eHealth, Inc.
Form 10-Q
November 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

001-33071

(Commission File Number)

EHEALTH, INC.

(Exact name of registrant as specified in its charter)

Delaware	**56-2357876**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

440 EAST MIDDLEFIELD ROAD

MOUNTAIN VIEW, CALIFORNIA 94043

(Address of principal executive offices)

(650) 584-2700

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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

The number of shares of the registrant s common stock, par value $0.001 per share, outstanding as of October 31, 2008 was 25,077,349 shares.

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EHEALTH, INC. FORM 10-Q

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EHEALTH, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	December 31, 2007	September 30, 2008 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 81,395	$ 90,525
Marketable securities	40,119	52,731
Accounts receivable	1,300	1,560
Deferred income taxes	13,240	6,582
Prepaid expenses and other current assets	2,098	1,482
Total current assets	138,152	152,880
Property and equipment, net	3,791	4,762
Deferred income taxes	4,535	4,535
Other assets	975	955
Total assets	$ 147,453	$ 163,132
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 1,495	$ 1,855
Accrued compensation and benefits	4,849	4,003
Accrued marketing expenses	2,454	3,942
Deferred revenue	436	351
Other current liabilities	2,073	2,272
Total current liabilities	11,307	12,423
Other non-current liabilities	252	432
Commitments and contingencies		
Stockholders equity:		
Preferred stock		
Common stock	25	25
Additional paid-in capital	167,847	172,032
Deferred stock-based compensation	(104)	(40)
Accumulated deficit	(32,060)	(21,541)
Accumulated other comprehensive income (loss)	186	(199)
Total stockholders equity	135,894	150,277
Total liabilities and stockholders equity	$ 147,453	$ 163,132

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EHEALTH, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(In thousands, except per share amounts, unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Revenue:				
Commission	$ 21,313	$ 25,788	$ 59,486	$ 74,663
Sponsorship, licensing and other	1,684	2,687	4,072	7,593
Total revenue	22,997	28,475	63,558	82,256
Operating costs and expenses:				
Cost of revenue-sharing	427	469	1,245	1,338
Marketing and advertising	7,309	11,502	21,021	30,633
Customer care and enrollment	3,002	3,722	8,859	10,655
Technology and content	3,108	3,565	9,025	10,548
General and administrative	4,308	4,731	11,698	13,475
Total operating costs and expenses	18,154	23,989	51,848	66,649
Income from operations	4,843	4,486	11,710	15,607
Interest and other income, net	1,403	935	3,849	3,085
Income before income taxes	6,246	5,421	15,599	18,692
Provision for income taxes	2,516	2,400	6,324	8,173
Net income	$ 3,730	$ 3,021	$ 9,235	$ 10,519
Comprehensive income:				
Net income	$ 3,730	$ 3,021	$ 9,235	$ 10,519
Change in unrealized gain (loss) on investments, net of taxes	49	(419)	43	(454)
Foreign currency translation adjustment, net of taxes	17	4	47	69
Total comprehensive income	$ 3,796	$ 2,606	$ 9,325	$ 10,134
Net income per share:				
Basic	$ 0.16	$ 0.12	$ 0.41	$ 0.42
Diluted	$ 0.14	$ 0.12	$ 0.36	$ 0.40
Weighted-average number of shares used in per share amounts:				
Basic	23,517	25,060	22,643	24,925
Diluted	26,263	25,921	25,746	26,007

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EHEALTH, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Operating activities		
Net income	$ 9,235	$ 10,519
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	6,109	7,146
Depreciation and amortization	1,275	1,271
Stock-based compensation expense	962	2,609
Excess tax benefits from stock-based compensation		(216)
Deferred rent expense	(22)	(43)
Loss on disposal of property and equipment	18	39
Changes in operating assets and liabilities:		
Accounts receivable	(331)	(260)
Prepaid expenses and other current assets	184	456
Other assets	(523)	21
Accounts payable	(302)	357
Accrued compensation and benefits	(67)	(700)
Accrued marketing expenses	776	1,488
Deferred revenue	215	(85)
Other current liabilities	753	148
Net cash provided by operating activities	18,282	22,750
Investing activities		
Purchases of property and equipment	(1,053)	(2,242)
Proceeds from the sale of property and equipment	14	
Purchases of marketable securities	(36,520)	(61,565)
Sales of marketable securities	2,156	10,120
Maturities of marketable securities	588	38,379
Net cash used in investing activities	(34,815)	(15,308)
Financing activities		
Net proceeds from exercise of common stock options	5,343	1,426
Excess tax benefits from stock-based compensation		216
Principal payments in connection with capital leases	(212)	
Costs incurred in connection with initial public offering	(252)	
Net cash provided by financing activities	4,879	1,642
Effect of exchange rate changes on cash and cash equivalents	64	46
Net (decrease) increase in cash and cash equivalents	(11,590)	9,130
Cash and cash equivalents at beginning of period	90,316	81,395
Cash and cash equivalents at end of period	$ 78,726	$ 90,525

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 Summary of Business and Significant Accounting Policies

Description of Business eHealth, Inc. (the Company, we or us) offers Internet-based insurance agency services for individuals, families and small businesses in the United States, as well as technology licensing and Internet advertising services. Our services and technology enable individuals, families and small businesses to research, analyze, compare and purchase health insurance products from health insurance carriers across the nation. We are licensed to market and sell health insurance in all 50 states and the District of Columbia.

Basis of Presentation The accompanying condensed consolidated balance sheet as of September 30, 2008, the condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2007 and 2008 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and 2008 are unaudited. The condensed consolidated balance sheet data as of December 31, 2007 was derived from the audited consolidated financial statements which are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, which was filed with the Securities and Exchange Commission on March 17, 2008. The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in our Annual Report on Form 10-K.

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim financial information. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in our Annual Report on Form 10-K, and include all adjustments necessary for the fair presentation of eHealth s statement of financial position as of September 30, 2008, its results of operations for the three and nine months ended September 30, 2007 and 2008 and its cash flows for the nine months ended September 30, 2007 and 2008. All adjustments are of a normal recurring nature. The results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for any subsequent quarter or for the fiscal year ending December 31, 2008.

Significant Customers Revenue for all periods presented was generated from customers located solely in the United States. The following carriers (or carriers owned by them) represented 10% or more of our total revenue for the three and nine months ended September 30, 2007 and 2008 (unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2008**	**2007**	**2008**
UnitedHealthcare	18%	17%	19%	17%
Wellpoint	17%	16%	18%	16%
Aetna	12%	14%	11%	13%

Revenue attributable to individual and family product offerings represented approximately 85% of our commission revenue in the three and nine months ended September 30, 2007, and represented approximately 88% and 87% of our commission revenue in the three and nine months ended September 30, 2008, respectively. We define individual and family product offerings as major medical individual and family health insurance plans, which does not include small business, short-term major medical, stand-alone dental, life and student health insurance product offerings.

Disposal of Capital Equipment During the three and nine months ended September 30, 2008, we disposed of certain capital equipment, primarily computer equipment and software, with a gross book value of $0.7 million. The net book value of these assets was not significant at the time of their disposal and we recorded an immaterial loss in our condensed consolidated statements of income and comprehensive income as a result of their disposal. During the three and nine months ended September 30, 2007, we disposed of certain computer equipment, software and office equipment with a gross book value of $2.0 million. The net book value of these assets was not significant at the time of their disposal and we recorded an immaterial loss in our condensed consolidated statements of income and comprehensive income as a result of their disposal.

Recent Accounting Pronouncements We implemented SFAS No. 157 (SFAS 157), *Fair Value Measurement*, effective January 1, 2008 for our financial assets and liabilities that are re-measured and reported at fair value at each reporting period, and non-financial assets and liabilities that are re-measured and reported at fair value at least annually. In

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

accordance with the provisions of FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157,* we have elected to defer until January 1, 2009 the implementation of SFAS 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. The partial adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

We adopted SFAS No. 159 (SFAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities,* effective January 1, 2008. SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The implementation of SFAS 159 did not have an impact on our consolidated financial position, results of operations or cash flows, as we did not elect to adopt the fair value option under this Statement.

In October 2008, the FASB issued Staff Position (FSP) No. FAS 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarifies the application of Statement No. 157 in an inactive market and illustrates how an entity would determine fair value when the market for a financial asset is not active. The Staff Position is effective immediately and applies to prior periods for which financial statements have not been issued, including interim or annual periods ending on or before September 30, 2008. The implementation of FAS 157-3 did not have an impact on our consolidated financial position, results of operations or cash flows.

Note 2 Cash, Cash Equivalents and Marketable Securities

Cash and Cash Equivalents Cash equivalents are comprised primarily of highly liquid available-for-sale financial instruments with an original maturity of 90 days or less from the date of purchase. As of September 30, 2008, our money market funds consisted primarily of federal agency securities. The cost, unrealized gains and losses, net of taxes, and estimated fair value of our cash equivalents consisted of the following as of September 30, 2008 and December 31, 2007 (in thousands):

	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
September 30, 2008 (unaudited)				
Cash	$ 1,288	$	$	$ 1,288
Cash equivalents:				
Money market funds	76,254			76,254
Commercial paper	10,484		1	10,483
U.S. government-sponsored enterprise discount notes	1,498	2		1,500
U.S. government-sponsored enterprise bonds	1,000			1,000
Total cash equivalents	89,236	2	1	89,237
Total cash and cash equivalents	$ 90,524	$ 2	$ 1	$ 90,525
December 31, 2007				
Cash	$ 4,580	$	$	$ 4,580
Cash equivalents:				
Money market funds	55,292			55,292
Commercial paper	21,521	2		21,523
Total cash equivalents	76,813	2		76,815

Total cash and cash equivalents	$ 81,393	$ 2	$	$ 81,395

We did not realize any significant gains or losses on sales of cash equivalents during the three and nine months ended September 30, 2007 and 2008.

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Marketable Securities Marketable securities are comprised primarily of highly liquid available-for-sale financial instruments with original maturities of more than 90 days from the date of purchase. Marketable securities that are available for use in current operations are classified as current assets in the accompanying condensed consolidated balance sheets regardless of the remaining time to maturity. The cost, unrealized gains and losses, net of taxes, and estimated fair value of our marketable securities consisted of the following as of September 30, 2008 and December 31, 2007 (in thousands):

	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
September 30, 2008 (unaudited)				
U.S. government-sponsored enterprise bonds	$ 18,344	$ 9	$ 27	$ 18,326
Corporate bonds	17,505	7	389	17,123
U.S. government-sponsored enterprise discount notes	10,565	4	2	10,567
Commercial paper	5,716		1	5,715
Certificates of deposit	1,000			1,000
Total marketable securities	$ 53,130	$ 20	$ 419	$ 52,731
December 31, 2007				
Corporate bonds	$ 15,368	$ 36	$ 6	$ 15,398
Commercial paper	13,047	2		13,049
U.S. government-sponsored enterprise bonds	11,298	25	1	11,322
Certificates of deposit	350			350
Total marketable securities	$ 40,063	$ 63	$ 7	$ 40,119

We did not realize any significant gains or losses on sales of marketable securities during the three and nine months ended September 30, 2007 and 2008.

During the three and nine months ended September 30, 2008, we incurred net unrealized losses on our marketable securities of $0.4 million and $0.5 million, respectively. Net unrealized gains and losses incurred on our marketable securities during the three and nine months ended September 30, 2007 were not significant. Net unrealized losses are the result of the change in fair value of our investments in marketable securities, primarily corporate bonds, at the beginning and end of the period and are excluded from earnings and reported as a component of stockholders equity in the condensed consolidated balance sheets and in comprehensive income on the condensed consolidated statements of income and comprehensive income.

At September 30, 2008, we evaluated each of our unrealized losses, the majority of which are from corporate bonds, and determined them to be temporary in accordance with Emerging Issues Task Force (EITF) Abstract No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. Factors we considered in determining whether unrealized losses were temporary included the length of time and extent to which each investment s fair value has been less than its cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value. Based upon our evaluation of these factors, and because we have the ability and intent to hold each of our investments with net unrealized losses until their respective maturity dates, we do not consider these investments to be other-than-temporarily impaired at September 30, 2008.

The contractual maturities of our marketable securities as of December 31, 2007 and September 30, 2008, were as follows (in thousands):

	Estimated Fair Value as of December 31, 2007	Estimated Fair Value as of September 30, 2008 (unaudited)
Due within 1 year	$ 28,219	$ 48,054
Due within 1 year to 2 years	11,900	4,677
Total marketable securities	$ 40,119	$ 52,731

Note 3 Fair Value Measurements

SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. SFAS No. 157 classifies the inputs used to measure fair value into the following hierarchy:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities

Level 2 Unadjusted quoted prices in active markets for similar assets or liabilities, or
Unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or
Inputs other than quoted prices that are observable for the asset or liability

Level 3 Unobservable inputs for the asset or liability

The following table presents information about our financial assets (cash equivalents and marketable securities) that are re-measured and reported at fair value on a recurring basis as of September 30, 2008, and indicates the fair value hierarchy of the valuation techniques we utilized to determine such fair value (in thousands, unaudited):

	As of September 30, 2008		
	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Total
Cash equivalents:			
Money market funds	$ 76,254	$	$ 76,254
Commercial paper		10,483	10,483
U.S. government-sponsored enterprise discount notes		1,500	1,500
U.S. government-sponsored enterprise bonds		1,000	1,000
	76,254	12,983	89,237
Marketable securities:			
U.S. government-sponsored enterprise bonds		18,326	18,326
Corporate bonds		17,123	17,123
U.S. government-sponsored enterprise discount notes		10,567	10,567
Commercial paper		5,715	5,715
Certificates of deposit		1,000	1,000
		52,731	52,731
Total cash equivalents and marketable securities	$ 76,254	$ 65,714	$ 141,968

We endeavor to utilize the best available information in measuring fair value. We used observable prices in active markets in determining the classification of our money market funds as Level 1. For our other cash equivalents and marketable securities classified as Level 2, we primarily relied on observable quotes in active markets; however if we concluded the market was non-active, we relied on independent market pricing data. We did not hold any financial assets as of September 30, 2008 whereby the fair value measurements are estimated using significant unobservable inputs (Level 3).

Note 4 Stockholder s Equity and Stock-Based Compensation

Stockholders Equity

Stock Plans Our 2006 Equity Incentive Plan (the 2006 Plan) became effective in October 2006. As of September 30, 2008, we had 2,909,252 shares of our common stock available for future grants under the 2006 Plan. On January 1 of each year, the number of shares available for future grant under the 2006 Plan will automatically increase by the lowest of (a) 1,500,000 shares, (b) 4% of the total number of shares of our common stock then outstanding or (c) a lower number determined by our board of directors or its compensation committee. As of January 1, 2008, shares reserved under the 2006 Plan automatically increased by 987,473 shares, which equaled 4% of the total number of shares of our common stock then outstanding.

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The following table summarizes activity under all of our stock plans (Stock Plans) (in thousands, except per share amounts and weighted-average remaining contractual life data, unaudited):

	Shares Available for Grant	Number of Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Balance at December 31, 2007	2,464	2,626	$ 7.44		
Additional shares authorized (1)	987				
Shares expired (2)	(14)				
Options granted	(497)	497	$ 21.95		
Restricted stock granted	(195)				
Options exercised		(380)	$ 3.91		
Options cancelled	154	(154)	$ 24.13		
Restricted stock cancelled	10				
Balance at September 30, 2008	2,909	2,589	$ 9.75	6.11	$ 20,977

(1) On January 1, 2008, the number of shares authorized for issuance under the 2006 Plan was automatically increased pursuant to the terms of the 2006 Plan by 987,473 shares.

(2) The 1998 Stock Plan and 2005 Stock Plan were terminated with respect to the grant of additional shares upon the effective date of the registration statement related to our initial public offering in October 2006, resulting in reductions in the total number of authorized shares from the expiration of unvested grants.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying stock options and the fair value of our common stock at September 30, 2008.

The fair value of stock options granted to employees for the three and nine months ended September 30, 2007 and 2008 was estimated using the following weighted-average assumptions (unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Expected term	6.1 years	6.1 years	6.1 years	4.8 years
Expected volatility	59.6%	57.4%	59.6%	54.9%
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.48%	3.48%	4.48%	3.15%
Weighted-average fair value	$ 14.63	$ 8.41	$ 13.04	$ 10.78

The following table summarizes restricted stock unit activity under the Stock Plans (in thousands, except weighted-average remaining contractual life data, unaudited):

	Number of Restricted Stock Units Outstanding	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Balance as of December 31, 2007	23		
Granted	195		
Cancelled	(7)		
Vested	(10)		
Balance as of September 30, 2008	201	1.85	$ 3,212

The aggregate intrinsic value is calculated as the fair value at September 30, 2008 of the underlying common stock outstanding and vested and expected to vest as of September 30, 2008.

EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Stock-Based Compensation

The following table summarizes stock-based compensation expense recorded during the three and nine months ended September 30, 2007 and 2008 (in thousands, unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Awards granted to employees accounted for in accordance with SFAS 123R:				
Common stock options	$ 267	$ 755	$ 712	$ 1,909
Restricted stock units	50	182	138	634
Restricted common stock	5	1	15	11
	322	938	865	2,554
Awards granted to employees accounted for in accordance with APB 25:				
Common stock options	4		17	
Restricted common stock	24	17	80	55
	28	17	97	55
Total stock-based compensation expense	$ 350	$ 955	$ 962	$ 2,609

The following table summarizes stock-based compensation expense by operating function included in the condensed consolidated statements of income for the three and nine months ended September 30, 2007 and 2008 (in thousands, unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Marketing and advertising	$ 45	$ 151	$ 113	$ 484
Customer care and enrollment	30	49	86	200
Technology and content	143	203	416	653
General and administrative	132	552	347	1,272
Total stock-based compensation expense	$ 350	$ 955	$ 962	$ 2,609

Note 5 Income Taxes

On September 23, 2008, the state of California approved its budget for fiscal year ending June 30, 2009, which contained changes to the California tax law which substantially limit our ability to utilize available state net operating loss and tax credit carry forwards to reduce our state income taxes payable. Under the new tax law, the utilization of net operating loss carry forwards is suspended for tax years 2008 and 2009; however, the expiration date of the net operating loss carry forwards is extended for an equivalent two-year period. Additionally, for tax years 2008 and 2009, taxpayers may only utilize available tax credit carry forwards to reduce their current tax liability up to 50% of their net tax amount before application of such credits. The new law does not affect the amount of net operating loss or tax credit carry forwards that we expect to ultimately use to offset future California taxes; however, it does limit the amount of net operating loss and tax credit carry forwards that we will be able to utilize to reduce our taxes payable during the years ending December 31, 2008 and 2009, resulting in an increase in cash taxes payable to the state of California in those years. While we do not expect this change in the California tax law to impact our effective tax rate, we expect that our cash outlay for federal and state taxes will increase to approximately 4.5% of pre-tax income for the year ending December 31, 2008.

Under SFAS 123R, we consider stock option deduction benefits in excess of book compensation charges realized when we obtain an incremental benefit determined by the With and Without calculation method. Under the With and Without approach, excess tax benefits related to share-based payments are not deemed to be realized until after the utilization of all other tax benefits available to us. For example, net operating loss and tax credit carry forwards from prior years are used to reduce taxes currently payable prior to deductions from stock option exercises for purposes of financial reporting, while for

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

tax return purposes, current year stock compensation deductions are generally used before net operating loss carry forwards. Indirect effects of excess tax benefits, such as the effect on research and development tax credits, are not considered. In accordance with SFAS 123R, only realized excess tax benefits are reflected in the financial statements.

During the three and nine months ended September 30, 2008, we recorded a provision for income taxes of $2.4 million and $8.2 million, respectively, representing an effective tax rate of approximately 44%. During the three and nine months ended September 30, 2007, we recorded a provision for income taxes of $2.5 million and $6.3 million, respectively, representing an effective tax rate of approximately 41%. Our deferred tax assets were reduced due to the extent we were able to utilize net operating loss and tax credit carry forwards to reduce taxes currently payable. In addition, due to the restriction on our ability to utilize net operating loss carry forwards to reduce taxes currently payable in California, we utilized excess tax benefits related to share-based payments and other unrecognized tax benefits, which resulted in a $0.2 million increase in additional paid-in capital and a $0.3 million increase in other non-current liabilities, respectively, in the condensed consolidated balance sheet as of September 30, 2008. Additionally, the $0.2 million of realized excess tax benefits related to share-based payments is classified in the condensed consolidated statements of cash flows as both a financing cash inflow and an operating cash outflow.

We adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, on January 1, 2007. As of December 31, 2007 and September 30, 2008, we had approximately $2.4 million and $2.6 million, respectively, of unrecognized tax benefits. As of December 31, 2007 and September 30, 2008, there were $2.0 million and $2.1 million, respectively, of unrecognized tax benefits, that, if recognized, would impact the effective tax rate. Due to net operating losses, all tax years after 1998 are open to examination and adjustment.

On October 3, 2008, the *Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008 and Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (HR1424)* was signed into law, which, as enacted, includes a provision that retroactively extends the federal research and development tax credit from January 1, 2008 through December 31, 2009. Federal research and development tax credits for the year ending December 31, 2008, which are not expected to be material, will be included in our provision for income taxes for the three months ending December 31, 2008.

Note 6 Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding for the fiscal period. Diluted net income per share is computed giving effect to all potential dilutive common stock, including options, restricted stock and restricted stock units. The dilutive effect of outstanding awards is reflected in diluted earnings per share by application of the treasury stock method.

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts, unaudited):

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Basic:				
Numerator:				
Net income allocated to common stock	$ 3,730	$ 3,021	$ 9,235	$ 10,519
Denominator:				
Weighted average number of common stock shares	23,517	25,060	22,643	24,925
Net income per share basic:	$ 0.16	$ 0.12	$ 0.41	$ 0.42
Diluted:				
Numerator:				
Net income allocated to common stock	$ 3,730	$ 3,021	$ 9,235	$ 10,519
Denominator:				
Weighted average number of common stock shares	23,517	25,060	22,643	24,925
Weighted average number of options	2,730	859	3,089	1,064
Weighted average number of restricted stock and restricted stock units	16	2	14	18
Total common stock shares used in per share calculation	26,263	25,921	25,746	26,007
Net income per share diluted:	$ 0.14	$ 0.12	$ 0.36	$ 0.40

For each of the three and nine months ended September 30, 2007 and 2008, we had securities outstanding that could potentially dilute earnings per share, but the shares from the assumed conversion or exercise of these securities were excluded in the computation of diluted net income per share as their effect would have been anti-dilutive. The number of outstanding anti-dilutive weighted shares that were excluded from the computation of diluted net income per share consisted of the following (in thousands, unaudited):

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2008
Common stock options	232	838	177	643
Restricted stock units	3	196		
	235	1,034	177	643

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EHEALTH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Note 7 Geographic Information

Revenue for all periods presented was generated from customers located solely in the United States. As of December 31, 2007 and September 30, 2008, our long-lived assets consisted primarily of property and equipment and indefinite-lived intangible assets. Our long-lived assets are attributed to the geographic location in which they are located. Long-lived assets by geographical area were as follows (in thousands):

	As of December 31, 2007	As of September 30, 2008 (unaudited)
United States	$ 4,172	$ 5,008
China	594	709
Total	$ 4,766	$ 5,717

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements relating to expectations regarding our future effective tax rates and the amount of tax credits and cash outlay for taxes we will pay for 2008, including as a result of recent changes to California tax laws; our expectation that the rate of online adoption will continue to be a primary driver of revenue; an increase in our cost of acquiring members and factors impacting such increase; exploration of new marketing initiatives that increase per member acquisition costs; critical accounting policies and estimates and related impact on our financial statements; estimated commission forfeiture rates; expected term and volatility of stock based awards; our expectation to continue to grant equity awards in the future and that stock based compensation expense will increase and be material over time; realization of earnings to utilize deferred tax assets; our expectation to continue to utilize excess tax benefits related to share-based payments and other unrecognized tax benefits and the related impact on additional paid-in capital; our expectation that total revenue will increase in absolute dollars as a result of continued growth in our membership base and growth in our sponsorship and technology licensing businesses; our expectation that our cost of revenue-sharing will remain at current similar levels on a percentage of total revenue basis but increase modestly in absolute dollars; our expectation that our marketing and advertising expenses will increase in absolute dollars primarily due to an increase in online advertising and marketing opportunities; our expectation that our customer care and enrollment expenses will remain at a similar level on a percentage of total revenue basis and increase in absolute dollars; our expectation that technology and content expenses and general and administrative expenses as a percentage of total revenue will remain at similar levels but increase in absolute dollars and related factors impacting such increases; our expectation that interest and other income, net will decrease in absolute dollars and as a percentage of total revenue; the sufficiency of our cash, cash equivalents and marketable securities; future capital requirements; our intention to invest in a variety of instruments; future expenditures; factors on which our future growth will depend; our anticipation that our branding initiatives become increasingly difficult and expensive; changes to our ecommerce platform and other initiatives and the potential impact of such changes; growth of the individual and family health insurance market and factors contributing to such growth; factors affecting a softening of demand for our products and services, including as a result of changes in customer preferences or a weakening of the U.S. economy, and the related impact on our revenue and business; expansion of our Chinese operations and the additional management and resources required; expansion of our insurance platform in China to other geographic areas; as well as other statements regarding our future operations, financial condition, prospects and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this report, and in particular, the risks discussed under the heading Risk Factors in Part II, Item 1A of this report and those discussed in our other Securities and Exchange Commission filings. The following discussion should be read in conjunction with our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 17, 2008, and the audited consolidated financial statements and related notes contained therein. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, you are cautioned not to place undue reliance on such forward-looking statements.

Overview

We are the leading online source of health insurance for individuals, families and small businesses. Our ecommerce platform enables individuals, families and small businesses to research, analyze, compare and purchase health insurance products that best meet their needs. Our technology also enables us to communicate electronically with our insurance carrier partners and process consumers health insurance applications online. As a result, we simplify and streamline the complex and traditionally paper-intensive health insurance sales and purchasing process.

Since our incorporation in November 1997, we have spent a significant amount on technology and content related to our ecommerce platform. We have also invested significant time and resources in obtaining licenses to sell health insurance in all 50 states and the District of Columbia, developing diverse and successful member acquisition programs and establishing relationships with over 180 leading insurance carriers, enabling us to offer thousands of health insurance products online. Our first online transaction relating to the sale of a health insurance policy was completed during the fourth quarter of 1998.

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Our financial model is characterized by recurring revenue, an average member product life that exceeds two years (estimated on a revenue weighted-average basis for all products purchased through us, including short-term products that are on average held for less than four months) and health insurance pricing that is set by each health insurance carrier and approved by state regulators. We generate revenue primarily from commissions we receive from health insurance carriers whose policies are purchased through us by individuals, families and small businesses. We typically receive commission payments on a monthly basis for as long as a policy remains active. As a result, much of our revenue for a given financial reporting period relates to policies that we sold prior to the beginning of the period and is recurring in nature. Because health insurance pricing is set by the carrier and approved by state regulators, health insurance pricing is fixed. We, therefore, are not generally subject to negotiation or discounting of prices by health insurance carriers or our competitors.

Sources of Revenue

Revenue

Commission revenue represented 93% and 94% of our total revenue for the three and nine months ended September 30, 2007, respectively, and 91% of our total revenue for the three and nine months ended September 30, 2008. The remainder of our revenue is primarily attributable to carrier sponsorship advertising on our website and licensing arrangements related to our technology. Our commission revenue has grown principally as a result of our penetration of the individual and family health insurance markets and corresponding growth in our membership. We estimate that as of September 30, 2008 we had approximately 602,100 members compared to the estimated 518,400 members we reported at December 31, 2007. We define a member as an individual covered by an insurance product for which we are entitled to receive compensation.

We believe our revenue and business have historically been more significantly affected by the rate of growth in the number of consumers using the Internet to research and purchase health insurance than by the rate at which the health insurance industry has grown. We expect that the rate of online adoption will continue to be a primary driver of our revenue.

Our commission revenue generally represents a percentage of the insurance premium a member has paid to his or her insurance carrier and, to a lesser extent, commission override payments that insurance carriers pay us for achieving sales volume thresholds or other objectives. Commission rates vary by carrier and by the type of plan purchased by a member. Commission rates also can vary based upon the amount of time that the policy has been active, with commission rates for individual and family policies typically being higher in the first twelve months of the policy. After the first twelve months, commission rates generally decline significantly. As a result, if we do not add a sufficient number of members on new policies, our revenue growth may be negatively impacted. Individuals, families and small businesses purchasing health insurance through us typically pay their premiums on a monthly basis. Insurance carriers typically pay us our commissions monthly, after they receive the premium payment from the member. We generally continue to receive the commission payment from the relevant insurance carrier until the health insurance policy is cancelled or we otherwise do not remain the agent on the policy. As a result, the majority of our revenue is recurring in nature and has grown in correlation with the growth we experience in our membership base.

We recognize commission revenue when our commission is reported to us by a health insurance carrier, net of an allowance for future forfeiture amounts payable to carriers due to policy cancellations. Commissions are reported to us by a cash payment and commission statement. We generally receive these communications simultaneously. In instances when we receive the cash payment and commission statement separately and in different accounting periods, we recognize revenue in the period that we receive the earliest communication, provided we receive the second communication corroborating the amount reported in the first communication within ten business days. If the second corroborating communication is not received within ten business days, we recognize revenue in the period the second communication is received. We use the data in the commission statement to identify the members for which we are receiving a commission payment and the amount received for each member, and to estimate our allowance for forfeitures. Commission override payments, which are recognized on the same basis as premium commissions, are generally reported to us in a more irregular pattern than premium commissions. As a result, our revenue for a particular quarter could be higher or lower than expectations due to the timing of the reporting of commission override payments.

Revenue attributable to individual and family product offerings represented approximately 85% of our commission revenue in the three and nine months ended September 30, 2007, and represented approximately 88% and 87% of our commission revenue in the three and nine months ended September 30, 2008, respectively. We define individual and family product offerings as major medical individual and family health insurance plans, which does not include small business, short-term major medical, stand-alone dental, life and student health insurance product offerings.

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In addition to the commission revenue we derive from the sale of health insurance products, we derive revenue from our online sponsorship advertising program and from licensing the use of our ecommerce technology. Our sponsorship advertising program allows carriers to purchase advertising space in specific markets in a sponsorship area on our website. In return, we are typically paid a monthly fee, which is recognized over the period that advertising is displayed, and often a performance fee based on metrics such as submitted health insurance applications. Our technology licensing business allows carriers the use of our ecommerce platform to offer their own health insurance policies on their websites and agents to utilize our technology to power their online quoting, content and application submission processes. Typically, we are paid a one-time implementation fee, which we recognize on a straight-line basis over the estimated term of the customer relationship (generally the initial term of the agreement), commencing once the technology is available for use by the third party, and a performance fee based on metrics such as submitted health insurance applications. The metrics used to calculate performance fees for both sponsorship advertising and technology licensing are based on performance criteria that is either measured based on data that is tracked by us, or based on data that is tracked by the third party. In instances where the performance criteria data is tracked by us, we recognize revenue in the period of performance. In instances where the performance criteria data is tracked by the third party, we recognize revenue when the amounts earned are both fixed and determinable and collection is reasonably assured. Typically, this occurs through our receipt of a cash payment from the third party along with a detailed statement containing the data that is tracked by the third party.

Member Acquisition

An important factor in our revenue growth is the growth of our member base. Our marketing initiatives are an important component of our strategy to grow our member base and are focused on three primary member acquisition channels: direct, marketing partners and online advertising. Our marketing initiatives are designed to attract consumers to complete an online application for health insurance on our ecommerce platform.

Direct. Our direct member acquisition channel consists of consumers who access our website addresses (*www.ehealth.com* and *www.ehealthinsurance.com*) either directly through algorithmic search listings on Internet search engines and directories or through direct links, such as links in news articles and email. Applications submitted through us for individual and family health insurance from our direct channel constituted approximately 40% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2007, and approximately 39% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2008.

Marketing Partners. Our marketing partner member acquisition channel consists of consumers who access our website through a network of affiliate partners and financial services and other companies. Growth in our marketing partner channel depends upon our expanding marketing programs with existing partners and adding new partners to our network. Applications submitted through us for individual and family health insurance products for which we paid fees to our marketing partner channel constituted approximately 31% and 30% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2007, respectively, and approximately 33% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2008.

Online Advertising. Our online advertising channel consists of consumers who access our website through paid keyword search advertising from search engines such as Google, MSN and Yahoo!, as well as various Internet marketing programs such as banner advertising, non-direct email marketing and an integrated partnership with MSN. Applications submitted through us for individual and family health insurance products from our online advertising channel constituted approximately 29% and 30% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2007, respectively, and approximately 28% of all individual and family health insurance applications submitted on our website for the three and nine months ended September 30, 2008.

Operating Costs and Expenses

Cost of Revenue-Sharing

Cost of revenue-sharing consists primarily of payments related to health insurance policies sold to members who were referred to our website by marketing partners with whom we have revenue-sharing arrangements. In order to enter into a revenue-sharing arrangement, these marketing partners must be licensed to sell health insurance in the state where the policy is sold. Costs related to revenue-sharing arrangements are expensed as the related revenue is recognized.

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Marketing and Advertising

Marketing and advertising expenses consist primarily of member acquisition expenses associated with our direct, marketing partner and online advertising channels, in addition to compensation and other expenses related to marketing, business development, public relations and carrier relations personnel who support our offerings. Our direct channel expenses primarily consist of television advertising, radio advertising, print advertising, direct mail, email and other activities that drive consumers directly to our website.

We compensate a significant number of our marketing partners by paying a one-time fee each time a consumer referral from a partner results in a submitted health insurance application on our ecommerce platform, regardless of whether the consumer s application is approved by the health insurance carrier. Many of our marketing partners have tiered volume-incentive arrangements in which the amount of the one-time fee increases as the volume of submitted applications we receive from such marketing partners increases over a particular period. We recognize these expenditures in the period when a marketing partner s referral results in the submission of a health insurance application on our website. The number of health insurance applications submitted through our ecommerce platform has generally increased in our first quarter compared to our fourth quarter and in our third quarter compared to our second quarter. Conversely, we have generally experienced a decline or flattening in submitted applications in our second quarter compared to our first quarter and in our fourth quarter compared to our third quarter. Since a significant portion of our marketing and advertising expenses are driven by the number of health insurance applications submitted on our website, those expenses generally have increased or decreased in conjunction with these patterns. In addition, because the total volume of submitted applications that we receive from our marketing partners is largely outside of our control, particularly during any short-term period, and because of our tiered volume-incentive marketing partner arrangements, we could incur expenses in excess of the amounts we had planned in periods of rapid growth in the volume of submitted applications from marketing partner referrals. Accordingly, an unanticipated increase in submitted applications resulting from marketing partner referrals could cause our net income to be lower than our expectation since the revenue to be derived from submitted applications that are approved by health insurance carriers will not be recognized until future periods.

Paid keyword search advertising on search engines represents the majority of expenses in our online advertising channel. We incur expenses associated with search engine advertising in the period in which the consumer clicks on the advertisement. We actively manage our paid keyword search advertising expense, taking into account the anticipated return from referrals. We also take into account the productivity and relative cost of paid keyword search as compared to other marketing channels and the anticipated lifetime revenue from members acquired, to control the amount of expense incurred during a given period.

We expect the average cost of acquiring new members to increase during the fourth quarter of 2008 compared to the third quarter ended September 30, 2008 primarily due to an increase in online advertising and marketing expenditures, including paid keyword search advertising. Our cost of acquisition depends significantly on the rate at which visitors to our website submit health insurance applications, particularly with respect to paid search advertising, as our paid search costs are incurred on the referral of a potential member rather than on the submission of a health insurance application. Other factors that may impact the average cost of acquiring new members include the mix of health insurance applications submitted through our three marketing channels, the mix of marketing partners referring consumers to our website, the overall trend in costs of online marketing, seasonality patterns, the amounts we pay marketing partners to refer consumers to our website, television and radio advertising expenditures, and an increase in compensation and benefit costs for marketing and advertising personnel. Additionally, we may explore new marketing initiatives that increase per member acquisition costs as part of our efforts to drive more consumers to our website.

Due to the departure of an executive officer in May 2007 who was not replaced, we reorganized the responsibilities of certain personnel in the second half of 2007. As a result, certain compensation, benefit and related expenses that were previously included in marketing and advertising and customer care and enrollment on our condensed consolidated statements of income were allocated to other functions starting in the second half of 2007 continuing through September 30, 2008. The net impact of the reorganization was to include an immaterial amount of compensation, benefit and related expense in our technology and content and general and administrative expenses during the three and nine months ended September 30, 2008, that would have remained as either marketing and advertising or customer care and enrollment expenses had the responsibilities of these personnel not changed.

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Customer Care and Enrollment

Customer care and enrollment expenses primarily consist of compensation and related expenses for personnel engaged in pre-sales assistance to applicants who call our customer care center and enrollment personnel who assist applicants during the underwriting process.

Technology and Content

Technology and content expenses consist primarily of compensation and related expenses for personnel associated with developing and enhancing our website technology as well as maintaining our website. A portion of our technology and content group is located at our wholly owned subsidiary in China, where technology development costs are generally lower than in the United States.

General and Administrative

General and administrative expenses include compensation and related expenses for staff working in our finance, legal, human resources, internal audit, facilities and internal information technology departments. These expenses also include fees paid for outside professional services, mainly for audit, tax, legal and information technology consulting.

Summary of Selected Metrics

The following table shows certain selected quarterly metrics as of September 30, 2007 and 2008 and for the three months ended September 30, 2007 and 2008 (unaudited):

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2008
Key Metrics:		
Operating cash flows (1)	$ 7,711,000	$ 8,257,000
IFP submitted applications (2)	97,900	117,300
IFP approved members (3)	83,600	100,800
Total approved members (4)	125,300	144,400
Total revenue (5)	$ 22,997,000	$ 28,475,000
Total revenue per estimated member for the period (6)	$ 48.16	$ 48.19
	As of September 30, 2007	**As of September 30, 2008**
IFP estimated membership (7)	408,100	506,100
Total estimated membership (8)	491,300	602,100
	Three Months Ended September 30, 2007	**Three Months Ended September 30, 2008**
Marketing and advertising expenses (9)	$ 7,309,000	$ 11,502,000
Marketing and advertising expenses as a percentage of total revenue (10)	32%	40%
Other Metrics:		
Source of IFP submitted applications (as a percentage of total IFP applications for the period):		
Direct (11)	40%	39%
Marketing partners (12)	31%	33%
Online advertising (13)	29%	28%
Total	100%	100%
Acquisition cost per individual on IFP submitted applications (14)	$ 49.07	$ 65.34

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Notes:

(1) Net cash provided by operating activities for the period from the condensed consolidated statements of cash flows.

(2) IFP applications submitted on eHealth s website during the period. Applications are counted as submitted when the applicant completes the application, provides a method for payment and clicks the submit button on our website and submits the application to us. The applicant generally has additional actions to take before the application will be reviewed by the insurance carrier, such as providing additional information and providing an electronic signature. In addition, an applicant may submit more than one application. We include applications for IFP products for which we receive commissions as well as other forms of payment. We define our IFP offerings as major medical individual and family health insurance plans, which does not include small business, short-term major medical, stand-alone dental, life or student health insurance product offerings.

(3) New IFP members reported to eHealth as approved during the period. Some members that are approved by a carrier do not accept the approval and therefore do not become paying members.

(4) New members for all products reported to eHealth as approved during the period. Some members that are approved by a carrier do not accept the approval and therefore do not become paying members.

(5) Total revenue (from all sources) recognized during the period from the condensed consolidated statements of income.

(6) Calculated as total revenue recognized during the period (see note (5) above) divided by average estimated membership for the period (calculated as beginning and ending estimated membership for all products for the period, divided by two).

(7) Estimated number of members active on IFP insurance policies as of the date indicated. See discussion below for further information as to our methodology in estimating membership.

(8) Estimated number of members active on all insurance policies as of the date indicated. See discussion below for further information as to our methodology in estimating membership.

(9) Marketing and advertising expenses for the period from the condensed consolidated statements of income.

(10) Calculated as marketing and advertising expenses for the period (see note (9) above) divided by total revenue for the period (see note (5) above).

(11) Percentage of IFP submitted applications from applicants who came directly to the eHealth website through algorithmic search engine results or otherwise. See note (2) above for further information as to what constitutes a submitted application.

(12) Percentage of IFP submitted applications from applicants sourced through eHealth s network of marketing partners. See note (2) above for further information as to what constitutes a submitted application.

(13) Percentage of IFP submitted applications from applicants sourced through paid search and other online advertising activities. See note (2) above for further information as to what constitutes a submitted application.

(14) Calculated as marketing and advertising expenses for the period (see note (9) above) divided by the number of individuals on IFP applications submitted on eHealth s website during the period. This metric may not reflect the true acquisition cost.

Our insurance carrier partners bill and collect insurance premiums paid by our members. Carrier partners do not report to us the number of members that we have as of a given date. The majority of our members who terminate their policies do so by discontinuing their premium payments to the carrier and do not inform us of the cancellation. Also, some of our members pay their premiums less frequently than monthly. Given the number of months required to observe non-payment of commissions in order to confirm cancellations, we estimate the number of members who are active on insurance policies as of a specified date. We estimate the number of continuing members on non-small business insurance policies as of a specific date by taking the sum of (i) the number of members for whom we have received a commission payment for the month that is six months (or three months in the case of short-term, student and dental insurance) prior to the date of estimation (after reducing that number using historical experience for assumed member cancellations over the three-month or six-month period); and (ii) the number of approved members over the six-month period (or three months in the case of short-term, student and dental insurance) prior to the date of estimation (after reducing that number using historical experience for an assumed number of members who do not accept their approved policy and for estimated member cancellations through the date of the estimate). We estimate the number of small business group members using the number of initial members at the time the group is approved, and we update this number for changes in membership if such changes are reported to us by the group or carrier in the period it is reported. However, groups generally notify the carrier directly of policy cancellations and increases or decreases in group size without informing us. Additionally, our carrier partners often do not communicate this information to us. We often are made aware of policy cancellations at the time of annual renewal and update our membership statistics accordingly in the period they are reported.

After we have estimated membership for a period, we may receive information from health insurance carriers that would have impacted the estimate if we had received the information prior to the date of estimation. We may receive commission payments or other information that indicates that a member who was not included in our estimates for a prior period was in fact an active member at that time, or that a member who was included in our estimates was in fact not an active member of ours. For instance, we reconcile information carriers provide to us and may determine that we were not historically paid commissions owed to us, which would cause us to have underestimated our membership. Additionally, carriers may require us to return commission payments paid in a prior period due to policy cancellations for members we previously estimated as being active. We reflect updated information regarding our membership in the membership estimate for the current period that we are estimating, if applicable. As a result of the delay in our receipt of information from insurance carriers, actual trends in our membership are most discernable over periods longer than from one quarter to the next. In addition, and as a result of the delay we experience in receiving information about our membership, it is difficult for us to determine with any certainty the impact of current economic conditions on our membership retention. Based on information that we now possess, we experienced a slight increase in member turnover in the fourth quarter of 2007 and in the first quarter of 2008. At this time, however, we do not have enough information to determine whether economic conditions are currently impacting turnover in our membership base.

Critical Accounting Policies and Estimates

The discussion and analysis of our consolidated financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates, judgments and assumptions that affect the reported amount of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the useful lives of long-lived assets including property and equipment, fair value of investments, fair value of intangible assets, allowances for commission forfeitures payable to carriers, income taxes and the assumptions used in determining stock-based compensation and our assessment whether internal use software and website development costs will result in additional functionality, among others. We based our estimates of the carrying value of certain assets and liabilities on historical experience and on various other assumptions that we believe to be reasonable. In many cases, we could reasonably have used different accounting policies and estimates. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results may differ materially from these estimates.

We believe the following critical accounting policies affect our more significant judgments used in the preparation of our condensed consolidated financial statements.

Revenue Recognition

We recognize commission revenue when our commission is reported to us by a health insurance carrier, net of an allowance for future forfeiture amounts payable to carriers due to policy cancellations. Commissions are reported to us by a cash payment and commission statement. We use the data in the commission statements to help identify the members for which we are receiving a commission payment and the amount received for each member, and to estimate our allowance for forfeitures payable to carriers. We are not obligated with respect to the insurance coverage sold through our ecommerce platform. As a result, we recognize the net amount of compensation earned as the agent in the transaction.

Our insurance carrier partners bill and collect insurance premiums that our members pay. We rely on health insurance carriers to report accurately and in a timely manner the amount of commissions earned by us, and we calculate our commission revenues, prepare our financial reports, projections and budgets, and direct our marketing and other operating efforts based on the reports we receive from them. Each month we analyze the reports we receive from our carriers by comparing such data to the database we maintain on our members. It is often difficult for us to independently determine whether or not carriers are reporting all commissions due to us, primarily because the majority of our members who terminate their policies do so by discontinuing their premium payments to the carrier instead of by informing us of the cancellation. Also, some of our members pay their premiums less frequently than monthly. This results in our having to identify underpayment or non-payment of commissions on a policy and follow up with a carrier to obtain an explanation and/or request correction of the amount of commissions paid to us. To date, we have not had disputes of any significance with carriers related to reported commissions. To the extent that carriers understate or fail to timely and accurately report or pay the amount of commissions due to us, we will not collect and recognize revenue to which we are entitled, which, if material in amount, would adversely affect our operating results and financial condition.

Commission override revenue, which we recognize on the same basis as premium commissions, is generally reported to us in a more irregular pattern than premium commissions. As a result, our revenues for a particular quarter could be higher or lower than expectations due to the timing of the reporting of commission override revenue to us.

Certain commission amounts are subject to forfeiture in circumstances where a member has prepaid his or her premium for a future period of coverage and subsequently cancels his or her policy before the completion of that period. We estimate and record an allowance for these forfeitures based on historical cancellation experience using data provided on commission statements. The forfeitures are typically reported to us by health insurance carriers one to two months after the commission

is reported and paid to us by the carrier. Our estimate of the allowance for forfeitures includes an estimate of both the reporting time lag and the forfeiture amount. Changes in our historical trends would result in changes to our estimated forfeitures in future periods. There were no changes in our average forfeiture rates or reporting time lag during the three and nine months ended September 30, 2007 and 2008, which had a material impact on our allowance for forfeitures.

In addition to the commission revenue we derive from the sale of health insurance products, we derive revenue from our online sponsorship advertising program and from licensing the use of our ecommerce technology. Our sponsorship advertising program allows carriers to purchase advertising space in specific markets in a sponsorship area on our website. In return, we are typically paid a monthly fee, which is recognized over the period that advertising is displayed, and often a performance fee based on metrics such as submitted health insurance applications. Our technology licensing business allows carriers the use of our ecommerce platform to offer their own health insurance policies on their websites and agents to utilize our technology to power their online quoting, content and application submission processes. Typically, we are paid a one-time implementation fee, which we recognize on a straight-line basis over the estimated term of the customer relationship (generally the initial term of the agreement), commencing once the technology is available for use by the third party, and a performance fee based on metrics such as submitted health insurance applications. The metrics used to calculate performance fees for both sponsorship advertising and technology licensing are based on performance criteria that is either measured based on data that is tracked by us, or based on data that is tracked by the third party. In instances where the performance criteria data is tracked by us, we recognize revenue in the period of performance. In instances where the performance criteria data is tracked by the third party, we recognize revenue when the amounts earned are both fixed and determinable and collection is reasonably assured. Typically, this occurs through our receipt of a cash payment from the third party along with a detailed statement containing the data that is tracked by the third party.

Deferred revenue consists of deferred technology licensing implementation fees as well as amounts collected from sponsorship or technology licensing customers in advance of our performing our service for such customers. We also defer amounts that have been reported to us related to transactions where our services are complete, but where we cannot currently estimate the allowance for future forfeitures related to those amounts.

Internal-Use Software and Website Development Costs

We account for internal-use software and website development costs in accordance with the guidance set forth in Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and EITF Issue No. 00 02, *Accounting for Web Site Development Costs*. We capitalize costs of materials, consultants and compensation and related expenses of employees who devote time to the development of internal-use software; however, we usually expense as incurred website development costs for new features and functionalities because it is not probable that they will result in additional functionality until they are both developed and tested with confirmation that they are more effective than the current set of features and functionalities on our website. Our judgment is required in determining the point at which various projects enter the states at which costs may be capitalized, in assessing the ongoing value of the capitalized costs and in determining the estimated useful lives over which the costs are amortized, which is generally three years. To the extent that we change the manner in which we develop and test new features and functionalities related to our website, assess the ongoing value of capitalized assets or determine the estimated useful lives over which the costs are amortized, the amount of website development costs we capitalize and amortize in future periods would be impacted.

Stock-Based Compensation

We account for stock-based compensation expense pursuant to the provisions of SFAS No. 123R (SFAS 123R), *Share-Based Payment*, which requires that all share-based payments, including grants of employee stock options, be recognized as an expense in the accompanying condensed consolidated statements of income and comprehensive income based on their fair value over the vesting period, which is generally four years. The grant date fair value of our stock-based awards was determined using the Black-Scholes-Merton pricing model and a single option award approach. The weighted-average expected term for stock options granted was calculated using the simplified method in accordance with the provisions of SAB No. 107, *Share-Based Payment,* as we did not have sufficient historical option exercise behavior on which to estimate expected terms. The simplified method defines the expected term as the average of the contractual term and the vesting period of the stock option. We have estimated the volatility used as an input to the model based on an analysis of our stock price since our initial public offering in October 2006, as well as an analysis of similar public companies for which we have data. We estimate our expected volatility using the weighted-average of: our implied volatility; our mean reversion volatility; and the mean reversion volatility of similar public companies for which we have data. We have used judgment in selecting these companies, as well as evaluating the available historical and implied volatility data for these companies. The assumptions used in calculating the fair value of stock-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of

management judgment. We will continue to use judgment in evaluating the expected term and volatility related to our own stock-based awards on a prospective basis, and incorporating these factors into the model. Changes in key assumptions will significantly impact the valuation of such instruments.

We recorded stock-based compensation expense totaling $0.4 million and $1.0 million during the three and nine months ended September 30, 2007, respectively, and $1.0 million and $2.6 million during the three and nine months ended September 30, 2008, respectively, related to stock options, restricted stock awards and restricted stock units granted to employees. Future stock-based compensation expense is dependent upon the fair value of each option at the date each option is granted and the number of awards issued and outstanding during each period. We expect stock-based compensation expense will increase in the future as the number of equity awards issued and outstanding increases.

Accounting for Income Taxes

We account for income taxes using the liability method as required by SFAS No. 109 (SFAS 109), *Accounting for Income Taxes*. Under SFAS 109, deferred income taxes are determined based on the differences between the financial reporting and tax bases of assets and liabilities, using enacted statutory tax rates in effect for the year in which the differences are expected to reverse.

Since tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains and losses, differences arise between the amount of taxable income and pretax financial income for a year and between the tax bases of assets or liabilities and their reported amounts in our financial statements. Because we assume that the reported amounts of assets and liabilities will be recovered and settled, respectively, a difference between the tax basis of an asset or a liability and its reported amount in the balance sheet will result in a taxable or a deductible amount in some future years when the related liabilities are settled or the reported amounts of the assets are recovered, which gives rise to a deferred tax asset or liability. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery does not meet the more likely than not criteria, we must establish a valuation allowance.

Management judgment is required in determining any valuation allowance recorded against our net deferred tax assets. In the fourth quarter of 2007, we were able to develop expectations of future taxable income and estimate other relevant factors sufficiently in the future to conclude that it was more likely than not that we will realize sufficient earnings to utilize all of our deferred tax assets. Accordingly, we reversed our valuation allowance against deferred tax assets in the fourth quarter of 2007.

As part of the process of preparing our condensed consolidated financial statements, we are required to estimate our income taxes. This process involves estimating our actual current tax expense together with assessing temporary differences that may result in deferred tax assets, as well as discrete tax items during the period, such as excess tax benefits related to share-based payments. Our effective tax rates in the three and nine months ended September 30, 2007 and 2008 were in line with statutory federal and state tax rates in those periods.

On September 23, 2008, the state of California approved its budget for fiscal year ending June 30, 2009, which contained changes to the California tax law which substantially limit our ability to utilize available state net operating loss and tax credit carry forwards to reduce our state income taxes payable. Under the new tax law, the utilization of net operating loss carry forwards is suspended for tax years 2008 and 2009; however the expiration date of the net operating loss carry forwards is extended for an equivalent two-year period. Additionally, for tax years 2008 and 2009, taxpayers may only utilize available tax credit carry forwards to reduce their current tax liability up to 50% of their net tax amount before application of such credits. The new law does not affect the amount of net operating loss or tax credit carry forwards that we expect to ultimately use to offset future California taxes; however, it does limit the amount of net operating loss and tax credit carry forwards that we will be able to utilize to reduce our taxes payable during the years ending December 31, 2008 and 2009, resulting in an increase in cash taxes payable to the state of California in those years. While we do not expect this change in the California tax law to impact our effective tax rate, we expect that our cash outlay for federal and state taxes will increase to approximately 4.5% of pre-tax income for the year ending December 31, 2008.

Under SFAS 123R, we consider stock option deduction benefits in excess of book compensation charges realized when we obtain an incremental benefit determined by the With and Without calculation method. Under the With and Without approach, excess tax benefits related to share-based payments are not deemed to be realized until after the utilization of all other tax benefits available to us. For example, net operating loss and tax credit carry forwards from prior years are used to reduce taxes currently payable prior to deductions from stock option exercises for purposes of financial reporting, while for tax return purposes, current year stock compensation deductions are generally used before net operating loss carry forwards.

Indirect effects of excess tax benefits, such as the effect on research and development tax credits, are not considered. In accordance with SFAS 123R, only realized excess tax benefits are reflected in the financial statements.

During the three months ended September 30, 2008, due to the restriction on our ability to utilize net operating loss carry forwards to reduce taxes currently payable in California, we utilized excess tax benefits related to share-based payments and other unrecognized tax benefits, which resulted in a $0.2 million increase in additional paid-in capital and a $0.3 million increase in other non-current liabilities, respectively, in the condensed consolidated balance sheet as of September 30, 2008. We expect to continue utilizing excess tax benefits related to share-based payments and other unrecognized tax benefits in the fourth quarter of 2008 and fiscal year 2009, which will result in further increases to additional paid-in capital and other non-current liabilities during those periods.

Future changes in various factors, such as the amount of stock-based compensation we record during the year and the related tax benefit we realize upon the exercise of employee stock options, potential limitations on the use of our federal and state net operating loss credit carry forwards, pending or future tax law changes including rate changes and the tax benefit from or limitations on our ability to utilize research and development credits, changes in our valuation allowance and state and foreign taxes, would impact our estimates, and as a result, could affect our effective tax rate and the amount of income tax expense we record, and pay, in future periods.

We adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, on January 1, 2007. As of December 31, 2007 and September 30, 2008, we had approximately $2.4 million and $2.6 million, respectively, of unrecognized tax benefits. As of December 31, 2007 and September 30, 2008, there were $2.0 million and $2.1 million, respectively, of unrecognized tax benefits, that, if recognized, would impact the effective tax rate. Due to net operating losses, all tax years after 1998 are open to examination and adjustment.

On October 3, 2008, the *Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008 and Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (HR1424)* was signed into law, which, as enacted, includes a provision that retroactively extends the federal research and development tax credit from January 1, 2008 through December 31, 2009. Federal research and development tax credits for the year ending December 31, 2008, which are not expected to be material, will be included in our provision for income taxes for the three months ending December 31, 2008.

Fair Value Measurements

We implemented Statement of Financial Accounting Standard No. 157 (SFAS 157), *Fair Value Measurement*, effective January 1, 2008 for our financial assets and liabilities that are re-measured and reported at fair value at each reporting period, and non-financial assets and liabilities that are re-measured and reported at fair value at least annually. In accordance with the provisions of FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157,* we have elected to defer until January 1, 2009, implementation of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized and disclosed at fair value in the consolidated financial statements on a recurring basis. The partial adoption of SFAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. SFAS 157 classifies the inputs used to measure fair value into the following hierarchy:

Level 1	Unadjusted quoted prices in active markets for identical assets or liabilities
Level 2	Unadjusted quoted prices in active markets for similar assets or liabilities, or Unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or Inputs other than quoted prices that are observable for the asset or liability
Level 3	Unobservable inputs for the asset or liability

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We endeavor to utilize the best available information in measuring fair value of our assets, and as such, use market data or assumptions that we believe market participants would use in pricing an asset or liability. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. We have determined that our financial assets are classified as either Level 1 or Level 2 in the fair value hierarchy as of September 30, 2008. The adoption of SFAS 157 did not have a material impact on our consolidated results of operations and financial condition.

In October 2008, the FASB issued Staff Position (FSP) No. FAS 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarifies the application of Statement No. 157 in an inactive market and illustrates how an entity would determine fair value when the market for a financial asset is not active.

During the three and nine months ended September 30, 2008, we incurred net unrealized losses on our marketable securities of $0.4 million and $0.5 million, respectively. Net unrealized gains and losses incurred on our marketable securities during the three and nine months ended September 30, 2007 were not significant. Net unrealized losses are the result of the change in fair value of our investments in marketable securities, primarily corporate bonds, at the beginning and end of the period As we do not consider our investments to be other-than-temporarily impaired at September 30, 2008, the unrealized losses are excluded from earnings and reported as a component of stockholders equity in the condensed consolidated balance sheets and in comprehensive income on the condensed consolidated statements of income and comprehensive income. We did not realize any significant gains or losses on sales of marketable securities during the three and nine months ended September 30, 2007 and 2008.

Results of Operations

The following table sets forth our operating results and the related percentage of total revenues for the three and nine months ended September 30, 2007 and 2008 (dollars in thousands, unaudited):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2007		2008		2007		2008	
Revenue:								
Commission	$ 21,313	93%	$ 25,788	91%	$ 59,486	94%	$ 74,663	91%
Sponsorship, licensing and other	1,684	7	2,687	9	4,072	6		