reputation and ability to sell our products and services and may expose us to significant third-party claims. Our business interruption insurance may not adequately compensate us for losses that may occur. In addition, we rely on third parties to securely store our archived data, house our web server and network systems and connect us to the Internet. While our service providers have planned for certain contingencies, the failure by any of these third parties to provide these services satisfactorily and our inability to find suitable replacements would impair our ability to access archives and operate our systems and software, and our customers may encounter delays. Such disruptions could harm our reputation and cause customers to become dissatisfied and possibly take their business to a competing provider, which would adversely affect our revenues.

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We may lose users and lose revenue if our security measures fail.

If the security measures that we use to protect customer or personal information are ineffective, we may lose users of our services, which could reduce our revenue, tarnish our reputation, and subject us to significant liability. We rely on security and authentication technology licensed from third parties. With this technology, we perform real-time credit card authorization and verification, as well as the encryption of other selected secure customer data. We cannot predict whether these security measures could be circumvented by new technological developments. Further, the audit processes and controls used within our production platforms may not be sufficient to identify and prevent errors or deliberate misuse. In addition, our software, databases and servers may be vulnerable to computer viruses, physical or electronic attacks and similar disruptions. We may need to spend significant resources to protect against security breaches or to alleviate problems caused by any breaches. We cannot assure that we can prevent all security breaches.

We may experience errors in our software products that administer and report on hospital performance, and these errors could result in action taken against us that could harm our business.

Certain survey data collected and reported by us, such as the survey data included as part of our CAHPS® Hospital survey is used by CMS to determine, in part, the amount of reimbursement payments to hospitals, and any errors in data collection, survey sampling, or statistical reporting could result in reduced reimbursements to our hospital customers if we are unable to correct these errors, and this could, in turn, result in litigation against us. Further, this survey data reported to CMS is then published by CMS to the general public, and any errors we experience that result in incorrect scoring on our hospital customer may result in damage to that hospital s reputation, and the hospital may in turn bring litigation against us. We may be required to indemnify against such claims, and defending against any such claims could be costly, time consuming and could negatively affect our business.

Risks Related to Government Regulation, Content and Intellectual Property

Government regulation may subject us to liability or require us to change the way we do business.

The laws and regulations that govern our business change rapidly. Evolving areas of law that are relevant to our business include privacy and security laws, proposed encryption laws, content regulation, information security accountability regulation, sales and use tax laws and regulations and attempts to regulate activities on the Internet. In addition to being directly subject to certain requirements of the HIPAA privacy and security regulations, we are required through contracts with our customers known as business associate agreements to protect the privacy and security of certain personal and health related information. As of September 23, 2013, we are required to comply with revised requirements under the HIPAA privacy and security regulations, except that existing business associate agreements may qualify for an extended compliance date of September 23, 2014. The rapidly evolving and uncertain regulatory environment could require us to change how we do business or incur additional costs. Further, we cannot predict how changes to these laws and regulations might affect our business. Failure to comply with applicable laws and regulations could subject us to civil and criminal penalties, subject us to contractual penalties, including termination of our customer agreements, damage our reputation and have a detrimental impact on our business.

We may not be able to maintain our certification to conduct CMS mandated surveys, and this could adversely affect our business.

Our survey product offerings include providing survey services to assist customers in their compliance with CMS regulations. We are currently designated by CMS as a certified vendor to offer CAHPS® Hospital Surveys and CAHPS® Home Health Care Surveys, including data collection and submission services. If we are unable to maintain these certifications, or secure certifications for future CMS mandated surveys, we would not be able to administer these survey instruments for our customers and our business may suffer.

Any reduction or change in the regulation of continuing education and training in the healthcare industry may adversely affect our business.

Our business model is dependent in part on required training and continuing education for healthcare professionals and other healthcare workers resulting from regulations of state and federal agencies, state licensing boards and professional organizations. Any change in these regulations that reduce the requirements for continuing education and training for the healthcare industry could harm our business. In addition, a portion of our business with pharmaceutical and medical device manufacturers and hospitals is predicated on our ability to maintain accreditation status with organizations such as the ACCME, ANCC, and ACPE. The failure to maintain status as an accredited provider could have a detrimental effect on our business.

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We may be liable to third parties for content that is available from our online library.

We may be liable to third parties for the content in our online library if the text, graphics, software or other content in our library violates copyright, trademark, or other intellectual property rights, our content partners violate their contractual obligations to others by providing content to our library, or the content does not conform to accepted standards of care in the healthcare profession. We attempt to minimize these types of liabilities by requiring representations and warranties relating to our content partners ownership of the rights to distribute as well as the accuracy of their content. We also take necessary measures to review this content ourselves. Although our agreements with our content partners in most instances contain provisions providing for indemnification by the content providers in the event of inaccurate content, our content partners may not have the financial resources to meet this obligation. Alleged liability could harm our business by damaging our reputation, requiring us to incur legal costs in defense, exposing us to awards of damages and costs, and diverting management s attention away from our business.

Protection of certain intellectual property may be difficult and costly, and our inability to protect our intellectual property could reduce the value of our products and services.

Despite our efforts to protect our intellectual proprietary rights, a third party could, without authorization, copy or otherwise misappropriate our content, information from our databases, or other intellectual property. Our agreements with employees, consultants and others who participate in development activities could be breached and result in our trade secrets becoming known, or our trade secrets and other intellectual property could be independently developed by competitors. We may not have adequate remedies for such breaches or protections against such competitor developments. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States, and effective intellectual property protection may not be available in those jurisdictions. We currently own several applications and registrations for trademarks and domain names in the United States and other countries as well as certain common law trademarks and service marks. The current system for registering, allocating and managing domain names has been the subject of litigation and proposed regulatory reform. Additionally, legislative proposals have been made by the federal government that would afford broad protection to owners of databases of information, such as stock quotes. This protection of databases already exists in the European Union.

Our business could be harmed if unauthorized parties infringe upon or misappropriate our intellectual property, proprietary systems, content, platform, services or other information. Our efforts to protect our intellectual property through copyright, trademarks and other controls may not be adequate. For instance, we may not be able to secure trademark or service mark registrations for marks in the United States or in foreign countries, or to secure patents for our proprietary products and services, and even if we are successful in obtaining patent and/or trademark registrations, these registrations may be opposed or invalidated by a third party.

There has been substantial litigation in the computer and online industries regarding intellectual property assets, particularly patents. Third parties may claim infringement by us with respect to current and future products, trademarks or other proprietary rights, and we may counterclaim against such third parties in such actions. Any such claims or counterclaims could be time-consuming, result in costly litigation, divert management s attention, cause product release delays, require us to redesign our products, restrict our use of the intellectual property subject to such claim, or require us to enter into royalty or licensing agreements, any of which could have a material adverse effect upon our business, financial condition and operating results. Such royalty and licensing agreements may not be available on terms acceptable to us, if at all.

We may be liable for infringing the intellectual property rights of others.

Our competitors may develop similar intellectual property, duplicate our products and/or services, or design around any patents or other intellectual property rights we hold. In the future, litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the patents, intellectual property or other proprietary rights of third parties, which could be time consuming and costly and have an adverse effect on our business and financial condition. Intellectual property infringement claims could be made against us, especially as the number of our competitors grows. These claims, even if not meritorious, could be expensive and divert our attention from operating our company and result in a temporary inability to use the intellectual property subject to such claim. In addition, if we and/or our affiliates and customers become liable to third parties for infringing their intellectual property rights, we could be required to pay a substantial damage award and develop comparable non-infringing intellectual property, to obtain a license, or to cease providing the content or services that contain the infringing intellectual property. We may be unable to develop non-infringing intellectual property or obtain a license on commercially reasonable terms, if at all.

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Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our principal office is located in Nashville, Tennessee. Our lease for approximately 73,000 square feet at this location expires in April 2017. The lease provides for a two-year renewal option with rates increasing during the renewal period. We are leasing approximately 19,000 square feet of office space in Laurel, Maryland. The lease expires in March 2016. We are leasing approximately 7,000 square feet of office space in Brentwood, Tennessee, and the lease expires in October 2015. We are also leasing approximately 6,000 square feet of office space in Pensacola Florida, and the lease expires in March 2015.

Item 3. ***Legal Proceedings***

None.

Item 4. ***Mine Safety Disclosures***

Not applicable.

PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock is traded on the NASDAQ Global Select Market under the symbol HSTM . Our common stock began trading on the NASDAQ National Market on April 14, 2000.

The following table sets forth, for each quarter of the two most recent years, the high and low closing prices per share of our common stock as reported on the NASDAQ Global Select Market:

	Common Stock Price			
	2013		2012	
	High	Low	High	Low
First Quarter	$ 25.23	$ 20.59	$ 24.05	$ 16.48
Second Quarter	27.75	20.04	26.22	20.72
Third Quarter	37.88	26.03	30.47	23.27
Fourth Quarter	39.46	30.21	30.53	22.28

As of February 27, 2014, there were 96 registered holders and 7,449 beneficial holders of our common stock. Because many of such shares are held by brokers and other institutions on behalf of shareholders, we are unable to estimate the total number of shareholders represented by these record holders.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our common stock, and we do not anticipate paying cash dividends in the foreseeable future. We intend to retain earnings for use in the operation of our business.

See the table labeled Securities Authorized for Issuance Under Equity Compensation Plans to be contained in our 2014 Proxy Statement, incorporated by reference in Part III, Item 12 of this Annual Report on Form 10-K.

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STOCK PERFORMANCE GRAPH

The graph below compares the cumulative total shareholder return on our common stock since December 31, 2008, with the cumulative total return of companies on the NASDAQ Composite Index and the NASDAQ Computer & Data Processing Index over the same period (assuming the investment of $100 in our common stock, the NASDAQ Composite Index and the NASDAQ Computer & Data Processing Index on December 31, 2008 (for our stock and the indices) and reinvestment of all dividends).

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN [(1)]

Among HealthStream, Inc., The NASDAQ Composite Index

And The NASDAQ Computer & Data Processing Index

(1) $100 invested on 12/31/2008 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

RECENT SALES OF UNREGISTERED SECURITIES

None.

ISSUER PURCHASES OF EQUITY SECURITIES

None.

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Item 6. ***Selected Financial Data***

The selected statement of income and balance sheet data for the past five years are derived from our audited consolidated financial statements. You should read the following selected financial data in conjunction with our consolidated financial statements and the notes to those statements and Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report.

HealthStream acquired DCI on June 29, 2012, Sy.Med on October 19, 2012, and BLG on September 9, 2013. The results of operations for these acquired companies are included within our consolidated statement of income data effective from the date of acquisition. Revenues may be subject to fluctuations as discussed further in Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report. During 2013, 2012, 2011, and 2010, we recorded a tax provision of approximately $6.4 million, $5.9 million, $4.4 million and $2.9 million, respectively. During 2009 we recognized portions of our deferred tax assets through the reversal of the valuation allowance, resulting in deferred income tax benefits of approximately $9.1 million. As a result of these factors, the annual results presented below are not comparable. The operating results for any single year are not necessarily indicative of the results to be expected in the future.

	Year Ended December 31, (in thousands, except per share data)				
	2013	**2012**	**2011**	**2010**	**2009**
STATEMENT OF INCOME DATA:					
Revenues, net	$ 132,274	$ 103,732	$ 82,066	$ 65,754	$ 57,398
Total operating costs and expenses	117,608	90,273	70,728	58,695	52,276
Income from operations	14,666	13,459	11,338	7,059	5,122
Net income	$ 8,418	$ 7,645	$ 6,944	$ 4,154	$ 13,972
Net income per share basic	$ 0.31	$ 0.29	$ 0.31	$ 0.19	$ 0.65
Net income per share diluted	$ 0.30	$ 0.28	$ 0.29	$ 0.18	$ 0.64
Weighted average shares of common stock outstanding basic	26,853	26,128	22,445	21,767	21,458
Weighted average shares of common stock outstanding diluted	27,663	27,507	23,748	22,488	21,838
BALANCE SHEET DATA:					
Cash and cash equivalents	$ 59,537	$ 41,365	$ 76,904	$ 17,868	$ 12,287
Marketable securities short and long term	48,659	51,952	12,548	5,703	
Accounts receivable, net	25,314	15,348	16,014	11,069	9,577
Goodwill and intangible assets	44,616	38,104	23,104	23,991	24,938
Working capital	90,912	83,259	78,631	19,524	10,714
Total assets	212,594	174,528	154,237	82,011	71,002
Deferred revenue	38,168	23,146	22,759	16,740	12,234
Shareholders equity	149,433	132,196	120,915	56,791	51,821

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion of the financial condition and results of operations of HealthStream should be read in conjunction with Selected Financial Data and HealthStream s Consolidated Financial Statements and related notes thereto included elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. HealthStream s actual results may differ significantly from the results discussed and those anticipated in these forward-looking statements as a result of many factors, including but not limited to those described under Risk Factors and elsewhere in this report.

OVERVIEW

We provide subscription-based workforce development and research/patient experience solutions for healthcare organizations all designed to assess and develop the people that deliver patient care which, in turn, supports the improvement of business and clinical outcomes. Our workforce development products are used by healthcare organizations to meet a broad range of their training, certification, competency assessment, performance appraisal, and development needs, while our research/patient experience products provide our customers information about patients experiences and how to improve them, workforce engagement, physician relations, and community perceptions of their services. HealthStream s customers include healthcare organizations, pharmaceutical and medical device companies, and other participants in the healthcare industry. Our customer base includes approximately 4,000 healthcare organizations (predominately acute-care facilities) throughout all 50 states.

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Revenues for the year ended December 31, 2013 were approximately $132.3 million compared to $103.7 million for the year ended December 31, 2012, an increase of 27.5%. Operating income increased by 9.0% to $14.7 million for 2013, compared to $13.5 million for 2012. Net income increased by 10.1% to $8.4 million for 2013, compared to $7.6 million for 2012. Earnings per share (EPS) were $0.30 per share (diluted) for 2013 compared to $0.28 per share (diluted) for 2012. Revenues from HealthStream Workforce Development Solutions grew by 32.1%, or $25.3 million, and revenues from HealthStream Research/Patient Experience Solutions grew by 13.1%, or $3.3 million. We had approximately 3.71 million total subscribers, of which approximately 3.39 million were fully implemented subscribers on our SaaS-based platform at December 31, 2013. During 2013, we renewed approximately 700,000 subscribers, representing a 97% renewal rate for the subscribers up for renewal, and a 97% renewal rate based on the annual contract value up for renewal. Additionally, annualized revenue per implemented subscriber increased to $32.41 per subscriber at the end of 2013, up from $27.04 per subscriber at the end of 2012, representing a 19.9% increase. As of December 31, 2013 our cash and investment balances approximated $108.2 million, and we maintained full availability under our $20.0 million revolving credit facility.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

We recognize revenues from our subscription-based workforce development products and courseware subscriptions based on a per person subscription basis, and in some cases on a per license basis. Fees are based on the size of the facilities or organizations employee user population and the service offerings to which they subscribe. Subscription-based revenue is recognized ratably over the service period of the underlying contract. All other service revenues are recognized as the related services are performed or products are delivered.

Revenues derived from the license of installed software products, associated with the Sy.Med products, are recognized upon shipment or installation of the software. Software support and maintenance revenues are recognized ratably over the term of the related agreement.

Revenues from research/patient experience services are recognized when survey results are delivered to customers via either Internet-based reporting throughout the survey period or by providing final survey results once all services are complete. A significant portion of revenues for survey and reporting services that are provided through the use of Internet-based reporting methodologies are recognized using the proportional performance method, reflecting recognition throughout the service period which corresponds with the survey cycle and reporting access by the customer, which typically ranges from one to five months. If survey results are delivered to the customer after all services have been completed, then the corresponding revenues are recognized in full in the period such results are provided to the customer. Coaching and consulting revenues are generally recognized using the proportional performance method as these services are performed throughout the contract term. All other revenues are recognized as the related services are performed or products are delivered to the customer. Revenues for these services can be subject to seasonal factors based on customers requirements that can impact the timing, frequency, and volume of survey cycles.

Revenues from professional services include content maintenance, consulting, and implementation services. Fees are based on the time and efforts involved, and revenue is recognized upon completion of performance milestones using the proportional performance method.

We offer training services for clients to facilitate integration of our SaaS-based products. Fees for training are based on the time and efforts of the personnel involved. Basic online training is generally included in the initial contract; however, incremental training is fee based and revenues are generally recognized upon completion of training services.

Accounting for Income Taxes

The Company accounts for income taxes using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. Management periodically assesses the realizability of its deferred tax assets, and to the extent that we believe a recovery is not likely, we establish a valuation allowance to reduce the deferred tax asset to the amount we estimate will be recoverable. The Company maintains a valuation allowance of approximately $1.3 million for the portion of its deferred tax assets which are related to the portion of our NOLs associated with deductions for stock option exercises.

Software Development Costs

Software development includes our costs to develop and maintain our products and applications, including our SaaS-based workforce development platform products and our survey reporting applications. Once planning is completed and development begins, we capitalize internal costs and payments to third parties associated with the development efforts where the life expectancy is greater than one year and the anticipated cash flows are expected to exceed the cost of the related asset. During 2013 and 2012, we capitalized approximately $4.3 million and

$4.4 million, respectively, for software development. Such amounts are included in the accompanying consolidated balance sheets under the caption capitalized software development. We amortize capitalized software development costs over their expected life, which is generally three to five years. Capitalized software development costs are subject to a periodic impairment review in accordance with our impairment review policy.

In connection with software development, our significant estimates involve the assessment of the development period for new products, as well as the expected useful life of underlying software or product created. Once capitalized, software development costs are subject to the policies and estimates described below regarding goodwill, intangibles and other long-lived assets.

Goodwill, Intangibles and Other Long-lived Assets

The Company evaluates goodwill for impairment at the reporting unit level by assessing whether it is more likely than not that the fair value of a reporting unit exceeds its carrying value. If this assessment concludes that is more likely than not that the fair value of a reporting unit exceeds its carrying value, then goodwill is not considered impaired and no further impairment testing is required. Conversely, if the assessment concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying value, a goodwill impairment test is performed to compare the fair value of the reporting unit to its carrying value. The Company determines fair value of the reporting units using both income and market based models. Our models contain significant assumptions and accounting estimates about discount rates, future cash flows and terminal values that could materially affect our operating results or financial position if they were to change significantly in the future and could result in an impairment. We perform our goodwill impairment assessment whenever events or changes in facts or circumstances indicate that impairment may exist and also during the fourth quarter each year. Intangible assets and other long-lived assets are also reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate an impairment is present. We measure any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management s best estimates, using appropriate and customary assumptions and projections at the date of evaluation.

Allowance for Doubtful Accounts

We estimate the allowance for doubtful accounts using both a specific and non-specific identification method. Management s evaluation includes reviewing past due accounts on a case-by-case basis, and determining whether an account should be reserved, based on the facts and circumstances surrounding each potentially uncollectible account. An allowance is also maintained for accounts not specifically identified that may become uncollectible in the future. Uncollectible accounts are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded when events or circumstances indicate an additional allowance is necessary based on our specific and non-specific identification approach. Our allowance for doubtful accounts totaled approximately $211,000 as of December 31, 2013.

Stock Based Compensation

We recognize compensation expense using a fair-value based method for costs related to share based payments including stock options and restricted share units. Measurement of such compensation expense requires significant estimation and assumptions; however, we believe that the Black Scholes option pricing model we use for calculating the fair value of our stock based compensation plans provides a reasonable measurement methodology using a framework that is widely adopted.

As of December 31, 2013, we had two stock incentive plans which qualified as stock based compensation plans. During the years ended December 31, 2013, 2012, and 2011, we recorded approximately $1.5 million, $1.1 million, and $0.8 million of stock based compensation expense, respectively. We have historically granted stock options or restricted share units to our management group on an annual basis, or when new members of the management group begin their employment. We have historically granted stock options or restricted share units to non-employee members of our board of directors in conjunction with our annual shareholders meeting, or as new members are added on a pro rata basis based on the time elapsed since our annual shareholders meeting. We expect to continue providing equity based awards to our management group and our board of directors for the foreseeable future. As of December 31, 2013, total future compensation cost related to non-vested awards not yet recognized was approximately $2.5 million net of estimated forfeitures, with a weighted average expense recognition period of 2.3 years. Future compensation expense recognition for new equity based award grants will vary depending on the timing and size of new awards granted, changes in the market price or volatility of our common stock, changes in risk-free interest rates, or if actual forfeitures vary significantly from our estimates.

RESULTS OF OPERATIONS

Revenues and Expense Components

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

Revenues, net. Revenues for our HealthStream Workforce Development Solutions business segment primarily consist of the following products and services: provision of services through our SaaS-based platform, authoring tools, a variety of courseware subscriptions, competency and performance appraisal tools, implementation and consulting services, content development, online sales training courses (RepDirect), HospitalDirect®, SimVentures, and a variety of other educational activities to serve professionals that work within healthcare organizations. HealthStream Workforce Development Solutions revenues also include products from the recent acquisitions of DCI and Sy.Med. Revenues for our HealthStream Research/Patient Experience Solutions business segment consist of quality and satisfaction surveys, data analyses of survey results, coaching/consulting services, and other research-based measurement tools focused on patients, employees, physicians, and other members of the community.

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

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

Sales and Marketing. Sales and marketing consists primarily of salaries, commissions and employee benefits, stock based compensation, employee travel and lodging, advertising, trade shows, promotions, and related marketing costs. We host a national customer conference in Nashville known as Summit, a portion of the costs of which are included in sales and marketing expenses. Personnel costs within sales and marketing include our sales teams, relationship managers, and marketing personnel.

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

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

Other Income (Expense), Net. The primary component of other income is interest income related to interest earned on cash, cash equivalents and investments in marketable securities. The primary component of other expense is interest expense related to our revolving credit facility.

2013 Compared to 2012

Revenues, net. Revenues increased approximately $28.5 million, or 27.5%, to $132.3 million for 2013 from $103.7 million for 2012. Revenues for 2013 consisted of $103.8 million, or 78% of total revenue, for HealthStream Workforce Development Solutions and $28.5 million, or 22% of total revenue, for HealthStream Research/Patient Experience Solutions. In 2012, revenues consisted of $78.6 million, or 76% of total revenue, for HealthStream Workforce Development Solutions and $25.2 million, or 24% of total revenue, for HealthStream Research/Patient Experience Solutions.

Revenues for HealthStream Workforce Development Solutions increased $25.3 million, or 32.1%, over 2012. Revenues from our subscription-based workforce development products increased by $22.5 million, or 31.0% over 2012 due to a higher number of subscribers and more courseware consumption by subscribers. Annualized revenue per implemented subscriber increased by 19.9%, to $32.41 per subscriber at the end of 2013 compared to $27.04 per subscriber at the end of 2012. Our implemented subscribers increased by 15.4% during 2013 to 3.39 million subscribers at the end of 2013 compared to 2.94 million subscribers at the end of 2012. Additionally, we had a 19.6% increase in total subscribers, with 3.71 million total subscribers at December 31, 2013 compared to 3.1 million total subscribers at December 31, 2012. Revenues in 2013 were positively influenced by courseware subscriptions associated with, among other products, ICD-10 training. Revenues from ICD-10 training were approximately $13.9 million in 2013, an increase of $11.5 million over 2012. Revenues from our credentialing software product, an installed solution, contributed $3.9 million during 2013, up $3.4 million over 2012. Revenues from SimVentures, our collaborative arrangement with Laerdal Medical A/S, increased by $664,000, or 39.8 percent, over the prior year to $2.3 million. Revenues from project-based services decreased $1.2 million from the prior year due to fewer content development projects.

Revenues for HealthStream Research/Patient Experience Solutions increased $3.3 million or 13.1%, over 2012. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, increased by $2.5 million, or 12.8%, over the prior year. Revenues from other surveys, which are conducted on annual or bi-annual cycles, declined by $449,000, or 8.3%, compared to the prior year due to fewer survey engagements. The financial results for Baptist Leadership Group (BLG) have been included in the Company s financial statements from the date of acquisition (September 9, 2013) and are included in the HealthStream Research/Patient Experience Solutions segment. BLG revenues were approximately $1.2 million during 2013, and contributed to the revenue increase over 2012.

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Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately $13.9 million, or 33.5%, to $55.6 million for 2013 from $41.7 million for 2012. Cost of revenues as a percentage of revenues was 42.0% of revenues for 2013 compared to 40.2% of revenues for 2012. Cost of revenues for HealthStream Workforce Development Solutions increased approximately $11.1 million to $39.5 million and approximated 38.0% and 36.1% of revenues for HealthStream Workforce Development Solutions for 2013 and 2012, respectively. The increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues and increased personnel expenses. Cost of revenues for HealthStream Research/Patient Experience Solutions increased approximately $2.9 million to $16.1 million and approximated 56.7% and 52.7% of revenues for HealthStream Research/Patient Experience Solutions for 2013 and 2012, respectively. The increase is primarily the result of additional costs associated with the growth in patient survey volume over the prior year and increased personnel expenses, including costs associated with the acquisition of BLG during September 2013.

Product Development. Product development expenses increased approximately $3.2 million, or 36.6%, to $11.8 million for 2013 from $8.6 million for 2012. Product development expenses as a percentage of revenues were 8.9% and 8.3% of revenues for 2013 and 2012, respectively.

Product development expenses for HealthStream Workforce Development Solutions increased approximately $3.2 million and approximated 9.9% and 9.0% of revenues for HealthStream Workforce Development for 2013 and 2012, respectively. The increase over the prior year is due to additional personnel expenses associated with new development initiatives related to our platform products. Product development expenses for HealthStream Research/Patient Experience Solutions decreased approximately $75,000 and approximated 5.3% and 6.2% of revenues for HealthStream Research/Patient Experience Solutions in 2013 and 2012, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $4.2 million, or 20.9%, to $24.1 million for 2013 from $19.9 million for 2012. Sales and marketing expenses as a percentage of revenues were 18.2% and 19.2% of revenues for 2013 and 2012, respectively.

Sales and marketing expenses for HealthStream Workforce Development Solutions increased approximately $4.3 million and approximated 17.6% and 17.9% of revenues for HealthStream Workforce Development Solutions for 2013 and 2012, respectively. This expense amount increase is primarily due to additional personnel and related expenses, increased commissions associated with higher sales performance compared to the prior year period, and increased travel expenses. Sales and marketing expenses for HealthStream Research/Patient Experience Solutions decreased approximately $4,000, and approximated 19.0% and 21.5% of revenues for HealthStream Research/Patient Experience Solutions for 2013 and 2012, respectively.

Other General and Administrative Expenses. Other general and administrative expenses increased approximately $4.9 million, or 36.4%, to $18.3 million for 2013 from $13.5 million for 2012. Other general and administrative expenses as a percentage of revenues were 13.9% and 13.0% of revenues for 2013 and 2012, respectively.

Other general and administrative expenses for HealthStream Workforce Development Solutions increased approximately $1.0 million over the prior year period primarily due to additional personnel, rent, and other support costs, while other general and administrative expenses for HealthStream Research/Patient Experience Solutions increased approximately $200,000 compared to the prior year period primarily due to additional personnel. The unallocated corporate portion of other general and administrative expenses increased approximately $3.7 million over the prior year period, primarily associated with additional personnel, professional fees, stock based compensation expense, rent, taxes, and other general expenses, as well as one-time expenses associated with the acquisition of BLG. During 2013, we incurred approximately $405,000 of costs associated with both the completed acquisition of BLG and other costs for evaluating potential transactions as part of our business development initiatives.

Depreciation and Amortization. Depreciation and amortization increased approximately $1.2 million, or 17.9%, to $7.9 million for 2013 from $6.7 million for 2012. The increase primarily resulted from amortization of capitalized software development assets and amortization of intangibles assets, as well as depreciation expense associated with leasehold improvements to our Nashville, Tennessee office space.

Other Income (Expense), Net. Other income (expense), net was approximately $176,000 for 2013 compared to $118,000 for 2012. The improvement over the prior year period was associated with higher interest income from investments in marketable securities.

Income Tax Provision. The Company recorded a provision for income taxes of $6.4 million for 2013 compared to $5.9 million for 2012. The Company s effective tax rate was 43.3% for 2013 compared to 43.7% for 2012.

Net Income. Net income increased approximately $773,000, or 10.1%, to $8.4 million for 2013 from $7.6 million for 2012. Earnings per diluted share were $0.30 per share for 2013, compared to $0.28 per diluted share for 2012.

Adjusted EBITDA (which we define as net income before interest, income taxes, stock-based compensation, and depreciation and amortization) increased by 12.7% to approximately $23.9 million for 2013 compared to $21.2 million for 2012. This improvement is consistent with the factors mentioned above. See Reconciliation of Non-GAAP Financial Measures in Management s Discussion and Analysis of Financial Condition and Results of Operations for our reconciliation of this calculation to measures under US GAAP.

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2012 Compared to 2011

Revenues, net. Revenues increased approximately $21.7 million, or 26.4%, to $103.7 million for 2012 from $82.1 million for 2011. Revenues for 2012 consisted of $78.6 million, or 76% of total revenue, for HealthStream Workforce Development Solutions and $25.2 million, or 24% of total revenue, for HealthStream Research/Patient Experience Solutions. In 2011, revenues consisted of $58.1 million, or 71% of total revenue, for HealthStream Workforce Development Solutions and $24.0 million, or 29% of total revenue, for HealthStream Research/Patient Experience Solutions.

Revenues for HealthStream Workforce Development Solutions increased $20.5 million, or 35.3%, over 2011. Revenues from our subscription-based workforce development products increased by $17.6 million, or 32.2% over 2011 due to a higher number of subscribers and more courseware consumption by subscribers. Annualized revenue per implemented subscriber increased by 17.7%, to $27.04 per subscriber at the end of 2012 compared to $22.97 per subscriber at the end of 2011. Our implemented subscriber base increased by 14% during 2012 to 2.94 million implemented subscribers at the end of 2012 compared to 2.57 million implemented subscribers at the end of 2011. Additionally, we had a 13% increase in total subscribers, with 3.1 million total subscribers at December 31, 2012 compared to 2.75 million total subscribers at December 31, 2011. Revenues from project-based services increased by $1.5 million compared to 2011 due to more engagements than the prior year. Revenues from SimVentures, our collaborative arrangement with Laerdal Medical, increased approximately $844,000 over 2011.

Revenues for HealthStream Research/Patient Experience Solutions increased $1.2 million or 4.9%, over 2011. Revenues from Patient Insights surveys, our survey research product that generates recurring revenues, increased by $1.8 million, or 10.1%, over 2011. Revenues from other surveys, which are conducted on annual or bi-annual cycles, declined by $633,000, or 10.5%, compared to 2011 due to fewer survey engagements.

Cost of Revenues (excluding depreciation and amortization). Cost of revenues increased approximately $10.6 million, or 34.1%, to $41.7 million for 2012 from $31.1 million for 2011. Cost of revenues as a percentage of revenues was 40.2% of revenues for 2012 compared to 37.9% of revenues for 2011. Cost of revenues for HealthStream Workforce Development Solutions increased approximately $9.5 million to $28.4 million and approximated 36.1% and 32.4% of revenues for HealthStream Workforce Development Solutions for 2012 and 2011, respectively. The increase is primarily associated with increased royalties paid by us resulting from growth in courseware subscription revenues, increased personnel expenses, and increased costs associated with project-based services. Cost of revenues for HealthStream Research/Patient Experience Solutions increased approximately $1.0 million to $13.3 million and approximated 52.7% and 51.0% of revenues for HealthStream Research/Patient Experience Solutions for 2012 and 2011, respectively. The increase is primarily the result of additional costs associated with the growth in patient survey volume over 2011.

Product Development. Product development expenses increased approximately $1.1 million, or 15.2%, to $8.6 million for 2012 from $7.5 million for 2011. Product development expenses as a percentage of revenues were 8.3% and 9.1% of revenues for 2012 and 2011, respectively.

Product development expenses for HealthStream Workforce Development Solutions increased approximately $1.1 million and approximated 9.0% and 10.2% of revenues for HealthStream Workforce Development Solutions for 2012 and 2011, respectively. The decrease as a percentage of revenue is the result of the growth in revenues over the prior year period, while the increase in amount is due to additional personnel expenses associated with the maintenance of our platform, as well as working on new product development initiatives. Product development expenses for HealthStream Research/Patient Experience Solutions increased approximately $4,000 and approximated 6.2% and 6.5% of revenues for HealthStream Research/Patient Experience Solutions in 2012 and 2011, respectively.

Sales and Marketing. Sales and marketing expenses, including personnel costs, increased approximately $3.9 million, or 24.2%, to $19.9 million for 2012 from $16.0 million for 2011. Sales and marketing expenses as a percentage of revenues were 19.2% and 19.5% of revenues for 2012 and 2011, respectively.

Sales and marketing expenses for HealthStream Workforce Development Solutions increased approximately $3.2 million and approximated 17.9% and 18.7% of revenues for HealthStream Workforce Development Solutions for 2012 and 2011, respectively. This expense increase is primarily due to additional personnel and related expenses, increased travel expenses, increased marketing spending, increased expenses for our annual customer Summit, and increased commissions associated with higher sales performance compared to the prior year period. Sales and marketing expenses for HealthStream Research/Patient Experience Solutions increased approximately $687,000, and approximated 21.5% and 19.7% of revenues for HealthStream Research/Patient Experience Solutions for 2012 and 2011, respectively. The expense increase was primarily due to additional personnel and related expenses and increased commissions.

Other General and Administrative Expenses. Other general and administrative expenses increased approximately $2.7 million, or 25.0%, to $13.5 million for 2012 from $10.8 million for 2011. Other general and administrative expenses as a percentage of revenues were 13.0% and

13.1% of revenues for 2012 and 2011, respectively.

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Other general and administrative expenses for HealthStream Workforce Development Solutions increased approximately $644,000 over 2011 primarily due to employee recruiting costs, rent, and other support costs, while other general and administrative expenses for HealthStream Research/Patient Experience Solutions decreased approximately $302,000 compared to 2011 primarily due to lower personnel costs. The unallocated corporate portion of other general and administrative expenses increased approximately $2.4 million over 2011, primarily associated with additional personnel, professional fees, stock based compensation expense, rent, franchise taxes, and other general expenses, as well as one-time expenses associated with the acquisitions of DCI and Sy.Med. During 2012, we incurred approximately $678,000 of costs associated with the completed acquisitions of DCI and Sy.Med, and other costs for evaluating potential transactions as part of our business development initiatives.

Depreciation and Amortization. Depreciation and amortization increased approximately $1.2 million, or 23.1%, to $6.7 million for 2012 from $5.4 million for 2011. The increase primarily resulted from amortization of capitalized software development assets and amortization of intangibles assets for DCI and Sy.Med within HealthStream Workforce Development Solutions and depreciation expense associated with leasehold improvements to our Nashville, Tennessee office space.

Other Income (Expense), Net. Other income, net was approximately $118,000 for 2012 compared to $10,000 for 2011. The improvement over 2011 was associated with higher interest income from investments in marketable securities.

Income Tax Provision. The Company recorded a provision for income taxes of $5.9 million for 2012 compared to $4.4 million for 2011. The Company s effective tax rate was 43.7% for 2012 compared to 38.8% for 2011. The increase in the effective tax rate primarily resulted from changes in certain state apportionment factor estimates, which resulted in a higher proportion of income subject to taxation in those states and a reduction in our state operating loss carryforwards.

Net Income. Net income increased approximately $701,000, or 10.1%, to $7.6 million for 2012 from $6.9 million for 2011. Earnings per diluted share (diluted) were $0.28 per share for 2012, compared to $0.29 per diluted share for 2011. A key factor impacting the comparison of EPS (diluted) for 2012 to EPS (diluted) for 2011 was the effect of additional shares of the Company s common stock outstanding that were issued during the Company s fourth quarter 2011 stock offering. The impact of the stock offering increased the weighted average outstanding share count by approximately 3.6 million shares for 2012 compared to 2011.

Adjusted EBITDA (which we define as net income before interest, income taxes, stock-based compensation, and depreciation and amortization) increased by 21.1% to approximately $21.2 million for 2012 compared to $17.5 million for 2011. This improvement is consistent with the factors mentioned above. See Reconciliation of Non-GAAP Financial Measures in Management s Discussion and Analysis of Financial Condition and Results of Operations for our reconciliation of this calculation to measures under US GAAP.

Reconciliation of Non-GAAP Financial Measures

This report contains certain non-GAAP financial measures, including, non-GAAP net income, non-GAAP operating income, non-GAAP revenue and adjusted EBITDA, which are used by management in analyzing the Company s financial results and ongoing operational performance. These non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance which are prepared in accordance with US GAAP and may be different from non-GAAP financial measures used by other companies.

In order to better assess the Company s financial results, management believes that adjusted EBITDA is an appropriate measure for evaluating the operating performance of the Company because adjusted EBITDA reflects net income adjusted for non-cash and non-operating items. Adjusted EBITDA is also used by many investors and securities analysts to assess the Company s results from current operations. Adjusted EBITDA is a non-GAAP financial measure and should not be considered as a measure of financial performance under US GAAP. Because adjusted EBITDA is not a measurement determined in accordance with US GAAP, it is susceptible to varying calculations. Accordingly, adjusted EBITDA, as presented, may not be comparable to other similarly titled measures of other companies.

The Company understands that, although adjusted EBITDA is frequently used by investors and securities analysts in their evaluation of companies, this measure has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for an analysis of the Company s results as reported under US GAAP. For example, adjusted EBITDA does not reflect cash expenditures, or future requirements for capital expenditures or contractual commitments; it does not reflect non-cash components of employee compensation; it does not reflect changes in, or cash requirements for, our working capital needs; and due to the Company s utilization of federal and state net operating loss carryforwards and other available tax deductions in 2011, 2012, and 2013, actual cash income tax payments have been significantly less than the tax provision recorded in accordance with US GAAP, and income tax payments will continue to be less than the income tax provision until our existing federal and state net operating loss carryforwards have been fully utilized or have expired.

Management compensates for the inherent limitations associated with using adjusted EBITDA through disclosure of such limitations, presentation of our financial statements in accordance with US GAAP, and reconciliation of adjusted EBITDA to net income, the most directly comparable US GAAP measure.

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As discussed elsewhere in this report, the Company completed the acquisitions of DCI during June 2012, Sy.Med in October 2012, and BLG in September 2013. In accordance with US GAAP reporting requirements for fair value, we recorded a deferred revenue write-down of $192,000 for DCI, $916,000 for Sy.Med, and $254,000 for BLG. These write-downs will result in lower revenues than would have otherwise been recognized for such services.

In order to provide more accurate trends and comparisons of the Company s revenues, operating income, and net income, management believes that adding back the deferred revenue write-down associated with fair value accounting for acquired businesses provides a better indication of the ongoing performance of the Company. The revenue for the acquired contracts is deferred and typically recognized over a one year period, so our US GAAP revenues for the one year period after the acquisition will not reflect the full amount of revenues that would have been reported if the acquired deferred revenue was not written down to fair value.

	2013	2012	2011
GAAP net income	$ 8,418	$ 7,645	$ 6,944
Interest income	(263)	(181)	(51)
Interest expense	51	48	48
Income tax provision	6,424	5,932	4,404
Stock based compensation expense	1,458	1,136	788
Depreciation and amortization	7,852	6,661	5,412
Adjusted EBITDA	$ 23,940	$ 21,241	$ 17,545
GAAP revenues	$ 132,274	$ 103,732	$ 82,066
Adjustment for deferred revenue write-down	839	490	
Non-GAAP revenues	$ 133,113	$ 104,222	$ 82,066
GAAP operating income	$ 14,666	$ 13,459	$ 11,338
Adjustment for deferred revenue write-down	839	490	
Non-GAAP operating income	$ 15,505	$ 13,949	$ 11,338
GAAP net income	$ 8,418	$ 7,645	$ 6,944
Adjustment for deferred revenue write-down, net of tax	476	276	
Non-GAAP net income	$ 8,894	$ 7,921	$ 6,944

FINANCIAL OUTLOOK FOR 2014

The Company provides projections and other forward-looking information in this Financial Outlook for 2014 section within Management s Discussion and Analysis of Financial Condition and Results of Operations. This section contains many forward-looking statements, particularly relating to the Company s future financial performance. These forward-looking statements are estimates based on information currently available to the Company, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to the precautionary statements set forth in the introduction in Part I of this Annual Report on Form 10-K above. Actual results are likely to differ, and in the past have differed, materially from those forecast by the Company, depending on the outcome of various factors, including, but not limited to, those set forth in Item 1A, Risk Factors.

On March 3, 2014, the Company acquired all of the stock of Health Care Compliance Strategies, Inc. (HCCS) for approximately $13.0 million in cash and 81,614 shares of its common stock. Taking into consideration the HCCS acquisition, the Company anticipates that consolidated revenues for the full year 2014 will grow by 25 percent to 29 percent as compared to 2013, which revenue growth reflects the impact of the deferred revenue write-down related to the HCCS acquisition. We anticipate revenue growth in the Workforce Development Solutions segment, which will include HCCS, to be in the 27 percent to 31 percent range, also reflecting the impact of the deferred revenue write-down related to the HCCS acquisition. We expect the Research/Patient Experience Solutions segment s revenue to increase by approximately 18 percent to 22 percent, part of which growth includes revenues from the BLG acquisition which we closed in September 2013. The foregoing guidance does not include the impact from any other transactions that we may complete during 2014.

We anticipate that the Company s 2014 full-year operating income will decrease between two and eleven percent over full-year 2013. This operating income estimated range includes the impact of HCCS, of which between $2.5 to $3.0 million relates to the combined impact of deferred revenue fair value write-downs, amortization of intangibles, incremental investments in HCCS sales, marketing, and product development to drive future growth, and approximately $450,000 of transaction costs. Similar to our revenue guidance, this estimate does not include the impact from any other transactions that we may complete during 2014.

We anticipate that our 2014 capital expenditures will be between $9.0 million and $12.0 million. We expect our effective tax rate to range between 42 and 44 percent for the full-year of 2014.

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SELECTED QUARTERLY OPERATING RESULTS

The following tables set forth selected statements of income data for each of the eight quarters in the period ended December 31, 2013. The information for each quarter has been prepared on the same basis as the audited statements included in other parts of this report and, in our opinion, includes all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the results of operations for these periods. You should read this information in conjunction with HealthStream s Consolidated Financial Statements and related notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the results to be expected in the future.

Factors Affecting Quarterly Operating Results

Revenues from our subscription-based products are recognized ratably over the subscription term. Survey and research revenues are impacted by seasonal factors resulting from the volume, timing, and frequency of survey cycles.

	Quarter Ended			
	March 31, 2013	June 30, 2013	September 30, 2013	December 31, 2013
	(In thousands, except per share data)			
STATEMENT OF INCOME DATA:				
Revenues, net	$ 29,646	$ 31,919	$ 33,659	$ 37,050
Total operating costs and expenses	26,473	27,813	29,780	33,541
Income from operations	3,173	4,106	3,879	3,509
Net income	$ 1,941	$ 2,422	$ 2,296	$ 1,760
Net income per share (1):				
Basic	$ 0.07	$ 0.09	$ 0.08	$ 0.06
Diluted	$ 0.07	$ 0.09	$ 0.08	$ 0.06
Weighted average shares of common stock outstanding:				
Basic	26,340	26,722	27,085	27,264
Diluted	27,409	27,649	27,735	27,858

	Quarter Ended			
	March 31, 2012	June 30, 2012	September 30, 2012	December 31, 2012
	(In thousands, except per share data)			
STATEMENT OF INCOME DATA:				
Revenues, net	$ 23,674	$ 25,841	$ 26,380	$ 27,838
Total operating costs and expenses	21,333	21,800	22,649	24,492
Income from operations	2,341	4,041	3,731	3,346
Net income	$ 1,420	$ 2,427	$ 1,977	$ 1,821
Net income per share (1):				
Basic	$ 0.05	$ 0.09	$ 0.08	$ 0.07
Diluted	$ 0.05	$ 0.09	$ 0.07	$ 0.07

Weighted average shares of common stock outstanding:				
Basic	25,999	26,127	26,173	26,212
Diluted	27,335	27,501	27,591	27,600

(1) Due to the nature of interim earnings per share calculations, the sum of quarterly earnings per share amounts may not equal the reported earnings per share for the full year.

Liquidity and Capital Resources

Net cash provided by operating activities increased by $3.8 million, or 16.7%, to $26.3 million during 2013 from $22.5 million during 2012. Our primary sources of cash were generated from receipts from the sales of our products and services. The number of days sales outstanding (DSO) was 56 days for 2013 and 55 days for 2012. The Company calculates DSO by dividing the average accounts receivable balance (excluding unbilled and other receivables) by average daily revenues for the year. The primary uses of cash to fund our operations include personnel expenses, sales commissions, royalty payments, payments for contract labor and other direct expenses associated with delivery of our products and services, and general corporate expenses.

Net cash used in investing activities was approximately $15.0 million during 2013 and $59.0 million during 2012. During 2013, the Company purchased $86.1 million of marketable securities, utilized $7.6 million (net of cash acquired) for acquisitions, spent $4.3 million for capitalized software development, purchased $4.4 million of property and equipment, and made $0.3 million in non-marketable equity investments. These uses of cash were partially offset by maturities and sales of marketable securities of $87.7 million. During 2012, the Company purchased $118.2 million of marketable securities, utilized $9.9 million (net of cash acquired) for acquisitions, spent $4.4 million for capitalized software development, purchased $4.3 million of property and equipment, and made $0.2 million in non-marketable equity investments. These uses of cash were partially offset by maturities of marketable securities of $78.1 million.

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Cash provided by financing activities was approximately $6.9 million during 2013 and $934,000 during 2012. The primary source of cash from financing activities for 2013 and 2012 included proceeds (net of payroll taxes paid) of $3.2 million and $823,000, respectively, from the exercise of employee stock options and issuance of RSUs. In addition, the Company recognized excess tax benefits from equity awards of $3.7 million and $111,000 in 2013 and 2012, respectively.

Revenues increased and operating income improved over the prior year, and our balance sheet reflects positive working capital of $90.9 million at December 31, 2013 compared to $83.3 million at December 31, 2012. The increase in working capital primarily resulted from increases in cash and investment balances and accounts receivable. At December 31, 2013, the Company s primary source of liquidity was $108.2 million of cash and cash equivalents and marketable securities. The Company also has a $20.0 million revolving credit facility loan agreement, all of which was available at December 31, 2013.

We believe that our existing cash and cash equivalents, marketable securities, cash generated from operations, and available borrowings under our revolving credit facility will be sufficient to meet anticipated cash needs for working capital, new product development and capital expenditures for at least the next 12 months. Over the past nine years, we have utilized our federal and state net operating loss carryforwards to offset taxable income, therefore reducing our income tax liabilities. We anticipate our remaining net operating loss carryforwards will become fully utilized over the next 12 to 24 months. Our actual tax payments are expected to increase significantly once the net operating loss carryforwards are fully utilized. As part of our growth strategy, we have recently completed several acquisitions and we continue to review possible acquisitions that complement our products and services. We anticipate that future acquisitions, if any, would be effected through a combination of stock and cash consideration. The issuance of our stock as consideration for an acquisition or to raise additional capital could have a dilutive effect on earnings per share and could adversely affect our stock price. Our revolving credit facility contains financial covenants and availability calculations designed to set a maximum leverage ratio of outstanding debt to equity. Therefore, if we were to borrow against our revolving credit facility, our debt capacity would be dependent on the covenant values at the time of borrowing. As of December 31, 2013, we were in compliance with all covenants. The credit and capital markets have been experiencing extreme volatility and disruption. There can be no assurance that amounts available for borrowing under our revolving credit facility will be sufficient to consummate any possible acquisitions, and we cannot assure you that if we need additional financing that it will be available on terms favorable to us, or at all. Failure to generate sufficient cash flow from operations or raise additional capital when required in sufficient amounts and on terms acceptable to us could harm our business, financial condition and results of operations.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company s off-balance sheet arrangements primarily consist of operating leases, contractual obligations, and our revolving credit facility, which is described further in Note 14 to the Company s consolidated financial statements contained elsewhere in this report.

The following table presents a summary of future anticipated payments due by the Company under contractual obligations with firm minimum commitments as of December 31, 2013, excluding amounts already recorded in the Consolidated Balance Sheets (in thousands):

	Payments due by period				
	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Operating leases	$ 2,665	$ 3,421	$ 505	$	$ 6,591
Purchase obligations	142				142
Total	$ 2,807	$ 3,421	$ 505	$	$ 6,733

Recent Accounting Pronouncements

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (ASU 2013-02), which is effective prospectively for public companies for reporting periods beginning after December 15, 2012. This new accounting standard improves the reporting of reclassifications out of accumulated other comprehensive income (AOCI) by requiring an entity to report the effect of significant reclassifications out of AOCI on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted this new guidance on January 1, 2013 and the adoption did not have a material effect on our consolidated financial statements.

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Item 7A. ***Quantitative and Qualitative Disclosures about Market Risk***

The Company is exposed to market risk from changes in interest rates. We do not have any foreign currency exchange rate risk or commodity price risk. As of December 31, 2013, the Company had no outstanding debt. We may become subject to interest rate market risk associated with any future borrowings under our revolving credit facility. The interest rate under the revolving credit facility is based on 30 Day LIBOR plus a margin of either 175 or 200 basis points determined in accordance with a pricing grid. We are exposed to market risk with respect to our cash and investment balances, which approximated $108.2 million at December 31, 2013. Assuming a hypothetical 10% decrease in interest rates, interest income from cash and investments would decrease on an annualized basis by approximately $64,000.

The Company s investment policy and strategy is focused on investing in highly rated securities, with the objective of minimizing the potential risk of principal loss. The Company s policy limits the amount of credit exposure to any single issuer and sets limits on the average portfolio maturity.

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

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Item 8. ***Financial Statements and Supplementary Data***

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of

HealthStream, Inc.

We have audited the accompanying consolidated balance sheets of HealthStream, Inc. as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HealthStream, Inc. at December 31, 2013 and 2012, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), HealthStream, Inc. s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 framework) and our report dated March 4, 2014 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Nashville, Tennessee

March 4, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of

HealthStream, Inc.

We have audited HealthStream, Inc. s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 framework) (the COSO criteria). HealthStream, Inc. s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, HealthStream, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2013 consolidated financial statements of HealthStream, Inc. and our report dated March 4, 2014 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Nashville, Tennessee

March 4, 2014

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HEALTHSTREAM, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands)

	December 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 59,537	$ 41,365
Marketable securities	48,659	51,952
Accounts receivable, net of allowance for doubtful accounts of $211 and $142 at December 31, 2013 and 2012, respectively	25,314	15,348
Accounts receivable - unbilled	1,392	1,163
Deferred tax assets, current		2,459
Prepaid royalties, net of amortization	8,857	3,738
Other prepaid expenses and other current assets	3,365	2,266
Total current assets	147,124	118,291
Property and equipment:		
Equipment	21,631	18,108
Leasehold improvements	5,521	5,050
Furniture and fixtures	3,854	3,368
	31,006	26,526
Less accumulated depreciation and amortization	(21,968)	(18,706)
	9,038	7,820
Capitalized software development, net of accumulated amortization of $13,910 and $10,987 at December 31, 2013 and 2012, respectively	11,077	9,732
Goodwill	35,746	29,299
Intangible assets, net of accumulated amortization of $11,389 and $10,036 at December 31, 2013 and 2012, respectively	8,870	8,805
Other assets	739	581
Total assets	$ 212,594	$ 174,528
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,311	$ 1,057
Accrued royalties	8,435	5,037
Accrued liabilities	5,503	4,671
Accrued compensation and related expenses	1,614	1,121
Deferred tax liabilities, current	181	
Deferred revenue	38,168	23,146
Total current liabilities	56,212	35,032
Deferred tax liabilities, noncurrent	6,173	6,474
Other long term liabilities	776	826
Commitments and contingencies		
Shareholders equity:		
Common stock, no par value, 75,000 shares authorized; 27,327 and 26,233 shares issued and outstanding at December 31, 2013 and 2012, respectively	166,888	158,020

Accumulated deficit		(17,424)		(25,842)
Accumulated other comprehensive income (loss)		(31)		18
Total shareholders equity		149,433		132,196
Total liabilities and shareholders equity	$	212,594	$	174,528

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

	For the Year Ended December 31, 2013	2012	2011
Revenues, net	$ 132,274	$ 103,732	$ 82,066
Operating costs and expenses:			
Cost of revenues (excluding depreciation and amortization)	55,605	41,658	31,066
Product development	11,757	8,610	7,473
Sales and marketing	24,052	19,892	16,017
Other general and administrative expenses	18,342	13,452	10,760
Depreciation and amortization	7,852	6,661	5,412
Total operating costs and expenses	117,608	90,273	70,728
Income from operations	14,666	13,459	11,338
Other income (expense), net	176	118	10
Income before income tax provision	14,842	13,577	11,348
Income tax provision	6,424	5,932	4,404
Net income	$ 8,418	$ 7,645	$ 6,944
Net income per share:			
Basic	$ 0.31	$ 0.29	$ 0.31
Diluted	$ 0.30	$ 0.28	$ 0.29
Weighted average shares of common stock outstanding:			
Basic	26,853	26,128	22,445
Diluted	27,663	27,507	23,748

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	For the Year Ended December 31, 2013	2012	2011
Net Income	$ 8,418	$ 7,645	$ 6,944
Other comprehensive income, net of taxes:			
Unrealized gain (loss) on marketable securities	(49)	25	(2)
Total other comprehensive income (loss)	(49)	25	(2)
Comprehensive income	$ 8,369	$ 7,670	$ 6,942

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)

	Common Stock Shares	Common Stock Amount	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Balance at December 31, 2010	21,805	$ 97,227	$ (40,431)	$ (5)	$ 56,791
Net income			6,944		6,944
Comprehensive loss				(2)	(2)
Stock based compensation		788			788
Tax benefits from equity awards		21			21
Common stock issued under stock plans, net of shares withheld for employee taxes	503	1,242			1,242
Issuance of common stock	3,588	55,131			55,131
Balance at December 31, 2011	25,896	154,409	(33,487)	(7)	120,915
Net income			7,645		7,645
Comprehensive income				25	25
Issuance of common stock in acquisitions	56	1,541			1,541
Stock based compensation		1,136			1,136
Tax benefits from equity awards		111			111
Common stock issued under stock plans, net of shares withheld for employee taxes	281	823			823
Balance at December 31, 2012	26,233	158,020	(25,842)	18	132,196
Net income			8,418		8,418
Comprehensive loss				(49)	(49)
Issuance of common stock in acquisition	15	534			534
Stock based compensation		1,458			1,458
Tax benefits from equity awards		3,722			3,722
Common stock issued under stock plans, net of shares withheld for employee taxes	1,079	3,154			3,154
Balance at December 31, 2013	27,327	$ 166,888	$ (17,424)	$ (31)	$ 149,433

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Year Ended December 31, 2013	2012	2011
OPERATING ACTIVITIES:			
Net income	$ 8,418	$ 7,645	$ 6,944
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	7,852	6,661	5,412
Deferred income taxes	2,506	5,601	4,027
Stock based compensation expense	1,458	1,136	788
Excess tax benefits from equity awards	(3,722)	(111)	(21)
Provision for doubtful accounts	115	120	50
Loss on non-marketable equity investments	37	16	
Other	1,660	722	83
Changes in assets and liabilities, net of acquisitions:			
Accounts and unbilled receivables	(10,056)	1,227	(4,997)
Prepaid royalties	(5,119)	(329)	(263)
Other prepaid expenses and other current assets	(1,207)	(537)	(283)
Other assets	105	(15)	212
Accounts payable	1,254	(1,529)	211
Accrued royalties	3,399	1,579	1,450
Accrued liabilities, accrued compensation and related expenses, and other long-term liabilities	4,822	542	124
Deferred revenue	14,761	(198)	6,018
Net cash provided by operating activities	26,283	22,530	19,755
INVESTING ACTIVITIES:			
Acquisitions, net of cash acquired	(7,560)	(9,901)	
Proceeds from sales of marketable securities	5,062		2,221
Proceeds from maturities of marketable securities	82,661	78,075	8,135
Purchases of marketable securities	(86,139)	(118,176)	(17,284)
Investments in non-marketable equity investments	(300)	(250)	
Payments associated with capitalized software development	(4,267)	(4,435)	(6,065)
Purchases of property and equipment	(4,444)	(4,316)	(4,115)
Net cash used in investing activities	(14,987)	(59,003)	(17,108)
FINANCING ACTIVITIES:			
Proceeds from issuance of common stock			55,131
Proceeds from exercise of stock options	3,318	823	1,242
Taxes paid related to net settlement of equity awards	(164)		
Excess tax benefits from equity awards	3,722	111	21
Payments on capital lease obligations			(5)
Net cash provided by financing activities	6,876	934	56,389
Net increase (decrease) in cash and cash equivalents	18,172	(35,539)	59,036
Cash and cash equivalents at beginning of year	41,365	76,904	17,868
Cash and cash equivalents at end of year	$ 59,537	$ 41,365	$ 76,904

SUPPLEMENTAL CASH FLOW INFORMATION:						
Interest paid	$	51	$	61	$	35
Income taxes paid	$	371	$	427	$	387
NON-CASH INVESTING AND FINANCING ACTIVITIES:						
Issuance of common stock in connection with acquisitions	$	534	$	1,541	$	
Acquisition of content rights in exchange for future services	$		$	500	$	

See accompanying notes to the consolidated financial statements.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity and Segments

HealthStream, Inc. (the Company) was incorporated in 1990 as a Tennessee corporation and is headquartered in Nashville, Tennessee. We operate our business in two segments: HealthStream Workforce Development Solutions and HealthStream Research/Patient Experience Solutions. Our Workforce Development products consist of SaaS-based services and subscription-based solutions to meet the ongoing training, certification, assessment and development needs of the healthcare community. These solutions provide, deliver and track computer based education for our customers in the United States through our software-as-a-service (SaaS) model. HealthStream Research/Patient Experience products offer healthcare organizations a wide range of quality and satisfaction surveys, consulting services, analyses of survey results, and other research-based services.

Recognition of Revenue

Revenues are derived from providing services through our SaaS-based workforce development platform products, courseware subscriptions, provision of survey and research services, professional services, content maintenance, custom courseware development and other education and training services.

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when persuasive evidence of an arrangement exists, prices are fixed or determinable, services and products are provided to the customer and collectability is probable or reasonably assured.

Revenue recognized from software and other arrangements is allocated to each element of the arrangement based on the relative fair values of the elements. While elements include software products and post contract customer support, the fair value of each element is based on objective evidence specific to the vendor. If fair value cannot be determined for each element of the arrangement, all revenue from the arrangement is deferred until fair value can be determined or until all elements of the arrangement are delivered and customer acceptance has occurred. Sales of the Company s SaaS-based workforce development platform products include customer support, implementation services, and training; therefore all revenues are deferred until the SaaS-based product is implemented, at which time revenues are recognized ratably over the subscription service period. In the event that circumstances occur, which give rise to uncertainty regarding the collectibility of contracted amounts, revenue recognition is suspended until such uncertainty is resolved. Fees for these services are billed on either a monthly, quarterly, or annual basis.

Revenues derived from the delivery of services through the Company s SaaS-based workforce development platform products and courseware subscriptions are recognized ratably over the term of the subscription service agreement or over the historical usage period, if usage typically differs from the subscription period. Other training revenues are generally recognized upon the completion of training.

Revenues derived from the license of installed software products, associated with the Sy.Med products, are recognized upon shipment or installation of the software. Software support and maintenance revenues are recognized ratably over the term of the related agreement.

Revenues recognized from the Company s survey and research services are determined using both the proportional performance method and the completed contract method. Revenues are generally earned over the estimated survey cycle, which typically ranges from less than one month to up to five months. The survey cycle is generally initiated based on the receipt of the first survey response and runs through provision of related survey reports to the customer. If survey results are not available to the customer during the survey fielding cycle, revenues are recognized at time of report delivery. Revenues for coaching and consulting engagements are recognized using the proportional performance method over the term of the underlying contract. Fees for survey services are billed upon initiation of the survey cycle, with progress billings made throughout the survey cycle. Fees for coaching and consulting engagements are billed upon initiation of the engagement with progress billings throughout the term of the contract.

Revenues from professional services, content maintenance, and custom courseware development services are recognized using a percentage of completion method based on labor hours, which correspond to the completion of performance milestones and deliverables. All other revenues are recognized as the related services are performed or products are delivered. Fees for these services are generally billed at project initiation and upon completion of various milestones.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All inter-company accounts and transactions have been eliminated in consolidation.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates and such differences could be material to the consolidated financial statements.

Cash Equivalents

The Company considers cash equivalents to be unrestricted, highly liquid investments with initial maturities of less than three months.

Marketable Securities

Marketable securities are classified as available for sale and are stated at fair market value, with the unrealized gains and losses, net of tax, reported in other comprehensive income (loss) on the accompanying consolidated balance sheets. Realized gains and losses and declines in market value judged to be other than temporary on investments in marketable securities are included in interest and other income on the accompanying consolidated statements of income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available for sale are included in other income (expense) on the accompanying consolidated statements of income. Premiums and discounts are amortized over the life of the related available for sale security as an adjustment to yield using the effective interest method.

Accounts Receivable-Unbilled

Accounts receivable-unbilled represents the following: 1) revenue earned and recognized on contracts accounted for using the proportional performance method for which invoices have not been generated or contractual billing dates have not been reached; and 2) the difference between billings for contracts containing escalated pricing over the term of the agreement and the recognition of revenue ratably over the subscription period.

Deferred Revenue

Deferred revenue represents amounts, which have been billed or collected in advance of revenue recognition, and is recognized as the revenue recognition criteria are met. The Company typically invoices customers in quarterly, bi-annual, or annual installments.

Prepaid Royalties

Prepaid royalties represents advance payments associated with the sale of third party products, such as courseware subscriptions. Royalties are typically paid in advance at the commencement of the revenue cycle, or periodically throughout the revenue cycle, such as quarterly, bi-annual, or annual installments. Royalty payments are amortized over the term of the underlying contracts, which generally range from 12 to 36 months, in order to match the direct royalty costs to the same period the subscription revenue is recognized. Amortization of royalties is included under the caption cost of revenues (excluding depreciation and amortization) in the accompanying consolidated statements of income.

Allowance for Doubtful Accounts

The Company estimates its allowance for doubtful accounts using a specific identification method. Management determines the allowance for doubtful accounts on a case-by-case basis, based on the facts and circumstances surrounding each potentially uncollectible receivable. An allowance is also maintained for accounts that are not specifically identified that may become uncollectible in the future. Uncollectible receivables are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded when events or circumstances indicate an additional allowance is required based on the Company s specific identification approach.

Changes in the allowance for doubtful accounts and the amounts charged to bad debt expense for the years ended December 31, were as follows (in thousands):

	Allowance Balance at Beginning of Period	Charged to Costs and Expenses	Write-offs	Allowance Balance at End of Period
2013	$ 142	$ 115	$ (46)	$ 211
2012	$ 149	$ 120	$ (127)	$ 142
2011	$ 157	$ 50	$ (58)	$ 149

Capitalized Software Development

Capitalized software development is stated on the basis of cost, and is presented net of accumulated amortization. The Company capitalizes costs incurred during the software development phase for projects when such costs are material. These assets are amortized using the straight-line method, generally ranging between one to five years. The Company capitalized approximately $4.3 million and $4.4 million during 2013 and 2012, respectively. Maintenance and operating costs are expensed as incurred. As of December 31, 2013 and 2012, there were no capitalized internal development costs for computer software developed for resale.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants at the measurement date. The fair value hierarchy prioritizes the inputs to valuation techniques used in measuring fair value. There are three levels to the fair value hierarchy based on the reliability of inputs, as follows:

Level 1	Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2	Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3	Unobservable inputs in which little or no market data exists, therefore requiring the Company to develop its own assumptions.

The Company evaluates assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level at which to classify them for each reporting period. This determination requires significant judgments to be made by the Company.

At December 31, 2013, the fair value measurement amounts for assets consisted of marketable securities which are classified as available for sale. The carrying amounts reported in the consolidated balance sheets approximate the fair value of the Company s marketable securities based on quoted market prices or alternative pricing sources and models utilizing market observable inputs. At December 31, 2013 and 2012, the Company did not have any financial liabilities that were subject to fair value measurements.

Property and Equipment

Property and equipment are stated on the basis of cost. Depreciation and amortization are provided on the straight-line method over the following estimated useful lives, except for assets under capital leases and leasehold improvements, which are amortized over the shorter of the estimated useful life or their respective lease term. Depreciation and amortization of property and equipment totaled $3.3 million and $2.6 million for the years ended December 31, 2013 and 2012, respectively.

	Years
Furniture and fixtures	5-10
Equipment	3-5

Goodwill and Intangible Assets

Goodwill represents the excess of purchase price over fair value of net tangible assets acquired. The Company evaluates goodwill for impairment at the reporting unit level by assessing whether it is more likely than not that the fair value of a reporting unit exceeds its carrying value. If this assessment concludes that is more likely than not that the fair value of a reporting unit exceeds its carrying value, then goodwill is not considered impaired and no further impairment testing is required. Conversely, if the assessment concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying value, a goodwill impairment test is performed to compare the fair value of the reporting unit to its carrying value. The Company determines fair value of the reporting units using both income and market based models. The Company will perform its goodwill impairment test whenever events or changes in facts or circumstances indicate that impairment may exist, and at least annually during the fourth quarter.

As of December 31, 2013 intangible assets with remaining unamortized balances include contract rights and customer relationships, internally-developed technology and patents, non-competition agreements, and trade names. These intangible assets are considered to have definite useful lives and are being amortized on a straight line basis over periods typically ranging between five and ten years. The weighted average amortization period for definite lived intangible assets as of December 31, 2013 was 8.7 years. Intangible assets are reviewed for impairment whenever events or changes in facts or circumstances indicate that the carrying amount of the assets may not be recoverable. There were no impairments identified or recorded for the years ended December 31, 2013, 2012, or 2011.

Long-Lived Assets

Long-lived assets to be held for use are reviewed for events or changes in facts and circumstances, both internally and externally, which may indicate that an impairment of long-lived assets held for use is present. The Company measures any impairment using observable market values or discounted future cash flows from the related long-lived assets. The cash flow estimates and discount rates incorporate management s best estimates, using appropriate and customary assumptions and projections at the date of evaluation. Management periodically evaluates whether the carrying value of long-lived assets, including property and equipment, capitalized software development, other assets and intangible assets will be recoverable. There were no impairments identified or recorded for the years ended December 31, 2013, 2012, or 2011.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Other Assets

Other assets are comprised of the long-term portion of content development fees and non-marketable equity investments.

Non-Marketable Equity Investments

Non-marketable equity investments are accounted for using the equity method when the Company can exercise significant influence over the investee. Investments for which the Company is not able to exercise significant influence over the investee are accounted for under the cost method. The proportionate share of income or loss from equity method investments are recorded under the caption other income (expense), net in the accompanying consolidated statements of income.

Financial Instruments

The Company has financial instruments, including cash and cash equivalents, accounts receivable, accounts receivable-unbilled, accounts payable, accrued liabilities, and deferred revenue. The carrying amounts of these financial instruments approximate fair value because of the short term maturity or short term nature of such instruments. Marketable securities approximate fair value based on quoted market prices, see Note 4.

Income Taxes

Income taxes are accounted for using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. 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. There are 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 its deferred tax assets each reporting period to identify whether any significant changes in circumstances or assumptions have occurred that could materially affect the realizability of deferred tax assets. As of December 31, 2013, the Company had established a valuation allowance of $1.3 million for the portion of its net deferred tax assets that are not more likely than not expected to be realized.

The Company accounts for income tax uncertainties using a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold are measured in order to determine the tax benefit to be recognized in the financial statements. The Company expenses any penalties or interest associated with tax obligations as general and administrative expenses and interest expense, respectively.

Other Long Term Liabilities

Other long term liabilities represent the deferred rent liability associated with an operating lease for office space in Nashville, Tennessee as well as deferred service credits (see Note 9).

Advertising

The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2013, 2012, and 2011 was approximately $408,000, $349,000, and $251,000, respectively.

Shipping and Handling Costs

Shipping and handling costs that are associated with our products and services are included in cost of revenues.

Earnings Per Share

Basic earnings 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 earnings 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, are included in diluted net income per share to the extent these shares are dilutive. Common equivalent shares that have an anti-dilutive effect on diluted net income per share have been excluded from the calculation of diluted weighted average shares outstanding for the years ended December 31, 2013, 2012, and 2011.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Concentrations of Credit Risk and Significant Customers

The Company places its temporary excess cash investments in high quality, short-term money market instruments. At times, such investments may be in excess of the FDIC insurance limits.

The Company sells its products and services to various companies in the healthcare industry that are located in the United States. We perform ongoing credit evaluations of our customers financial condition and generally require no collateral from customers. The Company did not have any single customer representing over 10% of net revenues during 2013, 2012, or 2011.

Stock Based Compensation

As of December 31, 2013, the Company maintains two stock based compensation plans, which are described in Note 12. The Company accounts for stock based compensation using the fair-value based method for costs related to share-based payments, including stock options and restricted share units. The Company uses the Black Scholes option pricing model for calculating the fair value of option awards issued under its stock based compensation plan. The Company measures compensation cost of restricted share units based on the closing fair market value of the Company s stock on the date of grant. Stock based compensation cost is measured at the grant date, based on the fair value of the award that is ultimately expected to vest, and is recognized as an expense over the requisite service period. The Company recognizes tax benefits from stock based compensation if an excess tax benefit is realized. Excess tax benefits are recorded as an increase to common stock when realized.

Newly Issued Accounting Standards

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (ASU 2013-02), which is effective prospectively for public companies for reporting periods beginning after December 15, 2012. This new accounting standard improves the reporting of reclassifications out of accumulated other comprehensive income (AOCI) by requiring an entity to report the effect of significant reclassifications out of AOCI on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted this new guidance on January 1, 2013 and the adoption did not have a material effect on our consolidated financial statements.

2. SHAREHOLDERS EQUITY

Common Stock

The Company is authorized to issue up to 75 million shares of common stock. The number of common shares issued and outstanding as of December 31, 2013 and 2012 was approximately 27.3 million and 26.2 million, respectively.

Preferred Stock

The Company is authorized to issue up to 10 million shares of preferred stock in one or more series, having the relative voting powers, designations, preferences, rights and qualifications, limitations or restrictions, and other terms as the Board of Directors may fix in providing for the issuance of such series, without any vote or action of the shareholders. During 2000, all outstanding shares of preferred stock were converted into common stock in connection with our initial public offering (IPO). There have been no shares of preferred stock outstanding since our IPO.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share for the three years ended December 31, 2013 (in thousands, except per share amounts):

	2013	2012	2011
Numerator:			
Net income	$ 8,418	$ 7,645	$ 6,944
Denominator:			
Weighted-average shares outstanding	26,853	26,128	22,445
Effect of dilutive shares	810	1,379	1,303
Weighted-average diluted shares	27,663	27,507	23,748
Basic earnings per share	$ 0.31	$ 0.29	$ 0.31
Diluted earnings per share	$ 0.30	$ 0.28	$ 0.29

Potentially dilutive shares representing approximately 70,000, 105,000, and 247,000 shares of common stock for 2013, 2012, and 2011, respectively, were excluded from the calculation of diluted earnings per share because their effect would have been anti-dilutive.

4. MARKETABLE SECURITIES

At December 31, 2013 and 2012, the fair value of marketable securities, which were all classified as available for sale, included the following (in thousands):

	December 31, 2013			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Level 2:				
Certificates of deposit	$ 2,260	$	$	$ 2,260
Corporate debt securities	46,430		(31)	46,399
Subtotal	48,690		(31)	48,659
Total	$ 48,690	$	$ (31)	$ 48,659

	December 31, 2012			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Level 1:				
Mutual funds	$ 5,042	$ 30	$	$ 5,072

Level 2:				
Certificates of deposit	2,254			2,254
Commercial paper	3,122	1		3,123
Corporate debt securities	27,017	1	(17)	27,001
U.S. government securities	14,499	3		14,502
Subtotal	46,892	5	(17)	46,880
Total	$ 51,934	$ 35	$ (17)	$ 51,952

The carrying amounts reported in the consolidated balance sheet approximate fair value based on quoted market prices or alternative pricing sources and models utilizing market observable inputs. As of December 31, 2013, the Company does not consider any of its marketable securities to be other than temporarily impaired. During 2013, the Company recorded realized gains of approximately $5,000 from sales of marketable securities. All investments in marketable securities are classified as a current asset on the balance sheet because the underlying securities mature within one year from the balance sheet date.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. BUSINESS COMBINATIONS

On June 29, 2012, the Company acquired all of the stock of Decision Critical, Inc., (DCI) an Austin, Texas based company that specializes in learning and competency management products for acute-care hospitals. The Company acquired DCI to further advance its suite of workforce development solutions. The consideration paid for DCI consisted of approximately $3.4 million in cash and 22,124 shares of our common stock. Also, the Company may make additional payments of up to $300,000, contingent upon achievement of certain financial targets and business outcomes within a three year period after the closing date. As of December 31, 2013, approximately $146,000 of these contingent payments have been paid to the DCI shareholders. The Company incurred approximately $203,000 in transaction costs associated with the DCI acquisition, which are included on the accompanying consolidated statements of income under the caption other general and administrative. In allocating the purchase price, the Company recorded approximately $2.9 million of goodwill, $1.5 million of identifiable intangible assets, $291,000 of net tangible assets and $456,000 of deferred tax liabilities. The goodwill balance is primarily attributed to assembled workforce, expanded market opportunities from DCI s workforce development products, and expected synergies from integrating DCI s products into our platform. The goodwill balance is not deductible for U.S. income tax purposes. The net tangible assets include deferred revenue, which in accordance with US GAAP, was adjusted down from a book value of $548,000 to an estimated fair value of $356,000. The deferred revenue recorded represents the estimated fair value of the contractual obligation assumed as of the acquisition date. The $192,000 write-down of deferred revenue resulted in lower revenues than would have otherwise been recognized for such services. The results of operations for DCI have been included in the Company s consolidated financial statements from the date of acquisition, and are included in the HealthStream Workforce Development Solutions segment.

On October 19, 2012, the Company acquired all of the stock of Sy.Med Development, Inc. (Sy.Med), a Brentwood, Tennessee based company that specializes in credentialing related software products for healthcare providers. The Company acquired Sy.Med to further advance its suite of workforce development solutions. The consideration paid for Sy.Med consisted of approximately $7.4 million in cash and 34,060 shares of our common stock. The Company may make additional payments of up to $1.5 million, contingent upon achievement of certain financial targets and business outcomes within a two year period after the closing date. As of December 31, 2013, approximately $625,000 of these contingent payments have been paid to the Sy.Med shareholders. The Company incurred approximately $165,000 in transaction costs associated with the Sy.Med acquisition, which are included on the accompanying consolidated statements of income under the caption other general and administrative. In allocating the purchase price, the Company recorded approximately $5.4 million of goodwill, $6.5 million of identifiable intangible assets, $294,000 of net tangible assets and $2.8 million of deferred tax liabilities. The goodwill balance is primarily attributed to assembled workforce, additional market opportunities of Sy.Med s credentialing software, and expected synergies from integrating Sy.Med s products into our platform. The goodwill balance is not deductible for U.S. income tax purposes. The net tangible assets include deferred revenue, which was adjusted down from a book value of $1.1 million to an estimated fair value of $229,000. The $916,000 write-down of deferred revenue resulted in lower revenues than would have otherwise been recognized for such services. The results of operations for Sy.Med have been included in the Company s consolidated financial statements from the date of acquisition, and are included in the HealthStream Workforce Development Solutions segment.

On September 9, 2013, the Company acquired substantially all of the assets of Baptist Leadership Group (BLG), a Pensacola, Florida based company that provides consulting services focused on patient-centered performance excellence in healthcare. The Company acquired BLG to strengthen its Research/Patient Experience Solutions. The consideration paid for BLG consisted of approximately $7.4 million in cash (taking into account the working capital adjustment) and 15,230 shares of our common stock. The Company incurred approximately $145,000 in transaction costs associated with the acquisition, which are included on the accompanying consolidated statements of income under the caption other general and administrative. In allocating the purchase price, the Company recorded approximately $6.3 million of goodwill, $1.6 million of identifiable intangible assets, and $28,000 of net tangible assets. The goodwill balance is primarily attributed to the assembled workforce, additional market opportunities from BLG s consulting services, and expected synergies from integrating BLG into the operations of the HealthStream Research/Patient Experience Solutions segment. The goodwill balance is deductible for U.S. income tax purposes. The net tangible assets include deferred revenue, which was adjusted down from a book value of $508,000 to an estimated fair value of $254,000. The $254,000 write-down of deferred revenue resulted in lower revenues than would have otherwise been recognized for such services. The results of operations for BLG have been included in the Company s consolidated financial statements from the date of acquisition, and are included in the HealthStream Research/Patient Experience Solutions segment.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. GOODWILL

Goodwill is evaluated for impairment at least annually to determine whether it is more likely than not that the fair value of the reporting units exceed their carrying value. If this assessment concludes that is more likely than not that the fair value of a reporting unit exceeds its carrying value, then goodwill is not considered impaired and no further impairment testing is required. Qualitative factors are considered for this assessment, such as, financial performance, industry and market comparables, and other factors affecting the reporting unit. If the assessment concludes that it is more likely than not that the fair value of a reporting unit is less than its carrying value, a goodwill impairment test is performed to compare the fair value of the reporting unit to its carrying value. The Company determines fair value of the reporting units using both income and market based models. Under these methods, the technique used to determine fair value is sensitive to estimates and assumptions associated with cash flow from operations and its growth, discount rates, and reporting unit terminal values. The Company performs its annual impairment evaluation of goodwill during the fourth quarter of each year and as changes in facts and circumstances indicate impairment exists. During the annual impairment evaluation in the fourth quarter of 2013 and 2012, the results of our assessment indicated goodwill was not impaired.

During 2013, the Company acquired Baptist Leadership Group, and during 2012, the Company acquired Decision Critical, Inc. and Sy.Med Development, Inc. The changes in the carrying amount of goodwill for the years ended December 31, 2013 and 2012 are as follows (in thousands):

	Workforce Development	Research/Patient Experience	Total
Balance at January 1, 2013	$ 11,459	$ 17,840	$ 29,299
Acquisition of Sy.Med Development, Inc.	133		133
Acquisition of Baptist Leadership Group		6,314	6,314
Balance at December 31, 2013	$ 11,592	$ 24,154	$ 35,746

	Workforce Development	Research/Patient Experience	Total
Balance at January 1, 2012	$ 3,307	$ 17,840	$ 21,147
Acquisition of Sy.Med Development, Inc.	5,291		5,291
Acquisition of Decision Critical, Inc.	2,861		2,861
Balance at December 31, 2012	$ 11,459	$ 17,840	$ 29,299

7. INTANGIBLE ASSETS

All intangible assets are considered to have finite useful lives. Customer related intangibles are amortized over their estimated useful lives ranging from eight to ten years. Other intangible assets include non-competition agreements, technology and patents, and trade names, and are being amortized over periods ranging from five to nine years. Amortization of intangible assets was approximately $1.5 million, $1.1 million, and $0.9 million, for the years ended December 31, 2013, 2012 and 2011, respectively.

Identifiable intangible assets are comprised of the following (in thousands):

	As of December 31, 2013			As of December 31, 2012		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Customer related	$ 16,889	$ (10,145)	$ 6,744	$ 15,619	$ (8,969)	$ 6,650
Other	3,370	(1,244)	2,126	3,222	(1,067)	2,155
Total	$ 20,259	$ (11,389)	$ 8,870	$ 18,841	$ (10,036)	$ 8,805

The expected future annual amortization expense for the years ending December 31, is as follows (in thousands):

2014	$ 1,569
2015	1,211
2016	1,122
2017	1,092
2018	990
Thereafter	2,886
Total	$ 8,870

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. COLLABORATIVE ARRANGEMENT

The Company participates in a collaborative arrangement, SimVentures^{TM}, with Laerdal Medical A/S (Laerdal Medical). The Company receives 50 percent of the profits or losses generated from this collaborative arrangement. The parties did not form a separate legal entity as part of the collaborative arrangement; therefore, the Company accounts for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. For the year ended December 31, 2013, the Company recorded approximately $2.3 million of revenues and $2.3 million of expenses related to the collaborative arrangement. For the year ended December 31, 2012, the Company recorded approximately $1.7 million of revenues and $1.7 million of expenses related to the collaborative arrangement. The Company also recorded approximately $0.9 million and $1.3 million of capitalized software development costs for SimVentures during 2013 and 2012, respectively.

9. CONTENT RIGHTS AND DEFERRED SERVICE CREDITS

During 2012, the Company entered into a renewal agreement with a customer in which the Company was provided continued rights to distribute and resell courseware owned by the customer. In exchange for the receipt of an exclusive license to distribute and resell this courseware, the Company has provided, and will continue to provide, the customer with service credits that can be exchanged for future purchases of the Company s products and services. The value assigned to the content rights and the deferred service credits was $500,000, which represents the estimated fair value of the assets relinquished. The content rights are classified within other prepaid expenses and other assets, and the deferred service credits are classified within accrued liabilities and other long-term liabilities on our condensed consolidated balance sheets.

These exchangeable service credits will be issued annually through December 31, 2016, and will expire twenty-four months after issuance. Any unused credits will be forfeited upon expiration. During 2012 and 2013, the Company issued exchangeable service credits of $100,000, respectively, in accordance with this agreement, and is obligated to issue remaining service credits of $100,000 annually through 2016. The content rights are being amortized on a straight-line basis through December 31, 2016. Revenues for products or services provided in exchange for these service credits will be recognized in accordance with the Company s revenue recognition policies.

10. BUSINESS SEGMENTS

The Company provides services to healthcare organizations and other members within the healthcare industry. These services are primarily focused on the delivery of workforce development products and services (HealthStream Workforce Development Solutions, formerly referred to as HealthStream Learning & Talent Management), as well as survey and research services (HealthStream Research/Patient Experience Solutions).

The Company measures segment performance based on operating income before income taxes and prior to the allocation of certain corporate overhead expenses, interest income, interest expense, and depreciation. The Unallocated component below includes corporate functions, such as accounting, human resources, legal, investor relations, administrative, and executive personnel, depreciation, a portion of amortization, and certain other expenses, which are not currently allocated in measuring segment performance. The following is the Company s business segment information as of and for the years ended December 31, 2013, 2012 and 2011 (in thousands).

	Year ended December 31, 2013			
	Workforce Development	Research/Patient Experience	Unallocated	Consolidated
Revenues, net	$ 103,820	$ 28,454	$	$ 132,274
Cost of revenues (excluding depreciation and amortization)	39,478	16,127		55,605
Product development	10,262	1,495		11,757
Sales and marketing	18,301	5,415	336	24,052
Other general and administrative	3,787	1,530	13,025	18,342

Depreciation and amortization	3,512	1,068	3,272	7,852
Total income from operations	$ 28,480	$ 2,819	$ (16,633)	$ 14,666
*Segment assets	$ 60,013	$ 34,727	$ 117,854	$ 212,594
Purchases of property and equipment	$ 2,598	$ 171	$ 1,675	$ 4,444
Payments associated with capitalized software development	$ 3,712	$ 555	$	$ 4,267

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. BUSINESS SEGMENTS (continued)

	Year ended December 31, 2012			
	Workforce Development	Research/Patient Experience	Unallocated	Consolidated
Revenues, net	$ 78,566	$ 25,166	$	$ 103,732
Cost of revenues (excluding depreciation and amortization)	28,390	13,268		41,658
Product development	7,040	1,570		8,610
Sales and marketing	14,081	5,420	391	19,892
Other general and administrative	2,760	1,330	9,362	13,452
Depreciation and amortization	2,877	1,179	2,605	6,661
Total income from operations	$ 23,418	$ 2,399	$ (12,358)	$ 13,459
*Segment assets	$ 46,693	$ 23,978	$ 103,857	$ 174,528
Purchases of property and equipment	$ 1,728	$ 120	$ 2,468	$ 4,316
Payments associated with capitalized software development	$ 3,536	$ 899	$	$ 4,435

	Year ended December 31, 2011			
	Workforce Development	Research/Patient Experience	Unallocated	Consolidated
Revenues, net	$ 58,078	$ 23,988	$	$ 82,066
Cost of revenues (excluding depreciation and amortization)	18,842	12,224		31,066
Product development	5,907	1,566		7,473
Sales and marketing	10,871	4,733	413	16,017
Other general and administrative	2,116	1,632	7,012	10,760
Depreciation and amortization	2,364	1,194	1,854	5,412
Total income from operations	$ 17,978	$ 2,639	$ (9,279)	$ 11,338
*Segment assets	$ 27,322	$ 26,088	$ 100,827	$ 154,237
Purchases of property and equipment	$ 1,577	$ 44	$ 2,494	$ 4,115
Payments associated with capitalized software development	$ 5,720	$ 345	$	$ 6,065

* Segment assets include accounts and unbilled receivables, prepaid royalties, prepaid and other current assets, other assets, capitalized software development, certain property and equipment, and intangible assets. Cash and cash equivalents and marketable securities are not

allocated to individual segments, and are included within Unallocated. A significant portion of property and equipment assets are included within Unallocated.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INCOME TAXES

The provision for income taxes is comprised of the following (in thousands):

	Year Ended December 31,		
	2013	**2012**	**2011**
Current federal	$ 2,474	$ 58	$ 163
Current state	1,444	273	214
Deferred federal	2,315	4,804	3,723
Deferred state	191	797	304
Provision for income taxes	$ 6,424	$ 5,932	$ 4,404

A reconciliation of income taxes at the statutory federal income tax rate to the provision for income taxes included in the accompanying consolidated statements of income is as follows (in thousands):

	Year Ended December 31,		
	2013	**2012**	**2011**
Federal tax provision at the statutory rate	$ 5,194	$ 4,751	$ 3,972
State income tax provision, net of federal benefit	898	974	337
Change in state valuation allowance	231		
Other	101	207	95
Provision for income taxes	$ 6,424	$ 5,932	$ 4,404

Management periodically assesses the realizability of its deferred tax assets, and to the extent that a recovery is not likely, a valuation allowance is established to reduce the deferred tax asset to the amount estimated to be recoverable. At December 31, 2013, a valuation allowance of $1.3 million exists, of which $1.1 million is comprised of the portion of net operating loss carryforwards attributable to the exercises of stock options. Any future reductions of the valuation allowance associated with the portion of the deferred tax asset comprised of stock option exercises would be recognized as an increase to common stock.

As of December 31, 2013, the Company had federal and state net operating loss carryforwards of $18.3 million and $13.9 million, respectively. These loss carryforwards will expire in years 2014 through 2024. As of December 31, 2013, $1.1 million of the net operating loss carryforwards deferred tax asset is attributable to the exercise of stock options, and if realized, the tax benefit will be recorded as an increase to common stock.

The Company has research and development tax credit carryforwards of $393,000 that expire in varying amounts through 2033. These credits were recognized in 2013 as a reduction to common stock. As of December 31, 2013, the Company had alternative minimum tax credit carryforwards of $592,000 that are available to offset future regular tax liabilities and they do not expire. Federal income tax payments of $28,000, $189,000 and $194,000, were made during the years ended December 31, 2013, 2012, and 2011, respectively. State income tax payments of $343,000, $238,000, and $193,000 were made during the years ended December 31, 2013, 2012, and 2011, respectively.

A reconciliation of the beginning and ending liability for gross unrecognized tax benefits at December 31, 2013 and 2012, are as follows (in thousands):

	December 31, 2013	December 31, 2012
Balance at beginning of year	$	$
Additions for tax positions in the current year	167	
Balance at end of year	$ 167	$

The components of the income tax liability at December 31, 2013 and 2012, are as follows (in thousands):

	December 31, 2013	December 31, 2012
Unrecognized tax benefits	$ 167	$
Accrued interest and penalties	2	
Balance at end of year	$ 169	$

None of the $167,000 of unrecognized tax benefits at December 31, 2013, if recognized, would affect the Company s effective tax rate.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INCOME TAXES (continued)

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 2009 through 2013. Loss carryforwards and credit carryforwards generated or utilized in years earlier than 2009 are also subject to examination and adjustment. The Company has no income tax examinations in process.

Deferred federal and state income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred tax assets and deferred tax liabilities are as follows (in thousands):

	December 31,	
	2013	2012
Deferred tax assets:		
Allowance for doubtful accounts	$ 84	$ 57
Accrued liabilities	1,225	463
Tax credits	702	902
Stock based compensation	966	650
Net operating loss carryforwards	1,256	3,485
Total deferred tax assets	4,233	5,557
Less: Valuation allowance	(1,325)	(1,093)
Deferred tax assets, net of valuation allowance	2,908	4,464
Deferred tax liabilities:		
Deductible goodwill	2,020	1,492
Nondeductible intangible assets	2,677	3,194
Prepaid assets	781	538
Capitalized software development	2,910	2,253
Deferred revenue		220
Depreciation	341	223
Basis difference on investments	533	559
Total deferred tax liabilities	9,262	8,479
Net deferred tax liabilities	$ (6,354)	$ (4,015)

12. STOCK BASED COMPENSATION

Stock Incentive Plans

The Company s 2010 Stock Incentive Plan (2010 Plan) and 2000 Stock Incentive Plan (2000 Plan; collectively, the 2010 Plan and the 2000 Plan referred to as the Plan) authorize the grant of options, restricted share units (RSU), or other forms of stock based compensation to employees, officers, directors and others, and such grants must be approved by the Compensation Committee of the Board of Directors. Options granted under the Plan have terms of no more than ten years, with certain restrictions. The Plan allows the Compensation Committee of the Board of Directors to determine the vesting period and parameters of each grant. The vesting period of the options and RSUs granted has historically ranged from immediate vesting to annual vesting up to four years, beginning one year after the grant date. As of December 31, 2013, approximately 813,000 shares of unissued common stock remained reserved for future stock incentive grants under the Plan. The Company issues new shares of common stock when options are exercised or when RSUs become vested.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCK BASED COMPENSATION (continued)

Stock Option Activity

A summary of activity and various other information relative to stock options for the year ended December 31, 2013 is presented in the tables below (in thousands, except exercise price).

	Common Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of period	1,914	$ 4.29	
Granted			
Exercised	(1,073)	3.15	
Expired			
Forfeited	(4)	6.11	
Outstanding at end of period	837	$ 5.73	$ 22,514
Exercisable at end of period	594	$ 5.06	$ 16,375

The aggregate intrinsic value for stock options in the table above represents the total difference between the Company s closing stock price on December 31, 2013 (the last trading day of the year) of $32.63 and the option exercise price, multiplied by the number of in-the-money options as of December 31, 2013. The weighted average remaining contractual term of options outstanding at December 31, 2013 was 3.8 years. Options exercisable at December 31, 2013 have a weighted average remaining contractual term of 3.4 years.

Other information relative to option activity during the three years ended December 31, 2013 is as follows (in thousands, except weighted average grant date fair value):

	2013	2012	2011
Weighted average grant date fair value of stock options granted	$	$	$ 4.67
Total grant date fair value of stock options vested	$ 723	$ 878	$ 644
Total intrinsic value of stock options exercised	$ 25,846	$ 4,992	$ 4,539
Cash proceeds from exercise of stock options	$ 3,318	$ 823	$ 1,242

Restricted Share Unit Activity

A summary of activity relative to RSUs for the year ended December 31, 2013 is follows (in thousands, except weighted average grant date fair value):

	Number of RSU s	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at beginning of period	73	$ 23.22	
Granted	80	22.02	
Vested	(16)	23.07	
Forfeited			
Outstanding at end of period	137	$ 22.53	$ 4,466

The aggregate fair value of RSU awards that vested in 2013, as of the respective vesting dates, was approximately $345,000. A portion of RSUs that vested in 2013 were net-share settled such that the Company withheld shares with value equivalent to the employees minimum statutory obligation for the applicable income and other employment taxes, and remitted the cash to the appropriate taxing authorities. The total shares withheld for RSUs during 2013 were 2,210, and were based on the value of the RSUs on their respective vesting dates as determined by the Company s closing stock price. One stock option exercise was net-share settled during 2013, resulting in 7,606 shares withheld for settlement of employee tax obligations. Total payments related to RSUs and stock options for the employees tax obligations to taxing authorities were approximately $164,000 in 2013, and are reflected as a financing activity within the Consolidated Statements of Cash Flows. These net-share settlements had the effect of share repurchases by the Company as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to the Company.

HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCK BASED COMPENSATION (continued)

Stock Based Compensation

Total stock based compensation expense recorded for the three years ended December 31, 2013, which is recorded in our statements of income, is as follows (in thousands):

	Years Ended December 31,		
	2013	**2012**	**2011**
Cost of revenues (excluding depreciation and amortization)	$ 81	$ 45	$ 41
Product development	144	133	179
Sales and marketing	175	151	104
Other general and administrative	1,058	807	464
Total stock based compensation expense	$ 1,458	$ 1,136	$ 788

The Company amortizes the fair value of all stock based awards, net of estimated forfeitures, on a straight-line basis over the requisite service period, which generally is the vesting period. As of December 31, 2013, total unrecognized compensation expense related to non-vested stock options and RSU s was approximately $2.5 million, net of estimated forfeitures, with a weighted average expense recognition period remaining of 2.3 years. The Company realized approximately $3.7 million of excess tax benefits during the year ended December 31, 2013, which was recorded as an increase to common stock.

Stock based compensation cost for RSU s is measured based on the closing fair market value of the Company s stock on the date of grant. Stock based compensation cost for stock options is estimated at the grant date based on the fair value calculated using the Black-Scholes method. The Company did not grant any stock options during 2013 or 2012. The ranges of assumptions used for determining the estimated fair value of stock options during 2011 were as follows:

Risk-free interest rate	1.05 2.39%
Expected dividend yield	0.0%
Expected life (in years)	5 to 7
Expected forfeiture rate	0-5%
Volatility	50%

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

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

Expected life is the period of time the option is expected to remain outstanding, and is based on historical experience. The contractual option life ranges from eight to ten years. The Company estimated the expected life of options granted to members of management to be five years and seven years for directors.

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

Volatility is the measure of the amount by which the price is expected to fluctuate. The Company estimated volatility based on the actual historical volatility of the Company s common stock, and management believes future volatility will be similar to the Company s historical volatility experience.

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. EMPLOYEE BENEFIT PLAN

401(k) Plan

The Company has a defined-contribution employee benefit plan (401(k) Plan) incorporating provisions of Section 401(k) of the Internal Revenue Code. Employees must have attained the age of 21 and have completed thirty days of service to be eligible to participate in the 401(k) Plan. Under the provisions of the 401(k) Plan, a plan member may make contributions, on a tax-deferred basis, not to exceed 20% of compensation, subject to IRS limitations. The Company has not provided matching contributions through December 31, 2013.

14. DEBT

At December 31, 2013 and 2012, the Company had no debt outstanding.

Revolving Credit Facility

The Company maintains a Loan Agreement (the Revolving Credit Facility) with SunTrust Bank (SunTrust) in the aggregate principal amount of $20.0 million, which matures on July 21, 2014. The obligations under the revolving credit facility are guaranteed by each of the Company s subsidiaries. The Company s borrowings under the revolving credit facility bear interest at the 30-Day LIBOR Rate plus a margin of either 175 or 200 basis points determined in accordance with a pricing grid. Principal is payable in full on the maturity date. The Company is required to pay a commitment fee of 25 basis points per annum of the average daily unused portion of the revolving credit facility.

The purpose of the revolving credit facility is for general working capital needs, permitted acquisitions (as defined in the Loan Agreement), and for stock repurchase and/or redemption transactions that the Company may authorize.

The revolving credit facility contains certain covenants that, among other things, restrict additional indebtedness, liens and encumbrances, changes to the character of the Company s business, acquisitions, asset dispositions, mergers and consolidations, sale or discount of receivables, creation or acquisitions of additional subsidiaries, and other matters customarily restricted in such agreements.

In addition, the revolving credit facility requires the Company to meet certain financial tests, including, without limitation:

a maximum total leverage ratio (consolidated debt/consolidated EBITDA) of 2.0 to 1.0;

funded debt to total capitalization may not exceed 40%; and

tangible net worth may not be less than $1.00

As of December 31, 2013, the Company believes it was in compliance with all covenants. There were no balances outstanding on the revolving credit facility as of December 31, 2013.

15. LEASES

The Company has non-cancellable operating leases primarily for office space and office equipment. Some lease agreements contain provisions for escalating rent payments over the initial terms of the lease. The Company accounts for these leases by recognizing rent expense on a straight-line basis and adjusting the deferred rent expense liability for the difference between the straight-line rent expense and the amount of rent paid. The Company also leases certain office equipment under operating leases. Total rent expense under all operating leases was approximately $2.4 million, $2.2 million, and $1.9 million, for the years ended December 31, 2013, 2012, and 2011, respectively.

Future rental payment commitments at December 31, 2013 under non-cancelable operating leases, with initial terms of one year or more, are as follows (in thousands):

2014	$ 2,665
2015	2,062
2016	1,359
2017	446
2018	59
Thereafter	
Total minimum lease payments	$ 6,591

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HEALTHSTREAM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. LITIGATION

In the ordinary course of business, the Company is from time to time involved in various pending legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon the financial condition and/or results of operations of the Company. However, in the opinion of the Company s management, matters currently pending or threatened against the Company are not expected to have a material adverse effect on the financial position or results of operations of the Company.

17. SUBSEQUENT EVENT

On March 3, 2014, the Company acquired all of the stock of Health Care Compliance Strategies, Inc. (HCCS) a Jericho, New York based company that specializes in healthcare compliance solution and services. The Company acquired HCCS to further advance its suite of workforce development solutions, including its offering of compliance solutions. The consideration paid for HCCS consisted of approximately $13.0 million in cash, subject to a post-closing working capital adjustment, and 81,614 shares of our common stock. The Company may make additional payments of up to $750,000, contingent upon achievement of certain performance milestones post-closing.

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Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***
None.

Item 9A. ***Controls and Procedures***
Evaluation of Disclosure Controls and Procedures

HealthStream s chief executive officer and principal financial officer have reviewed and evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2013. Based on that evaluation, the chief executive officer and principal financial officer have concluded that HealthStream s disclosure controls and procedures were effective to ensure that the information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and the information required to be disclosed in the reports the Company files or submits under the Exchange Act was accumulated and communicated to the Company s management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Management s Annual Report On Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, and for assessing the effectiveness of internal control over financial reporting. The Company s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The Company s internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Management s assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Management believes that, as of December 31, 2013, the Company s internal control over financial reporting was effective based on those criteria. The Company s independent registered public accounting firm, Ernst & Young LLP, has issued an audit report on the Company s internal control over financial reporting, which appears in Item 8 of this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There were no changes in HealthStream s internal control over financial reporting that occurred during the fourth quarter of 2013 that have materially affected, or that are reasonably likely to materially affect, HealthStream s internal control over financial reporting.

Item 9B. ***Other Information***
None.

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PART III

Item 10. ***Directors, Executive Officers and Corporate Governance***

Information as to directors of the Company and corporate governance is incorporated by reference from the information contained in our 2014 proxy statement for the 2014 Annual Meeting of Shareholders (2014 Proxy Statement) that we will file with the Securities and Exchange Commission within 120 days of the end of the fiscal year to which this report relates. Pursuant to General Instruction G(3), certain information concerning executive officers of the Company is included in Part I of this Form 10-K, under the caption Executive Officers of the Registrant.

Item 11. ***Executive Compensation***

Incorporated by reference from the information contained in the Company s 2014 Proxy Statement.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

Incorporated by reference from the information contained in the Company s 2014 Proxy Statement.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence***

Incorporated by reference from the information contained in the Company s 2014 Proxy Statement.

Item 14. ***Principal Accounting Fees and Services***

Incorporated by reference from the information contained in the Company s 2014 Proxy Statement.

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PART IV

Item 15. ***Exhibits, Financial Statement Schedules***
(a)(1) Financial Statements

Reference is made to the financial statements included in Item 8 to this Report on Form 10-K.

(a)(2) Financial Statement Schedules

All schedules are omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or the notes thereto.

(a)(3) Exhibits

Number	Description
2.1 (1)	Stock Purchase Agreement, dated as of March 28, 2005, by and among HealthStream, Inc., Mel B. Thompson and Data Management & Research, Inc.
2.2 (2)	Stock Purchase Agreement, dated as of March 12, 2007, by and among HealthStream, Inc., The Jackson Organization, Research Consultants, Inc., David Jackson and the Jackson Charitable Remainder Trust
3.1*	Form of Fourth Amended and Restated Charter of HealthStream, Inc.
3.2*	Form of Amended and Restated Bylaws of HealthStream, Inc.
4.1*	Form of certificate representing the common stock, no par value per share, of HealthStream, Inc.
4.2*	Reference is made to Exhibits 3.1 and 3.2.
10.1^*	2000 Stock Incentive Plan, effective as of April 10, 2000
10.2^ (10)	2010 Stock Incentive Plan, effective as of May 27, 2010
10.3^*	Form of Indemnification Agreement
10.4^ (3)	Executive Employment Agreement, dated July 21, 2005, between HealthStream, Inc. and Robert A. Frist, Jr.
10.5^ (4)	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Employees)
10.6^ (4)	Form of HealthStream, Inc. Incentive Stock Option Agreement (Employees)
10.7^ (4)	Form of HealthStream, Inc. Non-Qualified Stock Option Agreement (Directors)
10.8^ (5)	Form of HealthStream, Inc. Restricted Share Unit Agreement (Officers)
10.9^ (5)	Form of HealthStream, Inc. Restricted Share Unit Agreement (Non-Employee Director)
10.10 (6)	Loan Agreement dated July 21, 2006 between HealthStream, Inc. and SunTrust Bank
10.11 (7)	First Amendment to Loan Agreement dated February 16, 2007 between HealthStream, Inc. and SunTrust Bank
10.12 (8)	Second Amendment to Loan Agreement dated July 23, 2007 between HealthStream, Inc. and SunTrust Bank
10.13 (9)	Third Amendment to Loan Agreement dated July 17, 2009 between HealthStream, Inc. and SunTrust Bank
10.14 (11)	Fourth Amendment to Loan Agreement dated March 30, 2011 between HealthStream, Inc. and SunTrust Bank
10.15 (12)	Fifth Amendment to Loan Agreement dated July 19, 2012 between HealthStream, Inc. and SunTrust Bank

10.16^	Summary of Director and Executive Officer Compensation
21.1	Subsidiaries of HealthStream, Inc.
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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101.1 INS	XBRL Instance Document
101.1 SCH	XBRL Taxonomy Extension Schema
101.1 CAL	XBRL Taxonomy Extension Calculation Linkbase
101.1 DEF	XBRL Taxonomy Extension Definition Linkbase
101.1 LAB	XBRL Taxonomy Extension Label Linkbase
101.1 PRE	XBRL Taxonomy Extension Presentation Linkbase

*	Incorporated by reference to Registrant s Registration Statement on Form S-1, as amended (Reg. No. 333-88939).
^	Management contract or compensatory plan or arrangement
(1)	Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated March 29, 2005.
(2)	Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated March 12, 2007.
(3)	Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated July 25, 2005.
(4)	Incorporated by reference from exhibit filed on our Current Report on Form 8-K, dated June 1, 2010.
(5)	Incorporated by reference from exhibit filed on our Quarterly Report on Form 10-Q, dated March 31, 2012.
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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 4th day of March, 2014.

HEALTHSTREAM, INC.

By: /s/ ROBERT A. FRIST, JR.
Robert A. Frist, Jr.

Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title(s)	Date
/s/ ROBERT A. FRIST, JR.	President, Chief Executive Officer and	March 4, 2014
Robert A. Frist, Jr.	Chairman (Principal Executive Officer)	
/s/ GERARD M. HAYDEN, JR.	Chief Financial Officer and Senior Vice President	March 4, 2014
Gerard M. Hayden, Jr.	(Principal Financial and Accounting Officer)	
/s/ THOMPSON DENT	Director	March 4, 2014
Thompson Dent		
/s/ FRANK GORDON	Director	March 4, 2014
Frank Gordon		
/s/ C. MARTIN HARRIS	Director	March 4, 2014
C. Martin Harris		
/s/ JEFFREY L. MCLAREN	Director	March 4, 2014
Jeffrey L. McLaren		
/s/ DALE POLLEY	Director	March 4, 2014
Dale Polley		
/s/ LINDA REBROVICK	Director	March 4, 2014
Linda Rebrovick		
/s/ MICHAEL SHMERLING	Director	March 4, 2014

Michael Shmerling		
/s/ WILLIAM STEAD	Director	March 4, 2014
William Stead		
/s/ DEBORAH TAYLOR TATE	Director	March 4, 2014
Deborah Taylor Tate		

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